

ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE

February 23, 2006
12:36 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

Representative Jim Elkins
Representative Carl Gatto

OTHER LEGISLATORS PRESENT

Representative Berta Gardner
Representative Mike Kelly
Representative Beth Kerttula
Representative Vic Kohring
Representative Mike Hawker
Representative Kevin Meyer
Representative Mark Neuman
Representative Norman Rokeberg

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
02/22/06	(H)	Heard & Held
02/22/06	(H)	MINUTE(RES)
02/23/06	(H)	RES AT 12:30 AM HOUSE FINANCE 519

WITNESS REGISTER

DR. PEDRO VAN MEURS, Oil and Gas Consultant
to the Governor

Van Meurs Corporation

POSITION STATEMENT: Presented information on the proposed profits-based Petroleum Production Tax (PPT).

ROBYNN WILSON, Director

Anchorage Office

Tax Division

Department of Revenue

Anchorage, Alaska

POSITION STATEMENT: Answered questions regarding HB 488.

ROGER MARKS, Petroleum Economist

Department of Revenue

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

ROBERT MINTZ, Assistant Attorney General

Oil, Gas & Mining Section
Civil Division (Anchorage)
Department of Law
Anchorage, Alaska

POSITION STATEMENT: Began the sectional analysis of HB 488.

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 [12:36:34 PM](#). Representatives Samuels, Seaton, LeDoux, Ramras, and Kapsner and were present at the call to order. Representatives Crawford and Olson arrived as the meeting was in progress. Also in attendance were Representatives Gardner, Kelly, Kerttula, Kohring, Meyer, Neuman, Hawker, and Rokeberg.

HB 488-OIL AND GAS PRODUCTION TAX

CO-CHAIR RALPH 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."

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DR. PEDRO VAN MEURS, Economic Consultant, informed the committee that the committee packet should include the PowerPoint presentation entitled, "Petroleum Production Tax." Dr. Van Meurs said that he would discuss the proposed profits-based Petroleum Production Tax (PPT) from the international perspective. He began by highlighting that the fiscal system of Alaska, applicable to oil and gas, consists primarily of four components: royalties, production tax, property tax, and state corporate income tax. Additionally, the federal corporate income tax would be included when performing worldwide/international comparisons. He then turned to slide 3, which lays out the PPT as specified in HB 488. The PPT in HB 488 has a tax rate and tax credit of 20 percent, a tax-free allowance of up to \$73 million, and a capex [capital expenditure] clawback provision in the amount of 20 percent over the last five years.

CO-CHAIR SAMUELS recalled that when the economic limit factor (ELF) was instituted an extraordinary tax break incentivized the development of satellite fields, which, 20 years later, has resulted in the state having many satellite fields that don't pay taxes. Therefore, Co-Chair Samuels inquired as to what would prohibit a similar situation [under HB 488] with the \$73 million in tax-free allowances.

DR. VAN MEURS said he didn't foresee that problem because the North Slope will be the terrain of the larger oil companies. The level of investment and the complexity of the resource, particularly in regard to heavy oil, is the kind of investment that large/major oil companies make. Therefore, he predicted that the vast majority of Alaska oil and gas will be produced by major oil companies over the coming decades. However, the small oil companies could be attracted and the state would desire to

attract them to the basins around Fairbanks and Cook Inlet. Therefore, Dr. Van Meurs opined that there is definitely a place in the petroleum industry for smaller companies, although he said he didn't foresee a situation in which 90 percent of the oil would be used by small companies 20 years from now.

REPRESENTATIVE LEDOUX inquired as to what a capex clawback is.

DR. VAN MEURS related that although he wasn't involved in its development, he understood that the concept is that oil companies that have been investing for the last five years can take capital expenditures as a deduction over a specified price level, which he estimated to be \$40 a barrel. He deferred to Mr. Dickinson, consultant to the governor, for further details and noted that his analysis doesn't include the clawback provision.

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REPRESENTATIVE KERTTULA inquired as to what other jurisdictions have implemented something similar to the capex clawback provision.

DR. VAN MEURS said that the concept of permitting past depreciation when a new tax is introduced is a normal feature. However, in [Alaska's] context it's a bit unusual since [Alaska] permits a 100 percent write-off of the capital expenditures. Contributing to the uniqueness of the capex clawback provision is the fact that it would only apply over a particular price level. Therefore, the provision isn't easily identifiable in other countries.

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DR. VAN MEURS continued with his fourth slide. He reminded the committee that until early January 2006, he had recommended a 20 percent tax and a 15 percent credit based on the international competitiveness analysis. However, as a result of the economic analysis done in DOR and input from the various other consultants, he concluded that a 25 percent tax rate and 20 percent tax credit rate was a better package. The 20/20 PPT package was adopted after his analysis, and therefore he noted that his report doesn't include specific analysis on that. Dr. Van Meurs moved on to slide 5 with an outline of his report. He explained that the reason he preferred the 25/20 PPT and the 20/15 PPT is because the tax rate is high enough to balance the credits. The 20/20 PPT is a slightly more risky package because

there may not be enough taxes to make up for the tax credit. He commented that there are various risk distributions among these taxation systems.

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DR. VAN MEURS, in response to Representative Kerttula, highlighted the need to understand the balance between the tax rate and the tax credit rate. He explained that if large tax credits are used due to high investments, it results in significantly less income. Therefore, the notion is to have sufficient income for the tax credits to be taken, if the companies heavily invest. He reiterated that good balances are 20/25 and 25/20, although he noted that the difference between all of these packages is really small. Still, when there is a lower tax rate combined with a somewhat higher credit, it's somewhat riskier for the state, he said.

REPRESENTATIVE ROKEBERG questioned whether the administration's preference for the 20/20 ratio was impacted by negotiations with the producers. He then asked if Dr. Van Meurs has been able to quantify/model the capex clawback.

DR. VAN MEURS again deferred to Mr. Dickinson regarding the clawback provision. However, he related his understanding that at higher prices, these taxes bring in billions more in tax. The clawback provision, he opined, is just \$1 billion and thus is a relatively minor component that wouldn't dramatically change the economic impacts. "Consequently, it is just a feature that results in somewhat lower tax in the coming few years than otherwise would've been created, but it's not something that ... would change the basic conclusions that I'm also presenting," he said.

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DR. VAN MEURS reminded the committee that he and Mr. Marks, DOR, presented the full slate of options to the House Finance Committee. He opined that all of the options are attractive to the state, if there is at least a 20 percent tax rate. Therefore, it becomes a question as to the precise balance for the state in the opinion of the governor. From a consulting or international analysis point of view, all of these systems are closely related in terms of competitiveness. The higher the tax rate and the lower the tax credit, the more revenue there is for the state, he reminded the committee.

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REPRESENTATIVE ROKEBERG inquired as to why HB 488 wasn't drafted with a 30/20 [PPT] when another benefit was included.

DR. VAN MEURS pointed out that there can be higher tax rates. He noted that his report analyzed higher tax rates, including a 30 percent tax rate. However, he recommended not having a tax rate that is too high because he believes it would gradually make the system less competitive and the overall government take becomes gradually unattractive relative to other international fiscal systems, and therefore companies would probably start to invest less in Alaska. Dr. Van Meurs related his understanding that the goal was for the taxes to bring in more revenues, which any of the [PPT] combinations achieve. However, at the same time there was a desire to see more investment and stabilized production. Therefore, the goal is to find the balance between the aforementioned objectives, he said.

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DR. VAN MEURS moved on to slide 6, which relates the range of cost scenarios that were analyzed. He commented that with this type of fiscal analysis it's important to take a wide range of cost and field sizes because one never knows what is there. If the Arctic National Wildlife Refuge is ever opened to oil development, the desire is to ensure that there's a fiscal system in place that's adequate and that the fields provide the benefit to the state. However, he acknowledged that the ongoing developments of the North Slope relate to the smaller fields that are gradually getting expensive. In order to test whether this test is suitable for a wide range of field sizes, prices, and costs, much emphasis was placed on the high cost fields because there is abundant evidence that the majority of the fields will be "looked at" in the coming years.

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DR. VAN MEURS pointed out that slide 7 relates the various outcomes with a 20/20 PPT tax. He explained that the negative figures under the "dry hole" column are due to the tax credits and the deductions of the dry hole itself, for PPT purposes and corporate income tax purposes. The 64.7 percent specified for the total under the "dry hole" column means that the federal government and the state absorb 64.7 percent of the cost of a dry hole in terms of deductions. Therefore, the PPT will make an enormous contribution to increase the attractiveness of

exploration because a company could receive \$6.47 back for every \$10 spent. Furthermore, exploration would become far more attractive throughout Alaska. He then turned attention to the "50 MM," and explained that the smaller fields are more attractive because of the \$73 million allowance and don't pay the PPT, although they receive the tax credits. The hope is that will increase [exploration] activities, particularly outside of the North Slope. He then reviewed the Alaska government take under various scenarios, which illustrates that, in terms of field size, there is a progressive system with a heavy burden on the larger fields. Therefore, new investments would generate very significant revenue flow to the state.

DR. VAN MEURS moved on to slide 8, which illustrates the importance of tax credits for small fields. The tax credits have a considerable impact on the break-even point, he reminded the committee. The graph provides sensitivity analysis for a PPT of 20 percent with no tax credits, a 15 percent tax credit, and a 25 percent tax credit. The slide illustrates that the break-even point, in terms of the PPT received, depends upon the tax credits. He pointed out that the higher the credit, the higher the break-even price.

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DR. VAN MEURS highlighted that the graph on slide 9 illustrates the rate of return on a 150 million-barrel field. Again, this is a sensitivity analysis of the tax credits. The graph illustrates that the internal rate of return (IRR) is primarily determined by these tax credits. Therefore, the 20/20 [PPT] would result in the same return as the current system in Alaska for the specified field size. As the tax credit increases, the IRR increases. The graph specifies that the IRR can be increased by almost 7 percentage points by moving from 0 to 25 percent. The 20/20 [PPT] proposal in HB 488 would significantly increase the IRR, and therefore it makes investment in smaller fields or fields of any size by smaller companies far more attractive. Slide 10, he said, enters into the international comparison. He explained that his job was to ensure that whatever system was selected would be internationally competitive. The analysis carefully compares eight jurisdictions in which the companies are very active and thus the terms are sufficiently attractive to merit significant investment.

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DR. VAN MEURS said that slide 11 is important. He explained that one of the large drawbacks on the Alaska North Slope is that the wellhead prices are much less than anywhere in the world relative to West Texas Intermediate (WTI) taxes. He noted that there is a quality differential of about \$2.00, which varies from day-to-day. Therefore, in comparing the North Slope with the U.S. Gulf of Mexico, Alaska immediately has to overcome a \$7.00 difference [in value with Mexico]. He noted that Azerbaijan is similar to Alaska in that it is a low netback country and thus has low wellhead prices relative to the world price. Within the economic comparison, Dr. Van Meurs said that he subtracted the differential in order to address it and thus if Alaska is compared with Norway or the United Kingdom, the assumption is that the value of the crude oil in Alaska is \$7 less than in the Gulf of Mexico or \$6 less than in Norway. Therefore, if the graph illustrates that Alaska is competitive it's a real competitiveness because it corrects for the low wellhead prices.

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DR. VAN MEURS then turned the committee's attention to slide 12, which presents a graph comparing Norway and the United Kingdom. The aforementioned example was chosen because it presents a good spread in that the United Kingdom has an overall government take that is an overall percentage of the profits of about 50 percent whereas for Norway it's about 78 percent. Consequently, that almost represents the world from the lower government takes to the higher government takes. Slide 12 represents an IRR on a very large field. Slide 13 addresses smaller fields for new investors whereby the IRR becomes very significant due to the tax credit. From an international perspective, these smaller fields would be more attractive for the new investors, he said.

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DR. VAN MEURS, in response to Representative Seaton, explained that the 20/20 [PPT], which has an attractive tax credit, would have a high IRR. Furthermore, it fits right over the United Kingdom and is a bit higher than the United Kingdom at the higher price levels. At the low price levels for small fields, it's difficult to be attractive compared to international circumstances because at \$22 the \$7 has to be subtracted for the netback, and furthermore there is a very high cost for that field. Therefore, no matter the case, at low prices small fields aren't very attractive and not much can be done to address it.

REPRESENTATIVE KERTTULA asked if she understands the graph on slide 13 correctly in that the 25/20 [PPT] at the high price provides the highest IRR.

DR. VAN MEURS replied yes. He explained that small fields with new investors who receive the \$73 million allowance wouldn't pay taxes and would still receive the tax credits. Therefore, the higher the tax rate and the tax credits, the higher the IRR because of the much higher carry forward on the losses and thus it actually boosts how much the company gets back. In other words, the 25/20 [PPT] provides \$.45 per dollar while the 20/20 [PPT] only provides \$.40 per dollar, and therefore the 25/20 [PPT] is more attractive. However, once one reviews large fields, that's not necessarily the case.

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CO-CHAIR SAMUELS related his understanding then that the assumption is that it's a small new company with no other write-offs for the \$73 million.

REPRESENTATIVE KERTTULA inquired as to what would occur with a 30/20 [PPT]. She asked if it would result in the [IRR] being even higher for the small fields.

DR. VAN MEURS replied yes, and reiterated that the higher the tax rate and the higher the tax credit, the higher the IRR. For example, if the system in place was a 30/30 [PPT], the company would receive \$.60 per dollar, which illustrates that one must take care with these high tax credits and find the right combination.

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CO-CHAIR SAMUELS surmised then that a 30/20 [PPT] would have a higher IRR for the company than would a 25/20 [PPT]. However, he inquired as to whether both [the tax rate and the credit] would have to go up because only increasing the tax rate would seem to lower the IRR.

DR. VAN MEURS explained that the reason for the situation is because the company isn't paying the tax because of the \$73 million shelter. Therefore, it's an enormous incentive for the companies.

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DR. VAN MEURS moved on to slide 14, which reviews the overall government take of the various countries with Norway being on the high end of the international scale and the United Kingdom on the low end. The graph illustrates that Alaska fits in the middle, although located more closely to the United Kingdom. The graph further illustrates that the government take [in Alaska] is modest, which is because of the earlier mentioned \$7 [net differential] problem that doesn't allow [Alaska] to "ask" the same as Norway or the United Kingdom. However, the graph highlights that from an overall government take it doesn't really matter whether the [PPT] is 25/20, 20/20, 20/15, or 25/20. At most, there is a 2 percent difference between the options and thus small changes in the PPT only have small effects on the international competitiveness. He said that the same is true for smaller fields, although the [government take for the various countries] starts to spread a bit at very low prices due to the high costs of these fields and thus creates a modest degree of progressivity on the PPT.

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DR. VAN MEURS continued with slide 16, which reviews the PPT and competition. He explained that he systematically rated the fiscal systems to compare them with the other nations around the world in order to determine whether there was an improvement in competitiveness when moving from the current system to the PPT. Slide 17 clearly rates the 20/15 and 25/20 systems for the various countries. He highlighted that under the 20/15 [PPT] Alaska doesn't rate very well. However, with Alaska's PPT, the rating improves. With the 25/20 [PPT], the competitiveness is improved a bit, primarily because stronger tax credits are achieved. Dr. Van Meurs opined that under the 20/20 [PPT] it would show a slight further improvement in the competitiveness index.

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REPRESENTATIVE GARA inquired as how Alaska's competitiveness would be impacted if the 30/20 [PPT] was in place.

DR. VAN MEURS opined that it wouldn't be too different from the 25/20 [PPT]. He further opined that the 30/20 [PPT] would be somewhat less competitive because of the higher tax rate that would begin to [infringe] on the overall government take. Still, [the 30/20 PPT] would be more competitive than Alaska's current system. He explained that how the 30/20 would precisely

rate compared to the 25/20 [PPT], depends upon the effect on the smaller fields. However, he suggested that it would rate somewhat less than 244, but significantly better than 363. In further response to Representative Gara, Dr. Van Meurs agreed to provide the committee with a rating for the 30/20 [PPT].

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REPRESENTATIVE ROKEBERG highlighted that slide 17 specifies that the 20/20 [PPT] would rate somewhat more attractive to investors than the 25/20 [PPT], although not significantly more. He asked if that includes the provisions for the capex clawback. He also inquired as to what impact that would have on the calculations.

DR. VAN MEURS clarified that the aforementioned statements don't include the capex clawback. He related his understanding that the capex clawback is a corporatewide feature and thus isn't a field-by-field feature. However, Dr. Van Meurs related that his analysis was performed on a field-by-field basis, which is what his competition analysis is based on because investors make decisions on individual field opportunities. Therefore, the [capex] clawback wouldn't typically be included in a rating of this nature because the companies can deduct it regardless of the economic analysis.

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CO-CHAIR SAMUELS related his understanding that the analysis on slide 17 is for a new company that can take advantage of the \$73 million if that company has not taken advantage of that \$73 million in another field in another investment.

DR. VAN MEURS said that would be true. He then posed an example in which a new company enters [a field] for the first time and receives its \$73 million tax-free allowance. If that company invests in another field, it places the company over the \$73 million allowance and the PPT would rate significantly less attractive. Consequently, the rating is for first investors who would really obtain a boost to enter. Once the first investors are in and settled, the PPT is still better than the current system. However, not significantly better, as illustrated in the ratings and thus companies would still view Alaska as a more attractive environment than before. The aforementioned is exactly what's desired because once the companies are established, the incentives to reinvest through the tax credits are beneficial although the \$73 million allowance is gone and the full tax is paid on any size field.

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DR. VAN MEURS confirmed that the analysis and the \$73 million is for new investors with their first investment in Alaska. However, he noted that the report also includes rating analysis for current operators. He related that the analysis illustrates that the [proposed] system would be somewhat more attractive from an investment point of view, although not as attractive as slide 17 presents.

REPRESENTATIVE ROKEBERG surmised then that current producers with some costs in capital investments would have a slightly higher rate of return than are shown because of the clawback.

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DR. VAN MEURS replied yes, and explained that from an overall corporate perspective the clawback would primarily benefit the larger companies in Alaska and would lower their total PPT payments for a few years.

CO-CHAIR SAMUELS related his understanding that ConocoPhillips Alaska, Inc. ("ConocoPhillips") would receive the \$73 million write-off, but as it moves forward to invest in another field the \$73 million won't be counted because it has already been written off. Therefore, the proposal will only apply to a completely new company with zero [current investment in the state]. He surmised that this won't apply to even some of the smaller companies, such as Anadarko Petroleum Corporation ("Anadarko") that might be coming close to \$73 million in current investments in Alaska.

DR. VAN MEURS agreed and specified that he is attempting to illustrate that Alaska is attractive to new companies. He pointed out that these slides are representative of small companies that don't go over the \$73 million or new investors such as Shell. Although a company such as Anadarko is in the middle, and will still benefit significantly in the overall corporate cash flow from the \$73 million, there will be production that would go over that limit, making the reinvestment in new fields not as attractive. For the smaller companies in a heavy investment mode, such as Pioneer, the company would have so many tax credits that it wouldn't pay anything, even if it's over the \$73 million. The large companies, as illustrated by Mr. Marks' analysis, have so much existing production that the \$73 million is almost meaningless.

Furthermore, the larger companies' level of reinvestment as compared to existing production is relatively modest, and thus as long as the prices are reasonably high, the larger companies will pay a significant additional PPT.

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REPRESENTATIVE SEATON asked if the large companies still receive the tax credit for their investment.

DR. VAN MEURS replied yes. Therefore, under the 20/20 [PPT] system if ConocoPhillips wanted to drill a new exploration well, it would receive \$4 for every \$10 it invested. Consequently, even for the ConocoPhillips companies, this proposal is a significant encouragement to reinvest. Faced with large investment and budgets, the tax credit portion of the PPT is really designed to get [the large companies] going on those kind of developments.

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DR. VAN MEURS pointed out that slide 18 shows the heavy oil investment and the various PPTs. The graph illustrates that no matter the system, the tax credits are very important for heavy oil development. Therefore, he opined that there will be much more action with heavy oil, which is necessary to fill the pipeline and maintain production. Dr. Van Meurs further opined that much of the production in Alaska will come from the major oil companies and this system is designed to provide them with a strong incentive to maintain production on the North Slope and ensure that new technologies and ideas are being developed.

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REPRESENTATIVE ROKEBERG recalled the 400-500 differential in the IRR, particularly as it relates to heavy oil. However, the graph doesn't really illustrate the [magnitude] of the difference between a 20 and a 25 percent tax credit. He requested that Dr. Van Meurs speak to the actual numbers and the impact of the 5 percent difference on the IRR.

DR. VAN MEURS explained that there's about a 1-2 percentage point difference between a 20 percent tax credit and a 25 percent tax credit. He further explained that the graphs were included in the report because there was the desire to determine whether the state should support heavy oil production, even with a higher tax credit than the 20 percent. As the graph

illustrates, the difference isn't that much, and therefore at the 25 percent tax credit, the risk for the state becomes too high. Consequently, Dr. Van Meurs opined that the 25/20 or 20/20 [PPT] are good systems to promote heavy oil and there is no need to over stimulate that production with higher tax credits. In further response, Dr. Van Meurs confirmed that those figures are available in his report.

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DR. VAN MEURS, in further response, clarified that the PPT is designed to stimulate heavy oil exploration as well as [exploration] in the smaller fields in other areas.

CO-CHAIR RAMRAS recalled the presentations' from prior day's hearing, and expressed the need for there to be an apples-to-apples comparison. He then inquired as to whether Dr. Van Meurs, on the tax credit side, is comfortable with the things that are not included, such as the depreciation, the royalty payments, the tax on which it's based, et cetera. He related his understanding that adopting the approach [in HB 488] would make the accounting arm of these large oil companies much more material in regard to how to formulate new investment in the state because they will take advantage of these tax credits. "Are you satisfied that we have enough of a collar on the ability of the accounting arms of the large oil companies to not be too exploitative of how to manage the credit side of this equation," he asked. He requested that Dr. Van Meurs also speak to the cost side as well.

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DR. VAN MEURS noted that the vast majority of countries have established a profit-based system. When a country establishes a profit-based system, it requires a deeper accounting of costs and revenues. He explained that there must be sufficient power and definition in order to prepare detailed regulations and accounting procedures for companies to calculate the PPT. He noted that also contemplated is to make use of the joint venture accounting systems that the companies maintain. Therefore, there are different ways to tie into the extensive accounting that is already being done. Moreover, it wouldn't be a major problem to organize those systems. Dr. Van Meurs pointed out that [HB 488] also contemplates that in 2006 companies will be allowed to continue on the old basis and then in March 2007 there will be a "through up" to ensure that everything has been calculated properly. From the government side there will be a

shift in emphasis. He pointed that Alaska already has modest experience with running profit-based systems through the net profits leases that it has held for decades. However, the scale of the PPT will be much larger and thus Alaska will also have to prepare for more in-depth auditing and accounting. He pointed out that although companies will try to take advantage of [what they can], in Alaska there is an extremely sound base of highly knowledgeable people who can be hired. Alaska, he opined, is on the forefront of the oil and gas industry and has the infrastructure to properly do this without much difficulty.

CO-CHAIR RAMRAS asked, "What kind of a shift and what kind of an empowerment are we going to see from the different accounting arms of the large producers and some of these smaller companies to begin to make that shift and that assessment of whether projects in Alaska are viable as they try to shelter income by taking advantage of tax credits and the different variables that are going to drive that?"

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DR. VAN MEURS related his belief that the world is reacting quickly to the new incentives as the world is becoming more competitive. The introduction of the PPT system, which is oriented toward reinvestment and investment while gaining significant revenues will gain the attention of a wider group of investors. The aforementioned is desirable and will increase production, he said.

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REPRESENTATIVE SEATON referred to slide 3 of Robynn Wilson's [Tax Division, Department of Revenue (DOR)] presentation on February 22nd, which speaks to incremental revenue based on the Department of Revenue forecast. That slide illustrates that Alaska's income under the PPT will perform better through mid 2008 than under the current system with ELF. However, the PPT seems to under perform and generates less money than the current system through mid 2010 after which time the PPT and the current system remain even. He then pointed out that Dr. Van Meurs' slide 15 shows the current system out performing the PPT system.

DR. VAN MEURS pointed out that [the outcomes] depend on the various assumptions made, including the oil prices. If oil prices are assumed to be relatively low and it's assumed that there will be considerable investment, the PPT won't be very strong. If the prices are high, the PPT will be much higher.

He reminded the committee that he has not been able to evaluate the clawback and doesn't know whether Ms. Wilson's graphs include that feature. The broad concept, he explained, is that at low prices, the PPT could be less than the current system. Dr. Van Meurs reminded the committee that he has been working with the state since 1996 and has been monitoring the ELF annually. The most striking discovery is that the predictions of the ELF seem to decrease each year. For example, three years ago the ELF was predicted to be at .1 or .2 in the year 2011/2012. However, it is all gone and the ELF is crashing a lot faster than the typical production forecasts. Therefore, when looking forward to 2015 or later, one must keep in mind that the ELF may decline faster than the official forecast. The aforementioned, he opined, makes the introduction of this new system very important to avoid entering a situation that's far worse than already predicted.

[2:02:06 PM](#)

ROBYNN WILSON, Director, Anchorage Office, Tax Division, Department of Revenue, interjected that Dr. Van Meurs' presentation is on assumed field sizes while the figures in the fiscal note and the charts provided [by her to the committee yesterday] are actual Alaska numbers based on certain assumptions, which will be fully explained later.

[2:03:07 PM](#)

REPRESENTATIVE CRAWFORD related his understanding that [this proposal] is setting tax rates for both oil and gas at the rate of 6,000 cubic feet of gas per barrel of oil. However, all the charts are related to the worldwide competitiveness of oil. Therefore, he inquired as to whether, by setting these rates, the state's competitiveness with gas is being changed.

DR. VAN MEURS explained that the reason the charts focus on the competitiveness with oil is related to [the notion] that a stranded gas contract would be presented, which includes provisions with respect to the production tax for gas that differ from what's presented today. The idea with the stranded gas contract is that the state takes its taxed gas in-kind, which is a totally different concept. Since it's a totally different package with regard to the North Slope gas that may come on-line as a result of the stranded gas contract, he said he didn't present the hypothetical case of the system also applying to the large gas developments in the North Slope. If the stranded gas contract doesn't pass or isn't submitted, then

these terms will apply to gas as well as oil. In that case the Point Thomson field would be positively impacted. The overall structure and investment behavior of the tax would be similar, he said.

[2:06:35 PM](#)

REPRESENTATIVE CRAWFORD asked if Dr. Van Meurs means that Point Thomson would be positively affected for the leaseholder or the current operator of the field. If so, would it be more competitive and reduce the state's take, he also asked.

DR. VAN MEURS answered that the behavior will be the same. He posed a situation in which there is no stranded gas contract and [HB 488] only applies to Point Thomson. In regard to what would happen, he explained that Point Thomson would receive the same 40 percent tax credit as any oil development. Therefore, since the capital costs at Point Thomson are high, that would be an attractive feature. At the same time, Point Thomson is a large field and thus over time the PPT would decrease significantly and the revenues for oil and gas would be added together. The aforementioned would result in the total gas take being very significant and very high if prices increase. Therefore, the overall behavior demonstrated for oil would also apply to the gas development, in case there isn't a stranded gas contract. If there is a stranded gas contract, the law would still apply for oil.

[2:08:50 PM](#)

CO-CHAIR SAMUELS asked if the following is correct: the gas line itself is paid for by the tariffs; this [legislation] wouldn't have any implications on the main gas line or the gas treatment plant (GTP).

DR. VAN MEURS resounded that the tax credits he mentioned will not apply to the main gas line. In further response to Representative Samuels, Dr. Van Meurs confirmed that the tax credits are paid for by the tariffs, the users, and the shippers of the gas.

CO-CHAIR SAMUELS clarified that the tax structure for the gas pipeline will be established in the contract. Furthermore, if there is a contract, the tariffs will pay for the gas line and the associated facilities.

REPRESENTATIVE GARA said he is trying to differentiate between the 25/20 and the 20/20 plans. He recalled that Dr. Van Meurs had related [prior to the 20/20 plan] that the 25/20 plan and a January 1st effective date would place the state in a strong position competitively and would provide a fair return to the state. He asked if that assumption remains the same with the 25/20 plan.

[2:10:49 PM](#)

DR. VAN MEURS echoed his earlier comments that the 25/20 and 20/20 plans are both very competitive systems and considered very attractive to investors. However, a retroactive start date in January as compared to a mid-year start would gain an extra half year of income to the state, although typically taxes start after they have been approved. Dr. Van Meurs confirmed that a January 1st start date wouldn't impact the competitiveness of the system because new investors will not have to pay tax for a while. However, the difference between a January 1st and July 1st start date is the impact on current production.

[2:13:29 PM](#)

REPRESENTATIVE KERTTULA surmised that [the January 1st start date] would provide another six months and would result in the full five years for the clawback.

DR. VAN MEURS deferred to Mr. Dickinson.

REPRESENTATIVE KERTTULA turned attention to the royalty reduction and related her belief that it makes sense during exploration. However, once the company starts producing, she questioned whether the credit should continue. She asked if Dr. Van Meurs has seen systems that work that way.

[2:15:20 PM](#)

DR. VAN MEURS explained that the reason to look at a broader tax credit in Alaska is because building the necessary infrastructure is an enormous obstacle for many of the investors entering Alaska. The beauty of the proposed tax is that it is an enormous help for the smaller companies when building the infrastructure such that a wider group of companies can have access to it. Furthermore, a much stronger basis for development is formed, he stated.

[2:17:33 PM](#)

REPRESENTATIVE LEDOUX asked when the capex clawback feature was first discussed.

DR. VAN MEURS said it was discussed over the last week. He noted that the capex clawback was part of the discussions the governor had with the oil companies and was a component [that attributed] to the companies supporting the package. He clarified that the concept of recovering prior cost was discussed among the experts in DOR when alternatives to the ELF were discussed and when the PPT was discussed, but the official inclusion in the package occurred in the last two weeks.

[2:19:58 PM](#)

ROGER MARKS, Petroleum Economist, Department of Revenue (DOR), informed the committee that he would provide a quantitative analysis of HB 488 and how it impacts revenues as compared to the status quo. He further informed the committee that he would describe the department's model and its assumptions as well as the long-term cumulative revenues, annual revenues, and observations regarding the corporate take resulting from the tax. Mr. Marks then referred to the PowerPoint entitled, "PPT REVENUE STUDIES."

[2:22:47 PM](#)

MR. MARKS explained that it is important to know how much oil there will be, which is difficult to forecast. For the model, whether there is enhanced exploration success and development or not and whether there is a gas line or not, both of which would impact volume scenarios, were segregated. He specified that the presence of a gas line would impact oil volumes because Prudhoe Bay volumes would decline earlier on, although the life would be extended. Moreover, the assumption is that Point Thomson would come on line, although whether or not it's economic without the gas line is a question that remains. The assumption, from DOR, is that Point Thomson will only come on line with a gas line. The DOR, he related, believes that with Point Thomson there will be 15 trillion cubic feet (tcf) additional gas that will be discovered, and furthermore the department believes oil will also be discovered with that.

MR. MARKS explained that he would present a low and high scenario such that the low scenario doesn't include the enhanced volumes and gas line. As specified on slide 5, no enhanced volumes and no gas line produces a total of 5.5 billion barrels

through 2030. The model includes no additional heavy oil at prices under \$30. The basis of the volumes are included in DOR's revenue sources book, including oil that is in development now and some fields that are under evaluation. He then explained that the high volume scenario assumes enhanced volumes and a gas line, which would produce 10.5 billion barrels through 2050. The department further assumes that at the aforementioned point, the North Slope would be cut off at 2030 because it becomes questionable whether there would be enough oil to support the pipeline at that point. The high scenario includes an additional 3.2 billion barrels of conventional oil, including 700 million barrels from the gas line as well as an additional 1.8 billion barrels of heavy oil. Although DOR doesn't know from where the oil will come, the United States Geological Survey (USGS) and Alaska's state geologists, in reviewing the reserves on state and federal land, estimate that 23 billion barrels would be discovered in the mean commercial case. Therefore, the volume scenarios range from 5.5 billion barrels to 10.5 billion barrels.

[2:26:49 PM](#)

MR. MARKS turned attention to the graph located on slide 6. He explained that the fluctuation in the high volume scenario represent a series of new fields starting every four years. Mr. Marks pointed out that DOR knows the following: the more that is invested, the more is produced; the more incentives there are, the more investment there is; the credits in the PPT are incentives; higher taxes provide less investment; higher prices elicit more investment; and investment is driven by competitive international opportunities. However, the department doesn't know how to quantify the aforementioned. Therefore, the volumes as given were taken and the revenue effects specified are entirely attributable to tax mechanics.

MR. MARKS then turned to the question as to why the proposal went from a 25/20 [PPT] to a 20/20 [PPT]. He commented that what is internationally competitive is a broad spectrum that's continually evolving. If high prices continue, much oil that's not economic will become so and there could once again be a situation in which governments are competing for investment. He opined that more oil coming on line may reduce the competitive edge governments have if there are more governments competing for the same amount of investment. He reminded the committee of the Lafer (ph) curve, which showed that as taxes increase, more revenue is collected. However, if taxes increase too much, income could be lost and international economists don't know

exactly the point at which high tax rates lead to reduced activity. Therefore, the governor's 20/20 proposal attempts to [ensure that the tax rates don't become high enough to lead to reduced activity].

[2:30:23 PM](#)

MR. MARKS returned to the PowerPoint and the assumptions related to costs and prices, as specified on slide 7. He acknowledged that "at the end of the day" these numbers won't be correct. Mr. Marks informed the committee that the PPT will subject the [state] to cost volatility such that if the ongoing capital costs, operating costs, and developmental capital costs are off by \$1, the annual revenues of the state will differ by \$200 million up or down. He highlighted that for modeling purposes, the costs and prices are in real 2005 dollars and the heavy oil is discounted 8 percent for quality while viscous oil is discounted at 4 percent for quality. Mr. Marks then turned attention to the cumulative revenues for the high and low volume scenarios as presented on slide 8. In the enhanced volume scenario, which includes the oil from the gas line, the revenues specified don't include the gas line severance taxes, although they do include the gas line costs. He explained that the PPT is structured such that the upstream costs associated with the gas and the capital costs for developing new gas fields would be subject to deductions and credits through the PPT. In response to Co-Chair Samuels, Mr. Marks confirmed that "it" would be upstream of the GTP and wouldn't include the main line.

[2:35:41 PM](#)

REPRESENTATIVE GARA surmised then that there will be enhanced volumes of oil if there is a gas pipeline because oil will be found during the development of the gas fields. However, the producers have always said that once gas is produced, less oil will be derived from those [gas fields]. He asked whether the notion that there will be more oil if the gas line is built is based on science or is it debatable.

MR. MARKS said there are two different effects. At Prudhoe Bay, once gas is depleted from the reservoir, there is a loss in pressure, and initially Prudhoe Bay volumes will decrease. However, Mr. Marks opined that in the absence of a gas line, Prudhoe Bay will shut down in 2030. Therefore, with a gas line, it becomes more economic to keep the oil flowing and thus extended fuel life is experienced at Prudhoe Bay. He pointed out that the extended life doesn't offset all the oil lost

earlier. He estimated that at the end of 45 years, Prudhoe Bay, as a result of a gas line, may [produce] 150 million barrels less. The other effect is that between Prudhoe Bay and Point Thomson there is about 35 tcf. Since [the department] believes the gas line would be built with 50 tcf in mind, it believes people will look for another 15 tcf, which the department believes is there. When that 15 tcf is discovered, there will be oil associated with it. The gas line is a net effect of about 700 million barrels of additional oil, including approximately 250 million from Point Thomson, 150 million lost from Prudhoe Bay, and 600 million from the yet defined gas field.

[2:38:05 PM](#)

CO-CHAIR SAMUELS interjected that the GTP and the gas line will be paid for by the users of the gas. Therefore, the GTP is included in the tariff.

MR. MARKS clarified that the high volume scenario includes the gas line costs not the gas line revenues. At \$5 gas, the gas line's revenues would amount to about \$1 billion a year. In order to provide further clarity, Mr. Marks explained that the costs that are deductible and subject to the credit are technically costs upstream from the point of production. He confirmed Co-Chair Samuels understanding that the GTP and the pipeline would not be subject to these deductions and credits.

MR. MARKS then moved on to Figure 2A on slide 9, which shows cumulative revenues between the status quo and HB 488. The graph illustrates, depending upon the price, that the total revenues are either \$2 billion less or \$25 billion more. The crossover point under the specified assumptions is \$26.50. In reviewing these graphs, Mr. Marks encouraged the committee to keep in mind that the ELF is a modest standard of comparison. With regard to the crossover point, he encouraged everyone to keep in mind the slope of the line as well as the [amount] at the crossover point. In reference to Figure 2B on slide 10, Mr. Marks highlighted that although Plan B has a higher crossover point, it [over the long term] receives more money than Plan A.

[2:42:11 PM](#)

REPRESENTATIVE GARA returned to Figure 2A on slide 9, which specifies a crossover point at \$27 a barrel and illustrates that the state would receive less money under the proposed 20/20 plan versus current law. He recalled the department's fall forecast

for the next fiscal year that estimates total gross revenue of about \$6.5 billion and company profits of about \$2 billion, which is about a 30 percent profit margin. Representative Gara questioned whether that's a high profit margin at which to begin to reduce taxes.

MR. MARKS offered to provide Representative Gara an answer after thinking it through. He mentioned the need to be careful because heavy oil is expensive and under \$30, the department doesn't believe it makes sense. Furthermore, one must take into account what other countries are doing at those prices, the answer to which he deferred to Dr. Van Meurs.

REPRESENTATIVE GARA asked if the numbers provided by the department in regard to corporate profitability are reliable.

MR. MARKS said he hasn't reviewed the numbers himself, and therefore he said that he was uncomfortable addressing them at this point.

REPRESENTATIVE SEATON recalled that since this is a percent profits tax, the impact of heavy oil isn't as great as it would be for a gross tax. However, now he understands Mr. Marks to be saying this is not the case, and "not only do we discount what is going to be there, but even with the percent profits tax and the credit back, now we're again reinjecting a consideration that heavy oil has to be considered differently."

MR. MARKS clarified that the [crossover point] of \$26.50 is a mixture of all the oil, both the heavy and the light. Therefore, increasing the tax rate or decreasing the credit rate to decrease the crossover point impacts all the oil, including the heavy oil. The effect is to water down the beneficial effects of the PPT because heavy oil requires a lot of investment. This all makes heavy oil more of a challenge than it's structured to be treated in HB 488, he said.

[2:46:13 PM](#)

MR. MARKS moved on to Figure 3A on slide 11, which relates the high volume scenario. He highlighted that the crossover point is higher, which reflects the gas line costs and the heavy oil without the gas revenues. Therefore, under the high volume scenario, depending upon the price, [the state] receives from \$3 billion less to \$42 billion more. On slide 12, the high volume scenario with 2.5 percent inflation results in a crossover price of \$28. He then turned his attention to slide 13 regarding the

annual revenues. He pointed out that at \$20 a barrel, the state would lose money and would have bigger problems than having the wrong tax system.

MR. MARKS, in response to Representative Croft, confirmed that the status quo number [on the graph on slide 14] decreases due to the ELF as well as the defining volume. He then directed attention to slide 15, which reviews the low volume scenario with \$40 per barrel. He then informed the committee that one year at \$40 per barrel oil allows the state to recover what it lost in the three years at \$20. Therefore, the state makes more money at high prices than it loses at low prices. He reminded the committee that with the capex clawback included at prices over \$40, [the state] would [receive] \$170 million less for five years. He then turned to why the clawback is included in HB 488, and explained that most of the investment made to produce oil is made to produce future oil. The rationale for having the clawback is to not penalize the producers for not deferring their investments.

[2:51:28 PM](#)

REPRESENTATIVE HOLM pointed out that the [producers] made the investment when oil was predicted to be about \$25 a barrel, and therefore when the price of oil increases, it changes the [producers'] view of their investment life as well.

MR. MARKS reiterated that investments are for future oil, that is oil taken three to fifteen years in the future. The companies could have deferred those investments, and this wouldn't penalize them for not doing so.

CO-CHAIR SAMUELS inquired as to when the producers expect the increase in volume.

[2:53:15 PM](#)

MR. MARKS recalled the 1990s during which extensive gas handling expansion projects were implemented. At that time, more gas was coming up with the oil, and that was the limiting factor of production. Therefore, multi-billion dollar facilities were built in order to process the gas. Otherwise, the producers' oil production would have plummeted. Those investments made in the early 1990s are still producing lots of oil. Along the same vein, Mr. Marks indicated that the effective date was changed because making taxes retroactive is impossible to plan for and creates a weak business environment.

REPRESENTATIVE SEATON surmised then that HB 488 proposes to retroactively do the tax credits, but not the tax.

[2:54:54 PM](#)

MS. WILSON said the so-called recent recovery [clawback] of the investments is not a credit, but rather is a deduction similar to depreciation expenses. Furthermore, it recognizes that the asset is generating income into the future. She explained that any time net income is measured in accounting, it's important to match the income with the expenses. The [clawback provision] recognizes that "this is an amortized expense so it is not a credit that is being taken."

REPRESENTATIVE GARA surmised that under a 20/20 [PPT], whether it's a 20 percent credit or deduction, the companies receive the same amount of money.

MS. WILSON replied yes.

[2:56:19 PM](#)

MR. MARKS continued with Figure 6, which illustrates a low volume scenario at \$60 barrel oil. He noted that the transition rules are modeled and thus there is a reduction of \$170 million for the first six years. He highlighted that [at \$60] the average annual revenue amounts to over \$600 million more a year than the status quo. "This is, at \$4.70 gas price in Chicago, this is our gas line revenues without the gas line at current oil prices," he pointed out.

REPRESENTATIVE KERTTULA inquired as to how much more the state would have made under the 25/20 scenario.

MR. MARKS said he could model that for the committee.

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MR. MARKS then turned to the high volume scenarios under the \$20-\$60 prices. He reminded the committee that these include the gas line costs without the gas line revenues. As specified on slide 17, under the high volume scenario with \$20 a barrel oil, the average annual revenue is \$110 million less than the status quo while \$40 a barrel oil amounts to about \$190 million more than the status quo.

REPRESENTATIVE CROFT inquired as to why the graphs have bumpy lines.

MR. MARKS explained that in the high volume scenario a series of fields come on line every five years. Therefore, the bumps illustrate the field coming on line and then declining. The dip between 2025 and 2030 is when new investments for new gas fields come on line. The dip prior to 2014 is the upstream deduction for the Point Thomson field.

REPRESENTATIVE CROFT highlighted that the lines converge even with the ELF in 2030 and then separate out.

MR. MARKS explained that the [dip] in the graph in the year 2030 illustrates about \$3 billion of investment for new gas fields. He then turned attention to Figure 9 on slide 19, which illustrates that at the \$60 scenario, the average annual revenues are \$800 million more than the status quo. He continued with the effective tax rate under a low volume scenario, as specified on slide 21. He explained that the total severance tax divided by the total wellhead value less the royalty amounts to the effective tax rate. With the PPT, because the upstream costs are deductible and the tax increases, a higher percentage of the wellhead price is received as the price increases. Mr. Marks explained that when the ELF was originally submitted in 1977, it was supposed to be such that [companies] didn't have to pay tax on the amount of production necessary to cover the operating costs at the price of oil at the time the tax is being paid. Therefore, as prices increase, less oil would be tax free and thus there would be an increasing progressive rate. However, what ultimately resulted was a flat \$300 a barrel per well per day. He noted that the high volume graph on slide 22 looks about same.

MR. MARKS concluded by discussing the corporate take. He explained that he reviewed the U.S. Department of Energy's current long-term forecast, which amounts to about \$58 a barrel in 2004 dollars and modeled it under the status quo and the PPT. The graph [on slide 24] illustrates that \$58 over 45 years amounts to about \$600 billion in gross revenues that would be generated, with 2 percent inflation it amounts to about \$1 trillion. Mr. Marks highlighted that under the PPT the severance tax increases while the federal income tax decreases. Because severance taxes are deductible from the federal income tax, the federal government essentially picks up 35 percent of the PPT from the producer. The corporate take, in terms of gross revenues, goes from about 33 percent to 30 percent of

gross income under the PPT or 49 percent to 44 percent of the economic rent. The state, he noted, ends up with 32 percent of the economic rent. He reminded the committee that although the current system is a fairly modest standard of comparison, the corporations receive 30 percent of \$600 billion, which amounts to \$180 billion.

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REPRESENTATIVE KERTTULA requested annual scenarios under the 25/20, 30/20, and 30/15 proposals at \$20, \$40, and \$60 a barrel oil. She requested that the aforementioned proposals also be presented in the same type of chart as is presented on slide 24.

REPRESENTATIVE BERKOWITZ requested analysis of a straight 50/50 split between the state and the companies' profits.

MS. WILSON surmised that Representative Berkowitz is pointing out that often government take is quoted based on profit after expenses. She further surmised that Representative Berkowitz was interested in the net profit and a 50/50 split.

REPRESENTATIVE ROKEBERG said that he would like the charts to be based on the fiscal note and the credits to be increased to 25 percent such that the 25/25, 30/25, and 15/25 proposals are reviewed.

REPRESENTATIVE SEATON requested that Figure 12 on slide 24 be presented under \$20, \$40, \$60, and \$100 a barrel price scenarios.

[3:09:21 PM](#)

REPRESENTATIVE GARA asked where, under current law, the corporate profit margin would "sink" to 20 percent and 15 percent in order to consider if those are good crossover points.

REPRESENTATIVE ROKEBERG asked if the department has any progressivity models that would represent a sliding scale scheme that illustrated the change in both the tax and the credit rates at different levels of pricing as related to the amount of revenue.

MR. MARKS offered to put together a hypothetical sliding scale range.

CO-CHAIR SAMUELS pointed out that the 20/20 proposal would be considered flat not regressive nor progressive.

3:12:04 PM

REPRESENTATIVE MICHAEL KELLY, Alaska State Legislature, related that once some of these sensitivities are done, then all the ones in between can be determined and analyzed in regard to whether it's appropriate for the state.

REPRESENTATIVE REGGIE JOULE, Alaska State Legislature, turned to the fiscal note, and pointed out that with the proposed tax regime, three additional auditors and another lower level staff person are required. He asked if the aforementioned staffing will be enough to keep up with the changes.

MS. WILSON explained that the department, under HB 488, will be auditing different things than what it's accustomed and the department views this as the necessary increment to increase the department's capacity to audit additional things. She pointed out that included in contractals is temporary audit help to assist in the transition. She predicted that the primary and immediate needs are auditing the transition assets and writing regulations.

3:16:57 PM

CO-CHAIR RAMRAS opined that over the years there has been a great reluctance to adjust the tax system. However, no one has tested any numbers lower than 20/20, which he surmised to mean that [the administration] is predisposing the tolerance of the producers lays at that level. Therefore, he questioned the responsibility in proposing the 20/20 level.

MS. WILSON reminded the committee that a range of options were offered by Dr. Van Meurs. Furthermore, the governor carefully considered the whole picture. She then pointed out that other states are competing state-by-state and although Alaska is not forced to compete with other states, it is forced to compete globally. She opined that the governor surely took the aforementioned into consideration when selecting what he considers to be the best scenario for Alaska in the world market.

3:21:29 PM

ROBERT MINTZ, Assistant Attorney General, Oil, Gas & Mining Section, Civil Division (Anchorage), Department of Law, announced that he would review the highlights of the PPT as presented in HB 488. Mr. Mintz specified that the fundamental provision of HB 488 is Section 5, which is a repeal and reenactment of AS 43.55.011(a). He explained that the current production tax has a separate tax on oil and on gas, with different rates, minimum tax, and ELF. However, under HB 488 those differences are immaterial because it proposes a single tax on all oil and gas. Furthermore, the production tax remains a monthly tax with a flat tax rate of 20 percent that is being applied to the net value. The aforementioned differs from the current production tax that taxes the gross value of oil and gas at the point of production. In response to Co-Chair Samuels, Mr. Mintz confirmed that if the gas is used in the operation of the lease of property, it's not considered produced and thus isn't subject to tax.

MR. MINTZ then turned attention to the net value, which is found in Section 21. He informed the committee that net value still starts with the gross value at the point of production. He then explained that one of the philosophies with HB 488 is to preserve the existing law as much as possible. With HB 488, all of the gross value from all of the leases and properties in the state that belong to a producer together determine the statewide value for a producer. Once that value is determined, there will be the following two categories of deductions: lease expenditures as adjusted and a fraction of transitional investment expenditures. He then pointed out that Section 31 slightly redefines "gross value at the point of production." The major change, he highlighted, is moving the point of production downstream of gas processing plants. Under current law, once the oil or gas leaves the mechanical separators, the matter is either oil or gas depending upon its state. However, gas often continues to contain heavier hydrocarbons that can be extracted by gas processing. This legislation proposes to include gas processing in the upstream of the production process, which results in the liquids extracted by gas processing being treated as oil and the cost of gas processing, including investment costs, would be deductible and subject to the capital investment credit. The purpose, he explained, is to encourage small producers to be able to afford investing in gas processing, which is more economical.

REPRESENTATIVE CROFT asked if the aforementioned is the opposite of what was said in regard to gas treatment.

CO-CHAIR SAMUELS clarified that earlier he was referring to a gas treatment plant for gas entering the gas pipeline.

DAN DICKINSON, Consultant to the Office of the Governor, clarified that HB 488 distinguishes between gas processing and gas treatment. Gas processing involves production and separating the heavier hydrocarbons. However, gas treatment is specifically a transportation process. Mr. Dickinson explained that gas treatment is being treated as a transportation cost and is viewed as the first step of the pipeline process. However, with gas processing, as occurs in the central gas facility, there will be an upstream cost for both the gas and liquids produced at that point. Mr. Dickinson highlighted that under current rules about 8 percent of what is in Trans-Alaska Pipeline System (TAPS) is considered gas because the natural gas liquids were extracted at the central gas facility. However, under the new definitions proposed in HB 488, that 8 percent of the TAPS will be considered oil. He said that under HB 488 about 99 percent of what is done at TAPS will be considered oil.

[3:30:57 PM](#)

CO-CHAIR SAMUELS recalled Mr. Marks' example in which current gas production facilities were held out as a long-term investment as opposed to the GTP.

REPRESENTATIVE SEATON mentioned that there has been discussion of stripping some of the liquids at Fairbanks or elsewhere along the line. He surmised that these definitions wouldn't shift the pipeline or a portion of it to Fairbanks.

MR. MINTZ said that's not the intent of HB 488 because once the [gas] is in the main line it will be downstream to the point of production. He pointed out that Section 33 defines gas processing and gas treatment.

[3:32:19 PM](#)

MR. MINTZ, in response to Representative Rokeberg, confirmed that the language on page 20, lines 3-4, redefines oil. He then turned attention to [Section 19], which addresses gross value at the point of production in the same manner as current statute, save one respect that will be mentioned later. Basically, [Section 19] codifies the net back approach to calculating value and thus the cost of transportation is deducted.

REPRESENTATIVE CROFT related his understanding that the reasonable costs of transportation being used are the actual costs of transportation. However, sometimes reasonable and actual are not the same. Therefore, he inquired as to why the two are being equated.

MR. DICKINSON explained that the statute establishes three conditions, which if met, the market value of the transportation services are used. However, the three conditions establish a fairly high barrier and thus most of the time actual costs are used and they are deductible. He indicated that [AS 43.55.150(a)] has generated hundreds of pages of regulations in order to define actual costs for owners of tankers and pipelines.

REPRESENTATIVE CROFT surmised then that the current standard is to assume that actual is reasonable unless it meets all three criteria.

[3:34:05 PM](#)

CO-CHAIR SAMUELS opined that there won't be the TAPS settlement methodology (TSM) fight again rather it will be determined by the Federal Energy Regulatory Commission (FERC) or the Regulatory Commission of Alaska (RCA).

MR. DICKINSON replied yes.

MR. MINTZ clarified that Section 20 the bill varies from the existing law with regard to the net back calculation. He explained that the legislation would authorize the department to allow taxpayers in certain situations to use formulas to calculate the gross value at the point of production. For example, if a taxpayer has a royalty settlement agreement with the Department of Natural Resources (DNR) under which there is a royalty value that is similar to the tax value, rather than have two duplicative calculations the department could allow the royalty settlement value to be used subject to appropriate adjustments. However, there are other alternatives, such as a royalty valuation that the federal government utilizes on its leases when no state leases are involved. He noted that this is an option that the department would have.

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MR. MINTZ, referring to Section 21, explained that net value is determined by subtracting various items from gross value,

including lease expenditures. Lease expenditures are an aggregate of cost of a producer across the state and are defined as direct, ordinary, and necessary costs of exploring, developing, or producing oil or gas deposits in the state. He noted that exploring can include geological and geophysical exploration. He reminded the committee that [lease expenditures] are upstream of the point of production and downstream costs are already taken into account in reaching the gross value at the point of production.

REPRESENTATIVE BERKOWITZ asked if these definitions have been litigated.

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MR. MINTZ specified that the terms "ordinary and necessary" are used in the Internal Revenue System (IRS) code as well as existing department regulations for transportation costs. Although the term "direct" may not have as much legal interpretation, the legislation specifies particulars regarding the types of costs that would be excluded and included. In continuing with Section 21 subsection (c), he explained that this provision provides additional guidance to the department in determining the direct, ordinary, and necessary costs. The guidance has to do with the experience of the oil and gas industry in unit operating agreements and other joint operating agreements, which are situations in which an operator actually does the drilling and producing and other lessees share in the production and expenses. Therefore, the other lessees don't want to pay more than they owe. The aforementioned are examples of industry practice to which the department would review in developing its standards for what would be considered allowable costs. He then pointed out that there are appropriate safeguards in an existing actual joint unit operating agreement in the state. For example, a working interest owner, not the operator, has enough incentive to audit it effectively. Therefore, the department is authorized to allow producers to rely on their actual billings under the operating agreement in determining the deductible costs. In response to Representative Croft, Mr. Mintz clarified that it's a new concept because it addresses upstream costs that are currently not deductible.

REPRESENTATIVE CROFT surmised that it gives substantial weight to the industry practice, although it's not how the state assesses under the income tax or any other oil taxes.

MR. MINTZ replied yes. The income tax, he explained, doesn't usually get into that detail because it starts with the federal taxable income and merely apportions. He mentioned that HB 488 also directs DOR to look to DNR's standards and regulations in regard to what costs are deductible under net profit share leases.

CO-CHAIR SAMUELS commented that the costs are a huge concern. He recalled yesterday's testimony relating that the larger fields at Kuparuk [River Unit] and Prudhoe Bay have the dynamic of the three major producers looking over each other's shoulders exists. He characterized the aforementioned as good for the state. Therefore, he asked whether it's a completely different procedure for DOR when multiple producers are present versus a sole operator, as is the case at the Milne Point [Unit]. He then inquired as to the total revenue of the Milne Point [Unit] versus the Kuparuk [River Unit] and Prudhoe Bay.

MR. DICKINSON highlighted that the larger units are all owned jointly and they pale in size to Prudhoe Bay and Kuparuk [River Unit]. He informed the committee that DOR doesn't have any procedures because currently the department stops at the point of production. He related that the department intends to review the standards being used with joint operating agreements in order for the state to utilize when there is a sole owner and the state [provides oversight].

CO-CHAIR SAMUELS posed a situation in which an individual works for BP solely on Alaska issues but lives in London, and asked if that individual's salary is excluded [under the Commerce Clause].

MR. DICKINSON said the unit operating agreement would have to be reviewed regarding whether the tasks meet the standard versus where the task was performed. He noted that there are certain things for which all parties agree to pay.

CO-CHAIR SAMUELS, returning to the fiscal note, asked if it's a "shot in the dark" because the department doesn't know how many auditors it will need until the first audit is performed at Milne Point Unit.

MR. DICKINSON related that in Texas there are firms that perform joint venture audit billings for smaller partners. The thought is to hire a firm or several to review the transitional costs and at the same time help bring Alaska's auditors up to speed. He indicated that there wouldn't be a long-term relationship

with those firms. Therefore, the fiscal note specifies a large increment up-front for contract work and three specialized auditors with one support person.

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REPRESENTATIVE BERKOWITZ inquired as to who wrote this section and the instructions given to write it.

MR. MINTZ said that he basically wrote HB 488 through a long process. In terms of the direction given, Mr. Mintz said that he attempted to implement the concepts he was asked to do. Although a number of people were involved, he noted that he worked closely with Mr. Dickinson who was generally the conduit for the direction provided. In further response to Representative Berkowitz, Mr. Mintz said that the process was an iterative process involving many drafts, reviews, and changes.

REPRESENTATIVE BERKOWITZ asked whether it would be possible to review earlier drafts.

MR. MINTZ offered to check into that.

REPRESENTATIVE ROKEBERG informed the committee that the House Rules Standing Committee introduced legislation to reallocate 10 auditors to help with this issue. He then turned attention to [AS 43.55].160(a) and (b), which refer to transitional expenditures. He asked if those subsections only relate to the transitional investment expenditures.

MR. MINTZ explained that [AS 43.55].160(a) provides the basic structure with regard to how net value is calculated. In further response to Representative Rokeberg, Mr. Mintz confirmed that the language on page 12, lines 3-6, relate to the calculations for the clawback, which is addressed in subsections (g) and (h) on page 15. Subsection (b) addresses to what extent either are deductible in a given month, and what can be done if the deduction caused the net value to fall below zero. The \$40 floor is mentioned at the end of subsection (g) and elaborated on in subsection (h).

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REPRESENTATIVE ROKEBERG related his belief that there are elements in subsections (a) and (b) that go beyond the transitional investment expenditure.

MR. DICKINSON clarified that subsections (a) and (b) are general statements with regard to everything that's deductible. However, subsections (g) and (h) on page 15 specifically refer to the transitional investment expenditures and subsection (j) on page 16 refers to the allowance.

REPRESENTATIVE ROKEBERG referred to page 14, line 1, which relates that taxes based on net income are excluded. He inquired as to the federal policy effects on the revenue stream to Alaska if [a windfall profits tax] is enacted.

MR. MINTZ related his understanding that most taxes that aren't income taxes, including the production tax, are deductible for income tax purposes. Therefore, the windfall profit tax would not directly affect the production liability if it works like any other income tax. However, presumably price controls would effect the gross value at the point of production and could lead to a lower taxable value than if there were no price controls.

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MR. DICKINSON recalled when price controls have been imposed, and related that if the department believed the producers were following the price controls, it would just flow through and the lower profits would be recognized.

CO-CHAIR SAMUELS then related that tomorrow he would like assurance that the legislation addresses the \$73 million in a situation in which the Kuparuk River Unit is split into 20 limited liability companies (LLC). He also requested assurance with regard to [the \$73 million] in a situation in which a small company finds a good size oil field.

[HB 488 was held over]

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ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 3:53 p.m.