Alaska Oil and Gas Association

AOGA

121 W. Fireweed Lane, Suite 207
Anchorage, Alaska 99503-2035
Phone: (907) 272-1481 Fax: (907) 279-8114

October 24, 2017

Mr. John Larsen, Audit Master
Tax Division, Alaska Dept. of Revenue
550 West 5th Avenue, Suite 500
Anchorage, AK 99501

Re: Oil and Gas Properties Tax (AS 43.56) - Proposed Amendments to 15 AAC 56.100 Valuation of Production Property

Dear Mr. Larsen:

Enclosed for the record are comments of the Alaska Oil and Gas Association ("AOGA") and its members regarding the proposed amendments to 15 AAC 56.100. For nearly half a century AOGA has been the trade association of the petroleum industry in Alaska, and our members actively continue to explore for, develop, produce, transport, and refine oil and gas in the state. In keeping with our practice regarding tax matters, all our members have had the opportunity to review and comment on these comments here as they were being developed, and they have been approved without dissent.

The Department of Revenue gave public notice of these proposed amendments on September 18, 2017, following its "Property Tax Workshop" held in Anchorage on July 11, 2017.

Please contact me if the Department has any questions or comments regarding these comments.

Very truly yours,

ALASKA OIL AND GAS ASSOCIATION

Kara Moriarty

Kara Moriarty
President/CEO

Cc: Commissioner Sheldon Fisher, Department of Administration
Attorney General Jahna Lindemuth

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COMMENTS OF THE
ALASKA OIL AND GAS ASSOCIATION ("AOGA")
REGARDING PROPOSED AMENDMENTS TO 15 AAC 56.100
PERTAINING TO THE VALUATION UNDER AS 43.56 OF
PROPERTY USED OR COMMITTED FOR USE IN OIL AND GAS PRODUCTION

OCTOBER 24, 2017

The proposed amendments would REDUCE the State's overall tax revenue. The proposed amendments would materially increase the assessed value of the "production property" [1,*] they are applied to. Since the tax under AS 43.56 is a flat 20 mills, the result would similarly be a material increase in the property tax on that production property. Yet, despite this, the State stands to lose tax revenue overall because of two things.

First, roughly 90 percent of the production property in Alaska is located on the North Slope. The North Slope Borough's property tax — currently 17.99 mills in 2017 — is a credit under AS 43.56.010(d) against the State's 20- mill tax. This means ${}^{17.99}/_{20}$ or 90% of the increase in tax under the proposed amendments would go to the Borough and 10% to the State.

Second, the entire amount of the 20-mill tax on production property is a "lease expenditure"[2] under the Oil and Gas Production Tax in AS 43.55.011, which normally[†] is 35% of the "net" value of North Slope production after lease expenditures for that production.

Thus, for each dollar of additional property tax for North Slope production property that the proposed regulations would generate, the State would receive only a dime of that property tax while forgoing 35 cents in production tax under the Spring 2017 revenue forecast.[3]

[*] Endnotes like the adjacent one here (setting out the statutory definition of "production property") provide primarily technical information or documentation, they are indicated by being numbered, and they appear at the end of this document in the "ENDNOTES" section. Footnotes supplement the substance of the text they appear with and are at the bottom of the page the text is on so one can see the supplement at the same time.

[†] Under AS 43.55.011(f) production tax for North Slope production is based on 4% of the "gross" value of taxable production if this is greater than the 35% tax on the "net" value for an entire calendar year. The 4% rate steps down by one percentage-point at a time if the West Coast spot price of North Slope oil averages $25 a barrel or less for the year, becoming zero if that average is at or below $15.

<u>The "scaled-production" valuation methodology[*] is not authorized under AS 43.56.060(d)</u>. AS 43.56.060(b) requires that "[t]he department shall[†] assess property for the taxes levied under AS 43.56.010(a) *at its full and true value*" (emphasis added). AS 43.56.060(d) prescribes that this "full and true value" is to be determined for production property "on the basis of replacement cost less depreciation based on the economic life of proven reserves."[4]

Slide 6 of Assessor Greeley's slides at the Workshop shows the assessment of production property as having two "Phase[s]". The first is the "Pre-Decline Phase (ramp up or plateau production)" when the cost of a production facility is depreciated on a straight-line basis at 1% per year. Phase 2 is the "Decline Phase" when the scaled-production methodology applies, and it begins when "current" production (i.e., production during the calendar year immediately before the year for which the assessment is being made) is "10% or more off peak or plateau production[.]"

During Phase 2, the assessed value of production property equals its replacement cost new, times a factor reflecting its "percent good" — which is "the inverse of depreciation[.]" *Greeley Slide 8 ("Updated 7-12-2017")*. This "percent good" equals —

(Reservoir Current Production / Reservoir Historic Peak Production) ^ SF

where " ^ " indicates that the term following it is an exponent for the term preceding it, and "SF" is a number that, in Assessor Greeley's slide, is chosen to be 0.69. *Id*.

The legal failing of this approach lies in the fact that, in Phase 2 (which is most of the life of a production property), the assessed value would be determined by "Current Production" and "Historic Peak Production" — and neither of these production volumes, nor the ratio of either volume to the other, is "based on the economic life of proven reserves" as AS 43.56.060(a) and (d) require. "Economic life" is inherently temporal, while "Production" is physically volumetric. Logically they cannot be the same.

The Tax Division cannot use administrative efficiency as the justification for ignoring the statutory requirement to calculate depreciation based on the economic life of proven reserves. The statute makes no mention of current versus peak production as the measure of depreciation. The Alaska State Legislature has voiced its intent through clear statutory language and the

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[*] The discussion of the scaled-production methodology in this section and the following one relies on the description of the methodology by Jim Greeley, State Petroleum Property Assessor, during the Property Tax Workshop held by the Tax Division in Anchorage on July 11, 2017, and particularly slides 6 – 12 of his presentation.

[†] The use of "shall" here makes this sentence mandatory for the Department to follow. *See* Legislative Affairs Agency, Alaska State Legislature, *Manual of Legislative Drafting* (Juneau: 2017) at 65:

> Use the word "shall" to impose a duty upon someone. The Alaska Supreme Court has stated that the use of the word "shall" denotes a mandatory intent. <u>Fowler v. Anchorage</u>, 583 P.2d 817 (Alaska 1978). . . . For example:
>
> > The commissioner <u>shall</u> issue a license …, <u>i.e.,</u> it is the commissioner's duty to do so.
> > [underscoring and unspaced ellipsis in original]

Department must abide by that intent.*

The proposed depreciation methodology's disconnect from the economic life of proven reserves is exacerbated by the methodology's exclusive focus on current versus peak production without considering age-life depreciation, functional obsolescence (cost to cure) or external obsolescence such as super-adequacy. Simply put, the scaled production methodology only estimates external/economic obsolescence. It does not approximate excess cost, physical deterioration or functional obsolescence, and represents only the level of economic obsolescence inherent in the facility due to lack of utilization or inutility over the life of the asset — again, based on production and not the economic life of proven reserves.

In regard to functional obsolescence, the proposed methodology uses only a utilization adjustment based on current versus peak throughput and thus disregards actual capacity. If a field's production never reaches actual capacity of the production properties, the methodology fails to capture a meaningful component of obsolescence, but would ostensibly capture the cost of that excess capacity in the replacement cost. The taxpayer would suffer the burden of excess cost that does not add value, but would not be allowed depreciation for it.

The proposed methodology is not a proxy for both depreciation and obsolescence. Even if utilization is maintained at 100%, depreciation should still occur, and obsolescence may occur as well. The methodology makes no provision for these scenarios and its failure to capture depreciation is particularly acute for properties that are in the "pre-decline phase." The allowance of 1% per year is simply not adequate given the substantial depreciation that occurs early in the life of a field. The proposed regulations do not indicate whether the Department intends to adjust costs for inflation as it has in the past, but such an adjustment could be greater than 1% per year. The result would be no meaningful depreciation for a number of years. The argument that depreciation would be captured when the field is in decline lacks merit from a time value of money perspective.

The proposed regulations would also likely generate other unreasonable and incongruous results. For instance, a taxpayer that is optimizing production may not benefit from the depreciation required by statute. Further, once production drops below the arbitrary 90% threshold, the assessed value of the property may actually rise due to decreased depreciation attributable solely to the proposed methodology. In turn, a subsequent rise in production above the 90% threshold may raise the assessed value in a later year due to the reversion back to the previous percent good.

We are also concerned about the proposed methodology's treatment of wells. The proposed regulations make no mention of how wells will be treated. If the methodology will be applied to wells, we have the same concerns — depreciation would not be based on proved reserves and the methodology fails to address age/life depreciation and functional obsolescence and only captures

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* "While every word of a statute must be presumed to have been used for a purpose, . . . every word excluded from a statute must be presumed to have been excluded for a purpose." *Ganz v. Alaska Airlines, Inc.*, 963 P.2d 1015, 1019 (Alaska 1998).

some form of economic obsolescence. Also, although wells that are plugged and abandoned should not be subject to property tax, wells that are suspended have been taxed in the past and additional depreciation is warranted if they will be taxed in the future. Taxing suspended wells without a "shut-in factor" to reflect their status would be unreasonable and a departure from the Department's past practice.

Greeley Slides 2 and 3 appear to be trying to justify the "percent good" approach in the scaled-production methodology on the ground that production property is "special purpose" property and there is a very "limited market" for it which are similar to the situation with TAPS, and assessment of production property on the basis of replacement cost new minus cumulative depreciation has been "[p]hased out by DOR over the last four years with municipal and tax-payer review and input[.]" *Greeley Slide 4*.

These rationalizations are erroneous and readily debunked. First, there have been a number fairly recent sales of working interests in fields on the North Slope and in Cook Inlet, which offer market data. And there is always the possibility of more. So, instead of abstract, theoretical constructions about what the market might be now or might have been, the Department should take advantage of the present availability of empirical data that have not gone stale.

Second, about the alleged precedent[5] from the assessments for TAPS, to the extent there is such precedent, TAPS is a pipeline – not a production property – and so its assessment valuation is inapplicable here because production property is assessed under a separate, and substantively different, subsection of AS 43.56.060 from the one for TAPS.

And third, any "phase out" of assessment methodology that may have happened "over the last four years with municipal and taxpayer review and input" does not, and cannot, amend the statute. Only the legislature — or the people of Alaska by initiative or referendum — can enact, amend or repeal statutes. Until one of these happens, the Department is legally bound by what the statute requires, and any amendment to 15 AAC 56.100 that is inconsistent with the statute would not be "valid or effective" under AS 44.62.030 in the Administrative Procedure Act and could be challenged in court under AS 44.62.300(a) on this ground.

<u>Substantive flaws and omissions in the proposed amendments</u>. Quite apart from the legal problems and concerns discussed above, there are a number of defects, problems and issues about how the proposed amendments, if adopted, would operate in practice.

The exponent. 15 AAC 56.100(a)(3) describes how the exponent would be applied to the current-vs.-peak-production "quotient" to calculate the "percent good factor." And Assessor Greeley's slides 8 – 10 make a *prima facie* case for an exponent of 0.69, which is the most crucial parameter in the calculation of the "percent good." But the proposed amendments do not specify that the exponent under them will be 0.69, or any other fixed value (a higher number may be warranted) . They do not specify whether there would be specific exponents for individual fields or groups of fields, or whether "one size fits all" as Assessor Greeley's Slides 8-10 suggest. They do not specify whether a given exponent is fixed or redetermined periodically, and if the latter, how often. Nor do they specify the data and methodology by which an exponent would be calculated. Under the principles of Due Process and Equal Protection in the Alaska and federal constitutions, the Department cannot promulgate exponents willy-nilly however it wishes, without some standards to measure their reasonableness and their consistency with one another.

The exponent "scaling factor" should not be used in all circumstances. It represents the fact that a property has a value even though the property may be severely underutilized or idle, so using such a factor makes sense if the facility is severely underutilized. Using a scaling factor does not make sense in all cases for facilities and wells (if this exponent will be used for well valuations).

Reversal of decline back above 90% of historic peak production. It is unclear to us how the last sentence in proposed 15 AAC 56.100(a)(4) would operate. It says:

> If new proven reserves reverse a production decline such that annual production is above ninety-percent of the historic peak production, or results in a new peak of production, depreciation will revert back to where it left off on the original one-percent per year schedule for the property as prescribed in (2)(A) of this subsection, until production decline.

In the initial case where new reserves reverse the decline and raise production back above 90% of the historical peak, it is not clear what the depreciation would "revert back" — suppose the original 1% a year lasted 6 years so the percent-good was 94%, would this reverting-back be to 94%, or to 93% because the new production would be in the 7th year? In the case of new reserves "result[ing] in a new peak of production," would the resulting percent-good increase back to 100%, or to 94 or 93% (depending on the answer to the previous question), or to something else?

More fundamentally, the sudden jump in assessed value of the production property under this proposal not only defies the concept of depreciation over the life of an asset, but would also create a significant economic disincentive for producers to let new reserves raise production back above 90% of the historic peak production. We fail to see why it would be good policy for the State to encourage the potential throttling-back of new production (as this proposal would do) unless the new reserves are so large and commercially robust that they can overcome the significant economic handicap which this proposed amendment would create.

Purported relief for "extenuating circumstances" under 15 AAC 56.100(a)(5). This paragraph in the proposed regulations reads in pertinent part as follows:

> (a) … Value will be determined on a replacement cost less depreciation basis using the following methods:
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> * * * *
>
> (5) <u>the department will not deviate</u> from the provisions set out in this section <u>unless extenuating circumstances exist to justify deviation as determined by the department in its sole discretion</u>. Extenuating circumstances may include reservoirs that immediately and significantly underperform resulting in abnormal

> and excessive superadequacy of a property, and reservoirs that significantly over perform resulting in the facility constraint of a property. In addressing an extenuating circumstance <u>the department may, in its sole discretion, modify the assessment methods contained in this section</u> to account for the extenuating circumstance, <u>or rely on other acceptable methods to assess the property</u>. An extenuating circumstance does not require the department to modify the assessment method unless the assessment would be unequal, excessive, or improper without the modification. If seeking an adjustment to the assessment based on an extenuating circumstance <u>the burden of proof will be on a taxpayer or municipality to come forward with clear and convincing evidence that an adjustment is necessary. It is not sufficient for the taxpayer or municipality merely to show that an extenuating circumstance exists. Instead, a taxpayer or municipality must provide information that demonstrates the department's replacement cost or depreciation estimates are materially insufficient</u>. The department <u>may leave an assessment calculation unadjusted even if the facts show an extenuating circumstance to exist</u>. [emphasis added*]

It is worthwhile to review individually the underlined provisions being proposed, in order to see the progression of thought as the paragraph unfolds.

First, "the department will not deviate from [paragraphs (1) – (4)] unless extenuating circumstances exist to justify deviation as determined by the department in its sole discretion." It would be much simpler to say, "the department will not deviate from [paragraphs (1) – (4)] unless it determines that extenuating circumstances justify the deviation." The words "as determined by the department in its sole discretion" are unnecessary — who else would be making the determination? and in making it, wouldn't the department automatically be using its own discretion in deciding whether a "deviation" is "justif[ied]" without having to say anything in the regulation about its discretion?

Next, the regulation says extenuating circumstances "may include" reservoir underperformance and over-performance — which implies that other kinds of extenuating circumstances could also exist — even though, between the two of them, "under" and "over" performance covers the entire logical range of how a reservoir could perform differently from the performance expected when its production facilities were being designed and built. The choice of words here in the regulation leaves it open for the department to invent new extenuating circumstances based on something different from designed capacity of production facilities versus the volume of production they actually handle when the field first starts up. This possibility of inventing is expressly reinforced by the statement that "the department may, in its sole discretion, modify the assessment methods contained" in the other paragraphs of subsection (a). But the problem is, there is nothing in the proposal about the criteria for deciding how the "assessment methods" should be "modif[ied,]" nor anything about the procedures for taxpayers and municipalities to share their ideas about how and why the "assessment methods" should be "modif[ied.]" All there is, is the

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* All of the text set out in the quotation is text being proposed for adoption. None of it is in the regulation now.

department's "sole discretion[.]"

Further, the department may — instead of "modify[ing] the assessment method [under the regulation]" — "rely on other acceptable methods to assess the property." "[A]acceptable" to whom? clearly, this means "acceptable" to the department "in its sole discretion[.]" Taken literally, this means that, whenever "extenuating circumstances exist" as the department "determines[,]" it can ignore all the written provisions in the regulations about determining the assessed value of production property and simply make up and apply willy-nilly anything it wants instead, no matter how different or inconsistent it may be with the provisions in paragraphs (1) – (4) that are being written into the regulation.

Yet, even in that case, "the burden of proof will be on a taxpayer or municipality" to show by "clear and convincing evidence that an adjustment [to the department's chosen] assessment method] is necessary." This "clear and convincing" standard is significantly more strict than showing that it is more likely than not that the department's "replacement cost or depreciation estimates" are "materially insufficient" — it requires showing that it is substantially more likely than not that they are "insufficient. This is not quite the "beyond a reasonable doubt" standard for criminal convictions, but it's pretty close. It imposes a burden of proof on the taxpayer or municipality that would be difficult to meet even if there were any identified criteria in the regulation for judging whether the department's "replacement cost or depreciation estimates" are "materially insufficient" and that "an adjustment [to them] is necessary." The lack of objective criteria about material insufficiency makes it virtually impossible make such a showing and meet this burden of proof.

Article I, section 7 of the Alaska Constitution provides:

> No person shall be deprived of life, liberty, or property, without due process of law. The right of all persons to fair and just treatment in the course of legislative and executive investigations shall not be infringed.

The first sentence is the "Due Process" clause, while the second guarantees "fair and just treatment" at the hands of the government. Alaska case law has focused on the Due Process clause, and we are unaware of any decisions by the Alaska Supreme Court on the "fair and just treatment" clause.

With respect to Alaskan Due Process, municipalities are entitled to it the same as individuals are — *City of Homer v. State, Dep't of Natural Resources*, 566 P.2d 1314 (Alaska 1977) — so in this discussion we will not distinguish between situations where a municipality seeks to show that an adjustment to "replacement cost or depreciation estimates … is necessary[,]" and where a taxpayer seeks it.

While no one has a vested right in any particular mode of procedure, Alaska Due Process does require that a substantial and efficient remedy remains available. *Arctic Structures, Inc. v. Wedmore*, 605 P.2d 426 (Alaska 1979). Proposed 15 AAC 56.100(a)(5) denies anything close to even a feasible "remedy" — much less one that is "substantial" and "efficient[.]" It is a target without anything defining what it is, nor how it can be achieved.

Yet proposed 15 AAC 56.100(a)(5) has one final, but stunning surprise — "even if the facts show an extenuating circumstance to exist" that "demonstrate[that] the department's replacement cost or depreciation estimates are materially insufficient[, t]he department may leave [the assessment calculation unadjusted[.]" So even if a taxpayer or municipality — despite all of the usually insurmountable obstacles that the regulation puts in the way of making such a showing — actually succeeds in making the necessary showing, the department can ignore it.

This is not Due Process, nor is it "fair and just treatment in the course of [the department's] executive investigation[]" into the assessed value of any given production property.

[OPTIONAL PARAGRAPH depending on who, if anyone gets the cc's of the Comments] Because of this, we have included Attorney General Lindemuth and Commissioner Fisher among the cc-recipients of these comments, and we respectfully ask them to read proposed 15 AAC 56.100(a)(5) and to make their views known about its legality and appropriateness.

ENDNOTES

[1] “Production property” means “taxable property used or committed by contract or other agreement for the production of gas or unrefined oil or in the operation or maintenance of facilities for the production of gas or unrefined oil[.]” *See* AS 43.56.060(d).

[2] AS 43.55.165(b)(1)(B) specifically includes “payments of or in lieu of property taxes” among the “direct costs” allowed as lease expenditures under that statute in the calculation of the taxable “net” value. This has been part of the production tax since it was first converted in 2006 from the former “ELF”-based tax on the gross value of production to a tax on the “net” value. *See* ch. 2, § 25, TSSLA 2006 at p. 27, lines 22-23 and 28-29.

[3] SOURCE: State of Alaska, Department of Revenue, *Revenue Sources Book Spring 2017*, p. 11, “Table 4-4: ANS Oil & Gas Production Tax Data Summary” (column for FY 2018). The “ANS Wellhead” of $44.21 a barrel in Table 4-4 is the “gross” value of the production, and the 4% minimum tax based on that “gross” value under AS 43.55.011(f) equals $44.21 per barrel times 403,400 taxable barrels a day times 365 days times 4% — or $260.4 million.

The regular 35% tax on “net” value equals —

- the gross value of $44.21 per barrel times 403,400 taxable barrels a day times 365 days, or $6,509,524,610

minus

- “Deductible North Slope Expenditures” of $5,497,900,000 (using the higher of the two figures given for these expenditures in Table 4-4)

for a “net” value of $1,011,624,610, times 35%, equals

- $354,068,613 of “net” tax.

This is over $90 million more than the $260.4 million calculated in the first paragraph of this endnote for minimum tax under AS 43.55.011(f). If the lesser of the two figures given in Table 4-4 for “Deductible North Slope Expenditures” is used, the “net” value would go up from the figure above, and so would the amount of the 35% tax on “net” value.

[4] In full, AS 43.56.060(d) provides:

> (d) *The full and true value of taxable property* used or committed by contract or other agreement *for the production of gas or unrefined oil* or in the operation or maintenance of facilities for the production of gas or unrefined oil *is*
>
> (1) on the construction commencement date the actual cost incurred or accrued with respect to the property as of the date of assessment;
>
> (2) *determined* on each January 1 thereafter *on the basis of replacement cost less depreciation based on the economic life of proven reserves*. [emphasis added]

[5] E.g., *BP Pipelines (Alaska) Inc. v. State*, 325 P.3d 478 (Alaska 2014).