

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 22, 2006

12:35 p.m.

MEMBERS PRESENT

Representative Jay Ramras, Co-Chair
Representative Ralph Samuels, Co-Chair
Representative Carl Gatto
Representative Gabrielle LeDoux
Representative Kurt Olson
Representative Paul Seaton
Representative Harry Crawford
Representative Mary Kapsner

MEMBERS ABSENT

Representative Jim Elkins

COMMITTEE CALENDAR

HOUSE BILL NO. 488

"An Act repealing the oil production tax and gas production tax and providing for a production tax on the net value of oil and gas; relating to the relationship of the production tax to other taxes; relating to the dates tax payments and surcharges are due under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the treatment of oil and gas production tax in a producer's settlement with the royalty owner; relating to flared gas, and to oil and gas used in the operation of a lease or property, under AS 43.55; relating to the prevailing value of oil or gas under AS 43.55; providing for tax credits against the tax due under AS 43.55 for certain expenditures, losses, and surcharges; relating to statements or other information required to be filed with or furnished to the Department of Revenue, and relating to the penalty for failure to file certain reports, under AS 43.55; relating to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue, under AS 43.55; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the oil and gas production tax; relating to the deposit of money collected by the Department of Revenue under AS 43.55; relating to the calculation of the gross value at the point of production of oil or gas; relating to the determination of the net value of taxable oil and gas for purposes of a production

tax on the net value of oil and gas; relating to the definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making conforming amendments; and providing for an effective date."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 488

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

02/21/06	(H)	READ THE FIRST TIME - REFERRALS
02/21/06	(H)	RES, FIN
02/22/06	(H)	RES AT 12:30 AM HOUSE FINANCE 519

WITNESS REGISTER

BILL CORBUS, Commissioner
Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Presented HB 488 on behalf of the Administration.

MICHAEL MENGE, Commissioner
Department of Natural Resources
Juneau, Alaska

POSITION STATEMENT: Presented HB 488 on behalf of the Administration.

ROBYNN WILSON, Director
Tax Division
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: Presented HB 488 on behalf of the Administration.

DAN DICKINSON, Consultant
to the Office of the Governor
Anchorage, Alaska

POSITION STATEMENT: Presented HB 488 on behalf of the Administration.

ACTION NARRATIVE

CO-CHAIR RALPH SAMUELS called the House Resources Standing Committee meeting to order at 12:35:40 PM. Representatives Ramras, Samuels, Gatto, Seaton and Olson were present at the call to order. Representatives Crawford, LeDoux and Kapsner arrived while the meeting was in progress. Also in attendance were Representatives Meyer, Kohring, Kerttula, Guttenberg, Hawker, Gardner, Gruenberg, McGuire, Rokeberg, Joule, Salmon, Neuman, Dahlstrom, Gara, Moses, Wilson and others.

HB 488-OIL AND GAS PRODUCTION TAX

CO-CHAIR SAMUELS announced that the only order of business would be HOUSE BILL NO. 488, "An Act repealing the oil production tax and gas production tax and providing for a production tax on the net value of oil and gas; relating to the relationship of the production tax to other taxes; relating to the dates tax payments and surcharges are due under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the treatment of oil and gas production tax in a producer's settlement with the royalty owner; relating to flared gas, and to oil and gas used in the operation of a lease or property, under AS 43.55; relating to the prevailing value of oil or gas under AS 43.55; providing for tax credits against the tax due under AS 43.55 for certain expenditures, losses, and surcharges; relating to statements or other information required to be filed with or furnished to the Department of Revenue, and relating to the penalty for failure to file certain reports, under AS 43.55; relating to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue, under AS 43.55; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the oil and gas production tax; relating to the deposit of money collected by the Department of Revenue under AS 43.55; relating to the calculation of the gross value at the point of production of oil or gas; relating to the determination of the net value of taxable oil and gas for purposes of a production tax on the net value of oil and gas; relating to the definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making conforming amendments; and providing for an effective date."

BILL CORBUS, Commissioner, Department of Revenue, said HB 488 is the first major oil and gas tax legislation that has been pursued by an administration since 1989. The profit-based [petroleum] production tax (PPT) contained in HB 488 will replace the existing Economic Limit Factor-based severance tax (ELF), which is broken. The PPT will encourage badly needed

investment in oil and gas exploration, development, and production, he said. It will provide special incentives for emerging small Alaskan companies, and it will enhance state revenues, particularly during periods of high oil prices, he added. Commissioner Corbus said severance tax reform has been under study for a long time, beginning with the prior administration. He noted that oil and gas consultant Dr. Pedro van Meurs was originally engaged with the state in 1996, and the current administration began working on this issue after taking office.

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COMMISSIONER CORBUS said there are three days of hearings scheduled before the House Resources Standing Committee, and the committee will be hearing from several professionals. He acknowledged others who were involved in the process.

CO-CHAIR SAMUELS gave a timeline of the hearings. He said the big question is why the tax rate was dropped from the publicly announced 25 percent rate to 20 percent.

COMMISSIONER CORBUS said in early February, Dr. Pedro van Meurs made a presentation to a joint finance committee analyzing a range of tax rates and tax credits. As a result of his analysis, he recommended a 25 percent tax rate and a 20 percent investment credit. "Earlier this week, we had meetings with the [oil and gas] producers, and we ultimately decided on an acceptable 20 percent tax rate, 20 percent investment rate that was acceptable to both parties. The administration felt that this was in range of reasonableness compared to other regimes around the world." He said Dr. van Meurs will be testifying and he can address that issue in more depth.

REPRESENTATIVE KAPSNER said the governor has said that the tax would be retroactive to January 1, but it is not.

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COMMISSIONER CORBUS stated that the effective date "that we have before you in HB 488 is July 1, 2006."

REPRESENTATIVE KAPSNER said that represents \$500 million if the tax rate is 20 percent and \$750 million if the tax rate is 25 percent.

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MICHAEL MENGE, Commissioner-designate, Department of Natural Resources, said the issue of lowering the tax rate gets at the heart of what will have to be dealt with over the next weeks. He said the policy calls cannot be measured for decades, and the entire spectrum of [oil] companies needs to be considered, not just the big three. He said on state lands there will be an increasing number of small fields that mid-size and small companies will be interested in developing. He said he is talking about the fields with 100 to 150 million barrels.

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COMMISSIONER MENGE said he does not know what lies beneath the surface, so the state needs additional drilling and exploration. The governor's proposal sets a balance allowing "us to deal with what we do know today," and it sets a stage to encourage smaller companies "to lead us to the solutions and the future for Alaska." One can be critical about a particular provision, "but you really have to back off and see how that particular point interacts with 1,000 other points across the spectrum for oil and gas exploration." There are two major benefits of this historic undertaking, he said, one is smaller companies doing exploration and those benefits will come later. He said, "Lord willing, we will have our gas line and there will be a gas pipe line; the results of these companies will also send a lot of additional gas down the pipe line." He added that the true benefit lies in the future with increased investment.

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COMMISSIONER MENGE said there are 70 people working right now on the North Slope "that are bringing home pay checks and buying candy bars and bunny boots and making a net contribution to society," because of royalty relief. He said next year that number will grow to several hundred, but a single penny will not come to the State of Alaska, but he surmised that there is a net benefit to society "by virtue of [Alaska] providing an investment scene that encourages small and mid-sized companies to step up." The royalties are unaffected by HB488, and that is where the real benefit will be to Alaska. He said the state hopes to garner additional production taxes, too.

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COMMISSIONER MENGE said there are basins in Alaska that are geologically stressed because of hard rock minerals, but the

temperatures are not so high that the hydrocarbon has been destroyed. He said it is important to set an economic scene that allows that kind of exploration. He said there is a mature basin in Cook Inlet that is diminishing in prospects where it is critically important to bridge the gap until bringing North Slope gas "into the bowl." He noted an emerging basin on the Alaska Peninsula that is a high risk and the state needs to encourage people to step up. "So all of these things are wrapped up in what you are seeing presented to you today." Measure and judge the proposal in that context, he told the committee. "If you ultimately put blinders on and simply hone in on specific issues, you will find plenty there to work with." He said to look at the entire spectrum and the benefit that Alaska will garner over the years by encouraging companies to drill holes and hopefully find gas. He said the Nenana Basin is very exciting because the first hole had very high pressure areas of gas, but there was a large shale section. The driller needed to do "some exotic things" to maintain the integrity of the well, but it is enough to make them go back. We are trying to provide the incentives for companies to roll those dice, and it will be a partnership, he said. HB 488 is not charity, he stated, if those companies don't find anything, "at least we will have looked."

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COMMISSIONER MENGE said HB 488 does not just deal with 2006; it deals with the next two decades. If the tax is changed, "you're going to see people coming here from all over the world making investments, and those investments will bear results." He said there are tremendous opportunities in the National Petroleum Reserve Alaska and the Arctic National Wildlife Refuge. He concluded that this legislation is a balance and sets the stage to enhance Alaska's oil and gas future. He said he is absolutely impressed with the seriousness with which the legislature is taking this issue, and "all of us will write our names in the charter of history."

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REPRESENTATIVE CRAWFORD asked what the legislature will be voting on. The governor said the bill is for a gas line and oil tax package, and it is an up or down vote. He said in authorizing the Stranded Gas Act, the language was specific about being only a gas deal--that oil taxes would be separate. "Are we doing this under the Stranded Gas Act with a simple up

or down vote, or is this a separate oil tax deal that is open to amendment?" he asked."

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COMMISSIONER MENGE said the Stranded Gas Act set parameters that "we" used. He said the gas pipeline is tied to the oil and "everything." In negotiating the gas contract, it became "very obvious that we were going to have to deal with oil taxation as well." He continued:

Imagine a situation where the companies agreed to spend \$20 billion to build an infrastructure, and they reached the day when they make the commitments, the orders go in for the pipe, and the price of gas drops, and we sit back as a body here in the state going 'hmm not quite a good deal as we thought. Let's just bring the oil taxation piece in and let's plump up the oil side so we compensate for the gas side.' So then the oil companies are not only taking a beating economically on the pipeline, but they're also threatened significantly on the oil side. If you look at that they are inextricably linked. But the Stranded Gas Act said very specifically, as you point out...you cannot do this. We were locked on the horns of a dilemma at that point. The oil companies were unwilling to proceed without a recognition of a need for oil certainty.

COMMISSIONER MENGE said the state resisted that for many months, but it became obvious the state was not going to get a gas deal unless the it dealt with oil. Because oil was not specifically excluded under the Stranded Gas Act, "we said this will require a structured approach." The oil taxation is critical to the gas line, "but it is so important it touches everyone in the state...We are not authorized to present that to the legislature in an up or down vote." The decision was to present this stand-alone oil legislation. Regardless of a gas line, the oil piece in the bill will become the law of the land, and it will exist for 20 years or more.

COMMISSIONER MENGE said HB 488 will be subject to the full committee process. "It is connected but it's in a sequence," and he continued:

The oil thing is done by itself, fully amendable by the legislature. You exercise all of your authorities, and at the end a product is produced. That product is then set next to the oil legislation, but because we are now authorized to include this within the Stranded Gas Act, we will come to you with a package of amendments to the Stranded Gas Act. So step two, after you pass the stand-alone oil, will be contemplation of a package of amendments to the Stranded Gas Act. Within that will be an amendment requesting your blessing to attach it to the gas contract. Again, this will be amendable. This will be for the full consideration of the legislature, and you will draw your own conclusions as to whether this is an appropriate thing to do. If, as we hope, this is appropriate, you will have passed a piece of historic oil legislation. You will have authorized us to attach it to the gas contract through those amendments. And then we will lay the entire platter before you: the oil piece is there that you already blessed; the ability to connect it to the gas line, which you will bless; and the gas contract. And you will contemplate all of this as a single entity. That is the thing that you will vote up or down on as specified in the Stranded Gas Act.

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COMMISSIONER MENGE repeated the sequence. The package is necessary in order to set the economic environment within which people are prepared to invest \$20 billion or more and deal with the uncertainty of natural gas, he said. He said natural gas prices spiked recently because of [hurricane] Katrina. "Risk reduction is best done through being able to have certainty," and the bill provides certainty for taxation. He said the state was guilty of changing the tax structure after the Trans-Alaska Pipeline was built. Gas is more subject to market fluctuation than oil, he noted. He said there was great pressure to put this into an up or down vote, but he recognized the importance of running it through the legislative process.

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CO-CHAIR SAMUELS said there is a three-vote scenario: voting on oil; voting on whether to include oil with gas; and voting on the package. All three votes have consequences, he added. There will be three separate votes in order, but right now it is

only a discussion of HB 488, he said. Members must know that it is a long-term decision, "but you cannot base solely your decision on that because we might be changing the oil tax system and that's all we do this session." He said right now only a revision of the oil tax is before the committee.

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REPRESENTATIVE GATTO said it is being stated that the oil legislation is "stand alone," but then it was said that it will be combined with gas.

COMMISSIONER MENGE said the linkages will occur at the end of the day. "Once you have passed judgment on the oil pipeline, there will be a consequential definition of an economic picture. Now when you make the decision to link the oil piece to the gas, that will redefine the economic picture." He said the legislature can contemplate gas without any of the "others." It comes with its own specific economic picture.

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REPRESENTATIVE MCGUIRE asked if the governor will veto HB 488 if the legislature chooses not to adopt the amendments to the Stranded Gas Act.

COMMISSIONER MENGE said he doesn't know.

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CO-CHAIR SAMUELS said if HB 488 passes, the second vote won't take place until after the public comment period.

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REPRESENTATIVE KERTTULA said, "You already made an agreement on how the oil piece fits into the gas line contract. My problem is, if it is a sequence of events, we almost have to know what the end [indecipherable] before we can take step number one."

COMMISSIONER CORBUS said, "We have not completed that portion of our discussions with the producers."

REPRESENTATIVE KERTTULA asked, "Can you tell me what the issues around this is?" She said she is particularly interested in what is being spoke of as certainty with regard to oil tax.

COMMISSIONER CORBUS said, "Exactly how the wording in the contract concerning fiscal certainty on oil has not been determined. Certainly how HB 488 comes out will be important, but it is envisioned that it will be referenced in the contract, and that those will be most of the terms that will go forward. As far as the years of fiscal certainty goes, we're not in a position yet to go public on that issue."

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REPRESENTATIVE ROKEBERG said HB 488 has general applicability and is not designed to extract the maximum benefit in the short term. He asked how that reconciles with the constitutional requirement to maximize the benefit for all Alaskans.

COMMISSIONER MENGE said he thinks the constitution takes the long view.

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ROBYNN WILSON, Director, Tax Division, Department of Revenue explained the agenda and introduced speakers.

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DAN DICKINSON, Consultant to the Office of the Governor, said the PPT stands for Proposed Production Tax [although others have said that PPT stands for Petroleum Production Tax or Petroleum Profits Tax]. In fiscal year 2005 the state brought in \$8.9 billion in revenues, and he said \$3.4 billion came from oil; \$2.8 billion came from investments; \$1.9 billion came from the federal government; and \$800 million came from other things. He said oil revenue accounts for 88 percent of the unrestricted revenue.

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MR. DICKINSON showed a pie chart of FY2005 petroleum revenue where the largest amount of is from royalties and 25 percent of that goes to the permanent fund or public school fund. He showed the portion of the property taxes that the state receives and the corporate income tax. The production tax, which is what HB 488 deals with, was \$863.2 million in FY2005. He said the forecast for FY2006 is over \$1 billion. The production tax is a large piece of the total petroleum revenue picture, but not the largest, he noted. He showed a slide of oil production in Alaska and said Prudhoe Bay is huge, but its huge days are over.

In 1988 Alaska produced 2 million barrels of oil per day, and 1.6 million of those came from Prudhoe Bay. He said the Kuparuk River Unit is the second largest oil field in the United States, but it is very small compared to Prudhoe Bay. He said the North Slope has tiny areas of new production. He noted that it would be a vibrant place, except Prudhoe Bay is declining rapidly because the easy days of production are over.

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MR. DICKINSON showed the trend in Alaska North Slope (ANS) production and price on a graph. He said the price is rising so the value of the production is the same as when production was high. He said it is important that the change in price not obscure the continued decline in production.

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MR. DICKINSON said he will concentrate on the revenues of the PPT and the potential impacts on investments and production. He said the state has been looking at production tax issues for two years. He spoke of an administration decision to aggregate several fields in the Prudhoe Bay unit into a single unit for purposes of ELF. Assuming the bill passes, the aggregation will have been in effect for 18 months and will have raised almost \$400 million in additional revenue. He said what the legislature sees is part of an ongoing study.

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MR. DICKINSON showed a graph of the capital spending on the North Slope without money spent on tankers or the Trans-Alaska Pipeline. He said it has been about \$1 billion per year. He said tax is not the direct driver behind how much investment is made, "I would never claim it is the ultimate reason that investment gets made or doesn't get made." He stated that at the margin, tax policy can have an effect, so the administration is proposing a tax policy that favors making investments, which the status quo does not.

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MR. DICKINSON said in FY2005 the state produced about 330 million barrels, and the average price was \$43.43 per barrel, so the ANS oil was worth about \$14 billion at the destination point on the West Coast. He said the cost of getting the oil to the West Coast was about \$1.5 billion. At the point of production

it was worth about \$12.8 billion. The capital, exploration and operating costs were about \$2 billion. "That gives you the net value at the point of production...of about \$11 billion." That money gets divided up for royalties, federal taxes and the remaining either goes to producers or is what is hit by Alaska's production tax.

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MR. DICKINSON said under the PPT, Alaska would take the \$12.8 billion, remove the royalty and get a net value of \$11.2 billion. Under the current system a 15 percent tax rate is multiplied by the ELF, which is currently .55, so taxes in 2005 would be about \$927.15 million. He said it is not exactly correct, just an overview, but that is how the current production tax works. He said the current tax doesn't recognize the investments on the North Slope necessary to get the oil out of the ground; it looks at the gross value of oil. There are no incentives for getting heavy oil out of the ground and no recognition of the upstream investments, he noted. He said the proposed PPT would begin with the oil value net of royalty, and allow deductions for the upstream costs. It includes exploration, wells and everything that it takes to get the oil out of the ground. The taxable value in his example is down to \$9 billion, and with the proposed 20 percent tax rate and tax credits of 20 percent it would generate \$1.6 billion. He said the important thing is recognizing the investments. With a "huge slug of incremental investment," for example \$1.7 billion-worth, the production tax comes out at \$927 million--exactly where it started. The point is Alaska either gets the cash or the investment. The PPT is meant to incentivize investment, but "if we don't get the investment, we get the cash. The taxes are higher for folks not making investments." In the current system, taxes are the same whether a company is making investments or not.

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MR. DICKINSON said the current system is broken because the ELF was supposed to be a proxy for costs. It was supposed to be high for easy oil and low when oil was difficult to recover. He said the ELF was a very poor proxy for costs because it bore no relation to price. At the \$9 per barrel prices in 1999, the ELF would not even have covered all the costs that were spent, and at the \$55 per barrel price, the ELF creates a proxy that is many times higher than the actual cost. Under the current system there is a deduction as if investments were being made,

but it's not being made, he stated, and the proxy was not accurate with the price range of oil today.

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MR. DICKINSON said the PPT provides recognition that it costs money to get the oil out of the ground.

CO-CHAIR SAMUELS asked if the PPT is risky when there are high investments and then oil prices crash. How much risk is the state exposed to if there is a big investment followed by low prices? he asked.

MR. DICKINSON said he has wrestled with that. "I think you have correctly identified the problem." He said there is money for investing now. In a low price environment, especially four or five years from now, the production tax will only be \$100 or \$200 million. He said Co-Chair Samuels was right; when the PPT is only \$200 million, there is a very large hole in the pie, and the fact that it is \$100 million lower, there will have to be other measures taken at those low prices whether the state is using the PPT or not. But for every year of high prices, it will take 5-6 years of low prices to balance out. The state will have to look at other ways of dealing with cash flow at low prices, and the PPT will make revenues more volatile, "but I suggest to you that they will also be higher over time."

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CO-CHAIR SAMUELS said cost allocations are a problem, and the industry will not trust the state regulator, and "I don't want to pay for a building in Houston." He said he wants specific attention to cost allocations and auditing.

REPRESENTATIVE MCGUIRE said it is a real situation that the chair poses because "we allow, in this legislation, for unused tax credits to be transferred, and so you can envision a scenario where prices start to dip, folks may not be exploring actively but they may have these unused tax credits out in circulation." She asked how many years they are transferable.

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MR. DICKINSON said there is no limit on how long the transfers can be use. He said he tried to make those credits as close to their face value as possible. He added that it is important that investors "can sell the credit as close to a cents on the

dollar as they can do it." He said there has been trading of credits at over 90 cents on the dollar. The notion, he said, is the companies taking the risk, "who are likely to incur the losses, we want those to be able to trade at full value, and therefore we did not put a restriction on how long they could be used." He said there are other restrictions in the bill. He said the problem Representative McGuire raised is real, but the credits can't be used to reduce anyone's tax burden below zero. When looking at a low price environment, the important point is that even though a company can reduce its taxes to zero, when prices recover there will be revenues again.

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REPRESENTATIVE MCGUIRE asked if the Department of Revenue considered setting a cap. There has been other incentive legislation, like the raw fish tax, with a five-year limit. There is also a limit of 50 percent, so the state knows it will always get 50 percent back.

MR. DICKINSON said there is a limit on purchased credits of 20 percent of owed tax; however, if a company generates its own credits while making a huge investment and prices fall, there is no restriction on using those credits in the future. He said this is the kind of thing we need to get cleaned up. There were "a lot of things like this" that created internal debates, he added, and now they can be debated in a much larger circle.

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REPRESENTATIVE GARA said that Mr. Dickinson said that a tax policy often doesn't have an impact on industry investments. He said he really wonders if this PPT will have an impact. According to the Department of Revenue, profits next year would be about \$1 billion at \$20 per barrel, but at \$60 per barrel, the profits to the industry would be about \$7 billion. Under the current system and in the last three years, oil company profits have multiplied 5-600 percent, he said. The companies pay a zero percent production tax, but investments have gone down, he stated. Under this proposal, the state is going to give them an extra 20 percent of their costs back and charge them a 20 percent tax. So if a zero percent tax with 600 percent more money led to less investment, "why should I believe that giving them 20 percent more money--and increasing their taxes--is going to lead to substantially more investment than the current system?"

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MR. DICKINSON said the current effective tax rate on the North Slope is between 7 and 8 percent rate. He said there are two fields that have come on in the past several years, Northstar Unit and Alpine, that are paying tax rates close to 10 percent. Other smaller fields are paying zero taxes. He said companies other than the smallest fields will pay tax. He said one of the reasons why investments are not being made in Alaska and they are being made in other parts of the world is because other places reward those investments differently. He noted that every decision is not made by tax rates, but "part of the reason that investment has flowed to places that recognize investment is because you can make bigger investments or your investments have more bang for the buck."

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REPRESENTATIVE GARA said his point is that most new fields pay zero tax and some pay up to 10 percent, and a lot more cash flow has been made because of high oil prices. He noted that the proposal is to increase the tax. He asked why giving the oil companies a 20 percent tax credit benefit "is going to lead to so much more investment than the 600 percent benefit that oil prices have given them that has led to a decline in investment."

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MR. DICKINSON said there are two pieces, and a 20 percent tax rate means that for every dollar generated, "we get 20 cents on it." There will be other government takes, so the company will take home 40 cents on the dollar. "We are moving that rate up so once the tax basis is calculated, we are now taking a larger piece of it." But the bill gives the companies the opportunity to lower the tax base for investment incentive. He said if people thought there would continue to be high prices, why wouldn't companies drill every possible hole in the ground. He said the state could never create the same incentives that the current price structure does now. He said the state is trying to be "a little more focused" and to make investment in Alaska a better proposition than investment elsewhere.

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REPRESENTATIVE CRAWFORD asked about Mr. Dickinson's example of a small company drilling three dry holes and getting credit for

its losses, but the credits don't just come from losses; a company gets credits whether it is dry or not.

MR. DICKINSON said that is exactly right. He said he was giving an example of a company coming to Alaska, spending a lot of money and getting a zero return. He said the state wants to say the state will take part of the loss with tax credits. But he said the state will never question a company on whether their activities were successful or not. Supporting exploration is one of best ways to incentivize future production. Once a company has drilled and found oil, the chances are that it will develop the discovery. The bill kicks in at the exploration level and creates a credit, and the downside is a dry hole, and "we're going to make the downside a little bit less worse."

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MR. DICKINSON said the ELF uses the volume from wells and the field to calculate the tax rate, creating a problem when volume falls. The ELF is an exponential formula, and the net effect is when volume falls, the ELF falls faster. He showed a graph of the Kuparuk production. In 1993, at the height of production in the unit, 12 percent of every barrel was being taxed. As production fell by about one third, the ELF fell by more than half. From 2000 to 2005 the ELF essentially disappeared. So as volume falls, the ELF falls more rapidly. With the PPT there would still be a fall in taxes, but less quickly.

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MR. DICKINSON said taxes go down in maturing fields due to decreased production, but with the ELF it goes down to near zero. He addressed the North Star and Alpine fields where the ELF goes down to zero when volumes fall by about 50 percent. The sensitivity to volume is overstated, just as the sensitivity to price is understated, and he showed a slide highlighting that point. "Should we have a tax system that automatically falls—has a smaller tax on each barrel that is remaining to be produced, or as we're proposing here, we tax the profitability on each barrel..."

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CO-CHAIR RAMRAS asked for an addendum to Mr. Dickinson's presentation that describes the problem with the current tax. He said there will be surplus money this year, and royalties are invested around the world, and not generally in Alaska. Money

that goes to government services doesn't generally help the Alaska economy, he noted. He asked Mr. Dickinson to later discuss the incentive for exploration and the economic multiplier created by the additional exploration, "and I'd like to see what that will do for employment opportunities, for revenue and dollars that go into our economy." He said it was a great presentation but "I found that why it is a problem is also why we have had retarded growth in the Alaska economy over this as the ELF broke and as production broke down, we also have not had the blossoming economy we should have had." He asked for different scenarios of exploration at different rates that have been mentioned: 1 to 3 billion; "What that would mean when we apply some kind of an economic multiplier...to see how broken is that part of the system..."

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MR. DICKINSON said, "I think you've made the point, and I think it's very true that when we talk about investments yielding more barrels, that's only one of the effects, and clearly any work going on on the North Slope or around the state has a multiplier effect."

[2:06:12 PM](#)

MS. WILSON said the problem with the current tax is the lack of incentive to reinvest in Alaska. "It has a low take internationally at high prices, and a high take at low prices." The tax is referred to as a regressive tax, and the maturing of the North Slope leads to a decline in tax revenue.

REPRESENTATIVE ROKEBERG said it is not fair to say there is currently no incentive. The ELF was designed to try to generate investments, and the question is whether it is working. Producers are investing substantial money, he noted. He said he is concerned about the de facto tax credit that Representative Gara referred to.

MR. DICKINSON said that is a fair point, "and maybe we should say that there is no effective incentive." He noted that investment can be its own reward, and the state is trying to create a specific incentive tied to the amount of the investment.

[2:09:15 PM](#)

MS. WILSON told the committee to keep four ideas in mind regarding HB 488: the relative encouragement of the investment; competitive rates internationally; encouragement of small companies to invest in Alaska; and the efforts that have been made on streamlining the tax process. She said there are five basic elements of HB 488. 1) Tax base—or what is taxed. The current tax system is based on gross and the PPT is based on net. 2) Tax rate of 20 percent. 3) Incentive credit to encourage companies to reinvest in Alaska. 4) Base allowance of \$73 million, which is akin to the standard deduction on personal income tax. 5) Transition provision that recognizes recent investments in oil exploration and production.

REPRESENTATIVE KAPSNER addressed the \$73 million base allowance, and asked if any other industries have a base allowance.

MR. DICKINSON said the only similarity might be the mining license tax where there is an extended period of time in which there is no tax paid.

[2:12:45 PM](#)

REPRESENTATIVE KERTTULA asked if the allowance is on the gross profit or on the net profit.

[2:13:18 PM](#)

MS. WILSON said the base allowance is a deduction on the net. In terms of a personal tax return, the allowance would be similar to a charitable contribution deduction; however, credits are akin to the childcare credit and other dollar-for-dollar credits. She noted that the gross versus net can be confusing and said that the bottom-line might be the same for a gross and net system. She gave an example of both systems where the tax would be the same where a tax on gross might be 15 percent and a PPT on net would be 20 percent, but the tax before credit would be the same. "It makes sense that when you tax net your tax rate will be higher."

[2:15:55 PM](#)

MS. WILSON said the tax base starts with gross value at the point of production and then subtracts lease expenditures, which include operating costs, capital expenditures and allowance for overhead. She noted that capital expenditures are expected to generate income over a number of years. In HB 488, "the plan allows for basically immediate write off of capital

expenditures, so just as normal lease operating expenses are deductible in the year that they are incurred, by the same token then machinery, things that are normally capitalized that will have a life over a number of years, are immediately written off." She said there will also be an allowance for overhead, but the exact formula has not been "fleshed out," so the division will be writing the regulations. The lease expenditures must be direct costs and they must be ordinary and necessary, she added. The deductible expenses are in the bill. She said the department will write regulations on defining "direct" and "ordinary and necessary". The bill specifies that substantial weight be given to industry practice and standards adopted by the Department of Natural Resources.

[2:19:15 PM](#)

CO-CHAIR SAMUELS asked if it will be completely in the regulatory environment, and asked if that will create constant conflict between the state and the industry on valuations and costs. He said industry is going to be mistrustful that the state will not allow expenses that it thinks is real. "I'm not going to want to pay for the building in London and Houston," he said. He suggested the conflict might continue because the issue will not be in statute.

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MS. WILSON said, "This is an area where there is some streamlining, as I would see it." She said with regard to lease expenditures, there is recognition of established practices where there is joint interest. She said there may be disagreements about allocation of overhead, but "we have been given marching orders, so I would hope that that would minimize the conflict."

CO-CHAIR SAMUELS asked about the timeframe for the regulations.

MS. WILSON said the administration has not started on them. It may be required to be done on an expedited basis, she added.

[2:21:23 PM](#)

REPRESENTATIVE ROKEBERG asked if the net profit formula in Alaska leases has ever been litigated.

MR. DICKINSON said he doesn't believe it has gotten to litigation, but there have been differences. "I don't believe

that the overhead was one of those because I believe that is specified in the net profit share regulations as they exist."

REPRESENTATIVE ROKEBERG asked, "Are you not adopting the USC...the federal tax code?"

MR. DICKINSON said, "We will. For capitalized expensive, in other words, the rules that say when you self construct an asset, how much of your overhead can go into that, or has to go into that...we will be adopting the federal code for that." The issue, for example, is when an operator at Prudhoe Bay uses an engineer in Anchorage to do work on the North Slope, other working-interest owners will be billed an overhead beyond that engineer's salary, "so when we say we're going to look at industry practice, that's really what we want to look at...like Prudhoe Bay where there are lease expenses and how the operator charges overhead to other lessees."

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REPRESENTATIVE GUTTENBERG asked about the analysis for an independent.

MR. DICKINSON said a lease generally has several working-interest owners, and independents or wholly-owned operations have no one looking over their shoulders, and "that's when it's going to get a little bit harder, and that is where we are just going to have to look at industry practice and set out rules that embody industry practice and try to make sure we come as close to a reasonable number as possible." He said he didn't try to embody a rule in HB 488 because "we thought having regulations with a direction to look at industry practice would probably keep us more in line."

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CO-CHAIR SAMUELS said there was a previous bill on a decoupling because the federal government did something that the legislature did not like. He asked if there would be a problem with a federal rule change, "is there some worry that now we're stuck with this...and we have moved down the road with [the industry], and now the feds come in and do something to the two of us that changes the economics of the project or the economics of the state?"

[2:25:47 PM](#)

REPRESENTATIVE SEATON said, "We are looking at establishing the oil statute and then coupling that possibly with a future vote into gas; now is that going to couple in the regulations or are we essentially setting up regulations that...determine some tax policy that could be changed at a future date that are not going to be tied in here?" He said he sees future conflict and litigation, "if we're talking about trying to couple statutes into the long term gas, but then we're decoupling regulations that could be changed. Could that be a future problem?"

[2:26:59 PM](#)

MR. DICKINSON said that in the context of the Stranded Gas Act, discussions about fiscal stability focus very much on regulations because that is something the department really can do, aside from listening to public input, because the decision-making rests with the department. But with HB 488, "what we're trying to do here is create enough flexibility...the cost areas here are much more specific than they are in the current statute." The current statute uses 12 words talking about what costs are, and "we have written hundreds of pages of regulations interpreting what those 12 words do." He said he has tried to be more specific in HB 488 while maintaining flexibility. "Clearly, what's contemplated in the Stranded Gas Act, and again I can only tell you a window into that, is the discussion about regulations and the effects that they may or may not have on someone signing the Stranded Gas Act contract."

REPRESENTATIVE SEATON said he would like that addressed. This is a stand-alone bill but the intent is to have a future vote to tie it into a Stranded Gas Act bill. He wants to know if the regulations that are establishing these costs will be tied to stranded gas, or could there be litigation based on changing allowable costs in the regulations.

[2:29:07 PM](#)

MR. DICKINSON said, "I think what we contemplate is that where the statute sets up the option for regulations, essentially in the Stranded Gas Act, we might essentially come up with that." He gave an example using the Stranded Gas Act to guide how overhead will be calculated. He said the hope is that the Stranded Gas Act will be completed before the regulatory process of HB 488. There might be a situation where a signatory to the Stranded Gas Act had one set of interpretations, and a company that did not sign onto the act would have something different.

"They'd be under the same statutory authority but the interpretation might be slightly different."

REPRESENTATIVE ROKEBERG referred to the remark of coming back to committee if there were a change in federal law, and he asked Mr. Dickinson to speak to the issue of a federal windfall profits tax.

[2:30:25 PM](#)

CO-CHAIR SAMUELS asked about the extent of exposure the state and industry would have to the federal government.

[2:30:56 PM](#)

MS. WILSON said for income tax, what the federal government does is important because the state adopts the internal revenue code. But the production tax will not piggyback to the code except in certain areas. If the federal government wants to generate activity and not capitalize certain things, then the state could not capitalize those things. She said the state is not adopting the code generally, so a windfall profit tax would be not applicable because it is based on net income.

[2:32:34 PM](#)

REPRESENTATIVE ROKEBERG asked if the bill was adopting the federal code by reference.

MS. WILSON said no, and the last point is that any lease expenses where the producer is receiving any reimbursements, those would be taken off the expense amount.

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MS. WILSON listed non-deductible expenses: depreciation, royalty payments, taxes based on net income, interest and financing charges, lease acquisition costs and other costs. Rather than depreciating, the producer gets an immediate write off in year one. Royalty payments never enter the calculation in the first place, she said. She said taxes based on net income and interest are general expenses not tied to leases. Other costs including arbitration, donations and costs of organizing joint ventures are general expenses that are not tied to certain leases. She said the non-deductible expense list is on page 13 of the bill.

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MR. DICKINSON said any conflict or court case against the state is not deductible, nor are conflicts between interest owners. An injury case would be allowed as a deductible expense.

MS. WILSON discussed how value is determined under the current system. Transportation expenses, including TAPS and marine transportation, are backed out and simplified under the PPT because marine transportation expenses take a lot of audit time. Under the PPT the producer can elect to use royalty values, and that would be royalty values accepted by the Department of Natural Resources. The other option is to use a formula that estimates the value at a specific location, such as at a point of delivery...common carrier pipeline.

CO-CHAIR SAMUELS asked about the Trans-Alaska Pipeline System settlement methodology (TSM), and what the bill says about the trust on the tariff that is paid to the Alyeska Pipeline Service Company, which is probably not as high as it should be.

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MR. DICKINSON said when TSM expires there will be an alternative. He said he contemplated going to publicly available values for calculating a netback, particularly for small companies that aren't doing their own "tankering". He said he never contemplated anything other than using a published tariff.

MR. DICKINSON said, "The current standard, which we're not changing, talks about actual cost, so I suppose that if the department believed that what was ultimately determined was not actual cost, they could argue it's not deductible. I think in general, what we've contemplated is we have enough arguments on our hands about other things, we'll let those fights go on in the proper forums."

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MS. WILSON said the bill specifies that the Department of Revenue may use other factors like published prices, quality differentials, applicable transportation costs and inflation adjustments to guide it in the formula. She noted that the tax rate is 20 percent of net profits, and the bill provides incentive credits of 20 percent, which may be taken on exploration costs and capital costs incurred on the lease. She

said the credits are transferable and subject to audit. Exploration costs include geological and geophysical costs. Capital costs include intangible drilling costs, which are under the federal code and written off in the first year, but under the PPT, "what we've said is you've got a credit on capital costs and that includes any IDCs." The purchaser of a credit can only reduce their tax by 20 percent.

REPRESENTATIVE ROKEBERG asked about the credit and tax rate, and if they are additive.

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MS. WILSON showed a slide of how losses are handled. "If we look at a gross value...of \$50, and we write off lease operating expenses of \$12.50, and we give a deduction for the capital expenditures--that is, write off the equipment that was purchased--that leaves, at this point, a net loss, which commonly is referred to as a NOL, net operating loss, of \$22.50. Net operating losses. That's before any credit. Right now you've gotten to a negative place. You don't have any tax against which to apply the credit, so, you have a loss. And what the bill provides for is that the loss can be converted into a credit and we apply 20 percent of that amount to just get it on a dollar for dollar."

REPRESENTATIVE ROKEBERG asked about breaking even.

MS. WILSON said if the bottom line was zero there would be no tax; a company would not utilize any credit at that point.

REPRESENTATIVE ROKEBERG asked if he would get 20 percent investment credit.

MS. WILSON said he would get it on the books and have to carry it forward.

REPRESENTATIVE GARA said he is worried there is double accounting. The tax credit is for exploration and then also for building a facility, "so there's 20 percent there, and if you're a profitable company, when you pay your 20 percent tax on the other side, you're deducting your costs. So you're deducting 20 percent of your costs on the tax side and then getting a 20 percent credit on the credit side. For those companies that are making a profit...aren't they 40 percent credit?"

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MS. WILSON said that is correct, "if there's a piece of equipment on the lease, you will be able to write off the cost of equipment in year one as a deduction, and that will also qualifies for a tax credit of 20 percent." It was done this way to maximize the incentives for investment.

REPRESENTATIVE GARA said it really benefits the bigger companies who can get it at both ends. He suggested giving credit to help find oil but once it is found, why should the state give credit "after you've struck gold?"

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MR. DICKINSON said no matter the size of the company, if it has expense, it gets 20 percent if profits are below zero. A company can convert it into a credit, which is the same for large and small companies. He said Representative Gara is right that the state wants to incentivize credits for exploration. "One of the reason's this larger policy call was made was looking at the kinds of investments that were occurring, and whether in fact a focus on merely exploration versus exploiting resources that we know that they're there in place, but for whatever reason, appear to be more challenged. For example, heavy oil." People know where heavy oil is, "but the question is, should we be creating a system where you go out and you incentivize finding light oil more than just taking a known reserve of heavy oil and monetizing it? So as we look at the resources in the North Slope, is focus on exploration important? Absolutely, but so too is taking some of the more challenged pools of oil where we know exactly where they are...and try and incnet the technology and the investment to get those up and running at a higher productivity level."

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REPRESENTATIVE ROKEBERG said he has concern about heavy oil and frontier exploration, and having a discussion about a two-tiered system. He said it relates back to a three step gas line deal, and the adoption, by reference, of something that would be much more volatile. He mentioned separate legislation for further incentives for those types of investments.

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MR. DICKINSON said he is trying not to create a multi-tier system, but a system where one gets the same bang for the investment buck.

REPRESENTATIVE ROKEBERG said that may not be working.

MS. WILSON said she sees the ability to transfer credits as a way to help a small producer.

[2:52:50 PM](#)

MS. WILSON said the base allowance is a \$73 million deduction, and that number came from allowing \$200,000 per day in net profit to be produced without taxation. It is a standard deduction that cannot generate a net operating loss and cannot be carried forward. It is taken in monthly chunks, she said. She added that there is a monthly return filing, and "this bill envisions sort of a 90 percent safe harbor amount, month by month." There will be a yearly true up on March 31 when the rest of the tax is due. "I see that as being sort of a taxpayer friendly reasonable thing to do." The bill has an effective date of July 1, 2006, she stated.

REPRESENTATIVE SEATON asked if the 90 percent safe harbor is interest-free.

MR. DICKINSON said, "If you pay 90 percent in any month, there would be no tax due when you pay the additional 10 percent on the March 31 true up date." But if a company only paid 85 percent, then it would owe interest on five percent.

REPRESENTATIVE SEATON said so this isn't a safe harbor from penalty, it is a safe harbor from penalty and interest.

[2:57:07 PM](#)

MR. DICKINSON said that is correct. Penalty is about willful neglect, he said, and this simply says by paying 90 percent a oil company won't have to pay interest.

MS. WILSON said the transition provision allows cost recovery of assets placed in service in July 2001 through June 2006. She said when an oil company buys a piece of equipment for the North Slope, it will get 100 percent write off in year one. "What that means then is the assets that were invested last year, for example, they're getting no representation in the calculation of net income." She said those assets are producing income for a

number of years and yet if they were purchased last year, they aren't represented. The bill allows cost recovery of assets that were placed in service in the previous five years, and those deductions will be allowed for six years. The deduction will only be available when the average price of oil exceeds \$40 a barrel.

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CO-CHAIR SAMUELS asked if companies can carry that deduction forward beyond six years if the price of oil is below \$40 a barrel in the fifth and sixth year.

MS. WILSON said yes.

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CO-CHAIR RAMRAS said the three majors have chosen to explore and reinvest in Alaska between 2001 and 2006, and he asked Ms. Wilson to monetize it for each producer. He said he wants to know who will benefit most from this transition provision.

MR. DICKINSON said there is publicly available information but it is not broken down. He said ConocoPhillips Alaska, Inc. reports segment accounting, "so they report a set of numbers...we could certainly present that," but things that occur outside of that process are confidential.

CO-CHAIR RAMRAS asked who benefits from the transition provision, and why is it there.

[3:01:05 PM](#)

MR. DICKINSON said it would benefit the taxpayer who has made the largest investment, and the taxpayer who made no investment will get no benefit from it.

CO-CHAIR RAMRAS said, "We're really only talking about three taxpayers." He again asked which company will benefit the most.

MR. DICKINSON said ExxonMobil Corporation holds a third of the Prudhoe Bay unit and ConocoPhillips Alaska, Inc. has the same in Prudhoe Bay and owns a majority of Kuparuk and Alpine field, so it will have higher investments. BP owns a much smaller piece of Prudhoe Bay, but also has holdings in other places.

CO-CHAIR RAMRAS said the title of the presentation is "Current Production Tax, and why it is a Problem." He asked who has been the problem in stimulating exploration. The transition provision assumes someone benefits more or less. "Who benefits more, and who benefits less?"

[3:02:39 PM](#)

MR. DICKINSON said the two major fields that have opened up in the last five years were North Star, owned by BP, and Alpine, owned by ConocoPhillips Alaska, Inc. "Those are two large investments that will probably figure prominently in this calculation."

CO-CHAIR SAMUELS said costs that were incurred by the oil companies three years ago have probably been recovered by the \$60 a barrel price. As the price went up, the recovery should have been there, he said. If oil was \$30 a barrel the transition provision would make sense, because the companies would have calculated that into their rate of return, but he asked if it makes sense.

[3:04:31 PM](#)

MS. WILSON said in the accounting world, buying machinery will yield the value each year it is used. "Just because you had a windfall in year two...doesn't change your view that in year five that asset is still producing that income and should be offset against that. I think it's really from a, sort of, accounting perspective."

REPRESENTATIVE SEATON asked about the presentation about ELF spiraling down and that ELF stopped functioning as it was anticipated. He suggested the investment costs have been recovered by ELF not functioning.

[3:07:08 PM](#)

MR. DICKINSON said in the sense of gross cash flows the ELF provided a large window "that allowed that." He said the state is taxing profits regardless of what has been captured in the past. "We are trying to create a situation where there is some recognition of that--their contribution of the profits going forward."

REPRESENTATIVE SEATON said everything that has been invested "up there" is in the same structures. He noted that 2001 happens to

be where ELF free falls, but why are investments in 1999 or 2000 still not producing assets. He said he doesn't understand the transition going back to 2001.

[3:08:39 PM](#)

MR. DICKINSON said it could have been a different number of years. "This is what the governor is recommending."

REPRESENTATIVE GATTO said he is curious about the chart that the oil companies will show regarding the PPT.

MR. DICKINSON said the legislature will get many charts from the oil companies. He said the state will show charts on who will get what with the PPT.

[3:10:34 PM](#)

MS. WILSON said additional revenue will be based on the price of oil and the amount of producer investment in the state. The revenue forecast was modeled on three different price predictions. The Department of Revenue forecasts oil to be \$25.50 per barrel after two years. In that forecast the state revenue is less than it would be with the current system. She says she views that as the worst-case scenario, and it is in the fiscal note.

[3:13:25 PM](#)

REPRESENTATIVE GARA said a chart by Pedro van Meurs showed that under a 20:20 system, the state would earn less money with a PPT than the current system at \$27 a barrel. Now she is showing it roughly even at \$25 a barrel, and asked about any change in variables.

MR. DICKINSON said that modeling is based on five different-sized fields, but the state analysis looks only at the North Slope.

[3:14:39 PM](#)

MS. WILSON showed the fiscal impact at today's oil prices and then the impact of a "moderate" \$40 per barrel.

[3:15:14 PM](#)

MS. WILSON said the fiscal note shows tax revenues, and in terms of expenditures, there will be increases for auditing of expenses, except there will be less auditing on transportation costs. She noted that the transition deduction will require much auditing done quickly. There will be heavy upfront costs, and that work will be outsourced. There will be an additional three auditors and an employee for filing. There will also be outside help for regulation writing. Basic programming will be required, she concluded.

REPRESENTATIVE SEATON asked for a chart on oil at \$18 a barrel.

REPRESENTATIVE GARA said he would like to see the charts on three other tax/credit scenarios, including 30/15, 30/20 and 25/20, which is what the governor proposed the prior week.

[3:20:27 PM](#)

[HB 488 was held over.]

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at [3:20 PM](#).