TESTIMONY OF THE

ALASKA OIL AND GAS ASSOCIATION

TO THE HOUSE RESOURCES COMMITTEE

REGARDING DRAFT CSHB 308(RES), Version E

March 10, 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"). AOGA is the 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. The testimony I am about to present has been prepared and approved without dissent by the members of the AOGA Tax Committee.

Let me begin by thanking you, Mr. Chairman, and the co-sponsors of House Bill 308 — Representatives Newman, Ramras, Millett, Johansen and Hawker — for introducing this Bill during these crucial times.

In light of the relentless and continuous decline in the rate of oil production, one of the great challenges facing Alaska is in getting from today to the time when a Gas Pipeline begins operating a full 10 years from now. ConocoPhillips, in testimony to the Senate Finance Committee on February 23rd, said that "[p]roduction from the Core Fields [on the North Slope] may require more than $40 billion of expenditures by the industry during the next decade."[1]

We welcome House Bill 308 as an essential first step in a comprehensive review of ACES to ensure that it can and will succeed, as intended, in keeping Alaska competitive for this additional $40 billion that needs to be invested here during this decade. At the same time, ACES must be reviewed to ensure that it has not overshot the optimum point where "the utilization, development, and conservation of [this] natural resource[ ] belonging to the State" achieves the "the maximum benefit of its people" in terms of total state revenues, Alaska jobs and economic growth over the remaining life of the fields, as the Alaska Constitution requires.[2] Our testimony today is in two parts in order to address each of these vital concerns.

Part I. Problems with ACES

Mr. Chairman, there are a lot of things wrong with ACES. AOGA and individual companies have together submitted nearly 200 pages of comments and testimony to the Department of Revenue about what is wrong with ACES and with the regulations that have been developed and are either already adopted or are in the process of being adopted. In the interest of time I'd like to highlight only a few of the most important ones now.

Problem A. Excessive tax rate

The Department of Revenue, in testimony to this and other legislative committees, presented a lot of statistics that fail to distinguish investment and jobs for new projects from investment and jobs for projects that had already been begun or committed to before ACES was enacted. A more telling statistic about ACES is the number of new in-field wells drilled and completed, because they can be approved, drilled and go into production within a matter of months instead of years. As a result, the figures for them are much less distorted by momentum from pre-ACES commitments. The number of new in-field wells decreased from 166 in 2007 to 155 in 2008 and 147 last year.[3] BP, as an operator on the North Slope, has publicly said its in-field drilling "will be more than 50% lower in 2010 vs. 2007" and it has reduced its rig count by 30% since January of last year. Industry added about 450 million barrel-of-oil-equivalents to North Slope reserves in the last five years, according to ConocoPhillips at the Meet Alaska Conference last January, but "only 35 million since ACES". Why? Larry Archibald, senior vice president of exploration and business development for ConocoPhillips, told Meet Alaska that even though "Significant potential remains in North Slope Giants[, ...] Giant fields have [the] worst fiscal terms" under ACES.

And the news on exploration wells isn't good either. The number of exploration wells being drilled on the North Slope declined from 11 in 2007, to 9 in 2008 and 8 in 2009.

During testimony on February 16, 2010, Division of Oil and Gas Director Kevin Banks reviewed oil and gas activity across the North Slope, observing that "independents are flocking to Alaska". However, the companies identified on his map have been in Alaska for several years. Which raises the question of just who could be coming to Alaska but isn't. Rigdata identified the top 20 U. S. drillers in terms of footage drilled in 2009. Only seven of those companies are currently operators or have interests in fields here in Alaska.

Another disturbing trend is emerging in the area of oil and gas lease acreage. According to their testimony, ConocoPhillips—the leading explorer on the north slope for the last decade and more—relinquished 880,000 acres of leases in NPR-A last year. A significant amount to be sure, but this accounts for *less than half* of the state and federal acreage which was closed across the arctic slope last year. Attached to my testimony is a map and chart depicting lease closures for the years 2005-2009. As you can see, in 2009, 371 leases were closed totaling more than 2 million acres. And in 2008, 142 leases totaling more than 1.2 million acres were closed.

<u>Problem B. The impossible plight of non-operators</u>

Time after time in the ACES regulations being adopted, the Department of Revenue places impossible expectations and demands on producers ("non-operators") in a field or unit that are not the operator of that field or unit. A non-operator receives only a monthly invoice or bill from the operator with a description of the cost items going into the amount that the WIO is to pay. There are no timesheets or other documentation that comes with the invoice, nor copies of billings from third parties that the operator has received and paid on behalf of all the non-operators in the field or unit. Yet the regulations expect non-operators to have the same details and documents that their operator has, because they have to file tax returns each month that depend on those details and documents in order to be filled out to compute the amount of tax.

Worse, the standards for what an operator may bill to the non-operators are set by the particular terms of the operating agreement for that field or unit. While the amounts that the operator bills out to the non-operators are generally close overall to what is deductible as lease expenditures under ACES, the details of individual costs do not correspond exactly to the edges of the specific categories the Department has created for allowable lease expenditures. There are over 20,000 cost codes under the system of accounts for the Prudhoe Bay Unit, for example, but the Department's regulations have only 336 categories. Due to the lack of definition and clarity, the inconsistent use of terms, and arbitrary percentages of costs being applied, there is virtually no way a Prudhoe Bay non-operator can possibly determine, for all of the 20,000 cost codes in that system of accounts, which ones fit into the 336 categories under this regulation. And for some cost codes, part of it may fit into one category and the rest into a different one. But a non-operator is likely not to have the particular information required under the regulations in order to determine whether this is the case for a given cost code. And even if the non-operator can determine which category a particular cost code straddles, it may very well lack the information required under the regulation in order to determine how much goes into each of those categories.

<u>Problem C. Inability of Taxpayers to Determine with Certainty Amount of Tax</u>

The regulations to implement ACES are set up so that it is impossible for a taxpayer to determine what the correct amount of its tax is. For instance, of the 87 times that the words “the department” appear in the proposed regulations about costs for transporting oil and gas from the field to market, 80 of them are in the context of the Department of Revenue “determining” something — phrases like “determined by the department”, “the department will determine”, “the department may determine”, etc. appear over and over and over.

None of these “determinations” is likely to be made before the taxpayer has to make its monthly tax payment. None of them is likely to be made by March 31st of the following year, when the taxpayer has to make its annual “true up” to match its estimated payments to the actual results for the year. In fact, for many of them, the Department might not make its “determination” until audit, which — with ACES’ new statute of limitations — might be as long as 6 years after the taxpayer had to file its original monthly return.

The Department’s other ACES regulations reflect this same approach, in which “the department” will make the “determination” for factors in the tax calculation that are essential to know in order to calculate the tax correctly.

This approach all but guarantees ACES’ failure with respect to attracting the $40 billion of investment in the “Core Fields” on the North Slope that industry will need to make over this decade. The people making the go/no-go decision about an investment can only use the information they have at the time they make that decision.

While AOGA realizes this Committee is not considering tax regulations at this time, these examples illustrate the way that overly broad discretion for adopting regulations can substantially alter the nature and effects of the laws the Legislature passes. In this case, any benefits or incentives that may be offered under new legislation by this Legislature will be compromised and impaired by the regulations that have just recently been adopted or are in the process of being adopted as we speak. And this is before any new regulations that might be adopted, under this same broad discretion, to implement and interpret the new laws this Legislature may enact. It is crucial, therefore, that legislation like the CS for HB 308 be made as transparent, unambiguous and direct as possible if you want it to achieve the results you intend for it. We felt it is important to highlight just a few of the many issues the regulations create and why additional review of ACES as a whole is required.

Part II. Discussion of the Draft CS for HB 308 (Version E)

While the Committee’s working-draft CS contains some 25 bill sections, the substance of the legislation boils down to just six matters:

1. Providing for a rebate of up to 20% of a taxpayer’s basic 25% ACES tax, depending on the taxpayer’s performance with “Alaska hire”;
2. Making the “slope” for progressivity less steep;

3. Creating a 30% tax credit for "well-related expenditures";
4. Changing the statutory interest rate for underpaid or overpaid taxes so it is the lower of the "fed funds + 2" or 11%; currently it is the higher of "fed funds + 5" or 11%;
5. Providing that interest for an underpayment of tax directly resulting from the adoption of a regulation with retroactive application will accrue from the 30th day after the effective date of that regulation, instead of accruing from the original due date for the tax being retroactively changed by the regulation; and
6. Changing the statute of limitations for auditing tax returns under AS 43.55 and issuing an audit assessment, from six years back to three years as it was before the ACES legislation.

AOGA offers the following comments on these proposals.

The Alaska-hire rebate. AOGA members try to hire qualified Alaskans because it makes good business sense. They are making significant efforts and contributions to train more Alaskans to become qualified for industry jobs. The companies "subject to tax under AS 43.55.011(e)" who would stand to get this rebate already have a pretty good track record with Alaska-hire, and a number of them already have Alaska-hire rates over 80% according to the Alaska Department of Labor and Workforce Development.

However, if you are going to create an Alaska-hire rebate, we respectfully urge you to use Alaska-hire standards that the Department of Labor and Workforce Development is using, rather than creating a new and substantially different process based upon the number of hours worked by residents versus non-residents. There is already an almost hopeless degree of complexity merely to determine what labor costs are allowable as lease expenditures under the Department of Revenue's recently adopted regulations on deductible lease expenditures. Adding a rebate based on hours worked would threaten to redouble that complexity into a hopeless morass.

One other thing worth noting about the rebate is that the language in CSHB 308 seems to be silent about whether it is the operator's Alaska-hire performance that determines the size of the rebate, or the non-operator's. And, again, how this question gets answered will determine whether the rebate gets more complicated for non-operators or less complicated.

Over all, though, the rebate is generally a good idea, but it creates more complexity and ambiguity. In our opinion, if you want real results in terms of more jobs for Alaskans, then reduce the tax, make it clear and unambiguous, and let industry have the chance to make its investments. There will be more jobs, a healthier industry, and greater prosperity overall for Alaskans.

Changing the "slope" for progressivity. AOGA opposed the idea of progressivity when it was first introduced in Governor Murkowski's Petroleum Production Tax or PPT legislation in 2006. We opposed it when it was carried forward in Governor Palin's ACES legislation in 2007.

While AOGA continues to oppose progressivity, we acknowledge that lessening the steepness of the slope for progressivity would reduce its negative effects, and to that extent the draft CS, if enacted, would represent an improvement over the present situation. And we would suggest putting progressivity on an annual basis instead of a monthly one. This would smooth out short-term peaks and valleys in prices during the year and reduce the progressivity rate. But the present monthly method creates a false margin by comparing a monthly price to an average cost for the year. This mismatch creates unnecessary uncertainty and doubt in the minds of the decision-makers about making new investments.

<u>30% tax credit for "well-related expenditures"</u>. AOGA and its members support this provision.

<u>Changing the statutory rate of interest</u>. The justification for having interest accrue on tax underpayments or overpayments is to allow the State or the taxpayer, as the case may be, to recoup at least part of its loss from not having had the use of the money that it was entitled to have. The present statutory rate of interest is punitive in purpose and bears little if any relation to either side's actual harm from not having the money when it should have. The proposal in the draft CS reflects a more reasonable assessment of that harm, and AOGA endorses it.

<u>No interest on tax underpayments arising from retroactive application of new regulations</u>. AOGA agrees that it is highly unfair to have interest accrue retroactively on tax underpayments that arise directly from the retroactivity of a newly adopted tax regulation. In light of the punitively high rate of statutory interest under the current statute, the accrual of interest on such an underpayment starting from the date the original tax payment was due would also present constitutional issues as an *ex post facto* law if a taxpayer liable for such retroactive interest chose to raise those issues.

The draft CS avoids these difficulties by giving taxpayers 30 days from the date the retroactive regulation becomes effective after filing by the lieutenant governor, in which to pay the additional tax that directly results from the regulation's retroactivity. In light of the complexity of the tax regulations that the Department has adopted or is still proposing to adopt, 30 days is an unrealistically short period of time for a taxpayer to determine how much additional tax it owes for the all past periods to which the regulation retroactively applies. This would be especially so if such a retroactive regulation becomes effective during the first quarter of the year, when taxpayers are busy closing out the year just ended and preparing the annual true-up between their monthly estimated payments and the actual amount of their tax under ACES for that entire year — this true-up is due March 31st after the close of the tax year. Taxpayers simply do not have the tax staff to do, within the first calendar quarter, their annual true-up and simultaneously compute the additional tax for all the past tax periods to which a new regulation retroactively applies.

We recommend, therefore, that the due date for the additional tax be the end of the second calendar month after the month in which the retroactive regulation becomes effective, except when the regulation becomes effective in the first quarter of a calendar year, in which case the due date should be May 31st of that year. In both cases, this would give taxpayers at least two months in which to determine and pay the additional tax that is due as the result of a new regulation's retroactivity.

We would like to point out, however, the effective date of this provision needs to be made retroactive to the date ACES was made effective to ensure that this provision applies to any regulations adopted prior to the enactment of this provision.

Statute of limitations. AOGA endorses the proposal to shorten the statute of limitations for auditing taxpayers and assessing any additional tax found to be due, from six years back to the three years that it used to be before the ACES legislation. Three years is a reasonable time, and should it turn out that the Department needs more than that to complete an audit, taxpayers have historically been willing to extend the limitations period for a reasonable time to allow the audit to be completed. In fact, taxpayers often agreed to extend the statute more than once for a single audit. With a six-year statute of limitations, the Department could wait as long as five years before even starting an audit, and then asking the taxpayer under audit to extend the statute so the audit can be completed.

The purpose in having a statute of limitations, after all, is to allow issues to be raised, addressed and resolved while the evidence is still available and memories are still fresh. The present three-year statute of limitations has worked for all the other taxes under Title 43, including the present worldwide corporate tax for oil and gas taxpayers, the domestic or "water's edge income tax for other corporations, and even the former separate-accounting income tax. It is worth noting that separate-accounting involved not only determining net income from all of a taxpayer's interests in oil and gas fields and prospects, but also its income from interests in oil or gas pipelines as well. Like separate-accounting, ACES is challenging to administer and audit. However, if Alaska didn't need a longer statute of limitations for separate-accounting, we don't see why one is needed now.

Testimony Recap

In conclusion, Mr. Chairman, the draft CS which this Committee has before it will not eliminate all the problems that ACES has, either in the existing statutes or under the regulations the Department of Revenue has adopted or is proposing to adopt. Those problems are numerous and important. AOGA sees this CS — with the few changes we have suggested — as a first step in improving ACES. But, as we have stated, additional review and amendments are required to enable it to achieve what it was intended to achieve, which is to be more effective as a tax than the prior ELF-based tax or the PPT while enabling new investments to be made to find, develop and produce more oil and gas in Alaska.

Production from all but the most recently developed fields in this state continues its inevitable decline as the physical resource in each field is depleted. As an industry, we have looked for — and found — new technologies and methods for recovering more from the existing fields, and from known, but very difficult-to-produce resources like heavy oil in the Ugnu formation. As an industry, we have also looked for — and found — new technologies and methods for discovering new oil and gas resources. These activities must continue, both for our future here and yours. Massive new investments will be needed each year, and they must not be deterred or discouraged needlessly.

In adapting the state tax structure to fit the future, please bear in mind that one of the most important attractions that Alaska can provide is a clear and stable tax system. All the tax incentives in the world won't make a bit of difference if the people deciding whether to invest in Alaska or not don't believe those incentives will be realized. By making the tax as clear is possible, the features in ACES for attracting investments here will not be discounted or disregarded by those decision-makers. There is a lot of work to do if this clarity is to be achieved, but it can be done. AOGA and its member companies look forward to working with this committee and the legislature to fully examine ACES to achieve this clarity.

Thank you on behalf of the members of AOGA for this opportunity to testify today and to share our thoughts with you about this particular legislation and about factors that will ultimately determine and shape the very future of our industry here.

ENDNOTES

[1] Wendy King, Vice President –External Affairs, ConocoPhillips Alaska, *Senate Finance Committee Testimony* (February 23, 2010), slide 3 (footnote omitted).

[2] The quoted language is from Article VIII, § 2 of the Alaska State Constitution. As for Alaska jobs, *see* also Article 1, § 23 of the Alaska State Constitution.

[3] SOURCE: Alaska Oil and Gas Conservation Commission. The figures for in-field wells in 2007 and 2008 are different from those in Dept. of Revenue, *Response to Information Requests in December 4, 2009 Letter* (January 21, 2010), p. 6 Table 5 ("Monthly counts of New Wells Drilled and Completed 2000-2009"), which was an attachment to Commissioner Galvin's letter of January 21st to Speaker Chenault and 14 other members of the House as well as Senator Huggins. The Department's figures include exploration wells, which have significantly longer lead times that in-field wells and are more likely to be distorted by momentum from pre-ACES commitments.