BEFORE THE STATE ASSESSMENT REVIEW BOARD
STATE OF ALASKA

In the Matter of:	)	
	)	OAH No. 12-0090-TAX
	)	OAH No. 14-0586-TAX
ENI US OPERATING COMPANY INC.	)	OAH No. 15-0452-TAX
	)	OAH No. 16-0361-TAX
	)	OAH No. 16-0424-TAX
	)	Appeal of Revenue Decisions
Oil & Gas Property Tax (AS 43.56)	)	Nos. 12-56-03/14-56-08/15-56-08/
2012-2016 Assessment Years	)	16-56-04/13-56-04

CERTIFICATE OF DETERMINATION

The State Assessment Review Board convened on May 16, 2016, and May 19, 2016, to hear and deliberate on the AS 43.56 appeals of the assessment of Eni US Operating Company, Inc.'s Nikaitchuq Development for tax years 2012-16.[1] The Board certifies that the full and true value of Eni's oil production and pipeline property on the lien dates applicable to these appeals is as follows:

- January 1, 2012: $1,100,881,780[2]
- January 1, 2013: $1,147,954,190[3]
- January 1, 2014: $1,136,274,000[4]
- January 1, 2015: $1,131,012,980[5]
- January 1, 2016: $1,032,779,484 [6]

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1 Chair Steve Van Sant, and members James I. Mosley, Bernard Washington, and Bill Roberts heard the appeal, constituting a quorum as required by AS 43.56.130(b). Under AS 44.64.020(6) and 44.64.030(b), the Office of Administrative Hearings provides administrative law judges to advise the Board at the request of the Commissioner of Revenue. Administrative Law Judges Neil Slotnick and Cheryl Mandala from the Office of Administrative Hearings assisted the Chair.

2 *See* Division Exhibit y. The values represent all property in the North Slope Borough.

3 *Id.*

4 *See* Division Exhibit w. The values represent all property in the North Slope Borough without the inutility adjustment.

5 *See* Division Exhibit x. The values represent all property in the North Slope Borough without the inutility adjustment.

6 This value includes the Board's inutility adjustment applied to the value of North Slope property described in division Exhibit y at 6.

I. Introduction

The subjects of this appeal are the Department of Revenue Tax division's Revenue Decision numbers 12-56-03, 13-56-04, 14-56-08, 15-56-08, and 16-56-04.[7] Under AS 43.56.130(f), the Board cannot adjust the division's assessed valuation unless the evidence in the record shows that this valuation is unequal, excessive, improper, or otherwise contrary to the standards set out in AS 43.56. The Board has found that, on balance, the appealing parties have failed to show that the assessor inappropriately valued the Nikaitchuq property. The Board has determined that minor adjustments are required in one area: the application of an inutility adjustment, which the Board has determined should be applied only for tax year 2016 and at a lesser level than used by the assessor.

After correcting this item, the Board has determined that the assessed valuation of Eni US Operating Company, Inc.'s oil production and pipeline property should not be adjusted for 2012 or 2013 (where the inutility adjustment was already removed), for 2014 should be adjusted to $1,136,274,000 (to remove the inutility adjustment applied by the division), for 2015 should be adjusted to $1,131,012,980 (to remove the inutility adjustment applied by the division), and for 2016 should be adjusted for inutility as described below.

A. Description of the Property

This production and pipeline property being assessed is held by Eni US Operating Company, Inc. The parties challenge certain assessments to property within Eni's Nikaitchuq Development. For assessment purposes, the Nikaitchuq property is divided into the following categories: operations center (Account No. 002-000-1442), wells (Account No. 002-000-1512), offshore drillsite (Account No. 002-000-1513), offshore flowlines (Account No. 002-000-1514), onshore pipeline (Account No. 002-000-1515), process facility (Account No. 002-000-1516), and process support (Account No. 002-000-1517), as well as inventory accounts not in dispute.

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[7] The Notice of Assessment for tax year 2012 was issued on February 28, 2012, and upheld in decision number 12-56-03 on March 29, 2012.Exhibit h. The Notice of Assessment for tax year 2013 was issued on February 28, 2013, and upheld in decision number 13-56-04 on April 15, 2016. Exhibit k. The Notice of Assessment for tax year 2014 was issued on March 5, 2014, and upheld in decision number 14-56-08 on April 1, 2014. Exhibit i. The Notice of Assessment for tax year 2015 was issued on February 26, 2015, and upheld in decision number 15-56-08 on March 31, 2015. Exhibit j. The Notice of Assessment for tax year 2016 was issued on February 25, 2016, and upheld in decision number 16-56-04 on March 29, 2016. Exhibit l

B. Parties Appealing

The parties to the appeal are Eni US Operating Company, Inc., the North Slope Borough, and the Tax division of the Alaska Department of Revenue.[8]

C. Consolidation and Coordination of Appeals

At the request of the parties, Eni's and the North Slope's appeals of Revenue Decision Nos. 12-56-03, 13-56-04, 14-56-08, 15-56-08, and 16-56-04 were consolidated in a prehearing order dated April 18, 2016.

D. Preliminary Proceedings

Each tax year from 2013 through 2015, Eni appealed its assessments. Under the regulations that governed property tax appeals at the time these cases were filed, however, some appeals—those involving taxability issues—were to be decided by the Commissioner of Revenue.[9] Because Eni's appeals involved the taxability of intangible drilling and development expenses, they were stayed while a different case, with the same issue, was routed through the department's appeal process. While that case was on remand, however, the Alaska Supreme Court invalidated the regulation under which taxability issues were determined by the department.[10] Instead, all issues raised in an appeal of an AS 43.56 assessment were to be heard by the Board. After the court issued that order, the stayed assessments, along with the 2016 assessment were now before the Board for the 2016 appeal cycle.

The 2016 hearings before the Board were bifurcated between taxability and valuation. A preliminary hearing was held on April 5, 2016, to address the taxability of intangible drilling expenses in this and other currently pending AS 43.56 appeals. Because the issue was common in all of the pending 2016 property appeals (involving three taxpayers, each with multiple years at issue), the taxability issue was consolidated for one joint hearing.

The taxability issue involved construing Alaska law exempting intangible drilling expenses from being included in the taxable value of oil and gas pipeline and production property.[11] The

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8 The Owners were represented by F. Steven Mahoney and Ryan Fitzpatrick. Assistant Attorneys General Katherine Swanson and Martin Schultz represented the Tax division. The North Slope Borough was represented by Jessica Dillon and Molly Brown.

9 15 AAC 56.015.

10 *City of Valdez v. State,* No. S-15840, 2016 WL 1719372, at *5 (Alaska Apr. 29, 2016) ("revenue's interpretation of 'assessment' through its regulation is not consistent with the text of AS 43.56."); *see also* Order, *City of Valdez v. State of Alaska,* Supreme Ct. No. S-15840 (Alaska, January 29, 2016).

11 AS 43.56.060(f).

Department of Revenue has adopted a regulation defining "intangible drilling expenses" for purposes of this exemption.[12]

The taxpayers in the 2016 taxability appeal argued that the state intangible drilling expense exemption mirrors the federal income tax provision on intangible drilling and development costs.[13] Their reading of Alaska law is broader than the one followed by the division. The taxpayers asserted that the assessor erred in including intangible "development" expenses in the assessments.

On April 12, 2016, the Board upheld the division's determination that the state exemption under AS 43.56.060 and 15 AAC 56.120 incorporated federal income tax law only to the extent that federal law referenced intangible drilling costs. The Board concurred with the division that the state exemption did not incorporate the federal income tax law with respect to intangible development expenses. The decision did not, however, address which activities are included or excluded from the regulation's definitions of nontaxable "intangible drilling expenses" versus taxable "intangible development expenses." The April 12, 2016, decision is incorporated by reference and made part of this decision.

II. **Facts**

A. Property at issue

This appeal concerns the valuation of the oil production and pipeline property associated with Eni's Nikaitchuq Development on Alaska's North Slope.[14] The Nikaitchuq Development consists of onshore and offshore facilities as follows:

- The Spy Island Drillsite, an offshore artificial island;
- The Oliktik Point Pad, an onshore pad with additional wells and a production facility;
- A seabed pipeline connecting the island to the onshore pad; and
- An onshore pipeline connecting the onshore pad to the Trans-Alaska Pipeline System.[15]

The 11.5-acre offshore artificial island houses 23 of the 55 Nikaitchuq wells. Designing

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12 15 AAC 56.120.

13 *See* 26 U.S.C. 263(c); 26 C.F.R. § 1.612-4(a).

14 Exhibit kkk at 14.

15 Exhibit a at 14.

and constructing the island was “a very significant project.”[16] In addition to the wells, the island also has a personnel camp facility, a mud-mixing facility, and storage for fluids and various supplies.[17] The 6.9-acre onshore pad, the Oliktik Point Pad, is used for both drilling and production, and serves as a staging point for transferring supplies to the island.[18] The onshore pad houses two production modules, each with a capacity of 20,000 barrels of oil per day (BOPD).[19] A 5-kilometer “flowline bundle” buried beneath the sea floor connects the island and onshore facilities.[20]

The Nikaitchuq field has stated reserves in the 220-million barrel range.[21] Construction of Nikaitchuq began in 2008, and first oil was produced in 2011.[22] Nikaitchuq houses a total of 55 wells – 32 on Spy Island and 23 at Oliktik Point – of which 21 are injector wells, 29 are producer wells, 2 are disposal wells, and 3 are water source wells.[23] Eni suspended drilling at Nikaitchuq in October 2015 due to economic conditions.[24] The field is currently producing roughly 25,000 barrels of oil per day, and is not expected to exceed this amount in the future.[25]

B. Assessments

The assessments at issue in this appeal cover a span of five years and were all conducted by State Petroleum Property Assessor James H. Greeley. For all tax years at issue, the division assessed the Nikaitchuq property based on “replacement cost new less depreciation” (“RCNLD”).[26] Mr. Greeley described the RCNLD process after construction is completed as follows:

> DOR rolls all inception-to-date costs incurred, less excluded intangible drilling expenses, into an investment column in the RCNLD worksheet. [T]he investment costs are then trended to current price levels using the Marshall and Swift cost index to determine the current replacement cost new (RCN) for the given tax year. From this point, the model depreciates the RCN based on the economic life of proven reserves for a given tax year.

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16 Gauer testimony.
17 Greeley testimony.
18 Eni Prehearing Brief, at 2.
19 Eni Prehearing Brief, at 2; ENI-0061, at 2.
20 Eni Prehearing Brief, at 2; ENI-0061, at 2.
21 *See*, *e.g.*, Exhibit i at 5.
22 Eni Prehearing brief, at 1; Exhibit a.
23 ENI-0061, at 2; Gauer testimony.
24 Gauer testimony.
25 Gauer testimony.
26 Greeley testimony; Exhibit a, at 3.

The result is the RCNLD, and DOR's assessed value.[27]

When production commences, the division then assessed the wells under the division's standard well model.[28]

As is discussed further below, a significant issue of dispute between the parties is the identification of the "excluded intangible drilling expenses" referenced by the assessor. Eni argued to the assessor, and argues on appeal, that the vast majority of intangible costs associated with building and operating the artificial island should be excluded from taxation as intangible drilling expenses. The division rejected that argument, concluding that many of the facilities on the island have "uses that will serve production over the life of the property," and excluding from the intangible drilling expenses classification intangibles attributable to "long life property associated with production as well as drilling."[29] However, the assessment did exclude intangible costs "specific to the actual activity of preparing to drill and drilling a well," including some intangible "completion costs."[30] The Borough has argued that completion costs are not intangible drilling expenses and are therefore taxable.

C. Parties' positions on assessment value

For the assessment at issue in this appeal, the North Slope asks the Board to find that the assessment undervalues the property, Eni asks the Board to find that the assessment overstates the value of the property, and, with one exception for tax years 2014 and 2015, the division asks the Board to uphold the assessment. The values identified in the original assessment for each year, and the parties' position on the appropriate total assessment values for Eni's oil production and pipeline property, including the Nikaitchuq Development, are as follows:

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27 Exhibit aa, at 12; Greeley testimony.

28 Exhibit aa at 12; Greeley testimony.

29 Greeley testimony. As a general matter, the division expects that, once a project is complete, intangible drilling expenses will typically account for between 30 and 50 percent of total costs. Greeley testimony; Exhibit aaa-ccc. The assessments of Nikaitchuq identified intangible drilling expenses squarely within this range. Greeley testimony; Division Exhibit kkk, at 24

30 Greeley testimony; Exhibit a, at 5-9.

Tax Year	Assessment	division's Position	North Slope Position[31]	ENI Position[32]
2012	$1,100,881,780[33]	*Uphold assessment*	$1,206,004,602	$883,784,333
2013	$1,147,954,190	*Uphold assessment*	$1,282,609,480	$919,287,246
2014	$1,136,274,000[34]	$1,113,494,000	$1,301,335,730	$901,368,316
2015	$1,131,012,980[35]	$1,122,820,940	$1,342,467,718	$901,397,008
2016	$1,068,334,910	*Uphold assessment*	$1,371,750,295	$848,624,880

III. Discussion

A. Legal framework

This appeal concerns both production property and pipeline property. The valuation is thus determined under AS 43.56.060(d) and (e). Production property is valued based on "actual cost" during construction; thereafter, value is determined based on "replacement cost less depreciation based on the economic life or proven reserves."[36] The value of pipeline property – that is, "property used or committed by contract or other agreement for pipeline transportation of gas or unrefined oil or in the maintenance of facilities for the pipeline transportation of gas or unrefined oil or in the operation or maintenance of facilities for the pipeline transportation of gas or unrefined oil" – is determined "with due regard to the economic value of the property."[37] Here, as described above, all assessments were conducted using RCNLD. The parties do not dispute the propriety of using RCNLD to value the subject property, but dispute the assessor's application of that method to the property at issue.

Appellants bear the burden of proving, by a preponderance of the evidence, that the assessment results in unequal, excessive, or improper valuation, or valuation not determined in

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31 North Slope-Eni-AA. For each year, these figures include inventory assessments that are not being appealed.

32 Eni Prehearing Brief at 20.

33 *See* division Exhibit y. The values represent all property in the North Slope Borough.

34 *See* division Exhibit w. The values represent all property in the North Slope Borough without the inutility adjustment.

35 *See* division Exhibit x. The values represent all property in the North Slope Borough without the inutility adjustment.

36 AS 43.56.060(d).

37 AS 43.56.060(e)(2).

accordance with the standards set out in AS 43.56.[38] If a party satisfies this burden, the burden then shifts to the division to introduce credible evidence substantiating its assessment. If the division fails to substantiate its assessment, the Board will adjust the assessment based upon its own expertise and the evidence and arguments presented at the hearing.[39]

B. Eni's arguments

1. Has Eni established that the division erroneously included non-taxable Intangible Drilling Expenses in its assessments?

The determination of actual or replacement cost for assessment purposes excludes "intangible drilling expenses."[40] Intangible drilling expenses are those intangible expenses incurred or accrued in preparing to drill a well, such as, "clearing ground, draining, road making, surveying, and geological works," and actually "drilling wells."[41] But "intangible drilling expenses" do not include "intangible development expenses."[42] Nor do they include expenditures "that are properly allocable to the cost of depreciable property ordinarily considered to have a salvage value."[43]

The Assessor testified that, consistent with "many years of DOR policy and practice," the only intangible drilling expenses that are excluded from AS 43.56 property taxation are those "*<u>specific to the actual activity of preparing to drill and drilling wells</u>*."[44] Eni contends that the division's assessments should have allowed more than $100,000,000 per year in additional deductions for Intangible Drilling Expenses.[45] The Alaska Supreme Court has explained, however that "[a] taxpayer claiming a tax exemption has the burden of showing that the property is eligible for the exemption. Furthermore, the courts must narrowly construe statutes granting such exemptions."[46] For the reasons that follow, Eni did not meet its burden of proving that the division erred in its interpretation of the 15 AAC 56.120 exemption for Nikaitchuq.

The Assessor's affidavit and testimony summarizes his approach to the scope of the intangible drilling expenses exemption. He includes as intangible drilling expenses "intangible

38 AS 56.130(f).
39 15 AAC 56.040(g).
40 AS 43.56.060(f); Exhibit aa, at 12.
41 AS 43.56.210(4); 15 AAC 56.120.
42 15 AAC 56.120(c)(1).
43 15 AAC 56.120(c)(3).
44 Exhibit a at 5 (emphasis in original).
45 Eni Prehearing brief, at 5-12.
46 *Greater Anchorage Area Borough v. Sisters of Charity of House of Providence*, 553 P.2d 467, 469 (Alaska 1976).

expenses associated with gravel installation and construction only for wells"; "intangible expenses associated with drilling"; and "intangible expenses associated with well completion."[47] Additionally, "a portion of general overhead costs can be allocated to intangible drilling expenses if appropriate," but he cautions that "this is a delicate exercise [and] should be approached with caution, because some overhead costs may already be in the costs book to the drilling AFEs."[48] But he does not accept the taxpayers' broad arguments that all "costs associated with gravel and gravel installation and construction," "costs associated with drilling except for tangible tubulars and jewelry," "costs associated with completion except for tangible tubulars and jewelry," and "costs associated with long life production facility and pipeline infrastructure" are all also intangible drilling expenses.[49]

Eni takes an aggressive view of intangible drilling expenses and what it means for an expenditure or an item to be "incident and necessary to drilling wells" under 15 AAC 56.120. But the assessor has discretion to determine whether and how intangible expenses are allocated between drilling activity and longer term activity over the life of the development. As Eni's own case presentation acknowledges, an allocation of intangible costs between "drilling" and development or production is often necessary. Eni presented testimony and argument about the allocation of gravel as an intangible drilling expenses, arguing that the assessor should have allocated more of those costs into the intangible drilling expenses category. But part and parcel of the propriety of such allocation is the dvision's discretion to determine where the lines are drawn between intangible drilling expenses and other intangible but taxable costs. Eni failed to show that the assessor erred in drawing that line.

On appeal, Eni asserts that it was entitled to additional deductions for conceptual front-end engineering expenses, project management costs, and environmental studies.[50] But Eni has produced no evidence that the assessor erred in his allocation of drilling-related expenses in these categories to intangible drilling expenses. The Board is not persuaded by Eni's cursory arguments in this regard, and not persuaded that the assessor erred in not deducting the additional amounts claimed by Eni.[51]

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47 Exhibit a at 10.
48 Exhibit a at 9.
49 Exhibit a at 10; Exhibit c, Exhibit d.
50 Eni Prehearing brief at5-7.
51 The evidence was undisputed that Eni never provided the Assessor with detailed G/L information, instead

Relatedly, Eni's expansive view of intangible drilling expenses also seeks to exempt costs implicated in development or production beyond "the actual activity of preparing to drill and drilling wells."[52] In addition to the foregoing project management and related costs, these include construction of ice roads between the onshore facilities and Spy Island, and additional gravel expenses beyond those already credited by the assessor.[53] These expenses relate to development/production activities at Nikaitchuq, and are not "drilling expenses" as the division has interpreted that term in the regulation.[54] The division has interpreted the intangible drilling expenses exemption as covering only those intangible expenses "*specific to the actual activity of preparing to drill and drilling wells*."[55] Expenses occurred beyond well completion or to support development/production, even if also related to "the drilling operation" broadly construed, are not intangible drilling expenses for purposes of the 15 AAC 56.120 exemption. Again, Eni did not prove that the Assessor abused his discretion in apportioning costs attributable to intangible drilling expenses versus development or production expenses.

Lastly, a number of the costs claimed by Eni are excluded from intangible drilling expenses under 15 AAC 56.120(c)(3)(B). That section expressly excludes from intangible drilling expenses those expenditures "that are properly allocable to the cost of depreciable property ordinarily considered to have a salvage value." North Slope's accounting expert, Loretta Cross, identified numerous types of depreciable property on Spy Island, and testified that, as a basic principle of oil and gas accounting, intangible expenses on those items are properly allocable to the cost of the depreciable property.[56]

Specific items claimed by Eni that the Board finds to be excluded from the definition of intangible drilling expenses by 15 AAC 56.120(c)(3)(B) include off-shore camp facilities; camp costs during construction; on-shore and off-shore well containment structures; the diesel flowline;

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providing only "summary level" information. Greeley testimony; Exhibit a at 15. On appeal, Eni did not explain how it had identified the additional amounts it claims should have been allocated to the identified items, nor did Eni carry its burden of showing that the Assessor erred in his own allocation of these amounts.

52 Exhibit a at 5.

53 Eni prehearing brief at7-9.

54 It is noteworthy that Mr. Lemon, Eni's expert, characterizes Eni's claimed intangible drilling expenses as being "necessary for *the drilling operation*." *See, e.g.,* ENI-0063 (emphasis added). But "the drilling operation" is broader in scope than the intangible drilling expenses exemption as the department has defined it.

55 Exhibit a at 5 (emphasis in original).

56 Cross testimony; Exhibit North Slope-Eni-DI at 13.

drilling tanks and piperacks; and the waste management system.[57] As to each of the foregoing, Eni seeks to recover intangible expenses (such as labor, hauling and repairs) associated with the item. But each of the items listed is depreciable property ordinarily considered to have salvage value.[58] The costs associated with it therefore fall outside the scope of the 15 AAC 56.120 exemption. Eni's reliance on 15 AAC 56.120(b)(3) to support an exemption for these items is not persuasive. While that section defines intangible drilling expenses to include expenditures incident and necessary to "construction of derricks, tanks, pipelines and other physical structures necessary to drilling wells," North Slope persuasively argued that that definition references temporary structures erected as a prelude to drilling operations. This reading harmonizes (b)(3) with (c)(3)(B), the provision excluding expenditures "that are properly allocable to the cost of depreciable property ordinarily considered to have a salvage value."

In short, Eni did not come forward with any proof that the assessor's treatment of any of the items identified was improper or excessive, and so did not meet its burden of proving that the division erroneously applied 15 AAC 56.120. The division is entitled to deference in its interpretation of the regulation, and the Board believes that such deference is warranted here.

2. Did Eni establish that the 2015 and 2016 assessments failed to adequately address valuation issues relating to the camp that burned down?

Eni claims that the 2015 and 2016 assessments failed to adequately adjust the Nikaitchuq property value after a camp building burned down in late 2014, and was replaced in 2015 with a larger facility.[59] Eni has not met its burden of proving that the division erred in its assessment vis-à-vis these events.

For tax year 2015, the division removed $9.4 million from the assessment to account for the loss. The division arrived at this number by taking Eni's estimate for the replacement camp ($20 million), reducing it in half due to the size difference between the original and replacement camps, and then depreciating the amount to the 2009 price level (the year the original camp was constructed).[60] For 2016, the division assessed the new camp at its actual cost ($24 million).[61]

For both years, the division's assessment sufficiently accounted for the relevant events –

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57 Eni Prehearing brief at 7-12.
58 L. Cross testimony; Exhibit North Slope-Eni-DI at 13.
59 Eni Prehearing Brief at 12-13.
60 Greeley testimony; Exhibit u.
61 Greeley testimony; Exhibit v.

the loss of the camp in 2015, and the addition of a new camp in 2016. Eni did not demonstrate that the division erred in its approach to the burned down camp for either tax year, and the Board upholds the assessor's determination on this issue.

3. Did the assessments' determination of depreciation properly account for inutility?

All three parties raise arguments about the assessments' depreciation calculations and the methodology and assumptions used.[62] The specific issue is that the Nikaitchuq processing facilities can process up to 40,000 BOPD, but the Nikaitchuq field now is anticipated to never produce more than 25,000 BOPD.[63]

The department originally calculated and applied an inutility depreciation adjustment for 2013 through 2016.[64] At the informal appeal level, the division removed the depreciation amount for 2013 and 2016—the two years for which the division issued its informal conference decision in 2016.[65] In this appeal, the division suggest that the removal of an inutility adjustment would be appropriate for all years, 2013-2016. It invites the Board to remove the adjustment for 2014 and 2015.[66] The assessor testified that inutility is inappropriate because (1) Eni made a conscious development decision to design and construct a facility with anticipated excess capacity, and (2) utilization adjustments are warranted when production begins to decline, not where, as here, production is still ramping up.[67]

ENI seeks inutility deductions for each assessment year. Eni argues that the Nikaitchuq processing facilities' superadequacy for handling the produced oil at Nikaitchuq "warrants an additional adjustment for depreciation to account for the excess capacity of the Nikaitchuq processing facility and its associated pipelines."[68] North Slope denies that any obsolescence adjustment is warranted, and instead contends that "the division's inutility adjustment substantially over-depreciated the property."[69]

The evidence supports the assessor's conclusion that Eni intentionally designed the scope of inutility seen in the Nikaitchuq processing facilities. The Assessor testified that the excess

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62 Eni Prehearing Brief, at 13-16; North Slope Prehearing brief, at 25-35; Division Prehearing Brief, at 22-24.
63 Exhibit iii; Greeley testimony; Gauer testimony.
64 Exhibit a at 16.
65 Exhibit a at 16.
66 Division Prehearing Brief, at 22-24; Division Exhibit kk at 31.
67 Exhibit a, at 15; Greeley testimony.
68 Eni Prehearing brief, at 13-15
69 North Slope Prehearing brief at 34.

capacity – its two train system –is valuable because it allows the facility to continue to operate during planned or unplanned maintenance on one train.[70] Mr. Johnston explained that this ability is particularly valuable given the geological conditions at Nikaitchuq – namely, the risk of pump motors burning out if they are shut down and then restarted after sand has settled into the pump.[71]

Eni's Nikaitchuq production manager, Cody Gauer, agreed that the excess capacity is useful in this regard. However, he denied that the facility was intentionally designed at twice the needed capacity. Rather, Eni had hoped for a larger BOPD yield, and designed the Nikaitchuq processing facilities with that higher number in mind. Nevertheless, Mr. Gauer indicated that some excess capacity would have been built in. Mr. Gauer indicated that, if the actual production rate (peaking around 26,000 BOPD a day) had been known at the time of design and construction, he would have sought to build a facility with a BOPD capacity of "somewhere between 30[,000]; 32[,000]; 35[,000]."[72]

This means that in the first several years of production, before the facility hit its peak production, the 40,000 BOPD design (designed at a time when ENI had an expectation that it would hit a peak oil production of around 30,000 BOPD) was appropriate. For 2016, however, when production peaked, and Eni knew that the facility would not handle more 26,000 BOPD, some inutility adjustment is warranted. The Board finds that adjustment is appropriately based on the 8,000 BOPD difference between a reasonable intentional overcapacity of 32,000 BOPD, and the facility's actual capacity of 40,000 BOPD. For 2016, this results in a reduction of $35,555,426 from the assessment.[73]

In sum, the Board agrees that no inutility adjustment was warranted for 2012, 2013, 2014 or 2015. For 2016, the Board finds that an inutility adjustment is warranted. However, the evidence supports a smaller adjustment than the Assessor applied. For tax years 2012-2015, there is no inutility adjustment. For tax year 2016, the assessed value is reduced by $34,555,426. This

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70 Greeley testimony.
71 Johnston testimony.
72 Gauer testimony.
73 To arrive at this amount, the Board transferred the assessor's inutility formulas for tax year 2015 (located at cells A:140, B:140, I:140 and I:143 (onshore pipeline) and A:160, B:160, I:160 and I:163 (process facility) of the Detail tab of Exhibit u) into the spreadsheet for tax year 2016 (Exhibit v), adjusting the "current utilization" figure to 32,000 BOPD, the level at which Mr. Gauer testified he would have purposefully built extra capacity. The Board then subtracted these adjusted amounts for each item from the original assessment amounts, and added the two resulting deltas ($6,274,163.51 (pipeline) plus $28,281,262.58 (process facility)) to determine the total amount of the adjustment.

amount represents application of an inutility adjustment to the Onshore Pipeline and Process Facility accounts, based on a supercapacity of 8,000 BOPD.

C. North Slope's arguments

1. Does 15 AAC 56.120 require that actual costs be used for initial value of an RCN or that intangible completion costs be included in the well model used to value the RCN for a project?

The North Slope Borough has urged the Board to reject the tax division's application of the Department's regulation defining intangible drilling expenses, 15 AA 56.120. North Slope first argues that the replacement cost new (RCN) should be based on actual costs for the first year, and then trended for each subsequent year. Second, North Slope takes issue with the division's view of which costs should be included in the determination of RCN. In the North Slope's view, the division has failed to distinguish between "drilling" and "development." North Slope points out that the Board's April decision recognized that, unlike the federal income tax option to expense, in state property tax law, intangible development expenses are not included in the exemption. North Slope asserts that the division has drawn the line between "drilling" and "development" in the wrong place. North Slope also asserts that some intangible costs, such as those associated with the gravel for the island, should have been treated as nontaxable development costs because they benefit the development as a whole, not the individual well.

With regard to the use of actual costs for the RCN, the division is correct that appraisal theory does not require the use of actual costs to determine the value of replacement cost. Costs, designs, and equipment can change over time. Replacement cost methodology seeks to value the cost to build a similar product with similar utility. It does not, however, require replacement cost for an exact copy. By requiring that the division use an RCN to value production property, the legislature necessarily gave the division the discretion to use reasonable methodology (such as a well model) other than actual cost to determine replacement cost.

Moreover, the Board agrees with the assessor's testimony regarding the need to use a mass appraisal technique that is reasonable and administrable. Using a well model that can be easily applied to all production property, and easily amended as costs or technology changes, is a better approach to mass appraisal than actual costs. Given the statutory directive that assessment methodology must be applied equally among taxpayers, the same mass appraisal methodology should be applied to Eni as is applied to other taxpayers.[74]

Turning to the question of which costs are properly exempted as intangible drilling expenses, North Slope's engineering experts testified that drilling stops when the hole has reached what is commonly called "casing point."[75] At this depth, the bit no longer is grinding and the hole has reached final depth. The operator must make the decision about whether to complete the hole for production, complete it as a reinjection well, or abandon it as a dry hole.

If the well is completed as a production well, the operator will undertake additional steps before oil begins to flow. These steps are called "completion." Completion will include installation of the production tubing, hardware that goes into the well (called the "jewelry"), and the "Christmas tree" (the valve assembly that sits on the wellhead). Because completion occurs after casing point, the North Slope concludes that intangible completion costs are taxable costs of development, not nontaxable intangible drilling expenses.

The division's well model, however, does not include intangible completion expenses as part of the taxable costs for valuing the RCN of a well. Instead, this model includes intangible costs only for installation of production property after the Christmas tree. Downhole intangible costs are valued as drilling costs, not development costs. This version of the well model has been in place since at least 2002.

In arguing against including completion costs in the exemption, the North Slope urges that the term "drilling" should be narrowly construed. The North Slopes believes that completion costs could not be considered drilling costs under the regulation. Both as a matter of common sense, and as matter of expert opinion, the North Slope would limit drilling to activity that involves deepening the hole.

The North Slope also presents a textual argument, pointing out that the state regulation defining intangible drilling expenses, 15 AAC 56.120, contains many of the same terms as the federal regulation defining intangible drilling and development costs, 26 C.F.R. § 1.612-4(a). The state regulation, however, omits the phrase "expenditures made by an operator for . . . the preparation of wells for the production of oil or gas," which is included in the federal regulation.[76]

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74 As explained below, this does not mean that the well model could not be stratified among different types of developments.

75 Kelley testimony.

76 *Compare* 26 C.F.R. § 1.612-4(a) *with* 15 AAC 56.120(b). The state regulation also omits expenditures for "shooting and cleaning" the wells, which the North Slope believes further supports its argument because these terms

To North Slope, this omission is crucial: it identifies that the break point between drilling and development is at the moment drilling stops and preparation for production begins. Thus, because of the omission of this key phrase, the North Slope considers 15 AAC 56.120 to require that development begin at casing point.

If this were simply a matter of first impression, the North Slope's arguments might well be persuasive. Their experts have established that casing point could be a reasonable place to draw the line between drilling and development. Further, the omission of terms could be significant when construing this regulation, if the Board were applying the regulation without reference to the division's historical interpretation and application of the well model.

The terms "drilling" and "development," however, are not precise. Thus, even if "casing point" and "drilling" are precise terms to an engineer, "drilling" and "development" are not precise terms to a tax administrator. A tax administrator could reasonably determine that the activities that the legislature intended to incentivize by this tax exemption included all pre-oil activities. Under this approach, the division could reasonably determine that the best fit for the term "drilling" might be "downhole activity" or "activity before first oil." These activities generally involve use of the drill rig even if they do not necessarily involve use of bit to deepen the hole, so lumping pre-oil activities in with drilling is not unreasonable.

As for the North Slope's textual argument regarding the terms omitted from the regulation, that argument does not compel the result that completion costs *must* be taxed. If the department had intended to compel the taxation of completion costs, the department would have stated in its regulation that completion costs are taxable development costs. Similarly, the department could have specified that casing point was the operable moment in time after which all activity in the well is development. The omission of the terms "completion" and "casing point" from the regulation means that the division has discretion to determine where drilling stops and development begins based on the most reasonable application for purposes of administering the tax exemption.

The division has made this determination by adopting a well model that does not begin taxing intangible costs until production begins.[77] The Board's role in this matter is to defer to the

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also denote completion activity.

[77] The North Slope argues that the division's approach nullifies the distinction between federal law and state law by making all development costs nontaxable. As was seen in the discussion of the taxpayer's arguments,

assessor's determination unless the appellant has proven that the assessment is excessive, unequal, or improper. Here, the Board has no reason to second-guess the division's determination that the exemption to tax established in AS 43.56.060(f) should be administered by exempting completion costs from taxation.

Before leaving the issue of the well model, however, the Board will provide the following additional guidance. First, with regard to intangible expenses, the Board offers the following four observations:

- Nothing in this decision should be interpreted to mean that the Board has made a decision regarding where drilling ends and development begins. All that the Board is holding here is that the North Slope has not met its burden of proving that the division erred by using an event that occurs after casing point to distinguish between drilling and development.
- The Board appreciates the assessor's testimony that trying to distinguish between drilling and development is a difficult issue. The Board understands that some gray issues remain, and that the assessor is committed to working on defining this distinction with greater precision than exists now. Indeed, the Board was never clear whether the division's approach is to define development to mean "all costs after first oil" or to define drilling to mean "all down-hole costs." These two definitions would result in very different identification of taxable costs. Having more precision and certainty would be beneficial to the division, the taxpayer, and the municipality. The Board would encourage the division to adopt language in its regulations that clarifies the distinction between drilling and development.
- In that regard, the Board does not agree with the argument put forth by at least one of the taxpayers during the 2016 proceedings that hydraulic fracturing (commonly called "fracking") is equivalent to drilling. Although no party has proved that the division erred by exempting intangible fracking costs from taxation for these developments, if the line between drilling and development is drawn at first oil, then fracking would almost always be on the taxable side of the line. Again, the

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however, the division does not exempt facilities costs that the federal law would consider IDC because the division considers those expenses to be development expenses.

purpose of this observation is to encourage additional clarity, certainty, and precision in identifying taxable and nontaxable costs in the well model.

- Finally, and most important, the Board would encourage stratification of the well model among projects. Here, for example, this project (and the other projects at issue in the 2016 proceedings) was a state-of-the-art, technical, and expensive project. Although the Board understands that the well-model RCN must always be an approximation, the Board has concerns about valuing the RCN for this project using a single well model that is designed to value every well in the state.

The second observation relating to the well model follows directly from the Board's observation that stratifying the well model to arrive at a more reliable RCN would be an appropriate approach. Here, the North Slope has put forward evidence that the *tangible* costs included in the RCN through the well model are low. This is particularly true for projects that, like this one, are state-of-the-art projects, using higher-cost jewelry and other hardware than legacy projects.[78]

Yet, adding stratification to the well model must be done carefully. The point is not to have a sliding scale with multiple complex data points. The point is to have a very limited number of stair steps that recognize significant differences among projects. To do this would require analysis of multiple projects that fit into the "more complex" stratum, and a reliable way to identify the cost for this stratum that can be used to estimate a reasonably accurate RCN for like projects.

2. Has the North Slope proven that the division erred in its selection of end of life for purposes of applying age/life depreciation?

As explained above, after the construction phase, property committed to the production of oil or gas is valued based on "replacement cost less depreciation based on the economic life of proven reserves."[79] The North Slope, however, does not agree with the division's application of depreciation to the Nikaitchuq project.

This Board and the courts have spent considerable time in previous cases discussing the

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[78] There was question among the board members as to the value of the tangibles in the well model, including whether the jewelry (subsurface valves, electrical submersible pumps (ESPs), safety valves, gas-lift valves, control lines, etc.) were being recognized and valued. The Board would recommend that the division review its procedure in picking up all down hole equipment and other tangible costs.

[79] AS 43.56.060(d)(2).

issues raised by the terms "economic life" and "proven reserves." These terms have resulted in applying age-life straight-line depreciation to oil and gas property that is being valued under a RCNLD methodology. In order to determine age-life depreciation, the division must first determine when the field will cease producing oil.[80] In general, this determination is made on the basis of the economics of the field—when it costs more to produce a marginal barrel of oil than the revenue that will be generated for that barrel, production will cease.

To determine when the Nikaitchuq field would cease production, the division used its estimate for when the Trans-Alaska Pipeline System (TAPS) would no longer be economically viable. For the years at issue in this appeal, the division's methodology resulted in a determination that the end of field life for Nikaitchuq would be 2034 for tax years 2012-13 and 2016, and 2040 for tax years 2014-15.[81]

The North Slope does not accept the division's estimate. The North Slope's expert, Dudley Platt, offers a different estimate. He bases his analysis on the estimates of recoverable reserves provided by the industry to outside sources, including regulatory agencies and the media. He then predicts the end of life, based on assumptions that production will follow a typical decline curve, operation expenses will gradually decline, and prices will increase over time. Mr. Platt determined that the best estimate for end of field life in Nikaitchuq was 2055 for 2012-13, 2062 for 2014, 2077 for 2015, and 2082 for 2016.[82]

Eni's expert Shaun Hoolahan presented evidence that over the last several years Mr. Platt's estimates have been overly optimistic. He described his preferred methodology for estimating end of field life, which involves, among other factors, predicting the percent of water and gas recovered and then determining end of life based on the capacity for handling water and gas.[83] His estimates for end of field life for Nikaitchuq was that it would "water[] out somewhere around 2040."[84] He concluded that this estimate was not materially different from the division's

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80 *State, Dep't of Revenue v. BP Pipelines (Alaska) Inc.*, 354 P.3d 1053, 1058 n.19 (Alaska 2015) ("In the economic age-life method, total depreciation is estimated by calculating the ratio of the effective age of the property to its economic life expectancy and applying this ratio to the property's total cost" (quoting Appraisal Inst., THE APPRAISAL OF REAL ESTATE 410, 420 (13th ed.2008))); *BP Pipelines (Alaska) Inc. v. State, Dep't of Revenue*, 325 P.3d 478, 494 (Alaska 2014), *reh'g denied* (May 12, 2014) ("Both the Department of Revenue and the superior court took into account projections for declining throughput in determining economic life.").

81 Greely testimony; division Exhibit hhh.

82 Platt testimony; NSB-Eni-DK at 3.

83 Hoolahan testimony; ENI-0064 at 9.

84 Hoolahan testimony; ENI-0064 at 22.

estimates, and asked the board to affirm the division.

Estimating end-of-life for an oil field is problematical. In the past, this Board and the courts have been generally open to Mr. Platt's methodology, and critical of Mr. Hoolahan's approach. Yet, the data presented by Mr. Hoolahan is credible. As to the division's approach, the Board has concerns about estimating the shut-in date for TAPs (which has been a very controversial subject in previous proceedings) rather than using a field-specific analysis.

Here, however, the evidence supporting the division's estimate is stronger than the evidence opposing it. The report that Mr. Platt included in his materials acknowledges that the general reported field life for Nikaitchuq has been roughly 30 to 40 years.[85] The 30-year prediction is more consistent with the division's and Eni's estimates than with the North Slope's. The 40-year estimate is somewhat consistent with Mr. Platt's estimate for 2012-13, but for the later years, not consistent with either forecast. In any event, these reports are hearsay and not reliable evidence. Mr. Hoolahan's testimony, and his graph showing the results of his field-specific analysis, is the best evidence of when Nikaitchuq will reach end of field life. His expert opinion based on this analysis was that that the division's end-of-field-life estimates are reasonable. Therefore, the division's depreciation calculations are affirmed.

IV. **Conclusion**

Applying the standard of review in AS 43.56.130(f), the Board finds that the assessments for 2014 and 2015 should be modified to remove the inutility adjustment that was improperly used, and that the assessment for 2016 should be modified to reflect an inutility adjustment based on an excess capacity of 8,000 BOPD. The Board certifies that the full and true value of Eni's oil production and pipeline property on the lien dates applicable to these appeals is as follows:

- January 1, 2012: $1,100,881,780
- January 1, 2013: $1,147,954,190
- January 1, 2014: $1,136,274,000
- January 1, 2015: $1,131,012,980
- January 1, 2016: $ $1,032,779,484

[85] North Slope-Joint Qa at, e.g., 5 (referencing media reports that Eni estimated "a 30-year field life" and that "Eni expects to produce some 180 million barrels of oil over 30 years at Nikaitchuq."); *id.* at 25 (citing 2010 media reports that "[t]he Nikaitchuq field has an expected lifetime of 40 years.").

Under AS 43.56.130(g), I, on behalf of, and as Chair of, the State Assessment Review Board, certify to the Department of Revenue, State of Alaska, that the Board has made its determination as stated in this Certificate of Determination.

DATED this 27th day of May, 2016.

Signed
Steve Van Sant, Chair
State Assessment Review Board

Judicial review of this decision may be obtained by filing an appeal in the Alaska Superior Court in accordance with Alaska Rule of Appellate Procedure 602(a)(2) within 30 days after the date of this decision.

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