



REG-132634-14

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LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS BRANCH

JUN 26 2015

June 22, 2015

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

**RE: Public Comments on Proposed Rules Regarding Qualifying Income
(REG-132634-14)**

To Whom It May Concern:

Targa Resources Partners LP (“Targa”) and Targa Resources Corp., Targa’s publicly traded general partner, welcome the opportunity to submit comments to the U.S. Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) on the proposed Treasury regulations related to qualifying income for publicly traded partnerships published in the *Federal Register* on May 5, 2015. In general, Targa and Targa Resources Corp. believe that the proposed regulations create unnecessary uncertainty with respect to Targa’s activities that otherwise did not exist under Internal Revenue Code section 7704, the legislative history of section 7704, and prior administrative guidance issued to Targa.

Who We Are

Targa, a publicly traded partnership (NYSE: NGLS), is a leading provider of midstream natural gas and natural gas liquids (“NGLs”) services in the United States. Targa was formed in 2006 to own, operate, acquire and develop a diversified portfolio of midstream energy assets. Targa is engaged in the business of gathering, compressing, treating, processing and selling natural gas, and storing, fractionating, treating, processing, refining, transporting and selling NGLs and NGL products. Targa also engages in the business of gathering, processing, storing and transporting crude oil. Targa Resources Corp. (NYSE: TRGP) manages Targa’s activities.



Targa's Comments

Following are Targa's comments on the proposed regulations.

Natural Gas Processing: Purification – Removal of Sulfur, Reduction of Benzene, Enhancing Motor Fuel Blend Stocks, Isomerization

Processing natural gas should include the processing and purification of NGLs (i.e., the recovered liquid constituents of natural gas). Any activity considered as “processing” with respect to crude oil should also be “processing” with respect to NGLs. The conversion of one natural resource to another should also constitute “processing.” For example, the reduction of sulfur content from natural gasoline through hydrotreating, the reduction of benzene content from natural gasoline, any other natural gas process the purpose and the end result of which is the enhancement of motor fuel blend stock, and the isomerization of butane should constitute “processing” of NGLs for purposes of section 7704(d)(1)(E).

Prop. Treas. Reg. § 1.7704-4(c)(5)(ii) provides, “An activity constitutes processing of natural gas if it is performed to ... (A) purify natural gas [or] ... (B) Separate natural gas into its constituents which are normally recovered in a gaseous phase (methane and ethane) and those which are normally recovered in a liquid phase (propane, butane, pentane, and gas condensate) ...”

Sulfur Removal, Benzene Reduction, Other Similar Processes

In 2007, Targa modified an idle isomerization unit at its Mont Belvieu facility to hydrotreat natural gasoline (“the hydrotreater”). The purpose of the hydrotreater is to purify natural gasoline by reducing sulfur content. The end product is referred to as low sulfur natural gasoline (“LSNG”). Targa's customers' demand for LSNG is driven by the Environmental Protection Agency (“EPA”) Tier 2 regulations that mandated a reduction in the maximum sulfur content of motor fuel to 30 parts per million (“ppm”), and EPA's Tier 3 regulations that will require the sulfur content of motor fuel to be no more than 10 ppm beginning January 1, 2017. Prior to commissioning the hydrotreater, natural gasoline produced at Mont Belvieu was not a preferred motor fuel blend stock. The hydrotreater at Mont Belvieu produces a natural gasoline containing less than 10 ppm, making it a preferred motor fuel blend stock.

In February 2007, the EPA issued additional rules for motor fuels mandating a reduction in benzene content. In January 2012 at the request of its hydrotreating customer, Targa commissioned a benzene saturation unit at Mont Belvieu as an add-on to the hydrotreater. The benzene saturation unit reduces the benzene content of natural



gasoline from approximately 1.2 liquids volume percent (“LV%”) to less than 0.2 LV% in an integrated process with the hydrotreater. After being sent through the hydrotreater, LSNG is introduced to a catalyst in a hydrogen rich atmosphere in order to convert the benzene to cyclohexane. The resulting cyclohexane is blended back in with the LSNG to satisfy the EPA rules and is sold to third parties as gasoline.

The hydrotreating of natural gasoline to reduce sulfur content and the benzene saturation of natural gasoline to reduce benzene content constitute the refining or processing of natural resources to purify NGLs for purposes of enhancing motor fuel blend stocks. Natural gas streams contain – in various volumetric percentages based on the qualities of a particular stream – methane, ethane, propane, butane, isobutane and natural gasoline. Ethane, propane, butane, isobutane and natural gasoline (or gas condensate) are the constituents of natural gas recovered as liquids referred to as NGLs. As such, NGLs are without question a natural resource.

Because NGLs are natural resources, the question then becomes whether Targa’s activities with respect to the NGLs constitute “refining” or “processing.” The terms “refining” and “processing” are not defined in Section 7704 or in its legislative history. However, the Service has defined “refining” in other contexts. Treasury Regulations regarding the depletion of crude oil define “refining” as “...any operation by which the physical or chemical characteristics of crude oil are changed, exclusive of such operations as passing crude oil through separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and blending crude oil products.”¹ For this purpose, “crude oil” is defined to include “natural gas liquid recovered from gas well effluent in lease separators or field facilities before any conversion process has been applied to such production” in Treas. Reg. § 613A-7(g)(3). As previously discussed, NGLs include ethane, propane, normal butane, isobutane, and natural gasoline. In addition, Congress, by including the term “processing” in addition to the term “refining,” clearly intended that some activities other than refining would generate qualifying income.

Hydrotreating is a refining process and included as refining or processing with respect to crude oil in Prop. Treas. Reg. §1.7704-4(c)(5)(iii)(A)(2). Benzene saturation is also properly treated as refining or processing under -4(c)(5)(iii)(A)(2). The regulations provide with respect to crude oil processing or refining includes an “activity performed to ... chemically convert the physically separated components if one or more of the products are recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels.” Prop. Treas. Reg. §1.7704-4(c)(5)(iii)(A)(2). Targa asks that the Service clarify the proposed regulations to include these processing and purification activities within the definition of natural gas refining or processing (in addition to their inclusion as crude oil refining or processing). In any case where a publicly traded partnership processes natural gas or NGLs such that

¹ Treas. Reg. § 1.613A-7(s)(3).



the end result is an enhanced motor fuel blend stock, the process should also generate qualifying income under finalized regulations.

Targa would like the Service to note, with the exception of the gasoline hydrotreater and benzene saturation unit, both of which were driven by EPA motor fuel regulations, the operation at the Mont Belvieu facility remains essentially the same as it was in 1987 (when Congress enacted the publicly traded partnership natural resource exception). Additionally, all processes described above are those that would be found in refineries. Since inception, Targa and its advisors have relied on the language of section 7704(d)(1)(E), the legislative history of section 7704, and prior administrative guidance to classify the revenue generated from these processes as qualifying income. The proposed regulations create unnecessary uncertainty with respect to Targa's activities that did not previously exist.

Butane Isomerization

The conversion of butane to isobutane through isomerization also constitutes refining or processing NGLs for purposes of section § 7704(d)(1)(E). Butane and isobutane are both naturally occurring components of the NGL stream. Isobutane represents approximately 7% of total y-grade NGL volume while butane represents approximately 10% of y-grade volume. Isomerization converts a "straight chain" butane molecule into a "branched" molecule, also called the "isomer" of normal butane (which has a higher octane number). The isomerization process does not convert all of the normal butane, so the unit's output typically goes to a deisobutanizer tower that separates the isobutane from the normal butane. A significant portion of isomerization occurs within the gates of crude oil refineries. Isobutane is a NGL that is commonly used as a feedstock for refinery alkylation. Generally, refinery alkylation is a process used in petroleum refineries to convert isobutane and a mixture of propene and butene [olefins] into alkylate, a high octane component of gasoline.

The isomerization process simply causes the conversion of one qualifying natural resource, normal butane, into another qualifying natural resource, isobutane. As such, isomerization is similar to, and involves less chemical change than, the conversion of methane into liquid fuels otherwise produced from petroleum (*see* Prop. Treas. Reg. §1.7704-4(c)(5)(ii)(C)). Like the activities described above, a process with respect to crude oil, such as butane isomerization, would be considered refining or processing as an "activity performed to ... chemically convert the physically separated components if one or more of the products are recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels." Prop. Treas. Reg. §1.7704-4(c)(5)(iii)(A)(2). Targa asks that the Service clarify the proposed regulations to include these processing and purification activities within the definition of natural gas processing.



Proposed Clarification

To achieve Targa's suggested clarification with regard to processing and refining NGLs, Targa suggests that the Service eliminate the disparate treatment of NGLs and crude oil. In addition, the Service should amend the language of Prop. Treas. Reg. § 1.7704-4(c)(5)(ii)(B) to read as follows, "Separate natural gas into its constituents which are normally recovered in a gaseous phase (methane) and those which are normally recovered in a liquid phase (ethane, propane, butane, natural gasoline, and gas condensate), convert one such constituent of natural gas into another, or remove impurities from the gas or liquids or otherwise enhance motor fuel blend stock."

Operation & Management Fees

Operating transportation assets, processing facilities, storage facilities and related marketing activities should generate qualifying income under section 7704(d)(1)(E). For purposes of section 7704(d)(1)(E), the term "operating" should include the operation and management of a qualifying activity (for example, engineering, operations, maintenance, metering, monitoring, security, billing, hiring, accounting, tax, financial reporting and all other functions that, taken in the aggregate, are necessary for the overall operation of the qualifying activity).

Targa (through its wholly-owned subsidiaries) is the general partner and/or the operator of various joint venture partnerships or co-ownership facilities. Such joint venture partnerships and similar shared ownership arrangements are prolific in the oil and gas industry. The operator of such arrangements is often determined based upon which party has the controlling interest, the correct operating expertise, or certain geographic synergies with the business. Targa's joint venture partnerships engage in the business of natural gas gathering, crude oil gathering, natural gas processing, natural gas marketing, and the storage, fractionation, distribution and marketing of NGLs, and the storage of crude oil. Thus, the joint venture partnerships engage in activities that generate qualifying income under section 7704(d)(1)(E). As the chosen operator for one of the reasons above, Targa receives a fee and cost reimbursement from the joint venture partnerships for their operation and management (the "Management Fee"). The Management Fee covers Targa's costs incurred to operate the joint venture partnerships (including all day-to-day functions, such as engineering, operations, maintenance, metering, monitoring, security, billing, hiring, accounting, tax, financial reporting and all other functions necessary to the joint venture partnerships' operation) plus a minimal negotiated mark-up. Targa received Private Letter Ruling 2011-32-012 (April 29, 2011) that gross income (including cost reimbursements) from the operation of six such arrangements constitutes qualifying income. We believe this private letter ruling to be



consistent with section 7704(d)(1)(E) and the widespread use of shared ownership arrangements in the oil and gas industry.

Prop. Treas. Reg. § 1.7704-4(c)(6) provides the following activities qualify as transportation for purposes of section 7704(d)(1)(E): “(iii) Operating gathering systems and custody transfer stations; [and] (iv) Operating pipelines, barges, rail, or trucks,” among other transportation activities. It appears the Service intended the term “operating” to be interpreted broadly. However, further definition and clarification of the term is necessary for publicly traded partnerships to gain comfort around currently existing, traditional operating activities. The proposed regulations should be amended to specifically treat the operation of any qualifying activity as generating qualifying income.

Proposed Clarification

Targa requests an additional sentence be added to paragraph -4(c)(6) stating the following activities qualify as transportation for purposes of section 7704(d)(1)(E): “Operating processing (as defined in paragraph -4(c)(5) of this section) facilities, storage facilities and marketing activities.” Targa further requests the Service add clarifying language defining the term “operating” to include “The operation and management of day-to-day functions (such as engineering, operations, maintenance, metering, monitoring, security, billing, hiring, accounting, tax, financial reporting) that, taken in the aggregate, are necessary for the overall operation of the qualifying activity.” Finally, Targa suggests that the following clarifying language be added as the second sentence of Prop. Treas. Reg. Section 1.7704-4(c)(1): “A partnership may engage in such activities on its own account or as operator or manager on behalf of third parties.”

Construction of Extended Facilities

Transportation should include fees and cost reimbursements directly related to the construction of extended facilities for customers pursuant to gathering and processing agreements. For purposes of section 7704(d)(1)(E), the term “extended facilities” should mean: Pipeline, wellhead connections, metering stations, LACT units and pool delivery points to the extent that the pipe and accompanying connective, metering and delivery devices connect a producer or refiner to an interstate, intrastate or offshore line, processing facility or storage facility owned or to be owned by the publicly traded partnership.

Targa enters into extended facilities/facility expansion agreements with its customers whereby Targa agrees to construct extended facilities such as connective pipelines to preexisting interstate or intrastate lines, wellhead connections, metering stations, lease

automatic custody transfer units (“LACT units”) and pool delivery points. Targa’s extended facilities agreements are generally included within, or as codicils to, existing gathering and processing agreements with the customers. Targa receives a fee and cost reimbursement from its customers for the construction of the extended facilities.

Prop. Treas. Reg. § 1.7704-4(c)(6)(v) provides qualifying transportation includes, “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).”

Proposed Clarification

The proposed regulations’ exclusive definition of qualifying transportation under Prop. Treas. Reg. § 1.7704-4(c)(6)(v) should be clarified to include fees and cost reimbursements related to the construction of extended facilities: pipeline, wellhead connections, metering stations, LACT units and pool delivery points to the extent the pipe and accompanying connective, metering and delivery devices connect a producer or refiner to an interstate, intrastate or offshore line, processing facility or storage facility owned by the publicly traded partnership. Targa believes that, similar to an interconnect agreement, such facility expansions also are a necessary component of the transportation of a natural resource.



TARGA

We appreciate the opportunity to comment on this very important tax matter and would welcome further discussions. Please feel free to contact me at (713) 584-1580, if you would like to discuss these comments or otherwise have any questions or concerns.

Very truly yours,

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