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The House and Senate Resource Committees have conducted a number of hearings on HB 488 and SB 305, the Governor's bill repealing Alaska's current tax on oil and gas production and replacing it with a new petroleum profits tax, or "PPT." In the course of those hearings legislators have raised concerns about multiple issues, including certain terms appearing throughout the bill, which terms are defined in Sections 30-33 of the proposed legislation. Those terms and the potential for litigation and gaming they present are discussed in this memorandum.

Potential Ambiguities In Terms Used In The PPT and Consequent Opportunities for Disputes and Gaming

The PPT taxes the value of oil and gas at the "point of production." In calculating taxable value at the point of production, a producer is allowed to deduct capital and operating expenses incurred upstream of the point of production. Additionally, the very same expenses—to the extent they meet the PPT's rather broad definition of "qualified capital expenses"—garner a 20% tax credit, which may be either applied dollar-for-dollar against a producer's tax liability or sold for profit. And any net losses upstream of the point of production also earn a 20% tax credit that can be sold. Since both capital expense tax credits and loss tax credits attributable to operations upstream of the point of production can be liquidated at state expense, even in the absence of tax liability, both those that have a positive tax liability and those that do not have great interest in identifying the "point of production."

The "point of production" has been a subject of intense dispute between the State and its oil and gas lessees for many years. At various times the parties have argued that the point of production falls anywhere from the point at which oil and gas exits the wellbore to the point at which it is "in marketable condition," "of pipeline quality," and entering the Trans Alaska Pipeline System (TAPS) or other oil pipeline leaving the oil and gas unit of origin for market. These disputes have arisen with regard to both the State's royalty share of production (which compensates the State as landowner for its mineral interest) and the State's production tax on all oil and gas production occurring within its borders (whether on lands owned by the State or not).

Generally, oil and gas lessees have argued that the "point of production" is as far upstream as possible—preferably the wellbore. Conversely, the State has argued that the "point of production" is as far downstream as possible—where it leaves the Prudhoe Bay, Kuparuk River, or other unit of origin by pipeline for market. Producers have pushed the point upstream to minimize their royalty and production tax obligations while the State has pushed the point downstream to maximize the royalties and production taxes it collects and avoid issues about the allocation of costs accumulating between the wellbore and unit boundary.

With the PPT one cannot assume that the producers always will be best served by pushing the point of production upstream and the State best served by pushing the point downstream. For example, an explorer or producer that incurs costs and earns tax credits in a year where it does not have taxable income would prefer that the point of production be moved downstream—at least for that year—to maximize its capital expense tax credits and loss tax credits. Additionally, if the “point of production” for the Pt. Thomson Unit is not at the wellbore but downstream at the unit boundary at the time that field is being developed, under the PPT the State will, effectively, “pay” for 40% of the surface facilities as those expenses are incurred, an outcome producers are certain to favor. However, a producer’s financial interest in having the “point of production” pushed upstream or downstream may change for reasons currently unknown to legislators. For example, in a version of the PPT that predated its introduction as legislation, gasline-related capital expenditures incurred downstream of the point of production but upstream of a 2.0 bcf/d (or larger) pipeline leaving the state were eligible for a 35% tax credit. While this credit has been removed from the PPT as introduced, we do not know whether it has been included in the gasline contract tentatively reached between the executive branch and producers BP, ConocoPhillips, and Exxon Mobil; if so, it may create an incentive for producers to push the point upstream for a 35% tax credit when they otherwise would have preferred to push it downstream for a 20% tax credit.

The PPT legislation could be amended in an effort to reduce the potential for disputes about the location of the point of production and the allocation of costs incurred upstream and downstream of the point of production. However, as HB 488 and SB 305 now stand, a lawyer working for an oil and gas lessee is given considerable leeway in arguing the point upstream or downstream, and an accountant working for an oil and gas lessee may divvy up costs in a way that a state auditor finds difficult to untangle. Using the Prudhoe Bay Unit as an example, and with regard to gas only, here is why:

Under the PPT there are four different categories of places that may qualify as a point of production for some portion of Prudhoe Bay gas. Factors that influence identification of the point of production for any given gas molecule include whether it is recovered by mechanical separation or gas processing and if it is metered between “gas processing” and “gas treatment.” Under the PPT as proposed, the greatest potential for abuse appears to exist for gas run through an integrated “gas processing” and “gas treatment” facility, and the new Gas Treatment Plant planned for Prudhoe Bay may be just such a facility. “Gas processing” is defined to include processing of a gaseous mixture of hydrocarbons for the purpose of extracting and recovering liquid hydrocarbons, where upstream of any gas treatment. “Gas treatment” includes “conditioning gas” and removing non-hydrocarbon substances, as well as incidental removal of liquid hydrocarbons. Ambiguity arises for several reasons. First, “gas treatment” includes “conditioning gas,” which is not defined, and one could argue that anything done to take gas from its condition in the reservoir to the conditions it must meet to be placed in a pipeline leaving the state constitutes “conditioning gas.” Second, “gas treatment” also includes removing non-hydrocarbon substances from gas, but some non-hydrocarbon substances—like water and sediment—will be largely removed at the Flow Stations and Gathering Centers just downstream of Prudhoe’s wellbores, while other non-hydrocarbon substances—such as carbon dioxide and hydrogen sulfide—will be removed in a new GTP, which will be downstream not only of the wellbores, but also the Flow Stations, Gathering Centers, Central Gas Facility (CGF), and most if not all other Prudhoe Bay Unit surface facilities.

Given these logistics and definitions, the Prudhoe Bay Unit operator, with the concurrence of other Prudhoe Bay producers, could attempt to game the system as follows. If the producers chose to push the point of production upstream, the unit operator could run all gas destined for the gas pipeline through the new GTP, making sure not to meter it at a point between the processing and treatment equipment located within the GTP, and claim that “gas treatment” begins, and hence the “point of production” is located, far upstream at the Flow Stations and Gathering Centers where water and sediment are removed. To push the point of production downstream under otherwise identical circumstances, the Prudhoe Bay Unit operator could simply install a meter between the “processing” and “treatment” equipment located within the GTP, and that meter would become the “point of production” under the definitions proposed in the PPT.

Moreover, Prudhoe Bay could become an auditing quagmire if gas recovered by mechanical separation as well as gas recovered without either mechanical separation or gas processing bypasses the processing equipment in the GTP, so that there is a multitude of “points of production” for bits and pieces of the gas originating from the Prudhoe Bay Unit. In that event, the costs of the Unit would be divvied up in accounting and audits necessary only for production tax purposes, and the State would not benefit from the adverse interests of individual lessees or joint interest accounting in the ways discussed by the executive branch when testifying in support of the PPT; it would be left on its own to defend its own interests, which would be adverse to those of the producers.

Arguably, there are other ambiguities in the definitions contained in the PPT. For example, if the point of production is pushed upstream at Prudhoe Bay to the Flow Stations and Gathering Centers and a hydrocarbon that was natural, associated, or casinghead gas is in gaseous phase at one of these facilities but is subsequently recovered in the CGF or new GTP as a liquid, one might argue that “gas” does not become “oil” for production tax purposes downstream of the point of incidence for the tax. This argument becomes more likely if gas is selling for less than oil on a barrel-equivalent basis, as is frequently the case.

The definitions of “point of production,” “gas processing,” and “gas treatment” are troubling for other reasons. Typically, one thinks of “gas processing” as occurring downstream of the “point of production,” unless it is necessary to put gas in marketable condition, in which case it may occur upstream of the point of production, but, as to any governmental share, it is unlike other costs of production in that it is at the government’s expense. Yet with the PPT it appears that the executive branch intends gas processing to occur upstream of the point of production, with room for a producer to argue the opposite. Also, frequently “gas treatment” is used in industry to refer to gas handling upstream of the point of production, but with the PPT my guess is that the executive branch intends it to most often or always occur downstream of the point of production. There is danger in using terms regularly used by industry in a manner atypical of industry usage—anyone that chooses to start a dispute has been provided by the PPT with ammunition to do so. Further, typical industry usage may be obscured by atypical application in the PPT, to the potential disadvantage of the State in collecting the royalties it is due based on value at the “point of production.”

Please be aware that with the memorandum I am not representing that the arguments advanced for alternative constructions of terms found in the PPT are the best or “winner” arguments. Rather, the point is that there is room for an interested party to argue that the proposed statutory language is ambiguous, and argue they will, if history is any indication. In fact, there may be too much money riding on one possible outcome for a producer to pass up the opportunity for argument, even if only to later settle somewhere between a better state position and a tenuous producer position.

Possible Approaches to Minimizing Ambiguities and Unintended Consequences

There are a number of possible approaches to mitigate the likelihood and unintended consequences of disputes over the location of the “point of production” and what is meant by “gas processing,” “gas treatment,” “oil,” and “gas.” Seven are set forth below:

1. At a minimum, the executive branch and the producers should be asked to go on record in writing in legislative proceedings on the PPT to specifically identify agreed-upon “points of production” for oil and for gas in each of the existing oil and gas units, both for facilities now in existence and for those planned for the future.
2. If the arguable ambiguities identified in this memorandum are brought to the attention of the executive branch, its personnel may come up with their own thoughts on how to “clean-up” the language or may be able to convince legislators that there is no room to argue ambiguity.
3. Legislators may want to ask the executive branch whether its proposed gasoline contract will include tax credits for gasoline-related capital expenditures, especially those that might influence a producer’s desire to move the point of production upstream or downstream.
4. As long as the possibility for disputes over definitions remain, the State may want to retain the few advantages it has in multimillion dollar disagreements with some of the largest, most resourceful, and brightest companies in the world. Those advantages include the ability to set and change rules by regulation, the authority to decide disputes in the first instance by an agency hearing officer, and the jurisdiction of Alaska courts to hear those disputes on appeal, giving deference to agency decisions. If the executive branch is thinking of surrendering these advantages in a gasoline contract and the legislature would prefer that the executive branch not, the legislature may want to include language to that effect in any PPT bill passed.
5. Legislators may want to consider a different point of production than that proposed by the executive branch. For example, the point of production could be as discussed by outside counsel for the executive branch in a memorandum dated January 5, 2005 and as found by Judge Compton in an April 1979 decision regarding the State’s royalty share under state oil and gas leases. Both Judge Compton and the State’s legal counsel have identified the point of production—at least for royalty purposes—as the point where oil is in “merchantable condition” and “metered ... for removal from the unit.” More specifically, the point of production for oil could be at the entry of an oil pipeline leaving a unit and the point of production for gas could be at the entry of a gas pipeline leaving a unit, with a requirement in both instances that the oil or gas be in marketable condition and of pipeline quality, though fine-tuning would be needed to address situations where both oil and gas leave a unit in a single multi-phase pipeline, with

treatment that is normally considered part of the process of production occurring off-unit, as might be the case with offshore units or development at Pt. Thomson. Of course, use of the definitions discussed in this paragraph would require the executive branch, producers, and legislators to revisit the cost of the PPT's tax credits, which would increase if the point of production is moved downstream of where it would otherwise fall under the PPT's current definitions.

6. The legislature may want to include language in any legislation passed stating that the definitions used in the PPT are not "fair-game" for use in royalty disputes between the State and producers, at least if the final version of these definitions are in conflict with the principles discussed by Judge Compton in his April 1979 decision and the State's outside counsel in its January 2005 memorandum.

7. Legislators may want to address whether expenses related to experimental facilities for gas-to-liquids are eligible for the deductions and tax credits provided by the PPT. As the PPT now reads, a producer using Alaska as its site for a gas-to-liquids experimental plant may have the State "paying" for up to 40% of the experimental plant as long as one can argue that it is upstream of the "point of production," even if the producer intends to use gas-to-liquids technology in other parts of the world and not in Alaska, and there is little or no taxable production generated by the plant.

If legislators are interested in pursuing these or other ideas for minimizing the possibility of disputes and gaming as a result of terms defined in Sections 30-33 of HB 488 and SB 305, I would be happy to assist in that effort by drafting or reviewing language that could be proposed as an amendment to the PPT.