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
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Re: Second Set of Proposed Regulations Affecting the Oil and Gas Production Tax to implement Ch. 3 SSSLA 2017 (HB 111)

Dear Mr. Larsen:

The Alaska Oil and Gas Association ("AOGA") appreciates the opportunity to provide comments in response to the Department of Revenue's (DOR) second set of proposed tax regulations implementing HB 111. For nearly half a century AOGA has been the trade association of the petroleum industry in Alaska, and our members actively continue to explore for, develop, produce, transport, and refine oil and gas in the state. In keeping with our practice regarding tax matters, all our members have had the opportunity to review and contribute to these comments, and they have been approved without dissent.

Our comments below on the proposed regulations are in addition to our comments previously submitted on December 5, 2017 in response to the DOR's discussion draft of these proposed regulations. We again thank the DOR for having allowed industry the opportunity to provide advanced comments on the proposed regulations in their draft form. AOGA and its members are also pleased to acknowledge the DOR's acceptance of several of our prior comments as reflected in the second set of proposed regulations. We believe the process of the DOR and industry exchanging questions and concerns in advance of the issuance of the second set of proposed regulations resulted in proposed regulations that are significantly clearer and which should result in reduced misinterpretations and potential audit disputes.

While the second set of proposed regulations are overall clearer and less ambiguous, AOGA believes there remains several areas of proposed regulation 15 AAC 55.217 where additional guidance or clarity should be provided. As always, AOGA would request wherever possible the

DOR provide more detailed examples 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.

I. 15 AAC 55.217(c)(2):

Section (c)(2) provides that if a producer wishes to disclaim the right to use in a future year any carried forward annual loss, such disclaimer will be binding on any transferee of such an interest or any person that may acquire the producer. Under what circumstances does DOR envision a "disclaimer" of a loss and how would that work with respect to any assigned tax credits or tax credits that have been or may be transferred?

II. 15 AAC 55.217(e)(1):

Section (e)(1) provides that geological or geophysical exploration, other than a stratigraphic test well, that is within twenty-five miles of land that later becomes part or all of a lease or property of a producer shall be considered reasonably related to that lease or property for purposes of the determination and application of any carried forward annual loss. While AOGA appreciates the DOR expanding the geographic limitation from the originally proposed three-mile limitation to twenty-five miles, we remain concerned as to the genesis of that limitation? Where in HB 111 does that restriction appear? In addition, how will that twenty-five mile limitation be determined or measured? By surface well location, production facilities, bottom-hole, or other? Additional guidance and specifics by the DOR should be provided to avoid any boundary or audit disputes.

III. 15 AAC 55.217(e)(5):

Section (e)(5) provides that a lease or expenditure incurred by a producer by means of a stratigraphic test well will be considered reasonably related to a lease or property acquired by the producer if the producer "relies on information gained from the well in evaluating that lease or property for acquisition." How will this standard be established or even proven to the satisfaction of the DOR or an auditor? What information will the taxpayer be required to provide and in what time frame? How long will the DOR have to provide its acceptance of the taxpayer's reliance? Unless more guidance is provided in the regulation, how will a taxpayer reasonably know if the DOR has approved the use of the carried forward annual loss from such stratigraphic test well before the taxpayer files its production tax return(s)? How will the Division ensure consistency of audit position from one taxpayer to the next, especially when auditing the same project?

IV. 15 AAC 55.217(h)(1):

Section (h)(1) provides that if a producer acquires an interest in a lease or property that producer may use the unused carried forward annual loss established by lease expenditures previously incurred by the transferor provided, among other things, that the transferor of the interest provides the acquiring producer with a description and documentation of the lease expenditure which established the carried forward annual loss with sufficient specificity to distinguish those prior incurred lease expenditures from other lease expenditures incurred by the transferor and to justify on audit the deduction of the carried forward annual loss.

A carried forward annual loss is determined on a segment by segment basis, not on a lease or property by lease or property basis within the same segment. What authority is the DOR citing to allow the establishment of this new lease by lease requirement? Without sufficient statutory authority, it would appear the proposed regulation is inconsistent with HB 111 and, at least to that extent, would be invalid under AS 44.62.030.

Assuming proposed 15 AAC 55.217(h)(1) is valid, what information or documentation would the DOR accept as sufficient specificity to allow justification on audit? What guidelines will the DOR provide taxpayers in advance to allow them to be able to provide the necessary information? How would the application of this new audit justification standard work in practice? Different taxpayers could be at risk to different interpretations by different auditors as to the type or amount of information or specificity to justify the use of any acquired carried forward annual loss with all of the risk falling on the taxpayer.

Suppose a producer acquires an interest in a qualified lease or property with a carried forward annual loss from a transferor who provides what the transferor believes is sufficient information and specification to allow the use by the acquiring producer of the carried forward annual loss. Suppose the acquiring producer wishes to use that carried forward annual loss in one or more of its production tax returns for a tax year occurring before the transferor's lease expenditures which generated the carried forward annual loss have been audited by the DOR, what rules or procedures will be applied? How would the acquiring producer be made aware that the acquired carried forward loss may have to be adjusted? Will the acquiring producer be able to challenge the decision? Will the acquiring producer be subject to potential penalties or interest if one or more of its production tax returns have to be amended to reflect an adjustment to the acquired carried forward annual loss due to no fault of the acquiring producer?

Without specific guidelines set forth in the proposed regulations, these are but a few of the potential issues, concerns and inequities that the proposed regulation could create.

V. 15 AAC 55.217(i):

Section (i) provides that if a taxpayer 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." This limitation is not in the statute and was never intended by the Legislature so where is the DOR's authority for it? Without sufficient statutory authority the proposed regulation is inconsistent with HB 111 and, at least to that extent, would be invalid under AS 44.62.030.

Moreover, what is the DOR's or the Administration's policy reason justifying it?

Assuming the proposed regulation is valid, how will a taxpayer know what the DOR will accept to determine “the value of the consideration paid for the acquisition”? How will the DOR let the taxpayer know of its determination of the value of the consideration? By when? What rules or valuation standards will the DOR apply? Will the DOR publish those rules or standards?

Without specific guidelines or rules within the proposed regulations, taxpayers be subjected to a risk of a case by case/taxpayer by taxpayer inconsistent treatment under audit.

VI. 15 AAC 55.217(j):

Section (j) provides that a taxpayer must provide a written request to the Commissioner of the DOR to request the AOGCC to determine whether, and if so, when, regular production of oil or gas has commenced from a lease or property to allow of any gross value reduction under AS 43.55.160(f) and (g) but also in the determination and application of any carried forward annual loss. While we appreciate the DOR adding this procedural guidance to the proposed regulation, the proposed regulation still leaves many potential questions or concerns unaddressed.

What standards will the DOR or AOGCC use to determine the commencement of regular production? How long will the determination by the AOGCC or DOR take? Shouldn’t there be a specified period of time in which the AOGCC and/or DOR must act?

What remedies would a taxpayer have if it disagreed with the AOGCC’s or DOR’s determination?

What would happen if a lease or property previously determined to be in regular production ceases production for some prolonged period of time, would the taxpayer be required to submit another request for the AOGCC or DOR to determine if and when that lease or property is still or has resumed regular production? If so, how long must the cessation of production be to require a determination of regular production?

Thank you again for allowing AOGA and its members to provide comments on these proposed regulations. Please contact me if the DOR has any questions or would like to meet to discuss these comments.

Very truly yours,

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January 26, 2018

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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") Notice of Proposed Regulations to implement ch. 3, SSSLA 2017(HB 111) ("HB 111"), ConocoPhillips Alaska ("ConocoPhillips") provided oral comments at the January 11, 2018 hearing and submits the following comments and questions for the Department's consideration.

CARRIED-FORWARD ANNUAL LOSSES & RING FENCING CARRIED-FORWARD ANNUAL LOSSES

The Legislature ended net operating loss tax credits and created a carried forward annual loss deduction. While contemplating this change the Legislature decided that within the net value tax structure the net operating loss tax credit could not be removed without creating a mechanism that allowed taxpayers to recover a portion of costs. Only where costs exceeded production tax value would a carried-forward annual loss deduction be "ring-fenced." The application of the carried-forward annual loss was purposefully unrestricted due to diverse taxpayer situations leaving the taxpayer to decide when application of the carried-forward annual loss should be applied.

<u>Proposed Regulation 15 AAC 55.217(d)</u>

The Legislature's intent to leave the decision of when to apply a carried-forward annual loss deduction was embodied at AS 43.55.165(m):

> In a calendar year, after application of a producer's lease expenditures that are incurred that calendar year, the producer may choose to apply all or a portion of a carried-forward annual loss or carry an unused portion forward. The department may not require a producer to apply all or a portion of a carried-forward annual loss in a calendar year.

The Legislative discussion and intent behind AS 43.55.165(m) recognized taxpayers have different tax positions and rather than mandate application, the Legislature left the application with the taxpayer to determine the best way to maximize the value of their investment costs. Yet, the proposed regulation at 15 AAC 55.217(d) requires an allocation to gas used in state, after carried-forward annual loss deductions were created, using the current year production.

Proposed Regulation 15 AAC.217(d) states:

> (d) This subsection implements AS 43.55.165(o)(1). A carried-forward annual loss established under (b) of this section may be deducted only in calculating an annual production tax value for the same segment under 15 AAC 55.206(c)(1) for which the carried-forward annual loss was established. A carried-forward annual loss established for a segment described in
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> (1) 15 AAC 55.206(c)(2)(A) may be deducted **only** in calculating annual production tax values for the following segments, if the lease expenditures establishing the carried-forward annual loss were incurred to explore for, develop, or produce oil or gas deposits located within a lease or property that includes land north of 68 degrees North latitude, with the carried-forward annual loss allocated between the segments proportionally to the respective amounts of gas used in the state and of oil and other gas produced by the producer from the lease or property during the calendar year regular production of oil or gas commences from the lease or property:
>
> (A) gas used in the state produced by the producer from the lease or property;
>
> (B) oil and other gas produced by the producer from leases or properties that include land north of 68 degrees North latitude;
>
> (2) 15 AAC 55.206(c)(2)(A) may be deducted **only** in calculating annual production tax values for the following segments, if the lease expenditures establishing the carried-forward annual loss were incurred to explore for oil or gas deposits located within land that is not the producer's lease or property and is located north of 68 degrees North latitude, with the carried-forward annual loss allocated among the

> segments proportionally to the respective amounts of gas used in the state and of oil and other gas produced by the producer from leases or properties that include land north of 68 degrees North latitude during the first calendar year that regular production of oil or gas commences from any of the leases or properties:
>
> (A) gas used in the state produced by the producer from each lease or property that includes land north of 68 degrees North latitude;
>
> (B) oil and other gas produced by the producer from leases or properties that include land north of 68 degrees North latitude;

(Emphasis added).

During the January 11, 2018 hearing we discussed the existing regulation 15 AAC 55.206(c)(1) applies where a producer or explorer produces oil or gas. Once in production a producer or explorer would not move to 15 AAC 55.206(c)(2) because it applies to a producer or explorer that does not produce oil or gas. However, it the proposed regulation 15 AAC 55.206(d) requires that a producer or explorer that had no production of oil or gas for years 1, 2, 3 and 4 and calculated its carried-forward annual loss deductions pursuant to 15 AAC 55.206(c)(2) is required, upon production in year 5, to go back and allocate the loss deduction as if the producer or explorer existed under 15 AAC 55.206(c)(1) in years 1 through 4 using the production from year 5. Absent such allocation the deduction is not allowed.

A required allocation of a carried-forward annual loss deduction to gas used in state (even though the investment was for oil) means the taxpayer losses part of its carried-forward annual loss deduction(s). The Department of Revenue's Response to Questions Asked at January 11, 2018 Public Hearing at Question 2 appears to indicate that it will require the retroactive allocation to years 1-4 based on year 5, in the example above, due to existing regulation 15 AAC 55.215(d). We do not believe the proposed or existing regulations implement the Legislative intent that cost recovery is appropriate in a net value tax system. The regulations should not reduce the carried-forward loss deduction and discouraging producers from incurring costs in low price environments or explorers from incurring costs to find new oil. Rather the regulations proposed or existing should implement the Legislature's intent.

Proposed Regulation 15 AAC 55.217(f)

As noted above, the Legislature's intent to leave the decision of when to apply a carried-forward annual loss deduction was embodied at AS 43.55.165(m):

> In a calendar year, after application of a producer's lease expenditures that are incurred that calendar year, the producer may choose to apply all or a portion of a carried-forward annual loss or carry an unused portion forward. The department may not require a producer to apply all or a portion of a carried-forward annual loss in a calendar year.

Proposed regulation 15 AAC 55.217(f) prohibits a taxpayer from deducting carried-forward annual losses out of order. In other words, if a taxpayer has a loss in Year 1, 2 and 3, the taxpayer must first deduct the entire loss in Year 1 before deducting any of the loss in Year 2. Since the value of a loss begins to erode on January 1 of the 11th calendar year (AS 43.55.165(p)), it makes sense to use the losses in order, however, the Legislature's statutory language clearly provides, "[t] he department may not require a producer to apply all or a portion of a carried-forward annual loss in a calendar year." The administrative inconvenience explained in the Department of Revenue's Response to Questions Asked at the January 11, 2018 Public Hearing for Question 1 is an understandable concern. Administrative inconvenience will impact both the Department and the taxpayer under these circumstances. Nevertheless, we do not believe that administrative inconvenience authorizes a departure from the statutory language the Legislature debated and enacted.

Proposed Regulation 15 AAC 55.217(i)

This proposed regulation states:

> If a producer acquires another producer or explorer, the amount of 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 multiplied by 2.86.

At the January 11, 2018 hearing we inquired about the basis for the 2.86. The Department advised the 2.86 represents the tax benefit at 35%. The 2.86 multiplier applied to an acquisition price that is lower than the amount of unused carried-forward annual loss deductions reduces the carried-forward annual loss deductions. Mathematically, this regulation prohibits the acquisition price to be less than 65% of the unused carried-forward annual loss deduction amounts and if it is, then the Department decided to impose its own limitations.

As HB 111 progressed through the Legislature, the Department expressed concern the large producers would purchase small explorers for the tax credits and forgo development of exploration finds. The Legislature addressed that concern by ring-fencing the application of a carried-forward annual loss deduction until production begins as well as diminishing the value of such deductions beginning with the 11th year after the carried-forward loss deduction was established. Now, it appears the Department is removing an additional amount and the basis for doing so is not supported by the Legislative discussion or the statute enacted.

Proposed Regulation 15 AAC 55.217(j)

The last sentence of proposed regulation 15 AAC 55.217(j) states

> Upon receiving a written request from a producer, the department will request the Alaska Oil and Gas Conservation Commission to determine whether, and if so when, regular production of oil or gas has commenced from a lease or property.

At the January 11th hearing we inquired whether the Department's request to the AOGCC will address the determination of "regular production" for both the gross value reduction and the application of a carried-forward annual loss or whether the determinations would be separate. The Department expressed that it intended to utilize one request to the AOGCC where the determination of regular production is needed for both the gross value reduction and the carried-forward annual loss.

Since the proposed regulation pertains only to AS 43.55.165(o), the application of a carried-forward annual loss, we recommend the Department consider a different section for this sentence if it is also intended for the gross value reduction.

EXPLORATION EXPENDITURES REASONABLY RELATED TO THE LEASE OR PROPERTY

HB 111 added a new subsection, AS 43.55.165(s), and it states

> In adopting a regulation that defines the lease or property where a lease expenditure resulting in a carried-forward annual loss is incurred for purposes of (o) and (p) of this section, the department shall include an exploration lease expenditure that is reasonably related to the lease or property.

The proposed regulation, in relevant part, at 15 AAC 55.217(e)(1) states

> [A] lease expenditure incurred by a producer to explore for oil or gas deposits (A) within land that later becomes part or all of a lease or property of the producer, or (B) in the case of geological or geophysical exploration other than a stratigraphic test well, within 25 miles of land that late becomes part or all of a lease or property of the producer is reasonably related to that lease or property, beginning in the calendar year the land becomes part or all of that lease or property;

During the hearing we discussed that the use of a geographical restriction, 25 miles, is a linear measurement that does not evaluate "reasonably related." "Reasonable" is subjective. It is attempting to gauge the substance of a cost, not the linear distance. The use of distance to define the relationship of a cost to exploration is artificial and undermines the Legislative intent to incentivize exploration.

Furthermore, the use of 25 miles creates confusion with the statutory provisions at AS 43.55.165(b)(2) which, in defining lease expenditures, states

> an activity does not need to be physically located on, near, or within the premises of the lease or property within which oil or gas deposit being explored for, developed, or produced is located in order for the cost of the activity to be a cost upstream of the point of production of the oil or gas;

With the proposed regulation placing a distance restriction on exploration lease expenditures, the statutory definition of a lease expenditure is directly contradicted and the Legislative policy to incentivize exploration is diminished. In addition, it is going to be confusing and likely a point of disagreement on how to measure the 25 miles.

The proposed regulation language also uses a different time for deducting exploration lease expenditures than the statute and regulations use for lease expenditures by stating

> ...is reasonably related to that lease or property, beginning in the calendar year the land becomes part or all of that lease or property.

This language instructs a producer or explorer with a negative production tax value to remove those exploration costs from the loss, set the costs aside and wait until the costs become reasonably related. The costs will be "reasonably related" and thereby deductible "in the calendar year the land becomes part or all of" a lease or property. Due to the length of time between exploration and obtaining participating areas or Units, the exploration costs could be set aside for 5 or more years. Absent clarification, it appears that exploration costs incurred that do not result in success are lost altogether.

Compounding the confusion related to timing, the proposed regulation language at 15 AAC 55.217 (e)(2) and 15 AAC 55.217 (e)(4) differs. At 15 AAC 55.217(e)(2) exploration lease expenditures, if incurred when the taxpayer has a loss, become "reasonably related" "the first calendar year the lease expenditure is reasonably related to the participating are is the calendar year the participating area is established,...," but at 15 AAC 55.217(e)(4) exploration lease expenditures become reasonably related "...the later of the calendar year during which (A) the lease expenditure is incurred, or (B) the lease or property is first shown to contain all or part of the reservoir."

The differing standards for determining "reasonably related" generate instability and confusion, giving rise to questions like how the costs will be audited, what if the producer or explorer finds a different reservoir, and how will a taxpayer reconcile the existing statute and regulations with the proposed. Without clarification, the accounting for exploration costs is impractical and the Legislative intent to incentivize exploration and continued investment at low prices is thwarted.

In closing, the "opt-out" language the Department incorporated into the regulations is appreciated. While we do not believe the Legislature intended for the complexity of allocating costs to the gas used in state segment to create a carried-forward annual loss deduction purely due to math,[1] this will provide an alternative to forgo the regulatory complexities if the loss deduction is immaterial.

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s[1] Costs are incurred to explore, produce and develop oil on the North Slope not gas. Gas is a by-product and a small amount is used in-state therefore allocation of costs to this segment easily create a loss.

We encourage the Department to reconsider whether it is implementing the Legislative intent and the statute enacted with the proposed regulations.

Sincerely,

Marie P. Evans