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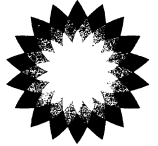

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March 12, 2010

Senator Bert Stedman, Co-Chair
Senate Finance Committee
State Capitol, Room 516
Juneau, AK 99501

Re: Senate Bill 305

Dear Senator Stedman:

Please accept my apologies for being out of state and unable to return to Juneau in time for the Senate Finance Committee's hearing today on SB 305. I hope, though, that you and the Committee will receive this letter in time for your consideration of the Bill.

Our understanding of SB 305 is that it would determine the taxable net "production tax value" for oil under AS 43.55.160 of ACES separately from that for gas, so that the respective production-tax values would then be taxed separately as well. We further understand that the stimulus for this decoupling is concern that tax revenues under the present version of ACES could be materially reduced when major gas sales begin from the North Slope into a gas pipeline. Specifically, the concern is that the gross netback value for major North Slope gas sales into a pipeline may initially be significantly less on a BTU-equivalent barrel basis than the gross netback value per barrel for oil.

All other things being equal, such a development could indeed reduce state revenues under ACES. But not all other things will be equal. Major gas sales would also greatly increase the number of BTU-equivalent over which the deductible lease expenditures are spread, thereby significantly reducing the deductible cost per BTU-equivalent barrel. State revenues under ACES would decrease only if the reduction in gross netback value per Btu-equivalent barrel is greater than the offsetting reduction in deductible costs per Btu-equivalent barrel. State revenues could actually increase under the current version of ACES if the reduction in cost per barrel is greater than the reduction in netback per barrel.

Our concern with SB 305 as it now reads is that, in addressing this potential problem that may arise a decade from now, it would come into effect today and require allocation of costs between oil and gas long before the potential risk it addresses could begin to materialize. SB 305 does not change the present rule in AS 43.55.011(o) that North Slope gas sold for in-state consumption is taxed under a tax cap similar to the cap for Cook Inlet production. So the allocation of costs under SB 305 would only be for gas that is already capped under AS 43.55.011(o) or any small sales that don't qualify under section .011(o). Allocation threatens to make a mountain out of a molehill because the change in gas taxes due to cost allocation during the coming decade will be tiny relative to the tax when major gas sales begin, but the Department of Revenue will have to apply the allocation rules with strictest rigor lest it create a bad precedent for the major gas sales.

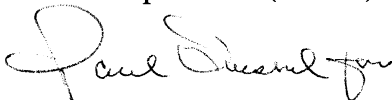
We understand that the impetus for enacting SB 305 this session is to avoid locking in the risk under the present law that major North Slope gas sales could materially reduce the overall tax under ACES. But we see a straightforward way to achieve that without all the problems and disputes that will arise by allocating costs to gas now. The solution is to add a Bill Section that defers the effective date for Sections 1 – 7 of SB 305 to the start of major gas sale deliveries from the North Slope into a gas pipeline for shipment. The Bill Section making such a deferral would be on the books as of the tax lock-in date and would thus be part of "the gas production tax in effect at the start of the first binding open season held under this chapter " for purposes of AS 43.90.320 — especially if the Committee adopts a letter of intent (or adds a statement of intent as a section of SB 305 itself) that specifically declares the deferred-effective-date provision to be part of the "tax in effect" as of that date for lock-in purposes. In other words, the substance in SB 305 could be locked in as of this year for AGIA purposes without triggering prematurely all the disputes and difficulties over allocating costs to gas before production for major North Slope gas sales begins.

Finally, whether or not you adopt our suggestion of deferring the effective date for decoupling, we would also ask that you not follow the pattern used during the ACES debate, where significant matters were left to the determination of the Department of Revenue. SB 305 currently uses the term "applicable to" to describe the allocation of lease expenditures between oil and gas. Such a broad term does not provide the industry or the Department of Revenue enough guidance of the legislative intent. There are instances already in use and available in the tax arena to model an allocation between oil and gas. For instance, ACES uses "BTU equivalent barrels" as a method to determine gas production in oil-equivalent terms in AS 43.55.024(c), the phase-out of the small-producer tax credit. Or, if you prefer, the allocation could be done on a basis of relative volumes as determined for the "extraction factor" in AS 43.55.072(f) for the oil and gas corporate income tax. The point is, no matter what cost allocation is performed for decoupling, you should make your choice clear in the Bill because that will clarify the obligation that taxpayers are held to, reducing latitude for argument about what compliance requires and making it easier for the Department of Revenue to enforce.

Thank you for your consideration of these comments.

Sincerely,

BP Exploration (Alaska) Inc.



Claire Fitzpatrick
Senior Vice President

cc: Senate Finance Committee
House Resources Committee