

HOUSE FINANCE COMMITTEE
July 31, 2006
3:09 P.M.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [3:09:01 PM](#).

MEMBERS PRESENT

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

MEMBERS ABSENT

Representative Richard Foster

ALSO PRESENT

Robyn Wilson, Director, Division of Tax, Department of Revenue; Dr. Pedro Van Meurs, Consultant, Office of the Governor; William Corbus, Commissioner, Department of Revenue

REPRESENTATIVES:

Representative Ethan Berkowitz
Representative Crawford
Representative Nancy Dahlstrom
Representative Les Gara
Representative Berta Gardner
Representative David Guttenberg
Representative Pete Kott
Representative Gabrielle LeDoux
Representative Mark Neuman
Representative Ralph Samuels
Representative Paul Seaton

PRESENT VIA TELECONFERENCE

Robert Mintz, Assistant Attorney General, Department of Law, Anchorage; Roger Marks, Petroleum Economist, Economic Research Section, Tax Division, Department of Revenue, Anchorage

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 in Committee for further consideration.

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 SCHEDULED but not heard.

[3:09:24 PM](#)
#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.

Co-Chair Chenault noted that there was a conceptual draft amendment for HB 3001 in the Committee member's files. The amendment is in the form of a WORK DRAFT (copy on file). He stated that the committee substitute would be available on 8/01/06. He hoped that the work draft would help the Legislature come to an agreement and address the problem. He stated that it was a produce or pay program (POP).

[3:11:52 PM](#)

DR. PEDRO VAN MEURS, CONSULTANT, OFFICE OF THE GOVERNOR, provided members with a handout: Produce or Pay (POP), July 31, 2006 (copy on file). He said the questions concerning PPT are whether or not the tax break would in fact create more investment and if there is not investment shouldn't the tax rate be higher. The concept of produce or pay addresses both issues.

[3:15:02 PM](#)

Dr. Van Meurs referenced Page 3. He introduced the produce or pay concept. He noted the difficulty in separating existing production from incremental production.

Dr. Van Meurs referenced Page 4.

In the Produce or Pay concept, the production of each company is split into:

- Base production
- Incremental production

The base production is determined on the basis of the 2005 production in terms of barrels equivalent.

Dr. Van Meurs compared the situation to Kuwait. He observed that the situation facing Kuwait is similar to that of Alaska. Kuwait has produced for many years, fields below cost, but now they face a period where fields are more costly due to water invasion and required recovery factors. He went on to say that in response to their concerns there was a simple decline curve established on the base

production whereby any incremental production over that decline curve could be taxed differently. As a result, Kuwait drafted a contract where the base production was taxed more than the incremental production. He stated that this was the example he used to bring forth the idea of base production and incremental production.

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Dr. Van Meurs defined "base production". The base production uses a defined and identifiable starting point. [Alaska's] base production was determined by taking 75 percent of each company's 2005 production. For 2006 and future years, a 5% decline per year would be used relative to 2005 on an exponential basis. This matches the way in which oil and gas fields typically decline. Any production of a company in excess of the base production is incremental production. If actual production is less than the base production, all production is considered base production. He said this concept has worked successfully in other nations.

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Dr. Van Meurs referenced Page 6. The graph illustrates a typical base production curve calculated on a 5% per year decline.

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Dr. Van Meurs referenced Page 7: Base Production. The geological and engineering evidence indicates that current actual decline curves for oil and gas are steeper than 5%. Current actual decline of the various mature reservoirs under a "do nothing" scenario may range from 8% to 12% or more. With current levels of ongoing investment, companies may be able to reduce the decline rate of 5%. Therefore, the 5% decline rate is based on the fact that oil companies need to continue the current levels of re-investment in the State.

[3:24:13 PM](#)

Dr. Van Meurs referred to Page 8: Tax Rates. The produce or pay is proposed to have the following tax rates:

- Base production: 25%
- Incremental production: Initially 15% going up to 5% per year from 2012 onwards until by 2031 the two rates are merged at 25%.

Dr. Van Meurs said that typically base production and incremental production are used during a time when a government is attempting to stimulate new investment. He

maintained that building in increase in government take is a good idea for Alaska and emphasized that an incremental tax can keep Alaska competitive.

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Dr. Van Meurs evaluated the concept as listed on Page 9. Five oil production scenarios were developed to test the weighted average tax rates on an Alaska wide basis.

- 500,000 bopd
- 700,000 bopd
- 900,000 bopd
- 1,000,000 bopd
- 2,000,000 bopd (ANWR)

[3:28:15 PM](#)

Dr. Van Meurs referenced page 10, which provides five production scenarios, including an ANWR scenario of an increase of up to 2 million barrels per day.

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Dr. Van Meurs pointed out that Page 11 provides the Alaska-wide blended rate based on a 5% decline. If the Alaska oil industry would rapidly develop further oil production, the blended rate may reach as low as 20%. If they do not actively pursue further developments, the blended rate would not decline below 22.5%.

[3:31:30 PM](#)

Dr. Van Meurs reviewed Page 12.

Page 12 indicates the effect on individual companies. The blended rate of individual existing oil and gas producers would vary more than the Alaska wide rate depending on their efforts:

- Companies, which pursue a harvesting approach, would rapidly pay a blended rate of 25%;
- Companies which let production decline at a 5% rate would pay 22.5% going up to 25%; and
- Companies that strongly maintain or increase production would benefit from a rate less than 22.5% for up to two decades until the rate goes up to 25%.

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Dr. Van Meurs referenced page 13 noting that though the examples reflected are the extreme, they show a clear

example of the produce or pay concept. He outlined in further detail with examples. He said that if production doesn't increase the tax rate will provide revenue and if there were greater production this would provide revenue into the future.

[3:33:54 PM](#)

Dr. Van Meurs referenced page 14.

He explained that because new investors start at zero base production they would be taxed at the incremental rate of 15%. He noted that this was considered to encourage investment and reinvestment.

The previous PPT did not address the concerns for investment and reinvestment, or the harvester only scenario, the POP addresses both by establishing both a base rate as well as an incremental rate.

He further noted that the state continues to collect corporate income tax, property taxes, and royalties.

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Dr. Van Meurs said that due to current circumstance in the world, oil prices in the future are uncertain. The provision in the POP to reevaluate in 2011 protects the state from being locked in.

He responded to earlier concerns regarding the soundness of the government's ability to audit. He stated that modifications made to the bill strengthen the concept of non-deductible costs and auditing procedures.

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Representative Kelly asked what would happen under a harvest only scenario regarding companies getting quickly to the 25%. Dr. Van Meurs said the base rate is established by taking 75% of the total production. If that declined by 5%, incremental oil would always be 25% and base production would be 75% so you would maintain a rate of 22.5%. He went on to say that the natural decline of a mature oil reservoir is 12%. At a 10% decline rate, after 4 to 5 years, you have no more incremental production because the 5% cushion is used up. All production would then become base production. If a company makes no investment they are up to 25% in 5 to 6 years. The incremental goes away quickly because of the strong decline rate of the total production while the base production continues to decline at 5%.

Representative Kelly asked about freezing the original base. Dr. Van Meurs explained that the incremental production

declines also. If a company does nothing, there would be no more incremental production. Base production is always locked in at 5% decline rate. That is why companies that are only harvesters would be faced with the 25% rate.

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Representative Kelly thought if the 5% was close to the average, and it was ridden down, the rate would stay at 22.5%. He questioned the balance behavior and asked if the scenario stated would be an unusual case.

Dr. Van Meurs stated it would not be an unusual case in a typical mature oil field during the final 10 to 20 years of that oil field. Oil production, at a 10% decline is the normal average. On the North Slope, the base decline rate without well work and supplemental investments is faster than 5%. This illustrates the point that if a company continues to make investments to maintain production the decline rate is maintained at 5%.

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REPRESENTATIVE ETHAN BERKOWITZ inquired if the POP could work with both the gross and net tax.

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Dr. Van Meurs stated the concept of produce or pay could be applied to any fiscal framework. It can be related to gross or net.

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REPRESENTATIVE KERTULA asked if deductions and credits are allowed, could a company have enough credits that it would undercut the requirement of more production, to get a lower tax. Dr. Van Meurs explained that 20% tax credits only apply if companies actually invest. The loss carried forward tax credits were also set in the bill at 20% and therefore are not really affected. The blended rate, the loss carried forward tax credit is also set at 20% to avoid excessive interaction between the possible blended rate and the loss carried forward.

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REPRESENTATIVE LES GARA commented on the incentive and the rate itself. He stated that in earlier discussions regarding the tax for new investors there was a 25% rate then a 20% tax rate and now a 15% tax rate. He asked Dr. Van Muers to explain the decrease in rate. Dr. Van Meurs responded by clarifying the concept. He supported the concept by saying that companies would get a blended rate on

the extra 25% over the base production. He contends that this would stimulate long-term investment in Alaska.

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REPRESENTATIVE PAUL SEATON asked if a separate base rate should be applied for the Alaska National Wildlife Refuge (ANWR). He voiced concern that the most significant source of oil would be taxed at an incremental rate rather than the base, which would not realize maximum return. Dr. Van Meurs responded that technically, there would be no limitation on regions that can be created with separate base production and incremental production. He referenced the graph on page 11. He went on to say that even if [ANWR] were declared open in 2007, it would take considerable time before there is production, possibly 8 to 10 years. At the point of actual production the State would realize the blended rate of 25%. He concluded with a recommendation that the proposed tax rates stay intact and that the legislature not establish a different base rate for ANWR.

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Co-Chair Meyer asked if there was a bias toward new investors. Dr. Van Meurs responded by clarifying that the POP system encourages new investors, but over time establishes a level playing field for all producers. He further maintained that there is no difference between incremental investments and new production.

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Dr. Van Meurs reported that it is common for existing production to be subject to a higher government take than subsequent production and is not seen as an inherent discrimination.

REPRESENTATIVE BERTA GARDNER inquired that if the system is known and encourages reinvestment, why was the original bill set at 20/20 PPT.

Dr. Van Meurs replied that it is his desire to propose a simple system, but often the political process makes it more complex. He opined that the previous system would have worked, but that there was an additional concern to incentivize investment. The proposal will assure Alaskans that investment is attained.

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Representative Stoltze asked how open the process with the Administration is. He wanted to make sure that the door is open and the effort is "good faith".

WILLIAM CORBUS, COMMISSIONER, DEPARTMENT OF REVENUE, reported that the Governor introduced the 20/20 PPT last session and is interested in seeing the process go forward.

Representative Stoltze asked if the Administration is open to looking at the alternative proposal. Commissioner Corbus encouraged the Legislature to come forward with legislation.

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ROBYNN WILSON, DIRECTOR, DIVISION OF TAX, DEPARTMENT OF REVENUE, identified changes in the WORK DRAFT^[L1]. She said that in addition to the variable rates there are four areas that represent change from the original bill. The first change is to the type of reports DOR is to prepare and the time frame they are due. The reports are more comprehensive and include the effects of tax rates and all credits. This report is due the 1st legislative day in 2011.

Secondly, she pointed out the requirement of an annual filing by companies with monthly installment payments or estimated tax payments. She noted that this guards against cash flow issues. Transportation costs would be estimated and paid at the end of the year.

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Thirdly, the changes clarified language in the bill. Ms. Wilson referenced Section 160 noting that this section is now broken in to 3 parts to make it easier to read. It does not change intent. She said there are also improved language additions to clarify intent, in particular the section explaining lease expenditures. She said she would further highlight these changes as she moved through the bill.

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Ms. Wilson referred to a matrix, "Limited Comparison of PPT Bill Versions and POP draft WORK DRAFT" (copy on file.) She reviewed the tax rate. She said the capex credit rate has not changed. The capex section has been renumbered and reordered.

She also noted that the bill maintains language regarding the ELF tax ceiling on Cook Inlet. The structure also remains for various regions.

Ms. Wilson noted that the particulars regarding progressivity surcharge are still under discussion.

She explained the credit for annual loss. The mechanism of a loss is converted into a credit for use in the following years. It is accomplished at the base tax rate (20%). She

pointed out that though there was a credit usage floor in the conference committee version, there is none in the WORK DRAFT. The bill maintains the language for the TIE (Transitional Investment Credit).

Ms. Wilson drew attention to the base allowance credit, which had been in the previous version of the bill to assist smaller, newer producers. In the WORK DRAFT, this credit no longer appears, as it was seen as a duplication of incentive with the incremental production tax. She discussed the new area development credit of \$6 million.

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Ms. Wilson talked about the lease expenditures: authority of industry practices. She reported that there are a number of language changes in the lease expenditures. These changes provide for improvement and clarity regarding nonallowable expenditures. As an example, overhead allowance will be a percentage of direct costs.

She stated that in the WORK DRAFT the Department of Revenue^[L2] reports to the legislature. She noted that the language regarding this starts on page 33 of the WORK DRAFT rather than page 34 as noted in the handout. She reported on the effective date, the tax returns date, and said that there is no safe harbor for payments due. She went on to say that installment payments and estimated tax payments are based on the federal tax rates rather than state tax codes. Under the federal tax code there are different rules for underpayments and over payments. She said in previous versions there was a 10-month transition payment on the old system, which would true up on 3/31/07. With new version the producer would pay under the old system through January of 2007 and then at the end of February the first estimated tax payment would be due.

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Representative Stoltze asked about interest rates for under payments and over payments and whether this impacts the rate for disputed payments. Ms. Wilson replied that it makes no changes in the state rate. Federal rates would apply from the date of installment payments until March 31; on March 31 the state rate of 11 ¼% would be applied.

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Representative Holms asked what the cost to the State of Alaska would be if the severance tax problem were not solved.

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ROGER MARKS, (TESTIFIED VIA TELECONFERENCE), PETROLEUM ECONOMIST, ECONOMIC RESEARCH SECTION, TAX DIVISION, DEPARTMENT OF REVENUE, ANCHORAGE, responded to the question by referencing the graph handout. (Copy on File).

Mr. Marks said that under the ELF, with no change at \$60 a barrel the loss would be approximately 1.1 billion. Under the POP system set forth by Dr. Van Meurs and Ms. Wilson the gain is approximately 2.6 billion, leaving a difference in loss of \$1.5 billion dollars per year.

Representative Holms asked if it were possible for the next legislature to make this policy retroactive. Mr. Marks advised that constitutionally there is not an issue of retroactivity within the same year. He went on to say that if retroactivity were to go much beyond that it could raise policy issues regarding the stability and health of the business environment.

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ROBERT MINTZ, (TESTIFIED VIA TELECONFERENCE), ASSISTANT ATTORNEY GENERAL, DEPARTMENT OF LAW, ANCHORAGE, added that there was no specific verbiage regarding retroactivity. He went on to say that when the courts have upheld retroactivity in tax law it was with regard to relatively short periods within the same calendar year.

He furthered the point by saying the longer period of retroactivity, the more risk of constitutional problems could be found by the court. He reiterated that retroactivity is usually handled within the calendar year without any legal challenges.

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Representative Kelly expressed concern regarding the accuracy of a 5% decline rate. He questioned whether a 3% decline might be more appropriate.

Dr. Van Meurs referenced page 11 of the POP handout: Alaska Wide blended rate. He pointed out that though there might be a dip to 22% or 21½% tax rate around 2011, the rate would increase relatively strongly because of a steeper decline^[L3], thus reaching the 25% rate.

On the 3% decline rate scenario companies would have to realize massive additional investment effort, but would remain at the 25% tax rate, losing the incentive of the incremental rate^[L4]. He agreed that the decline curve is a sensitive feature, but maintained that 5% is the most reasonable and fair level of decline.

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Mr. Marks added that the North Slope base decline rates have investment backing it up.

Representative Kelly asked if different base and incremental rates were calculated, specifically a 20-25 rate. Dr. Van Meurs stated that different rates were looked at and that there are infinite combinations. He went on to say, by making a differential between the base rate and incremental rate too low, the system is not strong enough to encourage investment.

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Representative Kelly asked if they froze the FY05 base rate, making a zero decline. Dr. Van Meurs stated that many rates were used. He emphasized that it is best to take a decline rate that is similar to average oil industry behavior. The 5% decline rate reflects that average.

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REPRESENTATIVE KELLY commented on the upcoming decade and pointed out that the opportunity to capture value would be higher. He asked if Dr. Van Meurs would be surprised if the model performed like a 20% tax and if so would he be pleased because additional production had occurred. Dr. Van Meurs responded by referencing the graph on Page 11, (Produce or Pay). The sensitivity of the graph illustrates what would happen in the case of major production increase.

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REPRESENTATIVE RALPH SAMEULS commented on the difficulties of establishing rates. He noted that in all scenarios they were basing their projections on corporate behavior, which is not necessarily a predictable variable in the future. He concluded by supporting the idea of keeping the decline curve as an average rather than taking averages per field.

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Representative Hawker commented on the reconfiguring of the Trans-Alaska Pipeline System (TAPS) and how the capacity for TAPS is less than a million barrels a day. In conclusion, he said that though the extremes scenarios (2 million barrels a day) are useful they have other realistic barriers such as the case with TAPS.

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Representative Gara questioned whether the state would be rewarding companies for doing what they are already doing. Dr. Van Meurs noted that was an important point. If the oil

[L5]industry continues to produce at the current level, the decline rate is roughly 5%. [L6]With a 5% decline of total production and 5% decline of base production, the ratio between base production and incremental production would always stay the same. Such a company would pay, until 2012, an average of 22.5%. After that, the blended rate would go up from 22.5% to 25%. The goal of the proposed scheme is to make distinction between existing production and incremental production. There is a penalty for companies in[L7] blended rate that decline steeper than 5% and a reward to companies that decline less than 5%. There is a strong reward on the blended rate to companies that double production.

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Representative Gara asked about companies artificially reducing the rate of production, thereby staying under a 5% loss. Ms. Wilson stated that the tax rate the next year does not calculate with respect to that lower deduction; it is still calculated with respect to the decline line.

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Representative Kerttula asked what geological information has been ascertained to determine rates of production. Dr. Van Meurs stated that many presentations have been made regarding the decline rate in the North Slope. He went on to say that in a state of mature decline, rates could vary between 8-12%. These rates are generally accepted as normal international decline rates.

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HB 3001 was HELD in Committee for further consideration.

#

ADJOURNMENT

The meeting was adjourned at 5:07 P.M.