

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON OIL AND GAS

February 1, 2005

5:33 p.m.

MEMBERS PRESENT

Representative Vic Kohring, Chair
Representative Lesil McGuire
Representative Ralph Samuels
Representative Berta Gardner
Representative Norman Rokeberg

MEMBERS ABSENT

Representative Nancy Dahlstrom
Representative Beth Kerttula

COMMITTEE CALENDAR

HOUSE BILL NO. 32

"An Act making a special appropriation for a grant to Arctic Power to promote the opening of the Arctic National Wildlife Refuge for oil and gas exploration and development; and providing for an effective date."

- MOVED HB 32 OUT OF COMMITTEE

Overview of Alaska Oil and Gas Association

- HEARD

PREVIOUS COMMITTEE ACTION

BILL: HB 32

SHORT TITLE: APPROP: GRANT TO ARCTIC POWER FOR ANWR

SPONSOR(S): REPRESENTATIVE(S) KOHRING

01/10/05	(H)	PREFILE RELEASED 12/30/04
01/10/05	(H)	READ THE FIRST TIME - REFERRALS
01/10/05	(H)	O&G, FIN
02/01/05	(H)	O&G AT 5:00 PM CAPITOL 124

WITNESS REGISTER

KEVIN HAND, Executive Director
Arctic Power

Anchorage, Alaska

POSITION STATEMENT: Testified on behalf of Arctic Power in favor of HB 32

JUDY BRADY, Executive Director

Alaska Oil and Gas Association

Anchorage, Alaska

POSITION STATEMENT: Presented a briefing on Alaska's current oil and gas fiscal system

TOM WILLIAMS, Chairman

Alaska Oil and Gas Association Tax Committee

Anchorage, Alaska

POSITION STATEMENT: Presented a briefing on Alaska's current oil and gas fiscal system

ACTION NARRATIVE

CHAIR VIC KOHRING called the House Special Committee on Oil and Gas meeting to order at [5:33:11 PM](#). Representatives Kohring, McGuire, Samuels, and Gardner were present at the call to order. Representative Rokeberg arrived as the meeting was in progress.

HB 32-APPROP: GRANT TO ARCTIC POWER FOR ANWR

CHAIR KOHRING announced that the first order of business would be HOUSE BILL NO. 32, "An Act making a special appropriation for a grant to Arctic Power to promote the opening of the Arctic National Wildlife Refuge for oil and gas exploration and development; and providing for an effective date."

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CHAIR KOHRING, speaking as the sponsor, explained that HB 32 appropriates \$1.2 million from the general fund (GF) to fund Arctic Power, a private nonprofit organization that advocates for the opening of Arctic National Wildlife Refuge (ANWR) [to oil exploration and development]. He said, "[The appropriation] is to fund [the Arctic Power] budget, or at least a portion of their budget, so that they can advertise and cover related expenses as it relates to advocating for the opening of ANWR and encouraging congressmen to vote in the affirmative on legislation that they'll have before them in [Washington D.C.]." He noted that the bill also includes a \$100,000 appropriation to the Native Village of Kaktovik for community outreach in an effort to gain the community's support of the opening of ANWR.

CHAIR KOHRING remarked that he views [the proposed appropriation to Arctic Power] as a small amount of money when one considers the potential payoff. He stated that there are estimates of as much as ten billion barrels of oil in the Arctic National Wildlife Refuge (ANWR). He opined that, if [the U.S. Congress] is able to get legislation passed and signed into law, the potential return will be phenomenal and well worth the investment of \$1,200,000. He remarked that [the legislature] is trying to open the Coastal Plain of ANWR for oil exploration and development, not ANWR as a whole. He said, "In the course of exploring and developing that area, we're expecting that there will likely be some additional unforeseen discoveries that could be added to the potential that is estimated up there that could further reduce our country's need for imported oil and help with our trade deficit and perhaps even improve our national security."

CHAIR KOHRING noted that Arctic Power has been in existence for 12 years and it received a \$1.8 million appropriation from the legislature two years ago. He said, "We really feel that the timing is critical on this, too. We have a very opportune situation here where ... Congress is very amenable to opening ANWR.... We've got a substantial number of prodevelopment people who believe in enhancing our oil and gas industry, and that like to support ANWR. So the time is right to really push this issue now. And then of course President [George W. Bush] is very supportive as well and he's pledged to sign legislation if it were to be produced from Congress."

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KEVIN HAND, Executive Director, Arctic Power, said that Arctic Power is a "nonprofit, grassroots organization of citizens and businesses from across Alaska and across the nation advocating for responsible exploration and development of the region which contains [the Coastal Plain] of the Arctic National Wildlife Refuge." He noted that Arctic Power has active education and advocacy programs that are currently underway in Washington D.C. The programs provide information such as caribou numbers, and statistics on the nation's dependence on foreign oil to the Alaska delegation and other members of Congress. Arctic Power facilitates congressional tours to ANWR, and sends delegations of Alaskans to Washington D.C.

MR. HAND remarked:

There is no one else out there focused on advocating on behalf of Alaska for ANWR, besides ... of course our congressional delegation. We know that we ... could not list on one piece of paper all the groups out there that are opposing us in this endeavor.... We are outspent many times over by the environmental organizations; it's an impossibility, unfortunately, to match their resources."

MR. HAND noted that [the U.S. House Committee on Resources] put out a press release today with new poll results showing that a majority of Americans support responsible development ANWR. He said, "The amount of support with Americans is ... up considerably when they are given a 'common sense' approach to responsible development of ANWR." He said that the poll was facilitated and paid for by Arctic Power.

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MR. HAND said that Arctic Power has a database that contains a record of every meeting that has ever taken place between an Alaskan and a member of Congress regarding the issue of ANWR. He also said that Arctic Power assembles advocacy pieces with state-by-state statistics including information on predicted revenue and jobs generated. He described several coalitions and alliances that Arctic Power has built in Congress and with other grassroots organizations. He outlined other work performed by Arctic Power that "sort of [goes] unnoticed, ... under the radar," including providing talking points and advocacy materials to legislators.

MR. HAND remarked:

We're going to face considerable challenges this year. The green community is not going to go away without a fight. I understand that ... they're going to come out with a new caribou study to combat and ... inflame the environmental argument in that regard.... And these attacks are only going to increase as we come to fruition here, come to a vote on the floor of the House and the Senate. Arctic Power is ready; we just require the resources to accomplish all that we are asked to do by the delegation.... Private fundraising has been undertaken in earnest. ... We definitely believe ... that the benefits to Alaska far outweigh any costs.

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REPRESENTATIVE SAMUELS moved to report HB 32 out of committee with individual recommendations and the accompanying fiscal note. There being no objection, HB 32 was reported from the House Special Committee on Oil and Gas.

Overview of Alaska Oil and Gas Association

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JUDY BRADY, Executive Director, Alaska Oil and Gas Association (AOGA) informed the committee that AOGA is a private, nonprofit corporation with 18 members.

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TOM WILLIAMS, Chairman, Alaska Oil and Gas Association Tax Committee, stated that he and Ms. Brady are here to provide the committee with a briefing about what Alaska's current oil and gas system is and how it works. He made four points: Alaska's revenue forecasts always count on new production; producers need to spend money to increase production and for the state to make money; state government policy decisions will affect the level of investment in oil exploration and development; and the aim is to take a healthy share of the profits while remaining competitive in the world market for oil and gas investment dollars. He said that the legislators need to consider the following questions about Alaska's fiscal system: does it protect the state's interest even when the prices are low; does it make the state more competitive or less competitive for investment dollars; and does it encourage or discourage new investment.

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MR. WILLIAMS referred to a pie chart showing that oil revenue provides at least 75 percent of the unrestricted general purpose revenue of the state, and the two elements most critical to the oil revenue forecast are price and value. The state cannot control the price but can control the volume.

MR. WILLIAMS stated that there are four elements to Alaska's present fiscal system: royalty, which paid over \$1 billion to the GF and just under \$500 million to the permanent fund last year; production tax, which contributed over \$600 million to the GF; property tax, which contributed \$47 million to the state and

\$218 million to municipalities; and the income tax, which equaled just under \$300 million.

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MR. WILLIAMS explained that royalty is the state's ownership share. He said, "It doesn't involve a inherent sovereign right of the state but merely its right as a landowner to make a contract for the use of its land." He noted that until 1979 virtually all of the leases had a standard one-eighth royalty clause but starting in 1979 some leases were offered with higher royalty rates and the State had the option to receive the royalty either "in kind" as physical oil or gas, or "in value" based on what the value of the oil or gas in the field, called a "netback value". He clarified how to calculate the netback value by subtracting the transportation costs and the pipeline tariff from the spot price.

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MR. WILLIAMS explained that the production tax, also known as the severance tax, is an excise tax on the act of actually producing the oil or gas. The tax "comes off the top" and is based on the gross value of the oil or gas in the field as it is being produced. He said that the gross value is the value at the custody meter where the oil goes from the field into the pipeline; field costs are not deductible for production tax or for royalty. The gross value is equal to the product of the netback value and the taxable volume. Taxable volume is equal to the total volume amount minus the state's royalty share. The amount of production tax is the product of the Economic Limiting Factor (ELF) multiplied by both the base rate and the gross value.

MR. WILLIAMS clarified that the base rate is 10 percent for gas and 12.25 percent for oil during the first five years of a field's production then it changes to 15 percent. He explained that the ELF is a number between zero and one that is calculated for each field. For oil, it is based on field size and well productivity; larger fields have larger ELFs and therefore higher tax rates, and more productive wells have larger ELFs and higher tax rates. The gas ELF is based only on well productivity.

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MR. WILLIAMS then turned attention to the property tax, which he said is independent of the price of oil and gas. Instead it is based on the assessed value of the taxable property, which is determined each year by the state assessor. The state property tax applies only to property that is used in oil and gas exploration, production, or transportation by a pipeline that is not a gas-utility transmission or distribution line. He noted that the tax is 20 mills per dollar or 2 percent of the value as assessed by the state. When property is within a municipality, that municipality can tax the property at the same rate that it taxes the local residents' properties. The municipality tax counts as a credit against the state tax.

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MR. WILLIAMS next discussed corporate income taxes. He said that this tax applies to all for-profit corporations in Alaska "except for the ones that aren't treated as corporations; Subchapter S corporations and limited liability corporations are treated as partnerships, so they're invisible for tax purposes and they don't count." All the corporate taxpayers have the same rates and the same tax brackets. He explained that all multistate corporations use apportionment to determine their taxable Alaskan income. He presented an example of how this tax would apply to a business such as WalMart, and then he explained how the tax would apply to a fictional worldwide oil company named Oilco. He said, as paraphrased from the handout: "The apportionment is the average of three numbers: the percentage of worldwide property in Alaska, the percentage of worldwide sales in Alaska, and the worldwide production in Alaska."

MR. WILLIAMS said:

One of the things that's interesting is how these pieces fit together. Royalty is sensitive to price volatility; if the market price of oil goes up a dollar or down a dollar, the rise flows straight back to the wellhead because the transportation costs essentially are the same. So your netback value in the field goes up a dollar. If it falls by a dollar in the marketplace the netback value basically falls by a dollar. So the oil royalty is very vulnerable with oil prices. ... The production tax is a similar sort of thing; it's sensitive to [oil prices]. The one protection in the production tax against very low prices is ... a cents-per-barrel floor against a severe downsize. Basically if your percentage of

value gets down below this floor price, an 80 cents-per-barrel tax rate kicks in instead.

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MR. WILLIAMS reiterated the "take aways", information he wanted the legislators to remember: Royalties are the mainstay of Alaska's revenue system; they're almost half of the GF unrestricted revenues and are the largest source of oil and gas revenue at present. He noted that every oil field on state land pays state royalty, which comes off the top and doesn't take into account the cost of exploring, developing a field or the costs of operating the field. Royalty in kind gives the state opportunities to develop or encourage value-added industry; there are several refineries in Alaska because of what the state has done with its royalty oil. He remarked that while oil prices and royalties go up and down, they don't go away until production stops.

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MR. WILLIAMS summarized the "take aways" for property taxes: the bulk of it goes through municipalities, and it is independent of the price of oil and gas.

MR. WILLIAMS listed the key points for corporate taxes: the same tax, same tax brackets and the same tax rates apply to oil companies as they do for other Alaskan corporate taxpayers. He explained that all the corporate taxpayers use apportionment to determine how much income was made from the Alaska piece of the business.

MR. WILLIAMS reviewed each tax's sensitivity to oil price volatility: royalty taxes are sensitive; production taxes are sensitive but have a cents-per-barrel floor against severe downside; property taxes are immune; and income taxes are moderately sensitive.

MR. WILLIAMS said, as paraphrased from the handout:

The corporate income tax ... is somewhat insulated against gyrating oil prices. This is because most of the oil companies operating in Alaska ... are vertically integrated. This means that, in addition to their "upstream" profits from producing oil and gas, they also have "downstream" profits from refining and the marketing of refined products. Some may also

have significant petrochemical businesses. Income from all of these sources goes into the "pie" of worldwide income out of which a "slice" is apportioned to Alaska. It is not uncommon to see profit margins in the "downstream" refining, marketing and petrochemical businesses being squeezed when oil prices are skyrocketing and "upstream" profits are soaring; but conversely, when oil prices are in the tank, these "downstream" businesses may tend to be countercyclical to those for the "upstream". There is a natural dampening effect that helps keep the income tax from swinging too far in either direction as oil prices rise or fall.

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MR. WILLIAM shifted attention to the ELF. He said that from a producer's point of view, the field life has four stages. He said that in stage 1, royalty and production taxes come off the top with low production costs and a large operating margin, which is the oil companies' goal.

MR. WILLIAMS said:

One thing that happens is that oil and gas [production] changes over time; it's a depleting resource. There's nothing new being created in the ground as you take it out, and so that means that in the natural course of things, you're going to have to work harder and harder to get the next barrel of oil ... or the next cubic foot of gas out of the ground than the one you just produced. Another thing that happens is that reservoirs change; over time you get more gas coming up with every barrel of oil, and that's more cost to separate it and manage it and put it back in the ground. And also over time you tend to have more water coming up with each barrel, and again that means more cost to separate the water and dispose of it properly. It's interesting ... how different Prudhoe Bay ... is now from when it started just over 25 years ago. When Prudhoe Bay first came onstream it ... [produced] 1,200,000 barrels a day [b/d] from 120 wells: 10,000 [b/d] per well. ... Today it's producing just under 400,000 [b/d] of oil and there's over 1,000 wells. When it started production the gas that came up that had to be disposed was about 1 billion cubic feet a day. Now we're injecting over 7.5 billion

cubic feet a day and handling 8.5 billion cubic feet a day.... In 1979 the water that we had to inject ... was 23,000 [b/d]; last year it was 1,500,000 [b/d]. So the field was very different. The costs for Prudhoe Bay have gone up, the volume [of extracted oil] has gone down.

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MR. WILLIAMS explained that the production costs have increased over time, which can happen to any field. He continued:

In 1976 there was a big stalemate in the legislature over whether Alaska should have separate accounting or not. The Department of Revenue [DOR] did not want to have a separate accounting income tax because we thought ... a production tax would be easier to administer and would avoid all kinds of messy disputes and litigation about trying to unwind transactions between affiliates in a vertically integrated oil company. ... The tax administrators [were concerned about] ... the possibility that there could be some creative accounting in the pricing of these things so that ... the profits ended up being in the subsidiary that was running ... outside of Alaska's jurisdiction. ... We didn't go down that path; [production] tax is nice and simple.

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MR. WILLIAMS said that the problem with the high rate production tax is that it comes off the top. At the beginning of a field's life it doesn't make much difference, but over time the situation changes: production costs rise and the operating margin is squeezed. He explained that new investments will become uneconomic and a field will be "thrown into the red". The operator has the option of operating at a loss, which is sometimes done if the prices might come back up, and sometimes it's done because it's more expensive to terminate the project and restore the land.

MR. WILLIAMS stated that the production tax can accelerate a company into operating at a loss, "stage 4". If the production tax was removed the companies would have an operating margin again and therefore make a profit. He remarked that the DOR wanted to have a high production tax but not to put the oil companies out of business. He said that the ELF was the answer

to this dilemma. The original ELF proposal is based on the total current production (TP) and the amount of production needed to cover production costs (PEL). The PEL divided by the TP equals the percentage of the current production that is needed to cover the production costs. Subtracting this fraction from one produces the "gravy percentage", which is the percentage of the production representing the producer's operating margin. He explained that the tax shrinks when production costs rise.

MR. WILLIAMS quoted from a 1977 DOR report titled "Alaska's Oil and Gas Tax Structure: A Study with Recommendations for Improvement" which read [original punctuation provided but formatting changed]:

The Department of Revenue recommends [the ELF] as a means of eliminating effects of the production tax on the economics of oil production operations. ... [T]he Department of Revenue recommends an Economic Limit Factor [ELF], based on the ratio of the rate at the true economic limit to the current production, as a mechanism for scaling down the tax rate as the production declines toward the economic limit.

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MR. WILLIAMS said that the legislature added an exponent to the ELF in 1977 legislation. He explained:

The reason it was put in was Prudhoe Bay could show that it needs 1,000 [b/d] to break even, and it was producing 10,000 [b/d] per well. Under the Knudson formula, which was the original formula, that fraction would be 0.1 ... subtracted from one gave you an ELF of 0.9. That was too big a tax break in the eyes of the legislature. The exponent took it away. Whether you left the presumption of 300 [b/d] to break even or showed you needed 1,000 [b/d], when you calculate it under the [Knudson] formula, the ELF is 0.95 either way.

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MR. WILLIAMS, at the request of Representative Gardner, repeated his explanation of the ELF calculation. He then said that in 1989 there was another change to the ELF equation. This added another exponent to the equation by taking into account the

field size as represented by the fraction of 150,000 b/d over TP. He stated, "The exponent from the original formula that carries over turns into a turbocharger; it accelerates the effect of the first exponent." He said that if a field produces over 150,000 [b/d], the ELF will increase closer to one. If the field produces less than 150,000 [b/d], the ELF drops toward zero.

MR. WILLIAMS presented the reasons for the 1989 ELF change: to get more revenue for the state; to give the producers an incentive for operating small fields; to give an incentive for drilling for West Sak heavy oil; and Prudhoe Bay and Kuparuk could afford it.

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MR. WILLIAMS then presented the effects of changing the ELF: "The legislature was told that it would reduce the rates for all fields except Prudhoe Bay and Kuparuk, and the marginal fields". He stated that probably any other field that would be discovered in Alaska will be considered marginal unless it was a super giant. He commented that the legislature was told specifically that Endicott would have reduced taxes under the bill even though it produced 100,000 b/d. He explained that this is a different concept of marginal than the standard, dictionary concept.

MR. WILLIAMS said that another effect of changing the ELF was that production tax rates could go to zero and be eliminated entirely. A third effect was that small fields would pay less tax even with a same well productivity. A fourth effect was that the revenue gains would change.

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MR. WILLIAMS said that with the introduction of field size to the ELF, it became important whether fields stood alone or lumped together. He remarked, "There was a provision put in the 1977 law, before Prudhoe Bay or anything on the slope started producing, that said where you have economically interdependent operations being conducted, you can lump together the various pieces of whatever you need to recognize the whole operation. ... It didn't make much difference if you lumped together or not." He showed an example where, before the 1989 changes to ELF, there was little difference between stand-alone fields and those that had been lumped together. However after changes were made to ELF in 1989, he said, "suddenly both fields are a lot

bigger by being combined than either was separately." He then showed an example of two fields under the new ELF formula and noted how it "rewards smallness".

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MR. WILLIAMS, in response to Representative Samuels, explained that when calculating the apportionment factor for a company, the percentage of worldwide sales in Alaska would include the actual refined products that are sold in Alaska as well as the pipeline tariffs.

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REPRESENTATIVE ROKEBERG asked about the numbers from the Wood Mackenzie study, titled "Global Oil and Gas Risks and Rewards 2004," that are mentioned in the handout.

MS. BRADY stated, "We've referred in these remarks to both the 2002 study and the 2004 study that Representative Samuels just announced with Senator Therriault, that they're going to release. We asked for the same ability to release information and we are in the same situation as the ... legislature talked about today. We are still reviewing those figures to see what they mean. But the figures that we have ... in there we have permission to release."

REPRESENTATIVE ROKEBERG commented that he missed the press conference and he doesn't know what was released today.

MS. BRADY responded that she has permission to talk about the information that [is included in the handout].

REPRESENTATIVE ROKEBERG remarked that he signed a confidentiality agreement and therefore he is constrained to asking questions.

CHAIR KOHRING noted that he has a copy of the news release that he can share.

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REPRESENTATIVE ROKEBERG paraphrased the page 29 of the handout, which read:

As in the 2002 study, Alaska's tax regime (state, local and federal) tends to stay in the middle of the

pack worldwide, although at higher oil prices, it moves the State into a more competitive position. This is positive. It reinforces the concept that governments can influence through their tax policies.

REPRESENTATIVE ROKEBERG commented:

This seems to indicate that, Mr. Williams, the testimony you gave before the [House Ways and Means Standing Committee] last spring indicates the policy of the state when you were with the state administration was to create a situation in our multiple sources of petroleum revenues a greater take for the state of Alaska when the prices are low, and a sliding scale, if you will, or a scale situation where its prices increase the percentages of the state take would go down albeit the gross revenues would go up but the percentages would go down. And there's been some criticism about that. Would you care to comment about that ... in terms of any ... arguments that you can bring before the committee?

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MR. WILLIAMS responded,

First of all, that is how Alaska works. And part of the reason for protecting the downside is that, in the 1970s ... and the early 1980's ... oil was just as big a percentage of the budget as it is now. And if it goes down, our revenue is impacted; it would not be the right time to be cutting taxes even further because the oil companies are also being squeezed.... When oil revenues fell to less than a billion dollars a year in 1986 ... the people needed government services and that would be the wrong time to be doing a cut for the oil companies.... To keep the revenues there we end up, unfortunately, taking a larger piece of what's available, a higher percentage. It's balanced out, if you have long-term expectations.... This regressive aspect of the tax gives encouragement to people who are Wildcatters because they're hoping that when oil prices are high they're going to have [large operating margins].... If the state's taking away the upside then it's reducing their expectations about what they might get.

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MR. WILLIAMS, in response to Representative Rokeberg, explained that the production tax is about a quarter of the total petroleum revenues that the state receives. He said that it was higher in the past "because the fields were higher and more robust and they had higher economic limits factors." He explained that when fuel is at a low price, it reduces the wellhead, or netback, price. The royalty and production tax continue to come off the top, but the costs don't come down just because prices have, so the operating margins get squeezed.

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REPRESENTATIVE MCGUIRE asked how other countries take into similar problems without using an ELF.

MR. WILLIAMS replied that Alaska's [ELF system] is unique. He remarked that the real question is whether investments are being made in Alaska.

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MS. BRADY commented that oil will continue to be the mainstay for Alaska's economy, and once the gas pipeline and ANWR are opened it will continue to be strong for the next 50 years. She returned to the topics of price and volume of oil. To illustrate the state's lack of influence over the price of oil, she described instances where the state has weathered several high and low oil prices swings over the last few decades. She said, "We can't do very much about prices ... but we can do something about volume." When the ELF changes were made in 1989 the state [taxed the Prudhoe Bay and Kuparuk fields the most] because those two fields were producing 2.1 million b/d, and the state knew that in the future the fields would not [produce such high volume of oil] because the costs would increase.

MS. BRADY opined that if there had not been any [further investments after 1989], [the oil industries] would be producing less than 300,000 b/d, and therefore the State of Alaska would not have the budget that it has now. She then remarked that [companies began to drill for] heavy oil in 1997, almost 10 years after the 1989 ELF changes. She said, "On the basis of the promise that there would be no tax on those [heavy oil] fields, it took about 10 years for them to be developed and starting to produce ... and now we're starting to get talk about taxing them again after the investments have been made." She

noted that by 2003, the satellite fields, the heavy oil production, and the Wildcat exploration began to be a larger part of the [total industry] investments.

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MS. BRADY turned attention to another graph which depicted the investments that DOR predicted the state will need in the future. She commented that the DOR forecasts that the state will drop from about 900,000 b/d to about 800,000 b/d between 2005 and 2015. Noting that this would be the least amount of production the state has dropped since 1989, she stated that "by normal course of events" the [declining fields] will be producing only 200,000 b/d by 2015. She remarked that the big fields will continued to be the state's "bread and butter" fields, but she opined that the reliance will become more and more on satellite fields, fields that were previously discovered but not developed, heavy oil fields and Wildcat exploration. She said that in 1989, "All [the state's] oil was coming from Prudhoe and Kuparuk, nothing else counted. They were hoping for more, that's why the legislature said, 'Okay, we're going to hit the big fields hard [with taxes] but everything else is going to be home free because we need that production.'"

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MS. BRADY posited, "If we don't get this production, no matter what the prices are going to be, we're going to be in a world of hurt. If we're getting the money that we need ... for new production then we are competitive. If we're not, then we need to start figuring out why...."

MS. BRADY said:

We believe right now that the state's tax system is working the best a tax system can work. It's not the perfect tax system but it is pretty darn close. You're getting investments in heavy oil, in satellites, in fields ... and in Wildcat. So we are getting the investments that we need right now with this tax system. The state is getting a consistently high return overall, especially on the medium prices and even at high prices.... So we are very much hoping that the fiscal system will stay the way that it is and ... that you keep in mind that we continue to need these four kinds of investment.

6:58:51 PM

REPRESENTATIVE SAMUELS asked how the state audits worldwide tax returns.

MR. WILLIAMS replied that the DOR allows the companies to use as a substitute its financial book income which is the sum of two parts: the amount reported to the Internal Revenue Service for the U.S. business, and the financial accounting income for the rest of the world.

7:00:08 PM

MR. WILLIAMS, in response to Representative Samuels, reminded the committee that whether the company needs 300 b/d or 1,000 b/d [to break even], the ELF was still 0.95. He said, "The formula worked very well; it was extremely clever."

7:01:28 PM

REPRESENTATIVE ROKEBERG asked Ms. Brady, "Would you care to comment on the statements made by the governor about his communication with AOGA as an organization regarding his potential administrative order, and what in fact you perceive to be his message? ... Can you describe what he warned you or asked you to do?"

MS. BRADY replied, "No, I wouldn't." She further explained that AOGA sent a letter to the governor, which they also released to the press, "that relates not only what ... [AOGA's] understanding of what he asked us but what our response was.... We're perfectly open to giving that letter to anybody who wants [one]. We are sorry for the misunderstanding on both sides."

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REPRESENTATIVE SAMUELS asked if AOGA would support the creation of more exploration credits for those companies that are making money at a high end.

MR. WILLIAMS responded that credits must be designed to influence the explorers. He opined that the current credits don't take into account the types of costs that are used to make the decision whether to explore or not. He said that the DOR has attempted to fix this through regulations, but "unfortunately it was presented in a way to [legislators] ... that makes that difficult." He emphasized his belief that the

legislature should design credits to influence the oil industry's explorers, and that the ELF is more of an incentive than past credits. He said that the industry would prefer a system that "makes Alaska attractive"; the fact that Alaska takes a smaller percentage at high oil prices makes oil development more attractive for a company that has a lot of money out at risk for many years.

MR. WILLIAMS noted that there are four different kinds of development investments: in-field, satellites, heavy oil, and Wildcats, and said that the economics of each of these investments is different from the other. He explained that the Wildcatters have to put a lot of money upfront and wait to see if they can recover it, while other explorers drill and see an immediate payout. He stated that offering an incentive in one of these [types of development investments] can have carry-over effects [to the other types]. He emphasized the importance of determining these effects before acting.

[7:07:46 PM](#)

MS. BRADY recalled that in the 1980s the oil prices were very high then very low, with a median price of about \$18 [per barrel], and even in the last four years the median price has been \$23. She said that [for the oil industry], years of high oil prices make up for the years when the prices were low.

[7:09:48 PM](#)

REPRESENTATIVE MCGUIRE remarked that [there are rumors that] perhaps oil companies were misusing the ELF formula. However she said that it appears that the effects of aggregation were discussed and the legislature understood that ELF would change the aggregation behavior [of the oil companies].

MR. WILLIAMS replied:

That was a consequence of making field size such a powerful part of the formula in the ELF. Suddenly to aggregate or not to aggregate became very much more important. The DOR has in fact adopted a regulation [15 AAC 55.027] that allows companies to come in that are proposing to share facilities, typically a satellite situation, and get a ruling from the department saying that the satellite will have a separate ELF from the field that owns the facilities it's going to share. And so those rulings have been

granted. That's ... how the administrative response has been to deal with the issue; there's standards that are set out in the regulation about what are the criteria the department will use because the statutory phrase is "economic interdependence", not "interrelatedness".... That means each depends on the other, not that they influence each other.

[7:12:31 PM](#)

CHAIR KOHRING commented that he would be willing to explore potential legislation to offset the effects of the increased tax. He said perhaps the legislature can offset the effects of the increased taxes through incentive legislation such as tax credits or royalty reduction.

[7:13:51 PM](#)

REPRESENTATIVE ROKEBERG asked that the committee meeting time be changed, and noted that he will not be at the next meeting.

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Oil and Gas meeting was adjourned at [7:15:00 PM](#).