

**ALASKA STATE LEGISLATURE
JOINT MEETING
SENATE RESOURCES STANDING COMMITTEE
HOUSE RESOURCES STANDING COMMITTEE**

January 18, 2006

3:07 p.m.

MEMBERS PRESENT

SENATE RESOURCES

Senator Thomas Wagoner, Chair
Senator Bert Stedman
Senator Kim Elton
Senator Albert Kookesh
Senator Ben Stevens
Senator Fred Dyson

HOUSE RESOURCES

Representative Jay Ramras, Co-Chair
Representative Ralph Samuels, Co-Chair
Representative Carl Gatto
Representative Paul Seaton

MEMBERS ABSENT

SENATE RESOURCES

Senator Ralph Seekins, Vice Chair

HOUSE RESOURCES

Representative Jim Elkins
Representative Gabrielle LeDoux
Representative Harry Crawford
Representative Mary Kapsner

OTHER LEGISLATORS PRESENT

Representative Berta Gardner
Representative Ethan Berkowitz
Representative Les Gara
Representative Mark Neuman
Representative Jim Holm
Representative Kurt Olson
Representative Mike Hawker

Representative Max Gruenberg.
Senator Gene Therriault
Senator Hollis French
Senator Gary Stevens

COMMITTEE CALENDAR

Overview: Profit Sharing Production Tax

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

Dr. Pedro van Muers, Economist
Consultant to Legislative Budget and Audit Committee
Alaska State Capitol
Juneau, AK 99801-1182

POSITION STATEMENT: Presented the overview

Mr. William Corbus, Commissioner
Department of Revenue
PO Box 110400
Juneau, AK 99811-0400

POSITION STATEMENT: Introduced Dr. van Muers

ACTION NARRATIVE

CHAIR THOMAS WAGONER called the joint meeting of the Senate and House Resources Standing Committees to order at [3:17:30 PM](#). Present were Representatives Carl Gatto, Paul Seaton, Ralph Samuels, and Co-Chair Jay Ramras. Also present were Senators Bert Stedman, Kim Elton, Albert Kookesh, and Chair Tom Wagoner.

CHAIR WAGONER announced the purpose for the meeting was to receive a presentation by Dr. Pedro van Muers and the Governor's administration on the subject of profit sharing oil-production tax.

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MR. WILLIAM CORBUS, Commissioner, Department of Revenue, made the introductions. Dr. Pedro van Muers was born in Holland and holds a PhD in geology and economics. Dr. van Muers is a petroleum economist who advises only governments. In addition to advising Alaska on the pipeline and gas tax policy he is also

currently advising Kuwait and Algeria. Dr. van Muers has appeared before the Alaska State Legislature many times.

DR. PEDRO VAN MUERS expressed pleasure to be involved in the introductory briefing for the idea of the profit-sharing production tax. It is an opportunity to provide feedback and exchange ideas for the purpose of preparation for final legislation.

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There are four main types of payments.

- Royalties
- Production tax (severance tax, ELF)
- Property tax
- State corporate income tax

Additionally there is federal corporate income tax. This presentation is about proposed changes in the production tax.

The current production tax for oil is 12.25 percent net of royalty for the first five years of production and 15 percent thereafter. These percentages are multiplied by the Economic Limit Factor (ELF), which is between zero and one. The ELF lowers the production tax rate for smaller fields and fields with low productivity wells.

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The ELF formula is immensely complex. It was developed in 1989 and has served the state well but no longer gives good results. The ELF tax is extremely sensitive to the number of wells in the field. A large number of wells bring a zero tax and a small number of wells bring a higher tax.

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This formula leads to an incentive for oil companies to keep every well producing and to build additional wells just to bring the tax down.

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The ELF formula reflects economic conditions in 1989 when oil prices were in the \$14-\$17 per barrel range and the values of 300 barrels of oil a day for well productivity and 150,000 barrels of oil a day for field productivity represented reasonable economic benchmarks.

Also the formula did not contemplate the subsequent development of a variety of satellite fields. While the production tax

stimulated the development of a variety of marginal fields, the benchmarks are now outdated. Therefore, an overhaul of the production tax is in the interest of the state.

The production tax has serious deficiencies.

- ELF is no longer rational in relation to well productivity and field production
- ELF is not responding reasonably in the case of field production decline
- ELF does not provide a reasonable balance under a range of oil prices
- ELF does not provide a sufficient incentive for re-investment

The tax has serious deficiencies at this point in time. A graph showing the Kuparuk Oil Field, the second largest in North America, shows that the ELF has already declined to zero and will phase to zero in the next two years.

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ELF is declining faster than production in some fields. Kuparuk is a world-class oil production field but the ELF has already declined. Dr. van Muers insisted it was ridiculous to have a world-class oil field that no longer pays a production tax. In ten years, the only field that will be paying is the Prudhoe Bay field. Now is the time to start changing the tax structure. Many fields in the North Slope are in the decline mode. ELF does not work well during the decline mode. If prices are high there is no reasonable balance.

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[Representative Max Gruenberg and Senator Fred Dyson joined the meeting.]

The Governor has proposed a profit-sharing production tax (PPT), which will be a complete replacement of the current ELF-based version of the production tax on oil and gas. This will be a law of general application.

The reason for the profit-sharing system is because so many other nations have been successful with it. Norway, for example is a lot like Alaska in that they produce oil, forestry products, and have a fisheries industry. On a per-capita basis Norway produces roughly half of the amount of oil and gas as Alaska but Norwegians are 50 percent richer.

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The big difference is that with the existing system wealth is slipping through the fingers of Alaskans and Norwegians hold on to it. Many nations have proved the effectiveness of the PPT.

The PPT is calculated as a tax rate multiplied by the corporate cash flow from production in Alaska from oil and gas, with tax credits to encourage investments. It is a consolidated tax at the corporate level. The tax rate will apply to the total cash flow of the company from oil and gas production. There will be tax credits to encourage production.

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It is a fair system that has been implemented in many countries. The PPT is calculated by taking the gross production revenues based on wellhead prices, less the producers lease expenditures. If there is a large amount of cash (high oil prices) then the share for Alaska is large. If there is a low amount of cash, then the share is low. It is a fair system for both parties.

[Senator Hollis French joined the meeting.]

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There will be tax credits to encourage investments based on a percentage of the amount of the investment. Losses in any year can be converted to tax credits by multiplying the amount of the loss with the tax rate. Tax credits can be transferred and traded. Explorers and independents will be able to monetize part of their investments immediately, thereby strongly encouraging exploration.

Another important purpose of the tax credits is to create a progressive tax. Progressive taxes can be created in different ways: tax credits, uplifts, IRR payout systems, sliding scales, etc. The PPT is proposed to convert losses to tax credits, which can be traded and transferred. This immensely increases the attractiveness of new interest investing in Alaska.

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There will be features to provide a favorable tax structure for explorers and independents and encourage exploration and new entrants to Alaska and it is desirable to attract smaller oil companies to the state. The easiest way to do that is through tax credits.

The proposed PPT:

- Is based on actual economics and generates tax when there are reasonable profits

- Provides a reasonable balance between the state and producers over a wide range of oil prices
- Strongly encourages investment and re-investment in the state
- Protects and encourages explorers and independents

The PPT tax rate and the tax credit rates will be proposed in the near future. General principle is that the overall revenues to the state must be significantly higher at today's prices. At low prices, the state revenues will be less than the current system, which provides a fair adjustment relative to market conditions. For average prices, companies making low levels of investment will pay significantly more than the current system, while strong investors will pay an amount that could be less, depending on the level of investment. If the price is low, Alaska shares the burden, if the prices are high; Alaska shares the benefits with the oil producers.

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Also important to note is that at average prices, companies that make low investments will pay significantly more, but strong investments may pay less. It depends on how much they invest.

The PPT is a profit-based system. There are two ways in which profit-based systems are implemented around the world: Based on taxation systems paid in cash, or based on production-sharing systems. All the large oil companies work in countries that have this profit-based system so they are familiar with them.

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The enhanced incentives to invest in exploration and development through the PPT as well as the gas line investment will create a new environment whereby Alaska will be considered by many petroleum companies a new core area for petroleum investment and increased oil and gas production.

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Dr. van Muers concluded his presentation by saying the current ELF-based production tax is completely outdated. It is a regressive tax and is no longer in the interest of Alaska. Therefore the Governor proposes that Alaska adopt a profit-based system that will provide on average for a higher government take. It is a progressive tax with a strong incentive for investment and exploration. It will also attract new entrants to the state.

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SENATOR WAGONER advised Dr. van Muers that the total production in Cook Inlet (16 platforms) is between 24,000 and 26,000 barrels per day. He asked how to model the PPT to encourage additional work in the aging fields.

DR. VAN MUERS responded that only a few fields pay production tax in Cook Inlet so the burden is modest. The PPT will not put a stronger burden on the operators. The PPT will enable the producers to take a new look at the oil and gas fields and realize there are new opportunities for investment through using tax credits.

REPRESENTATIVE GARDNER asked the moment it would have been prudent to change the outdated ELF tax structure.

DR. VAN MUERS admitted when ELF was designed it was innovative. It is most important to note that the current moment is the time to change the tax system. The economic equation has changed so dramatically that Alaska must move to the PPT structure.

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SENATOR STEDMAN asked Dr. van Muers whether the current splits between the oil companies and the governments were particularly dynamic to the point where governments were modifying the PPT.

DR. VAN MUERS responded there are two things going on around the world. A large number of countries have relatively strong progressive systems. For example Russia, Angola, Azerbaijan, and areas where the major oil companies have major investments. What is happening today as result of higher oil prices is the progressive systems are now clicking in and the government take is going up significantly. Many other countries today have adjusted their systems in view of the higher oil prices. He said everybody else is doing it and that it is the international way. If Alaska were to put a similar system in place it would remain competitive with the other countries.

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SENATOR DYSON asked whether the PPT would encourage major companies to invest more here, and what would happen to state's take if oil prices decrease dramatically.

DR. VAN MUERS said the major oil companies are significantly investing in Alaska and they would increase that investment. If oil prices went down, the PPT would be down to zero. Implicit in the PPT is if there are no profits, there are no taxes.

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SENATOR DYSON asked whether it was fair to imply the major oil companies would support the PPT.

DR. VAN MUERS admitted there was no agreement at this point in time but discussions were being continued.

SENATOR ELTON asked whether the proposal was going to be presented to the Legislature inside or outside the gas pipeline contract.

DR. VAN MUERS explained it would be presented as a law of general application.

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REPRESENTATIVE RAMRAS expressed concern over creating an adversarial relationship with the oil companies. He said British Petroleum has taken punitive measures in the past with ELF.

DR. VAN MUERS agreed. He said the PPT would encourage the industry to invest in Alaska on a large scale. Competition for investment dollars is very strong around the world.

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REPRESENTATIVE SEATON asked whether trade-able credits could be applied against royalty payments, corporate tax, production tax, and property tax.

DR. VAN MUERS said it could be applied to the production tax. It would not be creditable against royalty or property tax. It could become creditable to the state corporate income tax.

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REPRESENTATIVE SEATON asked whether the Norway 78 percent tax rate corresponded with Britain's 50 percent tax rate.

DR. VAN MUERS said no. Each nation has its own government take. Norway has been traditionally high and Britain has a low government take. Each region is competitive to its own environment.

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REPRESENTATIVE SEATON said Britain has recently increased its take 40-50 percent. He asked whether that was a PPT or a total government take.

DR. VAN MUERS said it is a total government take. Britain has a low government take by international standards. They have a corporate income tax of 30 percent and also a special surtax that used to be 10 percent and is now 20 percent.

(Representative Ethan Berkowitz joined the meeting.)

SENATOR OLSON asked what system that Alberta (Canada) is using.

DR. VAN MUERS responded they are using many different systems and at several stages. It is the same overall philosophy as the PPT just engineered differently.

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REPRESENTATIVE NEUMAN asked at what point would the state break even.

DR. VAN MUERS advised they were still working on the detail figures but that it depends on a number of different indices and assumptions.

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SENATOR FRENCH asked whether the administration was going to file a bill.

DR. VAN MUERS replied yes.

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REPRESENTATIVE GARA asked the level at which Alaska would envision lowering taxes for the oil companies.

DR. VAN MUERS advised he would have detailed studies to present with the final proposal. The final figures are not fully developed at this time.

There being no further business to come before the committee, Chair Wagoner adjourned the meeting at [4:28:06 PM](#).