ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE
March 2, 2006
12:06 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Representative Berta Gardner
Representative Norman Rokeberg
Representative Les Gara
Representative Ethan Berkowitz
Representative Beth Kerttula
Representative David Guttenberg

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
02/23/06	(H)	Heard & Held
02/23/06	(H)	MINUTE(RES)
02/24/06	(H)	RES AT 12:30 AM HOUSE FINANCE 519
02/24/06	(H)	Heard & Held
02/24/06	(H)	MINUTE(RES)
02/25/06	(H)	RES AT 10:00 AM SENATE FINANCE 532
02/25/06	(H)	Joint with Senate Resources
02/27/06	(H)	RES AT 12:30 AM CAPITOL 124
02/27/06	(H)	Heard & Held
02/27/06	(H)	MINUTE(RES)
02/28/06	(H)	RES AT 12:30 AM CAPITOL 124
02/28/06	(H)	Heard & Held
02/28/06	(H)	MINUTE(RES)
03/01/06	(H)	RES AT 12:30 AM CAPITOL 124
03/01/06	(H)	Heard & Held
03/01/06	(H)	MINUTE(RES)
03/02/06	(H)	RES AT 12:00 AM CAPITOL 124

WITNESS REGISTER

KEN THOMPSON, Managing Director
Alaska Venture Capital Group
Anchorage, Alaska
POSITION STATEMENT: Testified in support of much of HB 488.

ROBERT MINTZ, Assistant Attorney General
Oil, Gas & Mining Section
Department of Law
Anchorage, Alaska
POSITION STATEMENT: Gave a sectional analysis of HB 488.

DAN DICKINSON, Consultant
to the Office of the Governor
Anchorage, Alaska
POSITION STATEMENT: Gave a sectional analysis of HB 488.

ACTION NARRATIVE

CO-CHAIR RALPH SAMUELS called the House Resources Standing Committee meeting, which had been recessed on 3/1/06, back to order at 12:06:19 PM. Representatives Samuels, Gatto, Ramras, Seaton and LeDoux were present at the call to order. Representatives Kapsner, Elkins, Olson, and Crawford arrived as the meeting was in progress.

HB 488-OIL AND GAS PRODUCTION TAX

12:06:26 PM

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."

12:06:41 PM

KEN THOMPSON, Managing Director, Alaska Venture Capital Group (AVCG), relayed that his organization is an independent oil exploration company with a focus on the North Slope. It is a consortium of 15 independent oil and gas companies, and he is the principal Alaska owner and investor. He said most owner companies are second and third generation oil patch companies. He has a subsidiary company with technical staff in Anchorage, he noted. That office was just opened last month, and has been active in the past six North Slope area-wide lease sales, he said, and has acquired 600,000 acres of exploration leases. He said the strategy is to explore fields in the 25-100 million barrel range, fields too small for large producers. He suggested that there are hundreds of millions—if not billions—of barrels of oil left in fields of that size.

MR. THOMPSON reported that AVCG's first well started being drilled last night in partnership with ConocoPhillips Alaska, Inc. and Pioneer Natural Resources in the Kronos exploration well. He said Pioneer is the operator, and the prospect is a 50 to 100 million barrel field. "Or it could be a dry hole," he said, but he will know in three weeks. He said AVCG is planning two wells the following winter.

MR. THOMPSON said he is the past president of ARCO Alaska Inc., and he served as the head of ARCO's global oil and gas exploration programs covering 20 countries. He added that he has exploration and production experience in over 20 different fiscal regimes. He said the proposed profit-based petroleum production tax (PPT) is the right step for Alaska.

MR. THOMPSON said that in 1994 he had a briefing on Alaska's severance tax and the complicated policy of ELF (economic limit factor). He said he was told then that the state was looking at severance tax changes, which provided uncertainty in ARCO's forecasts. He said the company ran a range of economics based on that uncertainty. ELF has been the topic of controversy, and he often heard of the imminent threat of change, and it is time to put the new system in place. He said in most other countries, the system is either profit-sharing or production-sharing, and that's much more progressive because a government shares in the upside when the prices are high and "government also shares in the pain at lower oil prices." He said that can help smaller companies like AVCG.

12:12:25 PM

MR. THOMPSON characterized the 20 percent tax rate as fair. The state owns the land and the oil, "we simply lease it, and we do have implied covenants to be fair with the state." He mentioned that he would be addressing the value of the PPT to industry and what should or should not be changed in HB 488.

CO-CHAIR RAMRAS relayed that one of his articulate constituents gave the point of view that ELF is much simpler than a PPT.

12:14:21 PM

MR. THOMPSON noted that when he first saw it he viewed it as the most complicated tax system he had ever seen. He said ELF can become controversial for well rates, although the intent was fair, which was to foster development of fields that may be more marginal. He said Alaska's history was the prolific Prudhoe Bay field, but other well rates were not as prolific, so it was fair to try to come up with a system that would allow for development of more marginal fields. It is interesting that at very high oil prices very few things are marginal anymore, he noted. Technology has greatly improved well rates, "so it is time that the state look at something different." He said the PPT is complex, but most companies are familiar with that kind of system. It will mean more effort for the state and for the producers on auditing and control of expenses, because those are deducted from the revenues. The PPT is complex but so was the ELF, he opined.

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MR. THOMPSON suggested that some people might lose site of the fact that the PPT is merely tweaking one element of the oil revenue system—the severance or production tax. He said it only provides 25 percent of Alaska's oil revenue. Last year oil revenue was about $860 million, and in fiscal year 2005, the state received $2.5 billion through the following: royalties that are 12.5 to 16.66 percent of revenue; property tax ad valorem; lease bonuses; and corporate petroleum tax. None of which is being changed. "By the way, all those systems are based on revenues, and of course a property tax on capital investment level," he stated. It is wise for the state to have a mixed portfolio just like a person would have an asset allocation in different elements, whether it is stocks, bonds and others. It is wise for the state to have a revenue tied to profits as well as revenues. He suggested that the PPT will make the state more competitive and more similar to other fiscal regimes.

12:18:14 PM

MR. THOMPSON said his view, based on working for larger companies and now being involved with a small exploration company, is that the PPT can be good or bad for industry, depending on the company. He said for a start-up exploration company such as AVCG, the exploration economics provide an improvement in near-term cash flow and an improvement in the rates of return. He said when his company tries to raise private equity capital in Houston or elsewhere, "they principally look at this investor's rate of return and that's very important that we can show them a system where now Alaska is encouraging exploration because that rate of return for exploration improves with PPT versus the old system of taxing the revenues via the production tax." He said he thinks the PPT will attract new capital to his company. He asked that the tax rate be kept at 20 percent; a rate of 25 percent would be unfair because his company is also paying 12.5 to 16.66 [percent] in royalty right off the top. It is also paying corporate income tax, property tax and other fees.

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MR. THOMPSON said that the tax credit is important to a little company like his. He said Alaska is his only area of investment, and the exploration budget is $46 million for five wells. He said if [AVCG] makes a discovery of about 50 million barrels, it would spend $250-$500 million in development over the next few years. For AVCG the tax credit "allows us to

plough back tax saving through the credit into our exploration since this is the only place we invest." Mr. Thompson said that for a large producer that is planning to make large capital investments in oil or gasline development the bill could be seen as favorable. He said one concern is for a producer who is not planning to make large investments but plans to send cash flow outside without a high reinvestment rate in Alaska.

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CO-CHAIR SAMUELS asked if Mr. Thompson's company is an LLC and if corporate income tax is different.

MR. THOMPSON relayed that as an LLC, AVCG is turning in state income tax annually, but he is not familiar with whether the treatment of LLCs is different than an S corporation. He said he will check. His company has not had revenues yet, and if there are substantial discoveries, there is the possibility of an Alaska public offering to raise capital and become a regular corporation. But, he said, the company would like to stay private as long as it can. Even if it doesn't have a corporate income tax, AVCG stills has royalties as well as various taxes including federal taxes.

12:24:00 PM

MR. THOMPSON said three things should not be changed in HB 488. He said due to all the other taxes and fees, he hopes the legislature sees that the 20 percent [tax rate] is fair. He noted that there wasn't a dramatic improvement in rates of return from a model based on 25 percent as compared to ELF, "so why change if it wasn't meaning something – if I couldn't go to investors, and raise more equity capital?" His models show an improved rate of return at 20 percent PPT as opposed to ELF, because it allows his company more near-term cash flow. "So the state gives up something near term and the investor gets it, and that certainly helps our payout time." It also means that soon after AVCG's tax credits are used up, soon after field start-up, the state takes a higher percentage than before the PPT. "That's OK with me," he said. "We get the benefit in the early years, and that really does improve our rate of return."

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MR. THOMPSON said the 20 percent tax credit is very meaningful to his company. It allows him to plough those saving back in, "and for each five exploration wells, with a 20 percent credit,

I can drill a sixth well with the same budget." He noted that AVCG acquired eight of its ten leases at yesterday's lease sale.

MR. THOMPSON relayed that the third aspect [in HB 488] that he wants to see retained is the standard tax deduction, which is currently proposed at $73 million per year in profits that would not be taxed. It is a good concept, and Norway uses such a concept in its new fiscal regime, although it is calculated a bit differently. He said he likes it and wants it to be retained, but it will be difficult to explain to the public. But if this exemption were 5,000 barrels a day, which is really where the number came from, it would really help his small company. He stated that it would be easier to sell that idea to the public, the idea of giving a major producer an exemption for 5,000 barrels of oil per day and taxing it on the rest.

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REPRESENTATIVE ETHAN BERKOWITZ opined that the $73 million exemption gives disparate treatment to different investors. He said a preferable system would correlate the tax break to the reasonable costs of exploration and development of the field rather than being linked to the barrels produced or to the amount of $73 million.

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MR. THOMPSON pointed out that a standard deduction should be kept very simple. The exemption at 5,000 barrels per day is meaningful to a small company such as his because it would allow it to have a lot of start-up costs offset. Trying to correlate it to field costs just makes the issue more complicated. He said there was an exemption on the first $20,000 of property value for taxation on homeowners. It helps the owner of a small home a lot more than a person with an expensive home, but it is nice to give everyone the same kind of treatment.

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REPRESENTATIVE GATTO asked if the exemption would be for an average of 5,000 barrels a day.

MR. THOMPSON said there could be rules for that, but suggested it could be averaged monthly or quarterly.

CO-CHAIR SAMUELS said he agreed that the public would understand the barrels-per-day scenario, and it would provide for more protection [for the state] at low prices.

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MR. THOMPSON said the $73 million exemption is sound and he wants to keep it, but it will be difficult to align the public and the legislature behind it. He has heard strong opposition.

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REPRESENTATIVE CRAWFORD noted that no one can foresee the price of oil. He said the bill is setting a tax ceiling with a one-size-fits-all approach. If the price is going to average around $24 per barrel, this will provide a lot of concessions to the oil industry and keep it healthy, but if the price goes up to $60 or $80 per barrel, the economics on all of the proposal change very drastically, and a 20 percent tax rate is not fair for Alaska.

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MR. THOMPSON asked Representative Crawford to keep in mind that when prices are high, Alaska takes up to 16 2/3 percent straight off the top for royalties, and it gets property taxes and corporate income taxes. He said there are federal taxes too. He said a 25 percent tax crosses his fairness meter. Mr. Thompson relayed that AVCG uses $40 per barrel, wellhead, plus or minus $15, on its North Slope economic models.

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REPRESENTATIVE CRAWFORD noted that the federal government take appears to be 25 percent of the total government take, and he asked why Mr. Thompson has said it is 36 percent.

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MR. THOMPSON said that AVCG, when it gets to a sizable income level, will have a corporate taxation rate of 35 percent or more on its taxable income, which may translate to 25 percent of the gross amount.

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CO-CHAIR RAMRAS said he wants the state to be in partnership with small and large producers. He asked Mr. Thompson the value of having sellable credits and the concern Mr. Thompson raised of having to sell the credits at a discount to large producers. He compared oil exploration to pull-tab gambling, and asked whether it would be possible to incentivize traded or redeemed credits in such a way that the producers would be required to invest further in the state. He suggested that perhaps the state could offer more than 100 percent to get the small producers to continue to invest more and more in the state. He said one of his concerns is that the large producers will figure out how to exploit the accounting of this mechanism, and the state will not see the kind of enticement that it wants for small independents, like AVCG or Anadarko Petroleum Corporation.

12:45:56 PM

MR. THOMPSON said his company doesn't have revenue at this time, so it may hold its credit or, more likely, AVCG would need cash and so would market the credits to the big three producers. In the past, the credits have sold for about 95 percent of value, but he doesn't know the price in the future because the new system will provide more credits that companies will want to sell to the same number of limited buyers. Even if his company sells its credits to a big producer, that producer will take 100 percent of that value to lessen the taxes to the state. He said he would much rather see a system where the state could set aside a pool of money from the taxes it brings in from all production. If the state would buy his company's credits in cash at 100 percent, his company would commit to using the money for lease sales, seismic work, or exploration drilling. A similar system was set up in Norway for small explorers, he said. He noted that a company can choose to either do that or sell the credits at a discount to the major producers.

12:49:10 PM

REPRESENTATIVE CRAWFORD suggested a floor price at which the state would pay for the credit. He asked Mr. Thompson if that would be enough to have him commit to exploration and whether he would be amenable to such a concept. The state wouldn't be "on the hook for writing a check most of the time" because a state floor at 90 percent would continue the large producers' interest in the credits.

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MR. THOMPSON noted that there could be different outcomes from such an approach. If AVCG sold its credits for 90 percent of value, the buyer would use it to reduce the income to the state. His company would have the cash, but only 90 percent of it. He said rather, if his company had the credit from the state, it could be used when the company buys a lease from the state. He said Norway makes cash disbursements. The state may want to have a limit of making cash disbursements, and make them on a first-come-first-served basis. When that runs out, the small company would have to sell to a producer or carry it forward. If the state made cash disbursements and then said the money would have to be spent on "land, seismic, and exploration, that increases activity, which is what you're trying to accomplish."

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MR. THOMPSON reiterated comments made by Mr. Jim Weeks yesterday. He said AVCG incurs a lot of startup costs similar to indemnification costs, like bonding, insurance, and oil spill fees, and he would hope that those types of measurable costs could be included as deductions when the determination of net value of oil and gas is made. He said the regulations are currently unclear on that point. With regard to the $73 million allowance, he said he hopes that stays in some form, or else he suggests some type of exemption for smaller companies.

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CO-CHAIR RAMRAS said the wells AVCG is drilling is with ConocoPhillips Alaska, Inc. and Pioneer, and he asked how the $73 million provision should be viewed in situations when there are multiple companies taking it. If those three companies are taking the allowance, "what do we do when there's a company that's a consortium of the three of your interests; is that a fourth entity?"

MR. THOMPSON replied negatively; AVCG would get that exemption at the state level for all the profits that it might have from any sources of oil anywhere in the state. "So just our company gets that exemption." He said to keep in mind that for a company that gets that first $73 million without the 20 percent production tax, it will still pay $14 million on that level of production for royalties, $7 million for corporate income tax, $3 million to $5 million on property tax, and $26 million to the federal government.

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CO-CHAIR RAMRAS noted that it is still difficult to explain [the $73 million exemption] to his constituents who are seeking more funding for schools.

MR. THOMPSON acknowledged that it would be difficult to explain to a school district that needs $3 million that the state is giving an exemption to a company's $73 million profit, so he again suggested an exemption from the first 5,000 barrels of oil per day instead, for public perception purposes only. He would rather have the $73 million allowance, he stated.

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REPRESENTATIVE CRAWFORD asked whether the provision would tend to keep a company from growing past a profit level of $100 million, and encourage someone like Mr. Thompson to form another company. The concern he's heard, he relayed, is that "new" companies will be formed from the same players.

MR. THOMPSON opined that the legislature should simply not allow that to occur, but he doesn't think it would occur anyway because of the other taxes that aren't exempted. He said he would rather have the economy of scale of a growing company rather then creating small companies.

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REPRESENTATIVE BERKOWITZ asked about the profits AVCG would have in relation to the tax burden he spelled out. He noted that Mr. Thompson listed the numerical values of all the taxes he would have to pay, and so he was curious about what kind of profits would be achieved under that sort of situation.

MR. THOMPSON relayed that his highest cost burden is the Trans-Alaska Pipeline System (TAPS). He described other costs. He said, "We're not doing anything unless we can make a profit at above $25 per barrel, so when it goes below $25 some of our prospects do not make it." At $40 per barrel, his company is probably making a $15 to $20 per barrel before tax profit.

REPRESENTATIVE BERKOWITZ noted that the TAPS settlement is due for modification, and he asked Mr. Thompson's expectations.

MR. THOMPSON said that the single biggest hurdle in raising capital is the uncertainty regarding the TAPS tariff. Last year the TAPS tariff went up by 20 percent—in a single year. He said

that is the highest tax increase on the oil and gas industry in Alaska than anything the state has done. He said he wishes something could be done to level off the tariffs. He noted that the Federal Energy Regulatory Commission is looking at a tariff structure for the natural gas pipeline whereby it would be "levelized" for five to ten years. "I sure wish the TAPS tariff was "levelized" for five to ten years." He said it is controversial, but it is his company's biggest uncertainty along with the state's taxation. He said that is why he wants the state to pass the PPT this year in the terms stated now.

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REPRESENTATIVE BERKOWITZ surmised that the state would have more flexibility with its tax rate if it could help level the tariff.

MR. THOMPSON said he hopes the tax rate stays at 20 percent.

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The committee took an at-ease from 1:08 p.m. to 1:23 p.m.

1:23:15 PM

ROBERT MINTZ, Assistant Attorney General, Oil, Gas & Mining Section, Civil Division, Department of Law, noted that the presentation last week focused on the core elements of the PPT, and today's presentation will be more detailed and will include general issues that would benefit from the legislature's attention. He referred to a slide pertaining to Sections 1 and 11 [of HB 488] dealing with prevailing value or the calculation of the gross value at the point of production of oil and gas. Usually during an arm's length sale, the sale price is the starting point for valuation; however, the current statute recognizes that there are situations where it is not an adequate guide to value. He said, "Basically it says if the sale price is below what the actual prevailing value in the market is, that the department can substitute the prevailing value."

MR. MINTZ said sometimes there isn't even a sale at all, and the oil will be retained by the producer and run through its own refinery. The literal language in current law refers to sales price, and the department has interpreted and applied that provision for those situations. He said there was a past dispute, which was resolved favorably for the department, and he is not aware of any further disputes. But Section 11 clarifies that point by making sure that prevailing value applies when

there is no sale, and Section 1 adds legislative intent on that issue. "The slide also notes that in situations where a simplified formula would be allowed under the deal for calculating prevailing value such as a royalty settlement methodology, this would probably not even come up in that situation."

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REPRESENTATIVE BERKOWITZ said that the rewrite of Section 11 raises a question of the impacts on a proposed reserves tax.

MR. MINTZ said he didn't think anyone had that in mind, and he is not sure how to respond.

DAN DICKINSON, Consultant to the Office of the Governor, said "This would relate only to the production tax paid, and it simply adds the phrase 'not sold'." He added that he is not sure it would speak to any tax outside of the production tax. Only the barrels that are produced are taxed under the PPT, he said. A reserves tax would be gas that had not been produced, so he doesn't think there is a connection.

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MR. MINTZ said, "The production tax is a tax that is deductible for purposes of income tax; there's no intention in changing the production tax under this bill to change that deductibility." He said Sections 2 and 3 simply adds language clarifying that it continues to be deductible and not added back to federal taxable income when calculating state income tax.

MR. MINTZ said Sections 4 and 16 pertain to confidential information, and are intended to clarify existing law, which generally makes taxpayers' tax information confidential. It has an exception regarding use in an official investigation or proceeding. He said there are infrequent situations where information from certain taxpayers is actually relevant in determining another taxpayer's tax, including the determination of prevailing values. Sometimes it is necessary to share that information with the taxpayer, which has been the practice but includes various safeguards. Because existing language on confidentiality is so general, [HB 488] clarifies that it is permissible to disclose "that kind of information in carefully-regulated instances to taxpayers for calculating their own taxes." Additionally those provisions will specify that the department has to impose conditions on the disclosure to protect

it from misuse, and the private persons who get the confidential information and violate those conditions would be liable to criminal penalties that apply to state employees who violate confidentiality restrictions.

CO-CHAIR RAMRAS remarked that this provision might relate to different taxpayers participating in Alaska as part of different entities, "and how we follow the sausage through the machine."

1:33:08 PM

MR. DICKINSON noted that there is a section in the bill that specifically addresses that issue.

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REPRESENTATIVE SEATON asked for clarification regarding recipients of confidential information from other sources.

MR. DICKINSON said when the state established the prevailing value for sales on the West Coast it looked at publicly reported numbers, but when it established the value for Alaska, it looks at all the sales in Alaska and certain adjustments and tariffs. The state then turns that figure to a taxpayer whose market was significantly below that average, and taxes it on the prevailing value instead of what it sold the oil for. When the state is questioned on the source of that prevailing value, it will provide sanitized, sensitive commercial data from another company. The information will typically go to the attorneys or agents of the taxpayer, and they sign a document that they are using the data only for those purposes. He noted that the point is that "when we share information with someone in that company under these limited circumstances, we want to bring them under the confidentiality umbrella."

REPRESENTATIVE SEATON surmised that it is only when the state is the source of that confidential information.

MR. DICKINSON offered his understanding that it only relates to the information the state has provided.

REPRESENTATIVE BERKOWITZ asked if it was cleanup language.

MR. DICKINSON said it is taking language from existing regulations, making it a little more general, and then moving it into statute.

REPRESENTATIVE BERKOWITZ asked if it is essential to the PPT or if it could have gone into another bill.

MR. DICKINSON replied that it is not essential, but the state wanted to ensure that it is cleaned up.

1:36:44 PM

REPRESENTATIVE SEATON surmised, then, that it will only apply to the PPT and not a general application for minerals or anything else.

MR. DICKINSON said the provision "mainly goes in the powers of the Department of Revenue, and it refers specifically..." He asked Mr. Mintz to explain.

MR. MINTZ explained that the provision only relates to the production tax, and he doesn't think it is intended to apply outside of it.

REPRESENTATIVE SEATON said that will need to be clarified.

1:37:58 PM

MR. DICKINSON said [the provision] already exists for all taxes, "and we're simply extending it." It takes the rules of confidentiality and applies it to this specific information.

MR. MINTZ said Section 5 is simply the enactment of the 20 percent tax on net value.

REPRESENTATIVE BERKOWITZ noted that Pedro van Meurs analyzed the 20 percent tax with a 15 percent credit as well as a 25/20 split. He asked about an analysis of the 20/20 proposal.

1:39:31 PM

MR. DICKINSON said there was an analysis of the 20/20 proposal.

1:39:59 PM

REPRESENTATIVE BERKOWITZ asked why that wasn't made available.

MR. DICKINSON said there were many analyses done.

REPRESENTATIVE BERKOWITZ asked when it was done.

MR. DICKINSON said he wouldn't know the exact date.

REPRESENTATIVE ROKEBERG asked if that is what was requested last Friday.

CO-CHAIR SAMUELS said the legislature has requested a series of analyses, "so they are coming."

1:40:45 PM

MR. MINTZ relayed that Section 6 merely proposes to clean up a phrase that purported to track Internal Revenue Code language, but it didn't quite do that. Current statute uses the phrase: intangible drilling and exploration expenses. But the Internal Revenue Code uses the phrase: intangible drilling and development costs.

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MR. MINTZ relayed that Section 7 deals with the monthly tax payments and the March true-up. The producers know the most about their costs and deductions. Since the true-up payment will not be made until March 31 or the year following production, this provision ensures that the state will not have to pay interest on any overpayments that may have been made during those months, and if there is overpayment, the state will not have to pay interest until March 31, "and it just repeats current practice by giving the state a 90-day period to make a refund before interest starts to accrue."

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REPRESENTATIVE BERKOWITZ asked if the taxpayer is paying on a monthly basis so that the benefit of the float goes to the taxpayer. He noted that when he buys something, he owes tax at that moment.

MR. DICKINSON said he thinks it's the other way around. If the state was underpaid in any month the company owes interest. If the state was overpaid, the state does not owe interest. There is only interest due to the taxpayer if the state is beyond the 90-day timeframe in refunding the overpayment.

REPRESENTATIVE BERKOWITZ asked if tax payments could be made daily since the oil is metered.

MR. DICKINSON said, "We never considered daily tax payments."

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REPRESENTATIVE GATTO asked if the interest rate is stated.

MR. DICKINSON said another statute sets it at 11 percent compounded quarterly.

CO-CHAIR SAMUELS said [personal income tax] is not due until April 15th and taxpayers are the beneficiaries of the float.

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MR. DICKINSON said it applies to all taxes.

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MR. MINTZ said Section 8 is a technical change to conform language that the new tax would apply to oil and gas aggregated all over the state, and so existing language must be changed to address language on separate taxes for oil and gas.

CO-CHAIR SAMUELS noted that Representative Crawford has wanted to know if the gas in the bill, absent a gasline, only applies to Cook Inlet or Nenana Basin.

MR. DICKINSON said that as currently drafted, HB 488 assumes there is no gasline, so it will apply to all hydrocarbons produced in the state.

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REPRESENTATIVE KAPSNER said the bill almost always includes gas when it references oil, and she asked why is there not a bill for each; they are very different commodities with regard to production and marketing.

MR. DICKINSON told her to focus on the bill's recognition of the costs of production as deductible.

REPRESENTATIVE KAPSNER surmised, then, that any capital expenditures on gas can be deducted from oil profits.

MR. DICKINSON said any upstream expenditures on gas will be deducted from the PPT calculation. To clarify further, he said that a sales line to Chicago or a gas treatment plant to get it into a sales line will not be considered part of the costs of

production. He said those costs will be calculated in net-back value, "but they will not be available for the kinds of credits we've identified in this bill. They're not available for the operating deduction."

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MR. DICKINSON said the idea is that in Prudhoe Bay the equipment is indistinguishable between the two. "You punch a hole in the ground and oil and gas come out together." Separating the two costs would be a bureaucratic exercise that could be done if there was value to it. He noted that property tax doesn't make a distinction. "When you are out exploring, we don't want to try to figure out afterwards, were you looking for oil or looking for gas." Regarding the main things being identified--development, production, and exploration--oil and gas are a joint process and it is hard to separate the costs.

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REPRESENTATIVE KAPSNER asked how hard would it be if there were two different bills.

MR. DICKINSON said a high level of assumptions could be made, or the state could ask for all the ratios for every piece of equipment. Accountants wrestle with joint cost problems continually and find them very hard to solve.

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REPRESENTATIVE GATTO asked if the resource is considered to be "produced" as soon as it comes out of the ground or not until it comes out of the pipeline.

MR. DICKINSON explained that oil is considered produced after it is separated, metered, and measured and ready to go in the pipeline. He said gas is considered produced "either when that first level of separation occurs...or when you go through what's called a gas processing plant, when it is separated from the hydrocarbon liquids that you're going to do something else with."

REPRESENTATIVE GATTO asked whether the argument could made that "this stranded gas has been produced more than once and shoved back into a reservoir," and thus taxable.

MR. DICKINSON said that argument could be made, or the legislature could define gas that has come to the surface as being produced. He said there is currently no way to monetize that gas. "You get more oil production by putting it down in the ground, and so it's simply viewed as a cost of doing business and keeping the oil rates from declining even further."

REPRESENTATIVE GATTO suggested clarifying what the legislature means by the term "produced".

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MR. MINTZ added that Representative Gatto's concern is addressed because gas that is used in the operation of a lease or property for repressuring, for example, is not considered gas that has been produced for purposes of the production tax. He said current statute deals with that, and HB 488 deals with it in a slightly different way.

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REPRESENTATIVE CRAWFORD asked for information regarding gas used in production to run the field including how it is taxed and how it will be dealt with in the future.

MR. DICKINSON said, using Prudhoe Bay as an example, there is a central gas facility with 8.5 billion cubic feet per day [of gas] being put back in the ground for "repressurization". There are two additional streams "that come off of that." One looks like gas and is sold to industrial users on the North Slope. He said there is a four-inch line that goes to the first four pump stations of TAPS, and that is how they are powered. There's a number of times in which there will be third-party sales of gas, and that is taxed, he noted.

CO-CHAIR SAMUELS asked what rate that gas is taxed at.

MR. DICKINSON said the base rate is 10 percent and then there is a gas ELF. The last stream [of gas] is natural gas liquids, which are broken into two pieces. He said half are taken to Kuparuk and are injected to help oil production and are not taxed. The last stream [of gas] is about 45,000 barrels a day and is put in TAPS where is gets commingled with the oil and sold in the Lower 48 as if it were oil. There is a piece of the production in TAPS, which under current statute is defined as gas and it is valued as though it were oil, and once value calculation are made, it is multiplied by the gas ELF.

REPRESENTATIVE CRAWFORD asked how the bill will change that.

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MR. DICKINSON said, "For the stuff used in production, it will not change it. In other words, we are still saying that gas used in production will not be taxed."

REPRESENTATIVE CRAWFORD asked about the gas used in the pump stations.

MR. DICKINSON said that when it is used for TAPS, it is not considered part of production, because once it passes through the meter at pump station one, it is a third-party sale. It is similar to fueling a tanker, and it is taxable.

REPRESENTATIVE CRAWFORD asked about the new tax.

MR. DICKINSON said it will be covered under [HB 488].

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CO-CHAIR SAMUELS asked about getting the cost recovery for that portion of gas.

MR. DICKINSON said, "You calculate the total costs--the cash outlays to run Prudhoe Bay--and then you stick that in the PPT, and that becomes deductible for purposes of oil and gas. And if you're using gas internally, you don't go out and calculate up what it would have been had you had to go out and purchase that gas."

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REPRESENTATIVE LES GARA asked since the current system has a different tax for gas and oil, it must recognize that there are different economics in the two industries. He asked what is the case that the economics are so similar between the gas market/production and oil market/production, "that we would just slap the same exact tax onto both of them?"

MR. DICKINSON said no one would argue that the downstream economics are the same. The biggest difference is that transportation costs for gas will consume a much bigger percentage of the end value than oil. He said HB 488 is focused on the cost of production. That cost is a single cost. "So

what we've done here is put in place a deduction for the upstream cost and a credit for the capital investments that are made and a credit for the exploration. All of those things are identical for oil and gas." He said the vast majority of the hydrocarbons sold are oil, "and this bill is attune to the economics of that oil." He said the only gas moving into markets is Cook Inlet gas, and it is used in Alaska. He said ConocoPhillips Alaska, Inc. has an export facility. The economics in Cook Inlet are changing, and it has been isolated from world markets. There is one contract bringing world market prices into Cook Inlet, and he thinks that will change the situation, "as we analyze it...the economics reflected in this bill seem to be appropriate."

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MR. DICKINSON said, "I will confess to you that under these conditions you probably would not have a gas line, a major gas sale, on the North Slope without the kind of thing that is anticipated under the stranded gas contract. This wasn't anticipated to create the conditions for a major gas sale on the North Slope. We believe it will help set the boundaries, the parameters, for when that occurs." He noted that there are no features in [HB 488] designed to encourage the kind of downstream costs that are going to be the major costs in a gas line project.

2:02:24 PM

REPRESENTATIVE BERKOWITZ noted that the economics of oil and gas are different, and yet the taxing strategies are identical, including property tax, royalties, corporate income tax, and now the production tax is the same. There is no recognition by this bill that the economics are different.

MR. DICKINSON said Representative Berkowitz has properly identified the fact that the other taxes are the same.

REPRESENTATIVE BERKOWITZ said there is no distinction between oil and groceries either.

MR. DICKINSON said property tax only applies to oil and gas property, and there is one income tax for oil and gas taxpayers. "They make quite a distinction between groceries and oil and gas."

REPRESENTATIVE BERKOWITZ pointed out that the current gas tax is different than the current oil tax and yet they are being blended.

MR. DICKINSON said that is correct. The downstream economics are different; the upstream economics are not. It costs as much to explore and put a hole in the ground looking for oil as it does looking for gas, he stated.

REPRESENTATIVE BERKOWITZ said there has been no testimony to that effect. He posited that everyone knows there is "a ton of gas sitting up at Pt. Thompson" and people are struggling to find meaningful oil deposits. So the economics are different.

MR. DICKINSON said there is also a great deal of oil condensate at Pt. Thompson.

REPRESENTATIVE ROKEBERG asked if taxing on profits will level the tax [between oil and gas].

MR. DICKINSON said he thinks that is true.

REPRESENTATIVE ROKEBERG said the state will be taxing on the bottom line, and any peculiarities of production...

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MR. DICKINSON said that additional rules are appropriate. It is absolutely correct that profitability is a good way of equalizing everything, he added. The legislature could say the two are not equal and do something different.

REPRESENTATIVE KAPSNER pointed out that the bill doesn't just tax on profits; there are a number of different credit schemes that aren't just about profit.

CO-CHAIR SAMUELS said he agrees with Representative Rokeberg. If it costs more to develop gas, "you allocate for all the costs and then you tax on the profits." He noted that Nenana Basin may have no oil. He said the committee can argue about the percentage. He said the equalizer is based on profit, and that is what the bill does. "The bottom line is you are talking about splitting up the profits, and if the profits are different for oil than they are for gas, that will come out, generally speaking, in the wash."

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REPRESENTATIVE SEATON asked if gas has a different ELF.

MR. DICKINSON said it does.

REPRESENTATIVE SEATON surmised that the production tax being paid for gas fields are different than for oil fields.

MR. DICKINSON said that is correct. "Furthermore if you have a single field like Prudhoe Bay that is producing both gas and oil, you first have to do what's called a well-days allocation, so that each well you figure out how much of that is a gas well and how much of that is an oil well. And then you calculate the gas ELF based on the gas well days and the oil based on the oil well days."

REPRESENTATIVE SEATON noted that a number of things have been done for gas to encourage production, including different royalties, ELF and credits. He stated the problem is not knowing the differential impact on gas exploration from the PPT.

MR. DICKINSON said ConocoPhillips Alaska, Inc. may be different, but "in general, when you look at a gas project which will export gas to the lower 48, comparable with oil, you have the same thing. You have a huge structure that needs to be put in place. If what you're talking about is simply moving it around Cook Inlet. I mean there are costs there, but they are not comparable to moving it to the lower 48. So when you're looking at a gas market that is essentially a local market, that is a different set of dynamics than a market that is essentially an export market. But the notion is, I mean, typically, I think, in the lower 48, one thinks of the gas as being more challenged as compared to oil. But here we're talking about a local market for gas and an export market for oil."

REPRESENTATIVE SEATON said that is where he is not seeing the differentiation on these two very different commodities, as they are currently being produced in Alaska. He said a gas pipeline would be understandable, but that is not Alaska's current production, "and I don't want to get into the situation where we create a tax scheme that disincentivizes production for Alaskans, just because we threw it in with the oil tax."

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CO-CHAIR SAMUELS asked how much Alaska currently makes on gas tax.

MR. DICKINSON said it is in the $50 million range; it is not trivial.

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REPRESENTATIVE GARA remarked that taxing both oil and gas in an income tax makes some sense, "but if a 15 percent tax rate on oil results in profit margins of 40 percent, but a 15 percent tax rate on gas results in profit margins of 3 percent, then it doesn't make sense to tax both the same exact way. I think that's the point. The same exact tax rate on two separate industries, even though it is a corporate income tax, causes some concern."

REPRESENTATIVE BERKOWITZ noted that the state is making $15 million on gas tax now, and he asked how much would be made under the PPT.

MR. DICKINSON remarked that the problem is in determining what costs are gas and what costs are oil. He said he hasn't done that in his head.

REPRESENTATIVE BERKOWITZ pointed out that the legislature is being asked to create a taxing structure, and it needs that information. He asked if the tax will go up or down under the PPT.

MR. DICKINSON said the accountants could provide either answer depending on allocation of costs. "You could certainly look at players such as Marathon, who is primarily a gas player, look at their taxes. The total of gas and oil together will go up at higher prices. And looking at how that's allocated between the two, I mean we could certainly run through the numbers. My point is that there's a judgment that you're going to make that's going to be influenced by how you look at joint costs. But we could certainly look at a gas field, and say 'Here's what happens in a gas field, here's what happens when exploring a gas field,' I mean, that exercise is something that, I think, Roger Marks went through in his exercise showing us what was going on in Cook Inlet. And I can certainly revisit those slides with you if you'd like."

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REPRESENTATIVE BERKOWITZ said this is not a trivial issue, and there is a question of proper due diligence on the part of the

administration. "If Cook Inlet gas, for example, is in short supply and they haven't done analysis, and it turns out that this jacks up the tax rate considerably that would make the economics of Cook Inlet gas worse than they are today, which will put energy in South Central in some danger. I think it is the administrations responsibility, since they are putting this bill forward, to have those numbers ready for us.

MR. DICKINSON said he believes that on the existing producing fields in Cook Inlet, the tax would go up, but explorers would pay lower taxes. He said it is important to maintain that distinction. He said he is being a bit vague because he doesn't have those numbers available, but that work has been done.

REPRESENTATIVE CRAWFORD asked if the change in the gas tax will result in an increase or decrease in the tax collected on the North Slope pipeline quality gas.

MR. DICKINSON said he will provide that, but there will be a huge assumption on how costs are allocated.

CO-CHAIR SAMUELS asked him to respond to Representative Berkowitz's question tomorrow.

MR. DICKINSON said he will look at Roger Marks's slides and look at that. He will try to get it by then.

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MR. DICKINSON noted that in 2005 the total production tax on gas was $55 million with $30.5 million of it in the TAPS line.

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MR. MINTZ said the next three slides pertain to Section 9, taxation of royalty interest. He said it affects only a very tiny proportion of the oil and gas produced in Alaska and only changes current law in one respect. He continued:

> Current production tax and the production tax proposed under this bill would subject all oil and gas produced in the state to production tax except that proportion that's exempt. The exempt portion is the royalty share that's either owned by the state in state oil and gas leases or by the federal government in federal oil and gas leases. So the vast majority of royalty oil is tax-exempt because it's owned by the state or

> federal government. But the next thing to keep in mind is on private oil and gas leases, which accounts for only a very small fraction of oil and gas production. That royalty share is subject to tax. It is subject to tax under current law; it would still be subject to tax under this bill. However, it's the producer that is liable for paying the tax. That's true under current law; it would remain true. Because the producer is liable for paying the tax, but the royalty owner actually gets the royalty share or its equivalent in value, current law allows the producer to pass on the tax on the royalty share to the royalty owner, typically by deducting that tax from the royalty that's paid to the owner.

MR. MINTZ said HB 488 deals with a complication in how the royalty share is calculated. The new tax would be on the value of oil and gas produced from all leases and properties in the state for a given producer, subtracting all lease expenditures. There is no easy or obvious determination for the tax on the royalty share of particular leases. So Section 9 will provide a default mechanism for calculating the royalty share of the tax in the absence of an agreement between the producer and the royalty owner or some other method, he stated. He said it is a pro rata tax based on the producer's statewide taxes.

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CO-CHAIR SAMUELS said "If the state owns the royalty, you get it off the top. But if an individual Alaskan or a company owns the royalty, they have to absorb a portion of the costs."

REPRESENTATIVE KAPSNER asked about if an example would be a Native corporation.

MR. DICKINSON said yes. He said a private royalty owner does not have to share in upstream costs either, and that's what makes the new tax difficult to pass on. He said royalty owners generally receive their royalty free and clear of production costs, so this difficulty arises. The company paying those costs doesn't share them with the royalty owner, so why should it share the benefit of the credits or deductions, he said. The taxpayer with private royalty interests and with an agreement to pass on the costs takes the total tax paid by the company and divides that by the non-royalty barrels, he explained. Then the taxpayer multiplies that times the private royalty barrels. He

gave the committee an example of a taxpayer with two leases, producing 100 barrels from each. One lease belongs to the state, he said, and one belongs to a corporation. Both have 12 percent royalties. He said to assume that the gross value is $10 per barrel, totaling $2000, he said. "What they'll do is they'll take that wellhead value of $10 per each barrel, they will multiply it times the total barrels that tax is due on." He said for the state share it is 87.5 barrels, but for the private royalty owner it would be all 100 barrels. He said, "You take that $10 and you multiply times 187.5 barrels, and so the tax basis is going to be 1,875." He then subtracted $875 in lease costs and other upstream costs to arrive at the net basis of $1,000. He said to multiply that by the 20 percent tax rate, and the producer owes $200. When it is time to pay the royalty owner, the company will get to deduct those taxes from those private barrels, he stated. He said that exists in current statutes, but "the problem is defining what that number is."

MR. DICKINSON said the total taxes were $200, and then he divided by all the non royalty barrels, so each barrels pays $1.14 in tax. He multiplied that by the private royalty barrels and came up with $14.29. The company will subtract that before making a settlement with the royalty owner, he said.

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REPRESENTATIVE GATTO asked if the non-royalty barrels can ever be zero.

MR. DICKINSON asked Mr. Mintz if there is any other way for producing for a mineral interest other than a lease.

MR. MINTZ said the non-royalty barrels could be zero if there is no production, but they could never be zero unless the royalty barrels are also zero.

MR. DICKINSON said, "Or if there was 100 percent royalty rate."

REPRESENTATIVE GATTO said if the non-royalty barrels are zero, then the total tax is infinite.

MR. DICKINSON said either there would be no barrel produced and thus no tax, or a hypothetically 100 percent royalty interest.

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CO-CHAIR SAMUELS said, "You're treating different royalties differently."

MR. DICKINSON said the state is trying to treat them the same. "From the point of view of the state, they are indifferent about whether it is a private royalty barrel or a non-royalty barrel. The only royalties that the state treats differently are its own royalty barrels and the federal royalty barrels."

REPRESENTATIVE CRAWFORD said, "If it's the calculation of the tax on the state's 100 barrels, the state gets $200 plus 1/8 of the value of the...royalty. That's what they get. And the state gets, from the 100 barrels on the private royalty, they get $200 plus $14.29, but they don't get the royalty, because that went to the royalty owner. Is that how that works?"

MR. DICKINSON said, yes, sort of; the $14.29 is part of the $200. "They've paid [the state] $200," he said. But Section 9 says that since some of that $200 was tax that arose because of royalty barrels, the costs that accrue to the company with the lease can be passed to the...

REPRESENTATIVE CRAWFORD interjected that the state got $200, but $14.29 of it was paid from the royalty owner to the producer.

MR. DICKINSON said it is something like that. The legal point is that the tax obligation is to the producer. A private lease owner does not have a tax obligation to the state.

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REPRESENTATIVE ROKEBERG remarked that the old and new versions of this provision are default provisions, because there could be a private contract between the royalty owner and the producer. He spoke of the word "may" in line 2, and assumed that it could be a default in the absence of an agreement. He noted that in most places in the lower 48, private owners receive the royalties, not the state. He said he assumes the amount that could be passed on would be greater under the PPT than the ELF.

MR. DICKINSON said that would be correct if no investments are made and the price of oil is high. "The paradox...is, what happens when a producer makes a large investment" and pays zero taxes? "Is there a tax to pass on to the private royalty owner or not?" He said that is what this formula attempts to address.

REPRESENTATIVE ROKEBERG asked about the two having a different agreement that does not deduct that royalty payment as part of the royalty share. "Should they not deduct that royalty payment as part of their production expenses in PPT?"

MR. DICKINSON said the royalty is not a deductible expense.

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REPRESENTATIVE KAPSNER asked whether it would be possible for both the royalty owners to get their share off the top.

MR. DICKINSON said yes; they do both get their share off the top. The difference is that the state has passed a law saying that there is no tax on the state's royalty share, but it isn't extending that same consideration to a private royalty owner. He said in his mind, "off the top" means the production costs, and so "what you're saying is there is an additional cost which a private royalty owner must bear, and a public, someone having a lease...does not. I think that's a correct observation."

REPRESENTATIVE KAPSNER said the state doesn't pay a tax on the royalty, and the private owner does.

MR. DICKINSON said it is the other way around, the state receives a tax and the company producing the oil has to pay the tax on all of the oil it produces from a private lease, but only on 87.5 percent of the oil it produces from a state lease.

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MR. MINTZ said Section 10 deals with the issue raised by Representative Gatto, and it amends AS 43.55.020 (e). He said that currently it addresses the tax treatment of gas that never makes it to the sales meter. There are two ways that can happen, he said, if it is used in lease operations or reinjected for pressure maintenance. The statute will continue to provide that such gas is tax-exempt. He explained that flared or vented gases are exempt from tax if it is flared for safety purposes. If it is flared wastefully it will be taxed and subject to a penalty. Gas that is authorized to be flared, but not for safety purpose, is taxed but not subject to a penalty. He pointed out that it is harder under HB 488 to define a particular tax on a particular lease, so the bill will simply put flared gas into two categories. If the flaring is authorized, it will be tax exempt, and if it is not authorized, it will be subject to tax.

REPRESENTATIVE BERKOWITZ asked how much flared gas is taxed and subject to penalty.

MR. MINTZ it is a small part of the overall revenue picture.

MR. DICKINSON said he believes it constitutes tens of thousands of dollars.

REPRESENTATIVE BERKOWITZ said waste will not be penalized under HB 488.

MR. MINTZ said that is correct for production tax purposes; however, wasted gas is also subject to a penalty assessed by the Alaska Oil and Gas Conservation Commission, and that is not affected by HB 488. He said that under current law, there are two penalties assessed on flared gas, and under the bill there will only be one penalty, and that will be the AOGCC penalty.

REPRESENTATIVE BERKOWITZ asked if the penalties are the same.

MR. MINTZ said the AOGCC penalty is higher because it is the fair market value of the gas at the point of waste, whereas the production tax penalty is equivalent to the tax, which could be 10 percent of the gross value at the maximum.

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REPRESENTATIVE BERKOWITZ said it is not much of a penalty, but a "you break it you pay for it" consequence.

MR. MINTZ said that is correct under the production tax. Currently it is just a double tax. The AOGCC considers it a true penalty, because it doesn't have taxing authority.

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REPRESENTATIVE SEATON asked if the AOGCC considered a penalty a necessary item for conservation criteria.

MR. DICKINSON offered that no-flare orders are important, and most production operations are set up not to flare or vent gas.

MR. MINTZ relayed that the AOGCC closely regulates flaring, and requires it to be reported for conservation purposes, and that is separate from the view of the Department of Revenue.

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REPRESENTATIVE BERKOWITZ asked if this issue is integral to the PPT.

MR. DICKINSON characterized it as "cleaning up something where we spend a fair amount of time with very little net return."

MR. MINTZ said Section 10 also extends the tax exemption for gas that is used in lease operations to oil that is used in lease operations. He said he doesn't know how oil is used.

MR. DICKINSON said oil can be used as low diesel in well work.

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MR. MINTZ said Section 12 enacts the tax credit provisions of the PPT, "and we've been over a lot of this." He said subsection (c) on page 6 clarifies that a credit may not be used to reduce a person's tax below zero.

CO-CHAIR SAMUELS asked that Section 12 be covered later.

MR. MINTZ said one substantive change deals with the rare occurrence of a special penalty for failure to file, which is supposed to be repealed as redundant "and a trap for the unwary." He said laws provide for general civil penalties, including penalties for late filing, which can be substantial, he said. One penalty is $25 per day, and there has been one case where it added up "to a totally disproportionate amount." He said there is already a penalty under the general administrative provision, so the bill proposes to repeal the special $25 per day penalty. He said Section 15 addresses a true-up filing that is required in March.

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MR. MINTZ said Section 17 has nothing to do with changing the production tax, but it was obvious that an update was needed to reflect the passage of the constitutional budget reserve fund. It simply conforms the statute on disposition of collected taxes to the requirements of the fund, he said.

MR. MINTZ said Section 12 enacts the various credit provisions. He pointed out that subsection (e) contains the limitation on use of credits that are obtained through the purchase of certificates. Those credits may not be used to reduce the tax,

during a calendar year, more than 20 percent below what it would otherwise be. "That 20 percent limitation does not apply to the use of the producer's own credits."

MR. DICKINSON stated that Co-Chair Ramras asked about making the credits refundable. He said such credits could be called "Alaska Bucks," and used in a lease sale at a premium. Rather than have a commitment from a company to reinvest, the state would require the Alaska Bucks to be used to expand the company's acreage, "or something like that." He said that even though the economics are the same, whether a check is sent or the income is deducted, the point would be "if we were purchasing those, you would have to authorize that outlay, and again, if we're in a situation...where the companies weren't using credits because prices were very low, you might be in a situation...ten years from now, if you had the current budget of slightly north of $3 billion, and revenues are at $1 billion, you might be very loath to take a significant portion of those and turn them into credits." He suggested adding conditions to further incentivize those uses.

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REPRESENTATIVE ROKEBERG surmised that a refundable credit would require the state to write a check.

MR. DICKINSON said refundable means that the state would write a check to a person with the credit.

REPRESENTATIVE ROKEBERG said it would come from the general fund.

MR. DICKINSON said there could be fund created for credits.

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REPRESENTATIVE SEATON noted that the credit could be optional or out of royalty or production taxes to avoid getting into a deficit. If it were at 90 percent, the state would make 10 percent, which is more than it makes on the permanent fund. "If it gave the small producers another avenue if the credits were discounted to 70 percent..."

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REPRESENTATIVE ROKEBERG said, "But you'd have to be willing to enter the market place to make it real."

MR. DICKINSON said, "You write checks when there's a run on it."

CO-CHAIR RAMRAS spoke of attaching a premium to the playback, "because the large majors are going to be able to automatically use, in good times and bad times, the credit because they're generating, even at $20 barrel oil, in spite of some of their graphs, I think they're going to be generating significant income. But the small guys, the small players, it would be nice to see both a 90 percent provision and also 110 percent provision; 90 percent for cash, and 110 percent if they're going to use it to reinvest into additional explorations to incentivize the small guys."

REPRESENTATIVE BERKOWITZ asked what the amount of the tax credits would be, "how many qualified capital expenditures?"

MR. DICKINSON said the baseline expenditures for the last several years have been around $1 billion annually. He said, "It is our hope that those would increase." He said he has not modeled how effective he thinks the incentives will be. He stated that when Point Thompson is brought on line, "we believe that will more like a $3 billion figure over several years." If it is $1 billion per year, there will be credits of $200 million, he said.

REPRESENTATIVE BERKOWITZ suggested a credit that would differentiate between more difficult-to-produce hydrocarbons and the ones that should be driven solely by market. He said there is little reason to incentivize Pt. Thompson, but there may be reason to incentivize more difficult resources.

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MR. DICKINSON said that if the legislature requests varying credits, the department will do its best to craft those rules. He said, "The reason why we have resisted some attempts to create differentials here is precisely because" companies tell him to incentivize different kinds of resources. "You walk through and every company properly has their niche, knows their challenges, and thinks that a level of support would help overcome those challenges." He said the bill will allow for expensive operations to generate large credits and less expensive operations to generate smaller credits. In speaking with the governor, "we landed on this notion of not trying to pick and choose between the activities. We believe if companies believe that there's investments to be made that will produce,

we're going to support those." He added his personal observation that "we are spending a lot of time carrying out the instructions...on making sure that all the conditions are met. Because there's lots of conditions there. And there's been some complaints, you know, we've asked to prove up each of those conditions. They're there, so when you work on an audit, I recall in particular, you had one well that qualified, one well that didn't, how we dealt with all the support operations that supported them both. A lot of effort went into resolving that. I'm not sure that was, in the final analysis, a value added."

REPRESENTATIVE BERKOWITZ asked Mr. Dickinson to point out any operation that resulted from the incentive.

MR. DICKINSON said he said he saw on Gavel-to-Gavel that someone from Pioneer said that company had "undertaken some of that work as a consequence of that and was going to undertake work next year, also as a consequence of that credit."

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REPRESENTATIVE SEATON asked, "Is the reinvestment in hard assets by a small company almost already increased? In other words, if you take your tax credit and you reinvest it in hard asset, then you're going to get a 20 percent tax credit on that money that you've reinvested. So you're actually getting over your 100 percent anyway, aren't you?" He added that "in a way, it's a following year, but..."

MR. DICKINSON said, "That's certainly what we've tried to establish, is that as you generate profits, if you reinvest them, you pay less tax. If you don't reinvest them, you pay more tax. And so, in that sense, you're correct. You get more profit for investment; you get less profit if you're paying back to shareholders or investing elsewhere."

REPRESENTATIVE SEATON said he meant the application of credit, and how the state incentivizes credits. He spoke of paying 110 percent credit. "It all automatically will generate another 20 percent credit on the use of the money."

MR. DICKINSON said that is correct; "if you force those into a market and the market's weak, then you only get $70 to reinvest from your credits, of the full 100, and I think the notion is, could we support that up to 80 or 90 or then even think about making it 110?"

REPRESENTATIVE ROKEBERG said Pioneer may have indicated that it undertook its program because of exploration credit under SB 185. He said Pioneer also received a credit on royalty relief.

MR. DICKINSON said he believes there has been additional exploration due to credits, but the wells drilled in the first year may have been drilled anyway.

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REPRESENTATIVE BERKOWITZ said if that is the only example in front of the committee, "you can make the argument that royalty relief is a much more effective discretionary tool for stimulating exploration and development than, sort of, a broad brush tax credit."

MR. DICKINSON noted the length of time that various royalty reduction programs have been around. He said the main argument about why the state didn't get the amount of drilling that it hoped for under SB 185 is that it was a five-year program and "folks don't immediately change their behavior and come running." This will make things more attractive but won't precipitate a rush, he stated.

CO-CHAIR RAMRAS said he spoke with ExxonMobil Corporation who broke it into three separate fields: aggregated, non-aggregated, and under the PPT. He said, "they took the lease expenditures that pass through the eye of the needle of the particular hydrocarbon field they were working on. And they seemed to count the money twice, which was one of the points that Representative Berkowitz made yesterday. Which is they took the 20 percent as a lease expense, and then they took it again as a capital expenditure. And it was then that I clued into this double counting that I think you were referring to the other day. And I wonder if you can explain that...if it's relevant to Section 12." He said he didn't think there was an opportunity to count something as a deduction and then count it as a capital expense twice.

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MR. DICKINSON said he doesn't like to use the term "double count", since that tends to be used in a negative context.

CO-CHAIR RAMRAS said he is using it in a negative context.

MR. DICKINSON said the state could have instead crafted the bill such that operating expenses have a 20 percent allowance and credits get 40 percent, and a company can't deduct anything that qualifies for a credit as an operating expense. "The mathematical result would have been the same." He said that dollars spent on capital expenses will receive 40 percent of support under the tax system, and the operating dollars will receive 20 percent.

CO-CHAIR RAMRAS surmised that that would be a 20/20/40 program, "if it were straightforward like that, 20 percent on regular expenditures and 40 percent on capital credits if we were to state it in that regard." He said that means that a company hiring an army of groundskeepers to make its Anchorage office beautiful, who aren't doing a thing to discover or explore hydrocarbons, would get a 20 percent operational expense deduction against profits.

MR. DICKINSON said if it kept its leases in good shape and its partners approved, then yes. He said keeping a building in good shape does not qualify for a lease expenditure, and he suggested looking at the definition of a lease expenditure.

REPRESENTATIVE ROKEBERG said that was a good point, and it is not clear to the public or to him. He said it looks like a 20/20, 20/20, or something.

MR. DICKINSON relayed that Section 21 deals with lease expenditures where a company will receive 20 percent support for each one. It counts as a deduction.

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REPRESENTATIVE ROKEBERG said there is the 20 percent of the qualified capital expenditure, the 20 percent lease expenditure, the 20 percent of loss carry-forward, and the 1/72 look back provision.

MR. DICKINSON said the 20 percent carry-forward credit and the 20 percent deduction for expenses are essentially the same. "If, in a month, I have, even after paying all my costs, I have a 20 percent...profit, then I will pay 20 percent on that profit. If I subtract all my costs and my qualified lease expenditures and I now have a loss of $10 million, let's say. I pay no tax that month, but to make sure that those outlays are properly accounted for, I'm going to take them in a future year, and the mechanism we've created to do that is, you take 20

percent of those, so in this case...$2 million and that gets carried forward in credit in the future year. So...while it may be fair, or it may be inaccurate to characterize a dollar spent as qualifying for both a credit and a deduction, I don't believe it's fair to characterize it as receiving a carry-forward deduction and a regular deduction."

REPRESENTATIVE BERKOWITZ surmised that the bill has an effective deduction rate of 60 percent.

MR. DICKINSON said no; the reason that the effective tax rate and the tax rate in the bill are not the same, is because of the deductions. "The point is, typically what an effective tax rate will be is you will start with some number. There was some confusion the other day whether it was revenue or profit, but let's say for gross value at the point of production. You start with that, you divide through by the amount of taxes you pay, and that forms a ratio, and that's what the effective tax rate is."

REPRESENTATIVE BERKOWITZ said if there was a total tax take as a single unitary tax for the state's interest, for example, 50 percent or 60 percent including the federal rate, this item would be deducted one time or three or four times?

MR. DICKINSON said it would depend on how the law is written. "The point is, if you had single rate, if you wanted to say you take all your revenues, you subtract all your costs, and then you pay government 61 percent and let them figure it out. From the company's point of view, what you would be saying is that's a pure tax on profits, and you don't get any kick from investment. What we've chosen to do...is an emphasis [on] how do you take these dollars and how do you create a tax advantage to the person who decides to invest in the state."

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MR. DICKINSON read page 12, lines 24-26, in regard to the groundskeeper question: "ordinary and necessary costs of exploring, developing, or producing oil or gas." He said it is not the intent to create such a situation [of groundskeepers being deductible].

CO-CHAIR RAMRAS asked about "a bunch of engineers" working on Alaska leases in Houston.

MR. DICKINSON told him to move ahead to page 13. If people are solving problems of getting oil out of the ground in Prudhoe Bay, "and BP is willing to pay 18 percent of their costs and ConocoPhillips Alaska, Inc. 36 percent of their costs and ExxonMobil Corporation 36 percent of their costs, then, in general, we're going to say 'Yea, that probably has something to do with Prudhoe Bay production.'"

REPRESENTATIVE BERKOWITZ asked if they will make that decision based on the other tax rate they have to pay, for example, if Texas had a higher tax rate, and then they would benefit.

MR. DICKINSON said he supposed that could happen, but, "In general, I think what happens is the various owners are trying to keep costs out; they're making sure the operator doesn't spend costs that aren't a useful way of getting oil out of the ground."

REPRESENTATIVE BERKOWITZ said, "Yet strangely they can't tell us their profits."

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MR. MINTZ said subsection (h) on page 7 defines qualified capital expenditure that is eligible for the 20 percent credit. He said, “It is important to point out that that is a subset of lease expenditures.” “It has to start off being a lease expenditure, and of course lease expenditures are the things that are deductible under Section 160 in calculating your taxable net value, but then it’s a subset of lease expenditures, which are only that type of lease expenditure that’s considered a capital investment or capital expenditure.” He said when a producer wants to transfer its credit and gets the department to issue a certificate, the department retains the ability to go back and audit the producer. The deductions for lease expenditures and the credits for qualified capital expenditures can be taken advantage of by explorers who are actually not doing any current production, he said, and are thus without production tax liability. If they get a tax certificate and sell it to a producer, and then later the department finds that there was a problem with the claim. “We want the department to be able to recover that deficiency back against the explorer.” He said the bill makes sure the explorer is considered a producer, “that is, a taxpayer from whom the department could then recover a tax deficiency.”

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MR. DICKINSON referred to subsection (h) and said that to qualify as a capital expense it must fit three criteria: 1. it had to be a lease expense, 2. it would have to capitalize under IRS rules, and 3. it would not have been previously placed in service. "There's going to be some big numbers, but we believe that there's going to be things that really are capital investments in producing in Alaska that are new to the state."

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MR. MINTZ said Sections 18 and 19 are just technical changes to conform language and update syntax. He said Section 21 is an important provision explaining how to calculate net taxable value. "In general, deductible lease expenditures include not only production costs but also exploration costs." He said it would cover explorers who are performing seismic exploration on unleased land. Another possibility of exploration activity occurring on unleased land is under the DNR exploration license program, he stated. He said there could be wells drilled, and there is a particular provision that addresses the potential double-dipping problem. At the bottom of page 12, there is language that says: lease expenditures do not include the costs incurred to satisfy the work commitment under an exploration license. He said when a person gets an exploration license, part of the consideration is an agreement to spend a certain amount of money on exploration activities, and if that is successful, there is an option to acquire a lease. He said there is no bonus paid to the state for that. "In our view the money that's spent under the work commitment is sort of equivalent to the bonus...and not allowed to be deducted."

MR. MINTZ said there have been questions with regard to subsection (d), which lists costs that are considered direct costs and deductible and those that aren't. He said the lists are examples and are not meant to be exhaustive.

MR. DICKINSON said a Limited Liability Corporation (LLC) is a checker box organization where profits can flow through to a member subchapter (c) corporation. "Obviously, particularly in Alaska, many LLCs flow through to an entity that is not a taxpayer; that is one of the advantages of that form in Alaska, but I think you'll find that LLC--you should not assume that an LLC immediately is not a taxpayer."

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MR. DICKINSON, referring to lines 8-12, said if there is an arbitration or lawsuit with the state, the state will not allow the money spent to be deductible. A lawsuit like an injury case would be deductible, he said.

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MR. MINTZ referred to subsection (h) on page 15, and said the transitional provision is sometimes called the claw back. He said there is a requirement that the West Coast price of Alaska North Slope oil must exceed $40 per barrel in order for those expenditures to be deductible in a month. There are a variety of ways to calculate this price, and there are a variety of publications that publish spot prices, he noted. He thought it was important to provide a general statement in the bill so the department could decide how to calculate the price if available publications change. He stated that the spot trade may diminish, so there has be a fall-back provision for determining when the $40 per barrel threshold is met.

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MR. MINTZ said page 16, subsection (k), describes an unusual situation, and an example would be the Northstar Unit, which is partly on state land and partly on federal land. He said the department is charged with specifying reasonable allocation methods for expenditures on split properties.

MR. DICKINSON said subsection (j) establishes standards for determining whether there was a situation where multiple entities were formed to take advantage of the $73 million allowance. It also shows the information that can be requested and the standard that the commissioner would use to determine whether an entity could use that allowance.

MR. MINTZ said the number that determines the tax is the producer's net value of oil and gas produced during the month, and the 20 percent rate is applied to that. The $73 allowance is a way of reducing the net value by that amount. He noted that a producer might want to split up a company in order to take the $73 million allowance twice in order to evade taxes. He said he tried to define the problem in as general terms as possible to address numerous situations and devices that people could come up with to try and exploit the allowance provision. He said the state can't minimize the fact that there is definitely an incentive to try to get around it. He said the

general standard in the bill will hopefully work for any attempt to illegally exploit the allowance provision.

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CO-CHAIR RAMRAS said he understands the intent of subsection (j), but suggested that it be rewritten because he doesn't want something "that you can drive a truck through." He said when he earlier asked a question about [the problem of companies splitting to take advantage of the $73 million allowance], "you were shaking your head no, and there was a gentleman from ConocoPhillips Alaska sitting in the back row who was nodding his head yes." He said at every point, whether exploration or development, "everybody is always trying to lay off part of the risk on to other partners, and you can get this thing ginned up with a lot of partners."

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MR. DICKINSON said Co-Chair Ramras is absolutely correct. He said the future of the North Slope is in smaller entities coming in and entering partnerships, and the balance that must be achieved is between not stopping this sensible economic evolution and trying to prevent entities from dividing up the net value for the purposes of the allowance. The policy call is which side to err on, he opined.

REPRESENTATIVE BETH KERTTULA asked for examples of what kinds of things would reasonably be expected to be done by just one producer.

MR. DICKINSON said the type of entities the department would be concerned about are those that have no other purpose than a paper ownership, "and whose relationship with the larger owners was one that didn't appear to have any real indices of independence or any existence other than simply to take advantage of the tax credit. In other words, the value was split. On the other hand...if you looked at a situation where a new field was developed and some partner came and took 22 percent of it and 78 remained with...the major producer. You'd say, 'well, clearly that happened here on the North Slope before this bill was passed,' so that kind of thing would be allowed."

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CO-CHAIR SAMUELS asked how the state would know, and he gave an example of an international exchange. He said he spoke with the

industry about it, and was told it was not worth setting up the scheme because it is not enough money. "To ExxonMobil it is not that much money for them to set up a corporation and play a game around the globe so that they make an extra $15 million, which is probably three minutes of their revenue."

MR. DICKINSON said he is less concerned that there will be some international deal than with a company going into an enterprise and getting three legitimate partners, but then he asked if that is what the state is trying to encourage. "My concern is that what we take is the base production from the major fields that's occurring now, that is what will generate most of the revenue under this, and in fact, there I think we can be clearer if suddenly large portions of it start being spun off, particularly to entities that have no existence other than to hold that." He said that if he found a small field, "it won't be necessary, if you will, to get three or four entities in to make that work the way things are supposed to work here."

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REPRESENTATIVE GARA said the $73 million profit exemption concerns him because "we're starting to now let the tail wag the dog. It seems to me from the rumors in the hallway that it was a fair attempt to find a way to try and exempt Cook Inlet fields and some others." But the provision seems to really benefit others. He suggested scrapping the provision and coming up with a way to target a tax credit to heavy oil, small fields, and maybe new fields.

MR. DICKINSON said he is not sure he understands. He said heavy oil and exploration is one world and Cook Inlet is a totally different world. "The point is, ultimately, the credits are looking at capital expenditures, and I believe that is a distinct discussion from a reduction. The expenditure--the credits piece--simply doesn't matter what entity takes it. The effect is going to be the same. This focuses on entity level. If your notion is: do you get rid of an entity level and simply go back and focus on activities? Sure, that's a choice the legislature could make. Why we had this in there and the reason we keep focusing on it is--and we hear this a lot in the legislature, as well, walking the halls--is there needs to be a focus on bringing a different-sized company in and that's what we're encouraging here. So if what you're trying to encourage is dependent on company size, then it needs to be an entity-level encouragement."

CO-CHAIR RAMRAS said his concern is an unintended consequence that can grow out of something that looks practical. "You take five of these entities over ten years and pretty soon you're aggregating these $73 million units, and now over the next five, seven, ten years, you've got sixty or seventy or eighty of these $73 million units, and you have now aggregated $6 billion into—you put a 20 percent credit on that—and you now have 20 percent of $6 billion, and harbored $1.2 billion." He said on the other side, the state may have spurred exploration, but he is worried that the state is on thin ice. He said there may be no intent of malice.

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MR. DICKINSON pointed out that if there were 70 entities in five years, the legislature would probably repeal this provision, unless it works as intended. He said if the commissioner can't enforce it, "I believe the legislature would act on it."

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MR. MINTZ said Sections 22-29 deal with conservation surcharges, which exist in statute at $0.03 and $0.02 per barrel. "These are basically retained. We had to make clarification that even though the production tax now will be paid on a 90 percent monthly basis with a true up at the end of the year, the conservation charges would still be paid in full every month, as now. One change would be that they would be able to be taken as credits against the production tax owed, as long as there's a positive production tax liability." He said he also conformed the exemptions for oil to make it consistent, and it provides that oil used in lease operations does not incur the surcharge.

MR. DICKINSON said the net effect of changing the definition of oil is that the amount paying the surcharge will increase. He said he will get the exact numbers. There is a crude oil topping plant that produces fuel for use in trucks, he said, and those barrels are now included in the amount against which this fee is chargeable. That would change, he said. Natural gas liquids going down TAPS do not currently pay this fee, and under this change, they will pay the fee.

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REPRESENTATIVE BERKOWITZ asked the amount of the conservation surcharges.

MR. DICKINSON said it is about $8 million per year.

REPRESENTATIVE BERKOWITZ surmised that crediting it against the PPT would cost the state about $2 million.

MR. DICKINSON said it would actually be creditable dollar for dollar, so it would be the full amount if everybody is paying taxes.

REPRESENTATIVE BERKOWITZ said, "So it's not an expense? It's a credit."

MR. DICKINSON said that is correct.

3:49:09 PM

MR. MINTZ said the next few sections add and change definitions regarding the point of production. The gross value of oil and gas is calculated at the point of production, and that stays the same, but the point of production changes because lease expenditures under the PPT are incurred upstream. The main change is that currently gas processing plants are considered a downstream facility, which means that it is considered to have been produced before it goes through the plant and the liquid hydrocarbons (ngl) that are extracted are treated as gas under the current production tax statute. Under the PPT it generally doesn't make any difference whether something is gas or oil, he noted. The new definitions will result in considering anything a gas that is in a gaseous phase when it leaves mechanical separation or gas processing, and if it is in a liquid phase, it's oil. The impact is that the gas process will be subject to a deduction and a capital investment credit, he said. He said there is a definition of gas processing now, for the first time in statute. He said there is also a definition of gas treatment because it is important to point out that gas treatment is downstream of the point of production; it occurs after gas processing and it is the process of getting the gas into a transportable condition.

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MR. DICKINSON showed "a simple diagram of how this would work." He said fluids--oil, gas, and water--come out of a well. There is a mechanical separation, he said, and on the North Slope and Cook Inlet there would be something that looks like oil that goes into a pipeline, and there would be something that looks like gas--except for Prudhoe Bay--and those definitions are not

controversial. He said, “What we are changing is if you take a gaseous mixture of hydrocarbons, which is not yet produced gas, you send it to a gas processing plant. And the central gas facility on the North Slope would be an example of such a plant. In that gas processing plant, you would typically, through something like refrigeration, you produce a stream of heavier hydrocarbons that are going to be put in TAPS or used in Kuparuk, as I said earlier, and that is the point of production for those, what are currently gas but what we are now going to call oil, because they are heavier hydrocarbons in a liquid form. The gas processing also will generate the point of production for the gas, in other words, once you have that separation between those heavier hydrocarbons and the lighter hydrocarbons. In a situation where you’re going to sell that into a pipeline, after producing the gas you would then go into gas treatment, where you typically are removing things like CO2, getting that ready for a gas pipeline. The one situation which is on the very bottom [of the slide] is what happens if you build a plant in which both gas processing and gas treatment occur, and in that case, the point of production for gas, we’d simply go to the furthest point upstream, at which either gas processing ended or gas treatment began. And typically we’d be looking at the processes, and that’s what the definitions do, is go in and really identify which processes you’re doing to extract liquid hydrocarbons that you’re going to use and which processes you’re using to just get this gaseous mixture ready for sale to a pipeline.”

CO-CHAIR SAMUELS said the small oil companies right now have to pay the large companies who decide the rate. “Right now you’d be able to use the credits to build your own.”

MR. DICKINSON agreed; gas processing is upstream and therefore it qualifies for the credits and deductions. If someone finds gas and decides to build their own plant, they would get 40 percent of support. If they don’t build that plant, it will allow freedom in the negotiation process with a plant-owner trying to extract a high price for the use of that plant.

CO-CHAIR SAMUELS surmised that for someone drilling and dealing with oil, the state still allows them to build their own plant, using the credits rather than paying the big three producers.

MR. DICKINSON concurred.

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REPRESENTATIVE GARA asked whether "capital" includes just the cost of tangible items or if it includes the cost of labor.

MR. DICKINSON said it includes the labor. He said he is using the definitions in the tax codes. The total cost has to be capitalized for the number of years that the code requires. The code is written to require people to capitalize, he stated. The federal government will try to push things into capital while companies try to push them into operating.

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REPRESENTATIVE GARA asked about the labor after the field and the plant have been constructed.

MR. DICKINSON said once it is placed in service it no longer qualifies.

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MR. MINTZ said the next slide should be labeled Section 34, and it just repeals provisions that are superseded by the new tax approach. He said Section 35 provides that the new tax provisions would apply on or after July 1, 2006. It also provides that Section 11 would apply to oil or gas, no matter when produced because it is merely clarifying current law.

MR. MINTZ said Section 36 is the transition provisions, and the first four are designed to deal with the calendar years that have to be modified to apply to the half calendar year of July through December of 2006. He said subsection (e) is a transition provision that recognizes that in July, taxpayers will be filing for oil and gas produced in June, and that is under existing law, and it will continue to be applied. This assumes that there will be enough time for the department to develop and adopt appropriate regulations. At the end of August, taxpayers will have all the guidance they need to properly file their returns.

REPRESENTATIVE BERKOWITZ asked about how far back a retroactive tax can go.

MR. MINTZ said retroactive changes have been upheld by courts, but generally the time span needs to be relatively short.

REPRESENTATIVE BERKOWITZ asked the difference in revenue of going back to January 1, instead of July 1.

4:04:02 PM

MR. DICKINSON said further details are forthcoming but according to his recollection that would be approximately $450 million.

REPRESENTATIVE GARA said at a 25 percent tax rate it would be about $700 million.

MR. DICKINSON said that sounds about right.

REPRESENTATIVE GARA asked if the ELF started on January 1st.

MR. MINTZ believes the 1977 changes took effect on July 1, and he doesn't know when the 1989 changes took effect.

4:05:44 PM

MR. MINTZ said Section 37 is the transition provision that will ensure that regulations are adopted and implemented. He said Section 38 is conforming language to the captions of the various provisions. Section 39 includes miscellaneous changes in the bill that are not integral to the changes in the production tax "as such" and would take effect immediately.

4:07:04 PM

REPRESENTATIVE ROKEBERG asked about requested information.

MR. DICKINSON said there were 72 questions from the legislature.

REPRESENTATIVE ROKEBERG asked about the modeling of different tax and credit rate scenarios that were requested a week ago.

MR. DICKINSON said he had them.

REPRESENTATIVE ROKEBERG asked for information on gas production in Cook Inlet and comparing the ELF with the PPT, both with and without the $73 million allowance. He said it is very important to understand the impacts of the bill on Cook Inlet. He asked for information on the Chevron-Unocal amount of that. He wants another type of Cook Inlet exemption in order to encourage production in the next decade. He said the testimony showed that the PPT would raise taxes on Cook Inlet gas.

4:10:05 PM

MR. DICKINSON cautioned that there will be assumptions.

4:10:38 PM

BILL CORBUS, Commissioner, Department of Revenue, said the administration strongly supports the governor's bill, HB 488. He said the PPT will replace a broken ELF-based severance tax and provides incentives for development, with special incentives for small explorers. It will enhance state revenues, particularly in times of high oil prices. He said he wanted to make it clear that the governor made policy calls on the 20 percent tax rate, the 20 percent credit rate, and the $73 million exemption. He said Pedro van Meurs was the primary advisor, who was instructed to design a new tax regime that would accomplish two goals: increase state revenues based on what producers are paying in similar oil regimes around the world and to increase incentives. From August 2005 to February 2006, Mr. van Meurs suggested a 20 percent tax rate and 15 percent tax credit plan. His final proposal was a 25/20 ratio.

4:14:04 PM

MR. CORBUS said the governor appreciated those recommendations but wanted to tilt more towards investments, and so reduced the tax rate to 20 percent. "The governor has done a marvelous and unexpected thing for Alaska. He's gotten the producers to agree to increase their production tax by 100 percent and to build a gas pipeline."

REPRESENTATIVE BERKOWITZ said the legislature's job would be easier with more information made available to them. He asked if the administration looked at other systems besides a PPT, and why those were not chosen.

MR. CORBUS said he began working on the tax when the governor took office, and he did consider fixing the ELF by adding a price component and a heavy oil component. It became too complicated and the PPT route appeared to be preferable.

[HB 488 was held over]

ADJOURNMENT

4:17:06 PM

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 4:17 p.m.