

HOUSE FINANCE COMMITTEE
March 31, 2006
1:45 p.m.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [1:45:24 PM](#).

MEMBERS PRESENT

Representative Mike Chenault, Co-Chair
Representative Kevin Meyer, Co-Chair
Representative Bill Stoltze, Vice-Chair
Representative Richard Foster
Representative Mike Hawker
Representative Mike Kelly
Representative Beth Kerttula
Representative Bruce Weyhrauch

MEMBERS ABSENT

Representative Carl Moses
Representative Jim Holm
Representative Reggie Joule

ALSO PRESENT

Mark Hanley, Manager, Public Affairs, Anadarko-Alaska;
Robynn Wilson, Director, Division of Tax, Department of Revenue;
Dan Dickinson, Consultant, Tax Division, Department of Revenue

PRESENT VIA TELECONFERENCE

None

SUMMARY

**Anadarko Presentation
Questions and Answers with the Administration**

HB 488 "An Act repealing the oil production tax and gas production tax and providing for a production tax on the net value of oil and gas; relating to the relationship of the production tax to other taxes; relating to the dates tax payments and surcharges are due under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the treatment of oil and gas production tax in a producer's settlement with the royalty owner; relating to flared gas, and to oil and gas used in the operation of a lease or property, under AS 43.55; relating to the prevailing value of oil or

gas under AS 43.55; providing for tax credits against the tax due under AS 43.55 for certain expenditures, losses, and surcharges; relating to statements or other information required to be filed with or furnished to the Department of Revenue, and relating to the penalty for failure to file certain reports, under AS 43.55; relating to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue, under AS 43.55; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the oil and gas production tax; relating to the deposit of money collected by the Department of Revenue under AS 43.55; relating to the calculation of the gross value at the point of production of oil or gas; relating to the determination of the net value of taxable oil and gas for purposes of a production tax on the net value of oil and gas; relating to the definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making conforming amendments; and providing for an effective date."

HB 488 was heard and HELD in Committee for further consideration.

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HOUSE BILL NO. 488

"An Act repealing the oil production tax and gas production tax and providing for a production tax on the net value of oil and gas; relating to the relationship of the production tax to other taxes; relating to the dates tax payments and surcharges are due under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the treatment of oil and gas production tax in a producer's settlement with the royalty owner; relating to flared gas, and to oil and gas used in the operation of a lease or property, under AS 43.55; relating to the prevailing value of oil or gas under AS 43.55; providing for tax credits against the tax due under AS 43.55 for certain expenditures, losses, and surcharges; relating to statements or other information required to be filed with or furnished to the Department of Revenue, and relating to the penalty for failure to file certain reports, under AS 43.55; relating to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue, under AS 43.55; relating to criminal penalties for violating conditions governing access to and use of confidential information

relating to the oil and gas production tax; relating to the deposit of money collected by the Department of Revenue under AS 43.55; relating to the calculation of the gross value at the point of production of oil or gas; relating to the determination of the net value of taxable oil and gas for purposes of a production tax on the net value of oil and gas; relating to the definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making conforming amendments; and providing for an effective date."

MARK HANLEY, MANAGER, PUBLIC AFFAIRS, ALASKA-ANADARKO, referred to a handout entitled "Anadarko - PPT Discussion" (copy on file). He gave a brief overview of Anadarko, an independent producer without refineries or gas stations. Anadarko has 3,000 employees and operations around the world. The headquarters are in Houston, Texas.

Mr. Hanley referred to Slide 2, "Anadarko's Alaska Acreage Position". The pink acreage shows fields operated by other companies, generally ConocoPhillips. In the yellow acreage Anadarko is the operator, and includes Arctic Slope Regional Corporation land. Anadarko has about 2.2 million net acres, on par with ConocoPhillips. Anadarko has an extensive position across the North Slope.

Mr. Hanley explained that Slide 3 shows the opportunities in Alaska: a world class petroleum basin, a significant remaining resource potential, legacy type prospectivity (Anchor Fields), favorable political environment, and abundant new entrants/partnering opportunities.

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Mr. Hanley discussed the challenges found in Alaska: maturing basin/materiality, high costs, lack of infrastructure and competition, limited access to facilities and pipelines, extremely long lead-time exploration, seasonal drilling and regulatory timing requirements, and a lack of a gas market. He stressed that Anadarko is very supportive of getting a gas line bill.

Mr. Hanley spoke of PPT from Anadarko's point of view. They support the original bill and feel that the administration did a good job of balancing issues and priorities. Anadarko pays more in taxes, but exploration economics improve and there is some downside price protection.

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Mr. Hanley shared an editorial from the March 17, [Anchorage Daily News](#). Anadarko believes that declining production is

the biggest issue. Each new forecast shows a further drop in North Slope production.

Mr. Hanley maintained that more production is needed. He referred to Slide 6: Declining production is the primary driver of lower state revenue. Increased investment, compared with today's levels, is needed to increase production and stem decline. The original bill offset tax increase with credits and allowances. Tax rate increases and allowance decreases, with no credit offsets, reduce Anadarko's economics.

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Mr. Hanley referred to a chart by Dr. Pedro Van Meurs, which shows the 25 percent tax rate. It shows the value of the \$73 million allowance. Mr. Hanley disagreed with Dr. Van Meur's idea that increasing the tax rate does not have an impact. He compared the economics with the existing system to the PPT. At lower prices the state assumes more risk; at higher prices they get more of the "high side". The companies are giving up some of the high side, as well. He questioned where the kickoff point should be.

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Mr. Hanley referred to Slide 11, which shows small oil development - after tax net present value discounted at 12 percent vs. wellhead oil price. He noted a difference between Dr. Van Meurs' graph in that the wellhead price instead of the WTI price is used in Anadarko's graph. He emphasized the concept that the \$73 million has value and 20/20 is better, and he cautioned to carefully consider where the crossover point is.

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Representative Weyhrauch requested that Mr. Hanley reference the bill during the discussion.

Mr. Hanley addressed key issues regarding PPT. He informed the committee that the 20 percent tax rate is found on page 3, lines 21-26 of the bill. He said Anadarko agrees with that rate. He related that as the tax rate is increased, the company's economics is decreased.

Mr. Hanley explained the tax escalator is also known as the windfall profits tax or the progressive tax. In the bill it is found on page 4, lines 7-15. Some say that once \$50 per barrel is achieved, then a higher rate is paid. He maintained that the increment is paid on the whole thing. He gave an example. He advised that it is not a normal windfall profits tax. He noted that costs are not

considered and will go up. Steel and labor costs will increase. He opined that the tax needs to apply to the net.

Mr. Hanley questioned if \$50 is the right number. Companies look at various numbers, but many use the upside.

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Mr. Hanley referred to a slide used in a previous presentation regarding Economic Oil Reserves in Central North Slope Alaska at Alternative Prices. He suggested that Alaska should not plan on \$60 oil prices. As the price forecast goes up, some of the economically recoverable reserves are limited. He showed a graph that depicts Expected Discoveries Under Alternative Prices. He noted that the \$8 difference between WTI and ANS is significant. He questioned if using WTI is the right thing to do. He advised to go to \$55 and use ANS, which is equivalent to \$63 WTI.

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Representative Hawker asked about ANS vs. WTI. He summarized that the three major players have the ability to unduly influence price. The dominance of the three major players is a detriment. Mr. Hanley responded, "If they can do it, they should be doing it now". He said he finds it hard to believe.

Representative Hawker said he appreciates the distinction given between ANS, WTI, and wellhead. He stated he wants the index to be as objective, verifiable, independent, and determinable as possible. He asked if the wellhead met those criteria, as well as the West Coast pricings. Mr. Hanley agreed with Representative Hawker's concept that it needs to be fair and should take into account the actual factors that are out there. He pointed out the difficulty of figuring out what an average wellhead is, due to the variety. Representative Hawker concluded that there are as many challenges writing a structure based on wellhead as based on West Coast.

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Mr. Hanley spoke in support of the \$73 million allowance that has been turned into a \$12 million credit, which is more valuable to small players. For Anadarko if \$73 million went away it would be like increasing the tax rate to 25 percent. For the larger companies, it would be like taking their tax rate to 20.5 percent. He mentioned the 10-year sunset on the \$73 million allowance found in the bill on page 24, line 13. He spoke of the sunset's affect on a new player's buying leases having no value for credit down the line.

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Representative Weyhrauch summarized that the House Resources version turned the \$73 million into a \$12 million credit. He inquired about an unfinished statement regarding \$14 million. Mr. Hanley explained that the 20 percent tax rate, when it was an allowance, was the equivalent of a \$14 million credit. The \$73 million was reduced to \$60 million and turned into a \$12 million credit. The intent was to encourage new players and smaller players. He repeated that the sunset would eliminate this credit for smaller companies.

Representative Hawker asked for an opinion on the credits mentioned in the governor's bill. Mr. Hanley said he did not see that presentation. Representative Hawker wanted to discuss this further with Mr. Hanley. Mr. Hanley said the credit is non-transferable and non-sellable and applies after all other deductions and credits are taken.

Representative Hawker noted that the intent of the \$12 million credit is to benefit the small players, but everyone benefits. He suggested it not be made available to the big players. Mr. Hanley said that is a policy call. Currently, all existing companies would qualify. The tradeoff is a higher tax rate. It creates an incentive for some and applies to everyone so it is equitable.

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Mr. Hanley talked about the transition allowance, also called the five-year look back, on page 27, lines 24-27, which allows for a credit for the first three months of the year. In December 2004, Anadarko submitted approval for two satellites, and then the governor came out with the aggregation decision. The projects were put on hold. He explained the negotiation process with the administration. Anadarko decided to go ahead with the projects and spent over \$400 million getting them into production. Now the company will be hit with a higher tax rate. Had they known this was coming they would have put it off for a year and a half in order to receive the 20 percent deduction and credit. With no transition there won't be any credits and there will be a higher tax rate. Anadarko supports a look-back provision.

Representative Hawker requested an opinion on the 2-for-1 proposal. He spoke of concerns with the five-year look back. Mr. Hanley thought that the 2-for-1 would be beneficial for a longer time period than 3 years, such as 10 years.

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Mr. Hanley spoke about point of production on page 17, lines 5-16 of the bill. The concept is to remove the cost of transportation from the point of production, which makes sense. Page 25, line 24 starts to describe what the gross value at the point of production means. It means "where oil goes into the pipeline in pipeline quality". Everything it takes to get oil into pipeline quality is upstream of the point of production and qualifies for the credits and deductions.

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Mr. Hanley continued the discussion regarding gas and the point of production, which is upstream of any treatment facility. The treatment facility is not included for the purposes of credits and deductions. He speculated that in the new gas contract the treatment facility would be included. He opined that in future gas exploration, treatment facilities should be included.

In response to a question by Representative Weyhrauch, Mr. Hanley observed that the provision was in the original bill and was not added in the House Resources Committee.

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Representative Kelly requested suggestions from Mr. Hanley as to what language could be used in the bill to solve the problems he mentioned. Mr. Hanley agreed to do that. He observed that he would need to talk to the administration for clarification.

Representative Kelly reiterated his desire to have input from Anadarko.

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Representative Kerttula referred to page 2, lines 1 and 2. She questioned why the producers have to subtract a payment received for "the use by another person of a production facility in which the producer has an ownership interest" from those things that they can deduct. She predicted that would be problematic as far as access. Mr. Hanley agreed. He observed that it would be considered income and the state's goal is that it not be deductible. He said that he does not know if it would have a negative impact.

Representative Hawker referred to the gas point of production determination. He questioned if the development of Point Thompson was included. Mr. Hanley did not know how Point Thompson would be developed and if there would be separate gas treatment facilities. He concluded that everything upstream would probably be included. He felt

that it should be included if a separate treatment facility were needed.

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Mr. Hanley spoke to new gas economics, much of which remains unclear, which is typically worse than oil. He maintained that the government take is less than on oil. The cost of transportation versus the overall value of the product is a much higher percentage. The existing severance tax starts at 12.5 percent for oil and goes up to 15 percent after five years. Gas severance tax starts at 10 percent and does not go up. The escalator for gas starts at \$8 and is higher on a relative basis than the \$50 on oil. He suggested that there should be some extra incentives for gas.

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In response to a question by Representative Kelly, Mr. Hanley noted that on page 11, line 16, the existing expiration incentive credit system, more incentives were given for exploration. He felt that the 10-year extension is appropriate. The extension on the \$73 million was problematic because it applies to production.

He suggested either the credit in SB 185 or the 20 percent credit, but not both. The wells close to infrastructure would take the 20 percent credit under PPT. Bigger wells would take an additional 20 percent credit. Representative Kelly summarized that it pertains to both gas and oil. Mr. Hanley said that is correct.

Representative Weyhrauch noted that he found the 10-year extension on page 12. He asked where the 40 percent credit is located. Mr. Hanley responded that nothing was changed in the existing statute. They allowed the production credit to apply to the tax due under the new PPT. He pointed to page 8, line 7, which allows for the 20 percent credit under PPT or the credits in the existing law.

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Representative Kelly questioned if SB 185 solves the problem on the gas. Mr. Hanley felt that it offset some of the changes that were made such as reducing the credit to \$12 million, but that it did not solve the problems. SB 185 is not as valuable as PPT, since it does not change the question of gas being disadvantaged to oil.

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Questions and Answers with the Administration

ROBYNN WILSON, DIRECTOR, DIVISION OF TAX, DEPARTMENT OF REVENUE, addressed questions on PPT legislation. She read and responded to questions 1 and 2:

1. Why did the Governor offer five-year transition (clawback) when capital has already been depreciated in the tax rate over a five to seven year period?

The Governor believes that this is a fairness issue. Once enacted, the PPT will measure tax based on net profit. These will be profits generated by investments made prior to the effective date of the legislation. The cost of all new investments will be reflected in the calculation of net profits; the costs will be deducted. However, the costs incurred for recent investments would not otherwise be reflected in the calculation. Without the transition deduction, the producer would be taxed on the profits generated by assets, which would not be properly represented in the profit calculation.

Much of the oil and gas equipment is depreciated over seven years for federal tax purposes. In addition, certain oil and gas equipment is depreciated over 15 years. To our knowledge, the only oil and gas equipment with a 5-year life is offshore drilling equipment. It is notable, also, that these lives are those articulated for federal tax purposes. For accounting purposes, the depreciable lives are often longer than the lives under federal tax law. This means that very few of the assets are fully depreciated, even for those assets purchased five years ago.

The Governor believes that it is fair to give a five-year look back for, in effect, depreciation expense on recent investments that are generating future profits, which will be subject to tax.

2. Requested a written explanation of progressivity clause versus Governor's Bill.

As presented by the Governor, HB 488 included a fair tax rate of 20% of net profit. The Governor believes this strikes a good balance for long-term state fiscal health. That bill did not include a progressive tax rate. Over the long run, increased revenues should be driven by increased investment and production rather than swings in commodity prices.

The CS for HB 388(RES) includes a two-pronged progressive tax rate. At prices between \$50 and \$100 per barrel, the progressive rate adds 3/10% of the wellhead value for

every dollar the market price is over \$50. If the price of oil exceeds \$110 per barrel, the tax jumps up to 37.5% of gross wellhead value. The Governor believes that this is excessive, and will hinder future investment in the state.

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Representative Kerttula referred to Mr. Hanley's testimony. She noted that every dollar is taxed, not just the amount over \$50. Ms. Wilson said it is true that the progressive tax generates a percentage of that tax on the gross. Representative Kerttula asked if a normal progressivity works and what the implications are.

DAN DICKINSON, CONSULTANT, TAX DIVISION, DEPARTMENT OF REVENUE, clarified how the tax works.

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Ms. Wilson read question 3:

3. Provide information on the decline of oil field production over next 50 years by field.

She referred to the chart and table, "10-year ANS Decline Rates by Field" (copy on file) to answer the question.

Representative Hawker recalled, "No decline after 99". He suggested that the chart should scare every member.

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Ms. Wilson read questions 4 and 5:

4. I've been told that the incentives for the Major Producers are not the same as it would be for the new explorers. If that is so, what other incentives could we offer to make "wildcatters" interested in Alaska?

The Governor's bill was specifically designed to entice new entrants, particularly "wildcatters" to Alaska. The Governor's bill provides a 20% tax credit for exploration and capital investments, which could be immediately monetized by the explorer. In addition, current statute AS 43.55.025 provides a 40% credit for certain exploration expenditures. The Governor believes that these incentives are very adequate to promote new exploration.

5. Transition provisions should be allowed because no oil has been produced from those capital investments. But were those investments made at prices less than \$25/bbl and so would be recovered much more quickly at

\$60/bbl? How is this accounted for in the clawback provision?

The transitional deduction (or "clawback") accounts for recent investments by, in effect, allowing depreciation expense to be recognized in the calculation of the net profits generated by those assets. From an accounting standpoint, depreciation expense is recognized on a systematic basis over the life of the asset. The asset is considered to generate net income evenly over the life of the asset. A windfall in one year does not change the asset's ability to generate income later in its useful life.

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Representative Hawker asked about questions 1 and 5. Accounting depreciation is not the relevant measure of the underlying economics. This is an unusual circumstance and the investor has already recovered their capital investments. Ms. Wilson responded that if you look at it from an economic standpoint that may be true. However, new investment is trying to allow representation of those assets.

Mr. Dickinson said it is a matter of incentive. You don't want to have a situation where people think they should wait a year to invest. Representative Hawker suggested making an effective date.

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Representative Kelly said it is fairness issue driven by Kuparuk. It is a fallback. He wondered what the value of the Kuparuk ELF is and what the net clawback is.

Mr. Dickinson reworded it to say what would happen if the PPT had been in place for 5 years already. Representative Kelly noted that some believe that we waited too long to change ELF. He spoke in favor of the 2-for-1. Mr. Dickinson said roughly \$1 billion clawback and less tax would be paid. Representative Kelly thought there would be some balance between the two numbers.

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Ms. Wilson read question 6:

6. How much severance tax (dollars) did Alaska lose because the Kuparuk Tax went below the legacy field tax rate in 1998-99?

She referred to the attachment on "Production Value by Field" (copy on file).

In response to a question by Representative Kelly, Mr. Dickinson mentioned looking at the rate of decline.

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Ms. Wilson read question 7:

7. How might we smooth the progressivity curve to eliminate or moderate the steep increase at \$110?

The elimination of the steep increase can be accomplished by changing the values at page 4 line 18, AS 43.55.011(g)(2) to reflect the desired price/index ceiling. If the index of 125 at \$110 is removed, and the progressivity tops out at \$110, then the top surcharge rate would be 18% applied to gross value.

Representative Weyhrauch asked about the tax rate on oil relative to other natural resources in the state. Ms. Wilson said she could not answer that question.

ADJOURNMENT

The meeting was adjourned at 3:35 PM.