

01:39 HOUSE FINANCE COMMITTEE
August 1, 2006
10:19 a.m.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [10:19:19 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
Representative Bruce Weyhrauch

MEMBERS ABSENT

None

ALSO PRESENT

Robynn Wilson, Director, Division of Tax, Department of Revenue; Dr. Pedro Van Meurs, Consultant, Office of the Governor; Brian Wenzel, Vice President, Finance and Planning, Conoco-Alaska; Tom Williams, Senior Tax Counsel, British Petroleum; Ken Konrad, Vice President, Alaska Gas, British Petroleum; Dan Dickinson, Consultant, Tax Division, Department of Revenue; Representative Carl Gatto, Representative Ralph Samuels; Representative Mark Neuman; Representative David Guttenberg; Representative Jay Ramras; Representative Les Gara; Representative Paul Seaton; Representative Kurt Olson; William Corbus, Commissioner, Department of Revenue; Representative Eric Croft; Representative John Harris

PRESENT VIA TELECONFERENCE

Roger Marks, Petroleum Economist, Economic Research Section, Tax Division, Department of Revenue

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.

[10:19:29 AM](#)

#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 said the Committee would continue discussion on the Produce of Pay tax proposal as set forth by the Administration on 7/31/06. He provided members with a proposed work draft to HB 3001, labeled 24-GH2096\I, Bullock, 8/1/06 (WORK DRAFT).

DR. PEDRO VAN MEURS, CONSULTANT, OFFICE OF THE GOVERNOR, noted that he had distributed a graph entitled "Effect of a Do Nothing Scenario Under Produce or Pay" (copy on file). He explained how base production works relative to production decline. As shown on the graph, a producer would be in the 25% tax rate by 2010 in a "do nothing" scenario.

Co-Chair Meyer asked if the production curve included gas. Dr. Van Meurs responded by saying the graph illustrates oil, but the WORK DRAFT refers to both oil and gas.

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Co-Chair Meyer asked if, in 10 years when the gas pipeline comes online, production decline would be offset with gas production and henceforth reduce the overall tax. Dr. Van Meurs, said that the additional production would be a significant underpinning of the decline curve.

Co-Chair Chenault asked about IRS and taxation: Would there be penalties involved similar to IRS or would there just be interest that would be demanded on the underpayment versus overpayment?

ROBYNN WILSON, DIRECTOR, DIVISION OF TAX, DEPARTMENT OF REVENUE clarified how the tax payment and tax interest would be dealt with. She noted that there would be no penalties, there would just be interest owed.

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Representative Kelly asked why the 5 percent increases kick in at 2012 and not sooner. Dr. Van Meurs explained the concept of new production and the need for organization time by some companies: approximately 5 years. He also discussed the provision's goal to not discriminate against those companies that need the time to organize. He opined that 5-year's time is not unreasonable given the fact that there are many companies already in production on the North Slope. A 10-year timeframe has disadvantages because there is less incentive.

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Ms. Wilson explained that the first four sections of the WORK DRAFT remains the same and briefly explained that Section 5 (AS 43.55.011) establishes the tax rate; Section 9 (AS 43.55.020) establishes payment rules; and the credit provisions are in Section 13 (AS 43.55.023-025). The lease expenditures in AS 43.55.160 were broken into 3 parts.

Ms. Wilson provided an overview of the WORK DRAFT. She referenced page 3 and noted that the sections had been reordered to provide a more readable format. Subsection (e) will be what is established in (f). Section 5(f) is the core of the bill, detailing the base rate and incremental rate. Section 5(f)(2) identifies the rate applicable to base production Section 5(f)(3) is the percentage rate applicable to a producer's incremental production. Subparagraphs A, B & C detail the increase in percentage rates.

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Ms. Wilson observed that Section 5(f)(4) establishes base production. Section 5(f)(4)(A) provides the formula for base production. She also noted that the rate increase would be capped at 22.5% for the first 3 years. This ceiling rate was established in order to provide companies the opportunity to immediately increase production at a rate no higher than 22.5%. This was identified on the matrix from 7/31 presentation.

She continued an explanation of Section 5(5), which establishes that the production is calculated in BTU equivalent barrels and that it cannot be less than zero. This continues the rules for base production. Section 5(6) deals with transferring of properties in 2005. The base production transfers with the properties. This prevents

companies from transferring properties just to get a lower tax rate.

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Ms. Wilson explained that page 4, Section 5(g) is the progressivity language seen previously. Subsection (k), lines 27 and 30 are blank. [L1] These are the elements of progressivity still under discussion.

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Ms. Wilson discussed Section 5. She noted that Section (5)(h) is the second part of the progressivity provision. She explained that the only change reflects an annual calculation. There is no change of the concept in the WORK DRAFT. Royalties originally contained in Section 5(f) were moved to Subsection (i) with no changes. These subsections are reordered to provide more clarity i.e., to subsections with basic tax rate together the subsections with progressivity and the private royalties. Section 5(j) deals with Cook Inlet gas. Other than some clarifying language on how to calculate the average there is no change to Section 5(k), which deals with Cook Inlet oil. She clarified that there is no intended change to the gross value calculation. A new subsection was added (Section 5(l)) to clarify what happens when there is a lowering of the tax rate regarding Cook Inlet oil & gas. This clarification is important because the tax credits can only be used against the base tax. The language outlines the ordering of the tax deduction.

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Representative Kelly asked if the language changes the effective rate for Cook Inlet. Ms. Wilson replied that there is no change to Cook Inlet.

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Ms. Wilson described Section 5(o). There is improved language regarding regulations for determining heating value of the producer's gas. The language clarifies how BTU will be calculated.

Section 7, addresses how the estimated installment payments will be calculated. The producers will calculate their expected tax on a monthly basis. The also section sets out the calculations for the expected tax rate.

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Ms. Wilson observed that Section 7(B) (4) defines rules regarding estimated tax payments having to do with private royalties.

Language was included in Section 9 clarifying that the producers shall refund the excess to private royalty owner in accounting for the estimated tax payments:

If the total deductions of installment payments of estimated tax for a calendar year exceed the actual tax for that calendar year, the producer shall, before April 1 of the following year, refund the excess to the royalty owner.

The rest of the changes in Section 9 relate to tax liability calculated in a calendar year rather than monthly.

Section 12, describes the interest rules applicable to the estimated or installment payments due. Subsection (g) deals with underpayment and subsection (h) relates to overpayments. Interest is calculated from the due date of the installment payment until such time as the payment is made or March 31, whichever is earlier. The interest is calculated under, Internal Revenue Service 6621 & 6622: Determination of rate of interest (on file). This particular interest only occurs for the period in which the payment is outstanding, until March 31.

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Ms. Wilson observed that the Section 13, capex credits, was reordered, but not changed. Page 13, line 4, subsection (b) deals with the conversion of a loss into a credit, at 20%, to be carried forward.

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Ms. Wilson referred to Section 13, amendment to 43.55.024 on Page 17, line 13 and noted it contains the additional nontransferable tax credit that was in 43.55.170. The credit started as a deduction and was turned into a credit. The WORK DRAFT brings the credits all into one section. New area development credit reflects 6 million, which is the annual total of 500,000 x 12 months. The exploration credits in 43.55.025 remain the same.

Co-Chair Chenault asked why \$6 million. Ms. Wilson explained that the tax is based on the calendar year.

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Ms. Wilson noted that Section 25 (4.55.160) on Page 24, line 15, was divided into 3 sections: 43.55.160, determination of production tax value; 43.55.165, lease expenditures; and

43.55.170, adjustments to lease expenditures. The WORK DRAFT out specific regions: (A) North Slope; (B) the area south of the Brooks Range that is not Cook Inlet; (C) Cook Inlet oil; and (D) Cook Inlet gas. Paragraph 2 on line 13 is the calculation of the production tax value for the progressivity.

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Representative Paul Seaton asked distinction between the taxes in A and B. Ms. Wilson clarified that there is no difference between taxes. The difference comes into play with the new area development credit, which only applies to areas other than the North Slope and Cook Inlet. The value is calculated separately in order to apply the net tax.

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Ms. Wilson pointed out key elements on page 27, to 43.55.165, which determines whether costs are lease expenditures. The department shall consider, among other factors, industry practices replaced: "shall a substantial weight will be given to industry practice". Line 13 is the calculation of tax value for progressivity. The department shall consider industry standards but if it is on list it is prohibited. Subsection (e) specifies the list the list of prohibited expenses. This is reiterated in Line 19. The intent remains with the language clearer.

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Ms. Wilson continued to review Section 25. An amendment to 43.55.165 on Page 29, line 22, paragraph (2) clarifies intent to use a percentage of direct costs. She explained that exceptions to lease expenditures in subsection (e); and language to 43.55.170 on Page 32, assets and adjustments to lease expenditures, remain the same. Expanded language in 43.55.180 requires the Department of Revenue to report to the legislature on 2011. Language was changed to reflect an annual tax return on Page 34, line 27: 43.55.201.

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Representative Seaton asked about the definition of oil and gas in regards to taxing: at what point during production is it gas and where is it liquid? [The question was held for later discussion.]

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Representative Seaton asked about page 5, and asked for calculation on progressivity. Ms. Wilson replied that there would be monthly calculations, which would be triggered by the provisions in subsection (h). The slope is determined by subsection (g). In response to a question by Representative

Seaton, Ms. Wilson clarified that the goal is to calculate the net equivalent per barrel. She explained that the value for the month is divided by produced barrels to determine the net amount per barrel, which would be compared to the trigger point to determine progressivity.

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Representative Seaton asked for clarification on page 4, line 20, specifically the language regarding monthly and yearly calculations. Ms. Wilson replied that progressivity is calculated on a monthly basis and is a calendar year return. Representative Seaton asked if the progressivity is known each month and has to be paid in that month; otherwise would there be interest due on it. Ms. Wilson confirmed that his explanation is correct.

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Co-Chair Meyer asked about the decline rate. He suggested getting it could be a disincentive if it were not close to the actual rate. He requested an opinion about the 5 percent rate.

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Dr. Van Meurs replied that the natural decline rate of the "do nothing" scenario is 10% - 12% in a mature state. The 5 percent is not meant to match a do nothing scenario in order to maintain a 22.5% percent. Companies would have to have significant, on-going investment in order to prevent the decline. He suggested ways to slow the decline. In setting the decline rate, it is assumed that the industry has to make considerable effort. The 5 percent decline rate is very sensitive and has been tested.

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Co-Chair Meyer noted that the geology is different on each field; some declines are preventable and some are not. There is no perfect number. Dr. Van Muers reiterated previous comments on the decline rate.

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Representative Kertula asked if the decline rate is known for Prudhoe Bay or Kuparuk. Dr. Van Meurs said the sensitivity analysis was not done on specific fields. The blended rate is a corporate wide rate. Fields that have less decline set the impact for fields that decline more. The idea is to create a blended rate that is reasonable and requires the industry to maintain a certain amount of investment/production. Representative Kertula summarized

that it is more about the rate than the field. Dr. Van Meurs agreed.

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REPRESENTATIVE LES GARA inquired about the variables of geology and age of the field and the discrepancies this might present with the proposed tax system. Dr. Van Meurs said the geology of the fields vary greatly. During normal decline, the decline can be modified through various means of investment and reinvestments. He noted that the blended rate is the component that encourages investment.

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Representative Gara observed that no matter how poor an investment is made, the rate of 22.5% would not go up for 2006, 2007, and 2008. He noted that the existing tax has provided incentive for investment and yet most companies are at zero percent production rate. He asked Mr. Van Meurs to explain what seems to be a benefit to companies without an adequate return to the State. Dr. Van Meurs responded that the idea is to give companies some time to evaluate the favorable economics from a reinvestment point of view of the PPT bill. The goal is to increase production. The 3 year cap allows for companies to reorganize based on the PPT concept and create incremental production based on the new tax.

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Representative Gara posed another scenario pointing out that there would not be incentives for a company with a field in a low rate of decline, under the propose tax structure. He referenced Page 3, and noted that if a company is not adding production or investment their rates still stay the same for the following 3 years. He expressed concern that companies that have chosen for many years NOT to invest could continue without penalty, with no additional gain for the State. A gross revenue based system without tax credits would not encourage reinvestments. He related that, from Alaska's point of view, it is a negative effect when companies do not reinvest. Dr. Van Muers reiterated that the purpose of PPT is to encourage new investment and increase production in Alaska to create the neutral benefit of good investment. It attempts to change investment behavior. The POP is an additional layer of protection for the State.

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Representative Seaton questioned why, if the base rate is taxed at 75%, why the first year is it only 70%. Dr. Van Meurs explained that analysis is based on a request from the legislature to make sure the blended rate is 22.5%.

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Ms. Wilson referenced a handout from 7/31/06 (Copy on File). Page 1 indicates the severance tax under the Produce or Pay Plan (POP) and various PPT proposals at \$60/bbl.

Representative Hawker was troubled with the conclusion of the graph. He stated that the Department of Revenue curve is not a declination curve. Ms. Wilson agreed to the source of the numbers. The projections are based on forecasts of production amounts and do not reflect the assumptions of increased investment. It was presented as the model of all other versions.

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Representative Hawker requested modeling on alternate production scenarios. He noted that the graphs reflect the potential of production that seems achievable. He said that he would like to see modeling on a goal of production in which to create incentive for companies to achieve.

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Representative Holm noted that there was no discussion regarding the stranded oil. He asked what potential there was regarding stranded oil. Dr. Van Meurs stated that the Department of Revenue is concerned about the current activity on the North Slope. He thought it could potentially face a situation by 2007, that where it is no longer economic to recover [stranded oil]. He maintained that every reservoir can increase recovery if better technology is applied. Recovering factors could range from 20-60%. It is in the interest of every jurisdiction to maximize recovery. The Administration believes that the PPT proposal would provide continuous stimulus to technology for field recovery. At a certain point in time, the oil fields would be abandoned. It is in the joint interest of the State and industry to delay that timeline. A system based on net achieves that objective better than a system that is based on gross.

The Department has the ability to lower the rate of the royalties. The royalty proposal is the ability of the Department to lower the royalty in marginal situations and a PPT based on net built in will help Alaska.

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Representative Holm stated that the graph does not indicate the potential loss and gain. Dr. Van Meurs agreed, stating that was not intentional. He believed the State would see higher production with PPT.

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Ms. Wilson briefly overviewed the remaining graphs of the handout: Page 2 @ \$40/bbl & Page 3 @ \$20/bbl. Page 4 provides the State take and the distribution of future cash flows under status quo: Governor's bill, POP and various PPT proposals from FY2007-2030. Page 5 indicates the cumulative severance tax from 2007-2030, produce or POP and various PPT proposals. Page 6 shows the government share with the distribution of future cash flows under status quo: the Governor's bill, POP and various PPT proposals. Page 7 illustrates the comparison of forecast production to a 5% decline curve. In conclusion, Page 8 indicates the volume weighted average blended tax rate, equaling 22.35%.

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Co-Chair Chenault asked if the numbers were off a bit. Ms. Wilson commented that 2030 was the date chosen as the date the TAPS would be more costly than of benefit to keep on.

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DAN DICKINSON, CONSULTANT, TAX DIVISION, DEPARTMENT OF REVENUE, responded to Rep. Seaton's question. The notion of gas to liquid would not affect the point of production. The point of production determines getting it out of the ground. The changing of gas to liquids is a manufacturing process. Under current law, if there was such a plant, the cost would be deductible and the energy would not be deductible. It would be similar to a refining plant.

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KEN KONRAD, VICE PRESIDENT, ALASKA GAS, BRITISH PETROLEUM, related that increased oil investment is critical to a gas pipeline and the opposite is also true. When considering greater production on the North Slope there are two factors considered by the industry: cost and infrastructure. He related how they were interdependent.

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Mr. Konrad observed that in 2006 there is 7.6% less oil going thru TAPS than the year before. He noted that there is an increase in awareness on all sides of the importance of investment. The biggest risk to Alaska is the question of attracting investment. He presented the perspective from an investor's viewpoint.

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Mr. Konrad referred to a slide presentation called "Produce or Pay Proposal" (copy on file.) He commented on the key messages on page 2. He said the 20 percent PPT tax rate is high and was only agreed upon in order to produce gas. This tax structure will not maximize investment. He pointed out that the new proposal is a significant increase in tax. The structure recognizes the importance of production but is simplistic and relies on unrealistic assumptions.

Mr. Konrad related that the incentive is better focused on investment. A 5% decline rate does not reflect the current North Slope reality. In conclusion he said retaining progressivity makes it more difficult for Alaska to attract the capital it needs.

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TOM WILLIAMS, SENIOR TAX COUNSEL, BRITISH PETROLEUM, stated that the opening comments are a review of the original proposal. He further explained why the tax rate is too high and not in the best interests of Alaska. He opined that Alaska could gain more money overall with a lower tax rate. He stated that lower tax rate would stimulate more investment/reinvestment.

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Mr. Williams explained that the structure on Page 5 is simplistic. Production is an output; investment is an input. Producers have control only over the investment and can not forecast the production. The linkage of tax rate to production introduces additional uncertainty and thus risk for the investor. Added risk and uncertainty make investments less attractive and will make Alaska less attractive compared to its competitors. The POP structure could work, but only if the numbers are right. Care must be taken to avoid unintended consequences.

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Mr. Williams continued to review Page 6. He concluded that the future North Slope will be different from the past. Future production will become more and more challenging as light oil targets become smaller and less economic and the proportion of viscous oil increases. Future production from known resources in existing fields will greatly exceed that from exploration. Mr. Williams noted that the projection from the Department of Natural Resources is 310.43 million barrels a year for 2006. Production would represent just over 3 billion barrels, calculated at a 10% decline over the next fifty years. Of the seven and a half billion, more than half is going to need to have new investment or attract new investment. In response to a question by Representative Holm, he observed that they risk leaving oil in the ground

if it is not economic to produce. He further noted that at a 12% decline rate, only 2.6 billion barrels of the light oil would be recovered; and at 15% it would be recoverable at just over 2 billion barrels.

Page 7 - Depicts a 6.5%-7% actual decline rate from 1992-2006. Mr. Williams used the chart to show that a 5 percent decline rate does not reflect current North Slope reality. He furthered the point by adding that these are declines that are occurring in spite the industry's efforts to add new fields and get access to heavy oil.

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Mr. Williams reviewed Page 8 and emphasized that increasing taxes on new oil is bad policy. He referenced Dr. Van Muers handout page 11 noting different tax rates for different levels of production. He felt the graph was wrong in that the tax rate runs inversely to the economic robustness of the production. He went on to say the easiest, least expensive oil to produce is produced first. It is the opinion of BP that a flat 15% PPT tax rate for all new oil would be a step in the right direction. He observed on

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Mr. Williams observed, as outlined on Page 9, that lower taxes means more investment, more production, more jobs, more state revenue and a healthier economy in Alaska.

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Mr. Williams added that the structure does not provide for equal treatment for those companies who have spent more than 5% to slow the decline. He gave an example of how a newcomer would benefit unfairly. A second type of discrimination relates to new sources of production. The use of more fuel for production adds to the costs. An exploration may take 10 years to come to production and will be taxed unfairly because of the incremental tax rate. He also felt that heavy oil exploration would not be treated fairly.

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Mr. Williams made several points regarding investment as contained on Page 11 - Recommendations Investment Methodology:

- To tie the tax rate to reinvestment would be a more direct investment. Investment is in the direct control of industry.

- Increased production is the goal and increased investment is the means.
- In addition to increased production, increased investment benefits to the Alaskan economy, businesses and creates jobs for Alaskans.
- A tax rate based on reinvestment reduces the investor's risk. Gold plating can be prevented in a straightforward fashion.
- Tax based upon investment creates a more level playing field and may avoid unforeseen adverse consequences of a decline-based tax rate.

Mr. Williams related his experience with this as a commissioner. He explained how to limit gold plating.

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Mr. Williams addressed the concern regarding diluting of investment incentive by increasing the tax as the investment comes to fruition. He spoke of leveling the playing field to get more production in the long run.

Mr. Williams made several points regarding Page 12 titled Issues: Decline Methodology:

- A decline rate of at least 10 percent is required to reflect current mature North Slope fields.
- A rolling five year historical average would provide a more reasonable base than a single year base period.
- Given the period required to develop new barrels, an increase on the tax rate on new oil creates a disincentive.
- BP recommends that this built in tax increase be eliminated.
- Progressivity makes it more difficult to attract the additional capital Alaska needs. Progressivity should be dropped or reduced to a much lower rate.
- Tax rates for new and old oil should be lowered to ensure the blended tax rate is competitive with other US and global provinces.

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Mr. Williams said a single reference year is not indicative of mature field decline. The slide on Page 13 - North Slope Field Decline Rates with Investment, depicts base production five-year averages of Prudhoe, Kuparuk, Milne, Endicott, and Point McIntire.

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Representative Hawker referred to the slide on declining productivity. He recognized production decline as the common enemy and problem to be addressed. He summarized the industry's viewpoint that they will provide production if they have the lower tax rate. Representative Hawker said that the legislature is saying: give us production and we'll give you the rate. He asked BP what the difference was.

Mr. Konrad stressed that economics not physics is at issue. He noted that the only thing keeping oil in the ground is economics. The industry does not see a way to 20 percent based on the decline rate used relative to the actual rate. Representative Hawker asked why Department of Revenue analysis shows that this tax rate equalizes over time. He questioned why if they have the ability to access the oil, the tax structure doesn't work. Mr. Williams said the industry has different expectations about production forecasts. He recalled how ELF was designed and speculated at a different outcome. Mr. Konrad repeated his concerns about the 20 percent tax rate.

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Representative Hawker said the industry is rigid in their position of the 20% PPT being the only economics that could work. Mr. Konrad felt this was not what BP wanted to communicate. He reiterated comments by Mr. Williams on stimulating investment and what he feels were inaccurate percentages and production rates to base the rate on. Representative Hawker recalled all of the proposals and asked if the industry would be happy with the original PPT proposal with progressivity and a flat 25 percent rate. Mr. Konrad estimated the actual rate would be between 25 and 22.5 percent rate. Representative Hawker then asked if they would be happy with 22.5 percent and progressivity. Mr. Konrad emphasized that they could and would prefer to invest more under a lower rate.

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Representative Hawker observed that the House Finance Committee has twice sponsored a 20/20 tax rate bill to the floor that didn't pass. The House at this point is forced to make a compromise. He maintained that the industry has not shown a willingness to compromise.

Mr. Konrad replied that it would be possible for the industry to bring something forward outlining an investment incentive structure. Representative Hawker asked how the legislature could convince the people to accept that proposal.

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Mr. Williams spoke of possible compromises as he offered his advice. He maintained that there are alternatives which would be better than a flat rate

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AT-EASE: [2:28:48 PM](#)

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Representative Holm related that the Committee has been told that investments are not going into Prudhoe due to the business models the individual companies pursue. He asked why was investment flat in Prudhoe Bay when the ELF was in such a position that there was a minimal tax for the production of oil. He also asked for an explanation of the word "over-incenting". He questioned what assurance the State has that the oil industry would produce to the maximum benefit of the people of Alaska.

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Mr. Konrad responded to the question about Prudhoe Bay investments. He recalled that there were a number of satellite investments that did not pay production tax; production output/investment could be checked by looking at the previous five years. He mentioned situations where "over-incenting" created problems, but did not think that these circumstances existed in Alaska. In response to Representative Holm's comment about producing the oil too quickly, Mr. Konrad maintained that even with 50 year business plans there is still a large amount of oil, particularly heavy oil, left in the ground.

Mr. Williams noted that when production is added to a field it makes it larger. With the ELF formula, field size was the dominant parameter in setting the rates. When the field was increased, it raised the rate for the whole field. This was the burden for the industry in the ELF system. He answered the question regarding "over-incenting". He explained that the term was used only in the narrow sense with regards to gold plating. He spoke to the excess production issue and gave another example of damage to the reservoir. He noted that there are a number of variables during production and that it is important not to waste energy in the process of producing. He pointed out that the purpose of the Oil and Gas Conservation Commission is to prevent this from happening through regulation of field practices.

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Representative Holm asked where price and the value of the commodity fit into the scheme. He suggested there should be urgency to produce the higher valued commodity in the currently producing, known field. Mr. Konrad agreed that

there is an enormous undeveloped resource base. He emphasized that there is no risk of running out of oil; the concern is rather running out of economic opportunities to develop fields. He further noted that when production gets too low the unit costs go up. He said this is a greater concern for industry than running out of oil.

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Mr. Williams asserted that there is a lot of capital investment in Prudhoe Bay. Wells are being drilled horizontally through thin layers of rock on the edge of the reservoir, which was made possible with new technology. He concluded that there is a lot of activity in Prudhoe Bay, but added that there are maintenance and repair challenges associated with decline.

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Representative Kelly addressed the decline rate and asked if establishing a production curve for each company would solve the problem. Mr. Williams responded that it would be impossible to administer and to tax. He related that there are events that have an effect on production curves.

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Representative Kerttula asked about the Alaska Oil and Gas Conservation Commission (AOGCC) and the 5 year set of data. She requested this data. She mentioned a process that entails a refutable presumption whereby industry could come in and disprove the decline rate. Mr. Williams said that if that idea were pursued that there should be clear criteria on the basis that the determination be made.

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Representative Gara asked if production could be speeded up with enough industry incentives. Mr. Williams said with proper incentives, investments could be made to slow the decline.

Representative Gara questioned whether this approach would encourage companies to speed up production to reduce the tax burden. Mr. Konrad replied that in an operational sense, the company produces all they can. He emphasized that it takes many years to make investments and increase production. The price of oil does not determine production level. Representative Gara asked about incentives contained in the WORK DRAFT and asked if they would produce more in order to get the lower tax rate. Mr. Konrad responded that there is investment opportunity at all sites. Mr. Williams added that towards the end of the field life when margins are smaller, tax rates are higher, which means investments

are less. He gave an example of Prudhoe Bay in the past when nothing was gained by incentives because they were unable to produce more than 1.5 million barrels.

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Representative Hawker discussed the purpose of the decline curve. He pointed out that it might be better termed as a decline allowance. The point of the curve is a mechanism to create an incentive for investment; if the decline curve were actual, it would lose its purpose. He noted that the BP charts suggest the decline should be at 10% to represent current realities. Mr. Konrad replied that if nothing is invested it would be far in excess of 10 percent, probably around 15 percent. Representative Hawker asked if current spending is inevitably a 10% decline curve. Mr. Konrad replied that current spending is 7.6%. Representative Hawker asked if BP was asking for a -4% differential.

Mr. Williams said yes: in the context of \$2.5 billion tax increase. Mr. Konrad said that if the goal is to incentivize investment that is the way to do it. Representative Hawker commented on the sensitivity data that established the 5% rate. He further noted that this was a compromise with those that felt it should be at 2 or 3%. Mr. Williams said the industry suggests a base and looking at the natural decline and then seeing what "new" production is: production that results from new investment. He also felt that the 10% rate would put current investors and new investors on a more level playing field.

[3:47:10 PM](#)

Representative Hawker asked, on the matter of a level playing field, why there was a concern if the new investor gets taxed at 15% and companies spending on new investments get 15%. Mr. Williams replied that BP spent \$1 billion to get from the natural harvest decline rate to the historic decline rate of approximately 7%. He pointed out that the \$1 billion would be taxed at 22% or higher, compared to a new field being taxed at 15%.

Representative Hawker referred to earlier testimony from BP that spoke of reducing the decline to 3%, by doubling investment. Mr. Williams said yes, he would stand by that testimony. Representative Hawker said he is confused because the 5% provides for a mechanism to buy down the rate yet industry is not supportive of this concept. Mr. Konrad said, as investors they do not see it that way into the future.

[3:52:49 PM](#)

Mr. Williams reiterated comments on the discrepancy in incremental rate between new investors and current producers. Representative Hawker appealed for a compromise to resolve the tax issue.

[3:54:08 PM](#)

Representative Kelly brought up the 3% decline rate and the current decline and asked if it is correct. Mr. Williams said it is a subtle point. Each investment decision stands on its own merits. Each year there are unknown numbers that will need to be justified at the blended rate. Representative Kelly referred to 20 percent and said the House is at 22.5 percent. Mr. Williams expressed appreciation for the cap.

[3:58:11 PM](#)

BRIAN WENZEL, VICE PRESIDENT, FINANCE AND ADMINISTRATION, CONOCOPHILLIPS, stated that his company does not support the new WORK DRAFT for HB 3001. He said it puts a tax burden on the industry. He spoke against the 22.5 percent tax. He further noted that this system is not the \$1 billion tax increase originally proposed, which ConocoPhillips supports. The original proposal provided a balance and a foundation for an agreement for a gas pipeline contract, as well as investment incentives, production growth, and employment. He maintained that the current WORK DRAFT does not do that.

[4:03:24 PM](#)

Mr. Wenzel went on to say that the original bill incentivized production. He said the POP punishes production failure. There may be production shortfalls for a number of reasons. The 15 percent tax rate is not an incentive for exploration or for heavy oil.

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Mr. Wenzel said he was concerned that the WORK DRAFT further exacerbates the difference between a production adding project and a non production-adding project. Mr. Wenzel maintained that all investment is good investment. He commented that the work draft differentially hurts long-term investors. He reiterated concerns regarding the 5% decline curve.

[4:08:12 PM](#)

Mr. Wenzel referred to a chart entitled "North Slope Production and Individual Field Decline Rates" (copy on file.) He said the decline rate even with investment is accelerating.

[4:11:12 PM](#)

Mr. Wenzel pointed to structural flaws with the system. He questioned the rationale for 22.5 percent. He said Conoco Phillips does not support the WORK DRAFT. They do support seeking a linkage between a higher company reinvestment and lower production tax.

[4:13:19 PM](#)

Mr. Wenzel said the focus should be on reinvestment. He claimed that they already have motivation to produce from their shareholders. He argued that the answer can be solved with an investment-based system rather than a production based system.

[4:16:33 PM](#)

Mr. Wenzel maintained that reinvestment creates more economic development as well as state royalties. In closing, ConocoPhillips urged reconsideration of the billion dollars per year production increase proposal. He said it is the easiest way to accelerate progress on the gas pipeline. He urged there be a limit of the degree of progressivity of any tax bill or an elimination of it all-together.

[4:18:52 PM](#)

Representative Hawker asked why there a problem with incenting it if they are producing. Mr. Wenzel replied that there is inconsistencies in the proposed system from a fiscal policy stand point. He reiterated the desire for an investment approach rather than a production approach.

[4:22:03 PM](#)

Representative Hawker asked how the industry feels about a claw-back with gold-plating limits to reward companies that invest in Alaska oil and gas development. Under the ELF, the tax rate drops to zero, which is maximum incentive, but the State is not getting the desired results.

[4:25:00 PM](#)

In answer to Mr. Wenzel's question, Representative Hawker explained where the 75-25 split originated. He explained that a mathematical algorithm was created for the tax system, at status quo, which would result in a blended rate of 22.5 percent. The algorithm achieves the initial rate which, because of the concept of incremental and base, allows a means to determine, whether established production goals have been achieved. From there the rate would increase or decrease. Mr. Wenzel maintained that the same 22.5% could

be reached in another way, other than the 75-25. Representative Hawker agreed it could be done at a 15-30 or a 50-50 split and asked if that would be more acceptable. Mr. Wentzel argued that whether than using an algorithm that "appears to have some numbers that are acceptable" that he would rather go after some fundamental numbers and talk about the period of time to make those determinations of old oil versus new oil to reaching the correct answer. Representative Hawker stated that number was targeted to something acceptable to the entire legislature. He reinforced the need to get out of a legislative deadlock.

[4:28:01 PM](#)

Representative Seaton commented on investment and thought that the testimony on the PPT credit of 20% with a tax rate of 20% provided significant investment incentive. He asked if the program needed to be modified to further stimulate investment.

Mr. Wentzel responded that the original proposal provides sufficient and significant incentives for investment. ConocoPhillips is not opposed to the concept of drawing a linkage between lower production tax rates and incentive levels.

[4:30:39 PM](#)

Representative Kertula asked if there were provisions in the bill that address a situation where a company purchases another company, increasing production, but with no gain to the State. Representative Hawker said yes, there are provisions in the bill that address the issue.

[4:31:28 PM](#)

Representative Kelly asked Mr. Wentzel if the decline curve was the main concern. Mr. Wentzel said that even if the decline rate hit the target he would still have a problem with the absolute level.

[4:35:09 PM](#)

Co-Chair Chenault asked what ConocoPhillips' plans are for bringing heavy crude to market. He noted that there is a 5 or 6-year window for this development. He asked; if it were not profitable to produce heavy oil at \$74 a barrel, when it would be profitable. Mr. Wentzel stated that the grace period for that development is not long enough. He went on to say that he felt there should be no sunset on incentives. Co-Chair Chenault said the proposed system's intent is to keep taxes low to incent the development of heavy oil.

In terms of heavy oil, it takes a long time to develop. He commented on continually developing technology in order to expedite the process of extraction. He stressed that the state should encourage research and a lower investment risk through advance technology and other areas that assist in extraction.

[4:39:27 PM](#)

Representative Holm asked if they would not invest in Alaska if they did not get incentives. Mr. Wenzel stated that they would continue to do business in Alaska, but indicated that it might not be at the maximum level. He said the State and industry share mutual benefit of the resource.

[4:41:03 PM](#)

Representative Holm did not disagree. He pointed out that Alaska owns the assets and they are leased. He questioned if there should be a greater reward for owning those assets when the value goes up. He noted the issues of the lease agreements. Alaskans need a place at the table to state their needs. He asserted that those that live in Alaska get a negative impact when the price of oil is high; there should be some benefit as the price increases.

Mr. Wenzel disagreed about the lease agreements. He acknowledged that the State of Alaska sold the right to extract the hydrocarbon to take to market subject to certain conditions such as royalties, which is separate from the State's taxing authority. He questioned whether the current proposal further encourages investment in Alaska. The people of Alaska receive the increase by the increased royalty share. He further discussed changing of lease terms and the challenges of that.

[4:46:40 PM](#)

Representative Hawker discussed the investment metric versus metric production issue and the accompanying challenges. He asked how much the State should subsidize investment under the investment scheme.

Mr. Wenzel did not want to speculate on the issue. He felt that if there were going to be a discussion it would be best to bring in an economist to outline the variables.

[4:50:11 PM](#)

Representative Hawker addressed the problem the industry has with the 25% rate. Investment is both productive and non productive. He recommended an approach that establishes a base tax rate of 25% with a buy-back on some combination of

investment and production. Mr. Wenzel stated that the idea of combined incentive would be additionally complex.

Representative Hawker commented that there is already an unlimited reward for investment. Mr. Wenzel did not dispute that. He was willing to help evaluate other incentives but did not view it as necessary.

[4:54:55 PM](#)

Representative Gara noted that under the current ELF system, the effective tax rate is zero; how could a 20% tax rate cause greater investment. Mr. Wenzel said that investment would occur under the ELF and maintained that ConocoPhillips is currently investing. Representative Gara asked if they would invest more under the 20/20 than they are currently. Mr. Wenzel could not guarantee that raising taxes would result in projects Alaska.

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Representative Gara recalled earlier testimony, which stated that a 25% tax rate is less than the world average. He asked Mr. Wenzel if he is saying that if the tax stays at 25%, they are interested in investing in Alaska. Mr. Wenzel said that investment is based on a number of elements.

[5:00:08 PM](#)

Co-Chair Meyer MOVED to ADOPT the work draft to HB 3001, labeled 24-GH2096\I, Bullock, 8/1/06. Representative Hawker OBJECTED for a question. He asked if Mr. Mintz and legislative legal had reviewed the bill. Co-Chair Chenault replied it had been reviewed. Representative Hawker WITHDREW his OBJECTION. There being NO further OBJECTION, it was adopted.

[5:02:17 PM](#)

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ADJOURNMENT

The meeting was adjourned at 5:02 PM