**BEFORE THE ALASKA OFFICE OF ADMINISTRATIVE HEARINGS**

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| In the Matter of: | ) | |
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| CHEVRON U.S.A. INC.; CONOCOPHILLIPS ALASKA, INC.; EXXONMOBIL ALASKA PRODUCTION INC.; and FOREST OIL CORPORATION | ) | |
| | ) | |
| Prudhoe Bay Initial Participating Area ("IPA") & Five Other Participating Areas | ) | OAH No. 08-0673-TAX |
| | ) | |
| 2005 Oil & Gas Production Tax | ) | |

## DECISION

The Prudhoe Bay Unit (PBU) is a management unit encompassing oil and gas reservoirs in the Prudhoe Bay field and certain nearby satellite fields. It is the most productive of about 20 such units on Alaska's North Slope.

Five owners of working interests in certain participating areas of the PBU appeal a decision of the Department of Revenue aggregating participating areas of the PBU for purposes of calculating Economic Limit Factors (ELFs). At the time of the department's decision, ELFs were used to determine Oil and Gas Production Tax.

The parties stipulated that the case presents a purely legal issue that can be resolved solely by briefing.[1] According to an agreed schedule, they filed cross-motions for summary adjudication.

Substantively, the taxpayer-appellants do not contest that aggregating the participating areas was within the scope of the department's authority and represented a reasonable application of the statutory standard for aggregation. The central issue in this case, instead, is whether the aggregation decision was a regulation. If so, it would be invalid because it was adopted without following the procedures that Alaska law requires to create a binding regulation. This decision concludes that the aggregation decision was not a regulation and was an acceptable means of addressing the tax treatment of the affected participating areas.

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[1] Joint Proposed Schedule, Feb. 11, 2009. For this reason, the present decision may be better characterized as a decision on an agreed record rather than a summary adjudication. However, the distinction appears to be of little consequence, in that neither party has contended that any facts or factual inferences, material or otherwise, are in dispute.

## I. Background[2]

### *A. Structure of the PBU for Tax Purposes*

The tax period at issue in this case is February 1, 2005 to March 31, 2006.[3] During that period the taxpayer parties to this appeal, Chevron U.S.A., Inc., ConocoPhillips Alaska, Inc., ExxonMobil Alaska Production, Inc., and Forest Oil Corporation, owned working interests in the PBU. They will be collectively referred to in this decision as "the Owners."[4]

At the beginning of 2005, ten "participating areas," or PAs, were contributing to production from the PBU. These PAs generally were treated as separate "leases or properties" for purposes of calculating Oil and Gas Production Tax. The participating areas were:

Two Initial Participating Areas (IPAs) (treated as a unit for tax purposes)
Aurora
Borealis
Midnight Sun
Orion
Polaris
Pt. McIntyre
Lisburne
Niakuk

The PAs in the PBU were developed at various times and under various circumstances, the details of which are of little importance to the matters still being pursued on appeal. In 2004, the IPAs accounted for 77 percent of production from the PBU, with the remaining 23 percent distributed among the other eight PAs.[5]

During the period at issue, the production tax due on oil or gas from each PA (counting the two IPAs as a single PA) was calculated by multiplying a nominal statutory tax rate by an ELF calculated for that PA.[6] The higher the ELF, the higher the final tax rate.

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[2] Many factual findings in this section are drawn from the aggregation decision under challenge. The findings in that decision are unchallenged.

[3] The decision under appeal purported to become effective on February 1, 2005. Aggregation for purposes of ELF calculation became moot effective April 1, 2006, with the repeal of the ELF statute. *See* R. 1018.

[4] An additional owner of working interests in the PBU, BP Exploration (Alaska), Inc., has not pursued the appeal to this level.

[5] R. 0027.

[6] *See* former AS 43.55.011(a); 43.55.016(a).

### *B. Operation of the ELF*

The ELF formula contained a "field size" component representing the average daily production within the lease or property in question. Because of its position in the formula, a larger average daily production would always result in a larger ELF, all else being equal. With respect to oil[7] production tax, if two taxable PAs were combined into a single PA for purposes of calculating an ELF, the result would always be higher total production, therefore higher average daily production, therefore a higher ELF, therefore a higher tax rate.

Very broadly, the purpose of the ELF was to prevent fields from becoming uneconomic due to an excessive rate of taxation. The ELF was intended to scale the tax rate downward as the field approached its economic limit. Under circumstances that will be explored more fully later in this decision, the ELF statute permitted the Department of Revenue to "aggregate two or more leases or properties" if "economically interdependent oil or gas production operations are not confined to a single lease or property."[8] Because of the mathematical relationship just discussed, such an aggregation would lead to higher taxes.

By the end of 2004, the tax rates being applied in the smaller PAs was minuscule in comparison to the rate applied to production from the IPAs. While IPA production was taxed at an effective rate (after application of the ELF) of about twelve and a half percent, production from the satellite PAs was taxed at an effective rate of less than one-half of one percent.[9] This occurred notwithstanding the fact that the smaller PAs were not economically marginal and were, as a result of rising market prices, moving further away from their economic limit.[10]

### *C. Economic Relationships Between the Participating Areas*

The economic interchange between the PAs in the PBU was substantial, and it had expanded over time. Historically, there had always been a significant sharing of production facilities, with the Aurora, Borealis, Midnight Sun, Orion, and Polaris PAs having no production facilities of their own but rather making use of the IPA production facilities, and

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[7] The situation is potentially more complicated for gas, but the distinction is not material to this decision. *See* Mtn. for Summary Adjudication: Taxpayers at 3 n.4.

[8] Former AS 43.55.013(j).

[9] R. 0007.

[10] *E.g.,* R. 0006; R. 102-101.

the Pt. McIntyre and Niakuk PAs similarly using the Lisburne Production Center.[11] In early 2004 Pt. McIntyre was linked to the IPA production facilities, allowing production from that PA to join the "integrated 'system'" for processing fluids that was functioning within the IPA/Aurora/Borealis/Midnight Sun/Orion/Polaris area.[12]

In addition to sharing support costs, this integrated system enabled a production-shifting technique informally known as "backout" to occur across PA lines. Because PBU production facilities are not able to process for reinjection the amount of gas that would be produced if all wells were at full production, the unit operator chokes back some wells to increase production by others. The wells thus "backed out" are the ones that produce the most gas per barrel, which tend to be the older wells, located in the IPA. Integration with the smaller PAs allowed the operator to back out IPA production and replace it with production from the other PAs, which had the effect of replacing high-tax IPA oil with low-tax oil from elsewhere. Between 2000 and 2004, the amount of preferential backout production that was shifted from the IPAs to satellite PAs grew from 218,000 barrels to more than 1.2 million barrels.[13] The problem of differing tax rates for different oil was further complicated by the difficulty of determining how much oil came from each PA. Volumes were metered only after they had already been commingled, and assignment to particular PAs had to be done by way of estimate and allocation.[14]

### *D. Aggregation of the Participating Areas*

Over time, the Department of Revenue had come to regard the tax structure of the PBU as undesirable and inconsistent with the policy behind the ELF. As early as January 12, 2000 (in response to an application for assurance that the Polaris PA would *continue* to be treated separately for ELF purposes), the department notified the Owners' representative that—in the Owners' words—"the issue of separate-ELF treatment for fields sharing existing production facilities was under reexamination."[15] Five years later, on January 12, 2005, the department issued a decision over the signature of the Director of the Tax Division, informing

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[11] R. 0027-0026. Shared production facilities are facilities for separating and processing gas, oil, and other fluids gathered from or used by the wells, including such things as a central gas processing facility, a central compressor for gas reinjection, a central facility for treating seawater for injection, and a central power station. *Id*.

[12] R. 0026, 0013-0012. The quotation is from a ConocoPhillips Alaska report.

[13] R. 0012-0009.

[14] R. 0009-0008.

[15] R. 0042.

the Owners that the following PAs would be aggregated for ELF purposes beginning February 1, 2005:

The two IPAs
Aurora
Borealis
Midnight Sun
Orion
Polaris
Pt. McIntyre

The other two Prudhoe Bay PAs, Lisburne and Niakuk, were excluded from this aggregation.[16] The governor announced the decision publicly the same day.[17] The decision was reconsidered through the informal conference process, eventually becoming final and ripe for appeal to an adjudicatory hearing before this office in late 2008.[18] In the meantime, additional taxes due because of the decision were apparently paid under protest.[19]

### *E. Statutory Construction in the Aggregation Decision*

The 2005 aggregation decision turned, in part, on whether the statutory prerequisite for aggregation was met: whether production operations on multiple leases or properties (in this instance, multiple PAs) were "economically interdependent." Unless they were, the department would have no discretion to contemplate aggregation. The decision entertained two competing glosses on this phrase: one, which it labeled the "weak" version, would recognize economic interdependence if the economic activity or condition of one had a "material effect" on the economic activity or condition of the other. The second, which it labeled the "strong" version, would recognize economic interdependence if the PAs were "so integrated as to be reasonably treated as an economically unitary activity."[20] While suggesting that standard had been met under both the strong and weak interpretations of the

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[16] Lisburne and Niakuk had been the subject of prior advance rulings that they would not be aggregated with Pt. McIntyre, and including them in a PBU-wide aggregation that encompassed Pt. McIntyre would have run counter to those advance rulings. *See* R. 0003.

[17] R. 0435.

[18] R. 0954.

[19] *See* Mtn. for Summary Adjudication: Taxpayers at 39; Dep't of Revenue's Opp. to Taxpayers' Mtn. for Summary Adjudication and Cross Mtn. for Summary Adjudication at 2 n.3.

[20] R. 0014.

statutory phrase,[21] the decision went on the use the strong interpretation and found that economic interdependence existed across the affected PAs.[22]

Prior to the 2005 aggregation decision, the Department of Revenue had formally construed the "economically interdependent" phrase twice. First, and most significantly, in 1995 it had adopted a regulation, 15 AAC 55.027(b), which created a procedure for producers to apply for an advance ruling committing the department *to forego* its option to aggregate leases or properties as a way of encouraging new development. The regulation set out four threshold criteria, all four of which had to be met to make a set of leases or properties *eligible* for such a ruling if the department, in its discretion, chose to grant it. Three of the criteria related to the policy goals of enhancing production, enhancing efficiency, and accurate tax administration, goals unrelated to the "economically interdependent" standard. The fourth criterion was the one that construed that standard: it allowed a special segregation ruling only if the operations "would not be economically interdependent in the absence of the proposed use of common production facilities."[23] What this final provision did was to create a special, discretionary way of handling certain operations that were economically interdependent solely by virtue of their common production facilities. The implication of having such a provision is that such operations must exist—operations that are economically interdependent solely by virtue of common production facilities. This was an implicit construction of the statutory standard, implying that "use of common production facilities" could make operations "economically interdependent." The 2005 aggregation decision, which relied in part on the use of common production facilities as evidence of one type of economic interdependence, was consistent with this oblique regulatory construction of the statute.

The second formal construction came in 1998 in the context of an administrative decision (similar to the 2005 decision) to aggregate Niakuk with another PA. This decision focused on shared development history and found that to be one type of economic interdependence.[24]

In sum, the 2005 aggregation decision was the first time the department had grappled head-on, and in a formal or public context, with the meaning of "economic interdependence"

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21 R. 0013.
22 R. 0008.
23 Former 15 AAC 55.027(b)(4).
24 R. 0019. The full text of this decision does not appear to be in the record.

between the ongoing operations of different leases or properties. There had, however, been some internal discussions and even debates within the department that touched on this issue, which are reflected in about 300 pages of materials denoted as "The File"[25] and made available to the Owners in 2006 as this appeal was getting underway. It is important to recognize that these were confidential, deliberative materials on which no taxpayer could have relied. All the taxpayers knew of this discussion was that "the issue of separate-ELF treatment for fields sharing existing production facilities was under reexamination."[26] Nonetheless, because they have been so heavily cited by the Owners, it will be helpful to detour briefly to discuss what these documents actually show.

"The File" consists in large part of drafts, markups, and memos to and from staff that were made or collected by Dan Dickinson, who was then the director of the Tax Division. Mr. Dickinson was not the chief executive of the department, and his views, even if expressed in final documents rather than in drafts and ruminations, would only represent an official departmental view or position if he held a delegation of authority.[27] The papers indicate that Mr. Dickinson and his colleagues were wrestling with a number of related issues, including the best way to interpret the phrase "lease or property"[28] in the ELF statute and the possible interpretations of "economically interdependent."[29] At times, the Tax Division staff seem to have leaned toward addressing one or both of these issues through new legislation or through an interpretive regulation. In one 2002 draft analysis, for example, an unidentified author records a "consensus" that the PBU fields were already, or would soon be, "economically interdependent" under *existing* law, but nonetheless advocates having the legislature revisit

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25 R. 0400.

26 R. 0042 (describing January 2000 communication to PBU operator).

27 There are doubtless many situations where he holds a delegation, by regulation or order, to act for the department. An example of such a delegation is at R. 0403; another example is presumably the authority to sign the 2005 decision itself. There is no indication, however, that he held delegated authority to choose to seek new legislation or promulgate regulations without commissioner approval; his views on the desirability of those approaches would be those of a subordinate.

28 A broader construction+- of that phrase could have mooted the issue of aggregating individual PAs within production units. *See, e.g.,* R. 0240-0237.

29 Analysis in some of the documents is very preliminary and rough, reflecting confusion. When he wrote one memo to his file, for example, Mr. Dickinson seems to have been under the impression that 15 AAC 55.027(b) *prohibited* the department from aggregating PAs if they would not be economically interdependent in the absence of common production facilities. R. 0566. This is a reading of 15 AAC 55.027(b) that is sufficiently unsupportable that the Owners themselves have abandoned it in this appeal.

the ELF statute—but only with respect to the meaning of "lease or property."[30] Another unsigned draft analysis proposes aggregation of the PBU as an option, but opines that the approach taken to the statute "should [be] enshrined in a regulation."[31] These documents suggest that the question of how to interpret "economically interdependent" and other phrases in the ELF statute could have been approached by asking the legislature for clarifying amendments or by adopting an interpretive regulations, and that the department considered those options. As preliminary, informal, internal, confidential, and generally unattributed papers, the contents of "the File" show nothing more.[32]

### *F. Scope of the Current Appeal*

In the present appeal, the Owners focus exclusively on the *process* by which the department arrived at its interpretation of "economically interdependent." They do not contend that the interpretation is an impermissible one in light of the language and history of the statute. They do not dispute that, if the interpretation is applied, the affected PAs were indeed "economically interdependent." Further, they do not contend that, if the statutory prerequisite has been met, the department abused its subsequent *discretion* to aggregate (that is, the discretion implicit in the statute's opening words, "[t]he department *may* aggregate . . ."). These issues were pursued in varying degrees at informal conference, but they have not been advanced to this level of appeal, and they must be deemed to be conceded. The Owners' contentions on appeal are purely procedural:

- That the decision was a regulation, but not a properly adopted one;[33]
- That if the decision is deemed not to have been a regulation, it was still improper because:

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30 R. 0544-0543. The Owners rely heavily on a draft précis of the same paper that could be read to indicate that aggregation would reinterpret the ELF statute to "turn the current ELF practice over on its head." R. 0560. This illustrates one of the problems of relying on rough drafts: the précis (at least if read this way) does not agree with the longer text it purports to summarize, and the overall document is simply ambiguous. On the other hand, the "over on its head" language may refer to changing the interpretation of "lease or property," in which case it unconnected to the decision at issue in this case.

31 R. 0520.

32 *See Pennzoil Co. v. Department of Energy*, 1981 WL 1281, Energy Mgt. ¶ 26,340 (D. Del.) ("It is . . . final versions that reflect the Department's "contemporaneous construction" of its regulations. The drafts reflect only the tentative view of their authors; views that might be altered or rejected upon further deliberation either by their authors or by superiors."); *Dawson v. State,* 2001 WL 122340 (Alaska App.), *3 (a "draft policy, never adopted by the department", is not probative of the department's views); *Emory University v. United States,* 2008 WL 4542630 (N.D. Ga.) (draft not probative of author's "thoughts and conclusions" until it has been "completed and adopted").

33 Mtn. for Summary Adjudication: Taxpayers, at 19-36; Reply and Opposition: Taxpayers at 3-26.

- The decision was made without affording the Owners due process;[34] and
- It was an abuse of discretion for the department to proceed other than by regulation.[35]

## II. Analysis

### *A. The Decision Was Not a Regulation.*

There is no dispute in this case that the 2005 aggregation decision did not *purport* to be a regulation. It was therefore issued without following the rulemaking processes prescribed in Alaska's Administrative Procedure Act (APA), such as advance public notice and an opportunity for public comment.[36] And as a result, if it was indeed a regulation, it would be invalid and could not be relied on.[37]

The question of whether the aggregation decision was a regulation is a question of statutory law (the statute being the APA, rather than a Revenue statute), and one that does not involve agency expertise. It is reviewed under the independent judgment standard.[38]

The Owners' argument starts with the APA's definition of "regulation." Any agency action that meets both of the following criteria is a regulation:

- It is a "rule, regulation, order, or standard *of general application*" or amendment, supplementation, or revision of the same; and
- It is adopted "to *implement, interpret, or make specific* the law enforced or administered by [the agency], or to govern its procedure, except one that relates only to . . . internal management . . . ."[39]

The Owners contend the 2005 aggregation decision announced a standard of general application. They also point out that, among other things, the decision selected an interpretation of the key statutory phrase "economically interdependent." In their view, it therefore acted to "make specific" a law administered by the Department of Revenue, thereby meeting the second criterion.

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34 Mtn. for Summary Adjudication: Taxpayers, at 36-39.
35 Reply and Opposition: Taxpayers, at 26-36.
36 *See* AS 44.62.190 – 215.
37 *E.g., Jerrel v. State*, 999 P.2d 138, 144 (Alaska 2000). No opinion is expressed here as to whether the department could, without relying on the decision, have nonetheless aggregated the PAs on audit.
38 *See* AS 43.05.4345(2); *In re ConocoPhillips Alaska, Inc.,* OAH No. 09-0018-TAX (2009), at 5-6 (http://aws.state.ak.us/officeofadminhearings/Documents/TAX/TAX090018.pdf).
39 AS 44.62.640(a)(3) (italics added).

1. Not a Standard of General Application

With respect to the first criterion, the Owners are plainly wrong. The crux of their contention is that this was a broad ruling applying to multiple taxpayers and multiple properties.

The decision was, on the contrary, as narrow and situation-specific as it could possibly be in this context. Of course, an aggregation decision necessarily involves multiple leases or properties, and if they have more than one owner, it will also involve multiple taxpayers. It would have been nonsensical and unfair, for example, to try to aggregate the PAs connected to the IPA production facilities with respect to Chevron's tax obligations, but not with respect to ExxonMobil's.

Alaska's North Slope has about 20 production units (in addition, there are units elsewhere in the state). The decision aggregated some of the participating areas in one of these units. It did so because of the circumstances and interconnections specific to that group of PAs: the fact that they had all come to share the IPA production facilities, the fact that their oil was commingled without reliable metering, and the fact that production was increasingly being traded off from one to another in a manner that shifted production to low-tax wells at the expense of high-tax wells. The decision was a classic case-by-case ruling, addressing a particular factual situation at a specific location. It did not extend to any PA that was not an integral part of that factual situation.

In making this focused determination, the department apparently felt it needed to elucidate the meaning of the statutory phrase "economically interdependent." The department had done this before, in connection with the 1998 Niakuk decision, but this aggregation turned on a different kind of economic relationship and seemed to the department to require a fresh look at the meaning of the phrase in light of analogous legal authority. In so doing, the department did not alter any prior, publicly circulated interpretation of the phrase. It analyzed the phrase and came to an interpretation that is now conceded to be reasonable, finding that the PBU operations should be deemed economically interdependent if they were "so integrated as to be treated as an economically unitary activity."[40] In applying this reading to the PBU situation, it is not clear that the decision was ruling out that, in different situations, operations might be economically interdependent even if they were not "so integrated." But

[40] R. 0014.

the decision developed a way of construing the phrase that was usable in the case before it and, presumably, usable as important but not binding precedent in future, similar aggregation decisions.

The decision stands in strong contrast to the line of cases the Owners have relied on. The Owners point especially to *Jerrel v. State, Department of Natural Resources.*[41] *Jerrel* involved a properly adopted Department of Natural Resources regulation that allowed the Division of Land and Water Management to "require that . . . livestock be tagged, dyed, or otherwise marked."[42] The division had supplemented this requirement with a bright-line rule—not incorporated in any official regulation but held out as a firm standard—"that [the] mark must be plainly distinguishable from a distance of 20 feet."[43] The Alaska Supreme Court found this bright-line standard to be a regulation, meeting both criteria of the APA definition. Of particular interest for the present discussion, the Court found it to be a "standard of general application" because it "affects the public or is used by the agency in dealing with the public."[44] Several other Alaska Supreme Court decisions are in the same vein, finding "standards of general application" where an agency pronouncement imposes bright-line rules or detailed criteria on the public at large.[45]

In the present case, on the other hand, the Department of Revenue did not set out bright-line criteria, nor supplement one specific requirement (marking livestock) with another one (mark must be visible from 20 feet), nor lay out a detailed set of criteria; nor did it use such new benchmarks in dealing with the public at large. Instead, it simply parsed and translated the existing statutory language. It applied its interpretation of the language to the taxpayers participating in one discrete factual situation.

As a side note, the decision would *have* to be a regulation if it repealed or modified an existing regulation.[46] It is important to recognize, however, that the decision was wholly consistent with the department's one existing regulation on aggregation and segregation,

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41 999 P.2d 138 (Alaska 2000).

42 11 AAC 60.070.

43 *Jerrel*, 999 P.2d at 140.

44 *Id*. at 143.

45 *E.g., Noey v. Department of Envir. Conservation,* 737 P.2d 796 (Alaska 1987) (bright-line "rule of thumb" of five acres for subdivision approval); *Gilbert v. State, Dep't of Fish & Game,* 803 P.2d 391 (Alaska 1990) (detailed policy adopting a set of fisheries management goals); *Kenai Penin. Fisherman's Co-op Ass'n v. State,* 628 P.2d 897 (Alaska 1981) ("comprehensive management policy" for fisheries).

46 *See, e.g., American Fed. of Gov't Employees v. FLRA,* 777 F.2d 751, 759 (D.C. Cir. 1985).

former 15 AAC 55.027. That regulation set criteria for the department to forego aggregation, even though it might otherwise be available, in order to "enhance the likelihood of developing a new pool."[47] The regulation implicitly recognized that "use of common production facilities" could render operations economically interdependent, but created a special situation where that kind of interdependence could be disregarded, and aggregation waived, to promote new development. The Owners contended at one time that the 2005 decision was inconsistent with this regulation,[48] but they now concede that the two were consistent.[49]

2. Not Adopted to Make Specific

Although it is a closer question, the Owners' argument also fails on the second required criterion of the APA definition of a "regulation." The Owners contend that by placing a specific gloss on the phrase "economically interdependent," the decision acted to "make specific" that phrase and thus fits within that prong of the APA definition of "regulation."

Of course, if the decision *only* acted to "make specific" the statutory phrase, but did not fit within the first prong of the definition, it still would not be a regulation. The APA leaves agencies free to "make specific" the laws they administer without using regulations, as long as they do not do it through a rule, order, or standard of general application. With that said, the 2005 aggregation order falls short of this criterion as well.

Recognizing that agencies must be able to read and apply the law without adopting a regulation to cover every nuance, the Alaska Supreme Court has held that "common sense interpretations" of existing laws do not meet the second criterion of the APA definition of "regulation." Importantly, these need not be the *only* interpretation that common sense would allow; a "common sense" interpretation is simply a reasonable reading of the phrasing of existing law that does not add new requirements of substance, but instead interprets the language "according to its own terms."[50] Thus in *Alaska Center for the Environment v. State, Department of Environmental Conservation,*[51] the criterion was not met by an agency

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47 Former 15 AAC 55.027(b)(2).

48 R. 0037-0034.

49 The issue was not appealed to this level, and was affirmatively conceded on page 1 of the Owners' opening brief ("DOR never adopted regulations defining that standard").

50 *Alaska Center for the Envir. v. State, Dep't of Envir. Conservation,* 80 P.3d 231, 244 (Alaska 2003) (quoting *Usibelli Coal Mine, Inc. v. State, Dep't of Natural Resources*, 921 P.2d 1134 (Alaska 1996)).

51 80 P.3d 231 (Alaska 2003).

translation of the broad phrase "major energy facility" to mean "energy-related facilities, not to businesses that use fuel in daily operations."[52] This was a level of elucidation or definition quite similar to the Department of Revenue's 12-word gloss on "economically interdependent."

In the more recent case of *Smart v. State, Department of Health and Social Services,*[53] the Court addressed a situation where an auditing agency had not merely construed a broad phrase—"statistically valid sampling methodologies"—but had assembled a detailed protocol that it was applying in multiple audits. Even in that situation, where the construction of existing law involved formulating a set of precise criteria, where the court acknowledged that "policy decisions" could be involved in their selection, and where the "general application" criterion was clearly met, the Court did not find the second criterion fulfilled and declined to view the protocol as an unpromulgated regulation.[54] Important for the Court were the facts that the protocol did not impose new substantive requirements and that it was an application of the law that can be chosen from an array of approaches laid out in published sources, in this case statistics books.[55]

In the 2005 aggregation decision, the interpretation of "economically interdependent" chose from two widely-circulated glosses on that phrase that have been used by courts interpreting other statutes. It was an interpretation of the statutory phrase according to its own terms, without adding new steps or requirements. It was, therefore, a "common sense" interpretation as that standard has been applied by the Alaska Supreme Court, and hence was not adopted "to implement, interpret, or make specific the law" within the meaning of the APA definition of "regulation."

3. Decision Need Not Be an Adjudication In Itself

The Owners contend that the aggregation decision *must* have been a regulation because it was not an adjudication.[56] This line of reasoning seems to proceed from the fact that agencies have two ways to develop law: in the U.S. Supreme Court's words, they have a

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52 *Id.* at 242, 244.
53 237 P.3d 1010 (2012).
54 *Id.* at 1017-18.
55 *Id.* It was not the only one that could have been chosen. *See In re C Care Services,* OAH No. 11-0015-DHS (Commissioner of Health and Social Services 2012) (http://aws.state.ak.us/officeofadminhearings/Documents/DHS/DHS110015.pdf) (addressing same protocol).
56 *E.g.,* Mtn. for Summary Adjudication: Taxpayers, at 29-32.

"choice . . . between proceeding by general rule or by individual, ad hoc litigation."[57] The Owners take the view (rejected in Part II-A-2 above) that the decision was indeed developing law in this sense, and since it was not an adjudication growing out of litigation, they reason that it must fit under the other "choice."

The decision certainly was not, itself, an adjudicatory one. No litigation, and no opportunity to be heard in the adjudicatory sense, preceded its issuance. But the decision was a step, envisioned by statute,[58] that triggered an opportunity for adjudication. The adjudication, if desired by the affected taxpayers, would come afterward. This is a common circumstance in Alaska administrative law, in which an initial administrative order, effective when issued unless subsequently vacated, is tested through subsequent adjudication.[59] The fact that the initial order was not adjudicative does not prevent it from being part of an election to "proceed by adjudication."

### *B. The Owners Are Afforded Adjudicatory Due Process.*

In their initial briefing, the Owners argued that if the APA had not been violated, then their due process rights had been. The crux of their argument was the following:

> If . . . the Decision is not treated as an improperly promulgated regulation, a "legislative" decision, then it must be considered an "adjudicative" decision subject to the requirements of due process under the constitutions of both the United States and the State of Alaska.[60]

They went on to observe that the decision itself was announced without giving the Owners the advance notice and opportunity to be heard that are hallmarks of constitutional adjudication.

As noted in the preceding section, the Owners' contention that if the agency was "proceeding by adjudication," then the decision itself must be an adjudication, is a non sequitur. The decision was simply the first step of a process that subsequently proceeds to an adjudication in which the taxpayer can challenge its basis. This is the way due process is afforded in the tax context; as the U.S. Supreme Court has observed, "it is well established

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57 *SEC v. Chenery Corp.*, 332 U.S. 194, 204 (1947).

58 AS 43.55.013(j).

59 An example from the Revenue context is child support orders issued under AS 25.27.160-166. These orders can involve first impression issues of statutory or regulatory interpretation, which are then explored and affirmed or rejected in the subsequent adjudication. *See, e.g.*, *In re C.J.B.*, OAH No. 06-0515 (Comm'r of Revenue 2008) (http://aws.state.ak.us/officeofadminhearings/Documents/CSS/CSS060515.pdf).

60 Mtn. for Summary Adjudication: Taxpayers, at 36.

that a State need not provide predeprivation process for the exaction of taxes."[61] Apparently recognizing this, in later briefing and argument the Owners have largely abandoned the contention that they have not been offered a constitutional adjudicatory proceeding.[62]

### *C. The Department Had Discretion to Proceed as it Did.*

In their final brief, the Owners present the fallback argument that if the aggregation decision was not itself a regulation, the election not to proceed via regulation was an abuse of discretion by the Department of Revenue.[63] Insofar as the department's exercise of discretion to develop its interpretation of the statute by case-by-case application, rather than by regulation, is reviewable at all, it is reviewed on the deferential abuse-of-discretion standard.[64] However, as will be seen, the caselaw suggests that the discretion in this context is absolute unless there is a due process violation, while if there *is* a due process violation, it is always an abuse of discretion to proceed. Hence, the truly determinative question-within-a-question is a legal one on which no deference would apply: whether there is a due process violation.[65]

When it passed the ELF statute, the legislature did not include a requirement for the Department of Revenue to promulgate implementing regulations. The mainstream American view in administrative law is that, if the legislature has not mandated issuance of regulations, an agency has wide discretion to fill in the details and gaps left by a statute through either broad regulations or case-by-case adjudication, at the agency's election.[66] There is one recognized constraint on this discretion: where the absence of regulations creates a due process violation. Cases in other jurisdictions have found due process violations (i) where the underlying statute contains no standard at all, so that, for example, the agency is left to

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61 *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 37 (1990).

62 The due process argument nominally reappears in the Owners' reply brief, but there it has been recast as a dimension of the assertion that the department did not have discretion to proceed case-by-case rather than by interpretive regulation. Reply and Opposition: Taxpayers, at 36-39. That assertion is addressed in II-C below.

63 Reply and Opposition: Taxpayers, at 26-36.

64 *See* AS 43.05.4345(3); *Amerada Hess Pipeline Corp. v. APUC*, 711 P.2d 1170, 1178 (Alaska 1986) (choice whether to proceed by regulation is discretionary).

65 Although neither party has made the contention in this case, it is sometimes said that executive branch tribunals such as this one cannot address constitutional issues. This is true in some circumstances, such as facial challenges to the constitutionality of statutes, but is not true where, as here, the challenge is a case-specific one to the way an agency is applying or administering a statute. For further discussion of this distinction, *see, e.g., In re Holiday Alaska, Inc.*, OAH No. 08-0245-TOB (Comm'r of Commerce, Comm. & Econ. Dev. (2009) (http://aws.state.ak.us/officeofadminhearings/Documents/TOB/TOB080245.pdf), at 4-9, *aff'd*, 280 P.3d 537 (2012).

66 R. Peirce, *Administrative Law Treatise* (5th ed. 2010), § 6.9.

distribute benefits at whim, or (ii) where the agency has no mechanism to record its reasoning and publish its incremental decisions, so that no stable and consistently-applied standards are ever established.[67]

In *Amerada Hess Pipeline Corp. v. APUC,*[68] and *Alyeska Pipeline Service Co. v. State, Dep't of Environmental Conservation,*[69] the Alaska Supreme Court held to this mainstream approach, recognizing due process as the sole constraint on agency discretion to choose regulations or adjudication as a way to develop the law. Both decisions upheld an agency's election to forego rulemaking, but identified ways such a choice could, in theory, violate due process. In *Amerada Hess,* the potential concerns were (i) whether lack of notice of the policy ultimately adopted had prejudiced the litigant and (ii) whether the agency sufficiently explained its reasoning to prevent arbitrariness and permit meaningful judicial review.[70] In *Alyeska,* the Court addressed (i) again, whether lack of notice of the policy ultimately adopted had prejudiced the litigant, and (ii) whether there was an adequate after-the-fact opportunity to argue that the agency's substantive decision was impermissible or unreasonable.[71]

The recent *Smart* case,[72] on the other hand, could be read to suggest that a separate analysis of whether the agency had discretion to proceed "by adjudication" instead of by regulation can be wholly unnecessary. In that case the agency, faced with a vague statutory mandate to use "statistically valid sampling methodologies" in Medicaid audits, had formulated a specific methodology to use in its sampling, but had not put the methodology into a regulation. Instead, it had "proceeded by adjudication"—that is, the chosen methodology would be put in use and would be tested and formalized only through appeal decisions following audits.[73] Indeed, in subsequent appeals the appropriate choice of methodology became a hotly debated issue.[74] Nonetheless, in *Smart* the Alaska Supreme Court saw the "only question" raised by the choice to proceed by adjudication as being

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67 *Id.* at 512-515.

68 711 P.2d 1170 (Alaska 1986).

69 145 P.3d 561 (Alaska 2006).

70 *Amerada Hess,* 711 P.2d at 1179. A third due process focus in the decision—adequate notice of hearing procedures—is not transferable to the context of the present case.

71 *Alyeska,* 145 P.3d at 570-571.

72 237 P.3d 1010, discussed *supra*.

73 The agency erred, however, in the way it gave notice of the appeal rights. *Id.* at 1016.

74 *In re C Care Services,* OAH No. 11-0015-DHS (Commissioner of Health and Social Services 2012) (http://aws.state.ak.us/officeofadminhearings/Documents/DHS/DHS110015.pdf).

whether the chosen audit methodology *already* "constitutes a 'regulation' under the APA," and thus would have to be invalidated as improperly adopted.[75] After answering that question in the negative, the Court did not entertain a second inquiry into whether the agency abused discretion in electing not to proceed by regulation.[76]

Assuming the potential due process concerns broached in *Amerada Hess* and *Alyeska* need to be addressed at all in this context, they are easily disposed of. Both of those cases were concerned with whether the litigant before the court had altered its position, and thereby been prejudiced, by lack of knowledge of how the agency would interpret the statutory standard. There is no evidence in this case of any such prejudice. As noted above in note 16, the Owners had received assurances of segregation to support the development of only two fields, Lisburne and Niakuk. Those assurances were respected in the decision, with the more independent Lisburne and Niakuk PAs left out of the aggregation. The Owners knew the other PAs were subject to aggregation, and they received specific notice five years before the aggregation that "the issue of separate-ELF treatment for fields sharing existing production facilities was under reexamination."[77] Nonetheless, they chose to take steps to further integrate production, making the fields ever more interdependent. When the aggregation decision finally came, the department imposed it only prospectively, rather than through a retroactive audit. Far from showing prejudice, the record that the Owners have presented in this case suggests that the Owners received a windfall, enjoying the benefits of segregated treatment for a considerable time for PAs that were, or had become, economically interdependent.

The other concerns in *Amerada Hess* and *Alyeska*—whether there was sufficient explanation to prevent arbitrariness and permit judicial review, and whether there was adequate opportunity to challenge the substantive decision after the fact—are amply satisfied here. It would be hard to point to an administrative decision in Alaska that has been more

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[75] *Smart*, 237 P.3d at 1017.

[76] In another recent case, *Friends of Willow Lake, Inc. v. State, Dep't of Transp. & Pub. Facilities*, 280 P.3d 542, 549-50 (Alaska 2012), the Court merged the two inquiries.

[77] R. 0042.

exhaustively explained,[78] or for which a more extensive opportunity for post-decision challenge has been afforded.[79]

Likewise, the due process concerns occasionally identified by courts in other jurisdictions are absent here. This is not a case where the legislature omitted to include a standard; decisions to aggregate are made based on the standard of "economic interdependence." And as the agency developed the nuances of that standard through application to the various circumstances encountered in the oil fields, the reasoning would be elaborately recorded and developed to allow future consistency.[80]

Lastly, in their final brief the Owners have developed a new potential due process concern, one not found in any of the cases. The Owners argue that the election to proceed case-by-case violated their due process rights because the merits of individual aggregation decisions are reviewed on a deferential, abuse of discretion standard.[81]

The premise of this argument is weak, because review of an aggregation decision is not entirely deferential: in the appeal to the Office of Administrative Hearings, all factual underpinnings are addressed *de novo*.[82] To be sure, the aggregation itself is committed to agency discretion and reviewed deferentially, but this would be true *regardless* of whether the aggregation occurred as it did here or occurred after promulgation of an interpretive regulation. Further, the agency's interpretation of the statute would receive the same deference—or lack of deference—regardless of whether it occurred in a regulation or in a decision.[83]

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[78] The original decision contained 28 pages of concise, clearly written explanation, which was elaborated in a meticulous 65-page Informal Conference Decision.

[79] After an extensive informal conference process, appealing taxpayers may bring a formal appeal to an independent tribunal in which the taxpayer may offer new evidence under relaxed evidentiary constraints and receive a *de novo* determination of all fact questions. *See* AS 43.05.435(1). This is followed by two levels of court appeal.

[80] The dissemination of this reasoning can be constrained by taxpayer confidentiality. However, the whole record of any decision pursued through a full adjudicatory hearing will ordinarily become public, *see* AS 43.05.470, with the opinion itself published in a readily searchable location, *see* AS 44.64.090(a). Moreover, Alaska oil and gas development is such that different aggregation decisions are quite likely to involve overlapping participants.

[81] *See* Reply and Opposition: Taxpayers, at 36-39.

[82] AS 43.05.435(1). Of course, the *de novo* review did not arise in the present appeal because the Owners confined their appeal to procedural issues, conceding the merits.

[83] This review might be deferential if construing the statute is deemed to call for special expertise. *State v. Jeffery,* 170 P.3d 226, 229-30 (Alaska 2007); *see also Northern Timber Corp. v. State,* 927 P.2d 1281, 1284 n.10 (Alaska 1996).

More fundamentally, this final argument of the Owners is really a challenge to the constitutionality of deferential review, not to the constitutionality of what the department itself did. If the Owners felt their due process rights were compromised because of the existence of deferential review, they could have contested the merits of aggregation and asked, perhaps in this tribunal and certainly in the courts, for a non-deferential review standard in these circumstances. If the reviewing court perceived a due process problem caused by the review standard, the problem could be avoided simply by adjusting the standard.

## III. Conclusion

Because the January 12, 2005 aggregation decision was not a regulation and represented an acceptable venue for the department to construe the aggregation standard as it applied to the PBU, the Department of Revenue's motion for summary adjudication is granted and the Owners' motion for summary adjudication is denied. The Informal Conference Decision dated November 14, 2008 is affirmed.

DATED this 13th day of October, 2012.

By: *Signed*
Christopher Kennedy
Administrative Law Judge

## NOTICE

This is the hearing decision of the Administrative Law Judge under Alaska Statute 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.[84]

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

[84] AS 43.05.465(f)(1).

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.[85] 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.[86]

Judicial review of this decision may be obtained by filing an appeal in the Alaska Superior Court in accordance with Alaska Statute 43.05.480 within 30 days of the date this decision becomes final.[87]

[This document has been modified to conform to the technical standards for publication.]

[85] AS 43.05.470.
[86] AS 43.05.470(b).
[87] AS 43.05.465 sets out the timelines for when this decision will become final.