Alaska Oil and Gas Association

AOGA

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Kara Moriarty, President/CEO

September 12, 2018

Mr. John Larsen
Alaska Department of Revenue
550 W. 7th Avenue, Suite 500
Anchorage, AK 99501-3555

Dear Mr. Larsen:

Re: AOGA Comments in Response to the Alaska Department of Revenue's, Notice of Public Scoping Request, Published August 29, 2018 Regarding Possible Updates and Revisions of Regulations in 15 AAC 55: Oil and Gas Production Tax and Oil Surcharge

These comments are made on behalf of the members of the Alaska Oil and Gas Association ("AOGA"), who account for a majority of the oil and gas production and related operations in Alaska. They have been reviewed by the AOGA membership and approved with no dissent.

The two specific potential changes described in the Notice of Public Scoping Request ("Notice") by the Alaska Department of Revenue ("Revenue" or "DOR") relate to "calculating return on investment (ROI). . . and cost of capital allowances . . . for crude oil . . . tanker" for purposes of netting back from a price or prevailing value of Alaska North Slope crude oil ("ANS") delivered to a market destination on the U.S. West Coast or in Hawaii, in order to determine the corresponding "gross value at the point of production" on the North Slope for the ANS so transported.

Both of these potential changes seem to be narrow and technical. Changing the reference in the regulations to the published source for the "weighted average cost of capital (WACC) index" used in the "ROI Model"[1] will not change how the Model works since the source itself will not change. Likewise, updating "corporate tax rate entries in the ROI Model to reflect new federal corporate tax rates effective for the 2018 calendar year" would only change an input for the

1 This "ROI Model" is in *Computation of a Cost-of-Capital Allowance under 15 AAC 55.196, Incorporating Depreciation and Return on Investment Capital for Marine Vessels and Improvements*, Second Edition (dated September 19, 2003), adopted by reference in 15 AAC 55.196(d)

Model as provided in 15 AAC 55.195(a) for those years to which the new rates apply,[2] without changing the Model itself. AOGA has nothing to say at this time about these potential changes being considered by DOR.

The Notice adds, "Other minor changes proposed by the public or other interested parties may also be considered by the department." AOGA believes the Notice misses several significant and timely opportunities for DOR to revise the regulations in order to acknowledge the final resolution of TAPS-tariff disputes during the last 12 months to confirm that the present operation of the regulations will continue as various long-foreseen events occur during the next few years.

A. <u>TAPS Tariffs for 2009 – 2015</u>. The 2009 - 2015 interstate tariffs for TAPS and the Variable Tariff Methodology stipulated by the State of Alaska and other the parties[3] for TAPS tariffs beginning January 1, 2016 through June 30, 2021 and "potentially renewable for subsequent terms" — have been settled, adjudicated and approved by and the Federal Energy Regulatory Commission ("FERC").[4] Intrastate TAPS tariffs have been similarly settled, adjudicated and approve by the Regulatory Commission of Alaska ("RCA") for 2008 – 2019.[5] In some instances refunds of tariffs collected by TAPS Owners in excess of the adjudicated tariffs for some those periods – and amended production tax returns for the respective periods – may still be pending.

In his letter dated November 15, 2017 addressed to executives of the five pipeline companies with interests in TAPS ("Owner Companies"),[6] DOR Commissioner Sheldon Fisher wrote:

> Pursuant to Section 4 of the Settlement Agreement Regarding 2009-2015 Interstate Rates for the Trans Alaska Pipeline System ("Agreement"), this letter affirms my agreement that, for any Alaska producer affiliated with a TAPS Carrier, <u>the FERC Tariff Settlement Rates identified in Section 3(b) of this Agreement are the reasonable costs of transportation</u> for purposes of AS 43.55.150(a)-(c) and 15 AAC

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2 In pertinent part 15 AAC 55.195(a) provides, "If, in subsequent years, the federal tax rate changes, or other events occur that change the available federal income tax benefits, a revised level annual allowance must be calculated to yield the <u>same</u> after-tax return" (emphasis added).

3 Footnote 1 in 162 FERC ¶ 61,180 (February 28, 2018) states, "The parties are: BP Pipelines (Alaska) Inc.; ConocoPhillips Transportation Alaska, Inc.; ExxonMobil Pipeline Company; Koch Alaska Pipeline Company, LLC; Unocal Pipeline Company, <u>the State of Alaska</u>; Anadarko Petroleum Corporation; Tesoro Alaska Company LLC; Flint Hills Resources Alaska, LLC; and Petro Star Inc." (emphasis added).

4 *In re ConocoPhillips Transportation Alaska, Inc.*, Docket No. IS16-312-000, *et al.*, 162 FERC ¶ 61,180 Letter Order (February 28, 2018), p. 2, paragraph 3.

5 *In the Matter of the Tariff Rate Revision, Designated as TL131-301, Filed by CONOCOPHILLIPS TRANSPORTATION ALASKA, INC. for Revised Rates Pertaining to the Trans Alaska Pipeline; et al.*, RCA "ORDER ACCEPTING SITUPATION" (January 12, 2018).

6 While addressed to the pipeline-company executives, Commissioner Fisher's letter was submitted to FERC and to RCA by letters dated December 15, 2017 transmitting an "EXPLANATORY STATEMENT IN SUPPORT OF UNOPPOSED OFFER OF SETTLEMENT" (executed as of December 14, 2017 by all the parties, including Attorney General Jahna Lindemuth for the State of Alaska), including Attachment B thereto titled "Letters from Commissioner of Alaska Department of Revenue and Commissioner of Alaska Department of Natural Resources".

> 55.193 to the extent applicable to pipeline tariff rates for TAPS, for May 29, 2011, through December 31, 2015, and that the FERC Tariff Settlement Rates identified in Section 3(b) of this agreement are just and reasonable for the purposes of 15 AAC 55.193 to the extent applicable to pipeline tariff rates for TAPS. The Department of Revenue will not use the methodology set forth under 15 AAC 55.197 to determine the FERC TAPS cost of transportation for production tax purposes for purposes of the time period May 29, 2011 through December 31, 2015. [emphasis added]

The Commissioner's letter is already binding on DOR, including the Tax Division. Thus, amending 15 AAC 55 to reflect the provisions of his letter would change nothing legally and hence would be a "minor" change for purposes of the Notice. It would also put all producers — including those that may not be aware of the details of the settlements because they do not have affiliates owing interests in TAPS — on actual notice of what Commissioner Fisher has bound the Department to.

B. TAPS Tariffs for January 1, 2016 – June 30, 2020. Commissioner Fisher's letter of November 15, 2017 expressly states that DOR "will not use the methodology set for under 15 AAC 55.197" with respect to "the time period May 29, 2011 through December 31, 2015." However, the attorneys representing the State of Alaska in the FERC and RCA proceedings did have the legal authority to bind the State to the Variable Tariff Methodology —

- for interstate TAPS tariffs for periods from January 1, 2016 through June 30, 2021, and
- for intrastate TAPS tariffs for periods from January 1, 2016 through December 31, 2019 —

and they DID bind it. And so did Attorney General Lindemuth when she signed the "EXPLANATORY STATEMENT IN SUPPORT OF UNOPPOSED OFFER OF SETTLEMENT" on December 14, 2017 that was submitted to FERC the next day.

Since the State is already bound, it is also a "minor" change for purposes of the Notice to amend 15 AAC 55.193 and 15 AAC 55.195 – 15 AAC 55.197 so they will reflect the results from the Variable Tariff Methodology for the tax periods to which Methodology applies for interstate and intrastate TAPS tariffs.

C. Consistency in ROI methodology for tankers as their CCFs unwind. So-called "Capital Construction Funds" ("CCFs") are a federal income tax incentive for building U.S. vessels and ships that will transport goods, including crude oil, between locations within the United States. While details about how a CCF works are technical and complex, the basic idea is simple. Deposits into a CCF are tax-deferred until they are withdrawn from the CCF to pay for a vessel, but the vessel itself can be depreciated for income tax purposes to offset the withdrawals. Once depreciation has been taken for the vessel for tax purposes, the deductions and similar tax benefits that

> have been taken are reversed, and the result is that the deferred tax liability is eventually paid in the later years of a vessel's primary service life. The CCF thus works as an incentive because of the time-value-of-money benefit that results from deferring income tax liability on the money deposited into a CCF. And even this can be mitigated by making new deposits into the CCF during a vessel's later years that will be used for a new vessel to replace it.

15 AAC 55.193, 15 AAC 55.195 and 15 AAC 55.196 all ensure that these "front end" tax benefits of a CCF are reflected in calculating the allowance for a return on the capital investment in a vessel owned by a taxpayer or affiliate ("ROI Allowance").

Today the tankers that were built in the late 1990s and early 2000s in compliance with the Oil Pollution Act of 1990 (Pub. L. 101-380, 104 Stat. 484) are reaching – or may have reached – the point where the front-end tax benefits for the CCFs that built them are reversing.

15 AAC 55.196(d) requires taxpayers to calculate the "cost of capital allowance" for any vessel they own (or an affiliate owns) "using the methodology set out in the department's publication *Computation of a Cost-of-Capital Allowance under 15 AAC 55.196, Incorporating Depreciation and Return on Investment Capital for Marine Vessels and Improvements*, Second Edition, dated September 19, 2003 and adopted by reference." The publication is basically a set of instructions for creating spreadsheets under computer software like Excel® to perform the necessary arithmetical calculations.

It is important that Revenue's "master" set of spreadsheets for these calculations not be altered on the pretext that the reversal of income tax benefits from a CCF for a vessel are over-stating the proper capital costs for that vessel. Its capital costs are not being overstated because the ROI Allowance is "an amount" — that is, one uniform annual amount over a vessel's expected useful life — "that, when added to the amount of depreciation … will provide a reasonable return on the acquisition cost … of the vessel over [that] expected useful life." In other words, this reversal of income tax benefits toward the end of a vessel's expected useful life has already been built into the calculation of the ROI Allowance that is applicable for the vessel's entire "expected useful life."

Preserving the status quo is manifestly a "minor" change for purposes of the Notice, and accordingly we recommend adding specific language to 15 AAC 55.196 — either as a provision in subsection (d) or as a new subsection — that expressly states that the ROI Allowance does not change merely because a vessel reaches the point in its life where the front-end income tax benefits from the CCF for it start to be recaptured.

D. Consistency in ROI methodology for tankers as their basic charter-hires come to an end. This is a corollary to the previous point. For the same reasons that the ROI Allowance should not change because the income-tax benefits from a CCF are reversing for the ship-owner, neither should they change because the long-term charter that was the legal vehicle that allowed the vessel to be built and financed is now nearing its end. Amending 15 AAC 55.196 to state this would preserve the status quo and thus would be a "minor change" for purposes of the Notice.

Sincerely,

Kara Moriarty

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President/CEO