

HOUSE FINANCE COMMITTEE  
July 26, 2006  
10:13 a.m.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [10:13:18 AM](#).

MEMBERS PRESENT

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

MEMBERS ABSENT

Representative Bruce Weyhrauch

ALSO PRESENT

Representative Les Gara; Representative Ethan Berkowitz;  
Representative Gabrielle LeDoux; Robynn Wilson, Director,  
Division of Tax, Department of Revenue; William Corbus,  
Commissioner, Department of Revenue

LEGISLATORS IN ATTENDANCE:

Representative John Coghill  
Representative Harry Crawford  
Representative David Guttenberg  
Representative/Speaker John Harris  
Representative Kurt Olson  
Representative Ralph Samuels

PRESENT VIA TELECONFERENCE

Representative Eric Croft

SUMMARY

HB 3001 An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the production tax; amending the definition of 'gas'

as that definition applies in the Alaska Stranded Gas Development Act; making conforming amendments; and providing for an effective date.

HB 3001 was HEARD and HELD.

HB 3003 An Act relating to oil and gas properties production taxes; providing for a production tax adjustment to increase the amount of tax at high oil prices and a production tax adjustment to decrease the tax on the production of heavy oil; providing for an exclusion of a certain amount of oil and gas from the gross value at the point of production; relating to the determination of the gross value of oil and gas at the point of production; and providing for an effective date.

HB 3003 was SCHEDULED but not HEARD.

HB 3004 An Act relating to oil and gas, and to the oil and gas properties production (severance) tax as it applies to oil; providing for an adjustment to increase the tax collected when oil prices exceed certain amounts and to reduce the tax collected when oil prices fall below \$16 per barrel; providing for relief from the tax when the price per barrel is low or when the taxpayer demonstrates that a reduction in the tax is necessary to establish or reestablish production from an oil field or pool that would not otherwise be economically feasible; delaying until July 1, 2016, the deadline for certain exploration expenditures that form the basis for a credit against the tax on oil and gas produced from a lease or property in the state; amending the powers and duties of the Alaska Oil and Gas Conservation Commission; and providing for an effective date.

HB 3004 was HEARD and HELD.

#HB3001

HOUSE BILL NO. 3001

An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the production tax; amending the definition of 'gas' as that definition applies in the Alaska Stranded Gas Development Act; making conforming amendments; and providing for an effective date.

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Representative Hawker declared potential conflict of interest because a member of his family is employed by the oil and gas industry in Alaska; he requested to be excused from participating & voting. Representative Foster OBJECTED.

Representative Hawker asked that a roll call vote be taken regarding his vote exclusion on HB 3001. Co-Chair Chenault said it was not his intent to vote on any bills at the current meeting.

Co-Chair Meyer noted his own conflict of interest but since it is not the intent to move the bill, he reserved the motion until the vote.

Representative Hawker withdrew his request, noting he would not participate in the hearings until a Committee vote was taken.

Representative Foster commented that it is inappropriate for a member of the Finance Committee not to participate during discussions on complex issues.

Representative Holm agreed, relating the oil industry history with most legislative members.

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Co-Chair Chenault declared his own conflict, yet encouraged members to participate during the committee process. He encouraged Representative Hawker's participation. Representative Hawker voiced his appreciation.

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ROBYNN WILSON, DIRECTOR, DIVISION OF TAX, DEPARTMENT OF REVENUE, referred to a comparison matrix meant to highlight two approaches to the Petroleum Production Tax (PPT). (Copy on File.)

Ms. Wilson explained the four columns:

- CSSB 2001(FIN), version F;
- HCS SB 2001 (FIN), version X.A,
- Conference CS SB 2001, version C.A;
- Governor's bill, version A.

Ms. Wilson pointed out that the handout provides a "limited" matrix highlighting the differences between those versions and discussing the ramifications. She indicated that the bill is consistent with the Conference Committee substitute and instead of using a statewide system, there would be a

few slightly different areas - the North Slope, Cook Inlet special treatment and the 'other' areas. The matrix identifies the tax rate, progressivity surcharge, credits for annual loss, credit usage floor, gas (GRE) transition credit, base allowance credit, new area development credit, sunset of new area development credit, oil spill, and transition payment for each.

Ms. Wilson discussed the separate Economic Limit Factor (ELF) rate for Cook Inlet oil & gas. The Governor's bill contains no progressivity surcharge; the Administration believes that progressivity is not needed.

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Ms. Wilson referenced the annual credit loss at various rates. She highlighted the credit usage floor & the differences resulting, which the Conference Committee placed at 22.8%. That version also provides for a 3% floor; the cap credits could not be used to reduce the tax below 3% of the gross & North Slope region. The floor was eliminated in the Governor's version. She pointed out that gas (GRE) had not been a feature in recent versions of the bill.

Ms. Wilson explained the transitional investment credit (TIE). The Governor's bill maintains the language indicated in the Conference Committee version and provides for reviews of the 2 for 1.

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Ms. Wilson related that the base allowance credit of \$12 million dollars, based on production, varies depending on which bill version is considered. She pointed out that only Version F (CSSB 2001 (FIN)) is not based on production.

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Ms. Wilson discussed development credits for some parts of the State, not Cook Inlet. That credit amounts to \$6 million dollars, available at \$500 thousand dollars per month, for areas not in the North Slope or Cook Inlet; the language is consistent with the Conference Committee substitute. The credit has a rolling ten-year sunset for new area development.

Ms. Wilson addressed the oil spill component and the transition payment, which is the same as the Conference Committee version. She noted that the graph clarifies the amendment.

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Co-Chair Chenault inquired about the difference about the TIE credit in the Governor's bill and the Conference Committee version. Ms. Wilson said there is no difference and highlighted why it should be "corrected". A page number change resulted with no progressivity included in the Governor's bill.

Co-Chair Chenault requested Ms. Wilson explain the fiscal impact.

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Ms. Wilson explained that fiscal note #2 by the Department of Revenue includes funding for regulation & contractual regulation writing for ten positions. During various revisions, the number of audit positions has fluctuated. Co-Chair Chenault asked about the increase to the new note as compared to the others. Ms. Wilson offered to research that information.

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Co-Chair Chenault pointed out that the plan before the Committee brings the bill back to the original 20/20 as proposed by the Governor and excludes the progressivity surcharge.

HB 3001 was HELD in Committee for further consideration.

#HB3003

HOUSE BILL NO. 3003

An Act relating to oil and gas properties production taxes; providing for a production tax adjustment to increase the amount of tax at high oil prices and a production tax adjustment to decrease the tax on the production of heavy oil; providing for an exclusion of a certain amount of oil and gas from the gross value at the point of production; relating to the determination of the gross value of oil and gas at the point of production; and providing for an effective date.

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Representative Croft noted that he was available to discuss HB 2003. Co-Chair Chenault stated that HB 3003 would be heard at the next scheduled meeting.

HB 3003 was SCHEDULED but not HEARD.

#HB3004

SPONSOR SUBSTITUTE FOR HOUSE BILL NO. 3004

An Act relating to oil and gas, and to the oil and gas properties production (severance) tax as it applies to oil; providing for an adjustment to increase the tax collected when oil prices exceed \$20 per barrel and to reduce the tax collected when oil prices fall below \$16 per barrel; providing for relief from the tax when the price per barrel is low or when the taxpayer demonstrates that a reduction in the tax is necessary to establish or reestablish production from an oil field or pool that would not otherwise be economically feasible; delaying until July 1, 2016, the deadline for certain exploration expenditures that form the basis for a credit against the tax on oil and gas produced from a lease or property in the state; amending the powers and duties of the Alaska Oil and Gas Conservation Commission; relating to the conservation surcharge and additional conservation surcharge on oil; and providing for an effective date.

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REPRESENTATIVE LES GARA, sponsor of HB 3004, distributed information from the Wood Mackenzie materials, which indicates how Alaska ranks on company profitability & the internal rates of return. Overall, Alaska has lower costs than most places in the world; in Alaska, oil @ the \$40/bbl price, the industry's net is approximately 42%.

Representative Gara provided members with another handout on HB 3004: "The Alaska Fair Share Bill". (Copy on File). HB 3004 provides a modification to current law. There are many ways to reach that goal, but initially, a revenue goal at various price schemes must be determined. Numbers are moveable to attain the goal. He agreed with Dr. Van Meurs that investment decisions are affected with monetary reward for investment. Once oil companies are given a "carrot of the credit", they may attempt to reduce their tax rates by taking advantage of that rule.

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Representative Gara referenced Page 3 of the handout, gross taxation as straightforward.

- Current law taxes a percentage of the sale value of oil
- Sale value is easier to verify than the company profits

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Representative Gara advised that the Petroleum Production Tax (PPT) bets Alaska's future on high prices. According to the U.S. Energy Information Administration, the long term,

annual-average world oil price is forecasted at \$47/bbl through 2025.

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Representative Gara noted that according to British Petroleum (BP), they anticipate prices will stay at about \$40/bbl average. He highlighted gas field costs.

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Representative Gara addressed additional PPT revenue at \$40/bbl. According to Econ One:

- Governor's PPT: \$490 million over status quo
- House PPT: \$588 million over status quo
- Senate PPT: \$492 million over status quo

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Representative Gara stated that the PPT gas credits and deductions largely erase the PPT revenue benefits. Ten years of additional PPT revenue at \$40/bbl equals:

- Governor's PPT: \$4.9 billion over status quo
- House PPT: \$5.88 billion over status quo
- Senate PPT: \$4.92 billion over status quo

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Representative Gara thought that gas field credits and deductions should be taken from gas taxes, not oil taxes.

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Representative Gara referenced Page 11 of the handout from the report, indicating that Alaska is a more profitable world market place for the industry to invest. The graph indicates risks and rewards shown for 2004. Even at \$22/bbl, the global average rate of return is about 19%, while in Alaska, that number reaches 24%; a gap that continues to rise as prices increase.

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Representative Gara discussed a straightforward fix to the current system and presented information on how the current system works.

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Representative Gara explained the intent and effect of the Economic Limit Factor (ELF), a system designed to promote development of less profitable small and older fields. He questioned if the option had provided producers with more benefit than needed. The ELF ranges between 0 & 1 depending upon a combination of factors. Generally speaking, they are the size of a field and the field's per well production.

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Representative Gara discussed the ELF and production tax. The 15% oil production or severance tax varies because of the ELF. At the simplest, the ELF is a number between 0 & 1. (Production tax = ELF X 15). He suggested that ELF ignores economic reality - A field that pays 0% in production taxes, pays that rate at \$20/bbl, \$40/bbl, or even \$100/bbl of oil.

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Representative Gara addressed the need to make changes, despite the name "economic limit factor". The numbers ignore the largest, single economic determinant - the price.

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Representative Gara stressed that only three fields in Alaska currently pay a production tax:

- Prudhoe Bay pays about 12%
- North Star pay about 6%
- Alpine pays about 12%

He pointed out that Alaska currently is charging a zero percent tax on some of the largest oil fields in the country. Most of the State's production is at zero per cent fields. The ELF is "out of whack" & needs to be multiplied in order that Alaska can receive a fair share.

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Representative Gara addressed additional flaws with the ELF because it provides a tax rate based on a particular field - the Tarn field, a satellite to Kuparuk. In determining the ELF rate, the fields are not combined. He enumerated cost savings of that measure at Tarn. That field is the nation's 67<sup>th</sup> largest oil field with only two drilling sites and three ten mile pipelines to Kuparuk's facilities. They pay 0% production tax.

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Representative Gara continued, the ELF is decreasing each year. In 1993, the average North Slope production tax was 13.5% and in 2004, it had fallen to 7.5%. If Alaska does nothing, it would fall to approximately 1.5% by 2015.

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Representative Gara stated that current fields are profitable at oil prices of \$20/bbl. He shared a viewpoint that the State of Alaska should offer two separate taxation systems - one for the existing fields and one for the new fields. The existing fields were designed to be profitable at \$15-\$20/bbl price. Presently, the State is encouraging more expensive development & it may be that the fields developed from here on out will be tested at higher prices to be profitable.

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Representative Gara pointed out that Alaska Oil and Gas Association (AOGA) has indicated that \$12.82/bbl is a "high end estimate" of what producers need to find, produce and transport for the Alaska North Slope (ANS) oil. BP and ConocoPhillips report their Alaska profits, while Exxon does not.

In 2002, the lowest recent annual oil price was reported @ \$24.72/bbl. At that price, ConocoPhillip took in approximately a 30% company profit margin; BP assumed approximately 24% profit. In 2005, oil was reported @ \$53.48/bbl price; ConocoPhillips took in approximately 43% company profit margin & BP received 53% profit.

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Representative Gara referenced Page 27, a distribution from Department of Revenue indicating revenue between the State and the oil companies at various prices, generated in prior years.

In 2005, they estimated corporate net revenue @ \$5.2 billion dollars for Alaska oil & the State's share @ \$3.2 billion dollars. The Department of Revenue can estimate what the company's excess cash is but do not know the company's depreciation schedule.

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Representative Gara said based on sales value of the ANS oil produced last year at about \$13 billion dollars, their net revenue was approximately \$5.2 billion dollars. In FY05, the profit margin was approximately 40%.

He noted that with last year's profit, North Slope profits grew to an estimated \$2.7 billion more than the State's share.

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Representative Gara added in FY06, ANS prices averaged approximately \$62/bbl and at that price:

- Producer gross revenue: = \$16.8 billion dollars
- Estimated Producer net profit: = \$6.9 billion dollars
- Profit margin: = 41%
- Exceeds State share by: = \$2.7 billion dollars

He commented that HB 3004 could equalize shares better between the State and the industry. He highlighted Page 31 of the handout. The goal is to equalize shares, leaving Alaska with a fair share. He pointed out that in Norway, they take 70% of profit price.

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Representative Gara explained that HB 3004 leaves a healthy company profit margin with the North Slope producer's margin at:

- @ \$20/bbl price = 11.2%
- @ \$26/bbl price = 21.6%
- @ \$40/bbl price = 29.4%
- @ \$60/bbl price = 33.5%
- @ \$80/bbl price = 35.3%

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Representative Gara addressed the "mechanics" of HB 3004. He explained in the bill, there would be a minimum 5% base tax and all fields would be required to pay that amount; whereas, in the Governor's, the base tax would increase on fields paying 0% by changing the ELF formula. In both HB 3004 & the Governor's proposal, the current law base tax would remain the same for the larger fields. Both HB 3004 & the Governor's proposal, differ from "Shelf the ELF" efforts, which impose a flat 15% tax on all fields.

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Representative Gara continued, under HB 3004, the base tax rate remains the same on the three Alaska fields that pay more than 5%:

- Prudhoe Bay 12.38%

- Alpine 11.93%
- North Star 6.10%

HB 3004 addresses the price factor. The Governor's proposal and the Fair Share bill start with a modest tax and progressivity at \$20/bbl. As the price rises, so does the production tax. The second reform bases the production tax on the price on company profitability and again as the price rises, so does the production tax. He pointed out that BP profits, above the \$20/bbl are in excess of their financial needs; company upside reward protected with a 27.5% maximum tax and as the price of oil falls below \$16/bbl, so does the tax.

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Representative Gara pointed out that Page 36 shows the average effective tax rate under the Fair Share bill. If the price of oil is \$20/bbl, the tax would be 9%; @ \$40/bbl, the tax would be 18%; @ \$60/bbl, the tax would be 21.4% and @ \$80/bbl, the tax would be 23.2%. The status quo price for all barrel prices is 7.8%.

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Representative Gara added that if oil prices fell below \$10/bbl, HB 3004 waives half the production tax and defers payment of the other half until the price rise above \$16/bbl price.

HB 3004 extends the 20% - 40% tax credit for new exploration as established in SB 185. The bill could amend language allowing credit for expenses to extend the life of existing fields, although existing incentives might not justify the credits.

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Representative Gara pointed out the incentives for heavy oil. It exempts heavy oil [less than 20 American Petroleum Institute (API) gravity] from any of its measures. Heavy oil, like that contained in the West Sak reservoir, requires more expensive drilling and production measures. Alternatively, approaches to heavy oil should also be considered.

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Representative Gara spoke to fair tax relief. HB 3004 allows taxpayers production tax relief and borrows from 2003's Royalty Relief Law (HB 28). If production tax relief was needed for fields to be economically feasible, the

Department of Revenue has power to waive all additional production tax and royalties for that field.

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Representative Gara discussed major development incentive and facilities access. He pointed out that the former Division of Oil and Gas Director, Mark Myers stated that facilities access is one of the most important things Alaska can do to encourage new development. HB 3004 clarifies that if there is excess capacity at a facility, the facility owner shall make it available to independent producers at a reasonable rate. That standard is currently used by the Regulatory Commission of Alaska (RCA) in telecommunications.

Co-Chair Chenault asked if capacity availability was a large concern for Alaska at present. He thought that the problem with the North Slope was not re-injecting the volume of gas received from existing wells. He agreed to open access but thought that gas facilities were limited by the number of production wells.

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Representative Gara acknowledged that if all wells were operating at full capacity, then the concerns expressed by the small producers that fair access was being denied, would not be correct. He said it is difficult to discuss since the small producers do not want to go public. He proposed having a hearing on facility access, to make the North Slope more "friendly" for development.

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Representative Gara discussed that giving companies more profit does not guarantee more investment. He maintained that Alaska is giving away way too much money while under-taxing the industry.

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Representative Gara emphasized that providing extra revenue to oil companies does not equal additional investment. He enumerated revenues generated by the three major oil producers in Alaska.

- FY02 @ \$21.78/bbl generating \$1.7 billion dollars
- FY03 @ \$28.15/bbl generating \$2.9 billion dollars
- FY04 @ \$31.74/bbl generating \$3.5 billion dollars
- FY05 @ \$43.44/bbl generating \$5.2 billion dollars

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Representative Gara wondered what will happen if the State does nothing, while encouraging the other options:

- Adding new exploration credits
  - Dr. Van Meurs recommended that a gross tax could be modified to achieve desired revenue level and the credit would attract investment by companies seeking to reduce their tax burden
- Heavy oil - Alaska could impose a modified tax, allowing companies to apply for royalty and tax relief
  - Dr. Van Meurs recommended "stopping the bleeding" on lost revenue of existing fields should be the priority and perhaps applying new rules only to existing fields

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Representative Gara concluded that reform is needed by any measure. He pointed out that production tax effectively exempts huge fields. The exemptions apply even at prices where oil companies earn windfall profits and at average & high prices, corporate profit shares vastly exceeds Alaska's share. Corporate profit margins are larger in Alaska than less safe places in the world.

Representative Gara stated that Alaska can make the ELF work better; he concluded his testimony.

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Co-Chair Meyer mentioned a statement regarding the vastness of profit margins, but worried about investment decline. Representative Gara agreed but pointed out that as profits increase, oil companies have not been investing more in Alaska. He felt that the geology of the land was more important than the tax rate, noting that the producible oil in Alaska will be produced. He did not agree with increasing subsidies over the next five years. If Alaska oil fields are slated for exploration and development over the next twenty years, giving away more money now so that it happens next year as opposed to 2012, does not make good sense & does not help the State. Alaska has been much more attractive in terms of tax rate and profit margins than anywhere else in the world. He added that it would benefit the State to have oil come on line in 15 years, benefiting the next generation and creating a stable revenue stream.

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Co-Chair Meyer hoped that down the road, the State would be using more alternative energies. He disagreed with holding

off on producing oil in the next twenty years. He reiterated the difficult geology in Alaska for company exploration, which adds expense.

Co-Chair Meyer referenced comments regarding "stopping the bleeding", pointing out that through administrative action, the Governor had incorporated some of the marginal fields into Prudhoe Bay. He thought that would be additional revenue the State receives. Representative Gara responded that given oil prices, it could have amounted to \$200 million dollars. He credited the Governor for that action and recommended that it happen at Alpine and Kuparuk also.

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Co-Chair Meyer asked in reference to geology what is a stand alone or satellite field. Representative Gara explained that the Department of Law and the Department of Revenue have indicated that the fields being taxed as independent stand alone fields at a zero percent tax rate, under the current statute should be defined as part of the overall field. However, the interpretation approved the leases on those fields, the Department has allowed them to be stand-alone and zero percent fields. The definition is loose enough that there is room for argument on both sides. The law states that if they are an integrated economic unit, it should be one field; he did not think that it should be a continuous pool of oil. Leaving more money on the table for oil companies will not work.

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Co-Chair Meyer commented that if the profits were so large for the oil companies currently in Alaska, why every company in the world wasn't attempting to explore in this State. He asked if profits made by the oil industry had been compared to other industries such as soft ware or pharmaceutical. Representative Gara responded that there are no other industries that generate 40% profit margins outside of oil in Alaska; adding that 20% profit margins in the pharmaceutical industry would be huge.

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Co-Chair Meyer was not sure. He pointed out that 40% was at the current high oil prices and is not normal. He added that HB 3004 is "truly" not a gross bill.

Representative Gara responded that HB 3004 could bring the State back to the "good part of a net bill, not the bad part". The good part provides that there is a tax that is higher when profits are high and lower when profits are low. It would not discourage investment when profits are low and results in a fair share when profits are on the table. The

bad part of a net bill is that it only taxes a percentage of profits. He did not have confidence that the industry will honestly report profits in a real manner. Tax advice always pushes the margin. The industry has a duty to push the margins for their shareholders, which is the danger of taxing profits. The State will be paying about \$4 billion dollars for gas field development after the pipeline is built out of oil taxes. The big expense is the actual pipeline. Putting gas deductions on an oil tax is a "big danger" created in the PPT system. He recommended that oil tax should have oil deductions and gas taxes should have gas deductions.

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Representative Holm asked Representative Gara the intent of using "fair". He worried about a reduction of oil moving through the pipeline.

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Representative Gara defined "fair", referencing a quote from the Alaska State Constitution that the "citizens of the State are entitled to the maximum benefit from their resources". That means maximum long-term revenue. To provide that combines a high enough tax, but a low enough tax to spur future development with a goal of not only spurring new investment. He reiterated, "Fair share" should lead to the maximum revenue possible. He acknowledged it is more difficult to develop new fields; right now, Alaskans know the amount generated on the North Slope.

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Representative Gara stated that the goal of the bill is to encourage new investment & make sure that Alaska receives a fair share. Encouraging investment does not happen just by giving money to the industry what the State has done for years; that have not sparked tremendous new investment. He encouraged investments that will cause companies to do things that they would not otherwise; he mentioned severance tax relief.

Representative Gara discussed various tax breaks for different types of development. He maintained that spurring new investment can happen, once the industry knows what they can expect in the future.

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Representative Holm asked about the lost production at today's prices. He maintained that the State receives royalty, severance and income tax from the industry; he

wondered how tax reinvestment could happen in Alaska unless a decline in production stopped.

Representative Gara replied it is not possible to stop the decline. The goal is to produce long-term investment, stem decline and stabilize the industry. He recommended the following strategies:

- Tax relief when needed
- Facilities access
- Investment exploration credit
- Access to smaller producers

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Representative Holm emphasized that capitalism has raised more people's economic status in the world than any other system. Capitalism means that people take money and invest their own money into facilities that provide jobs and benefits. Oil companies provide 80%-90% of all the money coming into the State; he highlighted benefits unrelated to those dollars. Representative Holm commented that the Legislature should not "kill the golden goose". He thought that a company will not make investments based upon a 24-month price increase. He maintained that higher taxes would change the world market and be detrimental to Alaska.

Representative Gara argued that he had not "taxing the industry at the highest possible rate". The remaining profits margins have been quite healthy. He agreed that capitalism is a system that works and that it is important not to kill the goose that lays the golden egg, but that it is also important that the goose not take all the gold. It is important is to draw the balance.

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Representative Joule thought that access to facilities should be discussed at greater length and recommended the Committee pursue that issue.

Representative Gara agreed with Representative Joule. Co-Chair Meyer also agreed & thought that smaller oil companies team up with major companies to achieve access.

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Representative Kelly indicated appreciation for Representative Gara's presentation, noting that the Legislature only has short time to make these important decisions. He referenced Dr. Van Meur's comments regarding gross. In response, Representative Gara pointed out that the Legislature has not been interested in tax reform.

Representative Kelly asked had the gross been implemented earlier, would Alaska be at the place they currently are. Representative Gara concluded that Alaska would not be here if the proposal had been accepted, believing the proposal was similar to the one proposed in HB 3004. He indicated that the progressivity feature could make the tax law more stable in the future. Representative Kelly agreed that separating gas and oil was attractive and necessary and disallowed expenses should be defined. He asked if Representative Gara had compiled that list. Representative Gara replied that gas was number one; some items will require Court challenges as they might be illegal. He encouraged that language be added that only "direct Alaska costs" be deducted. He recommended that the Department of Revenue help create the list.

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Representative Kelly inquired about disallowed costs, using examples of rebuilding Prudhoe Bay. Representative Gara explained that to make a profit tax work, allowable expenses need to be defined at Prudhoe Bay. He addressed subsidies and severance tax relief and suggested a method for allowing deductions. Currently, the numbers considered are arbitrary.

[12:07:30 PM](#)

REPRESENTATIVE GABRIELLE LADOUX said she prefers a gross tax as it appears simpler, suggesting that most of the country operates on a profit system. Representative Gara agreed, it is fine to tax profits in some areas, but not on oil and not the way the Governor purposes. He suggested weighing the benefits and burdens of a profit tax and expressed shock that gas was being included in the oil tax bill - not "revenue neutral".

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Co-Chair Meyer commented on the "gaming" aspect of a profit tax and thought a gross tax could have the same potential. Representative Gara agreed it is okay to tax profits in many areas. He pointed out that around the world, most taxation on oil is determined by the profits and worried there would be no way to determine company profits for taxation. A severance & production tax relief system is not "gamed" and that there exists clear evidence to that effect. He referenced past royalty taxes.

Co-Chair Meyer maintained that gaming was possible under any system and that is why auditors are used. Representative Gara disagreed, explaining that the gaming in a profits tax does not profit access to a companies books; they tell the

State what the profits are and if the State does not challenge them, the State never sees what their profits truly were. There is no way to guess their profits accurately because they do a federal tax return, which does not itemize the Alaska profits. There is a lot of room for gaming in that system.

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Co-Chair Meyer said he appreciated inclusion of incentives for heavy oil in Representative Gara's bill but questioned how much was recoverable. Exploration is very costly; perhaps only one of ten wells is recoverable. Exploration is risky and costly. He asked if there were incentives included to recover heavy oil.

Representative Gara replied that heavy oil is a flexible system and that needs change. He proposed that current law be left in the bill to address heavy oil & then on large heavy oil fields, there should be a tax; most fields would not include a production tax. If a tax break is needed, it would need to be proven.

Co-Chair Meyer inquired how gaming on heavy oil could be prevented. Representative Gara explained they would need to provide geological evidence and unless a hearing is scheduled, there is not much available evidence.

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Representative Kerttula pointed out that no other state uses the profit sharing system. Representative Gara understood that most states use a gross value tax system and that worldwide, many countries own their own wells.

[12:18:19 PM](#)

Co-Chair Chenault understood in those systems, they pay for all exploration and most costs.

Representative LeDoux inquired about the hearings for tax break petitions. Representative Gara said that process is already in place and would be the same one used to hear royalty relief applications. Representative LeDoux asked if there was a right to appeal. Representative Gara understood there is always a right to appeal any agency decision.

[12:20:10 PM](#)

Representative Kelly reiterated the time constraints surrounding the issues and foresaw difficulties from the investor's perspective. He recommended splitting the oil and gas issues. Representative Gara responded that he is reluctant to use a net formula. If gas deductions were

eliminated and taxes were based on world averages, he would then consider it. He believed that Senator Wagoner's bill comes the most close to addressing that consideration. He was reluctant to give credit to Point Thompson. Representative Gara maintained that he is willing to negotiate.

Representative Gara noted that the reason he was pushing the gross is to determine a credit system with desired needed revenue. Determining that criteria, the Legislature could craft an acceptable bill. He opined that a gross tax would be easier and better than nothing and recommended taxing existing oil as a solution.

[12:25:27 PM](#)

Representative Holm asked why there was such a significant difference between the fiscal note for HB 3001 and HB 3004. Representative Gara replied that he had not viewed notes.

Ms. Wilson interjected that the key difference between the two fiscal notes would be the number of auditors - four in HB 3001 and eight in HB 3004. Representative Holm pointed out that it takes fewer auditors to implement a gross than net tax bill. Ms. Wilson agreed.

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Representative Joule pointed out Legislative reluctance to change and accepting new tax. He believed that staffing issues were important because more auditors could stop some gaming potential. He noted the tension between Department of Revenue and Department of Natural Resources.

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Representative Kerttula questioned if current audits found non-allowed evidence, in the operating agreement. Ms. Wilson responded, currently, the upstream costs are not audited. Representative Kerttula noted that she would be surprised if current wording allowed non-acceptable items. Ms. Wilson referred to Page 160©, "substantial weight should be given to industry standards if consistent with the principles of the rest of the bill". Representative Kerttula noted that she would check with the Department of Natural Resources regarding areas that should not be allowed in the operating agreements. Ms. Wilson noted that right now, the only things being audited were the transportation costs.

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Representative LeDoux commented that to date, the producer's word has been accepted to date. She wondered where the

burden of proof is and if it would change in the future. Ms. Wilson responded that it lies with the taxpayer. The bill does not change the burden of proof requirement and that the audit powers under the Administrative Section #43.05 are broad.

Representative Gara emphasized that lack of enough auditors causes inaccurate results; he questioned how frequent audits currently happen.

Representative LeDoux commented that the State can follow an audit procedure paper trail. Ms. Wilson said that was correct and that the State has the authority to do that. Undertaking an audit is a judgment call depending on the risk involved and the potential revenue.

[12:40:48 PM](#)

Representative Kelly asked about the problems associated with separating the PPT oil from gas. Ms. Wilson responded that there are asset allocation issues that could create a burden on record keeping and auditing. Representative Kelly inquired how that is currently done. Ms. Wilson replied at this time, it is not an issue. Representative Kelly thought it would be worth the risk to consider combining the two issues.

[12:43:21 PM](#)

REPRESENTATIVE ETHAN BERKOWITZ asked about current auditing discrepancies. Ms. Wilson advised that some are mathematical errors or could be a different interpretation of law. She did not know the dollar amount.

Representative Berkowitz was curious about the incidence of resulting conflict. Ms. Wilson deferred that query until she could get more information.

[12:45:17 PM](#)

Co-Chair Chenault referred to Page 26, State profits from BP and ConocoPhillips and asked why BP's were greater. Representative Gara guessed that the BP's portfolio was higher and perhaps ConocoPhillips was operating on a larger portfolio of smaller fields.

Co-Chair Chenault referenced the severance tax relief/royalty tax relief and asked if royalty relief actually came from the royalty share. Representative Gara said it does. Co-Chair Chenault inquired if Representative Gara's bill proposes severance tax versus royalty tax relief. Representative Gara responded that it gives the tax payer the option. Production tax relief is proposed in HB 3004.

12:47:56 PM

Representative Joule addressed the comparison of the net to the gross and asked about the "shelf life length" on the gross. Representative Gara explained that the reference to shelf-life expired about five years ago because it included no progressivity feature. Including such a feature, changes as the world price of oil changes & provides a more stable system. He acknowledged that any system will experience some flaws.

HB 3004 was HELD in Committee for further consideration.

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ADJOURNMENT

The meeting was adjourned at 12:50 P.M.