Alaska Oil and Gas Association

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**TESTIMONY
OF THE
ALASKA OIL AND GAS ASSOCIATION
REGARDING CSSB 305(FIN) (TITLE AM)**

**PRESENTED TO THE
HOUSE RESOURCES COMMITTEE**

April 7, 2010

Mr. Chairman and Members of the Committee:

My name is Marilyn Crockett and I am the Executive Director of the Alaska Oil and Gas Association (AOGA), the private, nonprofit trade association for the oil and gas industry in Alaska. Our 14 members account for the majority of oil and gas activities in the state. We appreciate the opportunity to share with you our deep concerns about Committee Substitute for Senate Bill 305, Finance, title amended — "SB 305" for short — which has passed the Senate and is now before you for consideration. The written testimony submitted for the record today has been approved by the AOGA Tax Committee, which can only approve testimony or public statements in AOGA's name about tax matters unless there is no dissent. We recognize, of course, that my oral testimony today will be included in the transcript for today's hearing.

We believe proposed legislation to revise a major tax like the production tax should be evaluated to see whether the change would improve the investment climate in Alaska, lead to more investment to help stem the annual oil production decline, simplify and add clarity to Alaska's complicated tax structure and whether it is it something that should be enacted now. AOGA's 14 member companies agree unanimously that SB 305 fails all of these tests and thus should not be enacted.

We have three main concerns with SB 305:

1) It is premature to establish decoupling at this time.

2) The justification for decoupling is flawed.

3) Determining an appropriate mechanism for cost allocations is complex and further analysis should be done to ensure a proper methodology is established.

SB 305 proposes to alter Alaska's current production tax structure by decoupling oil and gas so that progressivity will apply to them separately and so that revenues and costs will be separately determined, in order to avoid the potential for state revenue "dilution" when major gas sales are commingled with the oil stream. As a consequence of this decoupling, SB 305 proposes to have lease expenditures allocated between oil and gas.

Decoupling is Premature

Our first concern with proposed SB 305 is that it is premature to put decoupling into effect this year. The impetus to pass SB 305 this session appears to be driven by the AGIA provision that purports to provide gas tax fiscal certainty through a lock-in provision on May 1 to any company committing gas during the first open season. And that failure to address the dilution issue prior to that May 1 deadline might prohibit a future correction.

The apparent rush to address this issue will yield a "fix" that is not needed now and one that will result in further complexity to Alaska's already complex production tax system and will lead to adverse unintended tax and administrative consequences, further reducing an already shaky future investment climate—a potential result that neither the State of Alaska nor our industry can afford.

Potential changes to any tax regime need to be carefully considered and designed to ensure the desired objective of resource development is achieved. This is especially true for Alaska. Sufficient time should be given to examine the potential impacts and costs of SB 305 fully.

Flawed Justification for Decoupling

We are also concerned about the very idea of decoupling and the justification that is being offered for it. The $2 billion figure that is being circulated as the amount of production tax that the State would "lose" each year without decoupling is deeply flawed. Regarding the $2 billion figure, one must understand that there are three primary drivers that determine how much tax revenue the production tax generates. One is the netback value, the second is the amount of lease expenditures or deductible cost, and the third is the number of BTU equivalent barrels that are being produced. The difference between the first driver and the second is not only the value that is taxed, but when expressed on a BTU equivalent taxable barrel basis, it also determines whether progressivity applies, and if so, what the progressivity rate is.

The analysis for the $2 billion figure was based on generic deductible-cost data released by the Department of Revenue for the North Slope for 2008, and it also relied on oil production forecasts published by the State. The way these data were used in the analysis yields figures that are not likely to reflect actual circumstances in 2020 when a major gas pipeline is likely to begin operation. In particular, oil production in 2020 is likely to be significantly lower than the state estimate, which reflects an annual decline rate of only 2.7% during the current decade from FY 2010 to FY 2019. Historic annual decline rates for ANS oil have been 5.1% during the past 20 years and 6.6% during the last five.

This difference in decline rate means that, whatever the $2 billion analysis used as the figure for lease expenditures per barrel, the cost-per-barrel figure using these historic decline rates would be one-third to almost two-thirds higher. This means the analysis significantly overstated the taxable margin per barrel and overstated the tax rate to the extent it shows progressivity as applying. In addition, when

ANS gas production is added to the picture, it means the analysis understated the reduction in costs per BTU equivalent barrel because — with less oil production than the analysis assumed — the change in number of barrels to spread the costs over as a result of having the gas would be proportionally greater.

These distortions are inherent simply from the design of the analysis that produced the $2 billion figure, and do not depend on the particular numbers which that analysis used as the netback prices of gas and oil, or the deductible costs per barrel. Indeed, as stated in BP's March 12, 2010 letter to the Senate Finance Committee, it is possible in some situations that the State would actually receive more production tax without decoupling than with it. If, however, this Committee believes SB 305 needs to be passed this session, then the effective date of its key provisions, oil and gas decoupling and cost allocations, should be deferred until commercial production of Alaska North Slope gas commences.

Establishing Proper Cost Allocation Methodology is Complex

We are also very troubled over the potential cost allocations that SB 305 would require before major gas development. Under SB 305, taxpayers would be required — either immediately as the Bill now provides, or when commercial ANS gas production begins as we propose — to begin allocating costs between oil and gas. Developing a cost allocation methodology is a complex issue. Determining the proper methodology and understanding its potential impacts on the administration of and compliance with the underlying tax and on current and future investments are matters that should be fully evaluated and studied to ensure the concerns of all potentially affected taxpayers and the State can be adequately addressed.

The enactment of ACES was designed, in part, to incentivize investment and exploration of Alaska's resources. Requiring cost allocations prior to major gas development could undermine that objective. Currently, under AS 43.55.165(h), the Department of Revenue is authorized to develop, when needed, cost allocation methods to determine lease expenditures that are costs of exploring for, developing, or producing oil and gas deposits. If cost allocations are required prior to major gas development, how would costs associated for any lease or property (1) which contains both oil and gas, and (2) currently produces only oil (and possibly trace amounts of gas), be handled when the production of the oil provides information about the reservoir and its potential for major gas development? Would any of the costs be required to be allocated to gas, thereby raising the tax on current oil operations?

On the North Slope, there are producers with current oil production from one field that are also incurring gas related expenditures related to another field without gas production. How would those gas related expenditures be handled? Will the gas related expenditures be allowed for that producer against its oil related production income or only against future gas revenues from future gas production - revenues that producer may not have until many years in the future if at all?

Cost allocations prior to major gas development could also result in unintended consequences for explorers. Currently, an explorer who takes the risk and incurs the cost to explore in Alaska does so with the knowledge its expenses are deductible regardless of whether oil is discovered or gas. SB 305 is not clear and we are concerned that decoupling might be interpreted to mean that exploration expenditures will be deductible only for oil if oil is discovered, and only for gas if gas is discovered.

For an explorer with no production, or for one that only has oil production, discovering gas will mean there is nothing from which its exploration costs can be deducted for that discovery. As a result those costs will become "carried-forward annual loss" converted into a tax credit which can then either be used by that taxpayer in the next tax year or, if certain conditions are met, converted into a transferable tax credit certificate the taxpayer can then possibly sell to other taxpayers or to the state. Given the decoupling of oil and gas proposed by SB 305, the credit for the costs of a gas discovery could be limited so it could only be applied against tax on gas production. Since the tax on nearly all of today's gas production is capped under special rules, explorers who discover gas are likely to find it difficult, if not impossible, to find anyone with gas tax liability under decoupling who could use "carried-forward annual loss" credits from new gas discoveries. This needlessly penalizes explorers who are exploring for gas, as well as those who are exploring for oil but discover gas anyway.

The present tax without decoupling does not penalize explorers in this way, which is another reason why decoupling should be deferred until commercial ANS gas production begins. At that time there would be taxpayers with significant gas tax liability who would be in a position to use "carried-forward annual loss" credits from subsequent gas discoveries.

Entire Production Tax Structure Should Be Re-evaluated

It is important to reiterate AOGA's belief that the overall production tax structure in Alaska needs to re-examined carefully. As we have stated many times before, our primary concern is that the tax rates under the present production tax are already too high and place Alaska at a competitive disadvantage for oil industry investment. Based on the testimony you have heard this session and the Department of Revenue's own forecasts about expected future continuing decline in oil production and in projected industry investment, it is clear that a comprehensive evaluation and revision of the production tax needs to be undertaken if it is to achieve the objective of providing Alaska jobs, increasing Alaska production and maximizing State revenues.

Summary

In summary, then, it is premature to decouple gas from oil at this time. The concern that decoupling seeks to address will not arise until commercial ANS gas production begins. In addition, decoupling now will have unintended adverse consequences for current operations and explorers, particularly if they find gas instead of oil. Further, the case for any decoupling at all has not been adequately proven, and in any event, whatever negative effect there might be on production tax revenues without de-coupling seems likely to be substantially less than the $2 billion a year being claimed.

And finally, the production tax needs to be evaluated as a whole, both to see how well it works internally and how well it fits in with the other elements of Alaska's fiscal regime for oil and gas. We therefore ask this Committee to hold SB 305 in committee and let these matters be evaluated and addressed in a comprehensive fashion, instead of piecemeal as this Bill would do. Enacting SB 305 so it can be in place by May 1st and locked in for AGIA is premature. But if you feel you must enact it, then the effective date of its key provisions, oil and gas decoupling and cost allocations, should be deferred until commercial production of Alaska North Slope gas commences.

Thank you again for the opportunity to provide this testimony.