

HOUSE FINANCE COMMITTEE  
April 28, 2006  
1:49 p.m.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [1:49:27 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 Reggie Joule  
Representative Mike Kelly  
Representative Beth Kerttula  
Representative Carl Moses  
Representative Bruce Weyhrauch

MEMBERS ABSENT

Representative Jim Holm

ALSO PRESENT

Representative Kurt Olson; John Zager, General Manager, Chevron-Alaska; Ken Sheffield, President, Pioneer; John Barnes, Production Manager, Marathon Oil, Alaska; Mark Hanley, Manager, Public Affairs, Anadarko-Alaska

PRESENT VIA TELECONFERENCE

Jim Weeks, Managing Member, UltraStar Exploration LLC; Frank Weiss, President and Branch Manger, Alaska Anvil

SUMMARY

**Smaller Producers and Explorers**

CSSB 305(FIN) am

"An Act repealing the oil production tax and the gas production tax and providing for a production tax on oil and gas; relating to the calculation of the gross value at the point of production of oil and gas and to the determination of the value of oil and gas for purposes of the production tax on oil and gas; providing for tax credits against the production tax on oil and gas; relating to the relationship of the production tax on oil and gas to other taxes, to the dates those tax payments and surcharges are due, to interest on

overpayments of the tax, and to the treatment of the tax in a producer's settlement with the royalty owners; relating to flared gas, and to oil and gas used in the operation of a lease or property under the production tax; relating to the prevailing value of oil and gas under the production tax; relating to surcharges on oil; relating to statements or other information required to be filed with or furnished to the Department of Revenue, to the penalty for failure to file certain reports for the tax, to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue as applicable to the administration of the tax; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the tax, and to the deposit of tax money collected by the Department of Revenue; amending the definitions of 'gas,' 'oil,' and certain other terms for purposes of the production tax, and as the definition of the term 'gas' applies in the Alaska Stranded Gas Development Act, and adding further definitions; making conforming amendments; and providing for an effective date."

CSSB 305 (FIN) am was heard and HELD in Committee for further consideration.

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CS FOR SENATE BILL NO. 305(FIN) am

"An Act repealing the oil production tax and the gas production tax and providing for a production tax on oil and gas; relating to the calculation of the gross value at the point of production of oil and gas and to the determination of the value of oil and gas for purposes of the production tax on oil and gas; providing for tax credits against the production tax on oil and gas; relating to the relationship of the production tax on oil and gas to other taxes, to the dates those tax payments and surcharges are due, to interest on overpayments of the tax, and to the treatment of the tax in a producer's settlement with the royalty owners; relating to flared gas, and to oil and gas used in the operation of a lease or property under the production tax; relating to the prevailing value of oil and gas under the production tax; relating to surcharges on oil; relating to statements or other information required to be filed with or furnished to the Department of Revenue, to the penalty for failure to file certain reports for the tax, to the powers of

the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue as applicable to the administration of the tax; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the tax, and to the deposit of tax money collected by the Department of Revenue; amending the definitions of 'gas,' 'oil,' and certain other terms for purposes of the production tax, and as the definition of the term 'gas' applies in the Alaska Stranded Gas Development Act, and adding further definitions; making conforming amendments; and providing for an effective date."

JOHN ZAGER, GENERAL MANAGER, CHEVRON-ALASKA, began by stating that his company stands by previous testimony on PPT. He referred to a handout throughout his presentation entitled "Chevron-Alaska Area" (copy on file.) For the overall tax credit rate, the 20/20 is in the best interest of the state. For Cook Inlet the 5 percent tax is more appropriate because it encourages additional vital investment. Regarding the standard deduction, Chevron-Alaska supports either the \$12 million credit or the current 5,000 BOEPD exemption. He opined that the \$12 million credit makes the most sense and is the most simplistic approach.

Mr. Zager addressed transition capital - Chevron accepts that it must be earned again on a 2 for 1 ratio. He urged extending the time period to 10 years. He noted an error in the effective date of April 1, which should read July 1. He addressed challenged oil, where an additional credit is warranted due to the large resource waiting to be developed.

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Mr. Zager addressed the abandonment expense. Chevron-Alaska believes that it should be prorated and that it should be a qualifying expense.

Co-Chair Chenault asked if that issue should be addressed as a special piece of legislation. Mr. Zager saw the benefits of rolling it into this bill.

Mr. Zager talked about gas storage costs, which should be explicitly recognized as qualifying costs. It is not explicitly covered in the bill. The alternative is to drill many more wells at a great cost.

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Representative Kelly pointed out that for pump storage, the product brings a higher price at retail.

Mr. Zager responded that in the Cook Inlet, where gas is priced on long-term contracts, there is no differentiation for gas in storage vs. gas produced out of wells, in terms of price. Gas storage is a process of the treatment charge - it's what is required to get the gas ready to meet the market. Henry Hub prices are a component. It's the most capital efficient way of meeting that obligation.

Representative Kelly asked if it is a two-part process. Mr. Zager explained "peaking", which is only in effect if another producer fails to meet its obligation. Representative Kelly spoke of extreme situations.

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Mr. Zager spoke about the progressivity provision on Slide 3. He said that Chevron-Alaska does not support progressivity, but if it has to be, then it must be logical and sensible. He referred to the reason the state wants progressivity: to get a fair share when there is a price run up accompanied by large profits. It is not to raise taxes if the price increase is gradual over time and is accompanied by increases in costs and thus not accompanied by increased profits.

Mr. Zager described the problems with progressivity as currently proposed. The trigger price tied to ANS is not inflated, and over time costs will rise. High cost oil will be produced in increasing quantities. Over the long term, a fixed trigger price will not work as intended and is grossly unfair.

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Mr. Zager noted that in the current Senate bill, at \$250, the tax is 100 percent. He cautioned to be careful about tying into one number that is not connected to profitability.

Co-Chair Chenault inquired if Chevron-Alaska is in favor of a long-term oil contract. Mr. Zager replied that the 20-year number has nothing to do with his company.

Representative Kelly asked where the line should flatten out. Mr. Zager replied that he would cover that shortly.

Mr. Zager continued with Slide 4, concern about costs. The Cambridge Energy Research Associates report entitled "Rising Capital Costs Bear Down on E & P Profitability" was issued on 4/24/2006. He read several quotes from the report:

Higher oil and gas prices have encouraged a wave of new investments for discovering and developing resources. However, soaring costs of exploration and production

(E&P) programs and the volatility of energy prices have left many producers uneasy about future profit margins.

E & P capital costs are accelerating and have increased approximately 42 percent from 2000 to 2005 (third quarter) compared with a 15 percent rise in the Consumer Price Index.

Increasing costs and energy price volatility are having an impact on investments. Oil and gas projects that were profitable at \$22 per barrel in 2002, now require \$35 per barrel to achieve similar returns.

Mr. Zager pointed out that the oil industry in Alaska is made up of more than just the producers - service companies, drilling companies, and engineering firms - and they, too, would like a fair share. Costs are going to go up along with oil prices. He emphasized looking at the net effect, not just pegging the index with the WTI.

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Mr. Zager referred to Slide 5, "Proposal: Progressivity Based on Net Profits". Each company already will calculate a net profits every month and divide them by production to get a "net profits/boe". The trigger point should be set and the escalation factor should be based on the net profits/boe. He suggested that the trigger point be set at \$50 per barrel with 1.0 percent for each \$5 increase in profits. The original Senate CS adopted this methodology. It would provide a minimum rate of 20 percent tax on net profit, and a maximum general rate of 30 percent. The cap is reasonable and would give comfort to producers.

He spoke to the advantages of progressivity based on net profits. It would be self-correcting for inflation, costs, different commodities, and high cost production, as well as avoiding the discussion regarding WTI vs. ANS. Progressivity would capture a windfall upside without creating unintended consequences. The system would be fair to everybody, since taxes and progressivity will only be attached to actual company profits.

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Mr. Zager noted that Slide 6 shows examples of a net profits trigger. In the first windfall case, the price was up and the costs were fixed. The second case shows that there are increased profits when prices go up and costs go up. In the final case, which is an extreme end point, the profits are constant and if the price is up, the costs keep pace. Under this proposal if producers could cut costs, the state would see an increase in revenue without an increase in oil price.

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Mr. Zager concluded with Slide 7. Chevron-Alaska believes that Net Profits is the fair and logical method to implement progressivity. The Cook Inlet 5 percent tax is in the best interest of the state. He urged a cautious approach to increasing taxes. He voiced appreciation for the hard work and diligence of the legislature on this historic bill. He pointed out that Chevron has been in Alaska for many years and intends to continue an active exploration and production operation in the state if a sound and stable fiscal regime can be offered.

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Representative Kerttula asked what would jump the cost up to \$57. Mr. Zager replied that was intended to be an illustrated example. He related a 20-year extrapolation. He maintained that there are a lot of inflationary factors.

Representative Kerttula asked if Mr. Zager sees a difference between the large and small producers. Mr. Zager replied that it would be hard to generalize. To some degree it matters on a worldwide scale. In Cook Inlet, the worldwide scale is not a factor. He mentioned cost inflation, which continues. Representative Kerttula asked if Chevron's costs have increased. Mr. Zager said yes, and they are representative of the industry as a whole.

Representative Kelly summarized that Chevron prefers the net to the gross on progressivity. He asked if they use WTI of \$60 before progressivity hits and if it lays over at about \$110. Mr. Zager said that is correct for both WTI and ANS. Profitability is not a one-to-one relationship between oil price and "what you get at the end of the day" due to many factors.

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KEN SHEFFIELD, PRESIDENT, PIONEER NATURAL RESOURCES-ALASKA, expressed thanks to the members. He referred to a handout from Pioneer throughout his testimony (copy on file.) He shared several of Pioneer's projects. He related that in Pioneer's portfolio, as seen through the governor's bill, there is a modest incentive for investment. The governor's bill aims to strike a delicate balance between incentives and taxes.

Mr. Sheffield addressed tax rate. For oil, the recommendation is a 20 percent rate, for gas, the 7.5 percent rate, and for Cook Inlet, 5 percent. The outcome of the bill could affect Pioneer's decision on a Cosmopolitan project in Cook Inlet.

Mr. Sheffield talked about base allowance. SB 305 contains a 5,000 BOPD equivalent credit capped at \$14 million. He spoke of value deterioration and the calculation methodology as a disincentive.

Representative Kerttula asked for clarification on that point. Mr. Sheffield explained how the formula works - multiply 22.5 percent by 5,000 barrels per day, divided by the amount produced, and multiplied by the net income. This equals a tax credit much smaller than the cap. He offered to go over it later on using numbers.

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Mr. Sheffield addressed the 10-year sunset provision, which is problematic for explorers.

Mr. Sheffield recommended the House Resources CS methodology. It is simpler and contains flat tax credit currently at \$12 million. He requested several changes: increase \$12 million to \$14 million, eliminate the annual investment requirement, and eliminate the sunset provision.

Co-Chair Chenault asked if Pioneer would propose a trigger on the day of production. Mr. Sheffield replied that Pioneer is looking at a 10-year window if the sunset provision is required.

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Mr. Sheffield spoke to refundable credits. The House Resources CS contains \$10 million in annual credits. He called it a significant incentive to explorers with no current production. There's a thin market for credits and few buyers. It would allow explorers to receive full value for some credits at no extra cost to Alaska.

Pioneer requests an increase of the credit to \$30 million annually and to allowing credits to apply to lease bonus and rentals.

Mr. Sheffield addressed transition capital and the sunset provision. Pioneer has invested over \$100 million in the state and will easily spend the 2 for 1 to earn back credits, but would be unable to utilize capital credits earned with 2:1 in 7 years. It would be a disincentive to invest beyond 2:1, so Pioneer requests no sunset after credits are earned. If a sunset is required, they recommend allowing 7 years following the first utilization of the credits.

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Pioneer does not support the concept of a progressivity surcharge. If required, it should be based upon net profits consistent with PPT structure. He recommended a \$45/barrel net profit trigger in the SB 305 draft version.

Dr. Sheffield spoke to the point of production for gas. Gas treatment facilities should qualify for credits because the facility is required for marketable gas. There should be equal treatment for gas vs. oil.

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JOHN BARNES, PRODUCTION MANAGER, MARATHON OIL, ALASKA, pointed out that Marathon Oil's activities are focused on Cook Inlet Natural Gas. He observed that the industry has come together on many important aspects of the production tax. He referred to page two of a handout provided to the Committee (copy on file), which compares Alaska to the North American oil and gas business. He noted that WTI has risen. He referred to North American Rig Count and maintained that there is a strong correlation to oil price. The rig count in North America has risen from 700 to 2,000 working drilling rigs since April of 2001. The rig count in Alaska has not risen similarly nor been driven by product price.

Mr. Barnes referred to page three - "PPT - A World Class Tax Structure". He pointed out that Cook Inlet is small compared to the North Slope and its issues are different, thus the need for incentivization. He maintained that Cook Inlet needs to be addressed differently, and observed that SB 305 has done so.

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Mr. Barnes reviewed page four regarding Cook Inlet gas concerns. He observed the difference between Cook Inlet gas and oil. Gas is sold at a discount and there are strong drivers to keep the cost low. He discussed why capital is not being drawn into Cook Inlet. He spoke in support of a reduction in the tax.

Mr. Barnes did not support progressivity for gas. If it has to be used, then it should be based on net and not on gross and based on actual transaction value, not Henry Hub.

Representative Kerttula referred to the Alaska rig count. She observed that there was not investment under the ELF and questioned if further reductions would result in more activity. Mr. Barnes stressed that many factors apply: some fields pay taxes under ELF, some don't; some companies can factor in tax structures into investment decisions; permitting is a factor.

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Co-Chair Chenault questioned if there is a difference in the cost of Alaskan and Texan rigs. Mr. Barnes acknowledged that there are significant differences and that Alaska is a much more costly environment.

Co-Chair Chenault asked about a certain category of rig. Mr. Barnes responded that they were not considered.

Representative Weyhrauch summarized that the state of Alaska must take it on faith that lower taxes will result in more exploration, since there are no contract agreements. Mr. Barnes stressed that he represents a gas company in the Cook Inlet.

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MARK HANLEY, MANAGER, PUBLIC AFFAIRS, ANADARKO-ALASKA stressed that Anadarko's goal is to have a fair tax system that encourages more exploration and development and increases production. He noted that there would be a big tax increase on existing production, but Anadarko supports the governor's proposal because it is balanced by exploration incentives. The changes have been measured against the existing system. He observed that exploration has not occurred while the price remained around \$20 a barrel. Now that the price has gone up, the prospective for exploration has increased. He suggested that progressivity start at higher prices, \$60 or higher. He spoke in support of a 20 percent tax rate. Anadarko supports the Senate approach for gas, since it is less economic than oil.

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Representative Kerttula asked why the tax should be reduced to 7.5 percent and the credits left the same. Mr. Hanley emphasized that credits help the economics and it is a balancing act.

Representative Kerttula questioned if keeping the tax up and the credit rate up would be the most affective.

Mr. Hanley emphasized that a lower tax rate is the most important. The point of choice is a policy call. Representative Kerttula felt that the balance was not found in the Senate version of the bill.

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Mr. Hanley felt that the trigger point needs to be higher on equivalent basis than it is at \$50 per barrel. He spoke in support of a July 1, 2006, effective date. He spoke to the \$73 million allowance - the House approach of a \$12 to \$14 million credit is preferred. He did not want a sunset on

the credit. He suggested allowing the 10-year sunset provision to begin on the start date of production. He spoke in support of the Senate transition allowance, the 2:1, which has a sunset of 7 years. He would like to see that sunset extended. There are two issues. A company could run out of time to use the allowance. The allowance cannot be used if under \$40 per barrel of oil. He suggested once the allowance is earned, it should be taken on a schedule. If the \$40 is off, it should be rolled forward.

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Representative Kerttula felt that lack of a sunset would put the legislature in a precarious position.

Mr. Hanley clarified that there were two different sunsets. He emphasized how essential timing is with the credits and the allowance. He explained that Anadarko timed their investments wrong, since they have two projects for which they would not be allowed to capture the credit. A transitional allowance would rectify this, but there is still a problem with when they can be taken. He noted that there is a difference between when they can be earned and when they can be used.

Representative Kerttula reiterated concerns with credits rolling forward indefinitely.

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Mr. Hanley spoke to the point of production. The gas treatment facility should qualify because it is a cost. Anadarko has agreed to support Senate language that would allow part of the treatment facility as credit, but not as a tariff. He voiced support for exploration incentive credits and more opportunities to buy back credits for companies that don't have production.

Representative Kerttula asked if there was any reason not to have a flow-through credit. Mr. Hanley felt that Anadarko would support the concept.

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Representative Kelly observed that the price of oil has been low before and that it may be low again. He questioned how to include and implement a floor.

Mr. Hanley observed that if there is a floor and the low and high sides are taken away, then investment would be affected. He suggested that protections should be implemented at low price environment. He suggested paying down debt and buying back stock to keep investment, and

saving money during the high times. He stressed that the windfalls should be set aside during the high times.

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JIM WEEKS, ULTRASTAR EXPLORATION LLC, testified via teleconference. He observed that Ultrastar is a very small, independent explorer, formed in 2002 for the purpose of exploring and developing leases on the North Slope. UltraStar is 100% owned by Alaskans.

Mr. Weeks observed that he had testified and listened to a lot of testimony on the Governor's original proposal, in several committees. He observed that the bill has gotten more complicated, but that Ultrastar could support it with a few modest changes.

The Administration's original proposal was for a \$73 million base allowance for net profits below which there would be no PPT, with no sunset provision. The Senate, rightfully so in my view, changed that to 5000 barrels of oil per day, but established a sunset date of 2016, after which the allowance will expire. I question the need for a 10-year time limit after which the tax exemption will expire. UltraStar is a small, start-up company that is poking around the fringes of existing units and known reservoirs. Our leases are too small to stand alone, so access to existing facilities, owned mostly by the major producers, is the only way we can develop anything we might find. It took our sister company, Winstar, 6 years to negotiate access with the KRU to enable the drilling of the well that was completed in 2003. UltraStar has been in negotiations with the PBU for over 3 1/2 years now to get seismic data and facility access to enable the drilling of our Dewline Prospect. It takes a long time for these things to get done, and I question why our investments should be put at risk with this relative short sunset provision, whereas current producers can use the allowance immediately after the effective date of the bill, and receive the full ten years benefit. During this debate, I've heard more than once about the need for a "level playing field". No sunset provision does indeed level the playing field.

Mr. Weeks observed that a 10-year time field for everyone would level the playing field.

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Next is the issue of the effective date for the PPT. We agree that July 1, 2006 is an appropriate date, but also suggest that taxpayers should be given a 6-month "grace period" to come into complete compliance. I'm

not suggesting that any taxes not be paid, or be paid late, but rather that companies be allowed to get their act together within 6 months before the stiff penalties and interest provisions apply. During this period, any adjustments can be made for under and/or over payments. This bill requires a complex calculation of the appropriate amount of tax, and conforming to it will take some time, even for the current producers with tax accountants and attorneys on staff. UltraStar hopes to have production in the future, and we will be glad to pay our fair share of taxes, but we will need to contract for tax accounting and legal services on the street at market rates, and frankly, I don't know whether or not we can even find them. Anyone we hire will need to get familiar with the law and regulations, and develop the algorithms needed to comply with them. This will take some time, and I think that 6-month grace period is the minimum amount of time necessary to assure compliance before the penalties and interest starts. Obviously, to accommodate production not yet on stream, the 6-month grace period should begin when taxes under the PPT are due, and not necessarily July 1, 2006.

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Mr. Weeks commented on the 20/20 provisions and the progressivity feature of the bill, and their relationship to the gas pipeline.

I graduated from the University of Wyoming with a Petroleum Engineering degree in 1969. In the fall of 1968, nearly 40 years ago, as a class project, we designed a gas pipeline from Prudhoe Bay to Chicago. After graduation, I joined ARCO, and in the early 70's, spent several years working in project engineering and construction, based in Dallas, headquarters of ARCO's North American operations. I spent hours talking to the real life engineers who spent nights and weekends at the office, sleeping on cots, designing a gas pipeline from Prudhoe Bay to Chicago. For seven years in the late 80's and early 90's, I was in charge of all of ARCO's Prudhoe Bay interests, including the commercialization of natural gas. Except perhaps for Governor Hickel, I've probably worried longer than anyone in the State about getting North Slope Gas to market.

Mr. Weeks felt that the proposal has never been closer to coming to being realized.

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The legislature is to be commended for the fair and full hearing the PPT has been given. Many thankless hours of hearings, reviewing complicated drafts, and debates have been spent by you and your colleagues in both houses, and in my mind you all deserve a medal. During the process, I've heard more than once that there is no linkage between PPT and the gas line project. But as the Governor said this week, there is indeed linkage between the two. I think we all know that.

Also of concern to me as an Alaskan who hopes to build a business here that my kids and their kids can carry on, is the "so what" attitude I've heard from several legislators. They say "so what" if the big guys walk from the gas line deal over disgust with the PPT. Causing them to walk from the gas line as a result of the PPT would be a huge disservice to the State of Alaska. To forego the long term benefits of the gas line in favor of short-term higher taxes in the PPT would be a very mistaken, shortsighted approach. Therefore, I encourage you to adopt the Governor's 20/20 proposal, with no progressivity. Twenty percent of the net profits on seventy-dollar oil is progressive enough. Oil companies compete worldwide. The governments of China, Russia and the Middle East don't put their domestic oil companies at a competitive disadvantage with windfall revenue or profits taxes. Why should the State of Alaska? However, if you feel compelled to take a bigger share at higher prices, then that bigger share should be on net profits, not gross revenue. Be careful, though, lest they walk.

Mr. Weeks observed that they are as close to a gas pipeline project than they have ever been and cautioned not to throw out the baby with the bath water.

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FRANK WEISS, PRESIDENT AND BRANCH MANAGER, ALASKA ANVIL, testified via teleconference. He gave a brief history of his company and his involvement with it. He maintained that an industry must have consistent taxation. SB 305 is a message in conflict with Alaska's staying open for business. At today's prices, the governor's bill will increase taxes paid into the state by producers. He questioned how high a tax rate is high enough. He spoke strongly in favor of the governor's bill and against SB 305.

SB 305 was heard and HELD in Committee for further consideration.

ADJOURNMENT

The meeting was adjourned at 3:21 PM.