



August 3, 2015

CC:PA:LPD:PR (REG-132634-14)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on REG-132634-14, Qualifying Income from Activities of Publicly Traded Partnerships with Respect to Minerals or Natural Resources

Exterran Partners, L.P. ("*Exterran*") is a publicly traded partnership that provides natural gas compression services to customers throughout the U.S. engaged in the production of oil and gas and the transportation of natural gas. As the market leader in the U.S. natural gas compression service business, we appreciate the opportunity to submit comments regarding the proposed Treasury regulations (REG-132634-14) defining "qualifying income" under section 7704(d)(1)(E).¹ We commend the Service's initiative in publishing regulations to clarify the meaning of "qualifying income" under section 7704(d)(1)(E).

We are submitting this comment letter solely to request clarification of the application of the proposed regulations to compression services. We believe the definition of "qualifying income" in the proposed regulations encompasses income from the provision of natural gas compression services by compression service providers, either as a "section 7704(d)(1)(E) activity" or as an "intrinsic activity." However, we are concerned that the proposed regulations do not provide sufficient clarity to compression service providers. Therefore, the final regulations should include additional language confirming that the provision of natural gas compression services produces qualifying income from production and transportation of natural resources.

I. The Natural Gas Compression Services Business

Natural gas compression is a mechanical process whereby a volume of natural gas at existing pressure enters a compressor, is compressed to a required higher pressure and is transported toward the compressor's outlet. This compression allows the gas to be transported from one point to another, both within the compressor itself and beyond. *See* Exhibit A. As such, natural gas compression is unquestionably the transportation of natural gas.²

¹ Unless otherwise noted, all references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended.

² For example, natural gas exiting the wellhead may have a pressure of 10 pounds per square inch ("psi"), whereas the pipeline may have a pressure of 100 psi. Without sufficient compression, the gas could not move into and down the pipeline.

Typically, natural gas is compressed several times during the natural gas production and transportation cycle, including at the wellhead, throughout gathering and distribution systems, into and out of field processing facilities (*i.e.*, facilities that separate natural gas into its components) and storage facilities, and along intrastate and interstate pipelines. Without compression, the natural gas would not be able to flow through or between these systems and facilities. These applications are described below:

Wellhead Compression. Compression is applied at the wellhead when well pressures fall below the line pressure of the gathering or pipeline system used to transport the gas. At that point, gas no longer naturally flows from the wellhead into the pipeline. Compression is applied to boost the pressure levels of the natural gas flowing from the well and transport it into the pipelines. *See Exhibit B.*

Gathering Systems. Compression is used to transport natural gas from multiple pipelines into a single, unified pipeline. Typically, the compressor is located at a central point to collect gas from multiple wells by creating differential pressures and transporting the gas down the pipeline. *See Exhibit C.*

Storage. Natural gas is compressed for injection into and removal from salt domes for underground storage. *See Exhibits D and E.*

Pipeline Transmission. Natural gas transported through a pipeline loses pressure over the length of the pipeline. Compression is staged at various points along the pipeline to boost pressure to overcome the friction and hydrostatic losses inherent in normal operations and maintain flow. *See Exhibit F.*

In some applications, compression constitutes crude oil production under section 7704(d)(1)(E). For example, some compression is used to reinject natural gas into producing oil formations to maintain reservoir pressure, thus allowing the crude oil to be produced. This is known as “gas injection.” Similarly, some compression is used to reinject natural gas into an oil well to reduce the density of the oil in the well. The natural formation pressure is then able to force the oil out of the well. This is known as “gas lift.” These applications are described below:

Gas Injection. Gas injection is commonly used in oil production. It is a process in which gas is taken from the oil well (or another source) and is injected into the oil zone. This increases pressure in the zone and forces both the oil and the gas out through the wellhead and into the pipeline for processing. The gas will be recaptured as it comes out and then re-injected. The oil will be directed to a refinery or a processing plant. *See Exhibit G.*

Gas Lift. Gas lift is also used in oil production. Instead of the gas being injected into the oil zone, it is injected into the well casing. Inside the casing, the gas passes through a series of lift valves at various elevations causing the oil to be lifted out of the well. The



gas is then recovered and is injected into the casing again. The oil will be directed to a refinery or a processing plant. *See Exhibit H.*

Many natural gas producers, transporters and processors outsource their compression needs due to the benefits and flexibility of contract compression. Using specialized compression service providers, like Exterran, generally results in more effective and efficient compression because selecting and applying the appropriate amount of compression at various stages of production and transportation to maintain target pressure differentials requires personnel with specialized training, including engineers, service technicians and other field personnel.

Compression services begin with the compression service provider's selection of appropriate compression equipment (*e.g.*, number of compressors and compressor configuration, including number and size of cylinders, number of stages, emissions equipment needs, noise abatement requirements, housing requirements, types of metal used for valves and rods, and engine type and size) to provide compression services at the customer's location, taking into account the site conditions (*e.g.*, required inlet pressure and temperature, outlet pressure, gas volume and composition, presence of liquids or impurities in the gas, and ambient temperature range and altitude) and type of compression needed (*e.g.*, wellhead, gas gathering, gas injection or gas lift). Once the compression services provider has selected appropriate equipment, the compression service provider installs, operates, services, repairs and maintains that equipment.

A typical compression services agreement obligates the compression service provider to provide compression on a virtually continuous, 24-hour basis, typically at or above 97% each month. If the compression services provider does not maintain compression levels at or above contractual minimums, its service fee will be reduced and the customer will suffer economic losses. Compression services are designed to ensure that contractual service level commitments will be satisfied.

Exterran works with its customers regularly to optimize the throughput of the compression equipment as site conditions, including gas stream composition, pressures, and volume and performance objectives change over time. Exterran may adjust or reconfigure the compressor, including disabling a portion of the compressor. In some cases, it may replace the compressor it uses to provide the compression services to optimize efficiency. Exterran's compression services include a regular physical check of every compressor on an ongoing, rotating basis in accordance with recognized best industry practices.

II. Treatment of Compression Under the Proposed Regulations

Section 7704(d)(1)(E) Activities. Section 7704(d)(1)(E) provides that income from the production and transportation (among other activities) of minerals or natural resources is qualifying income. The proposed regulations define "production" to include "operating equipment to extract natural resources from mines and wells." The proposed regulations generally define "transportation" as "the movement of minerals or natural resources and

products...including by pipeline.” In addition, the proposed regulations provide the following exclusive list of activities that qualify as transportation:

- (i) Providing storage services;
- (ii) Terminalling;
- (iii) Operating gathering systems and custody transfer stations;
- (iv) Operating pipelines, barges, rail, or trucks; and
- (v) Construction of a pipeline only to the extent that a pipe is run to connect a producer or refiner to a preexisting interstate or intrastate line owned by the publicly traded partnership (interconnect agreements).

Intrinsic Activities. The proposed regulations also provide that some activities, not specifically enumerated in section 7704(d)(1)(E), that are intrinsic to the specifically enumerated activities also produce qualifying income. Under the proposed regulations, an activity is an intrinsic activity only if the following three requirements are satisfied:

- (i) the activity is specialized to support a section 7704(d)(1)(E) activity,
- (ii) the activity is essential to the completion of the section 7704(d)(1)(E) activity, and
- (iii) the activity requires the provision of significant services to support the section 7704(d)(1)(E) activity.

With respect to the third requirement, the proposed regulations provide that, to be considered “significant,” services must be conducted on an ongoing or frequent basis by the partnership’s personnel at the site or sites of the section 7704(d)(1)(E) activity. Services may be conducted offsite if they are performed on an ongoing or frequent basis and are offered exclusively to persons engaged in section 7704(d)(1)(E) activities. Whether services are performed on an ongoing or frequent basis is determined based on all of the relevant facts and circumstances, including recognized best practices in the relevant industry. The proposed regulations further provide that an activity that “principally involves” design, construction, manufacturing, repair, maintenance, lease, rent or temporary provision of property will not constitute significant services.

III. The Final Regulations Should List Natural Gas Compression as an Activity That Qualifies as Transportation

The proposed regulations define “section 7704(d)(1)(E) activities” through an exclusive list of activities. We believe the concept of an exclusive list is fundamentally flawed, and the final regulations should not include an exclusive list. First, the use of an exclusive list is inconsistent with the plain meaning of section 7704(d)(1)(E). The term “transportation” in this context means the movement of natural resources from one point to another, using whatever means of transportation exists at the time. Second, the specific methods of transporting natural resources have changed over time and will continue to change, and an exclusive list cannot accommodate such technological improvements. We believe that a comprehensive, exclusive list

is an infeasible approach. A non-exclusive list, on the other hand, would be sufficiently flexible to accommodate technological advances, and would help illustrate which activities qualify as transportation.

The list of activities that constitute transportation of natural resources under the proposed regulations excludes compression services, which, as described above, is the transportation of natural gas. In all applications, compression causes the movement of natural gas from one point to another, and thus qualifies as “transportation” under the plain meaning of section 7704(d)(1)(E). Without compression, natural gas transportation cannot occur. Providing compression services is as fundamental to transportation as operating gathering systems, pipelines, and custody transfer stations, or providing storage services, all of which are included in the list of transportation activities in the proposed regulations. In fact, compression services actively transport natural gas, whereas pipelines and storage facilities are passive installations, which have no ability to move the gas without compression services.

Because natural gas compression is transportation of natural gas, the final regulations should add “providing natural gas compression services” to the list of activities that qualify as transportation. Additionally, in some applications, compression services qualify as “production” or “processing” under Prop. Reg. § 1.7704-4(c)(4). For example compression equipment employed in gas injection and gas lift extracts crude oil from wells, so operating such gas compression equipment is “production,” a qualifying activity.

IV. If Compression Services Are Not Treated As Transportation, They Are An Intrinsic Activity

Compression is not just an activity that is “intrinsic” to the transportation of natural resources. It is the core activity that transports the natural gas, more so than pipelines or storage facilities, which are passive vessels. Nevertheless, if compression services are not added to the definition of “transportation” in the final regulations as they clearly should be, at the very least, the “intrinsic activity” standard should also be amended to include an example confirming that compression services are intrinsic to production, field processing and transportation of natural gas.

The language of the proposed regulations indicates that whether services are conducted on an ongoing or frequent basis will be determined based on the facts and circumstances. We are concerned that this subjective standard may not provide sufficient certainty to compression service providers. Further, the proposed regulations appear to discount important support services, such as repair and maintenance of the compression equipment used to provide the services, even though maintaining and repairing compression equipment is essential to providing compression services on a near-continuous basis as required under typical compression services agreements.

The preamble to the proposed regulations acknowledges that the facts and circumstances test may not provide sufficient certainty, and requests comments on whether and how the

requirement could be set forth as an objective standard. See Preamble, § 2.C. We believe that clarity with respect to compression services can be achieved by including an appropriate example in the final regulations.

V. Proposed Amendments to Prop. Reg. § 1.7704-4

The final regulations should be amended as follows:

Add Compression Services to Definition of Transportation. Section 1.7704-4(c)(6) should be amended to strike the word “and” in subparagraph (iv); redesignate subparagraph (v) as subparagraph (vi); and add a new subparagraph (v) to read “Providing natural gas compression services; and”.

Add Example Clarifying That Compression Services Are Transportation and Production of Natural Resources. Section 1.7704-4(e) should be amended to add the following new example:

Example 7. Providing natural gas compression services. (i) Y, a publicly traded partnership, receives income for providing natural gas compression services at customer locations. Depending on the location, Y’s compression services move gas from the wellhead to gathering systems, from gathering pipelines to a unified pipeline, along intrastate and interstate pipelines, and into and out of storage or field processing facilities. Y also provides compression services to reinject natural gas into wells to maintain reservoir pressure (“gas injection”) and into well casings to lift oil out of the well (“gas lift”).

(ii) Y’s income from the provision of compression services to move natural gas from wellheads into pipelines, through gathering system pipelines, and into and out of storage or field processing facilities is qualifying income for purposes of section 7704(c) because providing natural gas compression services is a section 7704(d)(1)(E) activity under paragraph (c)(6) of this section.

(iii) Y’s income from the provision of gas injection and gas lift services is qualifying income for purposes of section 7704(c) because Y is operating equipment to extract natural resources from wells, which constitutes production of natural resources under paragraph (c)(4)(i) of this section.

Add Example Clarifying That Compression Services Are Intrinsic Activities. Alternatively, Section 1.7704-4(e) should be amended to add the following new example:

Example 8. Providing natural gas compression services. (i) Y, a publicly traded partnership, receives income for providing natural gas compression services at customer locations. Depending on the location, Y’s compression services move gas from the wellhead to gathering systems, from gathering pipelines to a unified pipeline, along intrastate and interstate pipelines, and into and out of field




processing or storage facilities. Y also provides compression services to reinject natural gas into wells to maintain reservoir pressure (“gas injection”) and into well casings to lift oil out of the well (“gas lift”). Y’s engineers, service technicians and other field service personnel receive specialized training to select, install, operate, service, maintain and repair the compressors used to provide the services, and this training is of limited utility other than to perform or support the transportation of natural gas. As part of those services, Y’s specially trained personnel visit each site on a regular, rotating basis in accordance with recognized best industry practices to inspect, service, adjust, and provide preventative maintenance on the compression equipment, and the services are essential to the transportation of natural gas.

(ii) Y’s compression service activities are intrinsic activities because the activities support the production, processing and transportation of natural resources, which are section 7704(d)(1)(E) activities. The compression services provided by Y are essential to the completion of those section 7704(d)(1)(E) activities and require the provision of significant services to support the section 7704(d)(1)(E) activities. Y’s personnel are specialized because they receive specialized training regarding the selection, installation, operation, servicing, repair and adjustment of compression equipment, which is specialized equipment dedicated to section 7704(d)(1)(E) activities. Therefore, Y’s income from the provision of compression services is qualifying income for purposes of section 7704(c).

We believe that the foregoing amendments will result in clear and consistent standards that accord with the plain meaning of section 7704(d)(1)(E).

Sincerely,
EXTERRAN PARTNERS, L.P.
By: Exterran General Partner, L.P., its sole general partner
By: Exterran GP, LLC, its sole general partner

By: 
Name: Douglas B. Childers
Title: President and Chief Executive Officer




Exhibit A: Natural Gas Compression Applications

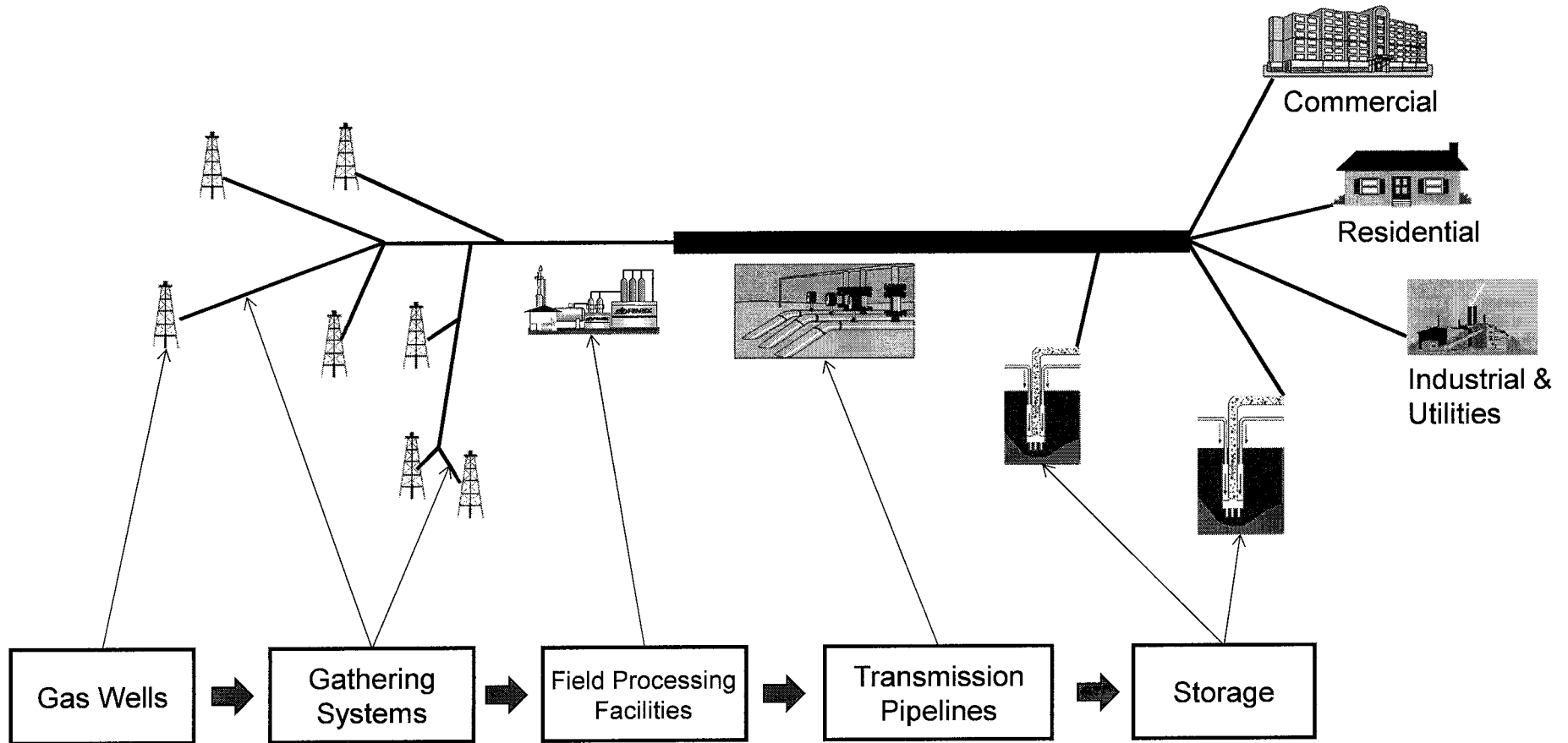


Exhibit B: Compressor Package Profile and Illustration of Wellhead Compression

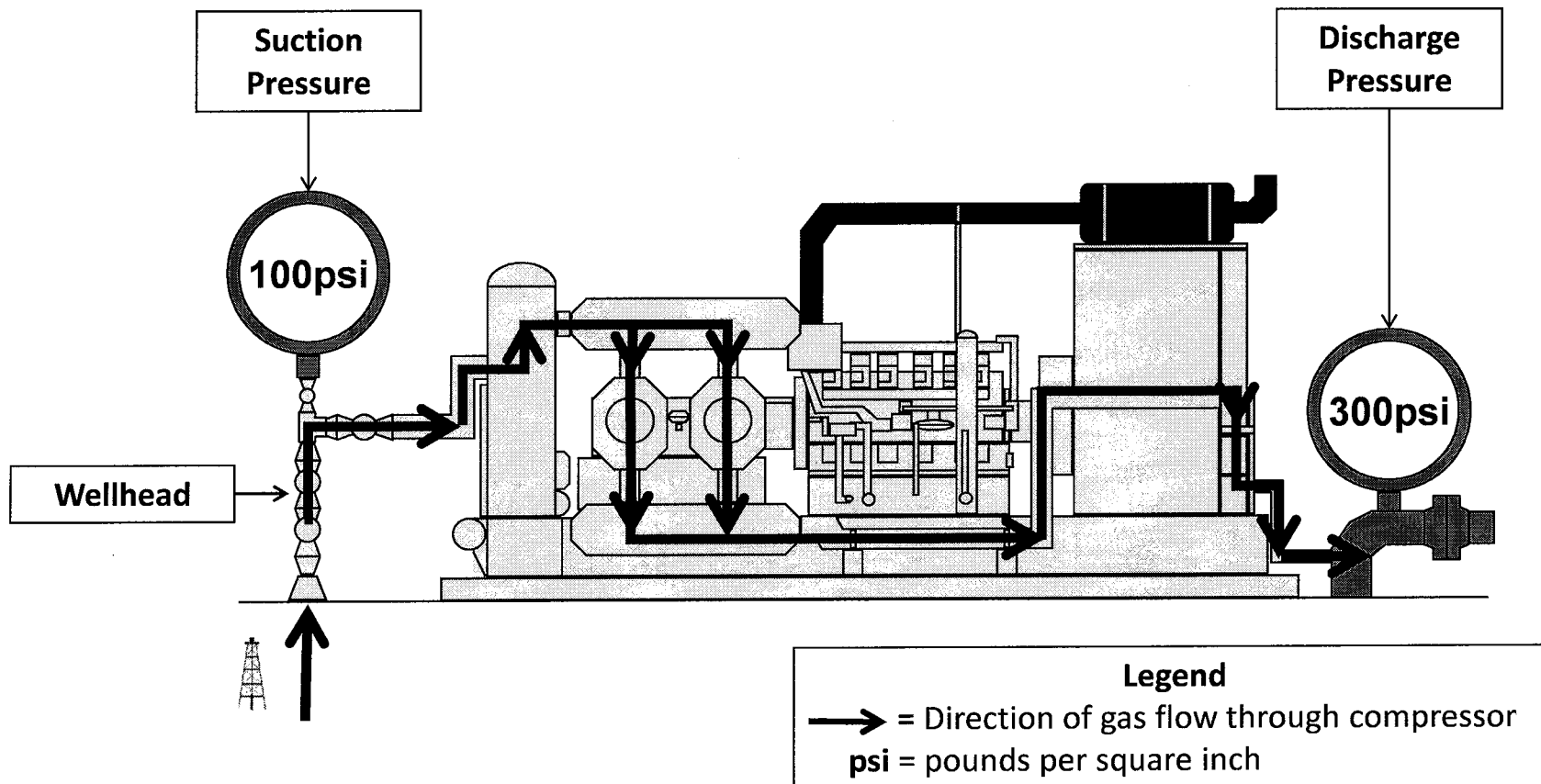


Exhibit C: Gas Gathering

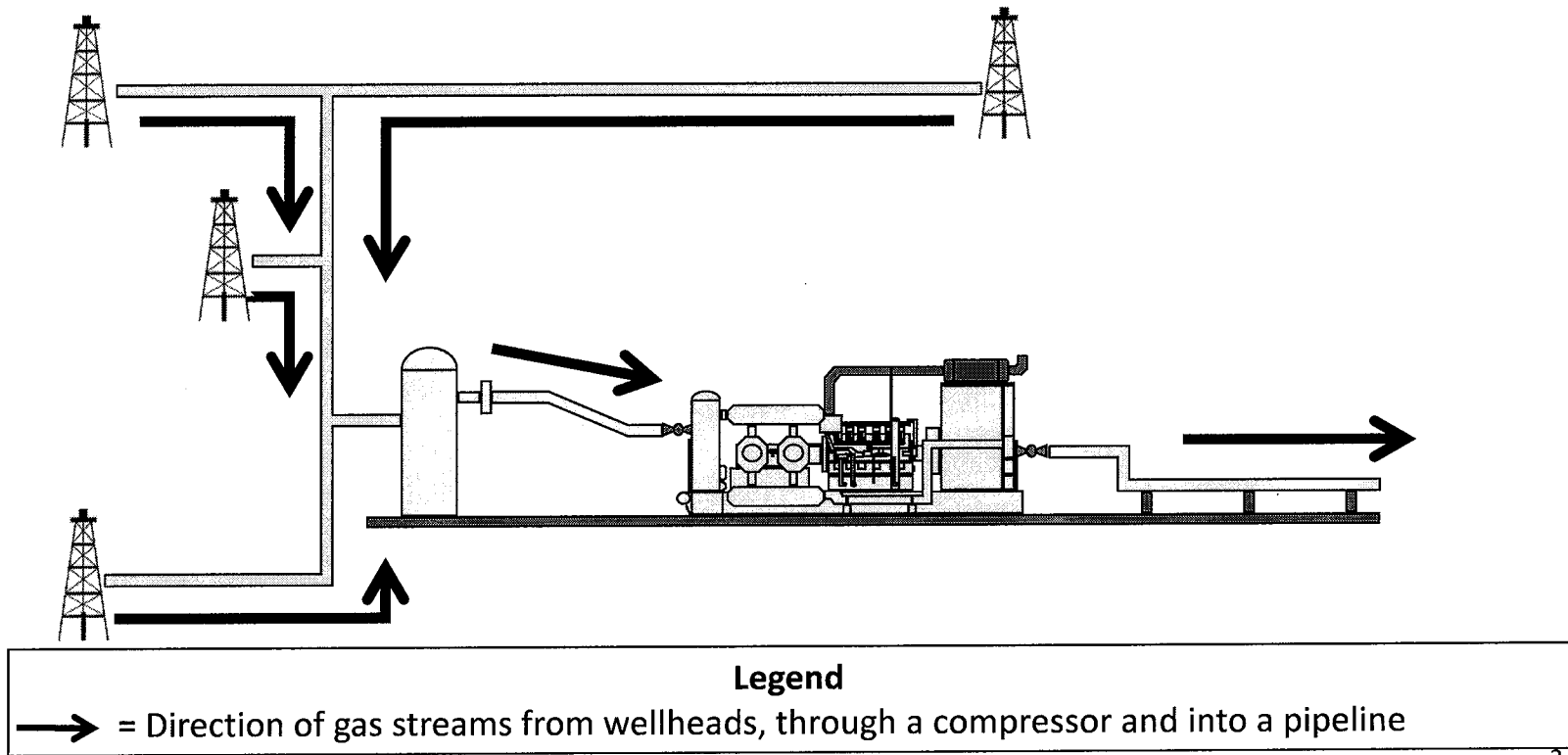


Exhibit D: Transportation of Gas into Storage

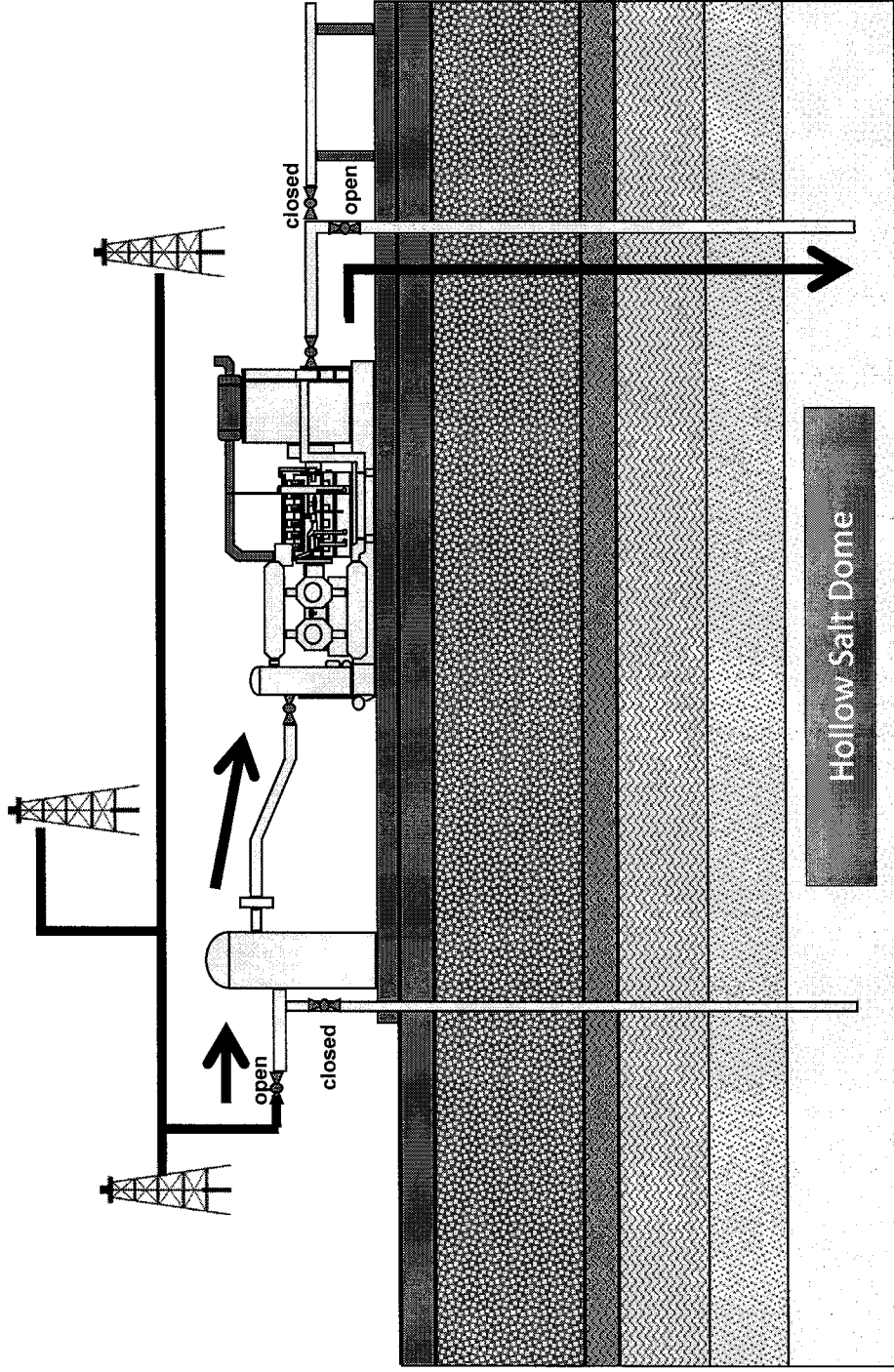


Exhibit E: Withdrawal of Gas from Storage

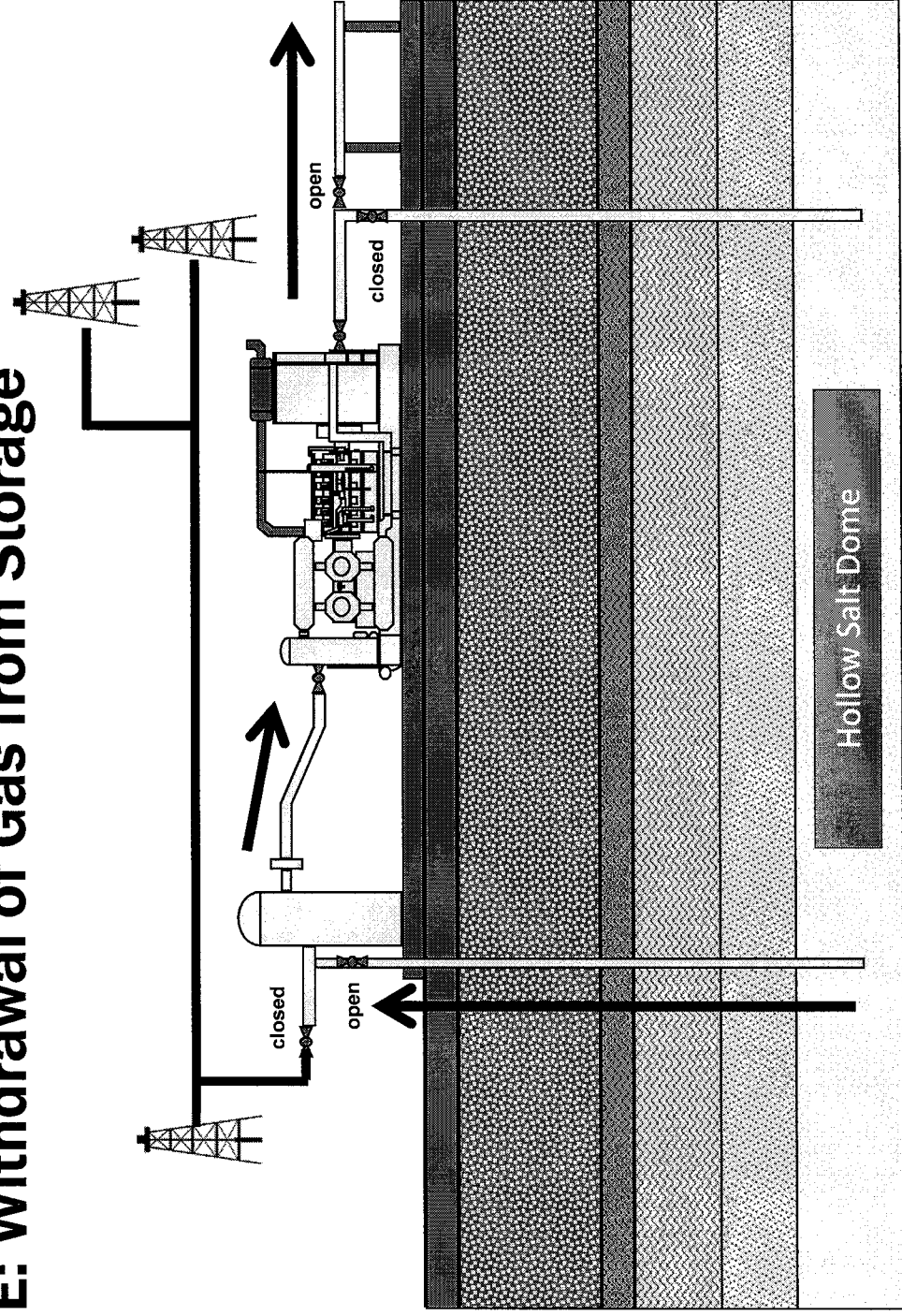


Exhibit F: Pipeline Transmission

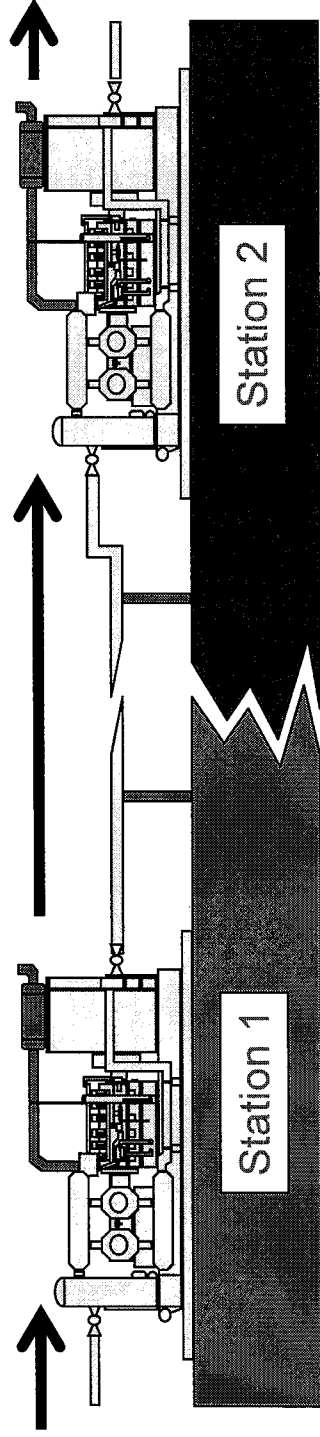


Exhibit G: Gas Injection

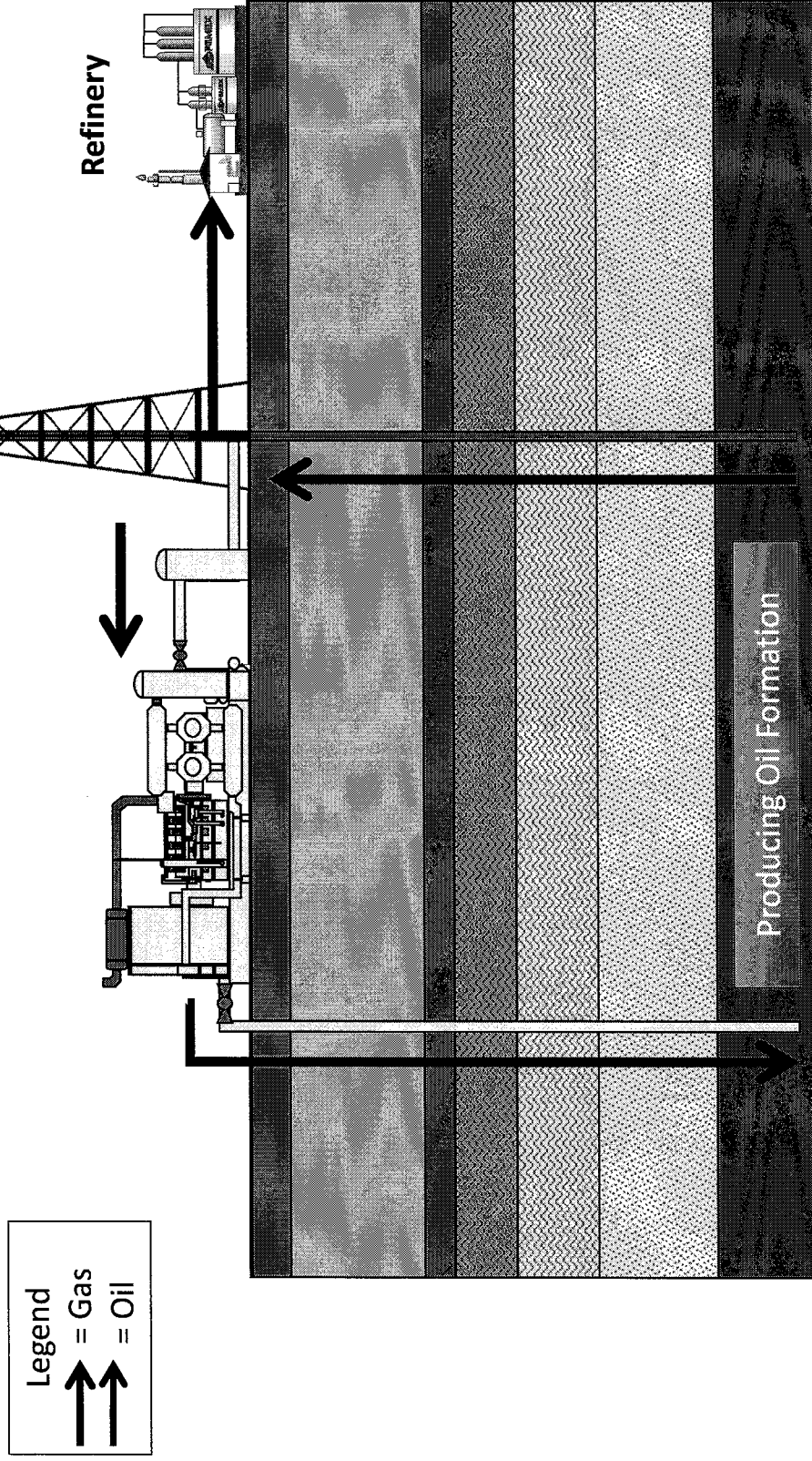


Exhibit H: Gas Lift

