

Department of Revenue
Responses to Questions Proposed 15 AAC 56.100

Question #1: The proposed regulation change for 15 AAC 56.100(a) removes the "replacement cost less depreciation basis" and replaces it with "use value standard." Since the authorizing statute AS 43.56.060(d) does not use the term "use value standard" and we could not find case law referring to or mentioning the term or phrase "use value standard" for AS 43.56.060(d) property, is the Department interpreting the "use value standard" to equate to "full and true value" as it is defined at AS 43.56.060(d)?

1. Department response: The replacement cost less depreciation basis remains in the currently proposed regulation amendment. The Department assesses the full and true value of oil and gas property in Alaska pursuant to AS 43.56 under a use value standard under the provisions of AS 43.56.010(a).

In its public workshop the Department previously discussed in detail the facts and circumstances pertaining to oil and gas production property in Alaska that necessitates the need to assess the full and true value under a use value standard. The two principal factors being, 1) the limited market place, and 2) the special purpose nature of the property.

Question 2: If the answer to Question 1 is negative, then how does a taxpayer reconcile that the assessment statute, AS 43.56.100(d) assesses the full and true value and the regulation is using the "use value standard?"

2. Department response: N/A

Question 3: At 15 AAC 56.100(a)(2) the proposed language states:

after the commencement of regular production replacement [REPLACEMENT] cost will be calculated **on January 1 of each calendar year** by the use of accepted appraisal techniques or other acceptable methods **and shall reflect the full current cost of a modern replacement for the production property physically present and installed as of the assessment date, and;**

For property that is not brand new or relatively new, how is it possible to have "a modern replacement" for "the production property physically present and installed" on the assessment date? For property that has aged that is "physically present and installed" isn't it likely "a modern replacement" will differ?

3. Department response: Typically trended original cost is relied on to estimate the cost of a modern replacement at current tax year price levels. It is true that for very old property care must be taken to ensure replacement cost is estimated accurately, and in such endeavors, independent cost studies may be relied on.

In administering AS 43.56 assessments under a use value standard, arguments that a modern replacement would theoretically differ from the actual subject property being assessed are without merit. The appraisal assignment under AS 43.56 is to assess the full and true value of the subject property, which is special purpose property and located in a limited market. As such, there are no readily available alternative properties or practical options to substitute for the existing property that match differing theories. Further, the actual subject property is expected to be in use over the economic life of proven reserves produced from the reservoir it is dedicated to and serves.

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Question 4: Proposed regulation 15 AAC 56.100(a)(3) states depreciation will be "based on the economic life of proven reserves" and then two methods are proposed. The first method states that where a production property is in "ramp-up or plateau" the "depreciation will be determined by application of a one-percent per year deduction to the replacement cost." How was the one-percent derived (i.e., what data was used to support and calculate?)? How does the one-percent correspond to the statutory required and the preceding regulatory language that depreciation is "based on the economic life of proven reserves?" If the economic life of the proven reserves is greater than one-percent, then wouldn't any standard of value require the assessment reflect such depreciation?

4. Department response: The Department discussed in detail during its public workshop how it derived the pre-decline phase depreciation methodology, what that methodology is measuring, and how that comports with the proven reserves mandate under AS 43.56. The pre-decline phase depreciation methodology estimates the depreciation effect the proven reserves produced during ramp-up and plateau production has on the total economic life of the oil and gas property. In deriving one-percent per year as the correct depreciation increment for oil and gas properties serving reservoirs in the ramp-up and plateau phases, the Department looked at several reservoir scenarios using different decline rates and sampling various depreciation rates to find the incremental depreciation rates at that point in time that best matched the performance of the reservoir over its life. To date, no interested party has come forward with information that demonstrates the Department's one-percent depreciation increment during ramp-up and plateau production is incorrect or that an alternative depreciation rate is more accurate.

Question 5: Why was the existing definition of "proven reserves" repealed?

5. Department response: No definitions of proven reserves in AS 43.56 changed as a result of the proposed regulation.

Question 6: Proposed regulation 15 AAC 56.100(a)(3)(B) addresses the depreciation calculation for production property serving one or more reservoirs where the combined production is in decline using a "percent good factor." The draft language defines "percent good factor" as "the result of applying an exponent to the quotient." How will the exponent be calculated? The proposed regulation also states that the "exponent shall scale the quotient to ensure the correct amount of depreciation." How will the "correct amount" be judged since "correct" is subjective in nature?

6. Department response: The exponent, or scaling factor, accounts for the non-linearity in development size (production levels) and development cost. Use of the scaling factor in determining depreciation ensures that the replacement cost for the property being assessed is never over or under depreciated at any point in time and that the assessment reflects the full and true value of a property commensurate with the amount of proven reserves and associated level of production occurring from the reservoir(s) that the property serves over its economic life. The exponent can be derived from actual costs of recent existing similar developments when available by solving for "x" in the following formula, where C = Cost and Q = Quantity:

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$$\left[\left(\frac{C_2}{C_1} \right) = \left(\frac{Q_2}{Q_1} \right)^x \right]$$

Question 7: Proposed regulation 15 AAC 56.100(a)(4) creates a floor for depreciation by stating the depreciation shall not exceed 80% or 90% of the replacement cost depending on the circumstances. By creating this assessment floor for property is this regulation conflicting with the statutory requirement where that the full and true value is arrived at using "the basis of replacement cost less depreciation based on the economic life of proven reserves?" Couldn't depreciation reduce the assessed value below the proposed floors?

7. Department response: Depreciation under the cost approach nearly always stops at a minimum base cost if the property is still physically in place, never reaching zero. For operating properties an eighty-percent depreciation floor is common. For shut-in properties anticipated to be dismantled, removed, and the site restored, a ninety-percent depreciation floor is normal.

Here, at the 80% depreciation floor, the remaining cost being assessed is required to reflect the full and true value of a property that can sustain production of the remaining proven reserves for the entire range of production occurring from that point in a property's economic life until shut-in. This is due in large part to economies of scale, and the reality that a minimum base cost is required to sustain a low end range of production.

At shut-in and the 90% depreciation floor, the remaining cost being assessed reflects the full and true value of a property that's use was dedicated to serving the proven reserves of a reservoir(s) and the value remaining in the property at the point of reservoir shut-in. The full and true value at shut-in also in-part reflects an Alaska based reality that a shut-in property may be put back in service at some point in the future.

It is also important to note that property tax tenets support the widely used application of floor depreciation in assessing programs. A fundamental purpose of a property tax is to ensure that local communities and governments are supported for the impacts associated with the presence of physical property (need for associated public infrastructure, increased populations and associated services, etc.). These impacts remain while the physical property exists. Therefore, allowing property to depreciate closer to zero while it is in operation or is still physically in place would be improper.

Question 8: Has the Department considered the language in proposed regulation 15 AAC 56.100(a)(5) may conflict with itself and the statute? The language states that "[a]n extenuating circumstance does not require the department to modify the assessment method unless the assessment would be unequal, excessive, or improper without the modification," but then the last proposed sentence says the

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"department may leave an assessment calculation unadjusted even if the facts show an extenuating circumstance to exist." Doesn't the statute require an adjustment if [an] assessment is unequal, excessive or improper?

8. Department response: The purpose of the language as written is to reflect the possibility that an extenuating circumstance may not lead to an assessment that is unequal, excessive or improper. If an extenuating circumstance did lead to an assessment that was unequal, excessive or improper, then the provisions proposed as set out in 15 AAC 56.100(a)(5) would be applied to adjust the assessment appropriately.

It should be noted that in the Department's view the chance of an extenuating circumstance necessitating the need to deviate from the prescribed provisions set out in the earlier sections of the proposed regulation are very slim, likely to occur only extremely rarely, if at all.

Lastly, 15 AAC 56.100 (a)(5) was added in part in response to industry comments from the workshop requesting the Department craft a regulation that is flexible enough to adjust in the event of an extenuating circumstance occurs for which the methodology in the regulation amendment was not sufficient.

Question 9: The definition of "production" as proposed states, "... the sum of all regular production produced and sold from reservoirs served by the production property plus the amount of otherwise commercial oil or gas produced that is used in operation of those leases or other leases in drilling for or producing oil or gas, including fuel and reservoir recovery uses." This definition results in the following questions:

- Why does the volume of oil and gas sold matter? (Please note the volume produced is highly unlikely to match the volume sold.)
- Why the qualification of "commercial oil or gas produced that is used in operation of those leases?"
- Why would it matter if the oil or gas is "commercial" or not?
- Since an Operator will not know the volumes of oil or gas sold by its working interest owners how does the Department propose tracking the volumes sold?
- Has the Department considered that sales volumes are not publicly shared or tracked by reservoir?

9. Department response: In measuring depreciation pursuant to AS 43.56 based on the economic life of proven reserves under a use value standard, depreciation is measured directly from the reservoir. It is of no consequence whether the owner of the property chooses to ship, sell, or use for other purposes (such as fuel or production support) the proven reserves being produced from the reservoir. DOR believes the production measurements that are publically available from the AOGCC, that it receives from companies, or are available from other public sources, are reliable and easily available.

Question 10: The definition of "production decline," as proposed, occurs when "production for the calendar year preceding the assessment date is ninety-percent or less of the historic peak production for the reservoirs served by the property" and this leads to the following questions:

- For new reservoirs how will "historic peak production" be determined?

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- Why would it be appropriate to ignore a decrease in value simply because it does not meet this threshold?
- 10. Department response: The property serving a new reservoir would initially be assessed using the pre-decline phase depreciation methodology. The reservoir's own performance and production history will indicate when it has decreased 10% or more from historic peak to enter the post decline phase depreciation methodology.

The depreciation methodology in the proposed regulation amendment is able to measure decreases in value when they occur.

NOTE: The Department of Revenue has made grammatical edits to some questions.