

**ALASKA STATE LEGISLATURE**  
**HOUSE SPECIAL COMMITTEE ON OIL AND GAS**

April 7, 2005

5:05 p.m.

**MEMBERS PRESENT**

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

**MEMBERS ABSENT**

Representative Nancy Dahlstrom  
Representative Norman Rokeberg  
Representative Beth Kerttula

**OTHER LEGISLATORS PRESENT**

Representative Jay Ramras

**COMMITTEE CALENDAR**

HOUSE BILL NO. 234

"An Act relating to the due date for the payment of oil and gas royalty and net profit shares and amending the rate of interest payable on royalties or net profit shares."

- HEARD AND HELD

**PREVIOUS COMMITTEE ACTION**

BILL: HB 234

SHORT TITLE: OIL/GAS ROYALTY DUE DATE & INTEREST RATE

SPONSOR(s): OIL & GAS

03/23/05	(H)	READ THE FIRST TIME - REFERRALS
03/23/05	(H)	O&G, RES, FIN
03/31/05	(H)	O&G AT 5:00 PM CAPITOL 124
03/31/05	(H)	Scheduled But Not Heard
04/07/05	(H)	O&G AT 5:00 PM CAPITOL 124

**WITNESS REGISTER**

SEAN PARNELL, Deputy Director  
Division of Oil and Gas

Department of Natural Resources (DNR)  
Juneau, Alaska

POSITION STATEMENT: Testified in opposition to HB 234 and answered questions regarding the bill.

MARTIN SCHULTZ  
Audit Section  
Division of Oil and Gas  
Department of Natural Resources (DNR)  
Anchorage, Alaska

POSITION STATEMENT: Answered questions regarding HB 234.

JIM STOUFFER, Accountant IV  
Division of Oil and Gas  
Department of Natural Resources (DNR)  
Anchorage, Alaska

POSITION STATEMENT: Provided information during discussion of HB 234.

MARK BOND, Legal Counsel  
UNOCAL Alaska  
(No address provided)

POSITION STATEMENT: Testified in favor of HB 234.

DON PAGE, Manager of Accounting and Finance  
UNOCAL Alaska  
(No address provided)

POSITION STATEMENT: Testified in favor of HB 234.

MARILYN CROCKETT, Deputy Director  
Alaska Oil and Gas Association (AOGA)  
Anchorage, Alaska

POSITION STATEMENT: Testified in favor of HB 234.

MICHAEL HURLEY, Director  
State Government Relations  
ConocoPhillips Alaska, Inc.  
Anchorage, Alaska

POSITION STATEMENT: Testified in favor of HB 234.

MYRL THOMPSON  
(No address provided)

POSITION STATEMENT: Testified in opposition to HB 234.

**ACTION NARRATIVE**

**CHAIR VIC KOHRING** called the House Special Committee on Oil and Gas meeting to order at [5:05:39 PM](#). Representatives McGuire, Samuels, Kohring, and Gardner were present at the call to order.

HB 234-OIL/GAS ROYALTY DUE DATE & INTEREST RATE

[5:05:54 PM](#)

CHAIR KOHRING announced that the only order of business would be HOUSE BILL NO. 234, "An Act relating to the due date for the payment of oil and gas royalty and net profit shares and amending the rate of interest payable on royalties or net profit shares."

[5:06:32 PM](#)

CHAIR KOHRING presented HB 234 on behalf of the House Special Committee on Oil and Gas, sponsor of the bill. He said:

[The bill] would basically, if passed, lower the interest rate that's charged for over and underpayments when it comes to royalties for oil and gas. ... When [oil and gas] companies submit their payments on royalties to the State of Alaska, if there's [an] overpayment on that, then the state, after they conduct their audit, they refund those monies back to the oil industry, and there's an interest rate ... associated with any outstanding dollars during the course of that audit in the time that elapses from when those payments were made until when the refund occurs. And then it cuts the other way too; as far as any underpayments were, upon the conclusion of an audit, it's determined that the industry has not paid enough, then they owe not only the money but an interest rate back to the State of Alaska. Now it's that interest rate that has been an issue of contention among folks which spawned this legislation, not that everybody agrees it should be lowered. But my position is that the interest rate should reflect prevailing market rates.

[5:07:42 PM](#)

CHAIR KOHRING continued:

The interest rate has been set in statute for quite a few years now. ... It's the higher of two: it's either

prime plus [5] ... or 11 percent, whichever is higher. In recent years, ... they've had the option of going with the 11 percent interest rate, which in this market is a pretty high rate when you consider interest rates having been as low as ... 1 percent or so, in some cases. So I'm looking at this from a perspective of fairness to the industry, but also fairness to the state because it cuts both ways because of the under and overpayment scenario.

[5:08:18 PM](#)

CHAIR KOHRING continued:

We're also, in this bill, looking at speeding up the process as far as calculating those payment amounts too, so that we can expedite that and not leave the industry or the state hanging for a long period of time in terms of receiving those refunds from either under or overpayments.

[5:08:48 PM](#)

REPRESENTATIVE GARDNER asked if HB 234 was filed as a committee bill.

CHAIR KOHRING replied, Yes, I filed it as a committee bill."

REPRESENTATIVE GARDNER asked if the bill was requested by anybody or if it was just something that Chair Kohring felt was needed.

CHAIR KOHRING answered that the bill was requested. He said:

The genesis of this bill was the result of a hearing that occurred down on Kenai Peninsula about two months ago, maybe six weeks ago, where there was a joint meeting of the House and Senate resources committee and we were part of that as oil and gas. ... There were a lot of issues that were looked at. We entertained testimony from the oil and gas industry and other folks just to find out what it is that the state can do to help the industry; what issues are outstanding. And from that came this issue, from that came the issue of possibly buying a jack-up rig for exploration in Cook Inlet. ... That's how this bill

was originated. It was not just a thought that came to mind....

5:09:59 PM

REPRESENTATIVE GARDNER pointed out that the fiscal note shows a cost to the state, which indicates that in practice the state doesn't often end up paying interest for overpayments. She asked if this conclusion was correct.

CHAIR KOHRING deferred to the Department of Natural Resources.

5:11:04 PM

SEAN PARNELL, Deputy Director, Division of Oil and Gas, Department of Natural Resources (DNR), replied that overpayments are rare.

5:12:20 PM

CHAIR KOHRING remarked that because of the committee members' busy schedules, he had to make a judgment call regarding whether a bill is a committee bill or not. He told the members that he will make a concerted effort in the future to communicate more with members before a bill is filed on the committee's behalf.

5:13:18 PM

MR. PARNELL stated that DNR opposes HB 234 for several reasons. He explained:

First, [HB 234] incentivizes a company ... to underpay their contractual royalty obligations to the state. And secondly, HB 234 would diminish state revenues with no correlative upside for the people or the state. In our view, the current statutory rate of compounding interest strikes an appropriate balance in favor of compensating the parties for lost use of money over time. ... [Under existing law], royalties, net profit share lease payments that get paid, interest is charged on underpayments at a floor rate of 11 percent; when the federal reserve rate goes above a certain rate on a floating basis [and] that rate is greater than 11 percent, then the greater rate is charged. In these times the going rate for ... underpayments of royalty is 11 percent. The state pays an equivalent interest rate in the infrequent

event that the state owes a refund because the company overpaid its royalty obligations. Under current law, interest compounds quarterly and interest is payable from the date the obligation becomes due....

[5:14:44 PM](#)

MR. PARNELL then described the state's royalty audit process. He said:

Our division employs six revenue auditors who are responsible for auditing or reviewing the state oil and gas royalty and their profit share lease payments. ... State royalty collections amounted to about \$1.4 billion in fiscal year (FY) [2004]. Department of Resources revenue auditors must understand oil and gas operations to perform audits; they are clearly professionals. ... The legislature transferred this sole audit responsibility to DNR less than two years ago. Prior to that, this audit responsibility or function rested with the Department of Revenue; [DNR] provided a backup audit function to them at the time. When the legislature transferred audit authority to DNR the backlog of audits was about on average six years. In the last two years that has been shaved down to an average of three years, in terms of the backlog, so we're gaining some improvement there.

[5:16:01 PM](#)

MR. PARNELL pointed out that the division completed one major audit in FY04 and has completed 14 audits so far in FY05. He explained that audits usually include two or three years of royalty payments, so the division looks at two years at a time. He noted, "It does take some time for those payments to settle out." Therefore if a company makes an audit payment in January, and then refiles within six to 12 months, it might take the rest of the year [for the division to have the correct numbers for the audit]. He said:

Within the last two years, the division completed Cook Inlet oil and gas production audits through 2002, and on the North Slope, most production is subject to royalty settlement agreements [RSA]. Audit challenges primarily relate to obtaining information necessary to perform an audit from lessees. ... Lease terms provide that the state is entitled to the higher of the price

the lessee receives for its oil or gas, or the prices received by other lessees in the area. So the auditors have to obtain information from the lessee and other producers in the area to calculate the royalty value because the state gets the higher of whichever barrel gets the highest value in that unit....

[5:17:38 PM](#)

MR. PARNELL continued:

Much of the information is confidential and the auditor must obtain confidentiality agreements from each producer. Obtaining this information can take a great deal of time. And another audit challenge is that each company's accounting system is different and the auditor must learn each system. Lessees do not always provide required information in a timely manner or promptly respond to audit claims. And likewise the state cannot always respond as quickly as we or a particular company might like, in large part due to our workload. Despite these challenges, the division believes that the audit process is equitable to lessees and provides a thorough review of an important source of state revenue. Our record demonstrates as well that we are on track to improving the timeliness of our audits.

[5:18:23 PM](#)

MR. PARNELL turned attention to HB 234 and commented:

[The bill] wrongly provides an interest-free period on contractual debts owed the state. Under HB 234, if a company failed to pay the state royalties in accordance with its lease, the company would pay interest at a much lower rate only after a completed audit resulted in notice to the company, and then only if the company failed to pay within 60 days. Contrast HB 234 with current law which requires payment of interest on amounts owed back to the due date of the payment. [House Bill 234] results in the state giving companies interest-free loans of public funds for an average of three years, depending on the audit backlog. Next, the bill imposes an asymmetrical repayment obligation on the state.... While HB 234

lets companies off the hook for interest over a number of years when they fail to meet their contractual obligations, the bill requires the state to pay interest to a company that overpaid its obligations from the date of the overpayment. There's no fairness or reciprocity in that provision.

[5:19:45 PM](#)

MR. PARNELL continued:

The bill eliminates the interest floor provision and significantly lowers the rate of interest owed the state. Unlike the current law which provides a floor of 11 percent, HB 234 sets a freely floating rate with no interest rate floor for the state. If HB 234 were in effect today, companies would pay interest at around 5.75 percent annually rather than 11 percent. In 1991, when the interest rate methodology was enacted, legislative committee testimony noted the then existing Federal Reserve rate was 6 percent. The Twelfth District Federal Reserve rate today is about 3.75 percent. Thus this bill attempts to redesign interest calculations based on a Federal Reserve rate that is only about 2 percentage points different than when the existing methodology was implemented.

[5:20:28 PM](#)

MR. PARNELL continued:

The bill removes the compounding feature of the interest provision. The compounding feature is important; it means real money to the state, and the bill eliminates this feature. [The bill] would take us back to a simple interest regime. In 1991 the compounding feature was added to the statutes. Before the amendment on compounding interest was adopted industry representatives testified about the appropriateness of using compounding interest before [Senate Finance Committee]. One industry representative stated, "Today's market interest charges are typically computed at floating rates which are compounded." Nothing today is different relative to interest rates typically compounding in market

transactions, and the committee ought to retain the compounding nature of interest in existing law.

[5:21:16 PM](#)

MR. PARNELL explained:

The essential purpose of interest is compensation for the lost use of money over time. Interest is not a penalty. Where the money is contractually owed and where the state loses the opportunity to invest that money in its people via appropriations or at a long-term rate of return in the Permanent Fund, the state should be compensated at a fair rate for lost use of those dollars over time. Royalty payments and interest are the lessee's contractual obligations. This is not a situation where the state bills someone for services rendered and charges interest forward from that date. Such an outcome effectively shifts all risks of underpayment to the state to catch the shortfall, and diminishes the state's rights under the leases.

[5:21:59 PM](#)

MR. PARNELL continued:

The companies have the ability to minimize interest charges on royalty underpayments. The Division of Oil and Gas posts sales information by company and by unit on the [Internet]. For example, if a company is genuinely concerned about 11 percent interest charges on its underpayments, the company could go on the [Internet] in March 2005, find out that the other lessees in its unit sold their oil in January for a higher dollar value per barrel, recalculate its payment to the state, and refile, thus avoiding most interest charges two or three years down the road.

Mr. Parnell commented that he asked division personnel if any companies actually check the Internet site for the sale values in order to refile, and he learned that one company in Cook Inlet has refiled its reports based on other lessees' data, thus mitigating its interest exposure.

[5:22:53 PM](#)

MR. PARNELL remarked:

In simple terms, the companies have information available to them to minimize their interest obligations, but choose to take the simple accounting route of reporting only their own sales values with little follow-up. ... A company's practice of reporting its own sales value without appropriate follow-up to see whether the company is meeting its higher royalty payment obligations under the lease effectively shifts the burden to the state to catch underpayments.

[5:23:28 PM](#)

MR. PARNELL continued:

[House Bill] 234 increases the likelihood companies will underpay royalty obligations. At 11 percent, the statutory royalty interest rate is less than the return on capital employed that most of these companies receive. Albeit indirectly, companies that underpay royalties could be said to be borrowing public funds for a number of years and investing those funds elsewhere. They are doing so at returns greater than 11 percent and, at least for the first three years, approximately, under HB 234, they would do so interest-free. ... In an HB 234 world, what incentive exists for companies to do what's right under the lease? Why under those circumstances would a company accountant ever proactively set about meeting his or her company's royalty obligations by following up on sales values listed at the division's web site.

[5:24:59 PM](#)

MR. PARNELL continued:

Next, HB 234 will result in lost revenue to the state. Lost interest revenue to the state from this bill is estimated in relatively normal years to be in the range of [\$1 million to \$5 million]. We did have a spike in interest revenue in FY01 that took our interest recovery figures in the last three to four years north of \$10 million. However, I did want to correct an impression that I mistakenly left the last time I talked with you and some members of the

committee: I said that we were talking about tens of millions of dollars, and ultimately we are over time. But on a year-to-year basis, we're talking about smaller dollars; we're talking about [\$1 million to \$5 million]. So while the amounts may seem small set against the state budget in the millions, I know that you'd agree that millions of dollars of public funds are still worthy of our attention.

[5:25:51 PM](#)

MR. PARNELL commented:

The current interest rate methodology is reasonable. The current interest rate of 11 percent compounded quarterly and the underlying methodology of AS 38.05.135 as reasonable when viewed from a number of perspectives. First, turning to the time-value of money and the state's lost use of it over time: the Permanent Fund, where part of these payments go, gets shortchanged because it misses out on the time-value of these payments. It has a published long-term investment return in excess of 10 percent. The current royalty interest rate of 11 percent is not out of line by that measure. Additionally, what percentage rate accurately reflects the value of lost use of that money on an ongoing basis to the public? Those interest rates become more precious to state residents in times of general fund shortfalls. One could easily conclude the existing law strikes a balance between the value of lost use across good times and bad. Third, the Federal Reserve rate ... is only about 2 percent different than it was in 1991 when the existing methodology passed. Today audits are being completed much more timely than in those early years. So why should we revisit the statute now?

MR. PARNELL continued:

Next, these companies enjoy returns on their capitals substantially in excess of the 11 percent we charge for underpaying royalties. There's nothing punitive nor coercive to a company that has to pay a state interest of 11 percent on underpaid royalties when the companies' return on capital employed exceeds the interest paid. Fifth, interest paid by the companies

is deductible in the companies' state and federal income tax returns. Thus the companies pay an effective rate of interest and the state receives an effective rate of interest less than the 11 percent floor we have discussed when tax deductibility is considered.

[5:28:10 PM](#)

MR. PARNELL stated:

Finally, the statutory legal rate of interest is 10.5 percent under the trade practices section of the Alaska Statutes. It's hard to make the case that 11 percent is out of line for royalty underpayments when a legal rate of interest by statute is 10.5 percent. A company might argue that its cost of money today is lower than when this legislation went into effect, and therefore you should pass the bill. What the company is saying is that it can borrow money to finance debt elsewhere at a lower rate, so the state should lower its interest rate. However the state is not the company's bank for royalty collection purposes. The state should not be perceived here as ... just another lender. The state is the lessor in a contractual relationship with the companies. The companies are transforming the state's royalty share of oil and gas to money; they're pulling it from the ground and doing that and we appreciate that. ... The companies simply need to be more proactive about accounting and paying royalties under the leases.

[5:29:00 PM](#)

MR. PARNELL concluded:

The existing statutory rate should remain intact. What has changed requiring interest-free loans to the companies? What new jobs will be created? What new wells will be drilled? What new opportunities will be available for Alaska citizens as a result of this legislation? In other words, what public policy is furthered?

[5:29:17 PM](#)

MR. PARNELL, in response to Representative Samuels, answered that currently interest is due from the date of the underpayment. The same is true for any overpayments as well. If HB 234 were to pass, he explained, a company would have 60 days after notification of underpayment before any interest would begin accruing, but in the case of an overpayment, the state would still owe interest from the date of overpayment.

[5:31:31 PM](#)

MR. PARNELL commented:

I am a person who has been known around here for supporting industry, supporting industry development as you all are, because it is one of the strong economic engines of the state. However there are moments in time when they simply ask too much, and it doesn't appear ... that that is in the state's interest, to go down the path of HB 234.

[5:32:58 PM](#)

MR. PARNELL, in response to Representative McGuire, replied that the majority of the companies underpay. He explained:

They're reporting their sales and if they're in a unit with other interest owners ... one company's going to sell higher than the rest, and so the majority of them are going to underpay if they don't take the time to go back and try to mitigate their interest exposure by looking at the web site and the ... sales values that the other companies have obtained.

[5:33:56 PM](#)

REPRESENTATIVE MCGUIRE stated that she appreciates the sentiment under which the bill's sponsor introduced it, but she also thinks that Mr. Parnell made compelling arguments about the fact that it's the state's money that could be going into capital projects or school funding. She voiced concern that the bill could offer further disincentive for the companies to make timely royalty payments if the interest rate was lower.

[5:35:15 PM](#)

CHAIR KOHRING commented that the legislature needs to decide if the current rates are punitive or not. He remarked that he was

under the impression that the current administration was actually considering this same legislation, and he asked why the administration would consider the concept, then have the Division of Oil and Gas vehemently oppose the bill.

MR. PARNELL explained that every administration will circulate draft legislation and collect comments from the impacted agencies. He noted that there is currently no legislation from the administration on this topic because the agencies opposed it.

[5:36:31 PM](#)

CHAIR KOHRING expressed dissatisfaction with the direction the administration is going. He reiterated his belief that the 11 percent interest rates are punitive.

MR. PARNELL acknowledged that he has heard the concern that audits take too long, but he pointed out that in the two years that DNR has had responsibility for the audits, the time taken for audits has decreased. He encouraged companies to bring concerns and complaints to his office. He noted that he has currently only heard such comments from one company.

[5:38:55 PM](#)

CHAIR KOHRING asked:

Do you suppose that maybe we ought to deemphasize the interest rate side of this legislation, and maybe emphasize the timing aspect? ... Maybe lower the interest rate so it does reflect market conditions, ... [and] speed up the whole [audit] process so that the industry is not hanging out there for a long period of time waiting to get their refund.

MR. PARNELL replied that this would be appropriate. He reiterated that an audit on average takes three years. He pointed out that one way to speed up the process would be to have more auditors, which would require more money in the budget. He noted that for efficiency purposes, DNR audits two to three years at a time. He commented, "I don't necessarily think we should be auditing every year, every unit."

[5:40:41 PM](#)

REPRESENTATIVE McGUIRE asked how the oil and gas industry doesn't know it's underpaying when it is one of the most sophisticated industries in the world. In addition she asked what other information tools are at the industry's disposal besides the DNR web site. Lastly, she asked if there is any law that prohibits a company from taking corrective measures at any point prior to the audit to remedy an underpayment.

MR. PARNELL deferred to the audit section chief of the division.

[5:41:44 PM](#)

MARTIN SCHULTZ, Audit Section, Division of Oil and Gas, Department of Natural Resources (DNR) replied:

Under our leases there are various forms of so-called higher of provisions, and what that means is that the state is entitled to a royalty value that is the higher of either the proceeds that the company gets for selling its oil, for example, or what others in the same field are selling their oil for. And the mechanism that a company can take to figure out what the other lessees are getting for their oil is to go to our web site. And we publish each month for both the North Slope and Cook Inlet what companies are reporting in terms of volumes and what they're reporting in terms of royalty values. So companies can do that; they do have access to that information. ... At least one company in Cook Inlet, an oil producer, routinely does check to see what others are selling oil for in its unit, and then refiles at that higher royalty value, if it is a higher number. So in other words, companies don't have to wait until they get an audit to figure out what these higher of values can be.

[5:43:13 PM](#)

REPRESENTATIVE McGUIRE asked what percentage of companies are audited.

MR. SCHULTZ responded:

Most of the production on the North Slope, which is of course the vast majority of production, is under so-called royalty settlement agreements [RSAs] that came about ... as a result of the ANS [Alaska North Slope]

royalty litigation. ... Basically the royalty values and the deductions to arrive at the royalty values are specified in great detail in these [RSAs]. And what we do in the audit section is basically review the company's financial information to verify compliance with those [RSAs], and also for the purpose of negotiating amendments where it's appropriate relating to the royalty values on a going forward basis. So that's the majority of the production. With regard to production that is not under settlement, our goal is to audit virtually all of the production that is not under settlement

[5:44:55 PM](#)

CHAIR KOHRING asked what rate the state pays when dealing with royalty settlement agreements.

MR. PARNELL replied that under almost all the settlement agreements the interest owed is Bank of America prime rate, compounded daily. He said:

I think there's a huge distinction there, when you've got those settlement agreements [that] were entered into following a decade or more of dispute over valuation issues. So that interest rate in those settlement agreements is a compromise amount; it represents compromise of those claims. We're talking today about, in most cases, ... undisputed interest charges. We're not settling any claims. This is the rate that is being charged. And additionally those ... [RSAs] which the earliest ones, BPs, ARCOs, and Exxons, were entered in 90-91, right around the same time as the statute, the most recent interest amendments to one of those royalty settlement agreements specifies the statutory rate ... the current rate of 11 percent. So the most current interest rate change to one of those settlement agreements reflects existing statute.

[5:46:41 PM](#)

REPRESENTATIVE SAMUELS asked how long the DNR web site has been up.

JIM STOUFFER, Accountant IV, Division of Oil and Gas, Department of Natural Resources (DNR), replied that the web site was

started in about 1998 or 1999, and has been up and running since that time.

REPRESENTATIVE SAMUELS asked if anyone had tested the web site for data accuracy.

MR. PARNELL reminded the committee that the division posts the sales values from the companies when they're due; however the companies can refile and change those amounts, and therefore "looking at the web is a way to minimize or mitigate their interest exposure." He noted that the data won't be completely correct if there has been a refiling. He continued:

They'll have the ability to see that Company X ... reportedly sold their oil for 40 cents more a barrel than I did in this particular month. But if Company X changes/recalculates/refiles six months later, then that's not going to get picked up in that web check. They are simply going to be able to minimize their exposure in most cases.

[5:48:51 PM](#)

REPRESENTATIVE SAMUELS said that he would assume that someone within the industry watches these numbers as well. He asked what percentage of the audits indicate an underpayment.

MR. SCHULTZ replied, "The majority of audits do indicate an underpayment, but not all audits."

[5:49:37 PM](#)

MARK BOND, Legal Counsel, UNOCAL Alaska, stated:

UNOCAL has been an oil and gas producer in the State of Alaska for over 40 years, and during that time our company has never been accused of fraudulent underpayment of royalties. There seems to be an indication that the companies would deliberately underpay royalties to take some sort of untoward benefit, and I guess it's fair to say that I, on behalf of the company, resent that insinuation. We attempt to pay our royalties on time and to the value that as best we can determine them. Our problem arises from the oil and gas lease, which provides that royalties are based on ... no less than the highest of

several alternatives, one of which is the prevailing price received by other producers in the field that the well for oil or gas of like grade of gravity. And because of the usual confidentiality in oil and gas sales agreements, and antitrust concerns ... it is not possible for producers to know what the highest price paid in the field or area is.

MR. BOND continued:

[The Department of Natural Resources (DNR)] has put the web site up and I guess we could digress into how frequently and how often each of the areas has been posted on the website, but at best, by the admission of the DNR folks, it is unreliable in terms of an indicator of the prices received. Furthermore, there are substantial antitrust concerns that all of us producers have in posting the prices for the other producers in the field. We're very concerned that federal law ... would prohibit us from actually looking at and using the data, which can be used not only for the payment of royalties, but obviously for correction - I could go beat up your marketing department, I guess, and say, "Well, these guys are getting X; why are we only getting Y?"

One of those who's very concerned about that is Tom Williams, who is formerly of the state and well-respected, and who probably understands royalties and taxes in the State of Alaska better than anyone, certainly better than I, and now works for [BP Exploration (Alaska) Inc.]. And Tom has expressed that concern repeatedly and lately in conversations that we've had.

[5:52:41 PM](#)

MR. BOND continued:

It requires us to assume also that the state is correct in its interpretation of the particular oil or gas sales contract. And furthermore, the deputy director indicates that a company could correct by refileing, which would require basically double-filing, so substantial additional work for the accounting department of the company involved.

We generally find out what the higher of value is on a reliable basis at the time of the audit. The deputy director indicated that the audits were as much as six years passed. Now typically we agree that they're about three years later, and they tend to aggregate two or three years, which requires them to wait for two or three or four years, and generally the years that are aggregated are years three, four, five, or four, five, six down the road. So there is a substantial lag in the audits.

MR. BOND continued:

And at that time, then, the producer is faced with an amount due based on the higher of; once they've had a chance typically then to look at the other producers' sales contracts under a confidentiality agreement that then requires its use only for royalty payments, not for any marketing purposes. Plus interest at 11 percent compounded quarterly. We've talked about various rates of interest; ... the compound quarterly is significant in the equation.

[5:54:02 PM](#)

MR. BOND continued:

The process ends up broken in two respects. Because of the language of the lease and because of the high rate of interest, there is actually an incentive for audits to be conducted in an untimely manner. There's certainly no concern on the part of the state that it conduct audits in a timely manner because ... if any of us could get 11.5 percent compounded quarterly in any investment, we would be very rich people.

Which brings me to the second point.... The interest rate is far beyond the compensation for the time-value of money. Now it's apparent to me from the department's testimony that it considers the interest rate on delinquent royalties to be a separate profit center rather than imposing interest at a market rate to compensate for the time-value of the money lost.

I share the deputy director's concern about the duality of the payments. I have this comment though: it's so rare for a producer to have made an

overpayment that the duality basically is a nonargument. However, it can easily be corrected by amending subsection (e) of the statute to make it a dual system, and UNOCAL would not be opposed to that kind of an amendment.

The bottom line here is that the producers face a punitive rate of interest for underpayments that they made in good faith due to unknowable variables, and we have to wait for DNR to undertake its audits, and at that point, then we get reliable information on the various sales contracts that they're applying to us. And then we find out the value upon which we were supposed to pay.

[5:55:41 PM](#)

MR. BOND continued:

Other comparisons can be made. In a memo that I prepared, I compared it to the rate of interest established for judgments between two litigants where the state has to impose an interest rate for prejudgment and postjudgment interests in AS 09.30.070 - that's substantially less than [what] we're looking at here. The minerals management service [MMS] rate for royalties that are due from federal oil and gas leases is significantly lower than the state collects. It's established under statute by 30 USC 17.21, which basically makes reference to the internal revenue code for Section 6621, which establishes a rate of interest at the federal short-term rate, which is for all intents and purposes equivalent to the discount rate plus 3 percent; that's the rate that the MMS does on its royalty leases.

We'd like to be in a position where we could pay our royalties on time and in the correct amount. Given the language of the lease and the unknowables associated with that language, it is virtually assured that in the absence of a royalty settlement agreement, a company will not be able to correctly pay its royalties on a timely basis. That puts us in the unenviable position of allowing the state then to decide when and where to audit, to aggregate two or three years, generally four or five years down the

road, and then impose the 11.5 percent rate of interest.

5:57:07 PM

DON PAGE, Manager of Accounting and Finance, UNOCAL Alaska, stated:

The one thing I must stress in here is that the 11 percent is compounded quarterly, and what we have found in previous audits is [that] you can have an audit, either in the Department of Revenue or the Department of Natural Resources, for either severance taxes or royalties where, by the time we're receiving the audit and attempting to negotiate the final settlement of the audit, the interest is more than the principal. And once again, I believe anybody who has a retirement account, a stock account out there or whatever, any type of investment out there, will love to have that type of rate of return, where your dollar is basically doubling in five, six, or seven years down the road. ...

The royalty payer should not have to pay for another agency to play catch-up. ... UNOCAL has operated for over 40 years up in Alaska, and at no point have we ever fraudulently tried to underpay either the severance tax, income tax, or royalty, all through those years....

5:58:36 PM

MR. PAGE continued:

One of the issues that was brought up by the chairman was the issue over having the audits being done in multiple years at one time. ... The Department of Revenue, when they do a severance tax audit, ... they audit one year at a time, and we're usually one in lag. So we don't have the interest rate issue with the Department of Revenue....

Because they're auditing the multiple years at one time and the compounded 11 percent, we shouldn't have to pay for that. ... The other thing that should be stressed is this is primarily a Cook Inlet issue, and as you know, most of these Cook Inlet assets are at the end of their life; they're very mature. ... It's a

closed-in market; we're all selling our crude oil to one person, and it's Tesoro, and we should not know the prices of any of the other producers out there. But not only that, because these assets are economically challenged as it is, to have an accounting department have to go out and file royalties one month and then, on the top of that, have to go check the following month and refile royalties again and again and again; to try to chase those numbers, the only thing we're going to do is add on additional administration burden on top of the producers.

[6:00:53 PM](#)

REPRESENTATIVE SAMUELS commented that he would expect the companies to keep an eye on each other's prices.

MR. PAGE replied, "We take very seriously our obligations under federal antitrust law, and we assiduously avoid any knowledge of any other producers' prices for that reason. ... We do not know and we do not want to know, frankly, what other companies are getting in price. "

MR. BOND noted that they do not have access to the competitions' contracts, and do not want to have such access.

[6:02:15 PM](#)

CHAIR KOHRING commented that he still thinks that 11 percent is a punitive rate of interest. He noted:

I also have concerns about the state's relationship with the industry, too. I know some of the testimony here has suggested that frustration by folks in the industry who feel like the state is implying that maybe you guys aren't being honest, and so that concerns me. ... I'd have to go back to Mr. Parnell's testimony as being very honest, and I don't think ... his intent was at all to communicate that to you. I just worry that perhaps [that], given the testimony we've heard, the road that we're going down, we're developing a further negative relationship with the industry in this state.

[6:03:54 PM](#)

MARILYN CROCKETT, Deputy Director, Alaska Oil and Gas Association (AOGA), explained that AOGA is a private, nonprofit trade association with 18 member companies that represent the majority of oil and gas exploration, development, production, transportation, refining, and marketing activities in Alaska. She stated:

We support purpose and intent of this legislation, and particularly the change to the statutory rate of interest under AS 38.05.135(d) that are proposed in [paragraph 2] of the bill. Currently the statutory rate is five percentage points above the Federal Reserve discount rate, or 11 percent APR, as we've heard today, whichever is higher. And it is compounded quarterly. This legislation, of course, would set the rate at two percentage points above the federal reserve discount rate, and it would eliminate that 11 percent floor, would use simple interest, and would eliminate the quarterly compounding. These changes would make the law much more reasonable and fair. Frankly, when prime rates ... are running well below 6 percent, as they are today and have been for several years, a statutory rate of 11 percent goes far beyond the line between proper compensatory interest and interest that constitutes punishment for underpaying. And as we heard Deputy Director Parnell indicate today that the interest is intended to be loss-use of money and not a penalty for underpayment.

6:05:50 PM

MS. CROCKETT continued:

[Alaska Oil and Gas Association (AOGA)] believes that abusive underpayments, ... if they are a problem, and we wonder if they are, there are better ways of dealing with this than having punitive interest rates. But from our experience, the great majority of royalty underpayments are not abusive. Under paragraph 16, the producer owes royalty on the highest of [either] the price that it gets from its oil - the posted price for oil from the same field, or the highest price that any other producer can get from oil from that field. And for competitive and antitrust reasons, individual companies cannot find out and should not find out, frankly, what other producers are paying for their oil. They only find out about those other prices if

DNR makes a claim as a result of an audit that there is a higher price that's being paid. In this situation, it would be inappropriate to apply punitive rate of interest for that sort of underpayment.

In summary, HB 234 would change the statutory interest back into a compensatory mechanism instead of being an instrument of punishment, and we welcome this change in philosophy about the purpose of statutory interest.

[6:06:53 PM](#)

REPRESENTATIVE GARDNER asked, "The whole concept of whether it's proper and appropriate or even legal for companies to know the prices that other companies are getting: how long has this ... [statute] been in effect, and has it not been an issue all along?"

MS. CROCKETT remarked that she wasn't sure she was qualified to answer that question.

[6:07:39 PM](#)

CHAIR KOHRING asked Mr. Parnell if he knew when the statute that allows for the current 11 percent interest rate was put in place.

MR. PARNELL replied, "In 1991."

[6:07:53 PM](#)

REPRESENTATIVE GARDNER asked, "If it's been in place for 13 years, and the issue of whether it's appropriate for companies to know other companies' prices - has that not been a problem during the 13 years?"

MS. CROCKETT responded, "Perhaps one of the other testifiers can tell you that." She added, "I know that the interest rate has been in place for 11 years but I'm not sure how long the process that you're speaking to has actually been on the books."

[6:08:22 PM](#)

REPRESENTATIVE SAMUELS, "Could the companies set up a Chinese wall where the auditor, the person who's making the audit payment, could look at the web site, make the payment correctly

with a bit of isolation? ... It seems that the information's on there [and] it shouldn't be [difficult]."

MS. CROCKETT responded:

I think you've heard concern from the previous testifier about the fact, frankly, that the information's on the web site in the first place. The oil and gas industry in particular and AOGA's members are extremely sensitive ... about any potential that they could be accused of any antitrust ... issues. One only has to think about the scrutiny that the industry comes over for gasoline prices, for example, to sort of lay the framework and the groundwork on ... what lengths [a company] will go to to avoid knowing information that the antitrust laws really say that they can't know. Or putting themselves in a position of being accused of knowing information that they really should not have access to.

[6:09:40 PM](#)

MICHAEL HURLEY, Director of State Government Relations, ConocoPhillips Alaska, Inc., stated:

[ConocoPhillips Alaska, Inc.] supports the change in the statutory interest rate for over and underpayments of royalties to something much more reflective of the actual time-value of money. The current statute with its arbitrary high fixed rate acts more like a penalty than a reimbursement for the opportunity costs of funds. Let me first point out that from ConocoPhillips' perspective, this hasn't historically been a big issue for us.... The royalty settlements cover most of the North Slope leases, so the interest rates applicable to most of our production are governed by those RSAs, and they are running at prime based on the Bank of America out of San Francisco. So it hasn't been a big deal for us.

However, as a matter of public policy, we believe that interests should reflect the costs of funds and not be some kind of weapon to be used to try and force people to pay more than they think they owed just out of fear. Additionally, the current system often makes resolution of substantive issues difficult because of the magnitude of the dollars that end up being at

stake just because of the interest. As you heard some of the other testifiers say, interest adds up very rapidly at 11 percent compounded quarterly. If you just do the arithmetic, interest can amount to 50 percent of the value of an underlying issue in just four years. So even as good as the department's getting at cutting down their audit times, you can quickly end up with 50 percent of the value of an issue being interest. If you carry that out to six years, you end up doubling the cost of whatever it is that's at issue, [because of the quarterly compounding and the high rate].

[6:12:10 PM](#)

MR. HURLEY continued:

We believe that rather than acting as an incentive for producers to pay their royalties in a timely fashion, it's actually become a disincentive for the state to work out these substantive issues. Recapturing the time-value of money is an appropriate thing for the state to do, and that's fine. But having a rate that appears to be a more onerous penalty seems out of step with a culture of encouraging resource development.

One thing we would want to suggest to the committee: if you consider this to be an appropriate policy, if you want to change the interest rate, we would suggest that you consider changing it on the tax side as well. Right now the royalty interest and the tax interest are set the same: they're both using the 11 percent compounded quarterly. However you decide as a policy matter to change those or not, you should keep them consistent. And if you agree that making a change makes sense, you can look for those in AS 43.05.225.

[6:13:32 PM](#)

CHAIR KOHRING asked, "Since ConocoPhillips does business pretty much throughout the world, other states, and so forth, how does Alaska's system here compare ... with other states?"

MR. HURLEY replied:

A lot of the different states do different things - I haven't gone and researched them extensively. I do

know that a couple of them are higher. I know a couple of them are lower. You heard the MMS example that was given by the UNOCAL folks who testified. I know that the IRSs actual rate of interest is somewhere around prime.

[6:15:46 PM](#)

REPRESENTATIVE SAMUELS asked, "If there is an overpayment by the industry, does the compounding take effect? The 11 percent compounding quarterly?"

MR. PARNELL stated that he believes this is the case.

[6:16:33 PM](#)

MYRL THOMPSON said that he is from the Matanuska-Susitna area and he stated:

This is almost shameful legislation, if you'll pardon me. And let me explain it to you this way: as a citizen, if I underpay my taxes, the government can go seven years and make me pay a fairly high interest rate and penalties on top of that. And that's just me as an individual, and I'm not rolling in billions of dollars of profit myself. And I'm not against development, and I'm not against even incentives for the oil industry, and ... we've given them plenty of those....

[Under this bill the interest is] the same for the state as it is for the industry. If the industry wants to escape having to pay this interest, ... low or high, all they have to do is hit their numbers right, not undercut it. And the testimony has shown that it's not over, it's under, and it's under the majority of the time. And personally, maybe there should be a penalty on it; I know I pay a penalty if my taxes aren't paid and I'm audited.

So ... let's just be fair to the state. The industry is not hurting; they're making billions and billions and billions of dollars of profit, in fact, billions more than the state's getting on the very same oil, which is our oil. And you folks are our representatives. I mean, we have to rely on you to do the right thing for us, and all I'm asking is that you

be fair to us. And shorting the state because of their inability to hit their numbers is not fair to us. And it's a simple matter of just [dropping] this bill and let them do the right thing and hit their numbers. They're not losing money; they're making billions, it's as simple as that.

[6:19:07 PM](#)

CHAIR KOHRING, after ascertaining that there were no more witnesses, closed public testimony. He stated that the bill would be held over.

**ADJOURNMENT**

There being no further business before the committee, the House Special Committee on Oil and Gas meeting was adjourned at [6:20:14 PM](#).