

HOUSE FINANCE COMMITTEE
May 5, 2006
1:52 P.M.

CALL TO ORDER

Co-Chair Meyer called the House Finance Committee meeting to order at 1:52 p.m.

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

ALSO PRESENT

Representative Ethan Berkowitz; Representative Paul Seaton;
Representative Les Gara; Representative Norman Rokeberg;
Representative Ralph Samuels; Representative Carl Gatto;
Robynn Wilson, Director, Division of Tax, Department of
Revenue; Dan Dickinson, Consultant, Tax Division, Department
of Revenue; Robert Mintz, Attorney contracting with the
Department of Law; Larry Dietrick, Director, Spill
Prevention and Response, Department of Environmental
Conservation

SUMMARY

CS SB 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.

CS SB 305(FIN)am was HEARD & HELD in Committee for further consideration.

#sb305

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.

1:53

Representative Chenault continued discussion on #24-GS2052\N, Chenoweth, 5/4/06.

1:53:44

LINDA WILSON, DEPUTY DIRECTOR, PUBLIC DEFENDER AGENCY, DEPARTMENT OF ADMINISTRATION, continued discussions of the proposed committee substitute for SB 305. She noted that page 22 clarifies that activities do not need to be "physically located on or near the premises of the lease or property from which oil or gas is recovered in order for the cost of the activity to be a cost upstream of the point of production of the oil or gas."

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DAN DICKINSON, CONSULTANT, TAX DIVISION, DEPARTMENT OF REVENUE, explained, in response to a question by Representative Kerttula, observed that foreign flagged vessels cost approximately one-third [the cost of an American flagged vessel].

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Mr. Dickinson observed that value at the wellhead is being decreased due to higher costs regarding the local content issue. He recalled an occasion where a system of a ship, which was purchased abroad had to be torn out and replaced by an expensive American system because of the domestic content issue; the question arose as to whether it should be deductible. He did not think that "those kinds of tests are really pertinent to what folks are trying to accomplish here."

Ms. Wilson referred to page 22, lines 26 - 28, which lists items that are not deductible. Subsection (b) was expanded to include royalty equivalents.

Representative Hawker referred to deductions "in lieu" of taxes on page 22 (B).

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Mr. Dickinson noted that the Administration supports an amendment, which would allow payments in lieu of taxes, as well as the taxes listed since it represents the cost of doing business in the state of Alaska. Representative Hawker stated that he would endorse the provision.

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Ms. Wilson went on to outline important changes. On Page 23, line 16 through 18, language from the Senate Bill was included to address transactions that may not be an arm's length:

for a transaction that is an internal transfer or is otherwise not an arm's length transaction, expenditures incurred that are in excess of fair market value;

Ms. Wilson noted concerns about inter-company transfers, and explained that they did not believe that amounts in excess of fair market value would ever be allowed because they are not "ordinary and necessary". The language clarifies the excess of fair market value and was included in the Senate version.

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Ms. Wilson reviewed lines 19 through 22, which clarifies that, if a business is purchased, the purchaser does not receive a credit for all of the assets. The language was adopted from the Senate version.

Representative Hawker observed that there is a broad exclusion. He summarized that the language would exclude the purchase of intangible assets. He questioned if a producer or explorer relocated and purchased a company in another state in order to bring a drill rig to Alaska, would they be precluded from deducting the cost of bringing the rig on site. Mr. Dickinson confirmed that the legislation appears to disallow such a deduction. He explained that purchases corporate assets, not the corporation itself, such as for federal tax purposes, would be disallowed.

Representative Hawker pointed out that if the same company sold the drill rig it would be deductible, but since drill rigs are often built on joint venture arrangements, they are often acquired by buying out the joint venture, solely to bring a portion of the assets to Alaska.

Mr. Dickinson explained that the language was meant to address situations where assets changed hands through large acquisitions, such as when a major corporation is purchased by another corporation with huge assets. He noted a recent acquisition where 42 percent of the assets in Prudhoe Bay changed hands. Representative Hawker noted that he would not

want to allow "rolling purchases", where companies take turns holding assets for the sake of deductions. Mr. Dickson confirmed that rolling purchases were disallowed.

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Representative Hawker referred to line 3 on page 23, the issue of negligence. He asked for a clarification of ordinary negligence vs. gross negligence. He concluded that an exclusion for simple negligence, such as a bucket of paint being spilt on a control modular would be disallowed. He noted that such accidents are ordinary and expected in the course of conducting business. He questioned the potential disallowance and suggested that a margin is being created that is far down the scale of negligence; the intent is to set a bar on acts of gross negligence, such as oil spills.

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Mr. Dickinson acknowledged that "gross negligence" might be appropriately used to indicate the intention to prohibit cases of fraud.

Representative Hawker asked whether catastrophic oil spill standards should be used such as the ones established in the House Resource Committee version. He pointed out the severe level of damage that could be done and the cost of cleanup.

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Ms. Wilson noted that House Resources version defined catastrophic oil spill and addressed marine waters. She suggested that the language be clarified, if it is the intent of the Committee to address spills on land or inland waters. She pointed out that catastrophic has a statutory definition (100,000 barrels), which was half of the Exxon Valdez spill. A more recent oil spill was 6,000 barrels.

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Representative Kerttula noted that negligence has a broad range. She pointed out that even simple negligence could be fairly profound. Mr. Mintz stated that negligence was associated with behavior that was not reasonable. He contended that gross negligence was a high standard. He suggested that it should be considered in terms of the consequences related to gross negligence. For example, using terms like "disaster" resulting from gross negligence.

2:11:09 PM

Ms. Wilson addressed Subparagraph (O) on line 23 of page 23, which clarifies that the progressivity tax is not deductible

for purposes of the PPT. Subparagraph (T) on line 24 through to page 24, would allow costs incurred for abandonment of facilities from old production. It provides a ratio calculation both before and after the effective date and the amount deductible. The language came from the Senate version.

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Representative Kelly inquired how this version compared in the world view of taxing authorities and contracts. Mr. Dickinson observed that a normal situation might typically include the costs of concluding a business as well as the costs of conducting business. Responding to a follow-up, he stated that he was not familiar with another situation qualified by a ratio pertaining to abandonment. He stated he could research the question.

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Representative Hawker referred to page 24, subsection (e), determining deductible expenses. He questioned whether insurance recovery was added back, and suggested adding language to make that more clear.

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Ms. Wilson stated that they believed the language was clear, but indicated that they would be happy to work on the language. Mr. Dickinson pointed out that the section was structured in statute (.160), which looks at typical industry practice. He felt that the majority owners would ensure that settlements were not kept by the operators. He concluded that the language was determined by how business was actually done on the North Slope and fair industry practice.

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Ms. Wilson referred to Page 26, lines 3 through 5. The subsection pertains to the Department writing regulations. Senate language was included, allowing the Department to apply concepts of Internal Revenue Code: U.S.C. 482. She then pointed out lines 15 through page 27, referring to a base allowance credit of \$12 million. This provision was included in HCS 305 (RES) and was modified in the CS on line 20 to "not exceeds one-half of the amount of that expenditure". This is the "gold plating" fixed previously discussed.

Representative Hawker contended that the provision did not seem to help small producers as intended.

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Representative Hawker observed the punctuation on page 26, line 9: "ordinary and necessary" and pointed out that it differed from page 21, (c): ordinary, and necessary. He suggested that the interpretation is a different statement [on page 21] than defined on page 26. He maintained that the intent on page 21 is to make sure the costs are both direct, and ordinary, and necessary. He suggested the new punctuation seemed to separate the terms, rather than join.

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Representative Kelly agreed with Representative Hawker on his concern regarding how credits were affecting the smaller explorer, non-producers. He proposed that smaller explorer, non-producers would have difficulty taking advantage of these credits. Mr. Dickinson stated that they would be happy to work with legislators and use earlier versions of the bill.

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Ms. Wilson referred to page 27, lines 3 through 6: application of rolling credits. She noted that if a person is in production, they can take the credit for 10 years. If a person is not producing commercial quantities, but will begin commercial production in two - three years, their 10 years starts at the time they begin commercial production. The \$120 million is the sum of \$12 million for ten years; this is the amount allowable over the entire life of the credit.

2:22:02 PM

Ms. Wilson referred to page 29, line 5, which changes the surcharge from \$.03 to \$.04 per barrel.

Representative Kerttula expressed a lack of clarity about NGL's, and the mechanical separation of the fluids. Mr. Mintz explained the treatment of NGL's had not changed from earlier versions of the bill. He observed that NGL usually refers to liquid hydrocarbons that are extracted from gas at a gas processing plant. He stated that under current law, NGL's were considered gas; as a result of the change in definition, NGL's would be upstream of the point of production and would be considered and taxed as oil under the bill.

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Ms. Wilson reviewed the definition of "gross value at the point of production" on page 5, lines 1 through 5. Representative Kerttula observed that these were current regulations. Ms. Wilson went on to refer to the definition

of "gross processing plant" on lines 20 to 29. On page 31, Ms. Wilson referred to dehydration, and its use, in the definition of gas treatment. Line 5 to 9 clarifies that gas treatment does not include dehydration. There is a new definition on page 31, lines 10 through 16. Private royalty production has a different tax rate under the bill. There was a question about surface owners that receive royalties and how they would be treated under the bill.

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Mr. Mintz explained that a royalty was a share of production from an oil and gas lease. There are two types: one retained by the owner of the land, usually the State; and overriding royalties, which the leaseholder sells to someone else. The latter is subject to the same tax as the rest of the production, but the bill provides a special and typically lower tax rate for royalties owned by the land owner. There are a few situations where a royalty is offered to a surface owner in exchange for use of the surface for oil and gas operations. The Committee was asked to extend the same treatment to that royalty as to lessor royalties. The definition expands the category of royalties to include the situation of a surface use agreement.

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Ms. Wilson noted that private royalty rates are found on page 3, section 011 (f). The term "landowner's royalty interest" has been used rather than "lessor".

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Ms. Wilson continued to review the definitions on page 31. She noted that a definition of "point of production" was added on line 19 to 32. This does not change the intent. She drew attention to page 34. The bill in its various forms provided a transition period of six months, with a seven month true-up. This did not include oil spill surcharges. Lines 12 - 23 address the payment of surcharges, and the rest addresses the filing. They will be handled the same way as the rest of the PPT provision, with a six month transition and a 7 month true-up. She noted that page 36 contains an effective date of July 1.

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Ms. Wilson referred to slides that outline comparative revenues (copy on file.) Ms. Wilson reviewed the slide: In terms of Cumulative Severance Tax, and noted that the status quo was represented by the blue line, the Governor's bill - red line, and the House and Senate bills - the yellow and green lines. She noted the similarity in the latter versions of the bill.

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Representative Kerttula referred to previous testimony that indicated that \$8.33 cents is the fixed barrel lease deduction and questioned how it was derived. Mr. Dickinson observed that the testimony was provided by Mr. Marks. He clarified that \$8.33 is the average cost. There are five different categories of costs. Four models were constructed, with heavier or lighter oils and their value. He reiterated that \$8.33 was an average capital expenditure per barrel.

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Ms. Wilson reviewed the next slide: Regarding the Annual Severance Tax, and noted that the sudden rise in the line at 2016 was a result of the transition sunset provision. She referred to the another slide, which pertained to \$60 oil and noted that the rise was not a pronounced at the sunset. At \$70 per barrel oil, there are collections of just under \$2.5 billion.

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Ms. Wilson discussion progressivity represented in the slide by a green line. The top line represented the House Resources CS, which is the highest. The slope in the HCS (RES) version is .003, which makes a sudden increase at \$110. The lowest line was the Senate Finance proposal, which was on a net of .001 and started at a trigger of \$45 per barrel net. The turquoise line represented the Senate progressivity based on gross. The dark blue line represented the current HCS (FIN) version, with a slope of .0025, which would be triggered at \$35 per barrel net, which is earlier. There had been interest in a line with a slope of .0025 and a later starting point. She explained that the similar point with \$130 would have a progressivity of .00245 per barrel. She explained that the difference between the blue and yellow lines was based on using the same slope and moving it to a lower trigger point. The green line was higher, even though it is deductible, due to the higher slope with the deductibility, and the fact that it was on gross vs. net. She concluded that the green line could be viewed at .003, which would be .0024 with deductibility. The green line would remain above the blue line because it would be applied against gross, which is higher than net in the case of the blue line.

2:39:17 PM

Mr. Dickinson discussed a chart listing Costs and Prices, which came from a February 23rd presentation to the House Resources Committee (copy on file.) The chart listed parameters in the modeling: \$100 million per year in

exploration expenses for the next 25 years; every barrel produced had a capital cost association as it was produced; there was a \$3.5 development capital on 2/3 of the conventional oil; known "heavy oil" had an \$8 per barrel developmental capital costs; and there is a \$3.50 developmental capital cost on new conventional oil. Finally, he noted that operating costs were \$3 for conventional oil and \$5 for heavy oil. He pointed out that for new heavy oil, the value was discounted. At \$70 per barrel oil, heavy oil would be \$56. Costs and prices were in real 2005 dollars. He concluded that if one calculated the value of a barrel of oil, with a mix between heavy and light oil, one could derive an average of \$8.33, but it would be just a guess.

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Representative Hawker referred to a proposal, which is not currently in the legislation, to allow the state to buy back credits from explorers of extremely small producers that are investing more money than they can recover as credits against production. Credits would be transferable, but the state of Alaska would still be responsible for the whole dollar. The House Resources version had a \$10 million buy back provision. He proposed putting the provision into the House Finance version of the bill, as an incentive to smaller producers. He noted that the \$10 million level seemed low, and recommended raising it to \$25 to \$35 million.

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Ms. Wilson responded that the risk, in falling oil prices, is that the State would be "on the hook", not only for decreasing PPT revenues, but also to refund tax credits. The risk at a \$10 million would be less than at the higher level.

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Mr. Dickinson agreed and pointed out that at \$10 million, with 8 users, the risk would total \$80 million; at \$25 million the risk would increase to \$200 million. He observed that the cost to the state could be high if every producer requested this provision, and there were heavy investment and a subsequent price correction. He noted that at one time an amendment was introduced to allow credits to be used against income tax. He explained that since the state income tax runs on factors an explorer could owe income tax due to their worldwide activity even though they have no production. He noted that an amendment to allow transfer of credits to purchase other resources failed in the Senate.

2:46:58 PM

Representative Hawker questioned if the response was skewed to the left hand bar of the chart, where the State is entitled to such an amount of production tax that not one of the eight users would be able to utilize their credits. He proposed that this would require a very small value and was an unlikely scenario. Mr. Dickinson contended that the price used in the modeling was substantially higher than the State received in the 1980's and early 1990's. He observed that at the time the State was receiving \$18 - \$19 per barrel oil, production was 2 million or four times higher. He pointed out that in 1999, when prices were \$12 per barrel, the State still produced hundreds of millions in revenue, which would not occur under PPT. He proposed that if prices were to fall, the scenario he described might be likely.

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Representative Hawker referred to multi state organizations and observed that Alaska would be the first to adopt a net profits tax, although this was a tool used worldwide. He asked if other states might interpret the net profit production tax as a tax on income earnings, rather than a tax on production. He asked why they would not place a disclaimer in the bill that this was indeed a production tax.

2:50:22 PM

Mr. Dickinson responded that the tax would be examined in detail. He maintained that it is a production tax and not an income tax. He stated that in measuring production value, elements have been added that resemble income elements. He noted that they were measuring the production value in a way that recognizes the state's greatest problem, which is the lack of investment incentives.

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Representative Hawker observed that the State did not wish to compromise the industry. Ms. Wilson noted that federal taxable income is used with an add back for state income tax in order to provide an equal playing field for all the states to be proportioned, which is a simple mechanism for domestic companies. However, since the industry is on a worldwide basis and deductions are taking place in other countries, it is more difficult to determine government take, particularly in Middle Eastern countries. This must be analyzed on a functional basis. She noted the Supreme Court case in the Gulf, which dictated that one must examine the essence of the tax and how it behaves and whether there are deductions, which she proposed made it an income tax. She felt that it could be considered an income tax and a statement that it was not might threaten their position. She

expected other states to examine the intent of the bill and not just its label.

2:54:53 PM

Representative Hawker did not think that their position would be compromised by providing a hook for those that "step up to the plate" with another \$2 billion dollars a year. Ms. Wilson noted a proposed language change to "severance" rather than "production" tax. She suggested this would be preferable to stating that it was not an income tax.

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Mr. Mintz stated he did not know the motivation for changing the label of the tax. He agreed with Ms. Wilson's concerns.

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Representative Kelly questioned if making the \$200 million in credits only available to explorers and small producers would prevent the extreme scenario.

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Ms. Wilson responded that limiting potential tax refunds would limit risk from the Administration's stand point; it could be done based on levels of production.

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Representative Kerttula asked what rights would apply, and noted the proposed change to \$.04 per barrel contained in the current bill. She also asked if the liability ought to be limited to catastrophe.

LARRY DIETRICK, DIRECTOR, SPILL PREVENTION AND RESPONSE, DEPARTMENT OF ENVIRONMENTAL CONSERVATION, responded to questions. He began by addressing the surcharge issue. He explained that there are two surcharge accounts. Both are based on crude oil production, not the price per barrel. The first account is the Response Account, with a surcharge of \$.02 per barrel; it is a \$50 million cash reserved used for response to catastrophic spills. The \$.02 surcharge that fuels the account only incurs when the account drops below \$50 million. The account was created in 1995. The surcharge was implemented for approximately three months before the account rose above \$50 million and it was discontinued and has not been implemented since.

Mr. Dietrick explained that the second account: Investment Account, is used as a revenue source for the state of Alaska's operating costs for spill and prevention programs.

There is a \$.03 surcharge based on crude oil production, which fuels the annual operating costs. Production has dropped from 1.65 million to 850,000 barrels a day, since the surcharges were created.

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Mr. Dietrick noted that general funds would be used to fill the budget shortfall [from the drop in production]. The Senate did not support the use of the General Fund and has proposed a look at a long-term fix. The Senate proposal would change the surcharge from \$.03 to \$.04 or \$.05 cents to avoid the use of general fund revenues.

3:02:52 PM

Co-Chair Meyer observed that most oil spills don't pertain to the oil industry. He suggested that the entities causing the spills should be charged. He pointed out that the Alaska Railroad, Department of Transportation and Public Facilities and others have been responsible for spills. He suggested that funding could be switched from the Response Account, since it is inactive, to operations. He concluded that an additional \$.02 to operations would be sufficient to support costs.

3:04:25 PM

Mr. Dietrick noted that the House proposal set the surcharge at 4 percent and observed that it would be sufficient for one to two years. He noted that there are approximately 2,000 spills a year that can be broken down by crude and refined oil and by source. Spills in the refined category come from a variety of vessels and others in the transportation sector.

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Representative Kerttula questioned if spills are generally catastrophic. Mr. Dietrick clarified that there has only been one catastrophic spill in the state. In response to a question by Representative Stoltze, Mr. Dietrick noted that the cost of the cleanup on the North Slope was incurred by the entity that caused the spill. State costs for oversight are estimated at \$200 to \$250 thousand.

3:08:21 PM

Representative Kerttula WITHDREW her OBJECTION to the adoption of the CS. There being NO OBJECTION, it was so ordered.

Discussion occurred regarding the timing of amendments and the need to hear from consultants.

CS SB 305(FIN) am was HEARD & HELD in Committee for further consideration.

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ADJOURNMENT

The meeting was adjourned at 3:10 p.m.