BEFORE THE STATE OF ALASKA OFFICE OF ADMINISTRATIVE HEARINGS

In the Matter of	)	
CONOCOPHILLIPS ALASKA, INC.,	)	
	)	
Appellant.	)	
	)	
2003 Oil and Gas Production Tax	)	OAH No. 07-0565-TAX

DECISION

I. Introduction

ConocoPhillips Alaska, Inc. appealed a Department of Revenue informal conference decision (ICD) concerning oil production taxes for tax year 2003. Three disputes remained for resolution on appeal after informal conference. The parties submitted these for decision based on the written record, briefing and oral argument.

On the first disputed issue, a return-on-investment calculation dispute, the department had a reasonable basis for use of a particular weighted-average-cost-of-capital percentage in the methodology implementing a regulation and thus is entitled to deference on this part of the return-on-investment dispute. ConocoPhillips Alaska, however, established that the department erred by excluding a make-whole premium payment from the return-on-investment calculation. As to the second disputed issue, the department's decision to strictly enforce a regulation requiring use of a particular source for fuel price information in determining the reasonable cost of transportation is consistent with the law. Regarding the third disputed issue, ConocoPhillips Alaska showed that the department erred by offsetting administrative fee payments against transportation costs.

As a consequence of the two errors, the reasonable cost of transportation deduction used in the department's determination of the gross value of oil at the point of production was incorrect. Accordingly, the department must recalculate ConocoPhillips Alaska's 2003 tax liability to correct these errors.

II. Facts

ConocoPhillips Alaska, an oil producer, ships Alaska North Slope crude oil to market via a combination of the Trans Alaska Pipeline System (TAPS) and oil tankers. During tax year 2003, some of the company's oil was diverted from TAPS under an exchange agreement which allowed an in-state refiner to extract products for in-state refining and return back to TAPS

degraded oil in volumes equal to that diverted.[1] From the Port of Valdez, oil from TAPS was transported to west coast refiners in tankers operated by Polar Tankers, Inc., a ConocoPhillips Alaska affiliate.[2]

One tanker used in 2003 to transport ConocoPhillips Alaska's oil was the *Polar Endeavor*. The *Polar Endeavor* was first placed in service transporting Alaska North Slope oil for ConocoPhillips Alaska in 2001, after having been initially purchased by the affiliate, which in turn sold the tanker to a third party and then leased it back for use in transporting the oil.[3] In December 2003, the tanker was repurchased under an agreement that required payment of a make-whole premium to the third party because the repurchase option was being exercised several years earlier than required.[4]

Tankers transporting ConocoPhillips Alaska's oil in 2003 used a variety of petroleum products for various purposes. One such product was marine diesel, "made from a blend of distillate gasoil and fuel oil components," which was used in port and at other times when environmental standards precluded use of intermediate fuel oil.[5] Marine diesel "is sold separately and priced differently from No. 2 diesel."[6] The *Platts Oilgram Price Report* does not set out prices for marine diesel, but a sister publication, *Platts Bunkerwire*, does.[7] The price differential between the marine diesel and the fuel the department considered comparable (Low Sulfur Diesel No. 2) was large.[8]

Following an audit for tax year 2003 (January-December 2003), the department issued to ConocoPhillips Alaska a notice adjusting the company's oil production tax for that year, resulting in an increase in tax liability for that year in excess of one-half-million dollars.[9] ConocoPhillips Alaska challenged the department's notice, raising several disputed issues, most

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1 August 15, 2007 ICD at 21 (Rec. 29); March 4, 2008 Affidavit of Dawn Thomas (Thomas Aff.) at ¶ 6 (showing approximately 50.1 million barrels of oil exchanged in 2003).

2 *Id*. at 4 (Rec. 12); March 7, 2008 Opening Brief: ConocoPhillips Alaska, Inc. at 22-23.

3 August 15, 2007 ICD at 4 (Rec. 12).

4 *Id*.; November 18, 2003 Notice of Election to Exercise Purchase Option (App. Ex. 4); June 28, 2001 Arctic Funding, Limited Partnership Note Purchase Agreement at §§ 6.1(c) & 6.7 (pp. 15 & 17) (App. Ex. 1 at 19 & 21).

5 February 1, 2008 Affidavit of Knut Torvik (Torvik Aff.) at ¶¶ 3-4.

6 Torvik Aff. at ¶ 5.

7 Torvik Aff. at ¶ 6; January 3, 2003 *Platts Oilgram Price Report* (App. Ex. 15 at 1) (listing prices by location for "LS No. 2" and other products but none for marine diesel).

8 *See* July 11, 2008 Second Affidavit of Dawn Thomas (Second Thomas Aff.) at ¶ 9 (illustrating that the Low Sulfur Diesel No. 2 price applied by the department was approximately $70 per metric ton lower than the price for the marine diesel used by the tankers).

9 February 2, 2006 Notice and Demand for Payment (Agency Rec. 96) (demanding payment of $527,111); August 15, 2007 ICD at 1 (Rec. 9) (indicating that the department sought $558,856 in additional tax resulting from the tax year 2003 audit).

of which were resolved through the informal conference process.[10] Three disputes, however, remained unresolved, all related to transportation costs, and became the subject of this appeal.

The first dispute concerns an oil transportation-related cost of capital allowance—specifically, the return-on-investment component of the relevant calculation—arising from the repurchase of the *Polar Endeavor*. "The audit staff ha[d] excluded $34,156,402 paid to noteholders as compensation for" the early payoff of the debt on the *Polar Endeavor*.[11] The company was permitted to deduct the purchase price of the tanker but not the additional $34.2 million payment triggered when it repurchased the tanker several years before required to do so under a leaseback arrangement.[12] The audit staff excluded this "make-whole premium" payment from the calculation because the auditor did not consider the cost "ordinary and necessary transportation expenses …."[13] The tax effect of disallowing the $34.2 million portion of the return-on-investment deduction was $272,553.[14]

On appeal, the return on investment calculation proved to be the source of an additional difference between ConocoPhillips Alaska and the department. The appeal briefing added to the mix of issues a question concerning the weighted average cost of capital allowance in the return-on-investment model. In its notice of appeal and the briefing that followed, ConocoPhillips Alaska challenged the propriety of the model's use of an SIC (standard industrial classification) code for a regulated utility industry group rather than a water transportation industry group.[15] The department selected the SIC code because the code reflects a lower business risk (and hence a lower rate of return), which the department concluded was appropriate for marine transportation of oil by a company using its own vessels and thus not subject to market competition.[16] Specifically,

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[10] *See generally* August 15, 2007 ICD (Rec. 9-30); *also* October 2, 2007 Record of Prehearing Conference (indicating that only three issues remained in dispute when this matter reached the formal appeal stage).

[11] August 15, 2007 ICD at 2 (Rec. 10).

[12] ConocoPhillips Alaska, Inc. Index of Tax Adjustments – Oil AS 43.55 Production Tax 2003 (audit narrative) at 21 (Rec. 51) (showing allowance of the $205 million repurchase price without the "prepayment for closing of partnership" amount).

[13] *Id*. The "make-whole premium" was required to be paid due to the exercise of a repurchase option under a synthetic lease for the tanker several years before the lease otherwise would have required the repurchase to take place. *Id*. at 4 (Rec. 12); *accord* March 7, 2008 Opening Brief: ConocoPhillips Alaska, Inc. at 2-6 (describing synthetic lease arrangement and early exercise of the option) and June 6, 2008 Department of Revenue Tax Division's Response Brief at 3-5 (same).

[14] *Id*.

[15] September 13, 2007 Notice of Appeal from Informal Conference Decision at 3-4; March 7, 2008 Opening Brief: ConocoPhillips Alaska, Inc. at 14-22.

[16] June 5, 2008 Affidavit of Roger Marks (Marks Aff.) at ¶¶ 5-8.

> [t]he department determined that the industry or industries that most closely approximated the similar low business risk as observed for a company that transports its own oil using its own vessels are public utilities such as those listed in SIC Code number 4924; *i.e,* regulated public utilities providing local natural gas distribution services [because they] also operate in a monopolistic setting, with captive customers, and their rates of return are determined by regulators.[17]

The second dispute concerns the price for marine transportation fuel used to determine the reasonable cost of transportation when fuel was obtained from a related entity rather than through an arm's-length transaction. At informal conference, the department disallowed $84,102 in transportation costs "for overvaluation of internally refined bunker fuel purchases[.]"[18] The department rejected ConocoPhillips Alaska's proposed use of price information from the *Platts Bunkerwire*, a sister publication to the *Platts Oilgram Price Report*. The tax effect of this determination is $8,903.[19]

During oral argument, the department asserted that its discretion is broad enough to allow it to use an alternative price information source, such as the *Platts Bunkerwire* on which ConocoPhillips Alaska relied, but that it is not required to do so.[20] ConocoPhillips Alaska took the position that though there are differences (beyond cost) between the marine diesel its transporter used and the Low Sulfur Diesel No. 2 the department considered to be a comparable fuel, comparability of the fuels does not need to be addressed in this appeal.[21] Instead, the dispute to be resolved on appeal focuses on the propriety of strictly applying a regulation incorporating only the Oilgram and not the Bunkerwire publication.

The third dispute concerns treatment of an administrative fee as additional compensation related to transporting oil through TAPS. The department reduced ConocoPhillips Alaska's "2003 transportation costs by $1,377,666, the amount of a $.0275 per barrel 'administrative fee' received for barrels [of oil] exchanged with Williams Alaska" for use in a refinery.[22] The department concluded that "[t]he fee is simply additional compensation for each barrel [of oil]

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17 Marks Aff. at ¶ 9.
18 August 15, 2007 ICD at 15 (Rec. 23).
19 *Id.*
20 August 12, 2008 Recording of Oral Argument (argument of Diemer).
21 *Id.* (argument of Vance, listing differences such as flashpoint that affect safety of the fuels, but stating that there is no need to debate comparability for purposes of engaging the issue raised in this appeal).
22 August 15, 2007 ICD at 20 (Rec. 28).

that was degraded[and was] unrelated to any administrative costs incurred by ConocoPhillips."[23] The tax effect of this reduction in transportation costs was $93,282.[24]

The administrative fee is paid pursuant to an agreement under which ConocoPhillips Alaska (as an assignee of BP Oil Supply Company) and Williams exchanged equal volumes of oil, with ConocoPhillips Alaska diverting Alaska North Slope crude from TAPS to Williams and Williams returning an equal, but degraded (by Williams' processing), quantity back to TAPS.[25] The agreement's "PRICE" terms provide as follows:

> The exchange differential paid by Williams to BP shall be equal to any quality bank degradation charges per barrel as assessed by the TAPS quality bank administrator. Any changes to the TAPS quality bank, including but not limited to retroactive adjustments, shall apply to this contract. Williams also agrees, in addition to quality bank assessments, to pay an administration fee of $0.0275 per exchange barrel.[26]

The consideration for performing under the agreement includes the per-barrel fee nominated an "administration fee," but that fee is in addition to the differential Williams pays for the TAPS quality bank degradation charges.[27]

The parties agreed that if the rulings on these predominantly legal issues dictate a change in ConocoPhillips Alaska's tax liability for tax year 2003, the task of recalculating that liability appropriately could be addressed between the parties if the matter were remanded to the department.[28]

III. Discussion

ConocoPhillips' appeal challenges three determinations made by the Department of Revenue, Taxation Division, in the 2007 informal conference decision. The appeal, therefore, is within the original jurisdiction of the Office of Administrative Hearings.[29] As such, the standards for decision set out in AS 43.05.435 apply. Under those standards, the administrative law judge exercises independent judgment to resolve questions of law and affords deference to the division's determination only "as to a matter for which discretion is legally vested in the

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23 *Id*. at 21 (Rec. 29).
24 *Id*. at 20 & 22 (Rec. at 28 & 30).
25 BPOSC Contract No.: BS55435/Williams Contract No.: ABS-129-0005 at 1-2 (App. Ex. 20 at 1-2).
26 *Id*. at 2, ¶ 6 (App. Ex. 20 at 2).
27 *Id*.
28 August 12, 2008 Recording of Oral Argument.
29 AS 43.05.405.

Department of Revenue[.]"[30] Questions of fact are resolved by a preponderance of the evidence unless "a different standard of proof has been set by law for a particular question[.]"[31]

Under the statutes applicable for tax year 2003, oil production tax is based on gross value of the oil at the point of production, which is calculated in part by deducting from the oil's sale price the reasonable cost of transportation.[32] "[T]he reasonable cost of transportation is the actual cost of transportation as determined in 15 AAC 55.191(a) and (b), if the actual costs incurred are ordinary and necessary transportation expenses."[33] All three areas of dispute raise issues related to deduction of transportation costs. The issues raised are predominantly legal and their resolutions depend to a large extent on the standard of review applied.

A. Return on Investment (Polar Endeavor)

In determining the reasonable cost of transportation when a producer-owned vessel is used to transport the oil, the "actual costs of transportation" include "a reasonable return on the acquisition cost … of the vessel over its expected useful life …."[34] For a vessel such as the *Polar Endeavor*, which was placed in service in 2001, the taxpayer is entitled to a cost-of-capital allowance "that consists of depreciation and a return on invested capital …."[35] The department has prescribed by regulation a methodology for calculating the cost-of-capital allowance.[36] ConocoPhillips Alaska and the department differ over whether the make-whole premium

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30 AS 43.05.435(2)&(3).

31 AS 43.05.435(1).

32 Former AS 43.55.011(b) (2004); former AS 43.55.150 (2004).

33 15 AAC 55.180(a) (as amended through January 1, 2000). When the method of transportation used "is not reasonable in view of existing alternative methods[,]" and the transportation arrangement is a non-arm's length transaction between affiliates, "fair market value as defined in 15 AAC 55.191(h)" establishes the reasonable cost of transportation. 15 AAC 55.180(b). The parties' briefing shows agreement that the section 180(a) actual ordinary and necessary costs rule applies here, rather than the section 180(b) fair market value rule. *See* March 7, 2008 Opening Brief: ConocoPhillips Alaska, Inc. at 7; June 6, 2008 Department of Revenue Tax Division's Response Brief at 5.

34 15 AAC 55.191(b)(3)(D), stating that the "[a]ctual costs of transportation allowable for purposes of 15 AAC 55.180(a)" if the transportation is by a producer-owned vessel are the sum of four costs, including

> an amount that, when added to the amount of depreciation allowed under (C) of this paragraph, will provide a reasonable return on the acquisition cost, as provided in 15 AAC 55.195(a), of the vessel over its expected useful life as used for financial accounting purposes and used for reporting income and expenses to shareholders and owners, or on the adjusted shipyard cost or invested capital as provided in 15 AAC 55.195(b), (c)(, (f), or (h) or 15 AAC 55.196, as applicable[.]

35 15 AAC 55.196(a).

36 15 AAC 55.196(d) (prescribing use of the methodology set out in the department's *Computation of a Cost-of-Capital Allowance under 15 AAC 55.196 Incorporating Depreciation and Return on Invested Capital for Marine Vessels and Improvements*). As a result of a 2004 amendment, the current version of this regulation incorporates the Second Edition of the methodology publication dated September 19, 2003 (copy at App. Ex. 6). The November 21, 2002 First Edition of the methodology publication (copy at App. Ex. 5) is substantially the same the Second Edition on the subjects at issue in this appeal.

payment should be included in the methodology's input schedule for capital investment and whether the weighted average cost of capital used in the methodology is appropriate.

1. Make-whole Premium for Repurchase

ConocoPhillips Alaska asserts that the department erred in excluding the $34.2 million make-whole premium from the cost-of-capital allowance for the reasonable-cost-of-transportation component used to calculate gross value of the oil at the point of production. "Reasonable costs of transportation are the ordinary and necessary costs incurred to transport the oil … from the point of production to the sales delivery point …."[37] The department has not disputed that the ordinary and necessary costs of transporting Alaska North Slope crude oil to refiners on the west coast of the lower-48 states include tanker transportation, nor that a purchase-sale-leaseback arrangement (synthetic lease) is an acceptable way of acquiring tanker transportation. Instead, the department excluded the make-whole premium payment because it concluded that the payment was not an ordinary and necessary expense of acquiring the tanker.[38] The ICD acknowledges that the synthetic lease arrangement ConocoPhillips Alaska used has become rather ordinary but essentially concludes that the early collapse of that lease, which triggered the make-whole premium payment, was not necessary.[39]

The department argues that its conclusion—i.e., that incurring the make-whole premium payment as a 2003 transportation cost was not necessary—is entitled to deference. Statutorily, agency deference is owed only "as to matters for which discretion is legally vested in the Department of Revenue" and then only insofar as the department's conclusion is "supported by a reasonable basis."[40]

> [L]ike the superior court, [the Office of Administrative Hearings, as successor to] the Office of Tax Appeals shall defer to agency decisions only where a question of law involves particularized agency expertise or where the agency's specialized knowledge and experience would be especially probative as to the meaning of a statute or regulation.[41]

Whether it was "necessary" for ConocoPhillips Alaska to pay the make-whole premium in 2003, when the *Polar Endeavor* repurchase occurred, is a legal question and not one involving the department's expertise. The obligation to pay the make-whole premium arises under a

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37 15 AAC 55.191(a).
38 August 15, 2007 ICD at 2 (Rec. 10).
39 *Id*. at 6-7 (Rec. 13-14).
40 AS 43.05.435(3).
41 *State, Dep't of Revenue v. Dyncorp and Subsidiaries*, 14 P.3d 981, 984 (Alaska 2000) (citing *State, Dep't of Revenue v. Atlantic Richfield Co.*, 858 P.2d 307, 308 (Alaska 1993)).

contract. Contract interpretation usually poses legal questions to which a non-deferential standard of review applies, unless a test prescribed by the contract implicates special expertise or resort to extrinsic evidence occurs.[42] The legal question here is simply whether the note purchase agreement requires payment of the premium along with the repurchase price, which it clearly does. No resort to extrinsic evidence is required and neither does the agreement prescribe a test implicating the tax expertise of the department. The agreement requires payment of the make-whole premium, as well as unpaid principal and accrued interest, "[c]oncurrently with the termination of the Lease pursuant to Section 13(b)."[43] Section 13(b) of the *Polar Endeavor* lease provides for termination of the lease upon exercise of the repurchase option.[44] Once the repurchase option was exercised, the obligation to pay the $34.2 million make-whole premium arose and was no more avoidable than the obligation to pay the $205.0 million repurchase price itself.

The agreement did not require that the repurchase option be exercised in 2003. In that sense, it was not "necessary" for ConocoPhillips Alaska to incur the make-whole premium cost in 2003 because it need not have triggered the obligations to pay the $205.0 million repurchase price and the $34.2 million premium that particular year. It could have continued making lease payments, and included those payments as part of its transportation cost deduction, until the end of the lease term. That the premium payment could have been deferred, or avoided altogether, if ConocoPhillips Alaska had made a different business judgment about when to repurchase the *Polar Endeavor*, however, does not render "unnecessary" the tanker repurchase-related costs incurred in 2003.

In short, ConocoPhillips Alaska had a choice in 2003: keep leasing the *Polar Endeavor* or repurchase the tanker. It chose the latter. Under the note purchase agreement it had to pay the make-whole premium. The $34.2 million premium payment was just as legally necessary to

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[42] *Jarvis v. Ensminger*, 134 P.3d 353, 357-358 (Alaska 2006) (explaining that interpretation of a contract is ordinarily a legal question entitled to no deference, unless the lower-level decisionmaker relied on extrinsic evidence in interpreting the contract); *ConocoPhillips Alaska, Inc., v. State, Dep't of Nat. Resources*, 109 P.3d 914, 920 (Alaska 2005) (stating that "contractual interpretation generally presents a question of law" while acknowledging that if an agreement—there a lease—prescribes a particular test the application of which implicates agency expertise, a deferential standard of review is appropriate); *Donnybrook Building Supply, Inc., v. Interior City Branch, First Nat'l Bank of Anchorage*, 798 P.2d 1263, 1267 (Alaska 1990) (stating that "[i]nterpretation of a contract against a given factual background is a question of law which we examine *de novo*, without deference").

[43] June 28, 2001 Arctic Funding, Limited Partnership Note Purchase Agreement at §§ 6.1(c) (p. 15) (App. Ex. 1 at 19).

[44] June 28, 2001 Lease Agreement/Demise Charter at 50 (App. Ex. 1 at 148).

perfect the repurchase as the $205.0 million repurchase payment. Accordingly, the make-whole premium payment should not have been excluded.

Even if a deferential standard of review were applicable because of the particularized expertise required to develop and apply the cost-of-capital-allowance methodology implementing a department regulation, the result would be the same. Under the deferential standard of review, the department's determination that the premium payment was not "necessary" would have to be "supported by a reasonable basis."[45] The ICD acknowledges that payments such as these "could be allowed if they qualify as both ordinary and necessary costs of transportation[, e]ven though the [return on investment] model does not address the early collapse of a synthetic lease[.]"[46]

The basis for excluding the make-whole premium, as articulated in the ICD, is that the lease was needlessly collapsed early, triggering payment of the make-whole premium, which was, in effect, a penalty for early repayment of the note that ConocoPhillips Alaska had not shown "was either a common or an ordinary cost of marine transportation."[47] Thus, the department's stated rationale for excluding the payment calls into question the taxpayer's business judgment—the judgment to exercise the repurchase option before the end of the lease term and the judgment to enter into this particular agreement containing, among the combination of many terms, an early repayment penalty. The difficulty lies in the fact that the department did not quarrel with those business judgments when allowing ConocoPhillips Alaska to deduct the $205.0 million repurchase price in 2003 or to deduct the annual lease payments in the prior years.

The inconsistency inherent in accepting a taxpayer's performance under a transportation-related agreement for purposes of calculating allowable transportation cost deductions as to some terms of the agreement while rejecting other aspects of the taxpayer's required performance undermines the "reasonable basis" for the department's exclusion of the make-whole premium payment. Under the agreement, ConocoPhillips Alaska had to pay both the make-whole premium payment and the $205.0 million repurchase payment when it exercised the repurchase option. The two payments together constituted the consideration necessary to repurchase the *Polar Endeavor* at the time the repurchase option was exercised. There is no reasonable basis for the

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45 AS 43.05.435(3).
46 August 15, 2007 ICD at 5 (Rec. 13).
47 *Id.*

department allowing some but not all of the contractually required consideration to be included in the cost-of-capital allowance calculation under these circumstances.

This is not to say that all synthetic lease- or other agreement-driven costs, under all circumstances, must be considered "ordinary and necessary" transportation costs. Taxpayers necessarily must accept the tax consequences of their business judgments, whether those consequences increase tax liability or decrease it. Under these particular circumstances, the department also must accept the tax consequences of the taxpayer's exercise of business judgment because the decision to include the $205.0 million payment but not the equally required $34.2 million payment in the calculation is not supported by a reasonable basis.

2. Weighted Average Cost of Capital

ConocoPhillips Alaska raised the issue concerning the propriety of using a regulated utility SIC code, instead of the water transportation SIC code, to select the return-on-investment methodology's weighted-average-cost-of-capital percentage for the first time at the formal appeal level, according to the department.[48] The department argued that ConocoPhillips Alaska abandoned this issue by not raising it (or raising it adequately) at the informal conference stage. ConocoPhillips Alaska countered that abandonment for failure to raise an issue at informal conference should not result because informal conference is optional. It also asserted that it had raised the issue at informal conference but that the appeals officer who prepared the ICD did not address the issue.

The department's appeal procedure regulations do suggest that submitting to informal conference may not be a prerequisite for proceeding to formal appeal in tax matters.[49] Those regulations are crafted to cover a variety of appeal types, not just tax appeals.[50] By statute, the Office of Administrative Hearings

> has original jurisdiction to hear formal appeals from informal conference decisions of the Department of Revenue under AS 43.05.240. Appeal to the office may be taken only from an informal conference decision.[51]

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48 June 6, 2008 State of Alaska, Department of Revenue Tax Division's Response Brief at 9-11.

49 *See* 15 AAC 05.010(a)(4) (stating that "if the request for appeal concerns a tax, tax credit, or license fee matter under AS 43, state whether an informal conference is requested, or waived in favor of proceeding directly to a formal hearing").

50 *See* 15 AAC 05.001 (indicating that the department's appeal procedure regulations are intended to apply to licensing, child support and permanent fund dividend appeals, as well as to tax appeals).

51 AS 43.05.405. The scope of jurisdiction for the office's predecessor, the former Office of Tax Appeals, was similarly limited to appeals from informal conference decisions by the department. *Cf.* Former AS 43.05.405 (2004).

AS 43.05.240 vests a taxpayer "aggrieved by the action of the department in fixing the amount of a tax or penalty" with the right to request an informal conference before a department appeals officer. A taxpayer, therefore, does not have the ability to bypass informal conference and proceed directly to a formal hearing before the office to challenge a pre-informal-conference determination of the Tax Division.

The extent to which a taxpayer must identify specific issues and the vigor with which the taxpayer must pursue them to preserve them throughout the administrative appeal process may be arguable. In its request for informal conference, ConocoPhillips Alaska did not mention the SIC code or the "weighted average cost of capital" when describing the return-on-investment issues.[52] It did, however, mention both, and specifically identify the selection of the SIC code as a concern, in a Power Point-style slide presentation in which it asked that the ICD address whether the department "overstepped its authority by selecting an inappropriate WACC SIC classification."[53] Whether the taxpayer's representatives and the appeals officer discussed this aspect of the return-on-investment issue during the informal conference was not established. The ICD does not address it. By a slight preponderance, the evidence in the record supports a finding that ConocoPhillips Alaska at least raised the issue concerning the propriety of the SIC code used to designate the weighted-average-cost-of-capital percentage.

Though issues preferably should be fully joined and addressed in the first instance at informal conference, on close questions such as this, the taxpayer's due process right to a full and fair hearing militates against declaring the issue to have been abandoned. When appropriate, a remand to informal conference can be ordered, thereby allowing the department to consider whether an error has occurred and, if so, to correct it, or to articulate in an ICD the department's reasons for denying the relief the taxpayer seeks. Here, a remand is unnecessary.

Although "gas distribution" may seem an inapt industry group for transportation of oil in tankers, the department was within its discretion to select the SIC code for that group, rather than the one for the "water transportation" group. Selection of an SIC code to reflect the appropriate business risk for the cost-of-capital allowance in a complex tax regime implicates agency

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[52] April 3, 2006 Request for Informal Conference at 1-4 (Rec. 84-87).

[53] ConocoPhillips 2003 Production Tax Informal Conference Decision (App. Ex. 11 at 4 & 5) (asserting in Power Point-style slide presentation print out, under heading "Issue 3—Weighted Average Cost of Capital" (WACC), that the SIC code used "is inappropriate").

expertise and thus deference is owed.[54] The SIC code selected to designate the weighted-average-cost-of-capital percentage is just one of several inputs used in calculating the cost-of-capital allowance.[55] The department articulated a reasonable basis for selecting a SIC code reflecting a lower business risk than ordinary marine transportation—that a company transporting oil using its own vessels, without the usual market competition, faces a lower risk. Selection of the "gas distribution" group for standalone marine transport service might not withstand scrutiny, but for an integrated enterprise such as an oil producer using its own vessels to transport the oil a reasonable basis exists to select a lower risk-associated industry group.

For these reasons, ConocoPhillips Alaska's request that the department be ordered to recalculate the tax using a group 44 SIC code-based weighted-average-cost-of-capital percentage in the return-on-investment methodology is denied.

B. Marine Transportation Fuel

ConocoPhillips Alaska challenges the department's use of the *Platts Oilgram Price Report* as the source for the price of tanker fuel in the reasonable-cost-of-transportation calculation. The dispute concerns only the price for marine diesel.[56] By statute, the "reasonable costs of transportation of the oil" are the actual costs, subject to some exceptions.[57] One exception is triggered when affiliates are involved in the transportation or the contract for transportation is not an arm's-length transaction. In those circumstances,

> the department shall determine the reasonable costs of transportation, using the fair market value of like transportation, the fair market value of equally efficient and available alternative modes of transportation, or other reasonable methods.[58]

This language, particularly the phrase "or other reasonable methods," gives the department relatively broad authority to come up with a surrogate for "actual costs" when the taxpayer's actual costs may be subject to manipulation by something other than market forces.

The department used its regulation adopting authority to prescribe, among other things, what fuel cost to use in the allowable voyage and port costs component of the transportation-cost

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54 *Cf. State, Dep't of Revenue v. Atlantic Richfield Co.*, 858 P.2d 307, 308 (Alaska 1993) (Alaska 1993) (applying deferential standard of review because interpretation of complex tax statute and regulations was involved); AS 43.05.435(3).

55 *See generally* November 21, 2002 *Computation of a Cost-of-Capital Allowance under 15 AAC 55.196 Incorporating Depreciation and Return on Invested Capital for Marine Vessels and Improvements* (App. Ex. 5).

56 July 15, 2008 Reply Brief: ConocoPhillips Alaska, Inc. at 14-15 (explaining that the company disputes the price the department used for marine diesel, not the prices used for intermediate fuel oil and high sulfur fuel oil).

57 Former AS 43.55.150(a) (2004).

58 Former AS 43.55.150(b) (2004).

calculation when the fuel has not been purchased from a third party: "the spot market price of comparable fuel as reported in *Platts Oilgram Price Report* at the time of the fuel purchase for the market nearest the point of refueling …."[59] By designating the spot market price of "comparable" fuel as published in the price report, the regulation informs oil production taxpayers (as well as the general public) that the price surrogate for "actual costs" used when fuel is not purchased from a third party may be a different but comparable fuel. By identifying only a single source for price information, the regulation informs taxpayers that the surrogate for "actual costs" will be drawn from this source and this source alone.

Relying on a single fuel price information source that does not cover every conceivable fuel a taxpayer might acquire without benefit of an arm's length transaction and use to transport oil has its shortcomings. This approach could, as happened here, result in application of a price surrogate much lower than what the taxpayer would have paid for the fuel actually used, if the taxpayer had purchased the fuel in an arm's-length transaction. Such a result, however, does not make the department's strict adherence to its regulation inherently unreasonable. Rules borne of a desire to make calculation and collection of taxes administratively convenient for the department and predictable for the taxpayer are common in the tax laws. In developing and adopting a regulation, the department might err too much in favor of administrative convenience and predictability, and thereby produce a regulation inconsistent with the statute it purports to implement. When that occurs, the regulation is not valid.[60] That is not the situation here.

The statute (AS 43.55.150(b)) and the implementing regulation (15 AAC 55.191(j)(1)) are consistent. The statute directs the department to use actual costs except when, *inter alia*, the transportation is through an affiliate or not through an arm's-length transaction. In those circumstances, the statute directs the department to determine the reasonable (not actual) costs of transportation. It gives the department three options for doing so. Two involve determining the "fair market value" of transportation—the first of "like transportation" and the second of an alternative but equally efficient (not necessarily equally inexpensive) mode of transportation. The third option allows the department to use "other reasonable methods" to determine the reasonable costs of transporting the oil. The statute, therefore, does not require that the implementing regulation use any particular method. It does not even require use of a method

[59] 15 AAC 55.191(j)(1).

[60] AS 44.62.030 (requiring consistency between statute and implementing regulations).

designed to most closely approximate what would have been the "actual costs" if an arm's-length transaction with a non-affiliate had been used.

Instead, the statute permits the department to determine the "reasonable costs of transportation" using reasonable methods of the department's choosing. This the department has done by adopting a regulation incorporating the *Platts Oilgram Price Report* as the sole source for the fuel price surrogate. Though the department might have also incorporated in the regulation other sources, such as *Platts Bunkerwire*, and broadened the universe of potentially comparable fuels to include the one ConocoPhillips Alaska's transporter actually used in tax year 2003, nothing in the statute required it to do so. Limiting the price source to a single publication and thereby necessitating that the price be based on a comparable fuel, rather than the precise fuel actually used, does not exceed the department's statutory authority to use reasonable methods to determine the reasonable costs of transportation.

Accordingly, the department is not required to use the *Platts Bunkerwire* price for the marine diesel ConocoPhillips Alaska's transporter actually used when the department calculates the deduction permitted by AS 43.55.150 and 15 AAC 55.191. Nothing in this decision, however, is intended to preclude the department from doing so in an exercise of the discretion it asserted it has during oral argument.

C. Administrative Fee

ConocoPhillips Alaska challenges the department's decision to treat the administrative fee paid by Williams as "additional consideration" that should be offset against the actual costs of transportation. The department relied on a regulation that requires reduction of the transportation costs by deducting consideration received for quality differentials when oil of different qualities is commingled.[61] In most pertinent part, the regulation provides that "[t]he gross value at the point of production for a producer's oil … must be adjusted for any consideration paid or received for quality differentials …."[62]

In effect, the department interpreted the phrase "consideration received for quality differentials" to include an administrative fee that is additional to payments made because of degradation of the oil but related insofar as both the fee and the payments are a product of the number of barrels diverted and presumably degraded. Another way of looking at the determination is that the department interpreted the exchange agreement as requiring Williams to

[61] August 15, 2007 ICD at 20-21 (Agency Rec. 28-29) (quoting and applying 15 AAC 55.151(b)(3)).
[62] 15 AAC 55.151(b)(3).

pay additional compensation "for" quality differentials, even though a separate quality bank-assessed payment is required. Under appropriate circumstances, an agency's interpretation of its own regulation is entitled to deference, but interpretation of a contract poses a legal question to which independent judgment of the adjudicator usually applies.[63]

Looking at this as a purely legal contract interpretation issue, and thus reviewing the department's determination under the non-deferential standard, the department's determination must be reversed. The unambiguous terms of the exchange agreement show that the administrative fee is not consideration for quality differentials. The key language is in paragraph 6 (titled "PRICE") which consists of three sentences. The first two sentences together, and independent of the third, address consideration for quality differentials by obligating Williams to reimburse ConocoPhillips Alaska for the assessments from the TAPS quality bank. In the third sentence, Williams agreed "in addition to quality bank assessments, to pay an administration fee of $0.0275 per exchange barrel."[64] Nothing in the language suggests that payment of the fee is contingent upon degradation of the exchanged oil.

Under the plain terms of the exchange agreement, if hypothetically Williams, instead of removing its target products from the input stream or mixing the stream with lesser quality oil, returned back to the TAPS oil of the same quality, ConocoPhillips Alaska would still be entitled to collect the per-barrel administrative fee. Payment of the administrative fee is contingent upon exchanging barrels, not upon degradation of the quality of oil so exchanged. Thus, the fee is additional consideration for performing the agreement, but the agreement's language does not support the conclusion that it is consideration for quality differentials. Instead, it is separate consideration, ostensibly to compensate ConocoPhillips Alaska for costs associated with administering the agreement. In short, the TAPS quality bank assessment payments are consideration for quality differentials; the fee is consideration for administration of the contract.

Looking at this as a matter of the department interpreting the phrase "for quality differentials" in a regulation implicating agency expertise (because of the regulation's role in a

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[63] *Dep't of Revenue v. Atlantic Richfield*, 858 P.2d at 308 (explaining that interpretation of an agency's regulations is a legal question to which the deferential rational basis or substitution of judgment standard of review may apply, depending on whether agency expertise is implicated; applying deferential standard because the issues "center[ed] around the interpretation of a complex tax statute and regulations that implicate the special expertise of [the Department of Revenue]"); *Jarvis*, 134 P.3d at 357-358; *ConocoPhillips Alaska*, 109 P.3d at 920; *Donnybrook Building Supply*, 798 P.2d at 1267; *also* AS 43.05.435 (providing specific standards of review applicable to tax appeals).

[64] BPOSC Contract No.: BS55435/Williams Contract No.: ABS-129-0005 at 2 (App. Ex. 20 at 2).

complex tax regime), the result is the same but for a slightly different reason. Deference is due to the department's interpretation of its regulation only if that interpretation is supported by a reasonable basis.[65] Under the reasonable basis test, if an agency's interpretation is "'plainly erroneous and inconsistent with the regulation'" deference is not paid to that interpretation.[66] The regulation calls for adjustment of the oil's gross value when consideration is received **for** quality differentials.[67] Though it is consistent with the regulation for the department to require an adjustment for a producer's receipt of payment for the quality bank assessment (a quality-differential payment), the same cannot be said as to a separate fee paid for contract administration rather than for a change in the oil's quality.

The department declared the $.0275 per barrel administrative fee Williams paid to ConocoPhillips Alaska to be "additional consideration" for degradation of the oil resulting when Williams returned oil to the TAPS downstream from its refinery.[68] The department did not explain why this fee, which was in addition to degradation payments ConocoPhillips Alaska had to pay to the TAPS quality bank and hence collected from Williams, was "additional consideration" **for** quality differentials—i.e., for degradation of the oil. The department's ICD implied that the fee is consideration for quality differentials because the fee was calculated on a per-barrel basis.[69] The ICD concluded, without reference to specific facts, that the fee "is unrelated to any administrative costs incurred by ConocoPhillips."[70] The department's decision does not explain why it reached this conclusion or how a per-barrel fee, rather than a flat fee or hourly-rate-based fee, makes the administrative fee "consideration for quality differentials" rather than for something else.

The department's audit staff decided to offset the administrative fee against costs "because [the staff believed] it reduces the Taxpayer's transportation costs."[71] The staff reasoned that rather than being payment for actual administrative costs, the fee was more like revenue to offset quality bank expenses, because it was "included on the invoice for quality bank

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65 AS 43.05.435(3).

66 *Button v. Haines Borough*, 208 P.3d 194, 203 (Alaska 2009) (quoting *Pasternak v. State, Commercial Fisheries Entry Comm'n*, 166 P.3d 904, 907 (Alaska 2007)).

67 15 AAC 55.151(b)(3) (emphasis added).

68 August 15, 2007 ICD at 21 (Rec. 29).

69 *Id*. (stating that "[t]he fee is simply additional compensation for each barrel that was degraded").

70 *Id*.

71 ConocoPhillips Alaska, Inc. Index of Tax Adjustments – Oil AS 43.55 Production Tax 2003 (audit narrative) at 44 (Rec. 74).

reimbursement due."[72] This elevates the invoice's form over the agreement's substance. The exchange agreement is meant to facilitate in-state refining of oil. It is not an agreement providing for ConocoPhillips Alaska's transportation of its oil, except in the very limited sense that it addresses a detour some oil must make and provides two forms of consideration paid for that detour: (1) reimbursement by Williams for quality bank assessments; (2) administrative fees. Revenues received under the agreement are not required to be applied to reduce oil transportation costs. Any revenue a taxpayer receives could be used to reduce costs generally or a specific cost in particular. Absent a requirement in the regulation that administrative fees be applied to reduce transportation costs or contract language tying the fee to transportation, however, the auditor's assumption it plainly erroneous.

The department's interpretation, in effect, reads "consideration paid or received for quality differentials" as meaning any revenue related to the arrangement that might result in a TAPS quality bank payment, even if the revenue is above and beyond an amount required to compensate for quality degradation resulting from commingling oil. That contorts the most apt meaning of the word "for," which in this context necessarily must mean "because of" – as in "consideration paid or received *because of* quality differentials." Only the quality bank assessment payments constitute consideration "because of" quality differentials; the administrative fee payments are "because of" the exchange.

On appeal, the department argued that the administrative fee is nothing more than profit, suggesting that "profit" must be offset against transportation costs.[73] That the fee payments might exceed the taxpayer's actual cost of administration, and thus might yield a "profit" of sorts, because they are calculated based on the number of barrels exchanged rather than some other measure, does not create a reasonable basis supporting the department's interpretation. The regulation does not call for any "profit" resulting from commingling of oil to be offset against transportation costs.

The administrative fee payments ConocoPhillips Alaska collected from Williams may constitute a revenue stream that could be taxable under a tax regime providing for taxation of such revenue. The department's conclusion that the payments are "additional compensation" for degradation of the oil under the gross-value-at-point-of-production tax regime in place for tax

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72 *Id.*

73 June 6, 2008 Department of Revenue Tax Division's Response Brief at 19.

year 2003, however, is not supported by a reasonable basis. Accordingly, the department must recalculate ConocoPhillips Alaska's oil production tax liability for 2003 without offsetting the approximately $1.38 million in administrative fee payments against the transportation costs deducted from the oil's gross value.

IV. Conclusion

ConocoPhillips Alaska established that the department erred in excluding the make-whole premium payment and in offsetting the administrative fees paid under the exchange agreement against deductible transportation costs. The department did not err in applying the weighted-average-cost-of-capital percentage designated by reference to the group 49 SIC code or in requiring use of price information from the *Platts Oilgram Price Report*. The department, therefore, shall recalculate ConocoPhillips Alaska tax year 2003 oil production tax liability in a manner consistent with the decision and, specifically:

1. shall include the $34,156,402 make-whole premium payment in the return-on-investment calculation;

2. shall not offset the $1,377,666 in administrative fee payments under the exchange agreement against deductible transportation costs.

This matter is remanded to the department for purposes of the recalculation required above. This decision shall become final for purposes of appeal as described in the Notice below, but the Office of Administrative Hearings retains jurisdiction over this matter to the extent necessary, if at all, to resolve any dispute resulting between ConocoPhillips Alaska and the department over whether the recalculation conforms with the orders herein.

DATED this 29th day of November, 2009.

By: *Signed*
Terry L. Thurbon
Chief Administrative Law Judge

NOTICE

This is the decision of the Administrative Law Judge under AS 43.05.465(a). Unless reconsideration is ordered, this decision will become the final administrative decision 60 days from the date of service of this decision.[74]

A party may request reconsideration in accordance with AS 43.05.465(b) within 30 days of the date of service of this decision.

When the decision becomes final, the decision and the record in this appeal become public records unless the Administrative Law Judge has issued a protective order requiring that specified parts of the record be kept confidential.[75] A party may file a motion for a protective order, showing good cause why specific information in the record should remain confidential, within 30 days of the date of service of this decision.[76]

Judicial review of this decision may be obtained by filing an appeal in the Alaska Superior Court in accordance with AS 43.05.480 within 30 days after the date on which this decision becomes final.[77]

Certificate of Service

The undersigned certifies that on November 30, 2009, this decision was distributed by **fax and U.S. mail** to the following: Leon T. Vance, counsel for ConocoPhillips Alaska, Inc.; Kenneth J. Diemer, Assistant Attorney General.

Signed
Neil Roberts

[74] AS 43.05.465(f)(1).
[75] AS 43.05.470.
[76] AS 43.05.470(b).
[77] AS 43.05.465 set out the timelines for the decision becoming final.