

HOUSE FINANCE COMMITTEE  
April 3, 2006  
9:09 A.M.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [9:09:55 AM](#).

MEMBERS PRESENT

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

MEMBERS ABSENT

Representative Carl Moses

ALSO PRESENT

Representative Les Gara

PRESENT VIA TELECONFERENCE

Dr. Pedro Van Muers, Consultant to the Office of the Governor, Algeria

SUMMARY

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 & HELD in Committee for further discussion.

#HB488

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.

[9:10:32 AM](#)

DR. PEDRO VAN MUERS, (TESTIFIED VIA TELECONFERENCE), CONSULTANT TO THE OFFICE OF THE GOVERNOR, ALGERIA, commented on the process the bill has gone through while moving through the legislative committees.

Dr. Van Muers addressed the 20/20 ratio versus the 25/20-ratio taxation package with regards to building the pipeline. Analysis indicates there is some difference between the two fiscal packages. Ultimately, the oil companies are the decision makers and it is important to include them in the process. He worried about the 25/20 ratio activity and international attractiveness including the progressivity feature. Analysis indicates there is a difference.

[9:14:01 AM](#)

Dr. Van Muers stated that negotiating could lead to delayed contracts. He reiterated that the question remains with the companies. Interesting ideas have surfaced over the past six weeks. He appreciated the progressive feature coming out of the House Resources Committee (HRC), which was considered and adopted in the Senate Resources

Committee (SRC). It is important to realize that the price at which it becomes progressive is an important feature. In the HRC proposal, that number was based on a nominal price that could not be escalated with inflation. Over time, the value of the insertion point becomes less. A progressive feature based on a nominal system should be on a reasonable price. If the price inserted is too low, it would be unattractive. If using the progress feature, oil and gas should be separated.

[9:17:42 AM](#)

Dr. Van Muers mentioned that the HRC version removed the "crawl back". He supported the idea of a 2 for 1 feature put in place by the SRC, insuring the maximum amount of commitment from the large companies.

He mentioned the small company allowance originally proposed at \$73 million dollars. HRC chose the tax credit; SRC choose the 5 thousand barrels a day with no tax payable up to 30 thousand barrel a day. He believed that was a good feature and could help the small companies.

[9:20:33 AM](#)

Co-Chair Meyer asked about the idea of starting at a high tax rate and adjusting it down until supported by the oil companies. Dr. Van Muers agreed that the companies could move out of Alaska. A famous case arose in Columbia where that county lost the investment; it took about five years for them to get their investment back. If the industry considers the overall fiscal package too tough, it becomes difficult to get the investment back. After Columbia lost their investment, it cost them more attempting to get their investment back. It is important that it not misfire. The fiscal systems overtime adjust. He thought that the proposed tax rate shifts were relatively modest compared to what has happened in other countries.

[9:24:57 AM](#)

Co-Chair Meyer hoped to get the "arrangement" correct the first time. He pointed out that Alaska is a more stable place than many others, although, there are more economically desirable places to invest such as the Gulf of Mexico and Texas.

Dr. Van Muers acknowledged that the Gulf of Mexico rates as one of the best fiscal systems in the world and comes with a lot of deep-water activity. There is no question that area's fiscal system would be more attractive than Alaska's. The same is true of the Alberta oil sands. There are places more attractive, however, that does not necessarily mean that all the investors go only to that spot. He addressed the overall tax rate and activity happening in Europe.

[9:28:15 AM](#)

Dr. Van Muers explained that the level of activity will be affected. The more attractive the fiscal system, the higher the activity.

Texas has an entirely different series of systems with the State water concerns. There are other jurisdictions in the world such as Norway and Russia, which have tougher fiscal systems and continue to have activity in those regions. It is a gray area. The Alaska fiscal terms as formulated would be "in the middle of the pack" and would not present the toughest or the best terms around the world.

[9:29:51 AM](#)

Representative Weyhrauch asked if when oil price falls below \$20 dollars a barrel, would it be reasonable to implement a per barrel tax rate at 75%. Dr. Van Muers explained that the Petroleum Production Tax (PPT), at least for the next ten years, is clearly more attractive than the current Economic Limit Factor (ELF) system. Obviously, Alaska with the high transportation costs of \$5 dollars per barrel provides a low netback. Every time the price declines, Alaska gets hurt more than anywhere else in the world. One of the advantages of the PPT in maintaining activity is that it is a profit-based system, which means that Alaska runs a higher risk at low price levels.

[9:32:37 AM](#)

Co-Chair Chenault asked what tax structure is used in the Gulf of Mexico. Dr. Van Muers advised that the Gulf of Mexico does not have the kind of tax credits considered by Alaska. They have two payments, a royalty and a federal corporate income tax at 35%. There is no production tax at all. The royalty tax offers a "royalty holiday" for

initial volumes of production. There could actually be a 0% royalty, with only 35% corporate income tax, which is the way the federal government encourages activity.

[9:35:32 AM](#)

Co-Chair Chenault inquired the actual royalty. Dr. Van Muers replied 12.5% for deep waters and 16% for the shallow waters.

Co-Chair Chenault pointed out that there are no state taxes involved, which makes it considerably different than Alaska. He mentioned the situation in Louisiana. Dr. Van Muers responded that in State waters, the fiscal system applies. In Texas, along the coast, the taxation system is as tough as the Alaska system. In federal waters, the system is based on the one previously described.

[9:37:14 AM](#)

Co-Chair Chenault noted that the three major producers were not as interested in the tax credit versus the 20/25 ratio. Dr. Van Muers explained that in discussing PPT with those companies, there was no indication of interest-free in the tax credit; they figured highly in that proposal for heavy oil. Those companies proposed that the tax credits should be higher than the 20/20 proposal. He clarified that they received incentive for investment. However, the current focus is on the rate; a higher rate means a lower corporate take. Tax credits are an integral part of the Industry's own discussion and the 20% credit number has been encouraged.

[9:40:05 AM](#)

Vice Chair Stoltze mentioned the remarks that the oil companies are the decision makers on the gas line. Dr. Van Muers advised that the first phase of the plan is changing of the oil tax, which is a stand-alone feature. As a result of that, the oil companies hoped it would be consistent with bringing a gas pipeline forward. Then the tax credits were consistent with putting the gas pipeline forward. At 20/20 ratio, the companies are willing to live up to the Stranded Gas contract. The Industry sees it that if the 20/20 ratio is in place, they are willing to move forward.

It is up to the Legislature to decide on the taxes. If there are certain levels of changes to the oil tax, it could impact the overall concept of the package. If an oil tax is passed, fundamentally different from the investment package that the Industry had in mind, there could be reconsideration. That needs to be investigated with those companies. He speculated on possibilities.

[9:45:40 AM](#)

Vice Chair Stoltze asked for recommendations on an incentive package. Dr. Van Muers commented that the worst-case scenario would be that the oil tax passed and then the sponsors became hesitant to move forward with the gas contract. That would leave Alaska with the oil tax; it would remain to be seen what happens then. It could mean there would be no gas contract put forward; anything could happen. It is important not to speculate, as the Industry is the one that will give clear answers on the questions.

[9:48:44 AM](#)

Representative Kerttula asked about the 2 for 1 concept discussed in SRC. Dr. Van Muers said SRC came up with a good formula - the crawl back. In the Governor's proposal, it was agreed that the bill would contain the possibility, that companies would have the ability to recover \$1 billion dollars expended over the past five years. In the HRC version, that feature was cancelled; canceling it, puts Alaska \$1 billion dollars ahead. The SRC version proposed that the three sponsors must indicate that they "mean business" with inclusion of the 20/20 ratio investment. They must show their commitment to Alaska. One way to prove that, Alaska would allow to recover whatever the number is, but only allow \$1 dollar extra deduction for every \$2 invested into the future. Alaska needs a doubling of investment. There is evidence that production is declining, which led to the SRC proposal, indicating that companies are allowed to recover \$1 in addition to the \$2 dollars as an extra encouragement. He thought that was a good idea, as Alaska needs more investment.

[9:52:38 AM](#)

Representative Kerttula asked if he had seen the New York Times article addressing the windfalls in the Gulf of Mexico and the congressional plunders resulting from that

action. Dr. Van Muers was aware of the fact that on the federal level, the fiscal system off the Gulf of Mexico has been questioned and may need to be reviewed.

[9:54:52 AM](#)

Representative Kerttula understood that Alaska would be competitive using the 20/20 and/or the 25/20 ratio. At this point, the companies will make their internal decision. Dr. Van Muers testified that he had analyzed all the levels of taxation credits and rates. There is a difference between the 20/20 and the 25/20 ratio. The 25/20 is approximately the same as currently exists. He assumed that at the 25/20 ratio, more tax would be collected but there would not be as much activity; the 20/20 rate provides more activity and would be the more attractive feature.

[9:58:13 AM](#)

Representative Kerttula mentioned the tax and tax credit for new investors. Dr. Van Muers agreed; it relates to the \$73 million additional allowance. If no tax is paid, the higher the tax rate & credits, the more that can be claimed in loss carried forward credits. The Governor's bill proposed using the flat rate for all companies. Dr. Van Muers preferred the version proposed by the SRC as it provides a sliding scale and only small companies would benefit from that. If a company falls within the small company bracket, the higher the tax rate, the better because they receive credits, more loss carried forward.

[10:01:26 AM](#)

Representative Hawker commented on testimony regarding the environment of lower net effective taxes, and how exploration and development is encouraged and expands; in an environment of higher taxes, exploration and development is discouraged. He understood that testimony on the PPT, establishes overall, a net effective tax rate, which leads to the conclusion that passing PPT could lead to less development and exploration in the State.

Dr. Van Muers stated there are two features, the tax credit and the tax rate. The Governor's bill attempts to achieve some kind of economic balance by creating higher tax rates, at the same time providing stronger tax credits. It is not

only the tax rate that is important, but rather, the entire structure of the credit. The economic analysis indicates that taxes could be increased but at same time providing increased tax credits. Some nations have been successful at creating the right tax structure such as Norway at the same time creating an environment that encourages reinvestment, which is the focus of the PPT proposal.

[10:05:22 AM](#)

Representative Hawker did not see how higher taxes could encourage economic development. Dr. Van Muers explained the idea is related to the entire cash flow. The concept of profitability is not the total amount of profit but rather how much profit results from how much investment. What they are saying is that they get less profit, but the investment is somewhat less and is affecting the total balance between what they get and what they pay. Consequently, it is the entire relationship between what you get and what you pay that determines whether an investment is attractive or not. In that balance, the 20/20 ratio is a favorable system.

[10:07:18 AM](#)

Representative Hawker advised that is the definition of an internal rate of return on any investment. He did not see how the net affects increased tax rates could be improved. Dr. Van Muers explained it would improve, because after tax investment, it would be considerably less. A rate of return is not the only criteria.

[10:08:52 AM](#)

Dr. Van Muers explained that if an investment is more profitable, then the investment becomes more likely.

[10:09:42 AM](#)

Representative Kelly inquired if the tax rate increases, should the credits be raised to 25% as well. Dr. Van Muers noted that his original report recommended 20/15 ratios, but has increased to a 20/25 ratio, in order to strike a correct rate. He explained that the downside risk for Alaska would be higher if tax rates and credits were too high. He did not recommend going "all out on a limb" on tax credits, due to the significant risks resulting to the

State of Alaska. He felt that 20% tax credit was as high as the State should go.

[10:13:31 AM](#)

In response to a question by Representative Kelly regarding connection of the gas line with the PPT, Dr. Van Muers observed that the Stranded Gas Act did not address fiscal stability for oil. The concept is to judge oil taxation on its own merit, next a public review, and then the Stranded Gas Act would have to be amended before considering the contract. Finally, the Legislature would have the view of the total package; a process which allows renegotiation and then the public and Legislature would have the opportunity to refute or accept.

[10:18:55 AM](#)

Representative Kelly spoke to the complexity of the issue. The system would be changed to taxing the net, with a claw-back provision and credits within that system. He questioned if there are other systems like that and how they perform auditing over time.

Dr. Van Muers recommended the PPT to the Governor because it is well established worldwide. Norway uses the system; Britain use to use that system; Australia, Newfoundland, Algeria and other areas have been successful with the profit-based system. The international experience is that more auditing is needed. Dr. Van Muers is presently in Algeria to create a monitoring system. It requires extra governmental effort to insure that they have their fair share. He felt confident that the Administration would be able to implement the process and encouraged the Legislature to listen to those who implement the law. He acknowledged it is more complex than the ELF. ELF has its own concerns regarding how fields are defined. There are advantages and disadvantages to both systems. Profit based systems seem to provide a fairer share for the jurisdictions. He recognized that regulations need to be passed.

[10:26:22 AM](#)

In response to a question by Representative Kelly, Dr. Van Muers commented he was positive about the 20/20 ratio proposal including the progressivity feature. He believed

that it was a more balanced proposal than his original one at 25/20. There is more balance in the number and will make companies more likely to reinvest. The 25/20 ratio scales have more risk than the 20/20 for carry forward credits. He agreed it is a superior system and supports that approach.

[10:29:19 AM](#)

In response to a question by Representative Kelly, Dr. Van Muers felt that international factors could lead to more investment in Alaska. He observed that the world is changing and a number of governments are considering higher taxes to make their systems more progressive. There is a trend happening and higher oil prices are causing governments to review their fiscal oil price. He thought that gas is still on the moderate side, but that could change once there is more supply. He expected more nations to join in higher takes over the next few years. He concluded that Alaska could take significant more without seeing investment decline. There currently is an over-supply of stranded gas, still on the modest side.

[10:32:55 AM](#)

Co-Chair Meyer advised that neither version addressed heavy oil and that significant amounts of heavy oil reserves are present. Dr. Van Muers spoke to stimulating heavy oil on the North Slope, depending of course on an adequate fiscal package. The conclusion is if there is a higher tax credit, there would be an additional stimulus, which the companies are seeking. The higher the credits, the higher the rate of return. The conclusion is if the tax credits are pushed up to high, the government becomes too exposed from a risk point of view, which would be unwise. The 20/20 is a package that would stimulate heavy development.

[10:38:13 AM](#)

Co-Chair Meyer indicated that the HRC was referring to the Western Texas Instruments (WTI) as the standard; whereas, typically, the Alaska North Slope (ANS) standard is used. He asked if the three major producers could manipulate the ANS price, based on the quality of the oil.

Dr. Van Muers advised that there are advantages and disadvantages in using the WTI versus ANS. ANS reflects

better the actual North Slope crude. There is quite a bit of variation; the advantage of using ANS is that it better reflects the value of the North Slope crude. ANS typically trails \$2 dollars less than WTI. There are disadvantages and no matter what the State does, eventually there will be a decline in production of the crude. Already, the level of production does not create a very transparent market and it will likely increase in the future. Eventually, if the Stranded Gas contract moves forward, WTI will be the reliable benchmark. The State at some point will need to switch to WTI because the market may become too narrow for the other. The WTI standard is used worldwide.

[10:42:50 AM](#)

Co-Chair Chenault asked if locking in the long term was done in other parts of the world. Dr. Van Muers advised that the Stranded Gas Development Act permits locking in the tax system for a period of time and many nations in the world are doing that. If there is a marginal gas project, fixed terms have an enormous risk factor for the investors. He worried about those risk factors. Other nations have been adept in guaranteeing fiscal stability. Nations are locking into terms for a considerable period [35 years] of time, which is attractive to investors and is the basis for the entire Stranded Gas Act. Not all investments have fiscal stability such as Norway & Britain. Those governments have sufficiently profitable projects that allows for no fiscal stability. Having fiscal stability gives the project a huge push forward. He urged that the entire oil package be considered with the idea of fiscal stability.

[10:48:00 AM](#)

Representative Kerttula asked if the profit-based system was similar to the severance tax based on profits. Dr. Van Muers responded that each fiscal system around the world is somewhat different. The Alaska PPT is not a copycat of one done anywhere else. If there are royalties, then the profit-based system must be designed differently. The PPT attempts to make a profit based system, the same goal of other nations, but unique to the situation of that place. He thought that Alaska was more favorable to offer tax credits. Once the PPT is introduced, other nations will watch to see how it works. The PPT is based on international standards.

[10:51:57 AM](#)

Representative Kerttula asked if any other country had a production tax based on profit rather than on the gross. Dr. Van Muers replied that it is common for nations to have three levels of taxation:

- Royalty based on gross value
- Extra tax based on the net value
- Corporate income tax

[10:53:36 AM](#)

Co-Chair Chenault asked if Dr. Van Muers could determine a fix for Cook Inlet. Dr. Van Muers pointed out that SRC came up with a good formula to insure that Cook Inlet produces. The levels there now are low and would not be hurt by the overall tax system of the 5 thousand barrel a day with a sliding scale going up to 30 thousand barrels a day was designed around Cook Inlet. It is a non-discriminatory system and achieves for that platforms producing little, no tax would be applied, yet producers still benefit from the tax benefit. The PPT stipulates that and will result in more activity in the area. There will be tax by some of the major players on the gas. He reiterated as a result of PPT, more development could happen in the Cook Inlet region.

HB 488 was HELD in Committee for further consideration.

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[10:56:17 AM](#)

#### ADJOURNMENT

The meeting was adjourned at 10:56 A.M.