Alaska Oil and Gas Association

AOGA

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August 30, 2010

Mr. John Larsen, Audit Master
Alaska Dept. of Revenue, Tax Division
550 West 7th Avenue, Suite 500
Anchorage, AK 99501

Re: AS 43.55 Regulations Proposed 7/23/2010

Dear Mr. Larsen:

The regulations proposed by the Department on July 23, 2010 principally address two matters: (1) joint-interest billings ("JIBs") under operating agreements for leases and properties already in production or that are being, or planned to be, explored; and (2) payments by a producer to one or more other producers to have its raw production stream produced through facilities that the latter own. Since the Proposed Regulations appear to complete the intellectual structure of the regulations to implement AS 43.55 as amended by ch 1 SSSLA 2007 (the "ACES Tax"), it is also appropriate to review that structure as a whole, and we have done so in the attached.

As you know, AOGA previously provided considerable input to you (and to the Legislature) on the ACES framework, and in particular, on the matter of Departmental use of joint interest billings as the starting point for reporting and paying tax under ACES. Despite assurances from the Commissioner and others during legislative debate that the use of JIBs would be one of the tools, the regulations as proposed will instead result in their disallowance.

If ACES is to be successful in attaining the goal of increasing industry investment in the State, the rules must be clear and predictable at the time investment decisions are being made. Unfortunately, the approach embodied in the nearly-completed implementing regulations is exactly the opposite and will continue to negatively affect these decisions.

Very truly yours,

Marilyn Crockett

Marilyn Crockett
Executive Director

Cc: Commissioner Patrick S. Galvin
Mr. Jonathan Iversen, Director, Tax Division

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ALASKA OIL AND GAS ASSOCIATION COMMENTS ON PROPOSED REGULATIONS UNDER AS 43.55 AND THE STRUCTURE AND EFFECTS OF THE OVERALL REGULATIONS IMPLEMENTING THE ACES TAX

AUGUST 30, 2010

Today the Alaska Oil and Gas Association ("AOGA") submits comments regarding the regulations (the "Proposed Regulations") under AS 43.55 proposed by the Department of Revenue (the "Department"). AOGA is a private trade association for the oil and gas industry in Alaska, and our members account for the majority of oil and gas exploration, development, production, refining and shipping activities in the state. AOGA and its members have provided considerable input to the Legislature and the Administration throughout the last 2 ½ years on provisions of the new ACES tax.

The Regulations proposed by the Department on July 23, 2010 principally address two matters: (1) joint-interest billings ("JIBs") under operating agreements for leases and properties already in production or that are being, or planned to be, explored or developed; and (2) payments by a producer to one or more other producers to have its raw production stream produced through facilities that the latter own. Since the Proposed Regulations appear to complete the intellectual structure of the regulations to implement AS 43.55 as amended by ch 1 SSSLA 2007 (the "ACES Tax"), it is also appropriate to review that structure as a whole.

I. Amendments to 15 AAC 55.245.

The Proposed Regulations would repeal the existing provisions of 15 AAC 55.245(a) – (c) and adopt a new subsection (d) saying, in effect, that operating agreements and JIBs thereunder are no longer "approve[d] or require[d]" for purposes of AS 43.55. A proposed amendment to 15 AAC 55.800(a) would make this retroactively applicable to oil and gas produced after March 31, 2006. AOGA believes the effect of these amendments will be the disallowance of JIBs as the starting point for reporting and paying tax under AS 43.55.011 and for the Department's audit and enforcement of that tax.

We are dismayed that the Department has apparently not been listening to what we have been saying about JIBs in our comments on the regulations to implement the ACES Tax. Our

concern all along has been about what taxpayers are supposed to use, and may reasonably rely on subject to audit, as the source of the information they need to have in order to compute and pay their tax as it becomes due.[*] [1] The Department, it seems, has misunderstood our advocacy of JIBs as that source, viewing it as an attempt to dictate what is or is not allowable under AS 43.55.165 on the basis of what is or is not billable under the respective operating agreement. Starting even when the ACES Tax was being considered during the 2007 Second Special Session,[2] that has not been our intention.[3]

AS 43.55.165(b)(3) grants the Department broad discretion regarding the kinds of information and the accounting standards and practices that it may authorize or require taxpayers to use for reporting and paying the tax.[†] This broad discretion may be helpful or convenient for the Department when it is auditing a taxpayer's reported lease expenditures on audit. But all that discretion is useless for oil and gas explorers and producers in this state who need to know by the end of each calendar month what costs they may deduct for the previous month, unless the Department through its regulations has crystallized its discretion into a clear, workable system that the taxpayers can use.

The information necessary for correctly computing and reporting the tax under ACES must be readily available to explorers and producers, and they must start somewhere. Since it is the one with all the statutory discretion, it is up to the Department to tell them where that "somewhere" is. The Department has basically two options available for defining "somewhere" — it can either create a special system of accounts for categorizing different types of expenditures that is used only for AS 43.55 purposes, or it can piggyback off a system of costs that already exists for another purpose. Of the latter there exist two alternative information sources: the federal partnership tax returns for the unit, and the JIBs under the operating agreement for that unit.[4]

Federal partnership returns, however, suffer from three major defects with respect to the ACES Tax. One, they lack the level of detail about expenditures that is needed for determining how much (if any) of them fall into forbidden-cost categories under AS 43.55.165(e). Two, the characterization for a cost item on the partnership return does not bind the individual partners to

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[*] For convenience in presenting the main text of these comments, footnotes (like footnote "1") that document our prior public statements to the Department appear as numbered endnotes after the end of the comments.

[†] AS 43.55.165 (b)(3) provides:

> (3) [I]n determining whether costs are lease expenditures, the department may consider, among other factors,
>
> (A) typical industry practices and standards in the state that determine the costs, other than items listed in (e) of this section, that an operator is allowed to bill a producer that is not the operator, under unit operating agreements or similar operating agreements that were in effect before December 2, 2005, and were subject to negotiation with at least one producer with substantial bargaining power, other than the operator; and
>
> (B) standards adopted by the Department of Natural Resources that determine the costs, other than items listed in (e) of this section, that a lessee is allowed to deduct from revenue in calculating net profits under a lease issued under AS 38.05.180(f)(3)(B), (D), or (E). [emphasis added]

characterizing it that way on their own federal returns. And the IRS audits the individual partners' returns, not the one for the partnership. And three, federal partnership returns typically are not prepared and distributed until September of the following year, meaning they are not available for ACES taxpayers when they file their monthly estimated returns during the year or their annual true-up on March 31 of the following year.[5] And so this leaves JIBs as the best available "somewhere" as the starting point for information to determine and report the ACES Tax.

While they are the most practical and practicable option as the "starting" point, we have acknowledged that JIBs are not the end point for lease expenditures. We "endorse[d,]" for example, "the substance ... and the points" of the following comments by BP Exploration (Alaska) Inc. ("BPXA") dated February 23, 2009:[6]

> Instead of attempting to list what's deductible as lease expenditures and what isn't, the regulations [sh]ould establish a process for DOR to audit the system of accounts under each active JIB agreement for oil and gas exploration or production, and the object of the audit would be to determine which cost codes within that system of accounts are allowable as lease expenditures and which ones aren't. The regulations to set up this process would provide for the following:
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> ...
>
> - The results of DOR's audit of a system of accounts under a particular JIB agreement would be given to, and be binding on, all parties to that agreement.
> - Instead of being definitions of "lease expenditures" and the elements thereof, provisions like those proposed in 15 AAC 55.250(c) and 15 AAC 55.160 ... would set audit standards by which cost codes in a system of accounts would be judged during the audit of that system as being allowable lease expenditures or disallowed. ...
> - Any party(s) to a JIB agreement who is aggrieved by the result(s) of DOR's audit of the system of accounts under that agreement would be able to appeal. The regulation could further specify that, during the pendency of such an appeal, the parties to that agreement must report and pay tax on the basis of the audit results (with a right to a refund or other adjustment of the audit results are overturned or modified in the final outcome of the appeal).
> - The audit results for a system of accounts under a JIB agreement would not preclude DOR from later re-auditing the system to ensure that neither it, nor the types of costs being entered into the cost codes within that system, have materially changed since the prior audit. To the extent a new audit finds there has been one or more such changes, it could address them as appropriate back to the item the changes occurred or to the earliest open tax period under AS 43.55.075 and AS 43.05.260(c), whichever is later — subject, again, to appeal by an aggrieved party. But, to the extent the later audit finds no such changes, any modification of the prior audit's results should only be prospective....

BPXA Comments (23 Feb 2009) at 5-6 (footnotes omitted). We endorsed this concept a year

and a half ago when BPXA presented it,[*] we have publicly reaffirmed it during the time since then,[7] and we still endorse it today.

Yet — in the July 27th "Considerations" justifying its removal of the JIB provisions from 15 AAC 55.245 (http://www.tax.alaska.gov/programs/documentviewer/viewer.aspx?543) — the Department addresses problems and matters wholly different from what has been proposed to it. The first "consideration" cites the repeal of AS 43.55.165(c) and (d) as the reason why allowing the use of JIBs "would be short-lived" — reflecting the view that DOR's legal authority to authorize or require the use of JIBs was cut off as of the April 1, 2006 effective date of that repeal. This is not what Commissioner Galvin and other representatives told the Legislature during the 2007 Special Session that enacted ch 1 SSSLA 2007.[†]

It was AOGA who first expressed concern to the Legislature that the repeal could be read

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[*] The BPXA comments also reflect what AOGA had earlier said at the very first hearing in the 2007 Second Special Session where we were invited to testify. *See* House Special Committee on Oil and Gas, MINUTES (23 Oct 2007), at 9:22:55 AM – 9:31:37 AM, which is quoted in pertinent part in Endnote 2.

[†] The other three "Considerations" posted by the Department about the amendments to 15 AAC 55.245 are also mis-founded. The second one asserts that the "use of operating agreements would require the Department to implement multiple auditing standards: one for each approved or required operating agreement, and another (the lease expenditure regulations) for situations not covered by an approved or required operating agreement." This reflects an erroneous belief that using JIBs as a starting point implies that the JIB agreements would then define what is deductible. To the contrary, the BPXA Comments quoted *supra* at 3-4 describe how a single set of principles about what kinds of costs are deductible could be applied to audit the system of accounts for each JIB agreement and identify which cost accounts in it are not deductible. This would involve an audit for each active JIB agreement, but it would avoid having the in-depth audits of each participant in each JIB agreement on a separate, individual basis as the Department is, or will soon be doing under the regulations it has adopted and is adopting.

The third "Consideration" is that, "were operating agreements to be used, allowance or disallowance of costs in some instances would depend on the outcome of internal unit audits, ... the results of which (e.g., in the case of compromises) may not be transparent with regard to the treatment of particular cost items." There is a simple tool that could be put into the regulations to solve this difficulty: namely, if there is a compromise or other resolution of such an audit that is not transparent, the non-transparent portion is nondeductible and allocated among deductible and nondeductible items in the JIBs in proportion to their size before taking the non-transparent items into account.

The fourth "Consideration" is that "the use of operating agreements would necessarily involve inconsistent treatment of taxpayers, depending on which operating agreement applied or on whether the allowance or disallowance of particular costs were governed by an operating agreement or by the lease expenditure regulations" (emphasis added). Again, the underscored language reflects the erroneous belief that using JIBs means the respective JIB agreement defines what is deductible, and again we point to the BPXA Comments quoted *supra* at 3-4 that illustrate how such a result is easily avoided. Second, having auditors audit participants in a JIB agreement on an individual basis and applying the lease expenditure regulations to their respectively reported costs promises to cause far more "inconsistent treatment of taxpayers" in practice than there could possibly be under our recommended approach — at least under ours all participants in a JIB agreement would get the same results from DOR's audit of the system of accounts under that agreement, so they would all have a common starting point for identifying which costs in the JIBs are deductible and reporting their tax accordingly. Finally, even the potential differences in the systems of accounts between one JIB agreement and another can be significantly reduced, if not eliminated outright, if the Department applies consistently the principles of its lease-expenditure regulations in its audits of those systems of accounts. Consistent application of those principles will mean the same kinds of allowable costs, in substance, will be allowed in the aggregate for each JIB agreement, with the only differences between one agreement and another being in how those costs are divided up into cost codes under the respective agreement's system of accounts.

the way the Department seems to be reading it now,[8] and it was Commissioner Galvin and other officials in the Department who reassured the Legislature that this would not happen. Two days after AOGA first raised this concern before the House Special Committee on Oil and Gas on October 23, 2007, Commissioner Galvin appeared before that committee and refuted AOGA. The Committee's minutes of October 25, 2007* read in pertinent part as follows:

> 10:23:53 AM
> REPRESENTATIVE SAMUELS called attention to the confusion regarding the joint interest billings. ...
> 10:26:05 AM
> COMMISSIONER GALVIN responded that the recommendation to remove those two provisions in reference to joint interest billings [i.e., AS 43.55.165(b) and (c)] came from the auditor section of DOR. The intent was to maximize the auditor's ability to use the joint interest billings in compliance with the law. .... Their view was that if you remove those provisions that have a mandatory aspect, and keep the general language, then DOR can use whatever tools appropriate to assess the joint interest billings. [emphasis added; underscoring of the times deleted]

This was not the only time Commissioner Galvin gave such a reassurance to the Legislature,[9] nor was he the only witness for the Department to do so.

HB 2001, which is what became ch 1 SSSLA 2007, was proposed by the Administration. Thus, Commissioner Galvin's statements to the Legislature about the intended effects of its provisions — and those by others testifying for the Administration — are exceptionally persuasive evidence of legislative intent when, as here, the Administration's proposal to repeal AS 43.55.-165(b) and (c) was enacted by the Legislature without change.

Yet now we see that — far from "maximiz[ing] the auditor's ability to use joint interest billings" — the proposed amendments to 15 AAC 55.245 will throw away "whatever tools [might have been] appropriate" for using them. We question why the Commissioner's comments and those of others who then testified have been ignored in the present regulations.

II. Payments to use another producer's facilities.

Here, also, we remain confused as to why the Department continues to promote regulations dealing with the treatment of facility sharing expenditures that could jeopardize future production decisions at the expense of state revenue. 15 AAC 55.260(e) as it currently reads (and as it will read as amended under the Proposed Regulations) would disallow a portion of a company's facilities-use payment to the extent the payment compensates the facility's owner(s) either for deferring production to make room for the user-company's production, or for holding the facility-owner(s) harmless for any additional tax it may incur as the result of a Section 170 Adjustment to its own lease expenditures resulting from the user-company's facilities-

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* These and all other committee minutes quoted in the main text of these comments or in the endnotes have been downloaded from http://www.legis.state.ak.us/basis/minutes_form.asp?session=25 (last accessed 17 Aug 2010).

use payment. As we have commented before, this level of artificial symmetry[*] is not necessary and under the statutes is not required.

The effect of the regulation would be to force taxpayers to choose between constructing expensive, duplicative production facilities (which will result in higher lease expenditure deductions and credits against state ACES Tax revenues) or lose the deductibility of otherwise valid business expenses in processing its production through facilities owned by another party. Thus, the proposed regulation creates an economic disincentive, not only for the taxpayer but for the state, against a taxpayer's use of an existing facility instead of incurring the substantial cost of building a new one and increases the risk that the decision to produce otherwise marginally economic production may not go forward.

III. Brief review of the structure and effects of the completed ACES Tax regulations.

As we have just noted with respect to 15 AAC 55.280(c)(3), the new 15 AAC 55 is rife with regulations that reserve the Department's authority to take corrective action. Yet, as currently written, the regulations require the results of such an action become part of what taxpayers have to comply with *as they report and pay their tax*. Besides Section 170 Adjustments, this misordering appears throughout the regulations for valuing Alaska oil and gas at the destination (or other valuation point) where it is delivered, the transportation-cost regulations for netting back from that distant value to the "gross value at the point of production" in the respective field where the oil and gas was produced from, and the regulations for the lease expenditures that are deductible from the netback GVPP.

More fundamentally, taxpayers need the Department to fill in the blanks and determine the substance of the ACES Tax obligation now, not sometime out in the future. A lynchpin for the successful working of this intricate tax is clarity about the obligations and benefits that it offers to the people making the decisions to invest in Alaska, and those people need to have that clarity at the time they are making those decisions. Without that clarity at the time of their decisions, they will decide on the basis of a substantial discount of the seeming benefits to reflect the risk that they won't turn out to be what they seem. And that means investments won't be made that would have been made if there hadn't been a need for that risk discounting. Thus, by reserving its decisions until it has fuller information about what actually happens, the Department is reducing its risk of making mistakes in substance, but it does so at the cost of making the colossal mistake of destroying the tax's intended effectiveness in attracting investment here.

Unlike state royalties, the ACES Tax is not a contract. If the regulations reflect a decision today in filling in the blanks for this tax that the Department later comes to dislike, it is free at any time to amend its regulations accordingly.

Earlier this year we testified to the Legislature about amendments to AS 43.55, and in

[*] Between the deductibility of a user-producer's payments in conjunction with using an existing facility and the Section 170 Adjustments to the facility's owner-producer(s) for those payments.

that testimony we pointed out disturbing, empirical evidence of trends in our industry that show our points about the negative effects of uncertainty are not idle chatter. We noted the number of in-field development wells being drilled each year had declined from 166 wells in 2007 to 153 in 2008 and 147 in 2009. We cited BPXA President John Mingé's statements at the Meet Alaska Conference early this year that his company's "total drilled footage" for in-field wells "will be more than 50% lower in 2010" from the million feet drilled in 2007, and that his company had reduced its rig count by 30% during the prior 12 months. We cited public statements by ConocoPhillips about the one-third decline in exploration wells drilling in NPR-A from 2007 to 2009. John Archbold, that company's senior vice president for exploration, told Meet Alaska last January that "Significant potential remains in North Slope Giants" but added that "Giant fields have [the] worst fiscal terms" under the ACES Tax. He noted that his company surrendered 880,000 acres in NPR-A in 2009. Even though ConocoPhillips did bid in the most recent NPR-A lease sale, it bid only on acreage near its existing Alpine field and nearby satellites — which to us seems more like a program to extend the known fields outwards if possible, rather than the start of any significant new wildcat exploration program. Moreover, ConocoPhillips was the only bidder in that sale, another ominous sign.[*]

Some Alaskans will not believe our industry is in trouble until the last company turns out the lights and moves away. And to be completely clear, we are NOT saying that the industry is anywhere close to that point today. But, long before that final endpoint is reached, decisions will have been made about investing to offset the natural decline in production rates that occurs as the recoverable oil resource remaining in the ground is exhausted. And those decisions will determine Alaska's remaining course as an oil and gas province.

We and our members have testified that it will take billions and billions of new investment dollars during the coming decade to meet this challenge of declining production, and this is still true. And the urgency in attracting all this investment capital here is even greater now because the production decline has relentlessly continued during the time since that testimony was given. With each day that passes, there is less time left to ensure the future that Alaska could have, and which Alaskans deserve to have.

To ensure this future it is necessary that the tax when put into practice actually succeeds in attracting all the potential investment it could attract. Unfortunately for us all, the tax that the Department has put into place with these and its previously adopted regulations is doomed to fall short. The Department has followed a progressive process of obtaining public comment, refining its draft, and then opening that refined version to further public comment. But a process by itself — no matter how progressive — does not guarantee a successful result, as is shown by these Proposed Regulations and the ones already adopted.

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[*] AOGA, *Testimony of the Alaska Oil and Gas Association to the Senate Finance Committee about the Failings of the "ACES" Production Tax (*23 Feb 2010) at 8-9.

ENDNOTES

[1] *See* AOGA Comments (17 Jan 2007) at 5:

> DOR appears to be willing to allow producers to use their joint billings from the operator as their "lease expenditures" for that operation, provided those billings are made at arm's length and audited at arm's length, without collusion or conspiracy to evade PPT or commit fraud under the PPT. If so, then DOR's objective here is to "trust but verity" that the operator's billings are indeed made at arm's length and are being examined in a truly arm's length, non-collusive, non-conspiratorial process. This is a proper objective, and we too want a process based on joint billings that DOR has confidence in.

Also AOGA Comments (20 Feb 2008) at 1:

> A producer/taxpayer that is not the operator of a unit or field has no information about the nature and amount of the expenditures for the development and operation of that unit or field, other than what it has been invoiced by the operator for such expenditures. For such a non-operator we see no other starting point or source fore the information it must report under AS 43.55 and for the tax it must pay, month by month and at the annual true-up on March 31 of the following year.

Also AOGA Opening Statement at the 7 Oct 2008 Public Workshop, at 4:

> A non-operator does not see the specific invoices, timesheets, etc., etc. that document the expenditures that the operator bills out to the non-operating participants, except in the course of formally auditing the operator's billings. A non-operator has no details about any given expenditure billed to it by the operator, other than the operator's classification of that expenditure into an accounting code under the governing joint-interest billing agreement, or the operator's description of it in some other way or format, or the description of the project to activity in the AFE under which the expenditures has been authorized.

Also AOGA Comments (23 Feb 2009) at 5:

> For a taxpayer that is not the operator of a unit or comparable oil and gas operation, the information that it has available by th[e] due date about its share of the costs for that unit or operation is what it has been billed by the operator, and has paid. The system of accounts under the joint-interest billing agreement for that unit or operation, and the billings that the operator makes under that agreement, are the only logical staring points that the non-operator has for the information about the unit or operation that it needs in order to report and pay this tax when it is due.

[2] *See* House Special Committee on Oil and Gas, MINUTES (23 Oct 2007), at 9:22:55 AM – 9:31:37 AM, recording AOGA's testimony to that committee as follows:

> The PPT statutes currently allow DOR a choice between starting from the joint-interest billings and invoices that operators bill to the other participants in an oil and gas field or venture, or starting from a comprehensive set of accounting rules and principles that DOR writes up. Which choice DOR chooses will determine nothing less than the very success or failure of PPT as a tax - and for SB 2001 as well, if it is enacted. It is like having a tax based on your federal taxable income, and choosing between your federal tax return (as audited by IRS) as the starting point, or starting with the Internal Revenue Code and leaving it up to you and DOR's auditors alike to find what the right answer is under the Code. ...
>
> The other choice that DOR could make is to start with what an operator bills to the other participants in an oil and gas operation. Note that I said "start" with those billings – not "and." Anything in those billings that is nondeductible under AS 43.55.165(e) would have to be backed out. [emphasis added]

[3] *See* AOGA Comments (17 Jan 2007) at 6:

> 15 AAC 55.245 should have provided for and established ... a process by which DOR could examine each operating agreement and approve those this it finds to be ... appropriate in terms of what

costs are billable[.]

Also AOGA Testimony at the 7 Oct 2008 Public Workshop, at 8:

> DOR auditors could focus ... on the state-law issues that the participants would not ordinarily enforce among themselves through their audit process — namely, whether any of the billed costs are disallowed under AS 43.55.165(c), and if so, how much is disallowed.

Also BP Exploration (Alaska) Inc. Comments (23 Feb 2009) at 6 —

> Instead of being definitions of "lease expenditures" and the elements thereof, provisions like those proposed in 15 AAC 55.250(c) and 15 AAC 55.260 ... would set audit standards by which cost costs with a system of accounts would be judged during the audit of that system as being allowable lease expenditures or disallowed.
>
> Any party(s) to a JIB agreement who is aggrieved by the result(s) of DOR's audit of the system of accounts under that agreement would be able to appeal. The regulation could further specify that, during the pendency of such an appeal, the parties to that agreement must report and pay tax on the basis of the audit results ....
>
> The audit results for a system of accounts under a JIB agreement would not preclude DOR from later re-auditing the system to ensure that neither it, nor the types of costs being entered into the cost codes within that system, have materially changed since the prior audit. [emphasis, bullet-points and footnote omitted] —

endorsed in AOGA Comments (23 Feb 2009) at 1:

> [BPXA] has shared [its latest draft comments] with the Tax Committee and ..., we are assured, it will submit [them] today without material change from what we have read. We concur in and endorse the substance of those comments and the points that BPXA makes in them.

[4] *See* AOGA Opening Statement at the 7 Oct 2008 Public Workshop, at 6-7:

> The most unreliable and expensive tax to administer is one that creates a system of accounting or bookkeeping that has no other function or purpose than for that tax. ... If Alaska is to avoid creating a unique system of bookkeeping principles for purposes of this tax, there are really only two potentially viable candidates for being this primary source. One is the partnership tax returns for individual units and other ventures that is [*sic*] field with the IRS, and the other is the joint-interest billings from the operator of that unit or venture to the non-operating participants.

[5] *Id*. at 7:

> Using partnership tax returns as the source for the amount of a unit's or project's lease expenditures has a lot of serious problems that may not be obvious at first glance. For one thing, the partnership tax returns are not prepared and available to any of the participants until September of the following year.... More fundamentally, partnership tax returns will not provide the level of detail about the expenditures ... that would enable either DOR or a taxpayer to determine reasonably and reliably how much of those expenditures fall into forbidden categories under AS 43.55.165(e). Also, the characterization of classification of expenditures on a partnership tax return is not binding on the respective participants.... And finally, there is no IRS audit of the partnership tax return as such. What the IRS will audit is the tax returns of the participants in the "partnership[.]"

[6] AOGA Comments (25 Feb 2009) at 1:

> BP Exploration (Alaska) Inc. ('BPXA') has shared [its current draft comments] with the Tax Committee and ..., we are assured, it will submit [them] today without material change from what we have read. We concur in and endorse the substance of those comments and the points that BPXA makes in them.

[7] *See*, e.g., AOGA Testimony on ACES to the Senate Finance Committee (23 Feb 2010) at 4-5:

> ... Instead of ignoring the joint-interest billings from operators to the non-operating interests,

the regulations should embrace them as the starting point for reporting and paying tax. ...

We are not suggesting, however, that the Department should rely blindly on the non-operators to audit the operator's billings. As Ronald Reagan famously said about dealing with the Soviet Union during the Cold War, "Trust, but verify." In the case of ACES, "verity" for the Department would mean auditing the automated system of accounts that each operator has for recording its expenditures as operating and billing out those costs to the non-operating participants. Particular cost codes within such a system of accounts could be identified by this audit as disallowed kinds of cost, and by giving notice to the operator and all the non-operating interests that those cost codes are disallowed, the Department would ensure that all the participants in a unit or property would be on the same page with respect to cost codes that are allowed and billable under the operating agreement but disallowed for ACES purposes. The Department's audits of individual companies could then be simplified to verifying that nothing in the disallowed cost codes was deducted by any of them in their respective ACES tax returns, thereby conserving audit resources while ensuring consistency among taxpayers.

At the same time the Department could "verify" the ongoing integrity of each automated system of accounts by periodically confirming, first, that the software for that system has not been changed since the Department's last audit of that system, or if changed, has not been changed incorrectly for ACES purposes. And if there has been an incorrect, change, the Department would identify the resulting new cost codes that are disallowed and put all taxpayers in that unit or field on notice of those changes to the list of disallowed cost codes.

The Department of Revenue could actually do al these things without having to change any of the substance of what it intends to allow or disallow as lease expenditures in its new regulations. But, to do so, the Department — instead of using the regulations to define what is or is not allowed — needs to adopt its concepts of allowed and disallowed costs as audit standards that it will then apply and enforce in its audits of automated systems of accounts and software, as well as in its audits of any claimed lease expenditures for costs that a company may incur in house that are not billable to others under the applicable operating agreement. [original emphasis]

[8] *See* House Special Committee on Oil and Gas, MINUTES (23 Oct 2007):

9:31:37 AM

...

A very dismaying thing about SB 2001 is that Section 64 would repeal DOR's explicit statutory authority under AS 43.55.165(c) and (d) to require or authorize the use of operators' joint-interest billings as the starting point for computing the amount of a producer's deductible lease expenditures for that unit or field, while Section 71(b) would make that repeal retroactive to April 1, 2006.

We believe that this repeal will mean DOR cannot authorize or require a producer to start with an operator's joint-interest billings, even when DOR wants to allow or require their use. ... [I]f if you enact a law specifically saying DOR may do something and later on you repeal that law, doesn't that repeal mean DOR can't do it anymore? We think so. ...

[9] For instance, on November 3, 2007 he testified as follows to the House Resources:

COMMISSIONER GALVIN: We have said on the record continuously and consistently that joint interest billings will be used as a starting point for our auditing and that's why they're specifically spelled out in the ACES statute [i.e., in AS 43.55.165(b)(3)(A) as proposed in HB 2001]. The change that was made was there was language within the existing statute [i.e., AS 43.55.165(b) and (c)] that made it, basically, mandatory to use them in certain circumstances[;] and there was language that was permissive in certain circumstances and our view was we'd rather have a general statement that says that we can use the industry standards as well as the joint interest billings as a way of characterizing whether costs are in or not. .... [emphasis added]

House Resources Committee TRANSCRIPT (3 Nov 2007, 3:17 p.m. hearing) at 100.