APPLYING THE ENERGY PROPERTY CONCEPT UNDER THE WINDFALL PROFIT TAX

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INTRODUCTION

On April 2, 1980 President Jimmy Carter signed into law the Crude Oil Windfall Profit Tax Act, ("WPT"),[1] effective retroactively to March 1, 1980.[2] This article identifies certain of the principal interpretive issues presented by the "incorporation" into the WPT of the so called energy "property" concept as it was developed by the Department of Energy ("DOE") and its predecessor agencies that administered the domestic crude oil price control system until early 1981.[3] First, however, the article examines the manner in which the transition was made from domestic price controls to a revenue statute.[4]

Enactment of the WPT has not deterred consideration of substantial, additional crude oil excise taxes. During the 97th Congress, new crude oil levies, as well as more broadly based consumption taxes extending to natural gas and other forms of energy, received serious legislative attention.[5] Debate over such measures is likely to continue, particularly if the Reagan Administration comes forward in the 98th Congress with legislation aimed at accelerating natural gas price deregulation.[6] In that event, the additional opportunity will be presented to consider a natural gas "windfall profit" tax modeled after the existing crude oil excise provision. As a consequence, natural gas practitioners may find this article worthwhile in acquiring an understanding of how the WPT grew out of the crude oil pricing system.

I. BACKGROUND: THE TRANSITION FROM PRICE CONTROLS TO THE WINDFALL PROFIT TAX

A. *Structure of Crude Oil Price Controls*

The crude oil price control system in existence at the time the WPT took effect dated back to 1973. Its implementation was preceded by an economy-

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[1]Pub. L. No. 96-223, 94 Stat. 229 (1980), I.R.C. §§4986, *et seq.* Throughout this article, the Reports of House and Senate tax-writing committees and of the conferees pertaining to the WPT are refered to in abbreviated form as follows:

H.R. Rep. No. 304, 96th Cong., 1st Sess. (1979) as "WAYS & MEANS REP."

S. Rep. No. 394, 96th Cong., 1st Sess. (1979) as "FINANCE REP."

H.R. Rep. No. 817, 96th Cong., 2d Sess. (1980) as "CONF. REP."

[2]I.R.C. §4996(b)(7).

[3]Terminated by Exec. Order 12,287, 46 Fed. Reg. 9,909 (Jan. 30, 1981).

[4]Because Section I is intended primarily to provide background, it leaves much ground uncovered. A thorough going review of the legislative history of the WPT and its growth out of the price control system was prepared by Drapkin & Verleger, *The Windfall Profit Tax: Origins, Development, Implications*, 22 B.C.L. Rev. 631 (1981).

[5]*See, e.g.* STAFF OF THE JOINT COMMITTEE ON TAXATION, DESCRIPTION OF POSSIBLE TAXES ON ENERGY CONSUMPTION 97th Cong. 2d Sess., prepared for June 9, 1982 hearing by the Senate Finance Subcommittee on Energy and Agricultural Taxation.

[6]On March 1, 1982, the Administration indicated that accelerated decontrol would not be sought "at this time," as "much needed changes to the Natural Gas Policy Act would overload an already-heavy legislative agenda." Unpublished "Statement by the Principal Deputy Press Secretary to the President."

wide wage and price freeze instituted in August 1971.[7] The Mandatory Petroleum Price Regulations[8] issued in August 1973 were promulgated by the Cost of Living Council under the temporary authority of the Economic Stabilization Act of 1970.[9] At the crude oil level, these controls were structured to limit price increases with respect to all production from a property at or below the average monthly levels during 1972 ("old" oil). The 1972 volume of production from a property was referred to as the Base Production Control Level (BPCL).[10] For each property, production in amounts greater than 1972 levels (less any current cumulative deficiency)[11] was treated as "new" oil and allowed to be sold at uncontrolled, or market prices. However, each barrel of new oil from a property triggered the "release" of a barrel of old oil to market levels[12] in an attempt to reward efforts to increase aggregate production from a property over its historic base.

There followed a transition period during which the original Cost of Living Council provisions were repromulgated virtually intact[13] by the Federal Energy Office ("FEO") under the authority of the Emergency Petroleum Allocation Act of 1973 ("EPAA").[14] Soon thereafter, the FEO's responsibilities were assumed by the newly organized Federal Energy Administration ("FEA").[15]

The pricing system itself, however, remained essentially unchanged during this transition, and underwent its first significant restructuring following enactment of the Energy Policy and Conservation Act of 1975 ("EPCA").[16] The EPCA required establishment of ceiling prices calculated to result in a maximum, nationwide composite first sale price of $7.66 a barrel as of February 1976, adjusted for inflation and by a production incentive factor totaling as much as ten percent annually.[17] Regulations implementing the 1975 amendments were issued early in 1976.[18] The FEA adopted at that time a modified two-tier pricing system for *all* domestic crude oil, eliminated the "released" oil mechanism, allowed producers to elect 1975 production levels (in lieu of 1972 average monthly production) for pricing purposes, and wiped out outstanding cumulative deficiencies. Oil formerly regarded as "old" oil was assigned to the "lower" tier, and oil previously classified as "new", "released", and "stripper" oil was assigned to the "upper" tier.

Although the basic two-tier structure mandated by the EPCA remained in place through the duration of price controls, it soon became necessary to create

[7]Exec. Order 11,615, 36 Fed. Reg. 15,727 (Aug. 17, 1971).

[8]6 C.F.R. Part 150, Subpart L, 38 Fed. Reg. 22,536 (Aug. 22, 1973), effective August 19, 1973.

[9]Pub. L. No. 91-379, 84 Stat. 799.

[10]6 C.F.R. 150.354(b) (1974).

[11]The current cumulative deficiency represented the accumulated shortfall between the level of production in the 1972 base period and subsequent monthly production levels. Thus, to the extent of any accumulated deficiency, oil otherwise marketable as "new" oil had to be sold at the lower "old" oil price level.

[12]6 C.F.R. 150.354(b) (1974).

[13]10 C.F.R. Part 212, 39 Fed. Reg. 1,924 (Jan. 15, 1974).

[14]Pub. L. No. 93-159, 87 Stat. 627, 15 U.S.C. §§751 *et seq.*, enacted in response to the 1973 Middle East oil embargo.

[15]Exec. Order 11,790, 39 Fed. Reg. 23,185 (June 27, 1974). On October 1, 1977, the Department of Energy succeeded to the responsibilities and duties of the FEA, pursuant to the Department of Energy Organization Act. Pub. L. No. 95-91; Exec. Order 12,009, 42 Fed. Reg. 46,267. (Sept. 15, 1977).

[16]Pub. L. No. 94-163, 89 Stat. 871 (Dec. 22, 1975).

[17]The President was given broad authority as to how to implement the composite price concept, but was required under section 401 of the EPCA to determine that the new ceiling prices were "administratively feasible" and "consistent with obtaining optimum production of crude oil in the United States."

[18]41 Fed. Reg. 4,931 (Feb. 3, 1976).

a third "uncontrolled" tier.[19] Before the FEA was able to do so, however, Congress enacted the Energy Conservation and Production Act ("ECPA"),[20] which, effective August 14, 1976, restored the exemption for stripper production and directed the FEA to develop incentive prices for tertiary enhanced recovery projects.[21]

The uncontrolled tier was significantly expanded in the spring of 1979 when, as part of President Carter's phased decontrol plan,[22] "newly discovered oil", was fully decontrolled.[23] At the same time, the bulk of oil produced from "marginal properties"[24] was released to the upper tier. "Heavy" oil was decontrolled in August 1979,[25] followed by implementation of the so called "front-end" program, effective January 1, 1980.[26]

These changes, coupled with the phased elimination of upper and lower tier controls with respect to all remaining oil, were designed to result in complete elimination of price controls by October 1, 1981.[27] This schedule, however, was accelerated by President Reagan who terminated the system on January 28, 1981.[28]

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[19]This was anticipated by the EPCA and by the FEA which announced its intention in February 1976 to consider in the near future reestablishment of such an uncontrolled tier for certain categories of very high cost oil. 41 Fed. Reg. 4,931 (Feb. 3, 1976).

[20]Stripper oil had enjoyed statutory exemption from price controls since enactment of the Trans-Alaska Pipeline Authorization Act (§ 406 of Pub. L. 93-153, 87 Stat 576, Nov. 16, 1973). The EPCA eliminated the statutory stripper exemption, effective February 1, 1976. Soon thereafter, FEA proposed administratively to reinstate the exemption (41 Fed. Reg. 18,875, May 7, 1976) and to redefine qualifying stripper oil. However, before taking final action on the May 7 proposed amendments, the exemption was permanently reinstated by section 121 of the Energy Conservation and Production Act ("ECPA") (P.L. 94-385, 90 Stat. 1125, Aug. 14, 1976). Under the June 1979 DOE regulations, exempt stripper oil is that produced from a "stripper well property," i.e., a

> "property" whose average daily productioin of crude oil (excluding condensate recovered in non-associated production) per well did not exceed 10 barrels per day during any preceding consecutive 12-month period beginning after December 31, 1972.

10 C.F.R. 212.54, 41 Fed. Reg. 48,319 (Nov. 3, 1976). This is the applicable definition for WPT purposes. IRC §§4991(d) and 4994(g).

[21]Section 122 of the ECPA, *supra,* note 20. Section 122 defined the term "tertiary enhanced recovery techniques" as certain "extraordinary and high cost enhancement technologies. . .to the extent that such techniques would be uneconomical without additional price incentives." These included such processes as miscible fluid or gas injection, insitu combustion, and various steam and chemical flooding and injection techniques. Implementation of this provision was attempted in September 1978 when incremental production attributable to qualified tertiary recovery projects was decontrolled, 43 Fed. Reg. 33,678 (Aug. 1, 1978), 10 C.F.R. §212.78. However, only the production in excess of that obtained through conventional or secondary production methods was eligible for uncontrolled sales. 10 C.F.R. §212.78(c) (1979).

[22]Announced by President Carter in his April 5, 1979 Energy Address, *infra,* note 29.

[23]44 Fed. Reg. 25,828 (May 2, 1979), 10 C.F.R. 212.79. Newly discovered oil, effective June 1, 1979, was defined as:

> domestic crude oil which is: (1) Produced from a new lease on the Outer Continental Shelf; or (2) produced (other than from the Outer Continental Shelf) from a property from which no crude oil was produced in calendar year 1978.

Section 212.79 was liberalized, effective Jan. 1, 1980, so that production during 1978 in less than "commercial quantities" would not disqualify production from the property as newly discovered oil, 45 Fed. Reg. 78,588 (Nov. 25, 1980). *See* however, note 48, *infra.*

[24]44 Fed. Reg. 25,160 (April 27, 1979), effective June 1, 1979. Marginal properties were those with respect to which average daily production per well in 1978 did not exceed a specified number of barrels at specified completion depths. 10 C.F.R. 212.72.

[25]Executive Order 12,153, 44 Fed. Reg. 48,949 (Aug. 21, 1979). Generally, heavy oil was defined as crude oil produced from a property the production from which in June 1975 had a weighted average gravity of 20 degrees API or less (16 degrees or less prior to December 4, 1979) corrected to 60 degrees F. 10 C.F.R. 212.59 (1980).

[26]44 Fed. Reg. 51,148 (Aug. 30, 1979). Effective January 1, 1980, market pricing became available for a limited amount of otherwise controlled oil to recover qualifying expenses attributable to a certified tertiary enhanced recovery project.

[27]This decision was implemented through a series of amendments to 10 C.F.R., Part 212, 44 Fed. Reg. 22,010 (April 12, 1979).

[28]Exec. Order 12,287, note 3, *supra.*

B. *The Switch to a "Windfall Profit" Tax Approach*

While the final legislation differed substantially in almost all of its details from the original proposal announced by President Carter in April 1979,[29] the Act that emerged from Congress did incorporate the basic structural features of the April proposal and represented an effective endorsement of the underlying policies pursued by that Administration.[30] First, the WPT was designed to capture only a *fraction* of the *additional* income attributable to the simultaneous phase-out of domestic price controls and to future price increases above the rate of inflation.[31] By allowing producers to retain at least some of the additional income[32] generated by the incremental rise of all domestic oil to world price levels, it was thought that adequate domestic production incentives would be restored.[33] It was argued that producers who found it economical to operate at controlled price levels would continue to do so under decontrolled prices net of windfall profit taxes.

At the same time, an "equity" argument was made that it was necessary to "prevent U.S. oil producers from reaping unearned excessive profits," [34] evidencing a belief that domestic oil producers should not be the sole beneficiaries of the pricing decisions of a foreign oil cartel. In part, these arguments reflected the resolution of the conflicting objectives of providing adequate production incentives while imposing a new and heavy tax on domestic oil. However, this approach compelled the additional result of a structurally complex provision requiring the measurement of the "windfall profit element" which varied according to the system of preferences built up over time by the crude oil pricing system developed under the EPAA.

The Carter Administration advanced two other principal arguments in response to criticism that the tax would seriously dampen production incentives [35] and otherwise to buttress the need for the WPT. The first was aimed princi-

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[29]President Carter first announced his intention to phase out petroleum price controls in conjunction with a windfall profit tax in his April 5, 1979 Energy Address. 15 WEEKLY COMP. OF PRES. DOC. 609 (April 5, 1979). The WPT was described more fully by the President in his April 26, 1979 Message to Congress, 15 WEEKLY COMP. OF PRES. DOC. 721 (April 26, 1979), and in an accompanying FACT SHEET bearing the same date. (Cited hereinafter as "APRIL 26 FACT SHEET.") The Administration proposal was introduced, with certain modifications, by Rep. Ullman on May 3, 1979 as H.R. 3919, 96th Cong. 1st Sess.

[30]The Administration proposal was only the latest of several attempts to terminate crude oil price controls in conjunction with enactment of a windfall profit tax. The most serious of the previous attempts was that undertaken by President Ford, announced in his State of the Union Address on January 15, 1975. The 1975 proposal was part of a larger program that also included oil import fees, and natural gas decontrol coupled with a gas excise tax. *See Hearings Before the Committee on Ways and Means on the President's Authority to Adjust Imports of Petroleum; Public Debt Ceiling Increase; and Emergency Tax Proposals,* (January 22-24, and 27-30, 1975) 94th Cong., 1st Sess. 26-30.

[31]APRIL 26 FACT SHEET 1, *supra,* note 29.

[32]Initially, the WPT had the effect of a temporary price rollback for decontrolled production because price increases occurring late in 1979 and in early 1980 were treated as taxable windfall. Stripper oil, for example, more than doubled in price between January 1979 and January 1980, increasing from an average of $14.55 to $36.02 per barrel. MONTHLY ENERGY REV. 75 (July 1980).

[33]APRIL 26 FACT SHEET 1, *supra,* note 29.

[34]*Id.*

[35]*See,* for example, Additional Views of Senator Gravel, FINANCE REP. 154.

pally at those who recognized the collective economic benefits [36] that could flow from dismantling price and related crude oil controls. In addition to the obvious possibility that the President could, at any time, suspend the schedule for price decontrol,[37] the Treasury Department did not fail to point out that the proposed WPT, by insuring the success of the attempt by administrative means to phase out controls,[38] made the risk of deterring some production worth taking:

> Political forces will not allow complete and permanent decontrol of oil so long as we face an unqualified threat of embargoes and sudden price increases. In the absence of a permanent tax, a future surge in oil prices may compel a return to regulation.[39]

The second argument combined the familiar theme of energy independence with the need to assure a stable source of additional revenue to support new tax and spending initiatives. The Carter Administration thus proposed to require the proceeds of the WPT, along with certain other receipts generally attributable to oil price decontrol, to be deposited in an Energy Security Trust Fund.[40] The assets of the trust fund would be used exclusively to support programs to accelerate the development of alternative domestic energy resources, to provide assistance to low income households hurt by higher energy prices, and to promote mass transit systems.[41] By splitting up the additional producer income attributable to decontrol between producers, the Federal and State and local governments, and consumers (through new spending and tax credits), this proposal offered an ultimately successful framework for the political compromises that would be required to secure enactment.[42]

These considerations also tended to foreclose at an early stage the possibility of serious debate over substitute excise tax mechanisms that would have constituted significant simplification of the Administration proposal.[43] A per barrel

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[36]As summarized by President Carter:

> The gradual deregulation of domestic oil prices will bring the price of oil to world oil price levels, with the following benefits: First, it will eliminate the current subsidy provided to imported oil, which has increased consumption and dependence on foreign supplies. Second, it will encourage producers of oil to seek out additional supplies and to continue production from marginally economic operations. Third, decontrol will phase out the complex system of controls which presently produces inequities and inefficiencies. Fourth, through replacement cost pricing, new sources of energy will come into commercial use, further reducing U.S. dependence on foreign oil. Fifth, it will strengthen the stability of the dollar and reduce balance of payment flows, both directly through reduced oil payments abroad and indirectly through confidence that the U.S. is attacking its energy problem.

Presidential Energy Message to Congress 721-22 (April 26, 1979) note 29, *supra.*

[37]Section 461 of the EPCA, note 16, *supra,* 89 Stat. 955, extended mandatory controls to June 1979 and provided that controls would continue thereafter until September 30, 1981 only at the discretion of the President.

[38]Not surprisingly, the issue has not gone away. In March 1982, Congress adopted by wide margins S.1503 (the Standby Emergency Petroleum Allocation Act). *See* 128 CONG. REC. S1371 (daily ed. Mar. 2, 1982) by a vote of 86-7. 128 CONG REC. H627 (daily ed. March 3, 1982) by a vote of 246-144. Among other things, the measure reinstated the President's authority to allocate petroleum products in the event of a "severe petroleum supply shortage" on a national or regional level, and, if necessary, to impose price controls. The President's veto, 128 CONG. REC. S2513 (daily ed. Mar. 22, 1982), was sustained by the Senate on March 24. 128 CONG. REC. S2745 (daily ed.).

[39]Statement of W. Michael Blumenthal, before the Committee on Ways and Means, May 9, 1979. *Windfall Profits Tax and Energy Trust Fund: Hearings Before The House Committee on Ways and Means,* 96th Cong. 1st Sess. 19 (1979).

[40]April 26 FACT SHEET 2-6, *supra* note 29. This special trust fund arrangement was rejected by Congress. Instead, the conferees adopted the nonbinding allocation formula for net WPT receipts set out in Section 102 of the Act, *supra,* note 1.

[41]APRIL 26 FACT SHEET 2, *supra,* note 29.

[42]For an illustration of the political effects of packaging the tax and spending proposals together, see Corrigan, *Who'll Get the Largest Slice of the $1 Trillion 'Windfall Profits' Pie,* 11 NAT'L. J. 1885 (Nov. 10, 1979).

[43]The Staff of the Joint Committee on Taxation estimated that a 10 percent levy on gross oil income would approximate the revenues produced by the Ways and Means bill (H.R. 3919). Additional views of Fortney Stark, Jr., WAYS & MEANS REP. 71.

or *ad valorum* severance or other excise tax was incompatible with a policy designed to capture part of the "windfall profit." As explained by Secretary Blumenthal, only the WPT would

> . . . accomplish the purpose that we wish to accomplish, which is that of gathering true windfall. A tax on a barrel of old oil has a different degree than a barrel of oil that is produced by someone who goes out and makes the investment and does it as a matter of the incentive of decontrol.[44]

A windfall profit approach, however, also meant that the "windfall" element on which the new levy was imposed would be determined by some degree of reference to the actual or constructive removal price of a barrel of oil under the crude oil price control system. This decision was made even though it was no secret that the price control rules were far from simple.

As the disparity between controlled price levels and uncontrolled sales widened between 1974 and 1979,[45] the agencies administering the pricing system found it necessary to take increasingly elaborate steps both to protect its integrity, and, through the proliferation of special preferences, to attempt to minimize built-in deterrents from choking off production at the margin. Neither task was simple. As Treasury Secretary Blumenthal observed in May 1979 before the Committee on Ways and Means:

> [T]he federal government has left in place policies that actually aggravate our energy problems. Of these, the most perverse and serious is the system of price controls and entitlements imposed on domestic oil production . . . The system has grown steadily more complicated. At present, no single expert can pretend to understand how all the regulations work or whom they benefit. If ever a federal program deserved to be called a "bureaucratic nightmare", the regulation of U.S. oil prices has earned that distinction. . .[46]

Despite such criticism, and its use by opponents of the WPT,[47] little attention was devoted to the suitability of the price control system as a foundation for the WPT. Rather such attempts as were made by the tax-writing committees to venture into the substance of the energy regulations generally represented

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[44] *Ways and Means Hearings* 26, *supra*, note 39.

[45] For example, in January 1974 "old" oil, which accounted for 60% of domestic production, sold at the wellhead at $5.25 per barrel, compared to an average $9.82 per barrel price for uncontrolled production (i.e., new, released, and stripper oil). MONTHLY ENERGY REV. 42 (Jan. 1975). In March 1980, lower tier oil, accounting for 20% of domestic production, sold at $6.25 per barrel at the wellhead. Upper tier oil, representing approximately 28% of domestic volume, averaged $13.99 at the wellhead. On the other hand, the average price for stripper oil in March 1980 was $36.33 per barrel. *Id.*, at 75 (July 1980).

[46] *Ways and Means Hearings* 15, *supra*, note 39.

[47] For example, Senator Dole observed: "It is misleading to talk about total price decontrol' . . .The windfall profits tax will perpetuate dometic controls through the tax system." Additional views, FINANCE REP. 166. Similarly, Barber Conable remarked: "The complexities of this tax are such that the bureaucrats who now reside at the Department of Energy would simply be transferred lock, stock, and oil barrel (as well as regulation booklet) over to the Department of the Treasury." Additional views, WAYS & MEANS REP. 82.

efforts simply to reject certain DOE positions set forth in that Department's regulations.[48]

C. Production Incentives and Other Tax Preferences

The WPT assigns all taxable crude oil (defined as all domestic crude oil other than exempt oil[49]) to one of three rate brackets ("tax tiers"), in most cases according to the classification of the oil under the DOE pricing scheme. Originally, a tax rate of 30 percent[50] was applied to the WPT element of production assigned to the upper tax tier (tier 3), which includes "newly discovered" oil, and "incremental tertiary" oil.[51] Newly discovered oil is now taxed at reduced rates.[52] "Stripper" production and federally owned oil were assigned to tier 2,[53] and all remaining taxable oil to tier 1.[54] Tier 1 and 2 oil generally is levied upon at the higher rates of 70 and 60 percent, respectively.[55] An exception, however, was carved out by the original Act under tiers 1 and 2 for up to 1,000 barrels per day of qualified "independent producer" oil [56] taxable at reduced rates (50 percent under tier 1; 30 percent under tier 2).[57]

The windfall profit element subject to tax under each of the three tiers is identified through a three stage computation. First, a "base price" is established.[58] The base price is equal to the actual or constructive sale price in May (tier 1) or December 1979 (tiers 2 and 3).[59] After an upward adjustment for inflation[60] and state severance taxes,[61] the adjusted base price represents the *nontaxable* portion of each barrel. The base prices are also effectively "graduated," affording the least immunity from tax in the lower tax tiers, where the highest tax rates

[48]For example, newly discovered oil is defined in terms of the definition set forth in the June 1979 energy regulations. I.R.C. § 4991(e). The June 1979 energy regulations provided, with respect to onshore production, that newly discovered oil is oil produced from a property from which *no crude oil was produced* in calendar year 1978 [emphasis added] 10 C.F.R. 212.79, 44 Fed. Reg. 25,828 (May 2, 1979). Having adopted the DOE rule for purposes of the statute, the Conferees, following the example of the Finance Committee, then expressed the view that "newly discovered oil includes production from a property which did not produce oil *in commercial quantities* during calendar year 1978" [Emphasis added], CONF. REP. 98, a view apparently flatly inconsistent with the energy regulations. *See* Rul. 1980-3, 45 Fed. Reg. 48, 577 (July 21, 1980), in which DOE took the position that production *in measurable amounts* in 1978 disqualified production from treatment as newly discovered oil. In the temporary regulations (issued prior to Rul. 80-3), the Treasury did not help the matter. merely tracking the language of the statute and remaining silent as to its view of the effect, if any, of language set out in the Conference Report. Temp. Reg. § 150-4991-1(b).

DOE subsequently amended the definition, 45 Fed. Reg. 78,588 (Nov. 25, 1980), so that effective January 1, 1981, the commercial production standard became determinative as to a property's eligibility for newly discovered oil status, (The effect of the amendment's prospective application was to preclude recertification of amounts sold in 1979 and 1980.) But, on May 19, 1982, the U.S. District Court for the Western District of Oklahoma found Rul. 80-3 substantively invalid, insofar as its interpretation of the term "produced" was concerned. Seneca Oil Co. v. DOE ___ F. Supp. ___, Doc. No. 81-215-T, (W.D.Okl. May 19, 1982) appeal docketed No. 10-45 (TECA June 18, 1982).

[49]I.R.C. § 4991(a).

[50]I.R.C. § 4987(b)(3), as originally enacted.

[51]I.R.C. § 4991(e).

[52]I.R.C. § 4987(b)(3) was amended by § 602(a) of the Economic Recovery Tax Act, Pub. L. No. 97-34, 95 Stat. 338. Beginning in 1982, the rate of tax applicable to newly discovered oil is scheduled to decline incrementally until it reaches 15% in 1986.

[53]I.R.C. § 4991(d).

[54]I.R.C. § 4991(c).

[55]I.R.C. §§ 4987(b)(1)-(2).

[56]I.R.C. § 4992(c).

[57]I.R.C. §§ 4987(b)(1)-(2).

[58]I.R.C. §§ 4989(c) and (d).

[59]*Id.*

[60]I.R.C. § 4989(a).

[61]I.R.C. §§ 4988(a), 4996(c).

are applicable. The inflation adjustment factor is generally the same for all three tiers, although in tier 3 it is "kicked up" an additional two percentage points, compounded quarterly.[62]

The difference between the "adjusted" base price and the removal or sale price of a barrel of oil, is the taxable "windfall profit." However, a downward adjustment in the amount of tax may still be possible under the net income limitation to assure the amount of WPT does not exceed 90 percent of the net income attributable to each barrel.[63]

This scheme of tax preferences roughly corresponded to existing price incentives under the DOE system. There were, however, several exceptions. The first involved the decision to tax oil owned by the Federal Government. Whatever accounting significance this decision may have had,[64] it had the more significant result of altering the distribution of net receipts between States and the Federal Government, to the relative advantage of the latter.[65]

The second exception involved the special treatment of independent producer oil.[66] Independent producers were accorded no comparable advantage under DOE crude oil pricing rules,[67] which turned on the source or other characteristics of the commodity rather than on any features of the producing entity.[68] The treatment of independent producers under the WPT was debated in the Senate. The Finance Committee, after rejecting a 3,000 barrel per day exemption for independent producers (excluding royalty owners) and a total exemption for stripper production,[69] agreed to a 1,000 barrel per day stripper

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[62]I.R.C. § 4989(b).

[63]I.R.C. § 4988(b).

[64]Under the Ways and Means and Finance Committee bills, Federal oil was generally subject to the WPT in the same tier as other types of production that was effectively uncontrolled at the time the bills were reported. Both committee reports contained the following, apparently misleading language:

> Any windfall profit tax imposed on this oil would be deposited into the energy trust fund. These tax revenues would not change the Federal unified budget deficit because the government would, in effect, be paying a tax to itself.

WAYS & MEANS REP. 22; FINANCE REP. 37.

[65]This effect is illustrated by the following exchange between Representative Hiler and Donald Kash, representing the U.S. Geological Survey, the "taxpayer" with respect to oil produced from Federal lands:

> MR. HILER. Aside from the law, is there a reason we are doing this?
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> MR. KASH. We are doing it because the law requires it.
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> MR. HILER. I mean, is there—
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> MR. KASH. The total income to the Federal Government does not vary. Well, that is not quite correct . . . [T]wo-thirds of the oil on which revenues are collected by the USGS comes from the Outer Continental Shelf. Those revenues are Federal revenues. For oil produced on shore, 50 percent of the royalties on the public domain lands goes to the States. Now, the benefit that the Federal Government receives from the windfall profit tax is that the windfall profit is taken out before the royalties are distributed to the States. So there is, of course, a difference, in terms of total Federal revenue.

IRS Administration of the Windfall Profit Tax and U.S. Geological Survey's Oil and Gas Royalty Collection Activities, Hearing Before a Subcommittee of the House Committee on Government Operations, 97th Cong. 1st Sess. 197 (April 13, 1981).

[66]Under I.R.C. § 4992(b), independent producers (other than royalty owners described in § 4992(d)(2)), are defined by reference to eligibilty for use of percentage depletion under § 613A.

[67]Except indirectly, to the extent working interests in stripper wells were disproportionately held by independents rather than integrated firms.

[68]In contrast, independent oil and gas producers (and royalty owners) have enjoyed statutory recognition for income tax purposes since 1975, when use of the percentage depletion method with respect to oil and gas wells was repealed, but only for integrated firms. I.R.C. § 613A, added by Pub. L. 94-12.

[69]*Daily Tax Report*, Oct. 2, 1979, G 7-8.

exemption for independents and certain royalty owners.[70] Ultimately, the Senate expanded[71] the limited Finance Committee exemption to include up to 1,000 barrels per day of all independent production.[72]

The effects of the bill on domestic production and the revenue cost [73] of exemption were the ostensible focus of the dispute over the treatment of independent producers. On the one side, it was argued that the bill would have a crippling effect on independents,[74] cutting domestic production by a total of one billion barrels over 10 years (about 275,000 barrels per day).[75] In contrast, opponents asserted that the bill already provided adequate production incentives because producers would be better off economically under the WPT and decontrol than under continuation of price controls.[76] It was thought that this higher rate of return on future investment made exemption — which merely added to a producer's current cash flow — unnecessary to assure adequate incentives for increased production.[77]

The Senate provision was narrowed considerably in conference,[78] with the final measure calling only for reduced rates on the first 1,000 barrels of independent producer oil in tiers 1 and 2. Subsequent amendments, however, enacted in 1980 and 1981, now provide a limited exemption for certain royalty owners [79] and beginning in 1983, a total exemption for qualified independent producer/stripper oil.[80]

Finally, the need for production incentives was also reflected in the list of

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[70]FINANCE REP. 39. In a related decision, the Committee also rejected a House passed resolution denying producers any increase in percentage depletion allowances attributable to price decontrol. FINANCE REP. 68. In the view of the Committee on Ways and Means, this restriction was necessary to prevent a "producer entitled to percentage depletion from reaping a double windfall—one from the decontrol and excessive world oil price increases and another from unearned increases in the depletion allowance." WAYS & MEANS REP. 45. This was not a small item, entailing accumulated revenue losses of about $2.5 billion through 1985. FINANCE REP. 14. The Conferees adopted the Senate provision. CONF. REP. 110.

[71]125 CONG. REC. S17284-85 (daily ed. Nov. 27, 1979).

[72]125 CONG. REC. S17189 (daily ed. Nov. 26, 1979).

[73]Estimated at $9.9 billion over ten years. 125 CONG. REC. S17189 (daily ed. Nov. 26, 1979).

[74]Independents, it was asserted, accounted for the bulk of new drilling activity and newly discovered oil, and reinvested more than 100 percent of their gross production revenues in exploration, drilling and production. Moreover, independents, the only competition to large integrated producers, had been hurt disproportionately by price controls, the proliferation of government regulation, and the rising cost and complexity of finding and bringing in new wells, so that their ranks had been cut roughly in half during the preceeding 25 years. 125 CONG. REC. S17190 (daily ed. Nov. 26, 1979). Pointing specifically to the compliance burdens arising out of the complicated interaction of the Finance Committee bill and the DOE regulations, Senator Bentsen also argued that unlike many independents, the larger, integrated firms could absorb such additional costs with minimal difficulty. 125 CONG. REC. S17274 (daily ed. Nov. 27, 1979).

[75]125 CONG. REC. S17190 (daily ed. Nov. 26, 1979).

[76]125 CONG. REC. S17274 (daily ed. Nov. 27, 1979). Opponents went on to argue as well that extending exemption to royalty owners contributed nothing to increased production, leaving at least to this extent, no justification for the revenue loss. This argument ultimately prevailed. Although the Senate bill provided for royalty owners, the Conference provision—providing for reduced rates on the first 1,000 barrels a day of independent production under tiers 1 and 2—specifically excluded most royalty interests. (I.R.C. § 4992(d)(2)). Opponents also attacked the significance of the drilling and related characteristics of independents, asserting that independents often merely operated farm-outs, developed leases already held by majors, or exploited the "most accessible resources in mature production zones."

[77]The principal point here being that the expected future rate of return on investment, not present cash flow, more accurately measured the ability to attract capital. 125 CONG. REC. S17275 (daily ed. Nov. 27, 1979).

[78]CONF. REP. 108.

[79]I.R.C. § 6429, added by § 1131(a)(1) of the Omnibus Reconciliation Act of 1980, Pub.L.No. 96-499, 94 Stat. 2691 (Dec. 5, 1980) and amended by § 601 of the Economic Recovery Tax Act of 1981, *supra*, note 52, 95 Stat. 335, effective during 1980 and 1981, provided for a $1,000 and $2,500 credit for the respective years. Section 4991(b) and § 4994(f) as amended or added by § 601 of the Economic Recovery Tax Act, established a 2 barrel a day exemption beginning in 1982, rising to 3 barrels a day in 1985 and thereafter.

[80]I.R.C. § 4991(b) and 4944(g), as amended or added by § 603 of the Economic Recovery Tax Act, *supra*, note 52. 95 Stat. 338, effective after 1982.

exempt oils by the original provision made for front-end oil[81] But, departing from the established system of incentives under the price control system, certain high cost Alaskan oil was added to the original list of exempt oils,[82] covering production that would otherwise have been treated as newly discovered oil.[83] Exemptions were also added for production attributable to certain interests held by State and local government entities,[84] certain charitable organizations[85] and Indian Tribes.[86] It is clear that these last three exemptions, having to do solely with the characteristics of the entity holding the economic interest, have nothing to do with encouraging the production of oil or with other special circumstances (such as high production or transportation costs) that might limit the "windfall" from rising oil prices.[87]

D. *"Incorporation" of the Energy Regulations*

The June 1979 crude oil pricing regulations provide the WPT definitions for newly discovered oil,[88] stripper oil,[89] incremental tertiary oil,[90] front end oil, [91] and crude oil generally.[92] These definitions necessarily "incorporate"[93] the underlying energy "property" rules as well.[94]

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[81] I.R.C. § 4994(c) exempted certain "front-end" oil, defined at note 26, *supra.*

[82] I.R.C. § 4994(e) raises interesting questions under Art. 1, § 8 of the U.S. Constitution, providing that excises "shall be uniform throughout the United States . . ." For a discussion of pending litigation over the constitutionality of the Alaskan exemption, and its severability from the Act should it be found deficient, *see* Note, *The Unconstitutional Exemption of North Slope Crude Under the Windfall Profit Act: Exhuming the Direct Tax and Uniformity Provisions,* 35 TAX LAWYER 717 (1982).

[83] CONF. REP. 103. Under I.R.C. § 4994(e) production from the Sadlerochit Reservoir in the Prudhoe Bay Field, evidently the only reservoir north of the Arctic Circle in production during 1979, is not exempt from tax. WAYS & MEANS REP. 30. Sadlerochit oil was nominally classified under the DOE system as upper tier oil, but because of high transportation costs, had consistently sold substantially below its ceiling price. *Id.,* at 30. It is taxed at the tier one rates. *See* also, Staff of the Joint Committee on Taxation, 96th Cong. 1st Sess. The Design of a Windfall Profit Tax 20.

[84] I.R.C. § 4994(a).

[85] I.R.C. § 4994(b).

[86] I.R.C. § 4994(d).

[87] Rather, these provisions appear to represent decisions to import corresponding income tax exemptions on a limited basis into the framework of the new excise tax, or possibly to eliminate doubt with respect to the interaction of the WPT with preexisting exemptions. The exemption for qualified governmental interests, whatever its motivation, was in the view of the Treasury not compelled by Constitutional considerations. *See* Additional Views of Senator Danforth, *et al.,* FINANCE REP. 173-4, setting forth the text of the opinion of the Treasury's General Counsel to this effect.

[88] I.R.C. § 4991(e)(2) provides that the term " 'newly discovered oil' has the meaning given to such term by the June 1979 energy regulations." *See* note 23, *supra,* for text of energy definition.

[89] I.R.C. § 4991(d)(1)(A) provides that "any oil which is from a stripper well property within the meaning of the June 1979 energy regulations" is included in tax tier 2. *See* note 20, *supra,* for text of energy definition.

[90] I.R.C. § 4993(c)(1) defines the term "qualified tertiary recovery project" to include projects "with respect to which a certification as such has been approved and as in effect under the June 1979 energy regulations." Discussed at note 21, *supra.* Projects not certified by DOE are also eligible provided the requirements of I.R.C. § 4993(c)(2) are satisfied.

[91] I.R.C. § 4994(c)(4)(B) provides that the "term 'front-end oil' means any domestic crude oil which is not subject to a first sale ceiling price under the energy regulations solely by reason of the front-end tertiary provisions of such regulations." Discussed at note 26. *supra.* Under I.R.C. § 4994(c), however, certain additional requirements must be satisfied to qualify for WPT exemption.

[92] I.R.C. § 4996(b)(1) provides that the "term 'crude oil' has the meaning given to it by the June 1979 energy regulations." But, see the retroactive amendments included in § 201(h)(1) of H.R. 6056 ("Technical Corrections Act") 97th Cong. 2d Sess., clarifying the treatment of certain condensates for WPT purposes. This amendment is evidently designed to codify the result in *U.P.G. v. Edwards,* 647 F.2d 147 (TECA, 1981). Under 10 C.F.R. 212.31, "crude oil" is defined as:

> a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities. "Crude oil" includes condensate recovered in associated or non-associated production by mechanical separators, whether located on the lease, at central field facilities, or at the inlet side of a gas processing plant.

[93] Although imprecise, the term "incorporate" is used throughout to describe the effect of statutory references to the "energy regulations." The Secretary of the Treasury has authority to modify the energy regulations for WPT purposes and it is obvious that the "incorporated" rules do not have the force of statutory language.

[94] The Finance Committee Report refers to Section 212.72(a) of the energy regulations (found in 10 C.F.R.) and to Rul. 1977-1 FINANCE REP. 52. *See* also Temp. Reg. § 150.4996-1(i), which includes identical references. The June 1979 energy property definition is set out in the text at note 136, *infra.*

For WPT purposes, these "energy regulations"[95] generally include "final action"[96] taken prior to June 1, 1979, and are treated as "continuing in effect without regard to decontrol of oil prices or any other termination of the application of such regulations."[97] However, the Secretary of the Treasury is provided specific authority to prescribe "such changes in the application of the energy regulations for purposes of [the WPT] as may be necessary and appropriate to carry out such purposes."[98] The Secretary of the Treasury also has general statutory authority to issue "all needful rules and regulations",[99] and to "prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."[100] As of August 1982, this authority to modify and interpret the energy regulations for tax purposes has not been exercised.

The discussion of these regulatory provisions in the Committee Reports is of little practical value in determining when reliance may safely be placed on the energy regulations. The Finance Committee, for example, began its discussion with the observation that the "energy regulations adopted by the tax do not purport to embody a comprehensive compilation of rules pertaining to all relevant crude oil matters."[101] With respect to pre-June 1, 1979 "final action", the Committee added that it "anticipated" that the Treasury would "give due consideration to the various administrative rulings and judicial decisions which have interpreted or which construe those regulations."[102] The Committee further "anticipated" that the Treasury would follow such interpretations and constructions to the extent consistent with the provisions of the tax, and would otherwise attempt to "reconcile" them "with the least change feasible".[103] As to DOE rulings and judicial construction handed down *after* the June 1 final action date, the Finance Committee observed that it anticipated that the Treasury "will *take into consideration,* in promulgating regulations and administering the tax, *any actions* taken under the energy regulations after May 31, 1979."[104]

In many key respects this treatment of the "energy regulations" by the statute and legislative history does little more than confer a name on a condition virtually no one admits to understanding. Looking at the energy property concept as an example, it is clear that the WPT "incorporates" the definition as codified at 10 C.F.R. 212 along with relevant intepretative rulings and court decisions that became final before June 1, 1979. However, in any instance where the "incorporated" rules fail to enunciate a clear position (or perhaps take no position at all), Treasury regulations providing guidance in such matters could be viewed as interpretative.[105] To this extent, retroactive application of such a rule

[95]Under I.R.C. § 4996(b)(8)(A), the term "energy regulations" generally means "regulations prescribed under section 4(a) of the Energy Petroleum Allocation Act of 1973 (15 U.S.C. 753(a))."

[96]I.R.C. § 4996(b)(8)(C). Incremental production from qualified tertiary enhanced recovery projects represents an exception from the "final action" provision. I.R.C. § 4996(b)(8)(C)(ii).

[97]I.R.C. § 4996(b)(8)(D).

[98]I.R.C. § 4997(b).

[99]I.R.C. § 7805(a).

[100]I.R.C. § 7805(b).

[101]FINANCE REP. 57.

[102]*Id.*

[103]*Id.*

[104]*Id.*, at 58. Emphasis added.

[105]*See* generally, 2 DAVIS, ADMINISTRATIVE LAW TREATISE §§ 7:08-13 (2d ed. 1979) on the subject of "interpretative" vs. "legislative" rulemaking.

to the effective date of the WPT would be within the Secretary of Treasury's discretionary power.[106]

II. The Energy "Property" Concept as an Instrument of Price Controls

The statutory task[107] of restraining domestic crude oil prices while creating price incentives for new and economically marginal production was bound to create severe difficulties. Nowhere were these problems better reflected than in the continuing attempts on the part of administering agencies to identify with precision the volumes of oil to be accorded preferential price treatment. The cornerstone of these efforts consisted of the property concept — the basic unit of a price control system administered on a property-by-property basis. As originally promulgated by the Cost of Living Council in August 1973, "property" was defined as "the right which arises from a lease or from a fee interest to produce domestic crude petroleum."[108] The Council, however, never formally elaborated on its definition,[109] and it was left for its successor agenices to try to give it a workable meaning. The FEA began this task by issuing a series of conflicting decisions and interpretations in 1974 and 1975 in the context of unitized "properties." In various situations involving the post-1972 aggregation of separate leases (and hence rights to produce) into new producing units, FEA exhibited a tendency to accept both answers to the question of whether the unit constituted a single property or multiple properties composed of the aggregated leases.[110]

In August 1975, FEA attempted to put these questions to rest through the issuance of Rul. 1975-15,[111] which, on a retroactive basis, primarily addressed the treatment of unitizations. First, it was held that where separate leaseholds or rights to produce had been aggregated before 1973 into a new producing unit, the unit, as composed during 1972 — not the component leases — constituted

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[106]I.R.C. § 7805. *See, e.g.,* Pollack v. C.I.R. 392 F.2d 409 (5th Cir. 1968).

[107]Section 401, EPCA *supra*, note 17.

[108]38 Fed. Reg. 22,538 (Aug. 22, 1973) 6 C.F.R. 150.354 (1974). Thus, as applied under the original 2 tier system only production from a property above the level during calendar year 1972 (less any current cumulative deficiency) constituted "new" or uncontrolled oil. The balance of production from that property represented "old" oil subject to the lower tier maximum ceiling price. This definition survived without change until February 1976, when it was slightly revised to read: "the right to produce domestic crude oil, which arises from a lease or from a fee interest." 41 Fed. Reg. 4,931 (Feb. 3, 1976), 10 C.F.R. 212.72.

[109]The Regulations proposed by the Council on July 20, 1973 (38 Fed. Reg. 19,182) contained no property definition. The definition was added to the final rule in response to industry comment.

[110]Compare, for example Sun Oil Co., 2 FEA 83,075 (Mar. 21, 1975), and Empire Drilling Co., 2 FEA 83,142 (May 9, 1975), *aff'd* 2 FEA 80,876 (Sept. 2, 1975), with Interpretation 1975-4, 42 Fed. Reg. 23,726 (May 18, 1977).

In *Pennzoil v. DOE,* however, 680 F.2d 156, (TECA 1982) Jamison, J., concurring, the Court attached little significance to this inconsistency, stating at 173, with respect to post-1972 unitizations that:

> Far from there being institutional uncertainty and conflict, there existed in official rulings almost a bright line of agency explanation . . . relatively clear and steadfast upon the . . . principle issue in this case.

Disagreeing as to the existence of such a "bright line," Judge Jamison at 180, noted that:

> the uncertain and confusing interpretations of §212.72 by the DOE prior to the adoption of Rule 1975-15 raise a close question with respect to the retroactive application of the Rule under . . . *Standard Oil Company v. DOE,* 596 F.2d 1029 (Em. App. 1978). I conclude however, that Pennzoil's own conduct, including its failure to seek a timely, official agency interpretation . . . and its inconsistent treatment of its production . . . precludes its recovery in this action.

[111]40 Fed. Reg. 40,832 (Sept. 4, 1975).

the property. Similarly, with respect to post-1972 unitizations, the ruling took the position that, where two or more separate rights to produce were aggregated into a new producing entity subject to a single right to produce, the resulting unit defined the property. However, because of the need for comparison of like quantities in measuring current production over a uniform historical base, the volume of new and released crude oil for post-1972 units was to be determined on the basis of the aggregate 1972 production of the constituent leases, *as those leases existed in 1972*. Thus, although the newly defined property never existed in 1972, as a practical matter the effect was to treat it as though it did by virtue of its imputed 1972 historical base. This was at least the result intended, as FEA observed that "[u]nder no circumstances . . . would a post-1972 unitization create a 'new' property, i.e., one that has no BPCL."[112] Rul. 75-15 reached an analagous result in the case of post-1972 subdivisions of a single right to produce "through assignment, creation of new leases, or otherwise."[113]

Finally, Rul. 75-15 set forth a rule purporting to govern situations where a producer held a single right to produce crude oil with respect to two or more reservoirs. On this point, the ruling merely asserted that all such reservoirs constituted a single property except "where there are separate and distinct rights to produce . . . from each reservoir." [114] However, as illustrated by *Grigsby v. DOE,* [115] and by subsequent administrative rulings,[116] property determinations involved more angles than a game of three corner billiards.

Grigsby involved the application of the property concept set forth in Rul. 75-15 to a pooling order entered by the Louisiana Commissioner of Conservation in June 1976. Pursuant to Louisiana law, the June 1976 order unitized various leasehold interests and designated a unit well with respect to a new reservoir. However, the constituent leases of the new unit had been the subject of a prior unitization order with respect to a separate reservoir located within a lower geological sand strata. The lower sand unit had been in production during 1972 and later years, and the Commissioner had initially designated the new unit well in the mistaken belief that it had been completed in the same reservoir contemplated by the original unitization order. The June 1976 Order corrected this mistake and for the first time recognized the upper sand unit as a distinct producing entity.

The court first rejected Grigsby's assertion that " 'property' is measured solely by the fee or leasehold interest," pointing out that the "focus of the 'property' " definition is upon "the right to produce" not the fee or leasehold nature of the ownership interest.[117] This holding effectively endorsed the basic premise of Rul.

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[112]*Id.* at 40,832. Base Production Control Level (BPCL). *See* note 10, *supra.*
[113]*Id.* at 40,833.
[114]*Id.*
[115]585 F.2d 1069 (1978), *cert. denied* 440 U.S. 908 (1979).
[116]Principally Ruls. 1977-1 and 1977-2. See text beginning at note 121, *infra,* for discussion.
[117]The Court, at 1083, further observed that:

> The "right to produce" arises from a combination of sources, including, but not limited to, the nature of the ownership interest, contractual extension or restriction of ownership interest, and orders of state regulatory agencies. A mineral fee owner has a "right to produce" subject to the terms of the lease and state law. The mineral leasehold owner's "right to produce" may be further circumscribed by voluntary or compulsory pooling. Although the fee or leasehold interest may be the origin of the "right to produce," such a "right to produce" is controlled, limited, or extended by contractual agreement and state authorities.

1975-15, even though the Court expressly declined to rule at that time on its procedural validity.[118] The *Grigsby* Court, however, went on to reject the FEA's argument that production from the new unit after the date of the Commissioner's Order was attributable to the same property as production from the lower unit,[119] holding instead that the Commissioner's Order "gave rise to a new 'right to produce' and, thus, a new 'property' under Ruling 1975-15."[120] In this respect, *Grigsby* could be viewed as consistent with the rules relating to partial unitization set forth by FEA in Rul. 1977-1,[121] its next major effort to clarify the property concept.[122]

Rul. 1977-1 purported to set forth guidelines describing the circumstances under which producers could appropriately have departed from a "literal" interpretation of the property definition. In certain cases, FEA was generally prepared to recognize the existence of multiple properties subject to a single right to produce, provided the producer had made such separate property determinations in good faith and had historically and consistently treated such properties as separate entities.[123] Having no sooner issued Rul. 1977-1, however, FEA then promptly issued Rul. 1977-2,[124] significantly restricting the permissible scope of producer property determinations departing from a literal application of the property rule.

Looking first at the overall parameters established by Rul. 1977-2, the later ruling began by making it clear that historical and consistent property determinations comporting with the modifications set out in Rul. 77-1 generally could not be altered. To fall within one of the safe harbors of Rul. 77-1, it was also generally necessary to have followed such practices historically and consistently "since the inception of price regulations when such determinations were first required to be made . . ." [125]

Rul. 77-1 described three types of situations in which a producer's historical and consistent departure from a literal application of the property definition

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[118] *Id.*, at 1084. The question was raised for the first time on appeal. The procedural validity of the ruling was not sustained by an appellate court until the spring of 1982. In *Pennzoil v. DOE, supra*, note 110, the retroactive application of Rul. 75-15 was sustained in the context of a post-1972 unitization. There, the producer's continued lease-by-lease property determinations after significant alteration of the unit's producing pattern were held violative of the crude oil pricing regulations. The Court could not have been unaware that much the same issues are presented in a number of separate, pending proceedings such as *U.S. v. Exxon,* Civ. Doc. No. 79-1035 (D.D.C., filed June 8, 1978). *See* also Hawthorne Oil & Gas Corp. v. DOE, 647 F.2d 1107 (TECA 1981) (dismissing petition for failure to exhaust administrative remedies).

[119] *Grigsby, supra,* note 115, at 1084.

[120] *Id.*, at 1085.

[121] Discussed at note 128, *infra.* Rul. 77-1 was initially set forth in the preamble to FEA's August 1976 amendment to the crude oil pricing regulations, 41 Fed. Reg. 36,172 (Aug. 26, 1976). Republished in the form of a ruling without substantive change, 42 Fed. Reg. 3,628 (Jan. 19, 1977).

[122] On February 1, 1976, however, FEA had announced the recision of Rul. 1975-15 insofar as it required the producer to treat the unit as a single property for purposes of determining quantities of new and released oil *as of the effective date of unitization.* 41 Fed. Reg. 4,931 (Feb. 3, 1976). Instead, these determinations would be allowed to continue to be made on a lease-by-lease basis after the date of unitization until enhanced recovery operations actually began or until there was a significant alteration in production patterns, whichever occurred first.

[123] In these circumstances, FEA would not, however, generally permit recertification of additional volumes of new, released, and stripper oil where producers had adhered to a relatively conservative interpretation of the property concept. Thus, in the belief that the modifications set forth in Rul. 77-1 were "consistent with the practices that have been followed by the substantial majority of producers. . . ," those who had construed the regulations more strictly against themselves than was now deemed necessary were to be bound by their determinations, the possible disparity outweighed by the "need for the greatest possible measure of administrative finality" with respect to the characterization of volumes of old oil. 42 Fed. Reg. 3,633 (Jan. 19, 1977).

[124] 42 Fed. Reg. 4,409 (Jan. 25, 1977).

[125] *Id.*, at 4,410.

would not be questioned. The first involved situations in which the instrument conveying the right to produce could be construed by its terms as effectively having "established more than a single 'right to produce' and, consequently, more than a single property." [126] This might occur where the conveyance imposed "differing . . . rights or obligations with respect to the development of and production from particular portions of the described premises." [127]

Even where an instrument did not by its terms give rise to multiple rights to produce, "segregation" of the interest created by a single instrument into multiple properties might still be possible. First, in the case of a partial unitization, the remaining, non-unitized portion would be recognized as a separate property.[128] Separate property status was available in this situation, however, only where a portion of a tract was aggregated with "premises subject to other *other* rights to produce." [129] Thus, for example, a single working interest could not be subdivided on the basis of multiple, State approved production units designated on a separate reservoir basis.[130] Additionally, there were three atypical cases where segregation of a property subject to a single right to produce was permissible: (1) multiple, non-contiguous tracts; (2) separate "geological formations" [131] contained in very large tracts subject to certain older leases or held by the producer in fee, and (3) where separate royalty or severance tax accounting was required with respect to identifiable portions of a property.[132]

Finally, Rul. 77-1, provided that, in addition to permissible aggregations discussed in Rul. 75-15, the aggregation of separate rights to produce, either voluntary or involuntary, was generally appropriate so long as a bona fide reason could be demonstrated.[133] Thus, for example, where two or more parties held partial, individual interests in the right to produce from the same tract of land,

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[126] 42 Fed. Reg. 3,633 (Jan. 19, 1977).

[127] *Id.*, at 3,633.

[128] This evidently, seemed to the Court to have been the situation in *Grigsby, supra* at 1084-5. Grigsby, however, would apparently have failed to meet the safe harbor requirement of a consistent and historic practice by virtue of the initial erroneous identification of the same unit by the Louisiana Commissioner. *See* discussion of *Grigsby* at text beginning at note 115, *supra*.

[129] 42 Fed. Reg. 3,633 (Jan. 19, 1977). Emphasis added.

[130] Evidently, this was at least part of the underlying problems in *State of Louisiana v. DOE,* 519 F.Supp. 351 (W.D.La. 1981), appeal docketed on August 27, 1981 (Nos. 5-65, 5-66, TECA) (upholding the producers' pre-September 1, 1976 reservoir-by-reservoir property designations based on state regulators' production unit orders). In *Louisiana*, at 353, the court stated that in *Grigsby* it was "held that the drilling unit and not the lease, controlled and defined the 'property' designation." This reading must be questioned, since *Grigsby* involved the partial *aggregation* of *multiple* rights to produce, whereas *Louisiana* evidently also involves the question of the *subdivision* of a *single* right. The court's view of the application of *Grigsby* was, however, unnecessary to its holding, since it reached the conclusion, at 354, that the government could not retroactively apply Ruls. 77-1 and 77-2 in the context of that proceeding. On this point, see *Pennzoil v. DOE, supra,* note 110, where, with specific reference to *Louisiana* at 178, n. 42, the Temporary Emergency Court of Appeals rejected the reasoning employed therein.

[131] Rul. 77-2 made it clear that FEA did not intend to signify individual reservoirs, but instead, "a number of producing reservoirs, usually of common characteristics. This term should be understood. . .to be equivalent to the term geological structure. . ." 42 Fed. Reg. 4,411 (Jan. 25, 1977).

[132] With respect to royalty owner accountability, in Rul. 77-2, at 4410, FEA indicated it did not intend to encompass separate accounting where required merely by division orders. Instead, the exception contemplated:

> only the situation in which an operator is required, under a single oil and gas lease, to account separately to different royalty owners (whose interests are limited to specific identified portions of the premises, as delineated in the oil and gas lease) for production from corresponding identified portions of the premises granted in a single oil and gas lease.

Under Rul. 77-2, separate severance tax accountability would require that different rates of tax apply to identifiable portions, as when the severance tax is essentially an ad valorem real estate tax, the rate varying according to the value of the crude oil.

[133] 42 Fed. Reg. 3,635 (Jan. 19, 1977).

the sacrifice of significant additional tax complexity. The fact remains, however, that even while recognizing the state of disarray into which the crude oil pricing system had fallen under the tutelage of DOE and its predecessors, like Moliere's philosopher who had only one ear attuned to words spoken in his native language,[157] Congress acted both to terminate the system and to preserve its tangled legal underpinnings for purposes of the WPT.

POST SCRIPT

In *Ptasynski v. U.S.*, No. C80-302 (D.C. Wyo., Nov. 4, 1982), the WPT was held unconstitutional beause the geographical-based exemption for certain Alaskan oil violated the uniformity clause of the U.S. Constitution (Art. 1, §8). However, *Ptasynski* does not stay collection of the tax during the period in which the decision is subject to appellate review.

In addition, on November 5, 1982, the Treasury Department issued proposed/temporary regulations clarifying certain aspects of the energy property definition. These regulations are applicable as of the effective date of the WPT, and focus on determinations with respect to production commencing after January 1, 1972 under a right not in "commercial production" on that date. Specifically, Temp. Reg. §150.4996-1(i) provides that in such cases property will be determined by reference to the mets and bounds of the right to produce at the time commercial production first commenced, not in reference to geographical boundaries as they existed on January 1, 1972. The geographical boundaries on January 1, 1972 are determinative only if the property was "in production" in commercial quantities of crude oil on that date. Commercial production is defined by reference to proposed Reg. §51.4996-1(m), issued on November 2, 1982.

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[157]Pancrace's other ear was receptive exclusively to Latin, the language of scholarly discourse. *See* Moliere, LE MARIAGE FORCE (1664) as described in The Concise Oxford Dictionary of FRENCH LITERATURE 386 (J. Reid ed. 1976).