

HOUSE FINANCE COMMITTEE

April 6, 2006

8:39 a.m.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [8:39:05 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 Carl Moses
Representative Bruce Weyhrauch

MEMBERS ABSENT

None

ALSO PRESENT

Marianne Kah, Chief Economist, ConocoPhillips-Houston;
Barry Pulliam, Senior Economist, Econ One Research; Dan Dickinson, Consultant, Tax Division, Department of Revenue; Angus Walker, Commercial Vice President, British Petroleum - Alaska; Dr. Tony Finizza, Special Consultant, Econ One Research; David Bramley, Vice President, CRA International; Representative Ethan Berkowitz

PRESENT VIA TELECONFERENCE

None

SUMMARY

Round Table Discussion

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.

[8:39:13 AM](#)

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."

Co-Chair Chenault introduced the speakers for the round table discussion. He summarized the PPT process so far. He noted that each oil corporation has had a little different opinion on the proposed tax.

[8:42:16 AM](#)

Co-Chair Chenault read the first question for the PPT panel:

1. Legislators took an oath to maximize the return on resources for the benefit of Alaskans. What do you believe is the best proposal to maximize this return while at the same time encouraging investment and exploration to extend the production life of our oil/gas resources?

[8:42:49 AM](#)

DAN DICKINSON, CONSULTANT, TAX DIVISION, DEPARTMENT OF REVENUE, began by challenging the basis of the question. He opined that encouraging investment and exploration to extend the production life of oil and gas resources is maximizing the benefit of our resources for all Alaskans. He suggested that the governor's bill does that and strikes the best balance. It is important to account for the long term as well as the short term.

ANGUS WALKER, COMMERCIAL VICE PRESIDENT, BRITISH PETROLEUM - ALASKA, responded that barrels in the ground have no value, so production and investment need to be maximized. The lowest tax rate would be best for Alaska because it would stimulate investment. He maintained that a 15/25 structure would be better than a 20/20 structure, which would be better than a 20/25 structure.

[8:44:24 AM](#)

MARIANNE KAH, CHIEF ECONOMIST, CONOCOPHILLIPS - HOUSTON, agreed with Mr. Walker, but added that a lower tax rate combined with tax credits would do the best job of maximizing production, investment, and revenues.

BARRY PULLIAM, SENIOR ECONOMIST, ECON ONE RESEARCH, responded that maximizing investment for investment sake is not the goal. The ultimate goal is to maximize the value of the resource. If you only maximize production and investment, there would not be a tax or a royalty. As Econ One views the proposals, 20/20 does not discourage investment.

[8:47:20 AM](#)

DR. TONY FINIZZA, SPECIAL CONSULTANT, ECON ONE RESEARCH, echoed Mr. Pulliam's comments. He opined that there are enough incentives for the new fields. He thought the ELF tax was not onerous and movements from it would not stifle investment.

Mr. Walker responded that PPT is not investment for investment sake, but to stem the 6 percent per year decline of Alaska North Slope oil production. In 10 years the production and revenue will be half of what it is today. This is a matter of great importance for Alaska because it

is about getting investment to Alaska to develop the barrels on the North Slope that are difficult to develop.

Ms. Kah added to the comment about investment for investment sake. Just providing tax credits and incentives for new players to come in for new exploration, versus supporting more production from existing fields, sounds like investment for investment sake. To maximize the value of investment, the industry should get more reserves from existing fields, particularly heavy oil. She pointed out that the 20/20 proposal is a 17-23 percent increase in the government take and is bound to have an impact on investment.

[8:50:21 AM](#)

Co-Chair Meyer requested Econ One's response to Ms. Kah.

Mr. Pulliam stated that the increase would be only a 4-percentage point increase in government take. At lower prices the take would be even lower. Ms. Kah agreed. He addressed the intent of the bill, which is to reach a balance and keep investment going. He suggested that even at higher prices, the take is not out of line in comparison to the industry in the rest of the world. He suggested that Mr. Johnston could comment further.

[8:51:57 AM](#)

Dr. Finizza observed that when he first came to Alaska, major producers agreed to a 20/20 tax, so he thought it was not too onerous, but a reasonable starting point. He advised not going higher than that.

[8:52:47 AM](#)

DAVID BRAMLEY, VICE PRESIDENT, CRA INTERNATIONAL, referred to Slide 91 from Econ One's presentation yesterday. Price projections at \$52.7 per barrel show calculations for government take figures go from 54.4 percent to 62.3 percent. He highlighted Alaska's competitive position. The step proposed by Econ One is a step from a high government take to an even higher one. He pointed out that his company's view is pessimistic. He termed this trend very onerous with a negative impact on investment.

[8:54:39 AM](#)

Mr. Pulliam said when you look at those take figures at \$52.7, at real prices, in time, with 2.5 percent inflation, the prices are high.

Mr. Walker said it important to remember that what has been proposed in the new CS and in the governor's bill will create the highest tax rate in the United States for a state that has the highest cost structure. He disputed the idea that if the producers agreed to it, it must be good. He emphasized that the agreement was part of a negotiation as a steppingstone to gas. He reiterated that it would be better for Alaska to have a lower tax rate.

[8:56:31 AM](#)

Co-Chair Meyer pointed out that the legislators take an oath of office to maximize returns to citizens. He noted that at Kuparuk the tax rates went down and investments went up. Pioneer is trying to decide whether to invest in Alaska or Texas. He suggested improving regulatory and permitting processes. He asked if there would be any difference, from the investor's point of view, between the various tax rates.

Mr. Walker repeated the statement, "The lower the tax rate, the more investment. The higher the tax rate, the less investment."

Co-Chair Meyer asked if oil price would impact the decision about tax rate. Ms. Kah noted that most of the remaining reserves are in small fields and in heavy oil outside of ANWR. She suggested that is why there is not more investment today. The effect of lowering the tax rate would make a marginal field more economic and result in more investment.

[8:59:40 AM](#)

Mr. Dickinson agreed with Mr. Walker's "the lower the tax" statement. He said people are faced with a competitive situation and with a limited capital budget. He wondered if dropping the tax would create a window. Dr. Van Meurs' work suggests that investment is more likely with the 20 percent PPT, but there will not be a dramatic shift in investment opportunities.

[9:00:50 AM](#)

Mr. Bramley pointed out a statistic that over the last five years, for every \$1 invested in exploration, more than \$10 has been invested in known reserves. The reason has to do with the underlying prospectivity. When looking at investment attractiveness, there is a concern about the extent of focus on exploration. He found it hard to see that new exploration would be more prospective than old exploration. Changing the balance of investment attractiveness between investment and development, in favor of investment, does not seem the sensible way to go. To contemplate a tax system focused on incentives does not make sense.

Co-Chair Meyer referred to a graph produced by Econ One with scenarios of 18/10 and 19/15. He noted that the government take does not differ so much from the 20/20 scenario, with the price of oil between \$35 and \$60. He suggested 18/10 and wondered if that would be more beneficial to existing producers and less attractive to the independents and explorers. Mr. Pulliam addressed the credit mechanism in the bill, which encourages reinvestment. Producers would like a lower tax rate, but also a higher credit. He suggested that the producers would not view it as better.

[9:04:48 AM](#)

Mr. Walker responded that the credit mechanism in the PPT bill is of the least concern because it is powerful and appropriate. The tax rate is of most concern.

Mr. Dickinson said that at today's prices the tax rate overwhelms the effect of the credit, but at lower prices, the two strike a better balance. At medium prices the credits become a significant portion of the overall economics.

Mr. Pulliam maintained that the two work together.

Mr. Walker did not disagree with that. He voiced concern for the very high tax rates.

[9:06:41 AM](#)

Representative Holm stated appreciation for the discussion about tax rates. He requested information about how the price of the commodity affects investment in Alaska.

Ms. Kah replied that the price upside is of great consideration. If that is taken away it is of concern. She commented that if prices are high, it is going to be because replacement costs are that high. The upstream margin will not change that much and costs will have caught up.

[9:08:59 AM](#)

Representative Kerttula said that at the current price the tax rate is overwhelmed. She asked if we are banking on the higher price. Mr. Dickinson clarified that the credits will reward investment at the same amount no matter what the price. He provided an example. Banking needs to create an environment that is pro-investment.

Mr. Walker responded to Representative Kerttula and said that everyone is banking on higher prices. Price is masking the real issue that production is declining. British Petroleum is very concerned about the decline of prices.

[9:11:50 AM](#)

Co-Chair Chenault read question 2:

2. Econ One stated that 25/20 was better in a low rate environment. What tax/credit rate best meets the balance between government and industry and high and low prices? Should we consider a two-tiered system dependent on price?

Dr. Finizza said that is a comment that came out of the new fields analysis for low prices. If you look only at new fields and the EIA price distribution, the 20/20 is better for producers and brings in more revenue for the state. He suggested not having a high tax rate at average prices, but rather at higher prices.

Ms. Kah commented about the economics of 25/20. She speculated that the only reason it appears to be better is because dry hole costs are being subsidized. She asked if

the state wants to be in the business of subsidizing dry hole costs.

Dr. Finizza spoke to dry hole costs, a necessary part of investment. Ms. Kah countered that was her point - a high success rate with known reserves.

[9:15:40 AM](#)

Representative Kerttula pointed out that in Norway a great deal of credit was successfully given. Ms. Kah commented about how successful how those credits were. Norway did not see the increase in exploration and had rig availability problems. The success of those credits is debatable.

Representative Holm asked what the rig availability is in Alaska. Mr. Walker said he does not know, but he observed that oil is a big industry and it takes time to ramp up investment. It is very important to have a fiscal policy to rely on.

[9:18:01 AM](#)

Representative Foster spoke of his air service experience with fares and taxes. He wondered if the consumer would pay for any operating increases in costs. Ms. Kah agreed that in a tight supply and demand environment, costs get passed to the consumer. She gave an example of demand destruction from last year. Prices are still high because of supply disruptions in places like Nigeria.

Dr. Finizza generally agreed, but commented that one cannot expect the same level of demand as prices rise. Mr. Pulliam questioned Ms. Kah's statement that if taxes rose in Alaska, it would cause crude oil prices generally to rise. Ms. Kah clarified if the cost of global production went up, that will happen. Mr. Pulliam agreed. He maintained that what happens in Alaska will not have an effect on consumers around the world.

[9:21:04 AM](#)

Co-Chair Chenault read question 3:

3. Substantial discussion has occurred over the progressivity surcharges in the House and Senate

bills. Outstanding issues of concern include inflation, the slope, and the cap. What do you consider to be a reasonable way to address these issues?

Mr. Kah maintained that the ideal solution would be not to have a windfall profits tax. If there were to be one, inflation adjustment is a must because otherwise it would make the investment incentive go away over time. The cap would have to be set high enough at a relevant range. The tax would have to be set wider and more upside. It would have to start the tipping point at a much higher level in order to not affect investment. It would need to be capped it at a lower level in order to maintain investment.

Dr. Finizza agreed somewhat. He suggested a minimum of indexing. Mr. Pulliam suggested taking increase in costs into account when looking at progressivity, otherwise the margin between cost production and delivering the oil to market, relative to the price at which the trigger for progressivity, shrinks. He advocated for the threshold price to be adjusted annually.

Ms. Kah asked about cost inflation increasing beyond 2.5 percent general inflation. Mr. Pulliam suggested increasing it dollar for dollar with increasing costs. He spoke to the threshold and where it should kick in. He suggested that one couldn't divorce progressivity from the underlying tax rate. If the tax rate is higher, the threshold should be moved up. A lower tax rate allows for a higher slope. He agreed with moving higher into the \$50 range. He concurred with the index level.

[9:25:22 AM](#)

Mr. Walker thought that if progressivity were to be chosen, it needs to be simple, balanced, and based on the realized price of crude on the North Slope. That is what the economics is based on.

Representative Weyhrauch thought that the bill had a progressivity feature in it. Ms. Kah agreed.

Ms. Kah, in response to a question by Representative Weyhrauch, replied that when a certain cap is reached the rate increase should be leveled off. Mr. Pulliam responded to a question by Representative Weyhrauch about moving up

the threshold for progressivity. Mr. Pulliam clarified that he was talking about adjusting the threshold in response to changes in cost. Representative Weyhrauch said that agrees with Ms. Kah's point on inflation. Mr. Pulliam agreed that there should be a cap. Representative Weyhrauch suggested finding specific language.

Mr. Dickinson pointed out that there is a real difference between merely acknowledging general inflation and acknowledging specific costs. He spoke to the possible ranges.

Dr. Finizza said it is possible to have a decrease in costs from year to year, which could change the threshold in the other direction. Mr. Dickinson agreed. Ms. Kah referred to 20 years of cost decline. Mr. Pulliam asked whether the state is collecting cost information as a part of this program. Mr. Dickinson said yes. Ms. Kah added that the \$20-\$80 dollar range is the working range ConocoPhillips uses. She emphasized that starting at \$50 would result in a negative impact on investment.

[9:30:39 AM](#)

Representative Hawker asked about progressivity and the windfall profits tax approach. He suggested finding a way to inflation-adjust the index. He wondered if other approaches to progressivity should be taken off the table. He questioned if a gross receipts surtax should be kept in place or a tax on the margins should be looked at.

Mr. Walker replied that it is a difficult question. What is on the table would create an unworkable outcome for Alaska and would not serve the industry well. Progressivity is not appropriate for Alaska. If it is part of the final solution, then an option based on margins, which is inflation-proofed and balanced, should be found. British Petroleum does recognize that there are different ways to approach this.

[9:34:25 AM](#)

Dr. Finizza suggested that progressivity should be addressed now. Ms. Kah repeated that investment will be impacted if the top is shaved off. \$50 is not high enough.

Representative Hawker said he heard two different opinions from the two companies. Ms. Kah emphasized that ConocoPhillips is strongly against the windfall profits tax. Representative Hawker asked for Mr. Dickinson's comments.

[9:36:29 AM](#)

Dan Dickinson responded, "The flatter the better. The further to the right it starts, the better." He mentioned when cost consideration is less relevant. In the governor's proposal there is nothing addressing that.

Representative Hawker asked if it would be better to keep progressivity on a gross receipts surcharge as a component of the state income tax, rather than as a component of the production tax.

Mr. Dickinson replied that he has not thought through that point. Representative Hawker said he is thinking in terms of simplicity. If PPT is worked out at a flat rate, then it is easier to write a gross-receipts calculation and tack it onto corporate income tax.

[9:39:41 AM](#)

Mr. Pulliam felt that mechanism, which allows for cost to increase, strikes the right kind of balance. Mr. Bramley observed that increasing taxes would bring a lowering of investment. He added that complexity would not be recommended. The consequences are hard to anticipate. Mr. Pulliam noted that one of the goals is to move the system into a more progressive structure. The old system is regressive. The base PPT only moves toward progressivity. The intent is to correct PPT to be more relevant.

[9:43:39 AM](#)

Representative Kelly noted that the regressive aspect can be changed later, but is in place now. He thought that the public might be confused about when the rate increase kicks in. There are three separate elements. Although most folks are going for the net and keeping it simple, there are good arguments for the other position. He stressed that it is not just a tax. The issue is what the state is getting for its oil. The market will adjust if a mistake is made on the high side.

[9:48:21 AM](#)

Mr. Walker felt that gross is an unworkable solution. He reviewed the share between the industry and the state as it moves to the new system. He explained what the move from the existing status quo to the 20/20 proposal does to the share. Under the status quo at \$60 per barrel, the state receives 32 percent, the federal government receives 25 percent, and the industry receives 43 percent. Under PPT, the state share moves from 32 to 40 percent, the federal government share goes from 25 to 22 percent, and the industry share goes from 43 to 38 percent.

In response to a question by Representative Foster, Mr. Walker observed that there would be a substantial increase in tax, which would result in less investment. He felt confident that there could be an agreement and movement on a gas pipeline.

[9:51:39 AM](#)

Co-Chair Chenault read question 4:

4. What issues are different when considering a progressivity surcharge on gas?

Ms. Kah noted that the industry doesn't like progressivity on anything, but it is worse on gas. The economics would be more difficult. Mr. Walker noted that the gas fiscal contract would govern the terms on the North Slope. The issue is appropriate for the Cook Inlet and other producers.

[9:53:19 AM](#)

Mr. Dickinson noted that in the Cook Inlet, Henry Hub prices are used to index the gas, while few are actually getting that price. There are many contracts that are lower priced than that.

Representative Kelly asked if Cook Inlet was taken out of the equation, if a "WTI/ANS-type comparison" applies. Ms. Kah stressed that it is important to go back to a wellhead value. The world's supply is getting more sour. She said she expects the differential between light sweet crude and sour crudes to widen over time. Over time, WTI is becoming

an increasingly poor indicator for all of the world's crude. There are similar issues for natural gas.

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

ADJOURNMENT

The meeting was adjourned at 9:58 AM.