The EOR Tax Credit Back in Play

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Presentation Outline

- The EOR Tax Credit – Who Cares?
- Summary of the EOR Tax Credit
- Qualified EOR Methods
  - Non-Qualified Methods
- EOR Project Original Certifications
  - Significant Expansion Certifications
  - Continuing Certifications and Project Terminations
- Qualified Tangible Property Costs
  - Non-qualifying Tangible Costs
- Intangible Drilling and Development Costs
- Qualified Tertiary Injectant Costs – CO_2
- Cost Allocations
- Wrap Up
- Bio

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The EOR Tax Credit – Who Cares?

- Worth $100's of Millions across the industry in 2016
  - Can reduce capex as much as 10% after tax
  - Can reduce opex as much as 8% after tax
  - Even more for California based projects
- Credit has been phased out in past years due to high oil prices
  - 2016 first year credit will be available since 2005
  - Many new EOR operators since 2005
  - Many new EOR projects since 2005
  - Few operators have kept up with projects
- Work should begin on identifying qualified projects right away
  - Identify projects
  - Update well lists
  - Make sure certifications are current
  - Establish systems for tracking costs
- Potential for positive cash flow and earnings impact in 2016

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Summary of the EOR Tax Credit

- Section 43 of the Internal Revenue Code
  - 15% Federal Tax Credit
    - Loss of related deduction
      - $100 qualified expense
        - » Without credit, $100 deduction, $0 credit
        - » With credit, $85 deduction, $15 credit
    - General Business Credit
      - Subject to AMT
        - » Carry back 2 years (2014) and forward 20
- Applies to Qualified EOR Projects
  - Working interest owners only
  - Qualified methods
  - Original and continuing certifications
    - First injection after 12-31-1990
    - Significant Expansions of pre-1991 projects qualify
  - Located within the United States
- Applies to Qualified Tangible, Intangible and Tertiary Injectant Costs

Qualified EOR Methods

- Thermal Methods
  - Steam Drive
  - Cyclic Steam
  - In Situ Combustion
- Gas Flood Recovery Methods
  - Miscible Fluid Injection
  - CO_2 Augmented
  - Immiscible Nitrogen
  - Immiscible Non-Hydrocarbon Gas Displacement
- Chemical Flood Recovery Methods
  - Micro-Emulsion Flooding
  - Caustic Flooding
  - MEOR?
- Mobility Control
  - Polymer Floods
    - Must impact oil/water mobility ratios
- Additional methods by IRS Private Letter Ruling

Non-Qualified Methods

- Water flooding
- Cyclic hydrocarbon gas injection
- Horizontal drilling
- Gravity Drainage
- Any unspecified methods
- These methods may qualify if they are part of a qualified project
  - Water flooding (WAG) with horizontal CO2 injections wells
    - Both water injection costs and well costs are qualified

EOR Project Original Certifications

- Identification of the Operator
- Name and Taxpayer ID of submitting party
  - Typically submitted by field operator but can be a designated owner
- Statement identifying the project and its location
- Tertiary recovery statement
  - Summary description of the EOR project
    - Implemented with sound engineering practices
  - Project employs a qualified EOR method
  - Date of first injection
- Statement of more than an insignificant increase in ultimate production
  - Reserve estimates with and without the project
  - Production history and forecasts
  - Reservoir delineation
  - More information required for Significant Expansions
- Signed by Registered Professional Petroleum Engineer
  - Statement that project is qualified under section 43(c)(2)(A)
  - Send to Ogden Submission Processing Center, P.O. Box 9941, Ogden, UT 84409
  - Due by the date federal tax return is filed

Significant Expansion Certifications

- Required where pre-1991 injection existed into the same “reservoir volume”
- Extra documentation required to certify projects in areas with pre-1991 injection
  - Delineation of previously affected reservoir volume
    - Affect reservoir volume substantially unaffected by pre-1991 injection
  - For projects where prior injection terminated for 36 months or more
    - When prior project terminated
    - How determined
  - Can request a Private Letter Ruling from IRS if less than 36 months
  - Can request a Private Letter Ruling from IRS if affecting same volume
- More than in “insignificant increase” in ultimate recovery

Continuing Certifications & Project Termination

- Continuing Certifications
  - Every year following Original Certification
  - Project and operator identification required
  - Operations essentially as set out in the Original Certification
    - Identify any deviations
  - Signed by responsible party
    - Doesn't have to be a Registered Petroleum Engineer
- Project Termination
  - IRS requires notice if an EOR project is terminated
  - Helpful if a Significant Expansion is subsequently initiated
- Certifications due by the date federal tax return is filed
  - Internal Revenue Service Center, Ogden, Utah
  - Operator may designate any other operating interest owner to file
  - Can't claim credits until certifications have been filed
    - No other penalties for failing to file certifications timely

Qualified Tangible Property Costs

- Costs paid for depreciable equipment that is an integral part of a qualified EOR project
  - Used directly in the project
  - Essential to its completeness
  - Almost all tangibles upstream of the LACT
- Examples:
  - Down-hole equipment
  - Pumping units
  - Steam generator
  - Separation equipment
  - Gas processing equipment essential to EOR operations
  - Injectant storage tanks
  - Financial costs associated with acquisitions of above
  - Allocated overhead

Non-Qualifying Tangible Costs

- Office buildings
- Vehicles
- Oil storage tanks
- Oil Refinery
- Gas processing plant not integral to EOR operations
- Oil pipelines
  - Gathering lines are ok

Intangible Drilling and Development Costs

- All intangible drilling and development costs incurred in connection with a qualified EOR project
  - Integral and essential
- Costs of drilling source wells for water, CO_2, or other qualified tertiary injectants
- Costs of water disposal wells in some circumstances

Qualified Tertiary Injectant Costs - CO_2

- Costs related to the use and acquisition of tertiary injectants
- "Integral and essential" to the project
- CO_2 purchase and transportation costs
  - Costs of producing CO_2 under certain circumstances
- Costs of recycling CO_2
  - Gas plant operating costs for separation, dehydration, inlet/outlet costs
  - Compression costs
- Costs of water injection under most situations
  - WAG injectant is a qualified tertiary injectant
  - Cleaning, filtration, lifting and injection costs
  - Injection well workover costs
- Certain types of overhead not generally recorded at the field level
- Many costs generally thought of as field operating costs

Cost Allocations

- Many costs relate to multiple projects
  - Require cost allocations
    - Among qualifying projects
    - Between qualifying and non-qualifying projects
  - Simplification
    - 90% can be rounded up to 100%
- Allocations can use "any reasonable method"
  - Does not have to be the "best" or most reasonable
  - Well counts
  - Production or injection volumes
  - Anticipated use is ok
- Choose the method that allocates the most costs as qualifying

Wrap up

- EOR Tax Credit generates a valuable tax benefit
  - Impacts earnings and cash flow
- Applies to
  - Tangible costs
  - Intangible costs
  - Operating expenses
  - Some types of company overhead and interest
- Most common EOR methods
  - Others by special request (PLR)
- Original and continuing certifications required
- Analysis of projects and certifications can begin now
- Set up systems to identify costs now
  - Earnings forecasts and computations
  - Tax forecasts and computations
- Take advantage of allocation options

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Jeff is a petroleum engineer turned tax expert who specializes in federal income tax issues and controversies. His primary areas of concentration are dealing with IRS audits, petroleum industry, and technical tax issues. Jeff and his company, Lambert Tax Consultants, have spent thousands of hours working with IRS Agents to apply tax law in the EOR tax credit area. Clients include the biggest names in the industry as well as a number of smaller independents. Jeff and the staff at Lambert Tax Consultants have generated more than $500 million in cash tax benefit for clients from the EOR Tax Credit.

Mr. Lambert has 30 years in the oil patch, most of them dealing with complex tax issues. His experience covers technical issues such as EOR, R&D, and Section 29 tax credits, depletion, G&G, capitalization issues, and statistical sampling. He has worked for both the IRS and industry, applying his unique background to developing and resolving complex tax issues, such as the EOR Tax Credit. He has testified as an expert witness for both industry and IRS and spoken at various tax conferences in addition to being an outside speaker at IRS training.

Jeff earned his Bachelor's degree in Petroleum Engineering from New Mexico Tech, his Master's degree in Mineral Economics from Colorado School of Mines, and obtained his undergraduate accounting education at the University of Virginia. He is a registered Petroleum Engineer, CA license number P001700.