BEFORE THE ALASKA OFFICE OF ADMINISTRATIVE HEARINGS

In the Matter of	)	
	)	
CONOCOPHILLIPS ALASKA, INC.	)	
PIONEER NATURAL RESOURCES, ALASKA, INC.,	)	
and ANADARKO PETROLEUM CORPORATION	)	
	)	
CONSOLIDATED APPEAL CONCERNING	)	OAH NOS. 09-0018-TAX
KOKODA #1 & #5	)	09-0019-TAX
	)	
Oil and Gas Production Taxes (AS 43.55)	)	

DECISION ON SUMMARY ADJUDICATION

I. Introduction

This is a consolidated appeal from two Department of Revenue Informal Conference Decisions (ICDs), each relating to the exploration tax credit for costs associated with a wildcat exploratory well. In each appeal, all three members of the consortium of explorers contest the disallowance of certain payments for environmental and subsistence protection services. Two members of the consortium also contest the disallowance of part of the price paid for diesel fuel used in the project. The net tax credit amount at issue in this appeal is approximately $282,000.

No underlying facts are in dispute. The parties agreed at the inception of the appeal that the matter turns solely on questions of statutory and regulatory interpretation, and should be resolved by summary adjudication.

Because the Department of Revenue correctly interpreted and applied the law on all three issues, its motion for summary adjudication is granted and that of the taxpayers is denied.

II. General Factual Background

The Kokoda #1 and Kokoda #5 wells are oil and gas exploration wells located south of Teshekpuk Lake in the National Petroleum Reserve, Alaska. Both were drilled and abandoned in early 2005. ConocoPhillips Alaska, Inc. was the operator managing the projects and was the owner of a 25 percent interest in each project. Pioneer Natural

Resources, Alaska, Inc. held a 70 percent interest in each project, and Anadarko Petroleum Corporation held a five percent interest in each.

With respect to Kokoda #1, ConocoPhillips claimed on behalf of the three owners eligible expenses of $11,443,064, resulting in a 40 percent exploration tax credit of $4,577,255.[1] Upon audit, the tax division disallowed $2,958,167 of the claimed expenses and thus $1,183,267 of the claimed tax credit.[2] The taxpayers requested an informal conference, in which they were successful in restoring approximately $900,000 in disallowed expenses. The resulting ICD yielded total allowable expenses of $9,392,471 and an exploration tax credit of $3,756,988.[3]

The taxpayers have appealed the following three categories of expense disallowances that were sustained in the ICD:

1. Payments to Alaska Clean Seas for Environmental Services $101,350[4]
2. Payments to Inupiat Community for Subsistence Representative $ 34,350[5]
3. Diesel fuel costs charged to Pioneer and Anadarko $111,152[6]

Collectively, if these expenses were not disallowed, the allowable exploration tax credit would increase by about $98,741.

With respect to Kokoda #5, ConocoPhillips claimed on behalf of the three owners eligible expenses of $15,394,577, resulting in a 40 percent exploration tax credit of $6,157,831.[7] Upon audit, the tax division disallowed $3,371,355 of the claimed expenses and thus $1,348,542 of the claimed tax credit.[8] The taxpayers requested an informal conference, in which they were successful in restoring approximately $1 million in

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1 Taxpayers' Motion Ex. 1 at 4.

2 *Id*.

3 Kokoda #1 ICD at 30.

4 Kokoda #1 Notice of Appeal at 3; Kokoda #1 ICD at 5-7. The separate expense of $14,673 for an environmental coordinator supplied by Doyon Universal Services, which was also disallowed, has not been appealed.

5 Kokoda #1 Notice of Appeal at 3; Kokoda #1 ICD at 5-8.

6 Kokoda #1 Notice of Appeal at 7-8; Kokoda #1 ICD at 18-20, 24-25. The figure given for the disallowances in contest on this item is approximate, having never been calculated by the parties. It represents the portion of the fuel costs ultimately disallowed in the ICD, aggregated from the two places they are addressed there, less $203 disallowed on grounds not at issue in this appeal, less 25% (the final deduction being the ConocoPhillips share of the fuel costs, since only Pioneer and Anadarko have appealed the fuel issue). The calculation is [(108,752 – 64,714) + (267,700 – 163,332) – 203] x .75.

7 Taxpayers' Motion Ex. 2 at 4.

8 *Id*.

disallowed expenses. The resulting ICD yielded total allowable expenses of $13,043,206 and an exploration tax credit of $5,217,282.[9]

The taxpayers have appealed the following three categories of expense disallowances that were sustained in the ICD:

1. Payments to Alaska Clean Seas for Environmental Services $220,100[10]
2. Payments to Inupiat Community for Subsistence Representative $ 34,053[11]
3. Diesel fuel costs charged to Pioneer and Anadarko $203,604[12]

Collectively, if these expenses were not disallowed the allowable exploration tax credit would increase by about $183,103.

Each of the three categories of expenditures at issue in this appeal will be explained in more detail in the separate discussion of its category in Part III-D-1, 2 and 3 below.

III. Analysis

A. Nature of the Exploration Tax Credit

The exploration tax credit at issue in this case was an incentive to explorers created by a version of AS 43.55.025 that was in effect in substantially the same form from 2003 until mid-2005, encompassing the early 2005 expenditures at issue in this appeal.[13] Among other things, it created a credit against production tax for certain exploration wells. The credit could be 20 or 40 percent of qualifying expenditures on those wells, depending on their location. The parties agree that Kokoda #1 and #5 were in a geographic location eligible for a 40 percent production tax credit.

To be eligible for the credit, former AS 43.55.025 provided that expenditures on the exploration well had to meet various qualifications, including that they

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[9] Kokoda #5 ICD at 28.

[10] Kokoda #5 Notice of Appeal at 3; Kokoda #5 ICD at 5-7. The separate expense of $11,057 for an environmental coordinator supplied by Doyon Universal Services, which was also disallowed, has not been appealed.

[11] Kokoda #5 Notice of Appeal at 3; Kokoda #5 ICD at 5-8.

[12] Kokoda #5 Notice of Appeal at 7-8; Kokoda #5 ICD at 16-18, 22. The figure given for the disallowances in contest on this item is approximate, having never been calculated by the parties. It represents total finally disallowed fuel costs from the two places they are addressed in the ICD, less $13,289 disallowed on grounds not at issue in this appeal, less 25%. *See* note 6 above.

[13] The exact version that applies to the expenditures at issue in this case is found at DOR Ex. A.

> must be for goods, services, or rentals of personal property reasonably required for the surface preparation, drilling, casing, cementing and logging of an exploration well . . . .[14]

Further, the expenditures could not

> be for testing, stimulation, or completion costs; administration, supervision, engineering, or lease operating costs; geological or management costs; community relations or environmental costs; bonuses, taxes, or other payments to governments related to the well; or other costs that are generally recognized as indirect costs or financing costs . . . .[15]

The Department of Revenue adopted a regulation, former 15 AAC 55.230, to interpret and implement the statutory provision regarding qualified expenditures.[16] The relevant parts of this long regulation provided as follows:

> (b) Qualified exploration expenditures for an exploration well include costs incurred for
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> (1) surveying and preparing the exploration well drill site;
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> (2) constructing new ice or gravel roads . . .
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> (3) in-state travel, temporary living quarters, and subsistence at or near the exploration well site for drilling crew and personnel engaged in onsite exploration activities;
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> (4) drilling rig costs, including
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> (A) transportation and preparation . . .
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> (B) onsite costs for operating the drilling rig . . . and
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> (C) drilling materials, supplies, maintenance, repairs, drilling crew labor, and drilling waste handling;
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> (5) transportation equipment used for drilling crews; . . . and
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> (6) communications expenses necessary to the exploration well.
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> (d) Qualified exploration expenditures do not include costs that are disallowed under AS 43.55.025(b)(3) . . . . For purposes of AS 43.55.025(b)(3) and this subsection,
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[14] Former AS 43.55.025(b)(2)(C).

[15] Former AS 43.55.025(b)(3).

[16] The text of this former regulation appears in the published version copied at DOR Ex. B, except that it contains a misprint omitting the word "disaster" from the end of 15 AAC 55.230(d)(4). The regulation as actually filed by the Lieutenant Governor can be seen in the department's Post Hearing Submission of Oct. 23, 2009.

> (4) "community relations or environmental costs" includes costs incurred for environmental compliance programs required as a result of an environmental incident, spill, or disaster . . . .

In short, qualifying expenditures must fit within the general statutory parameters—that is, "reasonably required for the surface preparation, drilling, casing, cementing and logging of an exploration well"—as those have been further defined in 15 AAC 55.230(b). They must also fall *outside* the statutory exclusion, as further defined in 15 AAC 55.230(d).

B. Department's Application of the Law

The department concluded that the payments to Alaska Clean Seas "were environmental costs which are specifically excluded under AS 43.55.025(b)(3)."[17] The department concluded that the payments for a Subsistence Representative were "environmental and community relations costs which are specifically disallowed under AS 43.55.025(b)(3)."[18] Hence, the disallowances for the costs in the first and second categories at issue in this appeal rested on the belief that they fell within the statutory exclusion. The department did not contest that they were bona fide costs and that, absent the exclusion, they were within the general parameters for eligibility for the tax credit.

The department disallowed a portion of the diesel fuel charges claimed on behalf of Anadarko and Pioneer on the basis that the amount claimed "is not a true measure of the cost incurred."[19] Accordingly, the diesel fuel disallowances did not rest on an exclusion, but rather on the threshold issue of whether the amounts claimed were "costs."

C. Parameters for Review

1. Deference

a. Statutory Interpretation

The parties agree that the only questions to be resolved in this case are questions of law. The legislature has prescribed a pair of standards of review for such questions. As a general matter, the administrative law judge (ALJ) is to "resolve a question of law in the exercise of [his] independent judgment."[20] At the same time, the ALJ must "defer to

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17 Kokoda #1 ICD at 6-7; Kokoda # 5 ICD at 7.
18 Kokoda #1 ICD at 7; Kokoda # 5 ICD at 7.
19 Kokoda #1 ICD at 19; Kokoda # 5 ICD at 17.
20 AS 43.05.435(2).

the Department of Revenue as to a matter for which discretion is legally vested in the Department of Revenue, unless not supported by a reasonable basis."[21]

This pair of standards is intended to track the normal approach to review taken by appellate courts, including the deference owed to the agency on certain matters of statutory or regulatory interpretation.[22] As the attorney general opined when this language first came into Alaska's tax statutes, the reasonable basis standard of review was to be used whenever there was "application of the tax law to complex factual circumstances *or other matters* of Revenue expertise."[23]

When a case presents questions of statutory interpretation that involve "agency expertise"—that is, where the agency's specialized knowledge and experience are helpful in giving meaning to the statute—a deferential standard of review is appropriate.[24] In such cases, "[a] 'statutory construction adopted by those responsible for administering a statute should not be overruled in the absence of weighty reasons.'"[25]

With respect to taxation, the Alaska Supreme Court has sometimes found a need for agency expertise and experience in administering a tax structure. Thus in *Gulf Oil Corp. v. State, Department of Revenue,*[26] the court observed that determining whether a tax is "based on or measured by net income" is a matter benefiting from the experience and knowledge of Tax Division personnel.[27] In *State, Department of Revenue v. Parsons Corp.*,[28] the court concluded that interpreting the Multistate Tax Compact involves questions of tax policy benefiting from Tax Division expertise. Further, in *State v. Jeffery*[29] (not a tax case), the court suggested that where the legislature entrusts a judgment to an agency but provides "little guidance" in the statute, the agency's interpretation and application of the law is entitled to deferential review.[30] On the other hand, the court has on several occasions declined deferential review in the tax context. In

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21 AS 43.05.435(3).

22 *See State, Dep't of Revenue v. DynCorp and Subsidiaries,* 14 P.3d 981, 984 (Alaska 2000).

23 Bill Review Letter for HB 341, June 10, 1996 (italics added).

24 *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).

25 *State v. Jeffery,* 170 P.3d at 230 (quoting prior authority).

26 755 P.2d 372 (Alaska 1988).

27 *Id.* at 378 n.19.

28 843 P.2d 1238, 1241 (Alaska 1992).

29 170 P.3d 226, 231 (Alaska 2007).

30 *Id.* (lack of guidance "necessarily grants the [agency] a certain degree of discretion"; "*[i]n other words*" the decision "is a question that involves [agency] expertise" (italics added)).

State, Dep't of Revenue v. DynCorp and Subsidiaries,[31] it found that the predecessor of the Office of Administrative Hearings owed no deference to the Alaska Department of Revenue on interpretation of federal tax law that had been incorporated into state law. More significantly, in a line of cases beginning with *Earth Res. Co. v. State, Dep't of Revenue,*[32] it perceived no need for agency expertise in ascertaining "whether a taxpayer's business is unitary," noting that "no complex tax computation" was involved,[33] notwithstanding that correctly applying the unitary business concept can entail a sophisticated grasp of financial relationships.

In the present case, the department seeks deference on the basis of agency expertise. The task of integrating of the holdings in cases such as *Earth Resources* with those in *Parsons* and *Gulf Oil,* and of working out how to apply them to new tax questions, is not a trivial one, however. Rather than address this task and submit its analysis to debate, the department did not assert that the questions of statutory interpretation in this case fall within agency expertise until its reply brief, after the taxpayers' opportunity to make responsive briefing had passed. Even then, its request for deference was confined to a single oblique sentence.[34] The department's opening brief, in contrast, flatly conceded that "[q]uestions of law are resolved in the exercise of the administrative law judge's independent judgment."[35] In the absence of a timely request, accompanied by an exploration of the agency expertise or other basis being asserted for deference, a deferential standard of review will not be applied in this case.

Although a deferential standard will not apply to the statutory questions at issue, the Alaska Supreme Court has made it clear that the administrative resolution of these matters below is always entitled to "some weight."[36] Thus, if the department's interpretation of a statute is as good as any competing interpretation, the department's interpretation will stand.

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[31] 14 P.3d at 984-5.

[32] 665 P.2d 960, 965 (Alaska 1983).

[33] *Id.* at 965.

[34] State's Reply Brief at 4 & n.10.

[35] State of Alaska's Cross-Motion for Summary Adjudication and Opposition to Taxpayers' Motion at 2.

[36] *See, e.g., Alaska Gold Co. v. State, Dep't of Revenue*, 754 P.2d 247, 251 (Alaska 1988); *National Bank of Alaska v. State, Dep't of Revenue*, 642 P.2d 811, 815 (Alaska 1982).

b. Regulations

The preceding discussion covered only departmental interpretations of statutes. As for regulations, the reasonable basis standard applies to the agency's "interpretation of its own regulations . . . unless plainly erroneous or inconsistent with the regulation."[37] The Department of Revenue timely requested deference on the issue of regulatory interpretation, and the taxpayers have not articulated a basis to apply a different standard.

2. Narrow Construction of Tax Relief Provisions

Although there is a general principle that ambiguities in tax statutes are to be resolved in favor of the taxpayer,[38] the opposite rule applies with provisions creating exceptions or exemptions from the general tax treatment.[39] This rule covers tax credit provisions. Thus in *State, Department of Revenue v. OSG Bulk Ships, Inc.,*[40] the Alaska Supreme Court upheld a narrow construction of a tax credit statute on the basis that it was "consistent with the following canon of construction: Exemptions are narrowly construed against the taxpayer."[41] This canon of strict construction applies to all types of taxes including—most relevant for the instant case—oil and gas production taxes.[42]

D. Review of the Department's Application of the Law

1. Services by Alaska Clean Seas

Alaska Clean Seas (ACS) is an oil spill cooperative that provides its members, including ConocoPhillips, with environmental services encompassing both preparation for and response to spills, as well as hazardous waste management.[43] With respect to Kokoda #1 and #5, the parties agree that the ACS charges "consist largely of on-site drill

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37 *Lake & Peninsula Borough v. Local Boundary Comm'n*, 885 P.2d 1059, 1062 & n.11 (Alaska 1994) (quoting prior authority); *see also Lakloey, Inc. v. University of Alaska*, 157 P.3d 1041, 1045 (Alaska 2007).

38 *Union Oil Co. of Cal. v. Dep't of Revenue*, 560 P.2d 21, 25 (Alaska 1977).

39 E.g., 3A N. Singer, Statutes and Statutory Construction § 66.09 (5th ed. 1992); *Green Constr. Co. v. State, Dep't of Revenue,* 674 P.2d 260, 266 (Alaska 1983).

40 961 P.2d 399 (Alaska 1998).

41 *Id.* at 409.

42 *E.g., Pledger v. Ethyl Corp.,* 771 S.W.2d 24, 25 (Ark. 1989) (in context of oil severance tax, "[a]ny tax exemption provision must be strictly construed against exemption, and to doubt is to deny the exemption."); *Secretary of Dep't of Revenue & Taxation v. Texas Gas Expl. Corp.,* 506 So. 2d 528, 530 (La. App. 1987); *Eagerton v. Terra Resources, Inc.,* 426 So. 2d 807, 808 (Ala. 1982); *Phillips Petroleum Co. v. Oklahoma Tax Comm'n,* 542 P.2d 1303, 1305 (Okla. 1975).

43 Kokoda #5 ICD at 6.

rig spill technicians, fees, and an ACS winter training program."[44] The purpose of the technicians was primarily to "provide assistance in the event of a spill."[45] The technicians had to be present during drilling operations, but they were not part of the drilling crew.[46]

The taxpayers concede that the ACS costs "were incurred for the oil discharge prevention and contingency plan, required by AS 46.04.030(b)."[47] AS 46.04.030(b) requires this plan to be in place for all exploration or production facilities and for all pipelines.

The taxpayers rely on both the statute and the implementing regulation in arguing that the ACS charges are eligible for the exploration tax credit. It will be simplest to look first at the regulation and, after establishing that it is of no assistance in resolving the ultimate question, to return to the statute itself.

a. *The regulation*

It will be recalled that former 15 AAC 55.230 addressed the statutory phrase "community relations or environmental costs" in a single respect, specifying that the phrase "includes costs incurred for environmental compliance programs required as a result of an environmental incident, spill, or disaster . . . ."[48] The taxpayers contend that "[u]nder the doctrine of *ejusdem generis*, the specific description provides guidance on what is contemplated by the general term 'environmental costs.'"[49]

The term *ejusdem generis* means "of the same kind," and the doctrine of that name is a canon of construction holding that "where general words follow an enumeration of persons or things, . . . such general words are not to be construed in their widest extent, but are to be held as applying only to persons or things of the same general kind or class as those specifically mentioned."[50] It is a guideline rather than an absolute

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44 *Id.*; Kokoda #1 ICD at 6.

45 *Id.* (quoting Spill Prevention Plan).

46 Kokoda #5 ICD at 7; Kokoda #1 ICD at 6. The taxpayers have not contended that these technicians qualify for treatment as drilling crew labor under former 15 AAC 55.230(b)(4)(C).

47 Taxpayers' Motion for Summary Adjudication at 6.

48 Former 15 AAC 55.230(d)(4).

49 Taxpayers' Motion for Summary Adjudication at 5.

50 Black's Law Dict. (5th ed. 1979) at 464.

rule, and it does not necessarily govern when there is evidence of a contrary intention.[51] An example of an application of *ejusdem generis* would be the interpretation of the phrase "horses, cattle, sheep, goats, or any other farm animal:" the doctrine would suggest, in the absence of contrary factors, that "any other farm animal" would encompass only similarly large mammals, and would exclude chickens.[52] The taxpayers assert that since 15 AAC 55.230(d)(4) mentions only costs in connection with an "incident, spill, or disaster," it must be read to exclude costs that are not connected with some sort of adverse event. An example of costs that would fall outside its coverage, in the taxpayers' view, would be routine preventive costs. These costs allegedly falling outside the scope of 15 AAC 55.230(d)(4) would not be "community or environmental costs" as defined in the regulation, and therefore would be eligible for the credit.

However, the principle of *ejusdem generis* cannot properly be applied to define "community relations or environmental costs" in a regulation such as 15 AAC 55.230(d)(4). The regulation actually lists just one example of such costs: "compliance programs." The Alaska Supreme Court has stated unequivocally that *ejusdem generis* "does not apply" where there is just one example, rather than a list of multiple examples.[53]

To be sure, a list of sorts does appear in the regulation, but it is only a list of types of *compliance programs*—that is, it is a list that through *ejusdem generis* probably helps to define what is meant by "compliance programs." What *ejusdem generis* cannot do here is carry backward to create a presumption that "community relations or environmental costs" can only be something similar to "compliance programs."

Instead of *ejusdem generis,* the most relevant principle for interpreting 15 AAC 55.230(d)(4) is one enshrined in statute. Alaska Statute 01.10.040(b) provides that when the word "includes" is used in a law (the regulation is a law), it "shall be construed as though followed by the phrase 'but not limited to.'" The ICDs used this principle to conclude that the regulation was not intended to limit the regulation to a narrow category

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[51] *E.g., State v. Adkerson,* 403 P.2d 603, 676 n.9 (Alaska 1965); *Crump v. State,* 625 P.2d 857, 859 (Alaska 1981).

[52] The example comes from *West v. Municipality of Anchorage*, 174 P.3d 224, 228 (Alaska 2007), quoting Black's Law Dictionary.

[53] *Id.*

of community relations or environmental costs, but rather simply to "describe[] certain environmental costs that should be included in the disallowance."[54]

As discussed in Part III-C-1-b, the department's interpretation of its own regulation must be upheld unless plainly erroneous or inconsistent with the regulation. The department's interpretation accords with Alaska law on construction of regulations, while the taxpayers' sole argument to challenge the department's interpretation is based on a legal maxim that cannot be applied in this situation. Under the circumstances, there is no basis to overturn the department's construction of this provision. As construed by the department, 15 AAC 55.230(d)(4) simply addresses certain costs (compliance programs relating to an adverse event) that were not incurred in this case, and thus the regulation has no role in construing the statutory parameters of the tax credit in this case.

b. The statute

The ICDs simply applied former AS 43.55.025(b)(3) literally: the statute excludes from eligibility "environmental costs," and the ACS charges are environmental in nature. The taxpayers seek, again, to apply the doctrine of *ejusdem generis* to give the phrase "environmental costs" a narrower interpretation than its plain meaning would suggest.

According to the taxpayers, *ejusdem generis* applies because the statutory exclusion of

> testing, stimulation, or completion costs; administration, supervision, engineering, or lease operating costs; geological or management costs; community relations or environmental costs; bonuses, taxes, or other payments to governments related to the well; or other costs that are generally recognized as indirect costs or financing costs

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[54] Kokoda #5 ICD at 6; Kokoda #1 ICD at 5.

As a matter of common sense, this is an intuitively plausible purpose for the regulation. The department, as will be discussed below, has interpreted the phrase "community relations or environmental costs" to encompass the environmental costs that *routinely* apply to oil exploration and production. Costs specifically attributable to a spill occurring at the exploration site, however, might arguably be more closely tied to the particular exploration well project than routine environmental protection costs, and thus more appropriate for the tax credit. Foreseeing that taxpayers might view such extraordinary, incident-specific costs as meriting different treatment, the department may reasonably have believed a clarifying regulation would be useful. Moreover, spill response costs have the potential to be vastly higher than routine environmental monitoring costs. The department may reasonably have thought it especially important to forestall by regulation a potential ambiguity that could conceivably lead to a tax credit claim in the tens or hundreds of millions of dollars.

contains the phrase "or other costs that are generally recognized as indirect costs or financing costs."[55] They contend that "under the doctrine . . ., costs excluded from the AS 43.55.025 credit as 'community relations or environmental costs' must be 'generally recognized as indirect costs' in order to conform to the construction of the list of exclusions."[56]

At the outset, it should be noted that this is a backward invocation of *ejusdem generis.* To use the classic example, mentioned above, of the phrase "horses, cattle, sheep, goats, or any other farm animal," it is equivalent to invoking the doctrine to prove that horses must be farm animals, rather than to prove that "other farm animals" must be something like horses. This is not *ejusdem generis.* Although it is true, in the example, that horses are farm animals, it is not *ejusdem generis* that makes them so.

That correction aside, fairness to the taxpayers still requires an examination of the context to see if it does—for any reason—require that the exclusion of "environmental costs" be limited to "indirect" ones. It does not. The phrase "or other costs that are generally recognized as indirect costs or financing costs" can be read either to mean "or other costs that are *likewise* generally recognized as indirect costs or financing costs" or to mean "or other costs *if they are* generally recognized as indirect costs or financing costs."[57] The taxpayers advocate the former reading, but the latter is a better fit. This is because there are several specific costs listed among the specific exclusions that are plainly neither indirect costs nor financing costs. Those items are "engineering" costs, "stimulation" costs, "testing" costs, and "completion" costs: there is nothing indirect about the cost of engineering a well, nor the cost of testing it,[58] nor the cost of stimulating it,[59] nor the cost of completing it.[60] Thus, the statutory exclusion is most naturally read

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55 Taxpayers' Motion for Summary Adjudication at 4.

56 *Id.*

57 The second construction is made possible by the word order the legislature used. It would be a less natural reading if the legislature had said "or other indirect and financing costs."

58 In this context, testing probably refers to reservoir characterization and like activities. *Cf. infra* note 61; A. Chaudhry, Oil Well Testing Handbook (2004), at 1.

59 Stimulation is a term that encompasses such activities as acidizing, shooting, or fracturing the formation around the well to improve flow. *See, e.g.,* H. Williams, Oil and Gas Terms (7th ed. 1987) at 941.

60 Completion is the process, after a well has been drilled, of preparing it for production, which can include such steps as perforating the casing in the production zone. *See, e.g.,* Williams, *supra*, at 163.

as a list of various specific costs that are excluded—with no common theme[61]—to which has been added two additional exclusions: costs generally recognized as indirect, and costs generally recognized as financing costs.

The taxpayers seek to overcome the plain meaning of the statute by reference to the legislative history. In Alaska, legislative history may always be considered to interpret a statute, but consideration is on a sliding scale: "the plainer the language, the more convincing contrary legislative history must be."[62] Here, the language of the statute is not especially unequivocal, but the legislative history the taxpayers have cited to overcome its most natural reading offers no support at all for their position.

The item of legislative history the taxpayers highlight is a remark in committee testimony by a Department of Natural Resources official, Mark Myers, who was one of the individuals explaining the administration's support for the bill. According to the taxpayers, Mr. Myers "testified [that] exploration credits would enable 'drilling costs and other expenses to be more manageable,' and then reference[d] 'maneuvering through the environmental permitting process' as an example of the type of costs a 40-percent tax credit would help relieve."[63] This is not an accurate characterization of Myers's testimony. Myers mentioned environmental permitting in a sentence about "other areas of concern." These "other areas" were environmental permitting costs, the "availability of rigs and ice making equipment," and "cost of transportation of the crude oil."[64] Equipment shortages and post-discovery crude oil transportation costs are plainly not

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[61] There are strong indications in the legislative history that testing, stimulation, and completion costs were excluded because they generally occur only after oil or gas is found, and once a well is successful there is no need to provide further incentive to the explorer. Testimony of Dan Dickinson, Director of Tax Div., before Sen. Finance Committee re CSSB 185 RES (May 14, 2003), at 7 [DOR Ex. C]; *see also* testimony of Mark Myers, Director of Div. of Oil & Gas, before Sen. Finance Committee re CSSB 185 RES (May 13, 2003) (two paragraphs beginning with phrase "Mr. Myers stated that there 'is a different element of risk' . . ."); testimony of Mark Myers before House Oil & Gas Committee re SB 185 (May 18, 2003), at no. 1057. Note that this reason for exclusion is entirely distinct from concluding that completion costs are a species of "indirect" costs.

In testimony regarding this provision when it was later amended in 2007, Division of Oil and Gas official Kevin Banks testified that testing, stimulation, and completion are "part and parcel" of an exploration project, again confirming that they are not indirect. Testimony before House Resources Committee re HB 2001 (Nov. 4, 2007) at 4:19:11 p.m.

[62] *Tesoro Petroleum Corp. v. State,* 42 P.3d 531, 537 (Alaska 2002).(quoting prior authority).

[63] Taxpayers' Reply to Opp. and Response to Cross Motion of the Dep't of Revenue at 3.

[64] Testimony of Mark Myers, Director of Div. of Oil & Gas, before Sen. Finance Committee re CSSB 185 RES (May 13, 2003) [Taxpayer Reply Ex. 1 at 17].

things eligible for the tax credit, and thus it is clear from the context that the "other areas of concern" to Mr. Myers were matters *not* addressed directly by the tax credit.

The other legislative history examples the taxpayers have cited are merely expressions of the general goal to encourage exploration.[65] The fact that the legislature intended to encourage exploration does not mean that questions of statutory construction should be resolved in favor of the greatest possible subsidy for exploration. Just as it is plain that encouraging exploration was a goal, it is equally plain that the legislature intended to preserve some tax revenue and that it set out, in former AS 43.55.025(b)(3), to put sideboards around the tax credit. Indeed, as noted above in Part III-C-2, where there is doubt about their construction, the Alaska Supreme Court has declared that tax credits should be narrowly construed. A plain-language construction of "environmental costs" —costs for services to protect the environment, however incurred—is a narrower construction of the AS 43.55.025 tax credit than the more complex interpretation that the taxpayers advocate.[66]

Since there is no contrary legislative history to overcome the plain meaning of the statute, and since the plain meaning represents the required narrow reading of the tax credit statute, the plain meaning prevails. The department's use of that meaning in the ICD will not be disturbed.

2. Services by Inupiat Community of the Arctic Slope

The subsistence representative for each project was supplied by the Inupiat Community of the Arctic Slope.[67] This individual was required to travel to and inspect operations in the field, including the ice road construction, and to monitor impact on the land, water, wildlife, and traditional subsistence use areas. The representative was to report noncompliance, including spills, and to assist the operator in correcting any issues

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[65] Taxpayers' Reply to Opposition and Response to Cross Motion of the Department of Revenue at 2-3 n.5.

[66] It should be noted that even if the taxpayers' view—that environmental costs are excluded only if they are "indirect"—were accepted, the outcome with respect to ACS costs would be in doubt. The taxpayers have admitted that the ACS costs were incurred to bring the Kokoda projects under an AS 46.04.030(b) contingency plan. While at oral argument some general representations were made that cannot substitute for evidence, no actual evidence has been offered on the extent to which C-plan arrangements for this project were simply an extension of area-wide arrangements. It may be that some or all of the ACS charges were simply allocated costs of an umbrella arrangement more akin to the "management" and "administration" costs excluded in AS 43.55.025 than to the hands-on work for which the statute provides a credit.

[67] Kokoda #5 ICD at 7; Kokoda #1 ICD at 7.

of concern.[68] As with the ACS charges, the ICD disallowed these costs as "community relations and environmental costs" under AS 43.55.025(b)(3).

The work of the subsistence representative—monitoring and correction of impacts to land, water, wildlife, and subsistence resources—can best be described as "environmental." For the reasons discussed in Part III-D-1, the department's conclusion that all environmental costs fell within the AS 43.55.025(b)(3) exclusion was correct.

3. Diesel Fuel Purchases

ConocoPhillips purchased diesel fuel from Colville, Inc. for use in both exploration projects. Colville is not an affiliate of ConocoPhillips, Pioneer, or Anadarko.[69] The purchases for Kokoda #1 totaled 72,550 gallons, and for Kokoda #5 totaled 203,372 gallons.[70] In claiming a tax credit for the three explorers, ConocoPhillips entered the full amount it paid to Colville for this fuel.

The fuel that Colville sold to ConocoPhillips was fuel that ConocoPhillips had previously sold to Colville. It had the following history:

- First, ConocoPhillips had taken the fuel "in kind" from the Kuparuk or Prudhoe Crude Oil Topping Plants, exercising its rights as a working interest owner.[71]
- Second, ConocoPhillips had paid the topping plant a processing charge of 7.28 or 11.269 cents per gallon.[72]
- Third, ConocoPhillips had sold the fuel to Colville under ConocoPhillips contract number AK 87-0441.[73] The price for this transaction was indexed to (but not identical to) the Pacific Northwest monthly average spot price for Number 2 diesel fuel for the prior month.[74]
- Fourth, Colville had resold the fuel to ConocoPhillips at the purchase price plus a negotiated differential to compensate Colville for transportation costs, apparently either 2.5 or 6.5 cents per gallon depending on the distance transported.[75]

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68 *Id.*

69 Taxpayers' Motion Ex. 1 at 24, ¶ 7; Daly Aff't ¶ 4.

70 Taxpayers' Motion Ex. 1 at 25; Taxpayers' Motion Ex. 2 at 30.

71 Taxpayers' Motion Ex. 1 at 23-24; Taxpayers' Motion Ex. 2 at 28-29; Kokoda #1 ICD at 18; Kokoda #5 ICD at 16.

72 Taxpayers' Motion Ex. 1 at 23; Taxpayers' Motion Ex. 2 at 28.

73 Taxpayers' Motion Ex. 1 at 24; Taxpayers' Motion Ex. 2 at 29.

74 Taxpayers' Motion Ex. 1 at 25; Taxpayers' Motion Ex. 2 at 30; Daly Aff't ¶ 7.

75 Kokoda #1 ICD at 18; Kokoda #5 ICD at 16; Taxpayers' Motion Ex. 1 at 25; Taxpayers' Motion Ex. 2 at 30. Daly Aff't ¶ 13 claims a different set of differentials and appears to be mistaken; however, the exact figures do not matter for this decision.

The ICD assessed the eligible cost of this fuel to the explorers as the sum of three components:

-- The fair market value of the crude oil feedstock used for the diesel at the topping plant;[76]

-- The processing charge at step two; and

-- Colville's transportation markup at step four.

The sum of these components is less than the final price that Colville charged ConocoPhillips in step four of the transaction. The difference, assuming the feedstock has been valued correctly, is essentially ConocoPhillips' markup to Colville at step three of the transaction—that is, the difference between what Colville had to pay and ConocoPhillips' cost to provide the fuel to Colville (the latter being the value of the feedstock that ConocoPhillips was contributing in kind, plus the cost of processing it).

ConocoPhillips has not challenged the three-component allowance on appeal, presumably because the potential fourth component—the markup—is plainly an illusory part of ConocoPhillips' "cost" for the diesel in this sale-and-repurchase transaction.[77] Pioneer and Anadarko, however, argue that *for them*, the cost of the diesel was not this sum of internal ConocoPhillips costs, but instead was the resale price charged by Colville at step four. Pioneer and Anadarko implicitly recognize that allowing them to claim a higher cost than ConocoPhillips would require the department, on audit, to evaluate these costs separately for the various taxpayers, even though joint explorers apply for tax

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[76] Kokoda #1 ICD at 19-20; Kokoda #5 ICD at 17-18. There was some controversy about how the feedstock was valued, but the valuation methodology (assuming any valuation is performed) is not challenged on appeal.

[77] This is true because the markup is a wash to ConocoPhillips; however much it marks up the fuel to Colville at step three, it pays back the full amount of that markup at step four; conversely, however high the price at step four as a result of the earlier ConocoPhillips markup, ConocoPhillips has already recouped that amount at step three. This is compelled by the contractual terms between ConocoPhillips and Colville, and it is true regardless of whether or not the step three price is an arm's length, market price.

Note, however, that in this case it has not been established that the step three price is an arm's length price. The ALJ invited the taxpayers to make a post-hearing submission showing that not all of the product sold to Colville under contract number AK 87-0441 is repurchased by ConocoPhillips under the cost-plus-transportation-differential formula. The taxpayers made a filing in response, but the filing does not quite address the question posed. If all of the product sold is repurchased under this arrangement, Colville would have no reason to care what the price was at step three, and that price could not be regarded as one developed at arm's length.

credits on a single consolidated application.[78] They point out, however, that "nothing restricts or prohibits the Department from granting credits in varying amounts."[79]

To accept Pioneer's and Anadarko's position would be to interpret the word "cost" in AS 43.55.025 to encompass something more than the cost that the managing partner incurred in procuring a particular good or service for the project. The department, in contrast, has declined to recognize as a "cost" a premium or markup that one explorer has, in effect, charged to another. The following example, which uses illustrative rather than actual prices, will show how this premium has been charged.

Suppose ConocoPhillips takes four gallons of fuel in kind at step one, foregoing the value of marketing that fuel on the open market, which for purposes of this illustration is 93 cents. Processing charges at the topping plant add 7 cents at step two. ConocoPhillips then sells the four gallons to Colville at step three for $5.00 per gallon. Colville resells the fuel to ConocoPhillips at step four for $5.065 per gallon.

For ConocoPhillips, which has a 25 percent share of this project and thus had to fund the purchase of one of the four gallons, the large markup at step three is a wash, and the effective cost of its gallon of fuel used in the project is $1.065. ConocoPhillips accepts this result on appeal. Pioneer and Anadarko, however, have had to pay $5.065 per gallon for the three gallons corresponding to their 75 percent share of the fuel purchases. Where did the extra $4.00 per gallon go? It went, indirectly, to ConocoPhillips. For each of those three gallons, ConocoPhillips now has $4.93, rather than the $0.93 it would have realized by marketing the fuel normally. To put it another way, ConocoPhillips has reimbursed Colville at step four for the $4.00 markup it charged Colville at step three, but it has done so using other explorers' money. Thus, to ConocoPhillips the markup at step three is no longer a wash; it is a potential source of profit.

In rejecting the taxpayers' bid to include this explorer-to-explorer markup as a "cost," the department has declined to adopt an expansive construction of that term. The department's conservative interpretation of the word "cost" in the tax credit statute comports with the Alaska Supreme Court's holding in *OSG Bulk Ships*, discussed

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78 The consolidated application is required by former 15 AAC 55.225(a)(2) [DOR Ex. B].

79 Taxpayers' Motion for Summary Adjudication at 9.

previously, that tax credit provisions "are narrowly construed against the taxpayer."[80] Further, as discussed above in Part III-C-1-a, the department's interpretation of the word "cost" in AS 43.55.025 is entitled to "some weight" and should not be disturbed unless a better interpretation is available. The taxpayers' short, citation-free argument on this issue has not provided the necessary counterweight; they have simply contended that the situation is intuitively "unfair" to Pioneer and Anadarko.[81] They have not explained why the unfairness, if any, should be viewed as being a result of the department's definition of "cost" rather than as a result of the way the taxpayers organized their venture, which effectively permitted their partner to charge them more for supplies than it cost their partner to procure those supplies.

Under the circumstances, the ALJ declines to rule that it is an error to interpret "cost" in former AS 43.55.025 to mean the cost that the operator incurred in procuring a particular good or service for the project, and not to recognize as a "cost" a premium or markup that one explorer has charged to another.

IV. Conclusion

The Department of Revenue correctly interpreted and applied the law with respect to all challenged elements of its Informal Conference Decisions on exploration tax credits for Kokoda #1 and Kokoda #5. Accordingly, the department's motion for summary adjudication is granted and the taxpayers' motion for summary adjudication is denied. The Informal Conference Decisions, both dated December 8, 2008, are affirmed.

DATED this 21st day of December, 2009.

By: *Signed*
Christopher Kennedy
Administrative Law Judge

[80] 961 P.2d at 409.
[81] *Id*. at 8.

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.[82]

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.

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.[83] 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.[84]

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.[85]

Certificate of Service: The undersigned certifies that on the 21st day of December, 2009, a true and correct copy of this document was mailed to Marie P. Evans, counsel for the taxpayers, and Susan Pollard, AAG; and was hand delivered to Hollie Kovach, Chief of Appeals, Tax Division.

By: *Signed*
Linda Schwass/Kim DeMoss

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

82 Alaska Statute 43.05.465(f)(1).
83 Alaska Statute 43.05.470.
84 Alaska Statute 43.05.470(b).
85 Alaska Statute 43.05.465 sets out the timelines for when this decision will become final.