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WHITE PAPER

PRUDENT USE OF OPERATORS' BILLINGS: STATE'S EXISTING STATUTORY DISCRETION & IMPLICATIONS FROM ITS REPEAL

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For purposes of ensuring compliance by taxpayers and facilitating audits by the Department of Revenue ("DOR"), the issue here is the distinction between starting from a set of standards or practices for billing oil and gas costs to the participants, and starting from the concrete results from applying those standards and practices.

The Administration has testified in committee hearings on SB and HB 2001 that subsections (c) and (d) of AS 43.55.165 are "mandatory" in nature for DOR, and may require DOR to take actions that it may not want to take. To free DOR from these constraints, the Administration says, these subsections need to be repealed.

The Administration is mistaken about the "mandatory" nature of AS 43.55.165(c) and (d) now in effect, as is clear simply by reading them. Side by side, they say:

(c) Subject to (g) and (h) of this section, if the department finds that the pertinent provisions of a unit operating agreement or similar operating agreement are substantially consistent with the department's determinations and standards under (a) of this section concerning whether costs are lease expenditures, **the department may authorize or require** a producer, subject to conditions prescribed under regulations adopted by the department, to treat as that portion of its lease expenditures for a calendar year applicable to oil and gas produced from a lease or property in the state only (1) **the costs**, other than items listed in (e) of this section, **that are incurred by the operator during the calendar year and that** (A) **are billable to the producer** by the operator in accordance with the terms of the agreement to which that lease	(d) Subject to (g) and (h) of this section, if the department makes the finding described in (c) of this section with respect to a unit operating agreement or similar operating agreement and, in addition, finds that at least one working interest owner party to the agreement, other than the operator, with substantial incentive and ability to effectively audit billings under the agreement in fact is effectively auditing billings under the agreement, **the department may authorize or require** a producer, subject to conditions prescribed under regulations adopted by the department, to treat as that portion of its lease expenditures for a calendar year applicable to oil and gas produced from a lease or property in the state only (1) **the costs**, other than items listed in (e) of this section, **that are incurred by the operator during the calendar year and that** (A) **are billed to the producer** by the operator under the agreement to which that lease or property is subject and

or property is subject;

(B) for a producer that is the operator, would be billable to the producer by the operator in accordance with the terms of the agreement to which that lease or property is subject if the producer were not the operator;

(C) would be billable to the producer by the operator in accordance with the terms of the agreement if that lease or property were subject to the agreement; or

(D) for a producer that is the operator, would be billable to the producer by the operator in accordance with the terms of the agreement if that lease or property were subject to the agreement and if the producer were not the operator; and

(2) a reasonable percentage, as determined under regulations adopted by the department, of the costs that are billable under (1) of this subsection as an allowance for overhead expenses directly related to exploring for, developing, and producing oil or gas deposits located within the lease or property, to the extent those expenses are not billable under the agreement. [emphasis added]

either not disputed by a working interest owner party to the agreement or are finally determined to be properly billable as a result of dispute resolution; or

(B) for a producer that is the operator, would be billable to the producer by the operator in accordance with the terms of the agreement to which that lease or property is subject if the producer were not the operator; and

(2) a reasonable percentage, as determined under regulations adopted by the department, of the costs that are billed under (1) of this subsection as an allowance for overhead expenses directly related to exploring for, developing, and producing oil or gas deposits located within the lease or property, to the extent those expenses are not billable under the agreement. [emphasis added]

Looking first at subsection (c), it starts with a declaration that it is subject to the terms of subsections (g) and (h) of the statute. Section 165(h) requires DOR to "adopt regulations that provide for reasonable methods of allocating costs between oil and gas and between leases or properties in those circumstances" where such an allocation is necessary — for instance, between oil and gas production in the Cook Inlet basin in order to apply the separate tax caps on such oil and gas.[1] Subsection (i) similarly allows DOR to adopt regulations to apply concepts of § 482 of the Internal Revenue Code to deal with costs incurred in transactions between affiliated parties. Neither kind of regulation bears on the question of using operators' billings or not as the starting point for determining the amount of the lease expenditures for such production, and there is no reason to assume that DOR would write them in such a way as to fetter its authority under subsection (c).

Subsection (c) continues with a statement that DOR must first find that the "pertinent provisions" of a an agreement of a "joint-interest billings" are substantially consistent with [DOR's] determinations and standards under (a)" of the statute, before it may wield its authority

[1] *See* AS 43.55.011(j) and (k) (capping the tax for Cook Inlet gas and oil, respectively).

under subsection (c). If it can make this threshold finding, then DOR "may authorize or require a producer" to use, as its lease expenditures for a lease or property, "(1) the costs ...[[2]] that are incurred by the operator during the calendar year and that (A) are billable to the producer by the operator in accordance with the terms of the agreement to which that lease or property is subject...."

This is the heart of subsection (c), and as it plainly says, it is not mandatory at all for DOR. DOR "may authorize or require" the use of what would have been "billable" to the producer (emphasis added). As used in the Alaska Statutes, the word "may" is permissive or implies a discretionary power or privilege, while the word "shall" — in contrast — is mandatory. [3]

Moreover, the exercise of this discretionary authority to "authorize or require" the use of "billable" costs is "subject to conditions prescribed under regulations adopted by the department[.]" In other words, even when the statutory conditions are met for DOR to "authorize or require" the use of "billable" costs, it may by regulation create further limitations or conditions on the use of those costs.

Structurally, subsection (d) is very similar to (c). It starts with the same provision that it is subject to subsections (g) and (h) of the statute. It requires DOR to "make[ ] the finding described in (c) of this section" about the joint-interest billing agreement under which the

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[2] The omitted language refers to the categories of costs disallowed under subsection (e) of the statute, and the effect of that reference is to require a taxpayer to remove from the "billable" or "billed" costs under a joint-interest billing agreement costs disallowed under subsection (e). We omit the language for the sake of clarity with respect to the issue we are discussing in this white paper, not to conceal the fact that all such disallowed costs would have to be taken out the "billable" or "billed" costs.

[3] *See* State of Alaska, Legislative Affairs Agency, *Manual of Legislative Drafting* (2007), p. 62; available online at http://w3.legis.state.ak.us/docs/pdf/DraftingManual2007.pdf (accessed 27 October 2007):

> (g) "May, "shall," "must"
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> Use the word "shall" to impose a duty upon someone. The Alaska Supreme Court has stated that the use of the world "shall" denotes a mandatory intent. Fowler v. Anchorage, 583 P.2d 817 (Alaska 1978).
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> Use the word "must" when describing requirements related to objects such as forms or criteria. (Use "must" sparingly, however, because most sentences using it can probably be written more clearly to impose a duty on a person, in which case "shall" would be the proper word.) Use the word "may" to grant a privilege of discretionary power. Rutter v. State, Alaska Board of Fisheries, 963 P.2d 1007 (Alaska 1998), p. 5. Use the words "may not" to impose a prohibition upon someone. For a further discussion, see Martineau, Drafting Legislation and Rules in Plain Englilsh (1991), pp. 81 – 82. For example:
>
> > The commissioner shall issue a license ..., i.e., it is the commissioner's duty to do so.
> >
> > The information on the form must include ..., i.e., the form is required to have something in particular on it.
> >
> > The commissioner may inspect records ..., i.e., the commissioner may if it is necessary or proper, but the commissioner is not obligated to do so.
> >
> > .... [underscoring in original]

billings are made. In addition, it requires that DOR ascertain that there is "at least one working interest owner party to the agreement, other than the operator, with substantial incentive and ability to effectively audit billings under the agreement" and that the owner or owners are "in fact ... effectively auditing" the operator's billings to them under the agreement. Once DOR makes both findings, it "may authorize or require a producer" to use, as its lease expenditures for a lease or property, "(1) the costs ... that are incurred by the operator during the calendar year and that (A) are billed to the producer by the operator under the agreement to which that lease or property is subject and are either not disputed by a working interest owner party to the agreement or are finally determined to be properly billable as a result of dispute resolution[.]"

The chief difference between (c) and (d) is that (c)(1)(A) pertains to costs that are "billable" by the operator, while (d)(1)(A) pertains to costs that are "billed" by the operator.[4] The same permissive "may" is used in the crucial phrase about "authoriz[ing] or requir[ing]" the use of "billed" costs, and again, the exercise of this discretion is "subject to conditions prescribed under regulations adopted by the department[.]"

It is thus clear that neither (c) nor (d) is "mandatory" on DOR in terms of allowing or requiring the use of "billed" or "billable" costs under a joint-interest billing agreement if that agreement meets the statutory tests for ensuring its reliability. DOR may allow or require their use, but it doesn't have to. Indeed, it may further condition or limit their use by adopting a regulation.

AOGA's concern is, what happens if this express discretion to allow or require the use of "billed" or "billable" costs is repealed? The natural conclusion is that, if the legislature allows an agency to do something and then repeals that authority, then the agency can no longer do it. We believe it is more likely than not that this will be the courts' conclusion if AS 43.55.165(c) and (d) are repealed. Even so, we concede for the sake of argument that there may be at least some chance that the courts might reach the opposite conclusion. But our point is — why take that chance?

There is nothing in the present law that requires DOR to exercise this discretion, and keeping it on the books still won't require DOR to exercise it. But if DOR may ever want to start with an operator's joint-interest billings (or "billable" amounts) in order to simplify its audits or to allow non-operators to have something to base their reported lease expenditures on, it makes no sense to repeal its explicit discretion and thereby risk that DOR could not do so.[5]

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[4] Section 165(c)(1)(B) – (D) similarly pertain to "billable" costs, and § 165(d)(1)(B) to "billed" costs.

[5] In some testimony DOR has suggested that the provisions being added to subsection 165(b) will still allow it to authorize or require the use of an operator's joint-interest billings. The language to be added to (b) is identical in substance to subsection 165(a), where it currently appears — its removal from (a) is not immediately apparent in the Bill because (a) is being repealed and reenacted. The problem with DOR's line of reasoning is that the language being relocated provides:

> (3) In determining whether costs are lease expenditures, the department shall consider, among other factors, the

(A) typical industry practices and standards in the state that determine the costs ... that an operator is allowed to bill a producer that is not the operator, under unit operating agreements or similar operating agreements that were in effect before December 2, 2005, and were subject to negotiation with at least one producer with substantial bargaining power, other than the operator; and

(B) standards adopted by the Department of Natural Resources that determine the costs, other than items listed in (e) of this section, that a lessee is allowed to deduct from revenue in calculating net profits under a lease issued under AS 38.05.180(f)(3)(B), (D), or (E).

These provisions merely allow DOR to adopt regulations establishing "standards" for what constitutes a lease expenditure. They say nothing about where a taxpayer is to look to find the amount of that lease expenditure for a particular unit or field. In contrast, subsections (c) and (d) say that, where DOR finds that a joint-interest billing agreement complies with DOR's standards about what constitutes a lease expenditure (this is the "finding described in (c) of this section" that (d) refers to), then it "may authorize or require" the use of "billable" costs or costs actually "billed" under that billing agreement. Repealing this latter authority will not affect DOR's authority to establish the "standards" but, as just explained in the main text, it may well preclude DOR from starting with joint-interest billings in determining the amount of the lease expenditures under those "standards."