

EXPLANATORY OVERVIEW OF PROPOSED REGULATIONS TO IMPLEMENT AS 43.55.160(f)(3)

The Department of Revenue (“department”) received requests to provide explanations of some of the proposed changes to regulations in 15 AAC 55, relating to the oil and gas production tax, for which public notice was issued on July 19, 2013. Comments received at the August 13, 2013 public hearing on the proposed regulation changes indicated that an explanation of the proposed regulations to implement AS 43.55.160(f)(3) would be helpful. Accordingly, the Department is providing the following material to assist those who wish to submit written comments on the proposed regulation changes to better understand the proposed regulations and to better inform their comments. Written comments on the proposed regulations must be received no later than 4:30 p.m., on Monday, August 26, 2013. Please see the public notice for details about how to comment on these proposed regulation changes. The public notice and proposed regulations are available on the Department of Revenue’s website at <http://www.tax.alaska.gov>.

A. Background

Under AS 43.55.160(f)(3), as enacted in § 29, ch 10, SLA 2013 (SB 21), North Slope oil and gas¹ produced “from acreage that was added to an existing participating area by the Department of Natural Resources on and after January 1, 2014” may qualify for a 20 percent reduction in the gross value at the point of production used in the

¹ AS 43.55.160(f) does not apply, however, to gas produced before 2022 that is used in the state.

calculation of the taxable value (“production tax value”) of the oil and gas. The legislature was emphatic that the reduction under AS 43.55.160(f)(3) would be limited to the volume of oil and gas that the producer “demonstrates to the department . . . is from” acreage added to an existing participating area, as opposed to, for example, from the pre-expansion part of the participating area. The legislature’s concern in this regard was presumably due, in part, to the fact that when acreage is added to an existing participating area, it typically includes an additional portion of the same reservoir from which the producer is already producing oil or gas.

Proposed 15 AAC 55.212(c) - (g) and 55.213 address both the procedural and substantive aspects of how producers can meet the statutory standard of demonstrating to the department, for the purposes of AS 43.55.160(f)(3), that the volumes of oil and gas are from the acreage added to an existing participating area. Both aspects are affected by the question of timing. Although the actual volumes produced during a given month or year cannot be known – and therefore cannot be demonstrated – until after that month or year is completed, it is desirable to afford producers substantial predictability as to the availability of the gross value reduction under AS 43.55.160(f)(3). Therefore, the proposed regulations allow a producer to request an early review and acceptance by the department of the *methodology* that producers will use to demonstrate the volumes of oil and gas from acreage added to an existing participating area. A methodology accepted by the department would then be used by the producers each year to determine the volumes of oil and gas eligible for the gross value reduction under AS 43.55.160(f)(3).

While there could still be room to consider, in the audit process, whether a producer has correctly applied the methodology or has used correct data in determining those volumes for a given year, the degree of predictability for producers should be much higher with the methodological issue settled.

B. Methodologies: Substantive Standards

Proposed 15 AAC 55.211(d) implements the statutory concept of “the volume of oil or gas produced [being] from acreage added to an existing participating area” to mean that the oil or gas is drained from the acreage that has been added to the participating area, regardless of whether the wells through which the oil or gas is produced have been drilled into that acreage (i.e., regardless of whether the producing intervals of those wells are located in that acreage). Thus, for example, if water injection wells drilled into the acreage added to an existing participating area sweep oil into producing wells located in the pre-expansion part of the participating area, that volume of oil would be considered to be “from acreage added to an existing participating area.” On the other hand, a volume of oil that migrates from the pre-expansion part of the existing participating area into producing wells drilled in the acreage added to the participating area would not be considered to be “from acreage added to an existing participating area.”

Two fundamental factual issues, therefore, need to be addressed by producers in a methodology to demonstrate the volumes of oil or gas that may qualify for a gross value reduction under AS 43.55.160(f)(3). One issue is the amounts of oil and gas produced from the wells whose drainage areas include the added acreage. The other issue is the

portion of that oil and gas that is drained from the added acreage rather than from outside the added acreage.

1. Subsection (f) option

Proposed 15 AAC 55.213 provides producers several options for obtaining the department's acceptance of a methodology. The option provided by subsection (f) imposes only a few specific requirements and otherwise leaves to a case-by-case determination whether a proposed methodology "is sufficiently reliable and accurate for the purposes of AS 43.55.160(f)(3)." One of the specific requirements is that the methodology includes reservoir simulation that is run and history-matched with a frequency approved by the department. (Reservoir simulation is a key technique for helping to understand the movement of oil and gas within the reservoir as production proceeds.)

Subsection (f) lists information and analyses that a producer must take into account in demonstrating the reliability and accuracy of a proposed methodology – most or all of which includes information that may be considered by the Department of Natural Resources in support of an application to expand a participating area. Note that this list is not a list of elements that the regulation requires to be part of the methodology itself (although it is conceivable that one or more of the items on that list might be included in a methodology).

Finally, subsection (f) makes clear that, in determining whether a proposed methodology is sufficiently reliable and accurate to be accepted, the department is not

bound to accept a methodology's proposed reliance on well production data derived from well testing and production allocation that may have been required or approved by applicable regulatory agencies for those agencies' purposes.

2. Continuous metering options

Apart from the option provided by subsection (f), proposed 15 AAC 55.213(a) – (e) describe two specific categories of methodologies, involving continuous production metering, that will meet with department acceptance. Under one category, covered by subsection (d), production from a subset of participating area wells would be metered, after mechanical separation, according to custody-transfer standards and in compliance with 20 AAC 25.228. Under the other category, covered by subsection (e), production from a subset of participating area wells would be metered by multiphase flow metering that is accurate to within plus or minus five percent and meets other standards and requirements that the department determines are necessary or appropriate for the purposes of AS 43.55.160(f)(3), considering the multiphase metering provisions of the American Petroleum Institute *Manual of Petroleum Measurement Standards*.

Subsections (a) and (b) of proposed 15 AAC 55.213 specify the subset of wells whose production would be metered under subsection (d) or (e).² Subsection (a) applies in circumstances where the producer can show that there is essentially no drainage of oil or gas from the pre-expansion part of the participating area into the added acreage.³ In

² Neither subsection (d) nor (e) would require separate metering of individual wells.

³ The regulation allows for the possibility of a *de minimus* degree of drainage, defined as no more than one-tenth of one percent of the oil or gas produced from wells drilled in the added acreage.

those circumstances, the subset of wells to be metered under subsection (d) or (e) would be the wells whose producing intervals are within the added acreage. And those metered amounts of oil and gas – subject to certain adjustments, described below -- would be considered to be the volumes of oil and gas “from” the added acreage,⁴ within the meaning of AS 43.55.160(f)(3).

Subsection (b) applies where there may be more than a *de minimus* degree of drainage into the added acreage or where the producer wishes to account for oil or gas drained *from* the added acreage into certain wells in the pre-expansion part of the participating area, or both. Under subsection (b), the subset of wells to be metered under subsection (d) or (e) would be the wells whose producing intervals are within the added acreage plus other wells, if any, “that are drilled, primarily or in substantial part, for the purpose of draining oil or gas from that added acreage.” For a methodology to be accepted by the department on the basis of metering under subsection (d) or (e) of production from a subset of wells under subsection (b), the methodology must determine how much of the oil and gas produced from those wells is drained from outside the added acreage. Those amounts of oil and gas, of course, must be subtracted from the metered amounts of oil and gas in order to calculate the volumes of oil and gas that are considered to be “from” the added acreage within the meaning of AS 43.55.160(f)(3). The part of

⁴ The calculation is a bit more complicated under proposed 15 AAC 55.213(e)(3), which applies where, after being subject to multiphase flow metering, the oil and gas in question are commingled with other oil and gas that have also been subject to multiphase flow metering, and the commingled stream is then mechanically separated and metered according to custody-transfer standards. In this situation, the total amounts metered according to custody-transfer standards are allocated back, proportionally to the respective amounts metered by multiphase flow metering.

the methodology that deals with that drainage is referred to in the regulation as a “sub-methodology,” and proposed 15 AAC 55.213(c) sets out the requirements for that sub-methodology.

3. Adjustments

Subsection (h) provides that any methodology must account for the fact that there may be oil or gas recovered from the acreage added to an existing participating area that is not considered to be “produced” oil or gas (and is therefore not taxed) under the production tax statute and regulations. Similarly, subsection (i) provides that any methodology must account for oil or gas recovered from the added acreage that originated outside the participating area and had been injected into the participating area. Neither of these categories of oil and gas may be counted in calculating a gross value reduction under AS 43.55.160(f)(3).

Subsection (g) addresses the situation where gas is run through a gas processing plant after being metered. Since oil is defined in the statute as including liquid hydrocarbons recovered by gas processing in a gas processing plant, AS 43.55.900(16)(B), a portion of what was metered as gas in this situation actually turns out to be oil, so the metered amounts of oil and gas need to be adjusted accordingly.

Subsection (j) deals with the fact that multiphase flow metering may overstate the amount of oil in a stream, as compared with the amount of oil that remains after mechanical separation is completed. Subsection (j) requires that a methodology adjust the metered amount of oil accordingly.

C. Methodologies: Procedures

The department's acceptance of a producer's methodology for demonstrating the volumes of oil and gas produced from acreage added to a participating area would be specific to that acreage. Under proposed 15 AAC 55.212(c), a producer's request for department acceptance of a methodology may be made as early as the date of the application to the Department of Natural Resources ("DNR") for DNR's approval of the expansion of the participating area.

Because the department believes it is essential that determinations of the volumes of oil and gas eligible for the gross value reduction under AS 43.55.160(f)(3) be consistent for all producers with an interest in the added acreage, an important aspect of the proposed regulations is their provision that all affected producers be afforded an opportunity to be heard with respect to a request for department acceptance of a methodology, and that all affected producers will be bound by the department's determination. Proposed 15 AAC 55.212(c). For the same reason, the proposed regulations would disallow a producer's *ad hoc* attempts to demonstrate the volumes of oil and gas eligible for the gross value reduction, but would instead require that all calculations of eligible volumes be made using a methodology that the department has accepted under subsection (e) in response to a request under subsection (c). Proposed 15 AAC 55.212(g).

Finally, there are two typographical errors in the proposed regulations:

- 1) On page 20 of the proposed regulations, under 15 AAC 55.213(e)(3)(B), for the definition of “TLG” the reference to “the provisions of (b)(1) – (3) of this section” should read: “the provisions of (d)(1) – (3)” of this section.
- 2) On page 35 of the proposed regulations, under 15 AAC 55.335(g) the reference to “15 AAC 55.212(f)” should be to: “15 AAC 55.212(g)”.