Alaska Oil and Gas Association

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September 10, 2020

Mr. John Larsen, Audit Master
Tax Division, Alaska Department of Revenue
550 West 7th Avenue, Suite 500
Anchorage, AK 99501

Re: Public Scoping Request 15 AAC 05 and 15 AAC 55 (August 31, 2020 Public Notice)

Dear Mr. Larsen:

The Alaska Oil and Gas Association ("AOGA") appreciates the opportunity to provide comments in response to the Department of Revenue's ("DOR") public scoping request for amendments to existing regulations in Title 15, Chapters 05 and 55. 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 contribute to these comments and they have been approved without dissent.

Our comments concern regulations DOR has identified as open for possible changes and additions pursuant to the public scoping notice dated August 31, 2020. Based on the public notice, DOR is soliciting input on existing regulations regarding the use of confidential information, monthly filings, direct charges, prevailing value of oil, the valuation of oil run through a crude oil topping plant and used in lease operations, and others for consideration.

We appreciate DOR's efforts to improve the State of Alaska's existing regulatory framework. AOGA has identified several items we believe would further clarify and streamline the implementation and management of the AS 43.55 production tax. These areas for improvement include:

15 AAC 55: Oil and Gas Production Tax and Oil Surcharge

15 AAC 55.171 Prevailing Value for Oil

Our members recommend that DOR recognize that the FERC tariff is the "applicable tariff" for the calculation of prevailing value under 15 AAC 55.171(g) for North Slope oil sales.

15 AAC 55.260 Direct Charges
Our members propose aligning the application of 15 AAC 55.260 with modern industry practices in regard to labor charges.

- 15 AAC 55.260(a)(3) – "On a Site"
  A few subsections, including (a)(3), use the phrase "on a site" or "on the site" or "in the vicinity of operations." Over time, it has become evident that some interpret this to mean labor must occur almost next to the well to be "direct," and that sometimes even being "on the North Slope" is inadequate. This interpretation is impractical due to the remote and costly environment of the North Slope, as well as the technical expertise required for the performance of certain tasks. It also fails to recognize modern technology and industry practices that allow both technical and non-technical employees and contractors to perform much of their work in locations other than the actual field.

  Developing large scale oil and gas resources requires identifying specialized professional employees (often with advanced degrees or training) from various technical disciplines, such as engineering and geology. These employees conduct both (1) the essential, sophisticated engineering design, drilling, and operational work necessary to develop the resource and (2) the preparation and acquisition of necessary permits, due to the technical knowledge implicitly required. Historically such work, necessary for the successful execution of the project, may be performed by qualified individuals located off-site or even out of the state.

  Under 15 AAC 55.260(a)(3)(B)(i), labor costs are deductible for technical employees executing tasks within their technical skill set to address issues, operating conditions, or support operations of an oil and gas resource. This subsection contains no language specifying that this work must be conducted on-site, or in the vicinity of the site, to be considered an allowable lease expenditure. Additionally, some labor, for example testing core samples, is without doubt directly related to exploration and development of oil and gas. Yet, due to the 15 AAC 55.260's general use of "on a site," such necessary labor expense unjustly becomes a controversial lease expenditure.

  The COVID-19 pandemic is a clear example of when labor had to be moved off the North Slope to Anchorage for completion. While this labor is no less "direct" than before, some may deem it no longer qualifes depending on the interpretation of "on the site" or "in the vicinity." As the industry continues to adapt to changes from the ongoing pandemic, it is reasonable to expect this type of arrangement to become even more common place.

  Therefore, our members recommend the DOR draft regulations affirmatively providing that taxpayers are eligible for deductions related to direct labor costs, even when performed off-site or out of the state by technical and non-technical employees. By interpreting the direct labor costs incurred in 15 AAC 55.260(a)(3)

expansively, the DOR would acknowledge the practical realities of developing large-scale oil and gas assets. Simply put, "the site or vicinity of operations" can be located virtually anywhere, including outside of Alaska.

- 15 AAC 55.260(a)(3) – Conformity with Statutory Allowances
  Subsection (a)(3) excludes from allowed labor costs "tax, legal, purchasing, or accounting matters, or matters involving a dispute before a government agency…" Our members share concern such regulatory disallowances are overbroad. In contrast, the production tax statute only excludes lobbying, public relations, advertising and policy advocacy (AS 43.55.165(e)(21)) and certain legal costs related to disputes with the state (AS 43.55.165(e)(8)). Additionally, other non-labor costs associated with purchasing are permitted under 15 AAC 55.260(a)(9). Therefore, the categorical exclusions and the breadth of the regulation encompassing more than disputes with state government warrant a review to reconcile this subsection with its authorizing statute.

  Further, overtime it has become evident that the term "purchasing" has differing definitions and in some cases has been interpreted to include the movement of goods to and from the North Slope, or what most would consider transportation and/or logistics. It has also been, at times, interpreted to preclude expenditures for technical labor, such as for engineers that are putting together plans and specifications for particular equipment.

- 15 AAC 55.260(a)(12)(B) – Equipment Purchases
  Subsection (a)(12)(B) appears to say that if equipment was previously purchased and charged to working interest owners, then it will not be considered a direct cost to a different joint operation. Due to the statutory provision requiring a reduction of lease expenditures for the sale or transfer of an asset, this regulation does not appear to be necessary. A new joint operation that purchases used equipment should have a lease expenditure, and reduction of lease expenditures by the seller would mitigate any risk to the State.

- 15 AAC 55.260(a)(20) – Fair Market Value Determination
  Subsection (a)(20) has led to differences of opinion since it was adopted, creating considerable uncertainty. The determination of Fair Market Value (FMV) of the oil or gas produced but not sold is unclear. DOR should resolve such uncertainty by providing regulations that FMV be determined by reference to the price a producer would have to pay a willing third-party provider to purchase the commodity.

- 15 AAC 55.260(c)
  Subsection (c) should be evaluated for its purposes and whether it has any practical application. It is unclear how the concept of "fair market value" and subsection (a)(12) relate.

- 15 AAC 55.260(d)
  Subsection (d) should be reconsidered in light of non-consent operations. Sometimes working interest owners opt-out and one working interest owner continues but pays 100% of the costs. The costs are not any less direct simply because one working interest owner incurs them rather than all. Yet, subsection (d) as written could cause a difference of opinion on audit.

15 AAC 55.520 Monthly Filings

This regulation lists a significant amount of information and documentation that is required each month. Since the monthly tax payments are estimates and the audit is of the annual return, narrowing the monthly filings to the documents used by DOR on a monthly basis would lead to efficiencies for both for the State of Alaska and the taxpayer. Alternatively, requiring the information submissions on a quarterly basis would alleviate some of the administrative burden.

Additional Regulatory Considerations

Our members also suggest the following new regulations for consideration:

- Unscheduled Interruptions
  Regulatory guidance by DOR regarding the exclusion from lease expenditures for unscheduled interruptions in production under AS 43.55.165(e)(19), including materiality thresholds.

- Regulatory Guidance Concerning AS 43.55.170
  In particular, it is counterintuitive to apply this statute to major asset sales (i.e. sales of entire oil and gas fields, in which only a portion of the purchase price could reasonably be allocated to assets acquired as a result of lease expenditures as opposed to leases and reserves). If DOR is absolutely set on applying this statute to sales of entire fields, it should clarify that the purchaser can claim as lease expenditures the same amount the seller reports as an AS 43.55.170 adjustment.

- Revisiting Advisory Bulletin 2017-01
  Revisiting Advisory Bulletin 2017-01 is recommended, specifically regarding the application of credits against the North Slope minimum tax when a purchaser uses the per barrel credit under AS 43.55.024(j)

- Confidentiality
  If DOR is going to (continue to) pursue obtaining invoices and similar documents of expenses incurred in unit operations directly from the unit operator, and then use those documents in auditing lease expenditures of the working interest owners in the unit, DOR should consider that the operator has two roles: operator and working interest owner/taxpayer. Given that the taxpayer information of all of the working interest owners – including the operator – is confidential, in order to ensure protection of confidentiality, DOR should adopt a regulation establishing processes and safeguards for audits and production of documents.

Finally, while perhaps outside the context of Title 15 regulatory changes, we would nevertheless also appreciate DOR's consideration in addressing audit inefficiencies through a variety of means, including:

- Making good use of joint interest billings and joint interest audits in the audit process to increase audit efficiency.
- Implementing policies to refine issue targeting within audits, including issue selection based materiality, sampling, and reducing audit effort on low risk issues.
- Recognizing that many upstream and downstream costs are stable and do not require a detailed review of every account and invoice for every audit.
- Not re-creating a taxpayer's workbooks and calculations from scratch when a review and verification of them is adequate.
- Establishing audit policies that are consistent from one audit cycle to the next—regardless of the auditor.
- Incorporating appeal decisions into audits such that issues need not be repeatedly contested.
- Providing clear, concise audit work papers.

We appreciate the opportunity to comment and recognize the value in DOR's efforts to improve regulations and process efficiency for both the State of Alaska and Alaska's taxpayers.

Please contact me if DOR has any questions or would like to meet to discuss these comments.

Sincerely,

ALASKA OIL AND GAS ASSOCIATION

Kara Moriarty
President/CEO

CC: Colleen Glover, Tax Division Director, Alaska Department of Revenue