Alaska Oil and Gas Association

AOGA

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

Re: Discussion Draft for Potential Regulations Regarding the Treatment of Carried-Forward Annual Losses under AS 43.55.165(a)(3)

Dear Mr. Larsen:

The Alaska Oil and Gas Association ("AOGA") appreciates the opportunity to provide comments in response to Department of Revenue's (DOR) discussion draft of potential regulations DOR may propose regarding the treatment of carried-forward annual losses under AS 43.55.165. 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. As an initial matter, AOGA understands that this comment deadline is merely prelude to a subsequent official public notice. As such, AOGA's comments are broad in nature and reflect an understanding that AOGA will be permitted to submit additional, and more detailed, comments during the formal public comment period.

At the onset, we wanted to thank DOR for issuing the discussion draft and providing industry with the opportunity to comment on the potential regulations DOR may be considering prior to the actual issuance of any proposed regulations. This process affords both DOR and industry the ability for meaningful exchange of concerns and suggestions which hopefully will result in a clearer and less ambiguous set of final regulations.

During AOGA's review of the draft, there were several issues and concerns that AOGA believed warranted discussion and greater clarity. For example, one overarching concern and request is that DOR provide more detailed examples where possible in the regulations to avoid any confusion or misunderstandings on how a specific regulation is supposed to be applied and affect a taxpayer's production tax return. For example, additional examples on how a carried-forward annual loss determined for a category and allocated between various properties, both within the same and different categories, will be recovered in future years would add needed clarity and greatly reduce potential tax return questions and audit disputes.

In an effort to ensure that all of our comments are easily digestible, AOGA has attempted to capture individual questions/concerns and if possible offer suggestions/solutions.

<u>I. AS 43.55.165(n)/15 AAC 55.217(g)</u>

A. Issue

AS 43.55.165(n) provides that a taxpayer need only use an amount of carried-forward annual losses to reduce a category's overall production tax value (PTV) to the level where application of the 35 percent net tax would yield an equivalent amount of gross minimum tax before application of any tax credits allowable against the minimum tax. This provision was added to HB 111 by the to preserve the value of those tax credits by a taxpayer from being required to use additional carried-forward annual losses to lower the PTV to a level where the net tax would equal the minimum tax liability after application of allowable tax credits against the minimum tax. Potential regulation 15 AAC 55.217(g), by excluding specific reference to the "amount calculated for the producer for the calendar year under AS 43.55.011(f)" being determined "before application of any credits under this chapter" as provided for in AS 43.55.165(n) is inconsistent with the underlying statute and, at least to that extent, would be invalid under AS 44.62.030.

B. Recommendation

AOGA urges DOR to include language that would adequately capture the protections articulated in AS 43.55.165(n). Specifically, AOGA suggests that 15 AAC 55.217(g) be revised as follows:

> In the calculation of an annual production tax value for a producer's segment described in 15 AAC 55.206(c)(1)(A), carried-forward annual losses may be deducted only to the extent that 35 percent of the resulting annual production tax value is equal to or greater than the amount calculated for the producer for the calendar year under AS 43.55.011(f) before application of any credits allowed under AS 43.55.

<u>II. AS 43.55.165(o)/15 AAC 43.55.217(l)-(m)</u>

A. Issue

AS 43.55.165(o) provides that a carried-forward annual loss may be applied to determine the PTV for an entire category provided the loss was incurred within the same category. In other words, a carried-forward annual loss would be determined for a category only if a taxpayer incurred an overall loss from all leases or properties within that category for a given tax year, regardless of from which lease or property the carried-forward annual loss was generated. And the application of the full amount of any carried-forward annual loss for a specific category would be available to reduce the PTV for the entire category in subsequent years regardless from which lease or property the carried-forward annual loss was generated or to which leases or properties within that category the carried-forward annual loss was allocated.

While our understanding is that DOR concurs with the above interpretations and the proposed regulations under proposed new section 15 AAC 55.217 seem to provide those results, AOGA is concerned that the examples DOR provides in proposed regulations 15 AAC 43.55.217 (l)- (m) are-ambiguous which could allow differing interpretations and unnecessary potential audit risks as to how any carried-forward annual losses, once determined and allocated to appropriate leases or properties within appropriate categories under the regulations under 15 AAC 55.217, can be used in future years.

B. Recommendation

To avoid any ambiguities or misunderstandings, AOGA requests DOR add additional examples, which include specific mathematical examples, to make clear how carried-forward annual losses are to be used in the following situations:

1. In a category where a producer only has multiple leases or properties in regular production, with one or more incurring a loss in year 1 with the others having positive PTV, but the PTV for the entire category is negative, with the total amount of the carried-forward annual loss allocated to the various leases or properties. In year 2, each of the leases or properties has positive PTV.
2. Same facts as in example 1, except in year 2 one or more of the leases or properties has positive PTV while one or more of the leases or properties continue in a loss situation.
3. In a category where a producer only has multiple leases or properties in regular production, but each incurring a loss in year 1, with the total amount of the carried-forward annual loss allocated to the various leases or properties. In year 2, each of the leases or properties has positive PTV.
4. In a category where a producer only has multiple leases or properties in regular production, but each incurring a loss in year 1, with the total amount of the carried-forward annual loss allocated to the various leases or properties. In year 2, one or more of the leases or properties has positive PTV while one or more of the leases or properties continue in a loss situation.
5. In the situation where a producer has multiple leases or properties, one or more of which are in regular production with one or more not in regular production, but each incurring a loss in year 1 with the total amount of the carried-forward annual loss allocated to the various leases or properties. In year 2, one or more of the leases or properties has positive PTV while one or more of the leases or properties remain not in regular production.

III. AS 43.55.165(s)/15 AAC 55.217(e)

A. Issue

AS 43.55.165(s) provides that in defining the lease or property where an exploration expenditure resulting in a loss is incurred, the department shall include exploration expenditures that are “reasonably related" to the lease or property. In passing subsection (s), the Legislature recognized that exploration activities necessarily cover much larger areas than just the lease or property that later commences production. This is the nature of exploration work, which is needed to locate, define and de-risk prospects to bring them into development and production. The Legislature intended that the exploration expenditure need only be “reasonably related” to the lease or property for purposes of the carried-forward annual loss. Attracting exploration investment often requires a suite of exploration targets to increase chances of overall profit based on the success of any particular target - the costs of unsuccessful efforts will reduce the revenues of the successful one. Accordingly, the Legislature did not limit deductibility to only those expenditures that result in success, but instead allowed the exploration expenditure to be deducted as long as it is “reasonably related” to the producing lease or property. DOR should abide by that intent and craft regulations that encourage exploration work rather than impose limitations that do not exist in the statute, and recognize that exploration projects and activities are often treated as a whole for management and investment decisions, not as a hodgepodge of disconnected successful and unsuccessful projects.

The proposed regulation 15 AAC 55.217 fails to appreciate these concepts. AOGA is concerned that 15 AAC 55. 217(e)(1) would allow only deductibility of costs for exploration within land that later becomes a lease or property of the producer or, for geological or geophysical exploration, within three miles of land that later becomes the lease or property of the producer. We question the justification for the three-mile limitation given that seismic shoots may justifiably cover much greater areas, and such work would be reasonably related to the lease or property that later comes into production. AOGA recognizes that DOR in 15 AAC 55.217(e)(2) attempts to address these issues in a manner that does not serve to discourage exploration. Nevertheless, the qualifier of "reasonably related" as utilized in both 15 AAC 55. 217(e)(1) and (e)(2) could benefit from more clarity, which would provide prospective operators will greater certainty moving forward.

B. Recommendation

AOGA suggests DOR consider the principles that exist in current law based on whether a cost is for exploration on the North Slope or in Middle Earth, which would be consistent with AS 43.55.165(b)(2). Regardless, DOR could provide additional clarity by modifying 15 AAC 55.217 to include examples addressing how carried-forward annual losses generated from seismic exploration and exploration drilling will be determined to be "reasonably related" to the lease or property that comes into production, including for an exploration well that is not itself successful, but that provides valuable information that leads to a successful well.

IV. 15 AAC 55.217(i)

A. Issue

15 AAC 55. 217(i) provides that if a producer acquires another producer or explorer the tax benefit of the acquired entity's unused carried-forward annual loss may not exceed "the value of the consideration paid for the acquisition based on the tax rate under AS 43.55.011(e) at the time of the acquisition." This limitation is not in the statute and was not intended by the legislature and as such would be invalid under AS 44.62.030. Further, AOGA believes such a limitation could result in a dangerous meddling in the commercial terms of corporate transactions, which will invariably result in unintended consequences. In addition, the proposed regulation leaves many provisions either undefined or without sufficient clarity to permit an acquiring taxpayer to appropriately reflect the acquisition and the application of any acquired loss in its production tax return(s) at the time of filing. For example, the proposed regulation lacks any discussion of the manner in which DOR will determine the "value of the consideration paid for the acquisition." What factors will DOR consider? Under which rules or standards will DOR determine such "value." How will a taxpayer know what DOR's determination "of value" will be before the taxpayer files any production tax returns and attempts to utilize the acquired loss?

In addition, the proposed regulation requires the acquired entity's "previously unused carried-forward annual losses that may be used may not exceed the value of the consideration paid for the acquisition <u>based on the tax rate under AS 43.55.011(e) at the time of the acquisition</u>." If a taxpayer is subjected to more than one potential tax rate under AS 43.55.011(e) at the time of acquisition, which tax rate applies? For example, if the transaction were to occur post 2021 and the acquiring taxpayer had both taxable oil and gas production, which tax rate, 35% net oil tax rate or the 13% gross tax rate for gas would apply? If the loss is to be determined based on some allocation between various potentially applicable tax rates, how would the allocation be determined?

These and potentially other conundrums highlight the complications inherent in the limitations proposed in 15 AAC 55.217.

B. Recommendation

AOGA urges DOR to remove proposed regulation 15 AAC 55.217(i).

V. Determination of Commencement of Regular Production

AOGA is concerned that the discussion draft and other previously proposed production tax regulations under HB 111 have not provided sufficient clarity around potential issues involving the determination of the commencement of regular production which is critical not only in the allowance of any gross value reduction under AS 43.55.160 (f) and (g), but also in the determination of any carried-forward annual loss and the potential application of that loss. As stated in our comments in response to the public regulatory scoping workshop dated September 19th of this year, we were then and remain now concerned that DOR's failure to provide adequate guidance on how the commencement of regular production will be determined, how it will or can be initiated, what standards will be used to make that determination and any taxpayer remedies available relative to the determination rendered by DOR creates a level of unnecessary ambiguities and uncertainties.

For example, our major concern is that somebody, DOR or the AOGCC, has to adopt a regulation to establish procedures for making these determinations about when commercial regular production commences. But without DOR (or AOGCC) issuing a regulation addressing the issue, it remains unclear how the determinations will be made. Can a taxpayer request the AOGCC make a determination, or does the request have to go through DOR commissioner? Similarly, who is going to set objective standards and criteria for determining what is, or is not, "regular production"? And what amount of production is required?

Moreover, what happens if a lease or property previously determined to be in regular production ceases production for some prolonged period of time, will a second "commencement of regular production" be required to allow any gross value reduction or carried-forward annual loss be available with respect to that property? How would such determination be made? What objective criteria will be used by DOR?

These are just a few of the potential issues that the lack of regulatory guidance by DOR on the determination of commencement of regular production could create.

VI. Drafting Concerns/Typos

In the fourteenth line of proposed regulation 15 AAC 55.217(b)(3)(A), appearing on page 7, the word "id" should be replaced with the word "is". In proposed regulation 15 AAC 55.224(f) appearing on page 27, on line six, the proposed addition of the word "segment" needs a qualifier – does the DOR intend the proposed changes to apply to "any" segment, "the" segment, "a" segment, or some other reference? In addition, on the eighth line of that proposed regulation, the intended removal of paragraph (7) should be bracketed.

VII. Conclusion

Again, AOGA recognizes that we will be afforded another opportunity to provide additional substantive comments after DOR issues its official public notice and official proposed regulations, however, AOGA believes it would be prudent for DOR to consider our concerns and potential suggestions to the discussion draft before that occurs.

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

Very truly yours,

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December 1, 2017

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Audit Master, Department of Revenue
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Re: Department of Revenue Notice of Proposed Changes on Oil & Gas Production Tax – Discussion Draft for Carried-Forward Annual Losses, November 18, 2017

Dear Mr. Larsen:

In response to the Department of Revenue's ("Department") discussion draft for regulation that the Department may propose for the treatment of carried-forward annual losses under AS 43.55.165(a)(3) related to the statutory change made in ch. 3, SSSLA 2017(HB 111) ("HB 111"), ConocoPhillips Alaska ("ConocoPhillips") submits the following comments and questions for the Department's consideration.

15 AAC 55.217 – Carried-forward annual losses after December 31, 2017

The proposed subsection (b), in relevant part, states:

If the annual production tax value for a segment under 15 AAC 55.206(c)(1) outside the Cook Inlet sedimentary basin equals zero taking into account any applicable reduction in the gross value at the point of production under AS 43.55.160(f) or (f) and (g), the following procedure must be used to determine the producer's carried-forward annual losses, if any, for the segment for the calendar year, unless no oil or gas is produced during the calendar year from the segment:

At AS 43.55.165(a)(3) the Legislature enacted a carried-forward annual loss lease expenditure in circumstances where a taxpayer is unable to deduct lease expenditures (AS 43.55.165(a)(3)). Since the Legislature did not create carried-forward annual loss if a taxpayer's annual production tax value is zero, why does the regulation apply when the annual production tax value is zero?

In determining when the carried-forward annual loss lease expenditures may be deducted, the Legislature used permissive language ("may") at AS 43.55.165(o) therefore a taxpayer should not be mandated to determine a carried-forward annual loss as proposed in regulation 15 AAC 55.217(b). A taxpayer may calculate its annual production tax value for a segment and decide it will never be able to deduct the carried-forward annual loss, or by the time it could deduct, its value will be lost. Perhaps the carried-forward annual loss amounts to a minimal amount like $1,000, then the cost of tracking it will out-weigh the benefit. Yet, as proposed in draft regulation 15 AAC 55.217(b) a taxpayer is mandated to follow the procedures outlined in the regulations. Why does the Department believe calculating a carried-forward annual loss is mandatory?

The proposed subsection (b) at (2)(A) and (2)(B) uses a new phrase "located within segment leases or properties." It appears the Department means "located within leases or properties of a segment," rather than introducing a new phrase we recommend the Department reword the proposed draft language to comport with existing and defined terms.

The portion of the proposed regulation, 15 AAC 55.217(b)(2)(A)-(C) introduces an entirely new concept by dividing each segment into three groups (producing, non-producing and exploration not on a taxpayer's leases), and then creates an exceedingly complex calculation that will require manual computations and an inordinate amount of administration on both the taxpayer's and the Department's part. Since lease expenditures are not tracked by Group A, B or C, it is unlikely that auditors and taxpayers will agree on the Grouped amounts. We strongly recommend against the use of these three groups, as this change, as well as the multiple references to "segment leases or properties", will greatly increase the complexity of the tax, negatively impacting both taxpayers and the Department.

Due to the proposed Grouping of lease expenditures, it appears the value of the carried-forward annual loss lease expenditures is being diminished. For instance, by segregating costs incurred into produced oil (Group A) and to Groups B or C, a greater loss will be created because Group B and Group C do not have revenues. The ability of utilizing the carried-forward annual loss will also be negatively impacted. Group A's loss will be less even though the costs incurred were for developing and producing oil.

Using the North Slope oil segment, as an example, a taxpayer that incurs costs in Group C (15 AAC 55.217(b)(2)(C)) for seismic is now required to allocate a portion of those costs to other segments if an annual loss is incurred. This is required even though the seismic costs are not related to the other segments. This allocation of costs to determine the carried-forward annual loss by segment potentially negatively impacts the ability to recover this carried-forward annual loss and could lead to reduced spending on seismic or exploration activity during periods when a potential loss could be incurred.

It is unclear in the draft regulations if the complex procedure for determining the carried-forward annual loss, as detailed in 15 AAC 55.217, apply if any individual segment has a production tax value equal to zero, or if this procedure only applies if the taxpayer in total has a production tax value equal to zero. Our understanding of the intent of HB111 was to apply ring fencing of the carried-forward annual loss only when the taxpayer in total has a loss. The regulations as currently drafted have the potential to require the use of the complex allocation procedures even if there is a very small loss within a specific segment, such as gas used in state. This will potentially add a significant administrative burden to address a very minor loss.

If the Department would like to discuss the above comments and questions, please feel free to contact me.

Sincerely,

Jamie Vog on behalf of Marie Evans

Marie P. Evans

Comment on November 18 2017 discussion draft of AS 43.55 Regulations
Dan E Dickinson, CPA
December 5, 2017

This set of regulations is intended to implement the new AS 43.55.615(s), which merely requires that in adopting regulations what costs can result in a "carried forward annual loss", "the department shall include an exploration lease expenditure that is reasonably related to the that lease or property."

It does not require the department to define "reasonably related", and indeed in the discussion draft of the proposed regulations, the department has not. Instead on page 11 – 12, the proposed 15 AAC 55.217(e) sets forth five examples of "reasonably related". If it is the departments intent to illustrate rather than define, then my first suggestion is that department should make it clear that just because a situation does not fit neatly in proposed 15 AAC 55.271(e) (1) through (5) does not mean is not a way to be reasonably related. (Alternatively, if there are certain ways of being related that the Department will not find reasonable, then it should identify them in this regulation.)

These listed examples focus on subsurface relationships. Surely those are only a subset of possible reasonable relationships. For example, North Slope frontier exploration is a costly and often cost-constrained activity. The ability to use common assets such as ice roads or personnel camp and other cost reducing measures to explore for two distinct reservoirs, or indeed building up North Slope capacities to undertake a multi-year exploration program would all appear to reasonably relate distinct reservoirs.

Given the broad range of possible was to be reasonably related, I do not believe that this regulation needs to be near this complex. When there is a pre-existing set of rules, based on tax, it would seem eminently reasonable to use those. At it broadest, (and simplest) I suggest these regulations make clear that any exploration activity within the North Slope Oil or Gas segment is reasonably related to other North Slope segment activity.