**TESTIMONY OF THE**

**ALASKA OIL AND GAS ASSOCIATION**

**TO THE SENATE FINANCE COMMITTEE**

**ABOUT THE FAILINGS OF THE**

**"ACES" PRODUCTION TAX**

**February 23, 2010**

Mr. Chairman and Members of the Committee:

My name is Marilyn Crockett and I am the Executive Director of the Alaska Oil and Gas Association ("AOGA"). AOGA is the trade association for the oil and gas industry in Alaska. Our 14 members account for the majority of oil and gas exploration, development, production, transportation, refining and marketing activities in the state. The testimony I am about to present has been prepared and approved without dissent by the members of the AOGA Tax Committee.

First of all, we apologize to the Committee for the fact that our testimony today cannot be a detailed or comprehensive review of the many problems, issues and failings of ACES. Instead, it is only an overview, a snapshot from 50,000 feet if you will, of what's wrong or going wrong with this tax. And we can offer at this time only a handful of specific examples to illustrate these problems — not because the examples are few, but because we were simply unable before this hearing to compile the many more examples that we could otherwise have presented. Also, during your hearings last week you were given information that was either inaccurate, incomplete or misleading, and we would like to use part of our time with you today to set the record straight on a number of those points.

ACES was proposed and enacted with two primary goals: One, to raise the amount of production taxes from what the State would have received under either the old ELF-based tax or the "Petroleum Production Tax" – also known as the "PPT" – that replaced the ELF. And two, to attract new capital investment for oil and gas exploration, development and production on the massive scale that is needed to mitigate the decline in production rates as the resource is depleted. These goals seem fundamentally inconsistent with one another. How can the tax be raised for the industry and at the same time have the tax attract greater industry investment here?

ACES' answer was to take the tax deduction and tax credits for new capital investments that PPT first created, modify the credits to make them less attractive, and substantially increase the amount of production taxes on the oil and gas industry. There are numerous technical problems in ACES that need to be fixed, and many others that

should be fixed simply as a matter of tax policy.

At the outset, let me reiterate AOGA's primary concern, that we believe the tax rates under ACES are too high and overshoot the optimum point where total state revenues, Alaska jobs and economic growth are maximized of the remaining life of the fields. We have said it before, no one ever taxed economic activity and prosperity into existence. We could spend hours discussing prospectivity, tax rates and what is needed to ensure Alaska has a tax rate that encourages investment, in fact we have on several previous occasions done so. Our intention is not to rehash those arguments at this time but to educate the committee on just a few structural issues and point out our contrary viewpoint regarding some of the State's testimony. We expect the dialog on what is the right tax rate to be ongoing and more appropriate for another time.

Another major issue with ACES is the regulations the Department of Revenue has adopted and is considering adopting. In order for ACES to work properly and have its full beneficial influence on investment decisions, ACES must be as clear and transparent as possible. The essential importance of this clarity is the same regardless of what the tax rate and progressivity might be, or what the percentage is for the tax credit from a capital investment. The basic structure of ACES — the foundation for it to have any chance of success — depends not only on having a reasonable rate of tax, but on having clarity and transparency with as little ambiguity as possible. Despite what you may have heard last week, the Department's regulations fail this test.

Even though the tax rate might be very high for current production from past investments, making a new investment will reduce the tax on that production under ACES and will also generate a credit against the remaining tax. For example, if the tax rate with progressivity is 50%, investing a dollar here for a regular capital project will reduce the tax on current production by 50% of that dollar, and in addition it will also generate a 20% tax credit. Thus, investing that dollar would save some 70¢ of tax on current production. This 70¢ tax savings would show up in the economics for that investment under metrics like Net Present Value and Internal Rate of Return, and it would make that investment seem more attractive.

The fundamental problem with this approach is that, even though it looks good in theory, for it to succeed in the real world it is necessary that the person making the decision about investing this dollar will be confident — at the time of making the decision — that the full 100 cents of the dollar will be recognized and the resulting benefits from investing this dollar will actually be 70 cents. If the tax is ambiguous, or if a substantial portion of this dollar could be unexpectedly disallowed by the state, a prudent decision-maker will reduce the expected tax benefit from the 70¢ it should have been in this hypothetical example. This is why “Clarity” is ACES’ middle name: “Alaska’s Clear and Equitable Share.”

Suppose, for instance, the decision-maker thinks only 60¢ of the invested dollar will actually be recognized under ACES. Then a 60¢ deduction at my hypothetical 50%

tax rate would be worth 30¢, and the 20% tax credit would be 12¢, making a total tax benefit of only 42 cents. This difference between a 42¢ tax benefit and a 70¢ one may not sound like very much, but if the hypothetical project being evaluated costs $100 million, it means $28 million would be drained out of its economic performance as perceived by the investment decision-maker, simply because of this lack of clarity in the tax. Put in these terms, one can begin to appreciate how the go/no-go decision for such an investment could be affected by a lack of clarity in ACES.

And the key point here is: this adverse impact on the investment decision will occur even if the Department of Revenue, after audit, would have ultimately found 100¢ of that dollar to be completely justified and proper. In other words, the tax benefit actually allowed would turn out to be 70¢ for that dollar, but only 42¢ of that benefit was taken into account by the decision-maker at the time of the investment decision. This is a terrible dilution or waste of the incentive for investing that ACES is designed to give.

There are clarity issues with the ACES statutes themselves, but as I mentioned, the regulations that the Department of Revenue has adopted and is in the process of adopting are compounding and re-compounding the uncertainty and lack of clarity. Attached to the written copies of this testimony is an attachment illustrating the kinds of uncertainty being created unnecessarily by the Department. I will not take the Committee's time to read that attachment now, but I invite you to peruse it at your leisure.

Bad as it is, that example is only the tip of the iceberg in terms of what is going wrong with the ACES regulations. There are many, many more examples that we could offer. The written comments and testimony submitted to the Department by AOGA and by individual companies about the issues and problems with the draft and final regulations run to nearly 200 pages — just on the subject of deductible lease expenditures. That total does not include what we told the Department about its tax-credit regulations. And, as Deputy Commissioner Marcia Davis acknowledged to this Committee last week, we expect to have a lot of comments about the transportation-cost regulations that the Department is proposing to adopt, especially since the Department is dispensing with the public workshop process and going straight to the public hearing for actually adopting them.

One final problem with the ACES regulations that I would draw to your attention is the fact that the Department of Revenue has totally failed to address the question of how the non-operating working-interest owners in a unit or other oil and gas property are supposed to comply with all these requirements. Each month the non-operating owners are required by ACES to report and pay estimated taxes, and on March 31 of the following year they have to "true up" those estimates to the actual results for the year. All that they have available when these reports and payments come due are the billings that they receive from the operator for their respective shares of the unit's costs. Even though the non-operating interests can and do audit the operator's billings to them, their audits are done for several years of billings at a time, and the billing periods in question for those

audits are in the past. These audits rarely if ever address billings for the current year because it would be premature to try to audit them: the operator's own books and records for the year won't even close and become properly auditable until after the year ends.

This puts the non-operating working-interest owners in an even worse spot than their operator in terms of clarity about how much of what they pay for costs being billed to them will end up actually being deductible under ACES. The regulations fail to take into account the fact that this "flying blind" situation about deductibility is the economic reality that these non-operators must face and deal with — and in particular, the one they face when it comes to making new investments in their unit or property. Their actual cash outlays for a new investment will be, in the first instance, whatever the operator bills them as their share of the costs for that investment or project — even if their audit of the operator's billings ultimately finds material error in them, that would be a cash outlay or receipt for the non-operators at that later time.

So, to go back to my example earlier, these non-operators have no way of knowing whether one dollar of new investment will end up being fully recognized for ACES and generate a deduction worth 50¢ and a tax credit of another 20 cents. Or whether, instead, only 60¢ of that dollar will be recognized, with the ACES tax benefit being 42¢ instead of seventy. This uncertainty about the amount of the ACES tax benefits exists at the time the non-operators have to vote "yes" or "no" in the ballot to sanction a new project or investment, which is exactly the wrong time for ACES to have uncertainty if it is to attract new investments here to Alaska. Why? Because the non-operating working-interest owners have the right to vote "no" on a ballot to approve a new project, and no matter now much the operator may support it, if the project fails to get the requisite number of "yes" votes, it simply does not proceed. And to stem or slow the decline in production, Alaska simply cannot afford to waste even one good investment opportunity as the result of too much uncertainty about the tax burden and benefits under such a major tax as ACES.

A solution to these problems would be for the Department of Revenue to take a different approach with its regulations from the one it has so far pursued. 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. This would put the tax, in the first instance, on the same footing as what the non-operators see, also in the first instance, in their billings from the operator. The non-operators do not give the operator license to spend their money without strictly limiting what that money can be spent for, and the Department could reasonably rely on the non-operators to enforce discipline on the operator's billings in much the same way that the Department relies on the IRS to audit the companies federal taxable income, which is the starting point for Alaska's own corporate income tax. Such an approach should also avoid most of the problems that Cherie Nienhuis of the Tax Division described to you last week about taxpayers reporting inconsistent data.

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, "verify" for the Department would mean auditing the automated system of accounts that each operator has for recording its expenditures as operator 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 their 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 all 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.

We have proposed this alternative approach to the Department in each round of public workshops and hearings on the lease-expenditures regulations. And in each new draft that came out after a workshop or hearing, including the regulation that has just been adopted, this superior alternative was rejected. We do not know why. But if the Department of Revenue will not adopt this superior approach voluntarily for administering ACES, then perhaps one alternative solution to fix ACES would be to rewrite the tax statutes so the Department has no choice but to use this clearer and more efficient approach.

This is very different from the picture that the Department of Revenue pointed for the Committee last week. In fact, they even showed a slide quoting from a letter I wrote. In the interest of time, I won't read the entire quote, but this the heart of it:

> There is an old quip about never having enough time to do something right, but always time to do it over. Here the Department has avoided falling into this quip, which is no small feat and deserves recognition.

Context is crucial for understanding this statement. The Declaration of Independence, of instance, says "all men are created equal." — but this cannot be taken out of context to day to mean "tough luck for women." Similarly, in context my statement specifically addressed some draft regulations about payments by one field to run its production through another field's production facilities, and reducing the owner-field's lease expenditures to the extent they are offset by the user-field's payments.

My statement about those specific regulations was not an endorsement of the far broader lease-expenditure regulations that the Department adopted January 26th, nor it is an endorsement of the pending transportation-cost regulations that were unveiled after I wrote my praise. In fact, it is somewhat ironic that — from the user-field's perspective — the Department's now adopted lease-expenditure regulations do not allow the user-field producers to deduct their full payments to the owner-field, even though the cost for using the existing facilities is far less than the alternative of putting in new production facilities. My comments, from which the quote is taken, urged the Department to allow the user-field to deduct the full amount of what it pays to the owner-field, which is the opposite of what the Department has done. And it is also ironic that the regulations I <u>was</u> praising have not been adopted by the Department.

At the present time, however, the bottom line for ACES is this: even if the tax rate was lowered, ACES is nowhere close to having the kind of clarity that it needs to have in order to succeed. And if it does not succeed, the penalty for all of us — for the state and the Alaskan public, as well as for our industry — will be that investments stand to be deferred or perhaps canceled outright that are urgently needed in order to offset the relentless decline in production that steadily goes on as this non-renewable resource is continuously depleted.

It is for this reason that our industry actually has a stake in making ACES succeed, rather than watching it fail. True, the tax rates are too high, and there are numerous technical problems in ACES that need to be fixed and many others that should be fixed simply as a matter of sound tax policy. But despite all these flaws, and they are serious ones, it is clearly better to have even a flawed ACES that succeeds in drawing more investments here, than to have a flawed ACES that fails to draw them.

At this point I would now like to shift gears and address several of the inaccurate, incomplete or misleading statements that this Committee heard during last week's hearings.

One of the most disturbing misconceptions in the whole public discussion of ACES is the apparently widespread notion that, by allowing tax deductions and tax credits in order to attract new investments here, the State is somehow actually investing

in those projects. This is completely and fundamentally wrong.

The only tax credits that the State is actually spending money for are the ones that the Oil and Gas Tax Credit Fund buys from explorers and small producers that do not have enough production to incur ACES tax liability that they could apply their credits against. This expenditure is incurred because the State has made the policy choice to do this in order to attract more independent explorers and small producers to Alaska. And, for the record, let me say AOGA supports this goal: Having more companies exploring and producing here is good for our industry, as well as Alaska.

But the overall tax deductions and credits under ACES do not inherently share this special attribute of the subset of tax credits that the Tax Credit Fund actually buys. Think about it for a second. Suppose it were true that each dollar of tax benefit from a deduction or tax credit is literally an expenditure or investment by the State. What would this imply? Well, in order to be true, it would mean the State is legally entitled that dollar instead of the producer — the State, in other words, literally owns that dollar and is making an expenditure or investment to the extent it lets the producer have any part of it.

Applying this principle in other contexts would mean the State owns the value of the next fish that a commercial fishing boat catches, that it owns the room charge that a guest pays to stay at the Baranof tonight, and that it owns the sales proceeds for the next car that a dealership sells. And consistent with this, the State would be "spending" billions and billions of dollars to the extent it lets the fishers keep any of the value of their catch, lets hotels keep any of their guests' room charges, and lets car dealers keep any of the proceeds from their car sales. This certainly would take the expression "owner state" to an extraordinary degree of literalness, but it is not what we have in this country as our legal and economic system.

Some might object to what I've just said, arguing that the State actually is the owner of the oil and gas since it is the owner of the land from which the resource is produced. Such an objection breaks down, however, at two levels. First, ACES applies to oil and gas produced from land that the State does not own, such as Native corporation land and federal lands within Alaska's legal boundaries. For these non-state lands, the very premise for the objection is lacking. Second, and more fundamentally, it ignores the fact, although the State owns the land, it has sold the exclusive right to explore for, develop and produce oil and gas from that land. The State sold this right in each of its oil and gas lease sales, and it has been paid more than $2.1 billion in bonus bids through 2007 for selling this right. Paragraph 37 in the Form DL-1 leases that represent virtually all of the main Prudhoe Bay and Kuparuk fields states, "the rights vested in Lessee by this lease shall constitute an interest in real property in said land." In other words, what the lessees have paid for is not a license, but actual ownership.

Thus, when a producer produces oil or gas from a state lease, it owns all of its share of that oil or gas as it comes out of the ground. In fact, when the State takes its royalty in value instead of in kind as physical oil or gas, the physical oil or gas attributable to

the state royalty-in-value production belongs to the producer as well.

Finally, when it comes to actually paying for a new investment, it is the producer, not the State, that shells out all the money. This whole notion that the State — by taxing the producer at less than a 100% rate — is somehow paying for part of that investment is simply wrong, even as a metaphor. The deduction of lease expenditures or the allowance of a tax credit is simply part of the calculation about how much tax a producer owes. The bottom line is that, between PPT and ACES, the industry's production tax obligations have more than tripled.

The next thing I'd like to debunk is the Administration's claim that capital spending and the number of workers on the North Slope show that ACES is working just fine. To support this claim, the Department of Revenue points to North Slope capital expenditures of $2 billion in 2007 and '08 and $2.2 billion last year, and to an increase in oil and gas jobs to approximately 12½ thousand in 2008 and '09 from about 11½ thousand in 2007.

The problem with these statistics is this: They do not distinguish between investment and labor to repair or replace existing plants and equipment, and investment or labor for new plants and equipment. Repairing and replacing existing facilities is very important, of course, but it is not evidence that ACES is drawing new investment to Alaska because those activities are done merely to maintain the status quo. The Department also does not account for projects and investments that were already under way or committed to before ACES was passed by the Legislature in November 2007 and signed into law that December. And expenditures and labor to complete such pre-existing commitments likewise do not show that ACES is drawing new investment to Alaska.

To indicate how important it is to break down gross statistics into these individual components, I would point out that John Mingé, the president of BP Exploration (Alaska) Inc., told the Meet Alaska Conference last month, "Our 2010 investment consists of roughly one-third infrastructure renewal, one-third for growth and one-third for drilling." Consequently, the Department's raw figures about total capital spending or the total number of people working on the North Slope do not show the decline in investment and work for new projects that has occurred since ACES was enacted.

But there is clear evidence from the public statements of individual companies, and even from some of the Administration's own statistics, that things are far from being as rosy with ACES as the Administration is saying.

Take in-field drilling for example. These wells can be approved, drilled and go into production in just a matter of months instead of years, in contrast to other kinds of investment in field development. As a result, the statistics about them are much less likely to be distorted by activities that had already been committed to before ACES was passed. And we have heard of members of this Legislature telling constituents that in-

field drilling like this has a rate of return of over 100 percent. Without getting side-tracked about the assumptions needed to mathematically allow rates of return to be that high, our reply is that, if in-field drilling is highly profitable, why did the number of these in-field wells decrease from 166 wells in 2007 to 153 in 2008 and 147 last year? Putting rhetoric or political posturing aside, this is the fact of the matter. And since we have been critical of the Department of Revenue, we should acknowledge at this point that the Department has disclosed this decline in its public ACES materials, although its numbers mistakenly include exploration wells.

The decline in in-field drilling is confirmed by public statements of the two major operators on the North Slope, ConocoPhillips and BP. For instance, John Mingé of BP told the Meet Alaska Conference last month that his company's "total drilled footage" for in-field wells "will be more than 50% lower in 2010 vs. 2007" when the figure was nearly one million feet drilled. He added that BP had "[r]educed our rig count from 10 to 7 from January last year." And I would point out that each drilling rig represents about a quarter of a million man-hours of work a year, or about 119 full-time equivalent jobs at 2100 hours of work per year. At that same Meet Alaska Conference Larry Archibald, the senior vice president of exploration and business development for the corporate parent in ConocoPhillips' organization, noted that industry in the last five years added about 450 million barrel-of-oil-equivalents to reserves for existing Alaska fields, but "Only 35 million since ACES".

The news is also bad for exploration wells. ConocoPhillips has been the leading explorer in Alaska for the last decade and more, focusing especially on the National Petroleum Reserve – Alaska, or NPR-A for short. But Helene Harding, who is now interim president of ConocoPhillips Alaska Inc., warned the Resource Development Council on November 18 last year that the number of North Slope exploration wells had declined from 11 in 2007, to nine in 2008 and eight in 2009, with the figure for 2010 expected to be even lower. More recently, Mr. Archibald in his remarks last month at Meet Alaska said ConocoPhillips will not be drilling any exploration wells in NPR-A this year, nor was he aware of any other company planning to do so this year. He noted that "Significant potential remains in North Slope Giants" but "Giant fields have worst fiscal terms" under ACES. Perhaps more ominous is the fact that Mr. Archibald told the conference that ConocoPhillips in 2009 had relinquished some 880,000 acres of leases that it had in NPR-A.

Now, lest we be accused of being misleading in this testimony to you, let us be absolutely clear: We do not claim that every single one of these signs of deterioration in the situation here has been solely the result of ACES. But ACES has necessarily been an economic factor within the overall circumstances surrounding each one of them. For some it may only have been a contributing factor, while for others it may have been decisive. It is even possible that ACES might not have been a material factor at all, although we would expect these to be very few in number. Be that as it may in particular situations, the point we wish to make is that these facts, taken as a whole, do provide a clear

warning that — contrary to what you were told last week — ACES is not succeeding in doing what the Twenty-fifth Legislature was told it would do.

AOGA is reluctant to criticize Gaffney, Cline's assertion that Alaska as a place to do business should not be compared to the Gulf of Mexico. This reluctance is not because AOGA fears they might be correct — to the contrary, our individual members disagree with Gaffney, Cline on this and say the Gulf of Mexico is indeed an appropriate comparison. But, because of competitive and other reasons, our members cannot disclose to one another the specific business reasons that lead individual companies to view the Gulf of Mexico as an appropriate comparison. So, for now, AOGA can only say our membership disagrees with Gaffney, Cline on this point.

One matter that Gaffney, Cline does not seem to have considered — nor have the Administration's in-house economists — is how a business under ACES could sustain itself on an ongoing basis in light of the enormous, front-end-loaded costs it incurs for risky opportunities and prospects that turn out to be unsuccessful, sometimes spectacularly so. SOHIO, it will be recalled, in 1979 and the early 1980s spent some $2 billion to bid for, and then drill an exploratory well on, the offshore Mukluk prospect in the Beaufort Sea, which turned out to be dry. Industry spent another billion dollars just in bonus bids for OCS acreage in the Gulf of Alaska offshore from Alaska's very first oil field at Katalla, which also turned out dry. The huge sums of money to be able to make highly risky "bets" like these must come from somewhere. And that "somewhere" is a company's current cash flows from its prior gambles that have turned out to be successful. But, if Alaska is taking 50 or 60 percent or more of the cash flows from current production here, where then will companies get the money to stay in business with the exploration odds already so stacked against them by Mother Nature?

In summary, then, ACES is, first of all, a complex and intricate tax that relies on tax credits and tax deductions to overcome the adverse effects on decisions to invest here or not that otherwise would arise from having such high rates of tax. To succeed in tilting those decisions toward investment here, the decision-maker must be confident, when she or he makes the decision, that the promised tax benefits from the investment will in fact be realized. This means that any uncertainty or ambiguity about the amount of tax owed or the promised tax benefits must be eliminated as much as possible. Most of the uncertainty and ambiguity in ACES could be eliminated by the regulations to implement this tax, but because if its approach for the administration of this tax, the Department of Revenue is in the process of adopting regulations that will actually compound the uncertainty and ambiguity in ACES, instead eliminating them.

Second, despite the investment incentives that ACES could offer with clarifying regulations, it has overshot the mark in terms of the optimum point where total state revenues, Alaska jobs and economic growth are maximized over the remaining life of the fields. This is because the tax is simply too high.

Third, there are clear, but ominous signs that ACES is not succeeding in attracting as much new investment as it is supposed to do. This impending failure is reflected in the decline in drilling, both for exploration wells as well as development wells within existing fields. It is reflected in the relinquishment of huge amounts of exploration acreage. It is reflected in the declining amounts being invested for new projects and development.

In its public presentations about ACES and the future, ConocoPhillips — using DNR's production forecasts and extrapolating from published data by the Department of Revenue about industry expenditures — has identified a need for more than $40 billion dollars of new investments for "core fields" to make it through the next decade and reach the promised land, where Alaska has a Gas Pipeline, where the technological challenges are overcome to produce the billions of barrels of heavy oil that are already discovered and known to exist, and where the dream for half a century or more of production from the North Slope is fulfilled. Alaska is blessed simply to have the possibility of such a future. But, to help this future become a reality, the State must correct the present-day problems and obstacles being created artificially by its fiscal regime.

Thank you, Mr. Chairman, for allowing us this opportunity to testify to your Committee today.

**TESTIMONY OF THE**

**ALASKA OIL AND GAS ASSOCIATION**

**TO THE SENATE FINANCE COMMITTEE**

**ABOUT THE FAILINGS OF THE**

**"ACES" PRODUCTION TAX**

**February 23, 2010**

## ATTACHMENT A

15 AAC 55.260 prescribes the rules about when costs are "direct" costs of exploring for, developing, or producing oil and gas. Here is what it says about the labor costs that are deductible for a unit or property, both for the operator's own employees and for the employees of all third-party contractors engaged by the operator to provide services for that unit or property:

> **15 AAC 55.260. Direct charges.** (a) Except as limited by (d) and (e) of this section, direct charges for purposes of 15 AAC 55.250(a) and (b) are
>
> ...
>
> (3) labor costs, not including work on tax, legal, purchasing or accounting matters, or matters involving a dispute before a government agency, in the form of salaries and wages of
>
> (A) employees of the operator, when those employees are directly employed in or in support of oil or gas exploration, development, or production operations, and
>
> (i) on the site or in the vicinity of those operations;
>
> (ii) in transit to or from the site or vicinity of those operations;
>
> (iii) on a site of a system described in 15 AAC 55.-250(c)(10) or (11) if assigned to and working on that system; or
>
> (iv) on the site of the construction, transportation, repair, or maintenance of a facility, a system, equipment, or infrastructure described in 15 AAC 55.250(c)(9) – (11) or (16) if assigned to and working on that construction, transportation, repair, or maintenance; or
>
> (B) any of the following employees of the operator, while those employees are assigned to a specific lease or property or unit that is the subject of oil or gas exploration, development, or production, and only as to that portion of the salaries and wages attributable to the time actually devoted to that exploration, development, or production, as supported by

an approved timesheet or other time writing documents:

(i) technical employees having special and specific engineering, geological, or other technical skills, including engineers, geologists, geophysicists, environmental specialists, and other technical personnel whose primary function with respect to that exploration, development, or production is the handling of specific problems or operating conditions involving the oil or gas exploration, development, or production operations or the support of those operations;

(ii) employees engaged in developing field automation systems dedicated to an specific to a unit or a lease or property and necessary for oil or gas production operations of the unit or the lease or property;

(iii) employees engaged in developing computer applications specific to a unit or a lease or property and necessary for oil or gas development or production operations of the unit or the lease or property;

...

(11) costs paid to a third party for contract services, utilities, or use of a facility equipment, or infrastructure provided by the third party and used in oil or gas exploration, development, or production operations, or used in support of those operations, or for use of a system described in 15 AAC 55.-250(c)(10) or (11) provided by the third party; for purposes of this paragraph,

(A) contract services

(i) do not include work in tax, legal, or accounting matters, or matters involving a dispute before a government agency;

(ii) are limited to services the labor costs of which, under (3) of this subsection, would be allowable as direct charges if the operator's employees performed the services[.]

Simply reading this regulation should speak for itself about how hard it is just to make sense of what it's saying. But even after one does read it a few times and finally figures out what it means, there are three hidden ways in which it fails to be clear.

First, subparagraph (a)(3)(A) requires an operator's own non-technical employees to be "directly employed in or in support of oil or gas exploration, development, or production operations" in order for their labor costs to be allowed as lease expenditures. But there is no definition or other indication about what "directly" means in the context of being "directly employed in ... oil or gas ... operations[.]" Since the entire regulation is defining what the "direct costs" are of oil and gas operations, the lack of any definition of "directly" within this regulation makes its logic circular. In addition, there is no objective standard for determining whether an employee is even "employed" at all "in support of [such] operations" — be it "directly" or otherwise.

Second, labor costs for an operator's own technical employees are allowed as lease expenditures for a specific lease or property or unit "only as to that portion of [their] salaries and wages attributable to the time actually devoted to [the] exploration, development, or production" of that lease or property. Moreover, the time so worked must be documented "by an approved timesheet or other time writing document[.]" However — to the extent they are used at all in our industry for technical employees like engineers — timesheets and other time writing documents may reflect only the total hours worked, not the specific activities being worked on by an employee and the amount of time that she or he spent on individual activities.

Third, sub-subparagraph (a)(11)(A)(ii) of the regulation applies these same standards to the labor costs for employees of a third-party contractor working for the operator, even though the confidentiality of personnel matters may make it difficult, if not impossible, for an operator to check timesheets and the like for the individual employees of each of its contractors — even assuming those timesheets exist and actually contain the detailed information that the regulation demands in order for those costs to be deductible lease expenditures. In other words, it is possible even for an operator to find itself unable to get the right answer about the labor costs that are allowed as lease expenditures under 15 AAC 55.260(c)(3) and (11).

This last problem is much bigger than you might think. In his remarks at the Meet Alaska Conference last month, John Mingé of BP said this about his company's labor costs on the Slope: "Of the 20 million man-hours worked last year, 80 percent were contractor man-hours." Eighty percent of the total labor costs for people working directly in fields on the North Slope are threatened to be made nondeductible — not because their work is inappropriate to be deductible, but merely because the contractor industry may have failed to anticipate the Department's stringent documentation requirements in this brand new regulation.

In addition, these problems with the limitations on allowable labor costs are compounded because they ripple through and affect other kinds of costs associated with the work force. For example, paragraph (a)(7) of that same regulation limits the deductibility of an "employer's share of contributions for employee ... benefit plans" like health and medical insurance, pension and retirement plans, savings plans etc. Those contributions may not exceed a fixed "percentage of the costs under (3) of this subsection". These fixed percentages are 32% for 2006, 33% for 2007, 36% for 2008, 35% for last year, and 30% for this year and forever after. So, regardless of what an employer actually contributes to the benefit plans for its employees, there is a problem if those contributions turn out to exceed these percentages of whatever the amount turns out to be for the labor costs for employees that are deductible under this regulation.

And this paragraph (a)(7) of the regulation can be read either as disallowing only the excess over these percentages, or as disallowing the employer's <u>entire</u> contribution if any part of it exceeds them. So apart from the enormous practical difficulty of correctly applying this complex regulation in the real world, here is a major ambiguity about what

happens even if the regulation is correctly applied and an employer's contributions turns out to exceed the specified percentages.