

HOUSE FINANCE COMMITTEE  
April 10, 2006  
2:19 P.M.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [2:19:34 PM](#).

MEMBERS PRESENT

REPRESENTATIVES:

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

SENATORS:

Senator Lyda Green; Senator Fred Dyson

MEMBERS ABSENT

None

ALSO PRESENT

Dan Dickinson, Consultant, Tax Division, Department of Revenue; Daniel Johnston, Legislative Consultant, Daniel Johnston & Co., Inc., New Hampshire; Patrick Foley, Manager of Land and External Affairs, Pioneer Oil; John Zager, General Manager, Chevron-Alaska; John Barnes, Production Manager, Marathon Oil, Alaska; Mark Hanley, Manager, Public Affairs, Anadarko-Alaska

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.

#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.

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Co-Chair Chenault explained the meeting's intent was to offer a panel discussion with Cook Inlet leaseholders and the Department of Natural Resource. The bill version before the Committee is the House Finance substitute and a new version will be forthcoming. He asked how the implementation of the bill would affect business in that area.

Question #1:

[2:23:12 PM](#)

- General: Legislators took an oath to maximize the return on resources for the benefit of Alaskans. What is the best proposal to maximize that return, while at the same time encouraging investment and exploration to extend the production life of the oil & gas resources?

JOHN BARNES, PRODUCTION MANAGER, MARATHON OIL, ALASKA, clarified Marathon Oil ranks the Governor's proposed bill 1<sup>st</sup>, the House Finance Committee (HFC) version 2<sup>nd</sup> & the Senate Finance Committee (SFC) version 3<sup>rd</sup>. Each proposal has strengths and weakness for the high cost/low price environment of oil. He discussed severance tax, greater activity and higher tax rates and that concern with all three bills is the marginal investment being weighed competitively with the Alaskan disadvantages. He recommended that Cook Inlet adopt a 5/20 formula and that any new committee substitute adopt the strength of all three proposals.

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JOHN ZAGER, GENERAL MANAGER, CHEVRON-ALASKA, voiced support for the proposal made by the Governor, providing a larger benefit to the smaller producers. He stated that Chevron-Alaska supports a 20/20 ratio and that there should be a lower tax rate for both oil and gas. He admitted the Cook Inlet area was different.

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Co-Chair Chenault commented Mr. Johnston was at a disadvantage amongst representation from the oil companies.

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DANIEL JOHNSTON, LEGISLATIVE CONSULTANT, DANIEL JOHNSTON & CO., INC., acknowledged that there is more work to be done to make the Cook Inlet area safe. The area has been caught in an attempt by the Legislature to create a system under a variety of conditions. That is of concern and needs fixing.

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MARK HANLEY, MANAGER, PUBLIC AFFAIRS, ANADARKO-ALASKA, reiterated support for the Governor's proposal, a truce made between all companies. He acknowledged it will be a challenge to come up with a proposal supported by everyone. The original bill is critical for both large and small players and that any changes to that bill, such as the 25% tax rate, decrease exploration economics. The 25/20 proposal is not as attractive as the 20/20, particularly given inability to use those credits for offsetting. He mimicked previous comments regarding the order of preference, the Governor's proposal 1<sup>st</sup>, the HFC version 2<sup>nd</sup> and lastly, the SFC version.

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PATRICK FOLEY, MANAGER OF LAND AND EXTERNAL AFFAIRS, PIONEER OIL, concurred with his colleagues in ranking the preferred versions of the bill. He stated that the Governor's bill would make Alaska more competitive. A key element of that proposal is the \$73 million dollar standard deduction. For a new investor, that exemption provides an opportunity to defray many start-up costs. Both the House and Senate versions offer a sunset before value can be derived.

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Co-Chair Chenault asked about the sunset length, set at 2016.

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Mr. Zager failed to see any logic of a sunset provision and worried about future discrimination. He supported no sunset.

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DAN DICKINSON, CONSULTANT, TAX DIVISION, DEPARTMENT OF REVENUE, reminded members that a lot of work went into the Governor's proposal and that the only sunset in the Governor's bill is the look-back, offering a specific transition provision. He encouraged more incentives.

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Representative Kelly inquired if the look-back provision had been indefinitely extended. Mr. Dickinson responded that the Administration was looking at it and that it could make sense to include it for a short period. He recommended a three-year sunset study consideration.

Mr. Hanley advised that development credits should not offer a sunset, in particular for new developers. Regarding exploration credits, a ten-year sunset might be appropriate. Development sunset could exclude Alaska for some.

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Mr. Johnston agreed, noting that Alaskan weather window, five-years anywhere else at best under ordinary circumstances would be like two-years in Alaska. He was not in support of the 10-year sunset provision.

Question #2:

- Progressivity: Substantial discussion has occurred over the progressivity surcharges in the House and Senate bills. Outstanding issues include inflation, the slope and the cap. What do you consider a reasonable way to address the issues?

Mr. Zager responded that gas would be tied to net profits. Each company each month would have to calculate their profits for that month and then taxed on that. He mentioned net profits as regulated for inflation; the costs go down, the State could receive a benefit. He urged consideration of the Governor's proposal.

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Mr. Johnston commented on the fairness and economic logic, in contradiction to having a progressive element governing a severance tax as proposed. Theoretically, it would be more consistent to base the progressive mechanism on profits per

barrel of oil and include progressive element based on the rate as well, making tax based profits; a determination could be based on profits as well. He thought that would be a good idea and offered to help assist in that discussion.

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Representative Hawker added his endorsement to the idea, thinking it could solve many issues still on the table. [inaudible]

Representative Kerttula asked for further explanation. [inaudible]

Mr. Zager explained that net profits could be calculated using revenue, minus qualifying expenses, creating capital; to achieve a net profit, multiplying it by 20% or 25%, which provides the actual tax amount. If costs were high, the profits would be more than double. If for some reason the costs increased, the margin would remain the same for more than 20-years. The formula ties the profit margin directly to what taxes are paid. If oil prices double, there is good rationale to take the higher percentage of the profit, not tied to the Western Texas Instrument (WTI). He addressed an appropriate inflation factor.

Representative Kerttula asked where progressivity would come in. Mr. Zager explained the number is determined by the Department of Labor & Workforce Development. He added that the number kicks off when the profit margins are at the number determined by the legislation, escalating at 2%. The same formula would be used. It would be most equitable to tie it to actual profits.

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Representative Kerttula voiced concerned in not indicating the profit. [inaudible]. Mr. Zager said that is the risk in business and is a different issue.

Representative Kelly asked how that would compare and if a net approach model could be accomplished. [inaudible]

Mr. Johnston responded that the issue discusses statistics, determining the valuable, keeping costs down. The question remains if companies get to keep any of the saved funds. The only incentive to keep cost-bases down is the profit based systems. Making it Petroleum Production Tax (PPT) profit based would increase incentive for those companies and was addressed during previous testimony. It will be difficult to make that shift, seeing an increase of 2/10 for every dollar. He maintained, it is important to know the rate and the base for every levy.

Representative Kelly inquired the amount of effort and time to determine that rate. Mr. Johnston said it was not as previously described. There are three rate types:

- The world bank model,
- The R-factor - payoff, and
- The Price cap formula - windfall profit taxes.

He recommended crafting a new system to accommodate both companies and the Administration.

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SENATOR LYDA GREEN asked if there were other sections of the bill, needing balanced with the impact of a credit calculation.

Mr. Dickinson explained that the specific concern would arise during a year of loss, in the Governor's bill, 20% of loss can be carried forward as a credit. The effect would be the same as having a loss one month; it becomes a question regarding the affect of the surcharge. It would be a tradeoff and that the calculation would be independent of that number.

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Mr. Zager added that it could be simplified with a policy call of 20% capital credit as an additional incentive, lowering the margin.

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Senator Green asked if there was an accepted process to determine the net profit for the industry. Mr. Zager pointed out that the Department of Revenue will work during the next several months to determine a net profits process. Mr. Dickinson added, currently, they work from a cash flow model concept.

Question #3:

[2:56:49 PM](#)

- What do you think will be the result of PPT regarding investment and how that would impact production?

Mr. Barnes commented that a 20/20 tax structure would make the incremental investments, especially in Cook Inlet, less competitive. He noted that at worst, there would be a decline in exploration with a subsequent decline in reserves and production. Efforts to mitigate the lack of

profitability might be effective and that there are considerations regarding alternatives that could benefit the activity level, including credits for exploration. He thought that drilling unproductive wells for investment credits was not a solution but rather creating better incentives.

Mr. Foley added that much depends on the structure of the ultimate bill. The original proposal made by the Administration seems moderate and fair; however, as it becomes more complicated, the incentive declines. In the Governor's bill even at the lower prices, there continues to be industry protection.

Mr. Hanley stated that the Governor's original bill improved exploration economics & that as the bill changes, industry perspective changes. He pointed out that higher taxes do not encourage investment.

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Mr. Zager referred to previous notes examining the program under the 20/20 scenario. At that scenario, it lowers overall investment. If taxes were lowered, it would improve many projects. He stressed that credits are important, noting a tradeoff between tax and capital credits.

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Mr. Johnston questioned how in raising oil prices could affect the overall perspective. Mr. Zager conceded it definitely changes the entire situation.

Mr. Johnston observed that the oil prices overrule the tax structure. He speculated that if the prices are high, even at the 25/20 structure, investment would remain high. He noted that with current oil price assumptions, there is a great deal of pessimism opposed to marketplace behavior. He suggested that the marketplace viewed oil prices differently.

He pointed out the "exuberance" expressed by oil companies during previous testimony, concluding that if oil prices are as high as predicted, the tax structure would not be the issue.

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Mr. Zager added that the Legislature could control the tax structure but not oil prices. He recommended exercising "discipline" in establishing fiscal policies and thought that speculation on long-term oil prices might be inaccurate.

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Representative Kerttula observed that progressivity provides an ability to react to the price and that Alaska is a different field from the rest of the marketplace. Mr. Zager agreed that individual areas should be treated differently; however, the situation discussed is unique in Cook Inlet.

Mr. Barnes said that the Cook Inlet fields are challenged at operating margins. Mr. Dickinson observed that if the margin was low, profits would be low. In Cook Inlet, operating costs are high, which should be considered.

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Mr. Hanley referenced earlier comments by Mr. Johnston, noting that many companies have indicated interest in the State for oil economics. As the prices go up, the amount of recoverable oil also increases. He referred to a chart by EconOne, comparing the amount of exploration to productivity. He thought that the North Slope provides more opportunity for productivity. Raising the tax lowers the size of economic minimum field for companies.

Mr. Hanley observed global discussions regarding progressivity and that larger fields in a portfolio change the economic prospects; however, such fields are remote. If the State wants to dictate the amount a company can be guaranteed per barrel that makes discussions more productive. He pointed out the risks taken by companies at lower barrel prices. Those rates are weighed against risk and progressivity, different from existing fields and new exploration. He suggested a break-even point would be \$25 per barrel and that he did not see incentives for new development.

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Co-Chair Meyer referred the EconOne presentation, which uses the \$40-\$50 per barrel price range. He referred to a chart reflecting the decline in tax rates, as well as increased investment rates, showing a correlation. He pointed out that Pioneer Oil is active both in Texas and Alaska, observing the impact of timeline differences and permitting productivity. He mentioned earlier discussion regarding differences in the costs between the two areas, with Alaska more costly. He asked the PPT intended rate to encourage companies like Pioneer to compete with places like Texas.

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Mr. Foley referred to previous testimony, pointing out that if Alaska wants to encourage companies like Pioneer to

invest, they need to make fiscal terms more attractive. He compared the structure to Oklahoma, with severance rates dramatically less than that being proposed. Co-Chair Meyer suggested that a 20/20 rate would be more competitive to other states.

Mr. Johnston voiced concern with the comments concluding that lower taxes mean higher production, not compared to oil prices. He agreed that Alaska presents some challenges compared to other areas and that has always been true. He pointed out that those present at the table have proved that other circumstances obviously mitigate such challenges; otherwise, there would be no exploration in Alaska.

Co-Chair Meyer advised that for many years, only the three major producers existed in Alaska, noting that Shell Oil had just returned after a 15-year hiatus. He encouraged consideration of those factors.

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Mr. Zager interjected that the largest advantage to exploring in Alaska is lack of competition and that the access to land is easier.

Mr. Dickinson added that to "truly compare taxes" to investment, it would be wise to include a larger sample size.

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Representative Kelly referenced the 5/20 gap; he inquired if smaller oil companies had requested other considerations that were not brought forward in the Governor's bill.

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Mr. Barnes responded that the 5/20 was a complicated tax bill. He noted that the 5% calibrated with the current severance tax with intent to hold the 20% tax credit, a good stimulus for Cook Inlet. He pointed out that the status quo was not acceptable because there is not enough activity in the Cook Inlet. He pointed out greater levels of activity in the Lower 48. He stated the Governor's bill structure was an attempt not to lose more ground.

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Mr. Barnes discussed the potential benefit of higher oil prices, noting that companies would compete. He stated that other places in the world are not as burdened with costs, regulations and fiscal uncertainty. He stressed the need for capital investment.

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Mr. Zager noted that his company operates 75% of their production out of Cook Inlet and right now pays no severance tax. If there is sufficient capital, they could generate credits out of Cook Inlet, paying more in royalties.

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Representative Kelly concluded that smaller companies prefer to be "left alone". Mr. Zager responded that putting PPT into effect statewide would be the best policy for the State since it increases activity in Cook Inlet and creates new incentives in less productive areas.

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Mr. Dickinson interjected that Mr. Zager's comments reflected the Administration's analysis. He noted that the decision to invest would drive the tax structure in the future, which is the intent.

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Representative Holm pointed out that there are fewer companies in Alaska. He asked if changing the tax regime would realistically increase the number of explorers and investment dollars spent. He referenced earlier comments that the price was as influential of a factor as is the tax structure. He observed everyone's desire for more production, but voiced concern that everything discussed offers incentives to encourage further production.

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Mr. Zager advised that the oil companies follow patterns of success. To attract other oil companies, there must be success, an important component of taxation as is geology, infrastructure and regulations. Changing the structure of taxation does not guarantee success. He noted that the success of companies like Pioneer, attract other companies. He proposed that in five to ten years, there will be no further grass-root exploration on the North Slope and referenced new recovery technologies.

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Mr. Johnston thought several situations could overshadow tax changes:

- A strong signal to the industry that a gas pipeline was going in and making it clear to the industry that they would have a fair and equal access to that pipeline.

- If Alaska National Wildlife Refuge (ANWR) opens, it could dwarf other considerations.
- High oil prices could drive exploration. (If prices dropped below \$25 or \$30 per barrel, it would not matter what tax structure was in place).

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Mr. Barnes pointed out that some small companies have come and gone, with some investment in Cook Inlet. He thought small operators could be enticed. He thought it could be the "peak of new activity".

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Representative Hawker referred to economic differentials between fields. He spoke to field operation differentials and the definitions of the point of production and how that affects someone working outside of the North Slope.

Mr. Hanley noted that the bill currently defines the "point of production" for oil, at the point, which pipeline quality crude enters the system. Gas has a different definition relating to processing (separation of carbons) below downstream from processing and still needs treatment. Treatment is down-stream and processing is upstream. There is a need for new treatment and processing facilities and the treatment would not be eligible for credits, but would be treated as transportation. He expressed concern with that element and maintained that it should be the point where it is ready to enter the pipeline. He argued that it might be less economic than oil-10% gas, 12%-15% oil. There are no run gas economics statistics yet and that those are important numbers.

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Representative Hawker questioned why the Governor had defined a "point of production" like that. Mr. Dickinson responded that many downstream costs, the upstream is utilized in the net. He spoke to the downstream and upstream deduction and credit. The bill moved the point of production downstream; otherwise, under current statute, they would both be considered transportation costs. There were no requests to change the status quo before the legislation. The question remains how far downstream it should be moved; it is a policy call. If gas is found in the foothills, a facility would need to be built. The question remains if Alaska can get a line and should they provide a deduction.

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Representative Hawker summarized the difference between the GDT and one operating in the foothills. He requested some kind of differential for that exclusion.

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Vice Chair Stoltze questioned if the truce [with larger companies] has taken certain items off the table [which would benefit the smaller companies]. Mr. Hanley stated that the issues center on the \$73 million dollar allowance, which is more valuable to the smaller companies. Larger companies would benefit more from dismissing the \$73 million deduction. Generally, lower tax rates are better, but the allowance is significant and that offsetting the tax increases with credits, is more valuable to the larger players.

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Mr. Dickinson explained that the Department of Revenue hoped to encourage investment with the package through discussions with producers, focusing on that effect. The Governor included all the small players in those discussions. With new investment, new players and exploration are important.

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Mr. Zager maintained that Cook Inlet producers are being conservative and playing "defense" in that area.

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Mr. Foley interjected that the issues are not company size, but rather, where they are in the investment life cycle. Without investment considerations, the most leveraging aspects would be credits & tax exemptions. On the other hand, in the harvest mode, tax rate is critical. The Governor's bill fits the intent of all companies. The exemptions should not be discriminatory and there should be no sunset or phase out. All companies should benefit equally.

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Mr. Johnston agreed that the concerns differ according to where a company is in their life cycle. He believed that the structure proposed by the Administration is the best intent for balancing it all. He voiced concern with the \$73 million allowance and agreed that the sunset proposed would be severe, but worried about no sunset also.

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Co-Chair Meyer inquired what the recommended effective date was for a severance tax. Mr. Barnes spoke in support of an effective date placed in front of the enactment of the bill.

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Mr. Dickinson advised that the Governor's bill set the date at July 1<sup>st</sup>. He pointed out that both House and Senate versions offer a six-month period rule, based on current rules.

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Mr. Zager commented that July 1<sup>st</sup> should be the earliest date considered. Writing regulations could take time and affect the date. However, moving the date too far forward could give companies the opportunity to change their investment behavior.

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Mr. Johnston said Alaskans might be paying for each day it takes to enact the tax change; it could be as high as \$1 million per day. To be fair, it could be addressed earlier and he thought January 1<sup>st</sup> was reasonable.

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Mr. Hanley added that while incorporating a look-back, his company could pay less due to satellites. Generally, companies prefer the bill move into effect after it is passed, July 1<sup>st</sup> or later.

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Mr. Foley commented that from a fairness perspective, it would be best to make the effective date, the first quarter after it becomes law. From the company's perspective, the earlier the better because of transition capital spent.

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Representative Kelly asked if smaller companies were adequately considered during the discussions. He referenced the gas pipeline and the affect on utility prices.

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Mr. Dickinson pointed out that the 4<sup>th</sup> through 6<sup>th</sup> largest producers were present at the table and completely aware of that position in those negotiations. He noted the importance of meeting conflicting goals of production size. He suggested that when considering Cook Inlet, legislators should be aware of changes, such as tying exploration to

world prices and other complex issues. He warned that if prices move to reflect world markets, it must affect the tax structure. The smaller producers are less likely to support the proposed new structure, but is not prohibitive.

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Representative Kelly reiterated his concern. Mr. Barnes pointed out that the State is in a transition regarding Cook Inlet gas. He noted the process of negotiating a contract, and then receiving review and approval through the regulatory commission. He noted that the attorney general would advocate for lower prices to protect consumers, although, energy producers argue for higher than world-prices. He thought that having lower than world prices could send a negative signal. He stressed that the price in the Cook Inlet was still being determined.

[4:13:30 PM](#)

Co-Chair Chenault echoed concern about prices in Cook Inlet, offering less volume than the North Slope. Cook Inlet affects many Alaskans' lives.

[4:14:15 PM](#)

Mr. Foley provided a perspective of the small producer with an unestablished production. He pointed out the advantage of credits sold to other producers at a discount, asking legislators to consider ways of enabling them to retain full value of such credits.

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Mr. Johnston voiced support for that idea.

Co-Chair Chenault concluded discussion and testimony.

HB 488 was HELD in Committee for further consideration.

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#### ADJOURNMENT

The meeting was adjourned at 4:15 P.M.