BEFORE THE STATE ASSESSMENT REVIEW BOARD
STATE OF ALASKA

In the Matter of:	)	
	)	OAH No. 14-0589-TAX
CAELUS NATURAL RESOURCES ALASKA, LLC	)	OAH No. 15-0450-TAX
	)	OAH No. 16-0362-TAX
Oil & Gas Property Tax (AS 43.56)	)	Appeal of Revenue Decisions
2014-2016 Assessment Years	)	Nos. 14-56-11/15-56-07/16-56-03

CERTIFICATE OF DETERMINATION

The State Assessment Review Board (Board) convened on May 18-19, 2016, to hear and deliberate on the AS 43.56 appeals of the assessment of Caelus Natural Resources Alaska, LLC.[1] The Board certifies that the value of Caelus's property on the lien dates applicable to these appeals is as follows:

- January 1, 2014: $409,049,930
- January 1, 2015: $438,909,650
- January 1, 2016: $532,087,110, less the amount calculated by the division, consistent with this decision, for intangible drilling expenses related to the Nuna drill pad and ice road.

I. Introduction

The subjects of this appeal are the division's Revenue Decision numbers 14-56-11, 15-56-07, and 16-56-03. The assessments for those years, and the parties' view of what the assessments should be, are as follows.

Year	Division[2]	North Slope	Caelus
2014	$409,049,930	755,357,350	142,233,567
2015	$438,909,650	816,167,576	176,186,383
2016	$532,087,110	904,854,110	246,030,252

Under AS 43.56.130(f), the Board cannot adjust the division's assessed valuation unless

[1] Chair Steve Van Sant, and members James I. Mosley, Bernard Washington, and Bill Roberts heard the appeal. Administrative Law Judges Neil Slotnick and Cheryl Mandala from the Office of Administrative Hearings assisted the Chair.

[2] These values are calculated from Division Exhibit zz, based on property located in the North Slope Borough.

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 finds that the appellants have not met their burden of proof except as to Caelus's argument regarding the assessment of the Nuna drill pad and ice road for 2016. The case is remanded to the division for the limited purpose of recalculating the value of the Nuna drill pad and ice road for 2016, using the same methodology for allocating intangible expenses to drilling as the division has used for similar property on other similarly-situated projects.

A. Description of the Property

Caelus's Oooguruk development is located on the Beaufort Sea in the Colville River area northwest of the Kuparuk River Unit. Oooguruk is in the North Slope Borough. A different oil company, Pioneer Natural Resources USA, Inc., began construction on Oooguruk in 2006, and first oil was produced in 2008. The project includes a five-acre artificial island.[3] The island houses wells and production facilities. A subsea flowline connects the island to the Oooguruk Tie-in Pad, an onshore facility that houses production facilities and electrical generation equipment.[4]

Caelus's Nuna property is located on-shore not far from Oooguruk. In 2015, Caelus began construction on the Nuna property, which currently consists of an onshore drilling pad, two wells, a camp, and a road. Plans exist for production facility equipment, but the same year that Caelus "sanctioned" the Nuna project, it decided to "defer the project indefinitely" due to falling oil prices.[5]

B. Parties Appealing

The parties to the appeal are Caelus Natural Resources Alaska, LLC, the North Slope Borough, and the Tax Division of the Alaska Department of Revenue.[6]

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[3] *See* PNC-0148 at 1.

[4] *See* PNC-0148 at 3.

[5] Testimony of David Hart.

[6] 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.

C. Consolidation and Coordination of Appeals

Caelus's and the North Slope's appeals of Revenue Decision Nos. 14-56-11, 15-56-07, and 16-56-03 were consolidated.[7]

II. Facts

Caelus acquired Oooguruk in 2014 from Pioneer Natural Resources USA, Inc., for approximately $300,000,000. This appeal concerns the assessments for tax years 2014, 2015, and 2016. For all tax years at issue, the assessment of Oooguruk was based on the appraisal approach called "replacement cost new less depreciation" (RCNLD). State Petroleum Property Assessor James H. Greeley conducted the assessment.[8]

Before Caelus acquired Oooguruk, issues had arisen regarding the accuracy of Pioneer's accounting records. An audit of tax years 2007-2009 revealed concerns about Pioneer's recordkeeping, and, specifically, about Pioneer failing to appropriately "book" certain types of costs. These included costs "associated with long-life property that will be in use over the life of the development to service production operations, such as pipeline and facility costs," as well as various front-end management, engineering and overhead costs.[9] Both Pioneer and now Caelus have disputed the division's inclusion of these costs in the assessed value of the property. More broadly, both owners have sought to exempt from taxation a wide swath of the intangible costs related to the Oooguruk project, arguing that Oooguruk is a drilling island, and most, if not virtually all, intangible costs associated with it are intangible drilling expenses.

Additionally, Caelus has argued that determination of RCNLD for Oooguruk should now be based on the price Caelus paid to Pioneer when it acquired the development in 2014. The assessor has rejected Caelus's argument about the significance of the purchase price. The assessor has also rejected the owners' arguments about intangible drilling expenses, concluding that many of the Oooguruk facilities have "uses that will serve production over the life of the property," and excluding from the intangible drilling expenses a classification of intangibles attributable to "long

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7 *See* Pre-Hearing Order issued April 18, 2016.
8 Exhibit a at 4; Greeley testimony.
9 Exhibit a at 8; Greeley testimony.

life property associated with production as well as drilling."[10] The assessment, however, did exclude intangible costs "specific to the actual activity of preparing to drill and drilling a well," including some intangible "completion costs."[11] The North Slope has argued that completion costs are not intangible drilling expenses and are therefore taxable.

Caelus appealed the 2014 and 2015 assessments. Under the regulations that governed property tax appeals at the time these cases were filed, some appeals—those involving taxability issues—were to be decided by the Commissioner of Revenue.[12] Because Caelus's appeals involved the taxability of intangible drilling and intangible 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.[13] 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 2014 and 2015 Caelus assessments, along with the 2016 Caelus assessment were now before the Board for the 2016 appeal cycle.

The 2016 hearing before the Board was bifurcated between taxability and valuation. A preliminary hearing was held on April 5, 2016, to address the taxability of intangible 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.[14] The Department of Revenue has adopted a regulation defining "intangible drilling expenses" for

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[10] 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 division's assessments of Oooguruk actually identified intangible drilling expenses above this range – a factor the assessor attributes to the lack of any processing facilities, making drilling expenses a more significant portion of total project expenses than is otherwise seen. Greeley testimony; DOR Exhibit kkk, at 24

[11] Greeley testimony; Exhibit a, pat 5-9.

[12] 15 AAC 56.015.

[13] *City of Valdez v. State*, Slip Opinion 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).

[14] AS 43.56.060(f).

purposes of this exemption.[15]

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.[16] Their reading of Alaska law is broader than the one followed by the division. The taxpayers asserted that the assessor erred in concluding that intangible "development" expenses were taxable.

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 income tax 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.

III. **Discussion**

An oil-and-gas project in Alaska is subject to the state oil-and-gas property tax imposed under AS 43.56. In general, during the construction phase of a project, the taxable value of an oil-and-gas project is determined by the actual cost of the project.[17] For tax years after construction, 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."[18]

The determination of actual or replacement cost for assessment purposes excludes "intangible drilling expenses."[19] 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."[20] But "intangible drilling

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15 15 AAC 56.120.
16 *See* 26 U.S.C. 263(c); 26 C.F.R. § 1.612-4(a).
17 AS 43.56.060(d).
18 AS 43.56.060(d)(2).
19 AS 43.56.060(f); Ex. aa, p. 12.
20 AS 43.56.210(4); 15 AAC 56.120.

expenses" do not include "intangible development expenses."[21] Nor do they include expenditures "that are properly allocable to the cost of depreciable property ordinarily considered to have a salvage value."[22]

In this appeal, both North Slope and Caelus have asserted that the assessment is in error. In particular, both parties focus on the treatment of intangible drilling expenses. We turn first to North Slope's arguments.

A. Has the North Slope established that the division erred?

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

We begin our analysis of the North Slope's arguments with tax years 2011-13. For these years, the division assessed the project under the replacement cost new less depreciation (RCNLD) appraisal approach, using a model for calculating the cost of drilling a well, and then adding in the cost of production equipment.

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. 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's engineering experts testified that drilling stops when the hole has reached what is commonly called "casing point." At this point, 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

[21] 15 AAC 56.120(c)(1).
[22] 15 AAC 56.120(c)(3).

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 replacement cost new 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.[23] 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.

The North Slope has calculated a per-foot cost of the intangible completion costs for purposes of using a well model to value the replacement cost for projects. It determined, based on 2016 data, that the cost per foot for intangible completion costs was $197.22.[24] It asserts that the Board should amend the assessment for 2011-13 by including this value in the replacement cost

[23] *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 also denote completion activity.

[24] Baggot testimony.

new less depreciation calculation.

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.

Although "casing point" and "drilling" may be 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 regulation 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.

In this assessment, the division has used a well model that does not begin taxing intangible costs until production begins.[25] The Board's role in this matter is to defer to the 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

[25] 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 will be seen in the discussion of the taxpayer's arguments, 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.

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 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 department 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 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 RCNLD must always be an approximation, the Board has concerns about valuing the RCNLD 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 RCNLD would be an appropriate approach. Here, the North Slope has put forward evidence that the *tangible* costs included in the RCNLD 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.[26]

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.

For the Caelus project, the North Slope chose to rely on the division's well model rather than have its experts recalculate tangible costs.[27] Because no information is available with which to adopt a stratified well model for the Caelus project, the Board will not amend the division's well model.

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

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[26] There was question among the board members as to the value of the tangibles in the well model, including whether the jewelry (subsurface valves, electric 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.

[27] Baggot testimony. Mr. Baggot explained that for this project "The tangible portions are handled by the entry of the tubing strings that the DOR has put in [the model]." Although the North Slope's expert had calculated a per foot tangible cost in one of the other appeals at issue in this appeal cycle, the experts did not recommend that the Board adopt that value in the 2016 proceedings, and the Board did not do so.

oil or gas is valued based on "replacement cost less depreciation based on the economic life of proven reserves."[28] The North Slope, however, does not agree with the division's application of depreciation to the Oooguruk project for tax years 2014-16.

This Board and the courts have spent considerable time in previous cases discussing the 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.[29] 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 Oooguruk 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 production in Oooguruk would cease in 2040 for tax years 2014-15, and in 2034 for tax year 2016.[30]

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 testified that "Oooguruk will likely be able to produce economically 5,000 barrels a day."[31] His report states that the best estimate for end of field life in Oooguruk was 2062 for 2014, 2077 for 2015,

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28 AS 43.56.060(d)(2).

29 *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.").

30 Greely testimony; Division Exhibit hhh.

31 Platt testimony.

and 2082 for 2016.[32] The North Slope bases its calculation of depreciation on Mr. Platt's estimates.

Pioneer'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 percentage of water recovered and then determining end of life based on water-handling capacity. He was not able to use this methodology for Oooguruk, however, because of a lack of data. Instead, he used an alternative analysis that he called "reservoir simulation." His estimates for end of life for 2014 was 2044.[33] Mr. Hoolahan concluded that his estimate was not materially different from the division's 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. Mr. Platt's expert report acknowledges that the general reported field life for Oooguruk has been roughly 20 to 30 years.[34] These reports are more consistent with the division's and Pioneer's estimates than with the North Slope's. Given these reports, and Mr. Hoolahan's testimony, the division's conclusions are reasonable. Therefore, the division's depreciation calculations are affirmed.

B. Has Caelus established that the division erred?

1. Should the division have used the sales price of Oooguruk as the replacement cost new?

In 2014, Caelus purchased Pioneer's interest in the Oooguruk project. The sales price was substantially lower than the actual cost or the replacement cost. Caelus argues that the sales price

[32] NSB-Pioneer-GV at 3.
[33] Caelus-0033 at 21.
[34] NSB-Joint Qa at, e.g., 12 (referencing media reports for 2013 that "[i]t is expected the field to [sic] remain economic for at least 25 years."); *id.* at 15 (giving production estimates "over a 20 to 30 year project life").

should be the starting point of the replacement cost new valuation. In Caelus's view, given that it could obtain the property at this price, this price represents a reasonable proxy for what it would cost to replace the property.

Caelus's argument has no merit. The statute specifically requires that the division assess the production property on the basis of replacement cost new less depreciation.[35] Replacement cost new is not equivalent to fair market value. When the legislature intends for property to be assessed at the price that the property would bring in an open market between knowledgeable buyers and sellers, it will require the division to use that technique to value the property.[36]

C. Has Caelus established that the division erred by not excluding additional costs Caelus characterizes as intangible drilling expenses?

Like North Slope, Caelus asserts that the division erred in its determination of which expenses qualify as nontaxable intangible drilling expenses. Caelus, however, believes that the division was too stingy in its allocation of expenses to the category of exempt intangible drilling expenses.

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 "*specific to the actual activity of preparing to drill and drilling wells*."[37] 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."[38] For the reasons that follow, Caelus did not meet its burden of proving that the division erred in its interpretation of the 15 AAC 56.120 exemption for Oooguruk. However, Caelus did meet its burden of proving that the assessor did not properly apply the intangible drilling expenses exemption to the Nuna property.

The assessor's affidavit and testimony summarizes his approach to the scope of the

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35 AS 443.56.060(d)(2).

36 *Compare, e.g.,* AS 43.56.060(c) (exploration property to be assessed at prevailing market price) *with* AS 43.56.060(d)(2) (production property to be assessed at replacement cost new less depreciation). In addition, as the North Slope's appraisal expert noted, using the subject property for a comparable sales approach is not consistent with standard appraisal methodology.

37 Exhibit a at 5 (emphasis in original).

38 *Greater Anchorage Area Borough v. Sisters of Charity of House of Providence*, 553 P.2d 467, 469 (Alaska 1976).

intangible drilling expenses exemption. He includes as intangible drilling expenses "intangible expenses associated with gravel installation and construction only for wells" ; "intangible expenses associated with drilling"; and "intangible expenses associated with well completion."[39] 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."[40] He does not accept the taxpayers' broad arguments that "costs associated with gravel and gravel installation and construction," "costs associated with drilling except for tangible tubulars and jewelry," and "costs associated with completion except for tangible tubulars and jewelry," are all also intangible drilling expenses.[41]

Like Pioneer has in its appeal of the earlier Oooguruk assessments, Caelus 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.[42] But the division has discretion to determine whether and how intangible expenses are allocated between drilling activity and longer-term activity over the life of the development. On appeal, Caelus asserts that the carryforward valuation of Oooguruk from Pioneer's assessed values should include additional intangible drilling expenses deductions for project management expenses, and that the assessment of Nuna should likewise exempt additional project management and engineering expenses.[43] Caelus further seeks carryforward intangible drilling expenses deductions for intangible expenses and gravel costs incurred in construction of most of the island and the tie-in site, as well as similar deductions in 2016 for the Nuna drilling pad and ice road.[44]

As to the Nuna drilling pad and ice road, Caelus has met its burden of proving that the 2016 assessment is improper.[45] For the Nuna project, the Assessor testified that, based on Caelus's own records (which booked these expenses to facilities), he treated the drilling pad and

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39 Exhibit a at 10.
40 Exhibit a at 9.
41 Exhibit a at 10; Exhibit c, Exhibit d.
42 *See* M. Lemon testimony.
43 Caelus prehearing brief at 9-11.
44 Caelus prehearing brief at 7, 9-11.
45 Caelus prehearing brief at 7, 9.

ice road as facilities, and did not provide any intangible drilling deductions. Caelus's engineer, however, testified that the long portion of the L-shaped drilling pad was, in his view, exclusively for drilling.[46] Given that two wells have been drilled at Nuna, and that the intent of building the pad and the ice road was at least in part for drilling purposes, the evidence established that the Nuna drilling pad and ice road should be credited with some reasonable intangible drilling expenses.

The Board does not, however, accept Caelus's characterization of the percentage of the pad that is drilling-related. To be consistent among taxpayers, we must allow the division to use its methodology for determining the percentage of the pad and the ice road that is drilling-related. This may be less than the percentage identified by Caelus because the division may reasonably recognize that some of the long portion of the L-shaped pad will be used for production purposes. Because the Board does not have sufficient information to determine how the division has made that determination in other cases, this case is remanded to the division for the Assessor to allow an intangible drilling expense deduction for the pad and the ice road under the same methodology employed in other cases for assessing a pad and ice road that were built at least in part for drilling.

Caelus is not, however, entitled to recalculation of the intangible drilling expenses deductions previously allocated for construction of the Oooguruk island or tie-in site. Caelus's arguments as to these items, and as to overall allocation of project management or other overhead costs for both Oooguruk and Nuna, rests on an overly broad view of "drilling expenses." Indeed, Caelus admits that the division has discretion under the regulation to allocate gravel, overhead, management, and engineering expenses. Its own assessment includes an allocation of these costs. Caelus's only argument here is that it disagrees with the division's exercise of discretion. Caelus, however, 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 Caelus's arguments in this regard, and is not persuaded that the assessor erred in not deducting the additional amounts claimed by Caelus.

Relatedly, Caelus's expansive view of intangible drilling expenses also seeks to exempt

[46] Hart testimony.

costs implicated in development or production beyond "the actual activity of preparing to drill and drilling wells."[47] In addition to the claims discussed above, these include the intangible expenses relating to control facilities, power systems, and communications facilities for Oooguruk.[48] These expenses relate to development/production activities at Oooguruk, and are not "drilling expenses" as the division has interpreted that term in the regulation. 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*."[49] Again, Caelus 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 Caelus claims as exempt are excluded from the intangible drilling expenses definition 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." The North Slope's expert in forensic accounting, Loretta Cross, identified numerous types of depreciable property at Oooguruk 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.[50] Specific items claimed by Caelus that the Board finds to be excluded from the definition of intangible drilling expenses by 15 AAC 56.120(c)(3)(B) include island camp renovations; Nuna camp construction; the construction and installation of well bay and interconnect modules; power systems; on-shore and off-shore control facilities; communication facilities; piperacks; the flowline; and the pump house.[51] As to each of the foregoing, Caelus 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.[52] The costs associated with it therefore fall outside the scope of the 15 AAC 56.120 exemption.

Caelus's reliance on 15 AAC 56.120(b)(3) to support an exemption for these items is not

47 Exhibit a at 5.
48 Caelus prehearing brief at 12-14.
49 Exhibit a at 5 (emphasis in original).
50 Cross testimony; Exhibit NSB-Caelus-CQ at 13.
51 Caelus prehearing brief at 6-8, 12-15.
52 W. Kelley testimony; L. Cross testimony; Exhibit NSB-Caelus-CQ at 13.

persuasive. Although 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," the testimony established that these are generally temporary structures erected as a prelude to drilling operations.[53] 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 sum, the Board is remanding the 2016 assessment to the division for recalculation of intangible drilling expenses associated with the ice roads and drill pad at Nuna, to be determined consistent with the division's historical approach to intangible drilling expenses as described in the Assessor's affidavit and testimony. As to the remaining items appealed, Caelus did not come forward with any proof that the assessor's treatment of any of the items identified was improper,unequal, or excessive, and so did not meet its burden of proving that the Assessor erroneously applied 15 AAC 56.120. The division is entitled to deference in its assessment, and the Board believes that deference is warranted here.

[53] Kelley testimony.

IV. **Conclusion**

Applying the standard of review in AS 43.56.130(f), the Board finds that the value of Caelus's property on the lien dates applicable to these appeals is as follows:

- January 1, 2014: $409,049,870
- January 1, 2015: $438,909,650
- January 1, 2016: $ 524,452,620, less the amount calculated by the division, consistent with this decision, for intangible drilling expenses related to the Nuna drill pad and ice road.

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.]