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September 30, 2013

HAND DELIVERED

State of Alaska  
Department of Natural Resources  
Division of Oil and Gas  
Attn: Greg Bidwell  
550 West 7<sup>th</sup> Avenue, Suite 1100  
Anchorage, Alaska 99501

RE: Proposed regulations dated August 29, 2013  
Net Profit Share Leases

Dear Mr. Bidwell:

ConocoPhillips Alaska, Inc. ("CPAI") has reviewed the proposed regulations regarding the accounting and reporting of expenses and revenues for net profit share leases ("NPSL"), issued by the Department of Natural Resources ("Department") by notice dated August 29, 2013. CPAI appreciates the opportunity to participate in the development of these regulations and submit the following questions and comments for your consideration.

As a comment of general application, CPAI would encourage the Department to adopt regulations whereby a lessee can calculate, report, and pay net profit share on a monthly basis without subsequent revisions that may accrue interest. The proposed regulations propose a significant amount of "look-back" and refile of past reports during the redetermination period, impose penalties on late reports, and reference other "forms and instructions prescribed by the department" without identifying the scope and content of such information. This creates an immense administrative burden on lessees without providing any gain, whether revenue or informational, to the state, or necessary changes as required by new legislation; therefore, the open question of whether the state intends to apply interest under the new proposed regulatory scheme looms large, yet is left unaddressed. It is imperative that the regulations be constructed to allow the lessee to file and pay a complete and accurate report by the due date of the filing, and equitably reflect the parties' (state and lessee) relative assumption of risk and access to

information prior to filing reports. To adopt regulations that require otherwise would impose unreasonable burdens on both the state and the lessee. CPAI has identified several significant issues with the proposed regulations that do not accomplish this objective.

1. In light of the express or potential retroactive effect of the proposed regulations, CPAI reminds the Department that in enacting the prior oil and gas tax scheme, the legislature limited the scope of retroactively applied regulations. Ch. 1 SLA 2007 (2<sup>nd</sup> SS) at Sec. 72 provided the following transition provision for the Department to adopt retroactive regulations as follows:

(2) a regulation adopted by the Department of Natural Resources to implement, interpret, make specific or otherwise carry out statutory provisions for the administration of oil and gas leases issued under AS 38.05.180(f)(3)(B), (D), or (E), **to the extent the regulation deals with the treatment of oil and gas production taxes in determining net profits under those leases**, may apply retroactively to April 1, 2006, if the Department of Natural Resources expressly designates in the regulation that the regulation applies retroactively to that date. (Emphasis added).

The statutory intent here was clearly to provide retroactive regulations to clear up circular references between the new tax law and the NPSL regulations, and for that limited purpose only. The Department should continue to adhere to this. CPAI will identify the regulatory changes in the comments below that it believes are beyond the scope of the circular reference issue.

2. The State of Alaska, Department of Natural Resources, Competitive Oil and Gas Lease Form No. DO&G-11-84 (Net profit Share) (Revised 4/84) NDR 10-1165, paragraph 40, states in part: "The lessee shall pay to the State of Alaska 30% of the net profit derived from this lease. For the purpose of this paragraph, calculation of the net profit will be determined in accordance with 11 AAC 83.201 through 11 AAC 83.295 *as those regulations exist on the effective date of this lease*, which by reference are made a part of this lease...."(emphasis added). Furthermore, paragraph 41 states in part:"...By signing this, the state as lessor and the lessee agree to be bound by its provisions." Hence, the state as lessor is bound to the lease terms just as the lessee is. The Department's authority to unilaterally attempt to change the leases by changing its regulations appears to conflict with these lease terms and fails to address the impact. The retroactive provision discussed above does not provide the authority to unilaterally amend lease terms or render this restriction on the state's conduct a nullity. When the proposed regulations are reviewed for impact to lessees, it is clear the proposed regulations result in detrimental changes to the lessee's NPSL position; therefore, to operate in good faith under the NPSL terms, the Department should address this issue and its effect on previously issued leases before proceeding any further with the proposed regulations.

3. The Department's proposed amendment to 11 AAC 04.040(a) violates AS

44.62.640(a)(3)<sup>1</sup> by making rules affecting the public through forms and instructions published on the internet without complying with rule-making processes and procedures. By removing the reference to a specific set of instructions and merely referencing obliquely some undefined, unidentified "forms and instruction", the content and scope of which is also neither defined nor identified, the Department violates the regulatory process required by law. The drafting manual that provides guidance to agencies regarding adoption of regulations states: "To decide whether a provision is a regulation, an agency must consider "whether it affects the public or is used by the agency in dealing with the public."<sup>2</sup> Generally, anything that directly affects the public or affects its rights must be adopted under the APA as a regulation. If an agency is in doubt, the agency should err on the side of adopting regulations under the APA. If adoption of a regulation is required, publication of an agency standard on the Internet does not fulfill the requirements of the APA for the agency to enforce the standard as a regulation."

CPAI recommends first and foremost, that the state invest the time and attention to fully developing and defining the requirements and procedures it will mandate by regulation. In light of the Department seeking to assess punitive fines against lessees in the proposed 11 AAC 83.245(h) (to be commented on further later), as a matter of due process, the Department needs to clearly identify by regulation the expectations and requirements.

In the alternative, CPAI recommends that, at a minimum, the Department post a disclosure that the forms and instructions referenced in the regulations do not have the force and effect of law until and unless they comply with the proper legal procedures, and specifically exempt such items from the punitive fine provision proposed in a new 11 AAC 83.245(h). By way of analogy, the U.S. Internal Revenue Service posts forms and instructions on the internet that do not have the force and effect of law, and so designates them, as such.<sup>3</sup>

Further, as a matter of administration for lessees, the proposed changes do not inform them of what additional information or format or reporting the Department may seek, increasing ambiguity, making late and incomplete reports more likely, and severely increasing the

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<sup>1</sup> AS 44.62.640(a)(3) states: "'regulation' means every rule, regulation, order, or standard of general application or the amendment, supplement, or revision of a rule, regulation, order, or standard adopted by a state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure, except one that relates only to the internal management of a state agency; 'regulation' does not include a form prescribed by a state agency or instructions relating to the use of the form, but this provision is not a limitation upon a requirement that a regulation be adopted under this chapter when one is needed to implement the law under which the form is issued; 'regulation' includes 'manuals,' 'policies,' 'instructions,' 'guides to enforcement,' 'interpretative bulletins,' 'interpretations,' and the like, that have the effect of rules, orders, regulations, or standards of general application, and this and similar phraseology may not be used to avoid or circumvent this chapter; whether a regulation, regardless of name, is covered by this chapter depends in part on whether it affects the public or is used by the agency in dealing with the public...." (Emphasis added).

<sup>2</sup> [www.law.state.ak.us/doclibrary/drafting\\_manual.html](http://www.law.state.ak.us/doclibrary/drafting_manual.html)

<sup>3</sup> <http://www.irs.gov/Tax-Professionals/Tax-Code,-Regulations-and-Official-Guidance>

likelihood of dispute between the state and lessees. Additionally, please provide the Department's written policy on (1) when and how the public would be notified of future changes to internet forms and instructions, (2) who would be notified, and (3) who (at the Department) has the authority to make changes to forms and instructions.

Lastly, since this proposed change would be an update to Section 04.040, and does not explicitly limit its application to NPSLs, CPAI believes that it could be abused and extend further than just the NPSL. It could require a change in what currently is included with all royalty payments by lessees, not just NPSL. CPAI recommends that the Department explicitly limit the scope of the proposed change.

4. The proposed changes to 11 AAC 040.040(d), by removing the reference to a specific set of instructions and substituting undefined requirement to be determined by the Department at some later date, continues the problematic formulation of regulations discussed above. Such an approach lacks a foundation in the legal procedures for promulgating regulations; increases ambiguity, uncertainty, and administrative burdens; has the potential for denying lessees due process; and increase the likelihood of disputes with the state. It unnecessarily burdens and compromises a reporting system that can otherwise be reliable, predictable, and efficient by readily identifying all regulatory requirements the Department seeks to impose on lessees. Further, the new instructions at II-E-24(iv), "Supplemental reports (as required by DO&G)", are not an instruction because it does not provide detailed information telling how the filing should be done nor which reports are required. The concept of undefined supplemental information exacerbates the failure and risks this approach presents and has been discussed above.

What are the reasons the Department requires monthly supplemental information? Do the supplemental reports required differ for each lease and/or lessee? Since the Department routinely asks for these reports during the audit process, this appears to be an unnecessary, duplicate process. Furthermore, the Department has the ability to seek supplemental information under 11 AAC 83.245(f). The supplemental report requirement is unreasonable and tantamount to the Internal Revenue Service requiring that a taxpayer submit receipts with their tax return. Continuing with this analogy, the taxpayer would only be required to furnish the receipts in the event of an audit. Also, what procedures does the Department have in place to ensure that any current crude oil sales price information and contracts are in a secure location and inaccessible to their marketing segment? The proposed regulations appear to lack any nexus to the newly passed Senate Bill 21, fail to rectify deficiencies in the pre-existing regulatory scheme, and do not provide a benefit to the state; yet they are likely to be administratively over-burdensome and ripe for dispute.

CPAI recommends that the Department adopt regulations consistent with the Generally Accepted Accounting Principle (GAAP) of Cost Constraint (i.e., the benefits of reporting financial information should justify and be greater than the costs imposed on supplying it). Instructions should be limited to providing information necessary to complete and file the required forms. Monthly reporting should be limited to these required forms. We request that the Department eliminates the filing requirement for monthly supplemental reports. Supporting documentation

should be requested during the audit process.

5. Under 11 AAC 04.199(7), definition of a royalty report, CPAI recommends that the Department remove "...and any supplemental reports required for an accounting unit, as required in forms and instructions prescribed by the department," for the same reasons stated in #4 above.

6. The proposed regulation at 11 AAC 83.231(a) and (e) addresses a retroactive redetermination of the quantity of oil and gas. While Ch. 1 SLA 2007 (2<sup>nd</sup> SS) at Sec. 72 provided limited circumstances for retroactive regulations where production tax statutory changes interfaced with determining net profit share leases, SB 21 does not provide any authority. The retroactive nature of this regulation appears out of scope and it will unnecessarily increase administrative burden. CPAI recommends removal or deletion of the proposed changes to 11 AAC 83.231.

Further, the Department's characterization of a "retroactive" redetermination is a misnomer as redeterminations are necessarily prospective and rely on new information. The concept of "retroactive" redeterminations raises the specter of interest, the duties of a prudent operator, and reverses the pattern and practice of redeterminations in the oil and gas industry generally and Alaska specifically, including those processes and procedures to which the state is a party in operating agreements. And for those units or fields already in operation, the prospect of this regulatory change would be a severe deviation from past practice, create an incredible administrative workload, and subject lessees to the proposed punitive fines that the Department is also proposing.

The Department is aware (as a result of an ongoing NPSL audit) that CPAI has accounted for redeterminations utilizing the extraordinary production revenue or loss category for the Fiord NPSL filings. Therefore the proposed regulation changes begs the question whether the Department is operating with good faith and fair dealing required of all contracts in Alaska when the Department uses the regulatory process to force a change in a filing requirement when it has the exclusive benefit of an extended look back period.

By excluding retroactive redetermination from extraordinary revenue and loss treatment, the Department has just created several important unanswered questions. The Colville River Unit (CRU) Agreement requires redeterminations in years 2, 5, 8, 12, and at the end of field life. Additionally, Fiord Nechelik and Fiord Kuparuk Participating Areas in the CRU require the same redetermination frequency but in different years. The proposal of the Department raises a host of serious questions that are unanswered by the proposed regulations or the workshop hosted by the state. For example: Will the new regulation require each lessee to revise NPSL reports for the Fiord NPSLs for each redetermination period in the CRU from first production to current? Will the Lessee also be required to revise the VV report volume information for the WIO, ROY, RIV codes, and royalty expense to reflect the redetermined volumes using the new tract participation factors? Do the Department's royalty reporting system data checks allow for mismatched volumes between the reports? In the event that the payout dates change (as a result of redetermination), are the lessees and state required to pay past due interest on the revised

filings under 11 AAC 83.245(d)? Under what authority will the Department apply this provision retroactively to the four redeterminations that have already occurred? Are the lessees required to submit revised monthly supplemental reports? What is the due date for revised filings that result from retroactive redeterminations? Will the state assess fines under 11 AAC 83.245 for delayed revised filings? To what extent is the Statute of Limitations re-opened as part of the revised filings? To what extent are the revised filings subject to an additional audit? Does this new regulation comport with the Colville River Unit Agreement at 10.1.4 that states, "No party shall be obligated to pay money to any other party to correct any imbalances that may result from retroactive application of a revised Unit Tract Participation"? Does this regulation conflict with 11 AAC 83.231(a), where revenue and losses are fully recognized in the month in which it is "realized"? Does it also conflict with 11 AAC 83.207, which requires the accrual basis of accounting?

These questions are generated in large part because the proposed changes have no connection to the passage of Senate Bill 21, does not alleviate current regulatory deficiencies, nor serve to financially benefit the state, except and unless the Department intends to use the changes to alter the relationship and responsibilities of the parties and use them as an avenue for charging interest and assessing fines. For this additional reason, CPAI recommends that the Department not enact the proposed changes to 11 AAC 83.231, and at a minimum, any changes be subject to further discussion with affected parties and subsequent revision.

Generally, the industry accounts for redetermination in one of two ways, both prospectively with no prior period adjustments resulting from redetermination:

1. CASH SETTLEMENTS. When the equalization is accomplished by a cash settlement, the accounting is handled in the same manner as the initial formation of the unit.
2. DISPROPORTIONATE LIFTINGS / SPENDING. Equalizations resulting from a redetermination can be accomplished by lifting a disproportionate amount of subsequent production and incurring a disproportionate amount of subsequent costs. The recovery method is determined by contract, and can be different for revenues, operating expenses and capital expenditures. During the recovery period, revenues and expenditures are recorded, as incurred, either by use of an interim participation factor (i.e., a percentage higher or lower than the ultimate percentage) or by adjusting the ultimate participation factor by a fixed volume or dollar amount, until the equalization is attained.

In both cases, redetermination is accomplished with no prior period adjustments. For NPSL reporting, CPAI effectively used the cash settlement method by entering the redetermination adjustment for the prior periods in the extraordinary revenue and loss category.

CPAI recommends that "retroactive redeterminations" are reflected in the extraordinary revenue category in the month in which they are realized; consistent with industry practice, GAAP,

revenue recognition, the matching principle, and 11 AAC 83.207. Again, CPAI recommends that the Department adopt regulations consistent with the GAAP of Cost Constraint.

7. At the workshop on Friday, September 13, 2013, representatives from BP made several substantive comments concerning the PT calculation in the Department's proposed Excel form. CPAI supports those recommendations as follows:

- i. Move the volumetric information to the VV report.
- ii. Reorder the PT calculation consistent with most tax forms by calculating the tax first and then the tax credits.
- iii. Test the formulas for non-producing leases.

CPAI also submits the following recommendations for the PT calculation in the Department's Excel form:

- iv. Separate input cells from calculation cells to improve the reliability of the form
- v. Eliminate duplicate values.

8. CPAI recommends that the proposed changes to 11 AAC 83.241(b) parallel the language of the statute and read, "meets one or more of the criteria in AS 43.55.160(f) **or** (g)...." Further, in reference to the product of \$5 and the number of barrels, CPAI recommends inclusion of the phrase "oil taxable under AS 43.55.011" in order to parallel the statutory language.

9. With regard to the proposed changes to 11 AAC 83.241(c), CPAI again recommends utilizing the statutory language and stating "is multiplied by .8 for oil or gas that meet one or more of the criteria" instead of "oil and gas." CPAI also believes that there is an erroneous reference to AS 43.55.160(f)(1) which should be AS 43.55.160(f).

10. CPAI objects to the \$75 fee proposed in 11 AAC 83.245 (h) because it is actually a fine or penalty which exceeds the statutory scope upon which the regulations rest its authority. Further, the "documentation" and "information" requirement in 11 AAC 83.245(h)(2) is vague and raises concerns of its practical enforceability, thereby implicating due process concerns. The provision also provides no mechanism for contesting the assessment of the penalty, which raises concerns regarding the degree to which potential abuse could be policed and prevented.

The 30 day filing deadline imposed under 11 AAC 83.245(h)(3) is unreasonable in light of the extensive number of royalty revisions required for unknown future settlements and 11 AAC 83.231. Also, the filing deadline in 11 AAC 83.245 is 60 days. CPAI recommends a minimum of a 90 day filing deadline for revised filing, plus an extension, if requested in writing.

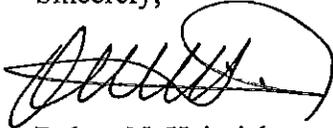
The statement under 11 AAC 83.245(h)(5), "...each schedule and attachment included in the NPSL report that is required to clearly present the facts of production, valuation, costs, or other payments associated with the NPSL lease for which the NPSL report is submitted is considered a separate report," simply cannot include supplemental information because the Department has

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Department of Natural Resources  
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not clearly defined "supplemental information" nor have they explained why they need it on a monthly basis. If this fine is assessed per report, per day, and includes supplemental reports, the amount of the fine would likely exceed any cost that the Department would incur for services provided. In government, the difference between a fee and a fine or tax is that a fee is paid for specific goods or services, while a fine or tax has no connection to the benefits received by the individual.

CPAI appreciates the opportunity to comment on these proposed regulations, and, due to the significance of the issues posed by the proposed regulations, looks forward to receiving notice of revised proposed regulations. If you have any questions please call Dawn Thomas at (907) 263-4203 or send an e-mail to [dawn.l.thomas@conocophillips.com](mailto:dawn.l.thomas@conocophillips.com).

Sincerely,

A handwritten signature in black ink, appearing to read "R. Heinrich", with a large, stylized flourish at the end.

Robert N. Heinrich