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July 31, 2017

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

Re: Notice of Public Scoping and Workshop for Possible Updates and Revisions to DOR Regulations 15 AAC 56: Oil and Gas Exploration, Production, and Pipeline Transportation Property Tax.

Thank you for the opportunity to provide comments regarding the possible revisions to the referenced Property Tax regulations.

GENERAL COMMENTS:

BP's pioneering role on the Slope. BP geologists began on-the-ground exploration of the coastal plain and foothills north of the Brooks Range in 1960, three years before Alaska selected any land on the North Slope as part of its land entitlement under the Statehood Act. In the first North Slope lease sale (December 1964), BP with its 50-50 co-bidder Sinclair won leases that turned out to have over 80% of the oil reserves in the Kuparuk River field. Sinclair declined to bid in the July 1965 lease sale and BP, bidding alone, won leases containing a little over half the oil and an eighth of the gas in the supergiant Prudhoe Bay reservoir, while Atlantic Richfield ("ARCO") and Exxon (bidding 50-50 together) won leases containing over 40% of the oil and 80% of the gas. In October 1968 BP, ARCO and Exxon formed the original joint venture to design and build the Trans Alaska Pipeline System ("TAPS") and BP still owns the largest share in TAPS. When the Prudhoe Bay field was unitized in 1977, a BP subsidiary was the operator of the western portion of the field and later, starting in 2000, became Prudhoe's sole operator.

Present situation. BP's total North Slope production ("ANS") averaged 280,000 barrels per day ("b/d") during calendar year 2016 and somewhat more so far this year.

Beginning in August 2014 the energy industry has been hit hard by a severe decline in the price of crude worldwide. The spot price for ANS delivered on the U.S. West Coast dropped from over \$100 a barrel to less than \$30 at times, and in June this year it averaged \$47.378 (SOURCE: <http://www.tax.alaska.gov/programs/oil/prevaling/ans.aspx>). This change in prices has weakened oil and gas production economics in Alaska and has also had similar effects on the State's annual budget.

The Department of Revenue's "Replacement Cost New Less Depreciation" methodology uses base year cost (1998), escalates that cost into a current replacement cost (2017), and then adjusts that amount for depreciation based on production levels and scaling to arrive at the assessed value.

The 2017 assessed value was \$6.667 billion for BP's production property on the North Slope. With such a large starting point, any material change to the methodology for calculating it stands to cause significant changes — favorable or unfavorable, depending on the particular change — in future assessed values and the resulting tax under AS 43.56 for that property.

STATEMENT:

This proposed change to the calculation of depreciation for production property seems to be applying aspects of a judicial ruling that were limited to a specific regulated transportation pipeline; *viz.*, TAPS. To apply any aspects of that ruling to production property is a stretch of the judicial and rulemaking process. What benefit is gained for the DOR or taxpayers in trying to apply narrower and limiting appraisal methodology without knowing what future technology, oil prices, and production levels will be realized?

QUESTIONS:

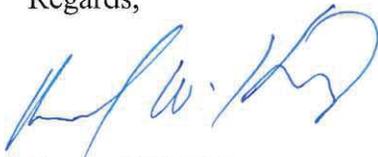
The Securities and Exchange Commission has defined the term "proved oil & gas reserves" in part as those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations.

1. How does the Alaska DOR address the reserve life of Prudhoe Bay based on the current market conditions? Logic would assume that the reserve life is dramatically impacted by a huge drop in market prices. When the current methodology was introduced oil was trading in the \$100/bbl. range. This methodology does not seem to account for economic obsolescence. A field's revenue stream must exceed its expenses for it to have true economic value.
2. A significant amount of equipment at Prudhoe Bay is over 40 years old. In the harsh North Slope environment is it realistic to assume that the equipment could potentially last another 40 plus years.
3. Current methodology doesn't consider retirements and replacements of outdated equipment. How can that be addressed in the future.

4. What impact would the proposed Gas Pipeline project have on the ability to produce oil from Prudhoe Bay? Currently up to 8BCF per day is re-injected back in the formation to keep pressure at a certain level. Without all of that gas being re-injected the oil production levels will be impacted.
5. What is DOR's position regarding the sale of assets and the differential between the existing RCNLD versus the new owners purchase price allocation of the assets purchased. We recognize that comparable sales cannot be used as a valuation methodology; however, these sales cannot be ignored as an indicator of obsolescence for similar assets.
6. Does equipment that has been fully depreciated under standard accounting practices still have economic value under the DOR's methodology even if that equipment is idle and unlikely to return to active operation?
7. One of the main advantages of the scaling factor is its general elementary application, however, if you do not account for changes in technology that now render large aspects of a current design obsolete super-adequate while other aspects cannot handle the volumes associated as the field changes the gas, oil and water production ratios over the 40 year period. A static scaling factor is not appropriate for appraisal of such a range of assets in age and size.
8. In your presentation on page 12 that a hypothetical 50 year development should have a percent good of approximately 25% in year 40. How does this reconcile with current percent good for Prudhoe Bay in year 40?

We look forward to participating further in any regulatory revision process regarding this subject.

Regards,



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July 28, 2017

John Larsen, Audit Master
Audit Master, Department of Revenue
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Re: Depreciation workshop – Alaska Department of Revenue Tax Division
Property Tax Workshop – AS 43.56.060(d)-(3) Depreciation
July 11, 2017

Dear Mr. Larsen:

Caelus Energy Alaska, LLC (“Caelus”) appreciated the opportunity to participate in the July 11, 2017 workshop where we were able to learn more about the Department of Revenue (“DOR”) Tax Assessor’s new depreciation methodology. We understand this new methodology will be proposed for possible regulatory adoption prior to the 2018 tax year, so we appreciate the opportunity to comment prior to that proposal.

Caelus does not believe the State Tax Assessor’s new depreciation method is in line with Alaska Tax Code Sec 43.56.060(d)(2) which states:

“The full and true value of taxable property...[shall be determined]...on the basis of **replacement cost less depreciation based on the economic life of proven reserves.**” (Current tax law)

or Regulation 15 AAC 56.100 which stated:

“Production property...will be valued on a replacement cost less depreciation basis. Depreciation will be based upon the economic life of proven reserves, with due consideration given to the elapsed life of the facilities. Replacement cost will be calculated by use of accepted appraisal techniques or other acceptable methods.” (Current tax regulation)

It seems clear that the DOR’s “scaled production methodology” [which calculates depreciation as (current production / historic peak production)⁶⁹] is inconsistent with both the current tax law and current tax regulation. Reproduction cost is being used as opposed to replacement cost, and depreciation is not being based on the “economic life of proven reserves,” as it does not attempt to estimate proven reserves or factor in the passage of time. Depreciation is also not being based on any kind of reasonable appraisal techniques.

Sec 43.56.060(d)(2) makes it clear that the Cost Approach should be used for the purposes of valuing production property; we believe all parties agree on this point. The Cost Approach is not ambiguous; it is very well defined and agreed upon by appraisal experts. The Cost Approach makes it clear that we should calculate value based on replacement cost new less all depreciation (including physical deterioration, functional obsolescence, and

economic obsolescence) also referred to as RCNLD. The American Society of Appraisers' *Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets* third edition chapter 3 titled "Cost Approach" states:

"Using the cost approach, the appraiser starts with the current replacement or reproduction cost new of the property being appraised and then deducts for the loss in value caused by physical deterioration, functional obsolescence, and economic obsolescence. The logic behind the cost approach is the principle of substitution: a prudent buyer will not pay more for a property than the cost of acquiring a substitute property of equivalent utility. The principle can be applied either to an individual asset or to an entire facility.

In its simplest form, the cost approach is the current cost (as if new) less all forms of depreciation. The appraiser identifies the property being appraised ("subject"), develops its current replacement or reproduction cost new, and subtracts all depreciation that makes it less desirable to own than if it were new or any other factors that may make it less desirable to own.

The replacement cost new is generally the proper starting point for developing an opinion of value using the cost approach. It is essential that the appraiser understand the difference between replacement cost new and reproduction cost new. Replacement cost is the current cost of a similar new property having the nearest equivalent utility as the property being appraised, whereas *reproduction* cost is the current cost of reproducing a new replica of the property being appraised using the same, or closely similar, materials. The replacement property would be the most economical new property that could replace the service provided by the subject. As professor James Bonbright states in *The Valuation of Property*: "Most physical properties are not replaced by properties of the same size, design, and materials. They are replaced by materially different properties of a more modern type, better designed to meet the owner's present needs."

The DOR's new methodology inappropriately uses *reproduction* cost instead of replacement cost. Alaska Tax Code Sec 43.56.060(d)(2) plainly states that property value should be determined "on the basis of replacement cost." We agree with the American Society of Appraisers' statement that "it is essential that the appraiser understand the difference between replacement cost new and reproduction cost new." To replace the current utility of an oil field which is in decline, you would not need to reproduce the entire existing infrastructure, but instead would only construct an asset capable of producing at the current production rate. The DOR clearly appreciated this concept given their previous depreciation method included an adjustment for unused excess production capacity, which the DOR refers to as super-adequacy. The valuation difference between replacement cost and production cost is drastic, and must be accounted for either in the State's calculation of replacement cost, or in the state's calculation of depreciation. The DOR's proposed new method no longer accounts for super-adequacy whatsoever; which results in less accurate valuations and incorrectly skews values upward.

The Cost Approach recognized three distinct types of depreciation an asset incurs over time, all of which should be accounted for in property valuation: physical deterioration, functional obsolescence, and economic obsolescence.

Physical deterioration is the loss of value from all causes of age and action of the asset. Physical deterioration, in the case of an oil field, is driven by the passage of time, and by the production of oil and gas volumes. The DOR's proposed "scaled production methodology" does not take into account the passage of time or the cumulative amount of volumes produced. This can be conceptually evidenced by a scenario in which an oil field in decline produces the same number of barrels two years in a row. In this instance, the new calculation would result in

zero depreciation being taken in the second year even though the equipment is one year old and has been worn down by an entire additional year of usage. Physical deterioration is a key part of valuation, yet the new methodology completely ignores this effect.

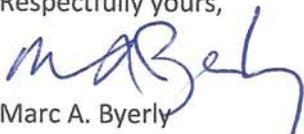
Functional obsolescence is a form of depreciation in which the loss in value or usefulness of a property is caused by inefficiencies or inadequacies inherent on the property itself, when compared to a more efficient or less costly replacement property. There are technological improvements that could be used in the design of the asset today which were not known 25 years ago; this fact should result in a downward adjustment to asset value over and above the physical deterioration an asset incurs over time. The DOR's previous depreciation method included a functional obsolescence component while the proposed "scaled production methodology" completely ignores this concept.

External obsolescence, also known as social or economic obsolescence is a cause of depreciation that reduces the value of an asset because of something external to the property itself. The American Society of Appraisers has stated: "Whenever the operating level of an asset or an entire plant is significantly less than its rated or design capability, and the condition is expected to exist for some time, the asset is less valuable than it would otherwise be. Such a penalty for inutility can be a measure of the loss from this form of economic obsolescence." This is the same topic discussed earlier regarding super-utility. We believe the external obsolescence/excess capacity/inutility/super-utility concept must be a factor in the calculation of RCNLD regardless of whether that adjustment is made in the calculation of replacement cost, or when factoring in external obsolescence. The DOR's proposed methodology ignores this important concept.

The DOR's proposed "scaled production methodology" does not account for physical deterioration or functional obsolescence at all, and its attempt to measure external obsolescence is misguided as it uses historical peak production in the denominator instead of production capacity (which is commonly accepted and was previously used by the DOR). The DOR's proposed method is inconsistent with the American Society of Appraisers description of the cost approach and external obsolescence, is inconsistent with Alaska Tax Code Sec 43.56.060(d)(2), and would result in drastically inaccurate/overstated asset valuations for many companies. The regulation is incredibly harmful to the economics of all properties, but will be particularly harmful to newer/future developments; as such projects will have to endure the hardship of this regulation for longer. The regulation could easily be the deciding factor between a project being developed and a project being permanently abandoned.

Thank you for considering these comments. We look forward to working together on an appropriate and fair conclusion to this matter.

Respectfully yours,



Marc A. Byerly
Vice President and Controller



Marie P. Evans
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RECEIVED

JUL 31 2017

**Tax Division
Department of Revenue
Anchorage, Alaska**

July 31, 2017

Mr. John Larsen
Audit Master, Department of Revenue
550 W. 7th Ave., Ste 1820
Anchorage, AK 99501

Re: Department of Revenue, Notice of Scoping & Workshop
Possible Updates & Revisions to DOR Regulations 15 AAC 56
Oil & Gas Exploration, Production & Pipeline Transportation Property Tax
(dated June 29, 2017)

Dear Mr. Larsen:

This letter responds to the request for input regarding the Department of Revenue's ("Department") Notice of Public Scoping & Workshop for Possible Updates & Revisions to DOR Regulations 15 AAC 56 ("Notice") dated June 29, 2017. Our response is organized based on the headings included in the Notice and then the Department's presentation.

Background for Regulation

The Department's Notice specifically expresses its belief that "subsection '(d)' of AS 43.56.060 covering production property should be treated consistently" with "the courts' decisions" from the Trans-Alaska Pipeline System. Yet, the Alaska Superior Court and the Alaska Supreme Court never received an appeal concerning production property (AS 43.56.060(d)) and certainly did not consider the facts, law or regulations applicable to such property. An extension of this nature goes beyond clarification or making a statute specific by regulation. "Use value" is not used in AS 43.56 or its regulations, the litigation on the Trans-Alaska Pipeline System did not present the facts and circumstances of assessing production property under AS 43.56.060(d) and we thereby recommend against the Department's proposed extended application of "use value."

Need for Regulation

The Department's Notice states it desire for a property tax depreciation methodology that is "efficient, transparent and easily verifiable." Efficiency, transparency and verification exist where a property tax system has regulations that interpret and make specific the statutes in a manner that taxpayers may analyze the accuracy and reasonableness of the entire property tax assessment rather than one part of the assessment.

By proposing to adopt a regulation for only scaled depreciation, assuming such regulation is clear and non-controversial, ample opportunity for misinterpretation, misapplication, misunderstanding, and disagreement persists over the remaining components of the assessment. For example, absent a common understanding on the starting point, replacement cost, it is difficult to ascertain whether one form of depreciation is appropriate. More than one form of depreciation may be occurring and need to be captured. Further, absent a defined starting point, any clarity gained by defining one form of depreciation may be easily obfuscated by diverse starting points.

If the Department is undertaking a regulation for depreciation, then the Department should consider defining the terms used in the statute:

(1) "Proven Reserves" - A definition would allow the taxpayer to factually understand, analyze and determine if the assessment properly reflects the property value. The Securities Exchange Commission, the U.S. Energy Information Administration, the Society of Petroleum Engineers and other commonly known associations have defined "proven reserves" and those definitions could be used. Providing a definition is necessary given that little definition existed in regulation for defining proven reserves.¹ The Department has an opportunity for efficiency, transparency and verifiability by adopting a definition commonly known, understood and readily applied for "proven reserves."

(2) "Replacement Cost" – A definition for "replacement cost" is typically the current estimate to construct a property as of the lien date to meet present day needs with up-to-date technology. While this definition seems straight-forward and common-sense, differing interpretation likely exist which provides plenty of opportunity for dispute.

¹ 15 AAC 56.100(a) is amended to read:

(a) Property used or committed by agreement for use in the production of gas or unrefined oil, or in the operation or maintenance of facilities for the production of gas or unrefined oil will be valued on a replacement cost less depreciation basis. Depreciation will be based upon the economic life of proven reserves, with due consideration given to the elapsed life of the facilities. Replacement cost will be calculated by the use of accepted appraisal techniques or other acceptable methods. ~~THE ECONOMIC LIFE OF PROVEN RESERVES WILL BE ESTABLISHED EACH YEAR USING PETROLEUM ENGINEERING METHODS.~~

In summary, isolating scaled production for a regulation without providing definitions and context for how it will be applied is unlikely to result in efficiency and transparency.

Presentation

The Department explained it is seeking to use the scaled production methodology because it is simple and efficient. Simple and efficient are understandable, especially with limited resources, but not at the cost of an improper assessment resulting in the wrong amount of tax. The scaled production methodology alone does not automatically result in a proper assessment.

(1) The “pre-decline phase” per the Department is 1% of depreciation per year based on something the Department studied (Attachment A – Department, Slide 6). The 1% of depreciation may be more or less than the actual facts and circumstances of the property, which will not result in assessing the proper amount of tax due.

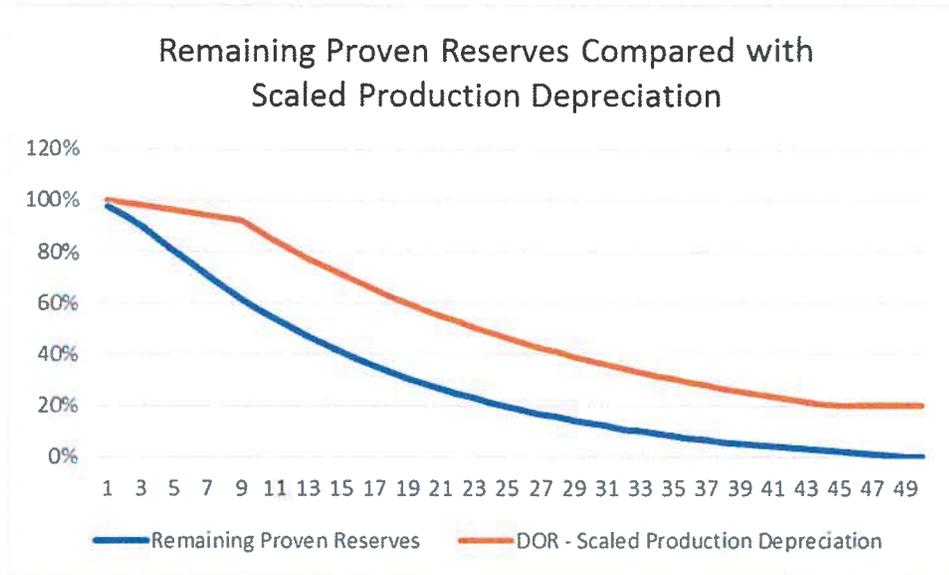
For example, assume at the beginning of the 2rd year of production the taxpayer discovers the reservoir is not performing as anticipated. The pipelines and facilities are completed and will not ever be fully used. In property tax lingo this is referred to as “super-adequacy.” As proposed, the taxpayer’s assessment would continue to decline in value at 1% per year even though it is of significantly less use and value, thereby collecting too much tax for at least the next 7 years.

(2) The “decline phase” begins (Attachment A - Slide 6) at year 10 and this is the point where the Department proposes applying the scaled production methodology (Attachment B – Slide 8). Both the “scaled production methodology,” calculated by the Current Calendar Year Production divided by the Historical Peak Production and the application of a “scaling factor,” relating capacity/volumes to cost, are currently not defined in regulation. Simplicity and efficiency will only result if new terms are defined and if the Department is going to proceed with regulations, then we recommend defining the term “scaling factor” in terms of what it is measuring rather than as a numerical exponent because the relationship of capacity to cost will not be identical for every facility and pipeline.

(3) An illustration of the “scaled production methodology” at Slide 12 (Attachment C) uses a blue line to measure the production of the reservoir over 50 years. If the “scaled production methodology” (orange line) was the only measurement needed to measure the “economic life of proven reserves” in valuing the asset, then the blue and orange line should not be diverging over the life of the asset. The lines should be close. In the example, the taxpayer’s asset has been overvalued for 40 of the 50 years.

On Slide 12, the orange line is measuring production rather than the statutory language “economic life of proven reserves.” Simulating the example used in Slide 12 and

calculating the remaining proven reserves, the over valuation of property using only the scaled production method is evident in the chart below.



Looking at the data underlying the orange lines with peak historical production of 120,000 barrels per day divided into the calendar year current production, the DOR's Slide 12 reflected the property is about 94% good, the reproduced DOR – Scaled Production above is similar at 93% good. Either orange line contrasted with the remaining proven reserves, as required by statute and represented by the blue line, shows that the assessment will be 27-28% over valued.

Yr.	b/d	mbbl	cum	Blue DOR Slide 12	DOR Scaled Prod. Depr.	Remaining Proven Reserves
1	60,000	21,900	21,900	50%	100%	98%
2	80,000	29,200	51,100	67%	99%	94%
3	120,000	43,800	94,900	100%	98%	90%
4	120,000	43,800	138,700	100%	97%	85%
5	120,000	43,800	182,500	100%	96%	80%
6	120,000	43,800	226,300	100%	95%	75%
7	120,000	43,800	270,100	100%	94%	70%
8	112,800	41,172	311,272	94%	93%	66%
9	106,032	38,702	349,974	88%	92%	61%
10	99,670	36,380	386,353	83%	88%	57%
11	93,690	34,197	420,550	78%	84%	54%
12	88,068	32,145	452,695	73%	81%	50%

At one point during the discussion, the Department acknowledged that the 1% and then the “decline” stage may not result in the proper tax amount on an annual basis but it would over time. We believe it is inappropriate to knowingly accept that too much or too little tax is being collected and that it is rare for a tax law to remain in place for a lengthy period of time. Even if the tax law remains in place, administrations change and so do interpretation and applications. We recommend the Department consider adopting regulations that arrive at the proper amount of tax.

(4) Discussion of depreciation must be done in context with the starting point of the assessment. For production property, the statute uses “replacement cost.” Assuming the “replacement cost” is based on current costs obtained from the market for the tax year at issue, then it must be determined whether the assessment is replacing the same facility or a new facility, the same size/type property or a different size/different type pipeline prior to measuring the forms of depreciation. The forms and quantification of depreciation will depend on the starting point for the assessment.

(5) The presentation on the “former” depreciation methodology described starting with the replacement cost and then quantifying multiple forms of depreciation in arriving at the assessed value (Slide 4). The new proposed depreciation method is the quantification of volumes to cost – “scaled production methodology.” This means only one of the multiple forms of depreciation previously quantified and applied is now being proposed even other forms exist. The physical wear and tear on the properties has not disappeared and the costs to cure also remain. We urge the Department to consider additional forms of depreciation.

(6) How the scaled production depreciation method will work for property impacted by multiple reservoirs was not addressed at the workshop. It is unclear whether the scaled depreciation method will re-start for a facility that is shared when a new reservoir comes on line. We recommend the Department share how it plans to address facilities when new reservoirs come on line.

Comments Regarding Other Possible Changes

The Notice provides that this is an opportunity “for other possible changes to existing regulations before the DOR drafts specific revisions...” and therefore we also recommend the Department consider regulations to assist in a transparent assessment and appeal process.

(1) Regulations providing that agreements or memorandums of understanding or any similar arrangement that the Department enters with other taxing jurisdictions should be timely posted on the Department of Revenue’s website to enable a taxpayer to understand who is involved in the assessment or audit or investigation of its taxable

Mr. John Larsen
July 31, 2017
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property. It is reasonable that taxpayers know who the Department shares confidential information with and who it shares its assessment function with -- especially when the taxing agencies/municipalities participating in the assessment process also have a statutory right to appeal the taxpayer's assessed property tax values.

(2) Regulations that disclose any funding, support or monetary arrangements between the Department of Revenue and any other person or entity participating in the assessment, audit or investigation of the taxpayer's property. For example, requiring timely disclosure of engagements by a Municipality engaging experts assisting in the audit or assessment process.

(3) Regulations providing for notice to the taxpayer when the Department discloses taxpayer confidential information to a person, entity or agency discussed in (1) or (2).

(4) Regulations stating that a Municipality participating in the audit or assessment process must forgo its appeal rights, and that the Department retains the ultimate responsibility for the assessment and policy.

If the Department would like clarification or to discuss the above, please feel free to contact me.

Sincerely,



Marie P. Evans

Enclosures:

Slides 6, 8, 12, Department's Property Tax Workshop, July 11, 2017

DOR Current Depreciation Methodology

AS 43.56.060(d)-(e)

➤ Scaled Production Methodology

- Depreciation measured directly from the reservoir the property serves in one of two ways (depending on reservoir phase):

1. Pre-Divide Phase (ramp up or plateau production)
 - One percent depreciation per year

OR:

2. Decline Phase (10% or more off peak or plateau production)

- Scaled production methodology:

- (Reservoir Current Production / Reservoir Historic Peak Production) ^ SF
- Current production = previous CY production

- Floor depreciation 20% for operating production/pipeline property

DOR Current Depreciation Methodology

Hypothetical Numerical Example

➤ Scaled Production Methodology

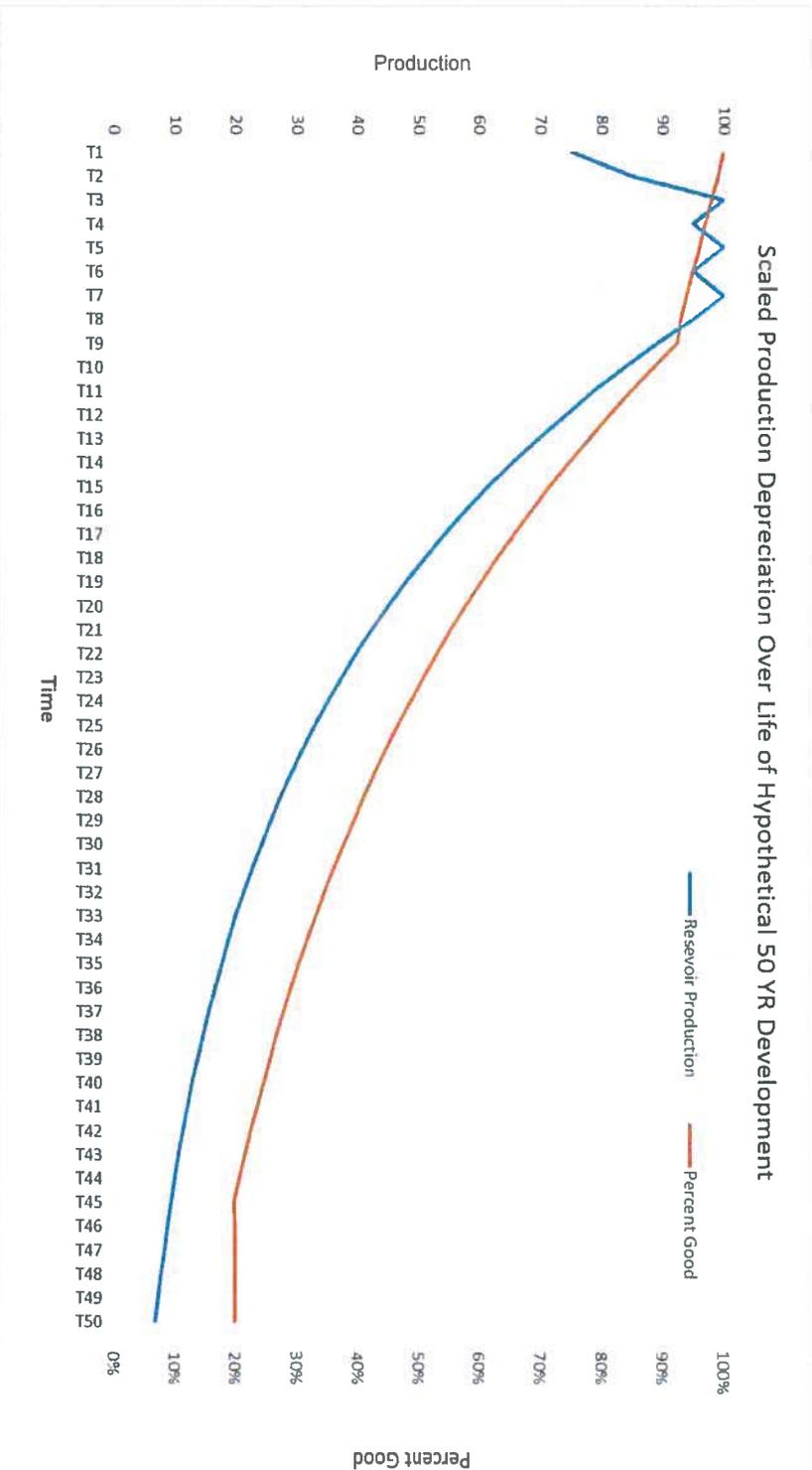
- Production facility built and reservoir peak oil production reached in a few years at 50,000 barrels of oil per day
- After fifteen years reservoir is producing 20,000 barrels of oil per day
- Factor applied to the production facility RCN for the fifteenth year to calculate depreciation on a percent good basis:

$$\left[\frac{20,000}{50,000} \right]^{.69} = 53.14\%$$

- Percent good is the inverse of depreciation, where here 53.14% good equals 46.86% depreciation (100% - 53.14% = 46.86%)

Scaled Production Methodology

Expected Depreciation Over the Life of a Hypothetical 50yr Development



* Hypothetical scenario based on a two year ramp up phase, a five year plateau production phase, and then a six percent annual decline.

BRENA, BELL & CLARKSON, P.C.

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MEMORANDUM

TO: John Larsen (john.larsen@alaska.gov)

C: Randall Hoffbeck (randall.hoffbeck@alaska.gov)
James Greeley (james.greeley@alaska.gov)

FROM: Robin Brena for City of Valdez (rbrena@brenalaw.com)
Jack Wakeland for City of Valdez (jwakeland@brenalaw.com)

DATE: July 31, 2017

RE: Written comments of the City of Valdez in response to the Department of Revenue's notice of possible updates and revisions to DOR regulations 15 AAC 56 regarding depreciation methodology

I. EXECUTIVE SUMMARY

The Alaska Department of Revenue ("DOR") has requested input from interested parties and the public regarding possible regulations under AS 43.56.060(d)-(e) regarding "an appropriate methodology under the use value criteria that is efficient, transparent, and easily verifiable by interested parties, and is both stable and predictable for use in future assessments by the DOR." At the public workshop on July 11, 2017, DOR presented a single depreciation calculation based on scaling current production over reservoir historic peak production. Though DOR noted that the Trans Alaska Pipeline System ("TAPS") value is currently subject to settlement and no change is intended to that value, the proposed change in depreciation would apply to TAPS outside the settlement context, as well as other AS 43.56 property within the City of Valdez's ("Valdez") jurisdiction.

Consistent with its comments submitted on August 16, 2016, regarding possible regulatory changes to the duration of replacement value and the determination of proven reserves, Valdez again urges DOR not to use its regulatory process to revisit settled law and disputed issues from the 2016 settlement of the TAPS tax assessments. The proposed depreciation method disregards the differing statutory standards for production and transportation property, is based on a misapplication of the judicial holdings on the acceptable premise of value, and has no connection to the core statutory requirement that the assessment be based on “the estimated life of the proven reserves” because it merely compares current production with historic peak production.

In practical terms, there are many questions as to how the formula would function, but a mass assessment technique such as this formula, while perhaps providing administrative ease, should not be enshrined in regulation. Doing so would undermine the fundamental role of property-specific best evidence in assessment appeals and limit DOR’s ability to appropriately consider such evidence. Rather than limiting disputes between appellants, codifying this new element into the AS 43.56 process would likely produce another area of litigation, because the scope of depreciation the formula is capturing would be at issue. Furthermore, based on the formula presented, this regulatory change could reduce the valuation of TAPS by more than \$2 billion. An effort to simplify the assessment process should not have such severe impact on the resulting value. The well-established breakdown method for determining depreciation has been repeatedly used and approved by the State Assessment Review Board (“SARB”) and the courts, and there is no need or benefit in changing the existing regulations. As with the determination of replacement cost, Valdez stands ready to work with DOR in refining the AS 43.56 assessment process to minimize administrative burden while satisfying the requirements of the statutes.

II. THE ALASKA SUPREME COURT’S DECISIONS DO NOT SUPPORT THE PROPOSED REGULATORY CHANGE

DOR’s notice expresses its belief that AS 43.56.060(d) should be “treated consistently” with the determinations of the Alaska Supreme Court “that a use value

standard is a proper premise under which to apply assessment methodology in administering AS 43.56.060(e).” First, subsections (d) and (e) of the statute provide different standards, and the meaning of the term “economic value” under AS 43.56.060(e) was thoroughly litigated by the parties and decided by the courts.¹ Further, the Alaska Supreme Court did not mandate a use value standard in its decisions, but rather held that “the statutory language of AS 43.56.060 does not compel the DOR to use a fair market valuation standard”² and that “it was not error to assess TAPS under a use value standard.”³ Thus, the referenced judicial decisions do not require a regulatory change regarding the calculation of depreciation. On the contrary, the courts approved the depreciation methodology DOR now contemplates changing with regard to pipeline transportation property.

On the other hand, the proposed regulation appears directly contrary to the statute’s core requirement that property be assessed based on “the estimated life of the proven reserves,” because the singular depreciation calculation looks only to current production versus historic peak production, without any consideration of the amount of current proven reserves or the effective age of the property being assessed.⁴ The definition and determination of proven reserves has been fully adjudicated by the courts.⁵ DOR should

¹ Amended Decision Upon Reconsideration Following Trial De Novo, Case No. 3AN-06-08446 CI (2006 Tax Year) ¶¶ 64-95 (October 26, 2010).

² *BP Pipelines (Alaska) Inc. v. State, Dep’t of Revenue*, 325 P.3d 478, 484 (Alaska 2014).

³ *State, Dept. of Revenue v. BP Pipelines (Alaska) Inc.*, 354 P.3d 1053, 1060 (Alaska 2015).

⁴ AS 43.56.060(e)(2) (comparing “the estimated life of the proven reserves of gas or unrefined oil then technically, economically, and legally deliverable into the transportation facility” with “the estimated physical life of the transportation facility.”)

⁵ Amended Decision Upon Reconsideration Following Trial De Novo, Case No. 3AN-06-08446 CI (2006 Tax Year) ¶¶ 394-97 (October 26, 2010) (construing the “Reserves Law” under AS 43.56 and holding that “no one industry, regulatory, or other definition of ‘proven reserves’ need be adopted and read into the Reserves Law” and that “the Department was not required to adopt a ‘reasonable certainty’ confidence level as urged by the Owners.”); *BP Pipelines (Alaska) Inc. v. State, Dep’t of Revenue*, 325 P.3d 478, 491 (Alaska 2014) (“The Owners have not shown that the superior court’s definition of ‘proven reserves’ is inconsistent with the statute or any widely accepted industry definition of the term.”)

not attempt via regulation to deviate from the clear “Reserves Law” holdings of the superior court, which included thorough discussion and analysis of the parties’ competing estimates⁶ and were twice affirmed by the Alaska Supreme Court. The statutory interpretation of the courts is controlling, and the standard for determining proven reserves under AS 43.56 is clear “Thus, so long as oil in each of the three categories of [Alaska North Slope] production established by [DOR] – producing, under development, and under evaluation – was economically, technically, and legally deliverable into TAPS as of the lien date, as proven by a preponderance of the evidence, that oil should be included when estimating the economic life of TAPS for ad valorem tax purposes.”⁷ Because the proposed depreciation calculation considers only production levels without consideration of proven reserves, it contravenes both the statute and the Reserves Law established by the courts.

III. THE PROPOSED DEPRECIATION FORMULA PRESENTS SEVERAL PROBLEMS

Because the proposed regulation departs from any consideration of proven reserves, which are not necessarily reflected or correlated by production levels, it will only add another layer of litigation as to the propriety of the depreciation methodology and what depreciation it is or is not capturing. This change ignores the holdings of the courts and risks reigniting the conflicts between the TAPS litigants. All of the litigants, including DOR, invested significant time and resources into achieving the litigation outcomes and the recent five-year settlement. While Valdez understands DOR’s desire to clarify issues and make the administration of its annual assessments more efficient, Valdez maintains that DOR should avoid any regulatory action that revisits litigation positions that have been decided and should be at a standstill under the settlement. DOR can exercise its discretion

⁶ See Decision Following Trial De Novo, *BP Pipelines (Alaska Inc.) v. State of Alaska Department of Revenue*, Case No. 3AN-06-08446 CI (2007/08/09 Tax Years) ¶¶ 439-506 (December 30, 2011) (finding that the Municipalities’ production forecasts and reserves estimates were reasonable, the Owners’ forecasts and estimates were not persuasive, and DOR’s forecasts and estimates were unreliable).

⁷ Decision Following Trial De Novo, *BP Pipelines (Alaska Inc.) v. State of Alaska Department of Revenue*, Case No. 3AN-06-08446 CI (2007/08/09 Tax Years) ¶¶ 459 (December 30, 2011).

in choosing depreciation methods, but there is no need to codify a singular method for all properties statewide and to do so would likely create more conflict than it would avoid.

A. The Proposed Formula is not an Established Appraisal Method.

Valdez is unaware of any appraisal authority that favors a single depreciation formula such as that proposed here to the established breakdown method of economic age-life with additional functional and/or economic obsolescence as found appropriate in each individual circumstance. DOR's presentation indicates that its proposed change would eliminate any separate consideration of economic age-life, additional functional obsolescence, or additional economic obsolescence, but the basis of this narrowed scope is unclear. Current regulation provides that DOR may use "standard appraisal methods" in its assessments⁸ and while DOR is free to apply mass assessment techniques in its initial valuations, it should not constrain its ability to respond to appeals by limiting its consideration of depreciation to this one novel formula.

B. The Proposed Formula is Contrary to the Best Evidence Rule.

Just as SARB and the courts have rejected trending costs when more accurate current information is available,⁹ so too should DOR avoid codifying a depreciation method based only on production levels when better property-specific information may be available. The annual AS 43.56 assessment process should be founded upon the best

⁸ 15 AAC 56.110(c).

⁹ Decision Following Trial De Novo, *BP Pipelines (Alaska Inc.) v. State of Alaska Department of Revenue*, Case No. 3AN-06-08446 CI (2007/08/09 Tax Years) ¶¶ 155, 157 (December 30, 2011) ("Reliance on a trended original cost as the basis for valuing TAPS is not warranted because TAPS' original design has been substantially updated and a trended original cost would not capture the value of the asset in place as of the lien dates . . . [a] replacement cost analysis replaces TAPS' current equivalent utility based on modern design, materials, and construction techniques."); Certificate of Determination, OAH No. 14-0555-TAX at 8 (May 23, 2014) ("In this situation, it was improper to compute current value by trending forward a 2009 value. More recent estimates of cost, based on actual quotes from vendors and research in the market, are preferable to trending forward old studies.")

evidence available. Again, a distinction should be made between administrative ease and consistency with the courts' holdings.

C. The Proposed Formula Implicates a Substantial Impact on the Valuation of TAPS.

DOR excluded TAPS from its presentation on the basis of the current settlement, but Valdez cannot assume that the settlement will remain in place or that the proposed formula could not be applied to TAPS if implemented. In terms of the formula's function, it is unclear how the peak denominator for the formula is determined (whether the peak is daily, annual, or an average), how the scaling exponent is selected, whether external factors such as drag-reducing agents are considered in the production inputs, or how the threshold between pre-decline phase and decline phase is determined or adjusted for each particular property. Depending on how these questions are answered; however, the proposed formula could result in a substantial reduction in the valuation of TAPS from the values established by the courts or the settlement value currently in place.

For the most recently litigated tax year, 2015, SARB used a replacement cost new of \$19.137 billion and found a replacement cost new less depreciation of \$9.609 billion, or approximately 50.21 percent good. Using TAPS historical data with the proposed formula as presented produces the following result:

$$[513,441/2,145,297] ^ .69 = 37.28 \text{ percent good, or approximately } \$7.135 \text{ billion.}$$

Thus, the formula results in a deduction of nearly \$2.5 billion from the assessed valuation of TAPS, with further reductions possible if additional depreciation is then somehow included. It is inappropriate for a regulatory simplification to result in a \$2.5 reduction in the assessed value of the most important asset in Alaska. Valdez would necessarily oppose such a radical shift in valuation, which would undermine the progress toward a stable valuation as established by the courts and SARB and reflected in the settlement. DOR should avoid any regulatory changes with such severe impacts on the valuation of TAPS.

IV. THE PROPOSED DEPRECIATION FORMULA WILL NOT ACHIEVE DOR'S DESIRED BENEFITS

As presented by DOR, the perceived benefits of the regulatory change broadly include objectivity and empirical basis, transparency with public data, stability and predictability, accuracy and defensibility, and administrative efficiency. Valdez understands DOR's goals of simplifying the assessment process and reducing disputes, but the proposed depreciation formula takes simplification too far by codifying a technique that is disconnected from the determination of proven reserves and will likely create more conflict than it avoids. While the formula may be simple to apply at the outset, it will add another layer of litigation as to the application of the formula under appraisal theory and the proper consideration of proven reserves, thus nullifying any efficiencies gained. Moreover, a simple formula based on two historical inputs and an arguable scaling exponent is necessarily less accurate for any particular assessment than property-specific evidence under the established breakdown method. In light of all the above, Valdez strongly urges DOR to forego the proposed regulation.