**ALASKA STATE LEGISLATURE**
**HOUSE RESOURCES STANDING COMMITTEE**
March 7, 2006
12:36 p.m.

**MEMBERS PRESENT**

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

**MEMBERS ABSENT**

Representative Jim Elkins
Representative Mary Kapsner

**OTHER LEGISLATORS PRESENT**

Representative Ethan Berkowitz
Representative Les Gara
Representative Berta Gardner
Representative David Guttenberg
Representative Vic Kohring
Representative Woodie Salmon
Representative Bruce Weyhrauch

**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

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| 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 |
| 03/02/06 | (H) | Heard & Held |

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| 03/02/06 | (H) | MINUTE(RES) |
| 03/03/06 | (H) | RES AT 12:30 AM CAPITOL 124 |
| 03/03/06 | (H) | Heard & Held |
| 03/03/06 | (H) | MINUTE(RES) |
| 03/04/06 | (H) | RES AT 2:00 PM HOUSE FINANCE 519 |
| 03/04/06 | (H) | Heard & Held |
| 03/04/06 | (H) | MINUTE(RES) |
| 03/06/06 | (H) | FIN AT 12:30 AM HOUSE FINANCE 519 |
| 03/06/06 | (H) | Presentation by Legislative Consultant |
| 03/06/06 | (H) | RES AT 12:30 AM HOUSE FINANCE 519 |
| 03/06/06 | (H) | Testimony by legislative consultant |
| 03/07/06 | (H) | RES AT 12:30 AM CAPITOL 124 |

**WITNESS REGISTER**

ROBYNN WILSON, Director
Tax Division
Department of Revenue (DOR)
Anchorage, Alaska
POSITION STATEMENT: Presented HB 488 on behalf of the governor.

DAN DICKINSON, Consultant
to the Governor
Juneau, Alaska
POSITION STATEMENT: Presented HB 488 on behalf of the governor.

ROBERT MINTZ
Assistant Attorney General
Oil, Gas, and Mining Section
Department of Law (DOL)
POSITION STATEMENT: Presented HB 488 on behalf of the governor.

**ACTION NARRATIVE**

**CO-CHAIR RALPH SAMUELS** called the House Resources Standing Committee meeting to order at 12:36:04 PM. Representatives Crawford, Gatto, Kapsner, Elkins, LeDoux, Olson, Samuels, and CO-CHAIR RAMRAS were present at the call to order.

HB 488-OIL AND GAS PRODUCTION TAX

12:36:24 PM

CO-CHAIR SAMUELS announced that the only order of business would be the continued discussion on the proposed profit-based petroleum production tax (PPT).

12:37:23 PM

ROBYNN WILSON, Director, Tax Division, Department of Revenue, introduced Dan Dickinson as a consultant to the governor's office and former director of the division.

DAN DICKINSON, Consultant to Office of the Governor, told the committee members to get as well informed as they can on this issue. The governor has made his judgments, and Mr. Dickinson said he has heard interesting ideas from the legislators. He said he will tell the committee how the policy calls by the governor are the correct ones. Regarding direct lease expenditures, the legislature has justified concerns about how the division will audit those. Giving substantial weight to industry practice has been questioned, he stated, because "it really seems to be turning things over to industry, not sticking up for the state's rights." He said to look at the safeguards that are built in and "to look at exactly what we said." He noted Section 160(c) where "what we have suggested doing there is looking at industry practice in the following situations: We want to look at industry practice that was in effect on December, 1, 2005, before folks were aware of what was going on here, so the kinds of deals they put together then, and secondly, and more important, when industry practice was subject to a negotiation with working-interest owners who were not the operator who had substantial bargaining power." He said three units out of twenty on the North Slope meet that qualification.

MR. DICKINSON said the state will be looking at industry practices "where adverse parties negotiated a deal and keep looking at each other with adverse economic interests in mind," and the state wants to take advantage of that. He said it would be great to be able to audit everything, but when he was the director he spent a lot more time talking about what would happen if the division were cut by 15 percent. He said the state doesn't intend to roll over. The built-in safeguards allow the practice of looking at how the industry defines costs to make sense. The state's auditing would be internal controls to see if industry is following those agreements and implementing arms-length transactions, he stated.

MR. DICKINSON said the adoption of royalty settlement methodologies is a policy call the legislature needs to review. He said it makes sense to have one set of auditors looking at a set of figures versus two sets of auditors looking at the same figures. Over the years different standards have been developed for royalty and for tax, "but the point is, if you go back up to

50,000 feet, are those differences that really create value for any party? And I would submit that they don't." He agreed that cross checking provides a better result, but in this instance there doesn't need to be two sets of rules interpreted by two sets of auditors. He said as long as there is the ability for the commissioner to define the rules, the commissioner should have the option of allowing the producer to use that for their net back for taxes.

12:44:43 PM

REPRESENTATIVE SEATON referred to the language saying "shall give substantial weight to", and he asked what flexibility that gives the commissioner.

12:45:20 PM

ROBERT MINTZ, Assistant Attorney General, Oil, Gas, and Mining Section, Department of Law, said the provision does give directions, but substantial weight is different from conclusive effect. There will still be room for judgment and discretion in making these determinations, he stated, but the commissioner would be expected to give substantial weight to industry practice as set out in the bill, "meaning that he can't just ignore industry practice and would not be limited to referring to industry practice, but that would be a substantial part of the input to the determinations, and presumably there would have to be a good reason to do something contrary to industry practices."

12:46:27 PM

REPRESENTATIVE SEATON said he is trying to figure out why statute should restrict the commissioner to develop a set of criteria. He suggested there would be more flexibility in allowing the commissioner to consider industry practice instead of directing him or her to use it. He also suggested it sets up the state for a future legal battle.

12:47:03 PM

MR. MINTZ said it is a policy call.

12:47:14 PM

MR. DICKINSON said he was just trying to acknowledge that there are ways for the state to "leverage work that is now being done

to its advantage. And so what we are trying to do is say we will look at that where those conditions exist." He said Mr. Mintz is right in that the legislature might decide the language is too strong. There are savings out there that could be captured if the state uses industry reports, he stated.

12:48:27 PM

MR. DICKINSON noted "downstream costs" are now audited by DNR under the standards set out in the royalty leases and by DOR under the standards set out in statute and regulations. He said the differences don't add value. Under the leases, there are four measures and the state can select the highest of those. He said it is not clear whether that is a monthly or yearly exercise, "but basically they can look at the value of the crude, they can look at the sales price of the crude, they can look at what others sold it for, or they can look at the posted price." In the royalty settlement agreements that closed out the Amerada Hess litigation, the state looked at the lease well before there were transparent or spot market prices, and said "we're going to go to a single value" based on a formula derived from spot prices of Alaska North Slope (ANS) or a basket of crude. The state decided that markets are sufficiently transparent so that using that technique as the starting place for royalty net-back, gives the state the same kinds of protections that were being built into the lease, he stated. Under current statute the DOR has two options. "It could either tax on the value of the sale - what someone got for that oil. Or, if that sale doesn't represent market conditions on the prevailing value for like-kind crude, again, what we're saying is, if we look at transparent markets and if this is working for the Department of Natural Resources in valuing our crude, we ought to be able to take that same standard and have it apply in valuing the crude for tax purposes." If DNR goes to a different standard, "then we might not adopt that anymore." The commissioner would have to write regulations saying what happens when the methodology doesn't work. He said the system is working and resources should not be used to re-create that work.

12:51:15 PM

MR. DICKINSON referenced Daniel Johnston's presentation which suggested a minimum value, "you shouldn't do worse than you could, so maybe you should leave the ELF (economic limit factor) in place and just have the higher of, similar to the Canadian system. " Mr. Dickinson countered that the state always has royalties, which generate half of the state's general fund

income. "If a severance tax goes to zero, it's very different than in Newfoundland when the tax formula goes to zero, because Newfoundland has no other way of getting revenues from the oil." He said Alaska also has property taxes and income taxes, so building in a minimum [tax] doesn't make any sense to him. He said Alaska has a minimum tax, but when applied to the ELF it is "no minimum at all." "If we're trying to make these credits effective, and we have this minimum ELF tax, would it be before or after the application of the credits?" he asked. He said he is not sure he understands how a $73 million tax-free allowance works in with a minimum tax. If the legislature wants a minimum tax, "some consideration should be given to those mechanics." A minimum tax would be more regressive, he stated. Mr. Johnston's idea of different [tax] regimes for different locations sounds attractive, he said, and that is what he tried to do in the bill by taxing profitability, which considers costs. Mr. Johnston also promoted progressivity, but "this bill makes the Alaska system much more progressive than it was." So the question is whether to make the tax system hyper-progressive and make this element more price sensitive, he said.

12:55:34 PM

REPRESENTATIVE GARA said the legislature received an opinion on the Cuno case [Cuno et al, v. DaimlerChrysler Inc. et al.], and asked if that has an effect on the differential taxes for Cook Inlet, heavy oil, or legacy fields, for example.

12:56:08 PM

MR. MINTZ said the Cuno case dealt with the Commerce Clause limitations on state taxation and the constitutionality of investment tax credits, not on differential taxes for heavy oil or different geographical areas. The issue "may be more of an equal protection issue, whether there are other constitutional limitations on the ability of the legislature to tax different taxpayers or different properties differently." He said that in general courts have treated the taxing power very generously, using the lowest type of scrutiny, which is if it has legitimate state interest. He said he doesn't expect that there would be an equal protection problem when there is an evident rational reason for differing taxes.

12:57:41 PM

CO-CHAIR RAMRAS provided an example of buying a new car and not buying one that is just better than the old one, but buying one

that fits current needs. "To say that this is better than what we have, I think there is already broad consensus in the room ... but I think this is a matter of trying to get a perfect fit: one that doesn't leave much money on the table and doesn't make the producers or their incentives go away."

12:59:21 PM

MR. DICKINSON said there is a balance between progressivity and other aspects of the tax. If prices went to $200 [per barrel], the state, clearly, should have been taking more, he stated. He added that the important aspect is the incentive piece "and the conditions under which the investments are going to be made." He told the committee to make a judgment and strike a balance. He said the balance that he came up with struck that balance between the incentives and getting enough money for the state.

1:00:57 PM

CO-CHAIR RAMRAS requested a summary document for the legislature so it can draw its own conclusions. He said he wants to know how many barrels are flowing per day and how much of a decline there is, "and what would happen if we moved rates up one point and we moved credits up one or down one ..." using a table instead of graphs.

1:02:49 PM

MR. DICKINSON said, "If you tell us what you want on that page, we'll put it on that page." He said he has gotten many requests. "We publish every six months – you can go and look and you can see how many barrels are flowing and what we are projecting for their decline, and we now even say how much off were our projections." However, he said he can't predict the outcome of a tax change.

1:03:34 PM

CO-CHAIR RAMRAS noted that changing tax credits is entirely different than changing taxes, and may have more effect.

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REPRESENTATIVE SEATON highlighted that DOR has only discussed a single tax rate. He then asked why this is called progressive, and why Mr. Dickinson used the term hyper-progressive for any tax escalator.

1:04:16 PM

MR. DICKINSON explained that the term progressive is being used to describe a situation in which when one variable changes there is another variable that changes more rapidly.

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REPRESENTATIVE SEATON said he knows what a progressive tax system is, but questioned Mr. Dickinson calling a fixed tax rate a progressive system.

1:05:11 PM

MS. WILSON explained that for income taxes, progressive means that as net income increases so does the tax rate. She noted people using the term "progressive tax rate" with respect to the price of oil. She questioned, "What happens if you've got one taxpayer that's really doing what we want and investing in the state, those costs, when it comes to setting the tax rate, are sort of ignored." Ms. Wilson highlighted information from Pedro van Meurs that specifies that many countries have a progressive tax rate with respect to the rate of production. It is important to know the definition of progressive, she stated.

1:07:01 PM

MR. DICKINSON said he [questioned whether] as the price of oil increases, the state's share increases. In that sense, he added, a 20 percent tax rate is more progressive than a 19 percent rate, "because of the slope of the line." He said that by taxing net profits, "you're increasing the progressivity in the sense of the early profits, the early revenues get absorbed by costs."

1:08:23 PM

REPRESENTATIVE BERKOWITZ said he still has not heard the answer on what is meant by a progressive tax. If it is a linear, or straight-line, function, it is a flat tax. A progressive tax has a curve, and he asked how the administration defines progressive, as well as profit, revenue, and production. He said these are all terms that seem to be interchanged, thus making it difficult to follow these discussions.

1:09:16 PM

MR. DICKINSON said:

> In general, when folks are talking about progressivity, they're talking about the relationship between either the price or the revenue, which are generally going be related, as compared to state take, and what the relationship is, one against the other. When ... if you are simply looking at percent of state take, for example, you illustrate the regressivity, because you say, gee, ... as the price goes up, the state's take falls. If you are looking at the amount that's taken as the price goes up, the state's take, as total dollars, is increasing. It's just the percentage of the total is decreasing. So you're absolutely right that we have not been disciplined on those terms when we're looking at any specific graph, the person looking at it may know precisely what they're talking about and ... on several occasions it has been clear to me that there have been conversations in which one person was thinking about it one way and the person they were talking to was thinking about it differently.

REPRESENTATIVE BERKOWITZ then requested that those speaking should define the terms when using them.

1:10:45 PM

REPRESENTATIVE LEDOUX asked if Mr. Dickinson used the term "progressive tax" to mean "proportionate tax".

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MR. DICKINSON said he is not familiar with that term's usage.

MS. WILSON said question number 1 has been addressed already, but she has added a table showing the amount of expenditures subject to the transitional adjustment. It is about a billion dollars a year in investment. She presented historical data through 2004 that can be extrapolated to show exploration for 2005 of about $94 million and development of $1 billion. For the first half of 2006, "those numbers would be $47 million for exploration, $500 million for development."

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MR. DICKINSON said, "We have done some work on the 2005 capital costs, so the extrapolation isn't just an average."

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REPRESENTATIVE ROKEBERG asked if it includes actual figures for all exploration and development oil firms in the state.

1:14:24 PM

MS. WILSON answered that it includes the main three producers. Answering a question about other tax regimes with progressivity, she said it is common around the world.

1:15:07 PM

REPRESENTATIVE BERKOWITZ asked how she is defining progressivity.

CO-CHAIR SAMUELS said the taxes are explained for each country.

1:15:31 PM

MS. WILSON said the question that she was asked to answer did not include asking for a definition of progressivity, "so it was answered generally to show you some of the different types of progressive structures around the world."

1:15:45 PM

REPRESENTATIVE BERKOWITZ said someone must have had an understanding of what the term meant when putting together this chart. He asked for that understanding.

MR. DICKINSON said Pedro van Meurs assembled the table, and noted that the figures "are indices that are tied generally to profit-sharing, occasionally to price sensitivity, so they're looking at the kinds of features we talked about which are going to drive the higher revenues or the higher profit and some aspect of the tax system driven by those."

1:16:32 PM

REPRESENTATIVE BERKOWITZ asked if he can assume that the chart represents any tax system whereby as profit or royalty or "whatever it is" goes up, the percentage of the take increases as well.

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MR. DICKINSON said he will let the chart speak for itself, but he will check to see if that assumption is correct.

REPRESENTATIVE BERKOWITZ said the chart doesn't speak for itself very clearly.

1:17:27 PM]

REPRESENTATIVE CRAWFORD asked if the chart's deep-water region represents Trinidad and Tobago or "the Gulf."

MS. WILSON said deep water would be part of Trinidad and Tobago.

1:18:08 PM

REPRESENTATIVE SEATON asked if "progressive" means that there are more dollars generated, "and we don't know whether that's based on production or price ... it's just absolute number of dollars."

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MR. DICKINSON said he is "pretty sure" that there is some feature of the tax systems listed on the chart "that if there was a linear projection would go one way, and ... some of them might be that you add, let's say, an extra percentage point when the price goes above x, but another one might say you add on another traunch of, you know, you make payments or you don't get ... you add another traunch of payments on, so ... you can't have this phenomenon where your percentage is increasing while your take is decreasing or vice versa."

1:19:30 PM

REPRESENTATIVE GATTO asked if is it possible [for the tax/credit] to be recessive and progressive at the same time, "because most of us are looking at the end result rather than the mechanism that reached the end result."

MR. DICKINSON said if the terms are defined differently, "you can be regressive in relation to one thing and progressive in relation to another."

1:20:07 PM

REPRESENTATIVE GATTO said, "If progressive is linear and regressive is not linear ... it's hard to get information that's useful without taking [a] class – it's just conversation."

1:20:24 PM

MR. DICKINSON said linear depends on what is being plotted.

1:21:12 PM

REPRESENTATIVE ROKEBERG said if the tax rate is too high, then a progressive system can become regressive too.

1:21:35 PM

MS. WILSON referred to question 11 and the table on page 4, which shows expenses versus credits in the last two years.

1:22:13 PM

REPRESENTATIVE BERKOWITZ asked if is there any way to access whether those projects that took advantage of the incentives would have taken place anyway.

1:22:22 PM

MR. DICKINSON suggested determining that with interviews. He recalled testimony from Pioneer that the credits were critical, although he opined that some of the projects drilled the first year of the credit would have occurred even without the incentive.

1:22:44 PM

REPRESENTATIVE BERKOWITZ suggested that the incentives in the bill should be targeted to provide the maximum benefit.

MR. DICKINSON said there have been informal conversations with explorers. He recalled being told that the credit is very useful, but ultimately opinions varies, and it is difficult to assess.

1:24:08 PM

MS. WILSON said these things are difficult to interpret in retrospect. She then turned to question 18 which is in regard

to relying on outside expertise and whether outside advice resulted in any changes to the legislation. She answered that the bill reflects discussions with counsel that took place during the drafting process. She said the advice was not given in a formal manner.

1:25:25 PM

REPRESENTATIVE SEATON asked about question 11 and if the tables on the top of page 4 show that the state had $104 million in expenses and about a 30 percent tax credit already paid on those expenses on that development.

1:26:00 PM

MS. WILSON said that is correct; of the $104 million in expenses, there were 33 claimed credits based on that. That particular statute offers two different rates, she said, so it is not a clear percentage.

REPRESENTATIVE SEATON asked if those are "the same expenses that would be claimed in the transitional for another 20 percent credit."

1:26:36 PM

MS. WILSON answered that they would qualify as capital expenditures as defined in the definition section. She said that just as current capital expenditures are subject to both a deduction and the credit, it is true that those taxpayers would have claimed a credit and then claim a transition deduction, as well. "In this table, I've addressed the credits that were claimed, which is what was available then, and they would be subject to the transitional deduction, in effect, the depreciation for the transition. So it is subject to both a credit and a deduction," she explained.

1:27:31 PM

REPRESENTATIVE SEATON surmised that the transition provision does not allow a credit for capital, but only allows a deduction.

MS. WILSON said that is correct – it is a deduction.

1:27:49 PM

REPRESENTATIVE ROKEBERG asked Mr. Mintz about question 18 and if it is the policy to ask the governor's office to ask the Alaska's congressional delegation to support remedial legislation to overcome the Cuno v. DaimlerChrysler case and any issues that may arise about apportionment of tax. He said he is referring to the March 1, 2006, letter from Marvin Kirschner that raises two issues: the Supreme Court's ruling on the legality of subsidized tax incentives, and the introduction of HR 2471 and SB 1066 in Congress to ameliorate it. He said Mr. Kirschner addressed the issue of the validity of a state tax imposed on a foreign corporation in regards to the Commerce Clause not allowing discrimination against interstate commerce. He stated that there may be a need for remedial legislation in order to deal with the bill.

1:30:00 PM

MR. MINTZ said he doesn't know the governor's policy on seeking remedial legislation, but there may not be a need because the case is before the United States Supreme Court. Even if it's vacated, the U.S. Court of Appeals has extended the Commerce Clause to tax types not previously thought to be problematic from the standpoint of that clause. "The Cuno case basically held that investment tax credits in a state income tax are discriminatory against interstate commerce," he said, and it would seem to apply to the tax credits in the bill. However, it doesn't necessarily apply because there is a difference between income tax and production tax. Every state will have the same issue. He cited a case with Montana's coal severance tax in which the Supreme Court ruled "there's really no problem in terms of apportionment or discrimination for a severance tax because the severance has to take place only in the state where the resource is located." The court upheld the property tax exemption in the Cuno case, he noted. There are several possible outcomes, and if it invalidates the tax credits in this bill, there are ways to seek a congressional remedy.

1:33:49 PM

REPRESENTATIVE ROKEBERG said Mr. Kirschner also equates the PPT with a value-added tax. These issues need to be addressed as this legislation moves forward, he stated.

1:34:45 PM

MS. WILSON moved on to question 24, which asks what standard will be used to determine whether oil or gas is of pipeline

quality under the definition of "gross value at the point of production." Current statute taxes the gross value at the point of production to ensure that the costs of production downstream of the well would not be deductible in calculating the taxable value of oil and gas, rather taxable value would be calculated at the point that production is complete. She said that in the case of oil, gross value at the point of production was defined as the value of oil where it is metered in the condition of pipeline quality--in good, merchantable condition. "This definition essentially adopts commercial standards of marketability for oil. HB 488 and SB 305 would simplify and shorten the definition of gross value at the point of production for oil but does not materially change it. The definition of oil is broadened to include liquid hydrocarbons recovered by gas processing in the case of leases or property whose production is subject to gas processing," she said. For gas, the bill and the existing statute do not use the phrase "pipeline quality" or "good and merchantable condition," but the definition of gross value at the point of production is interpreted by regulations 15 AAC 55.900(a)(6)(B) and (C). "The new bills retain this concept, but in effect, expands separation to include gas processing so that in case of leases or properties whose production is subject to gas processing, the point of production for gas recovered by gas processing is the point where it is metered downstream of the processing," she explained.

1:37:27 PM

REPRESENTATIVE BERKOWITZ said, "It seems to me that gross value at the point production is not a fixed definition and is something that could be subject to change based on a series of criteria listed, primarily in section 2 and 3 of Section 20 on page 11. I was wondering how that could affect the definition of gross value at the point of production."

1:38:08 PM

MR. MINTZ said Section 20 really doesn't purport to change the definition, but it provides options for different methods to calculate the gross value for purposes of simplification. Gross value at the point of production is defined in the definitions and it is also addressed in existing AS 43.55.150(a), which refers to the net-back principle for calculating gross value.

1:39:04 PM

REPRESENTATIVE BERKOWITZ said definitions are normally fixed and objective, but Section 20 allows the definition to mean royalty value, a formula proscribed by the department, or another formula. He added that the terms are central for assessing value and they could mean any number of things.

1:39:45 PM

MR. MINTZ said Section 31, page 19, of the bill has the definition of gross value at the point of production. He said, however, that it is true that a calculation can come up with somewhat different figures, "and, of course, it's always been a fruitful area for controversy between taxpayers and the department in terms of getting to the right number. But the underlying definition is not something that varies."

1:40:29 PM

REPRESENTATIVE BERKOWITZ asked if the change in definition is critical to the PPT or part of the cleanup.

MR. MINTZ said it is not critical to the PPT itself, but it isn't merely cleanup either. It is there to reflect a policy choice, "mainly as to promoting or improving the economics of gas processing to facilitate smaller producers on getting into North Slope development."

1:41:15 PM

REPRESENTATIVE BERKOWITZ asked about possible alternatives.

MR. MINTZ said it could have been left as is, changed to an "ad hoc method of ... incentivizing ... improving the economics of gas processing," or changed to some other method. He said this "isn't a situation where current definitions are broken, but I think there is some clarity that's been added to the definitions that should be helpful. He said it is "not really central to the basic change in the taxation."

1:42:10 PM

REPRESENTATIVE BERKOWITZ asked for a better description, in writing, of the policy debate behind the policy change.

MR. DICKINSON said his presentation will cover the choices.

REPRESENTATIVE SEATON referred to hydrocarbons recovered in cases of leases in which production is subject to gas processing, and asked if that definition of gas processing includes Prudhoe Bay "where gas comes out ... [and] it is all injected, there's no sale of that."

1:43:25 PM

MR. MINTZ said re-injected gas and gas used in operations is tax exempt and considered not produced.

1:43:53 PM

REPRESENTATIVE SEATON said he is referring to gas that is re-injected, and asked if "subject to gas processing" means that those gas liquids would not be considered to be oil until the gas is processed and sold.

1:44:36 PM

MR. MINTZ said, "The gas that comes out of the central gas facility, the gas processing facility, it's a little bit paradoxical. If it's metered after that point, it has gone to point of production, but because of the exemption for gas that's re-injected, it's not considered produced."

REPRESENTATIVE SEATON asked if, in that case, this oil, or liquid hydrocarbons, would not be defined as oil.

MR. MINTZ said it would still be oil, but if those liquid hydrocarbons are used in the operation of the lease or property, they would be tax exempt under this bill.

1:45:51 PM

MR. DICKINSON said he struggled with that issue five years ago and put into the regulations the following: a facility may be a gas processing plant with respect to certain of its products even if it's not a gas processing plant with respect to other products.

REPRESENTATIVE CRAWFORD said that the language says that those liquid hydrocarbons are taxed the same as oil, and he asked if oil is taxed at different levels with regard to the value of it.

1:47:18 PM

MR. DICKINSON said, "Those can differ in value widely...what you will typically find in the Lower 48 is a plant that when, let's say, ethane suddenly becomes more valuable as ethane, they'll pull out the ethane and sell it. And when suddenly it becomes more valuable for its BTU value, they'll leave it in the gas." But on the North Slope, he said, there is nothing to do with the ethane.

1:48:15 PM

REPRESENTATIVE CRAWFORD said, "So that 45,000 barrels of liquid hydrocarbons, we call it oil and that's the proper value ... it's not more expensive at the point of sale, and we tax it at the same rate as oil."

1:48:41 PM

MR. DICKINSON said under the current system, the state values it like oil but taxes it like gas. "You dump them into TAPS [Trans-Alaska Pipeline System], they get commingled in with the stream as they move down TAPS." He said some people will argue that, because those are so volatile, most of the losses in TAPS are from those natural gas liquids (NGLs), so they haven't added that much value. But purchasers of the oil will know it includes a percentage of volatile hydrocarbons, and the state takes the prevailing value and adds that value to both the NGLs and the oil. "We net it back" all the way up to pump station [x], and at that point the state takes the oil "times 15 percent, times the oil ELF, and we have some gas here, we'll take that times 10 percent, times the gas ELF. But the starting value for both will have been calculated through the exact same net-back process. So we value it like oil, but we tax it like gas."

1:50:14 PM

MS. WILSON continued with question 25 regarding the historical analysis of the results of valuation methodologies adopted by the Department of Revenue, Department of Natural Resources (under all agreements) and the [US] Department of the Interior. She said that although much is parallel in the calculation of gross value at the wellhead between the royalty and tax, many differences have developed. Both start with destination value, she said, and then tankering, pipeline, and other costs are subtracted to arrive at a wellhead value. She said DOR valuation comes from statute and regulation. The DNR valuation for royalty comes from lease contracts, supplemented by the

royalty settlement agreements, which are different for each large North Slope producer, she added. For DOR, destination value is the price for which the oil was sold or when the oil is not sold for market price, the prevailing value or spot price is used. For DNR, that value is a formula driven by the ANS or a basket of similar crude, she said.

1:51:55 PM

MR. DICKINSON noted that it is the ANS spot price.

MS. WILSON said each method subtracts marine transportation, TAPS, feeder-line, and other costs. She explained that DOR deducts the costs specific to each taxpayer, while for royalty, some of the [reimbursable services agreement] RSAs have a formulaic deduction, and others use the royalty payer's actual costs. She said DNR subtracts field costs for most DO1 leases on the North Slope while DOR does not. The differences between wellhead values narrow across time, she added. The average difference for 2000 through 2005 was 3.9 percent, but the average difference for the last 12 months was 6.1 percent, she stated. "The critical point is that the DOR uses actual proceeds and only resorts to prevailing value when the conditions of zero to zero F are met, that is, sort of the non-arms'-length transaction. Thereby taxing on the higher proceeds or prevailing value. For each of the three producers DNR uses a single-destination formula based on spot prices rather than actual proceeds," she concluded.

MS. WILSON moved on to question 34, which relates to how many investment credits were sold under SB 185 and one ensures the person who holds the credit, not the original recipient, receives the credit. She noted that only two credits have been issued and sold to another party.

1:54:19 PM

REPRESENTATIVE BERKOWITZ asked if the two credits were sold at a discount or at full value.

MR. DICKINSON said they were sold at a discount.

REPRESENTATIVE BERKOWITZ asked how much of a discount.

1:54:33 PM

MR. DICKINSON recalled that it was about 90 percent.

1:54:45 PM

REPRESENTATIVE BERKOWITZ asked if smaller producers sold the credits to bigger producers.

MR. DICKINSON said that is correct.

CO-CHAIR SAMUELS asked if it is always public information and not a private transaction.

1:55:14 PM

MR. DICKINSON said, "We would know about it ... but that would not make it public information."

REPRESENTATIVE ROKEBERG said he thought there was a registry of certificates.

1:55:54 PM

MS WILSON said the division obtains a waiver of confidentiality from the seller, which allows the division to confirm that the credit exists to a prospective purchaser, and once sold, the division makes the transfer and issues the credit to the purchaser.

1:57:07 PM

REPRESENTATIVE BERKOWITZ asked if there is a tax consequence for the transaction.

1:57:27 PM

MR. DICKINSON said he believes the purchase would be an ordinary and necessary way of going about business, "you could either have the deduction for the tax or the deduction for purchasing the credit. I believe you'll get a smaller deduction as a consequence of it. Again, for the seller, that would show up as income to them. They could not use it otherwise, so ... it will be a transaction just like any other ... to carry on their business."

1:58:16 PM

REPRESENTATIVE BERKOWITZ said, "So, if the purchaser buys a dollar's worth of credit for 90 cents, is that viewed as 10 cents of income?"

MS. WILSON said, "I would expect that there would be a dollar claimed as income and 90 cents written off as a deduction against that."

1:58:48 PM

REPRESENTATIVE ROKEBERG asked if the bill contemplates using the same methodology for the registration of the certificates and if the discounts can be published or if they are proprietary.

1:59:16 PM

MR. DICKINSON said anything could be published in a disguised or generalized form.

REPRESENTATIVE ROKEBERG asked about the state helping to generate a market [for the credits].

1:59:55 PM

MR. DICKINSON said that would be similar to the salmon pricing report, which presents the price for which things are being sold. He said the department could do so, given that direction.

2:00:07 PM

REPRESENTATIVE OLSON asked about question 25 and Cook Inlet.

2:00:24 PM

MS. WILSON said that information will be included in the final packet. She then turned to question 40 regarding whether other nations with a net-profit system have the 90 percent payment of taxes with the sure-up provision the following year, and what the economic impact of this change is. She said net-profit systems work on the basis of three different concepts, including monthly payments without an annual true-up, yearly payments without monthly payments, and yearly payments based on a yearly-return with monthly payments on account. The monthly payments could be based on estimates for a month or based on actual information from the previous month. She explained that corporate income tax style procedures are when payments are based on taxes paid in the prior year, which is used in Norway.

The 90 percent rule proposed in HB 488 is unique, she stated. The overall economic impact would depend on the taxpayers' cost estimates for each month. She said she expects underpayments in some months and overpayments in other months. However, she said she does not expect any material net economic impact from this aspect of the bill.

2:02:08 PM

MS. WILSON continued with question 66 and its answer:

> The discussion of oil field needs, i.e. not to deplete the gas pressure, did not recognize the CO2 re-injection. How will that lengthen the field life(s) and at what volumes, i.e. how will it affect taxes?
>
> At Prudhoe Bay, about 8.5 billion cubic feet of gas a day is reinjected into the field for pressure maintenance. After stripping out certain hydrocarbon liquids, CO2 is reinjected along with the other hydrocarbons (and non-hydrocarbons). When an export line is built on the North Slope, the CO2 will be stripped (in "gas treatment"), and there is some question about what will happen with that CO2.

2:02:47 PM

REPRESENTATIVE BERKOWITZ asked if someone from DNR will be available to explain such answers.

CO-CHAIR SAMUELS offered to speak with the commissioner's office regarding such a request.

2:03:08 PM

MR. DICKINSON emphasized that the main point is that no independent CO2 injection is occurring now, which would be a consequence of the gas line.

REPRESENTATIVE BERKOWITZ commented, "One of the collateral points is that DNR has been conspicuous by its absence at this point."

CO-CHAIR SAMUELS said that he invites Mr. Dickinson to come before the committee and any complaints [regarding who is present to answer questions] can be directed to him.

2:04:07 PM

MS. WILSON moved on to question 67 and its answer:

> What happens if the "Big Three" sell off their assets to 20 smaller companies? Will the significant tax benefits ever be realized?
>
> Assume 20 new companies suddenly showed up on the North Slope and each qualified for the $73 million dollar allowance. A total of $1.4 billion in profits would be sheltered from taxes. If these companies had simply purchased their way in, then taxes would be lower by $280 million (20 percent of $1.4 billion) than they would be otherwise. At current prices, or say even at $40 oil, this could be a material portion (though not all) of the tax.
>
> If that is the future of the North Slope and the sell off was for business purposes, the Legislature may choose to act and make it less attractive to new firms coming in. If these were tax-motivated sales, we hope the powers of the commissioner that are built into the bill would prevent the new entrants from using the $73 million allowance.

2:05:08 PM

REPRESENTATIVE LEDOUX inquired as to the built-in powers of the commissioner that would prevent the new entrants from using the $73 million allowance.

2:05:19 PM

MS. WILSON specified that the bill contemplates that the department will qualify recipients of the $73 million allowance on a yearly basis.

MR. DICKINSON directed the committee's attention to page 16, subsection (j), which sets forth the powers of the commissioner.

MS. WILSON clarified, "And so it is upon written application, and it's done on a calendar year basis."

MR. DICKINSON pointed out that the language specifies that it includes any information the department may require, and therefore its relevance is a determination of the commissioner.

2:06:11 PM

MS. WILSON moved on to question 73: "Will the new confidentiality provisions extend to or have an effect on any other taxes besides the production tax?" She began by noting that the general confidentiality requirements in AS 43.05.230 covers all of the taxes. The confidentiality provisions included in HB 488 are what she characterized as an extra detail specific to production taxes.

> The new confidentiality language added by secs. 4 and 16 of the bill applies only to information relating to the oil and gas production tax, not other taxes. This is because:
>
> (1) AS 43.55.040(1) addresses information "necessary to compute the amount of the tax," and the phrase "the tax" is used throughout AS 43.55 as referring only to the production tax; and
>
> (2) AS 43.55.040(1) deals only with information obtained from persons "engaged in production," or their agents, and with purchasers "of oil or gas," and with owners of a "royalty interest in oil or gas."

2:07:25 PM

MS. WILSON continued with question 77 and its answer:

> How much gas was flared so as to trigger taxes and/or penalties in recent years?
>
> During FY 2005, 351,000 Mcf of gas was flared that was considered gross taxable production. Of that, only 120,000 Mcf was from fields with a positive ELF and subject to tax. During the same period 31,000 Mcf was flared and considered waste and subject to both tax and penalty.

2:07:59 PM

REPRESENTATIVE BERKOWITZ asked if there is a value for that.

2:08:06 PM

MR. DICKINSON answered that he didn't have it with him, but he recalled that the regulations for prevailing value establishes a ratio to oil value. He estimated that it would be $3-$6 per Mcf.

REPRESENTATIVE BERKOWITZ surmised then that it's between $100,000-102,000.

MR. DICKINSON specified that it's the gross value and then 10 percent of that would be taken. As alluded to earlier, this isn't shaping behavior.

2:09:04 PM

MS. WILSON read the following questions and answers:

> 80. When the 1989 ELF change was enacted, was it retroactive and were there transition provisions?
>
> The 1989 ELF changes were made retroactive to January 1, 1989, and applied to oil produced after December 31, 1988. There was a transition provision to the effect that tax payable as a result of the retroactive changes would be due on the 20th day of the calendar month following the effective date of the Act. (The effective date of the Act was August 6, 1989.)

2:09:38 PM

> 82. Under the new gas and oil definitions, what will the net change to the spill fee be? In other words, looking at FY 2005, how much, if any (a) oil did we tax for its use in production operations and (b) how many NGLS were put in TAPS?
>
> During FY 2005, tax was collected on 1,222,400 barrels of crude oil used in production operations. During FY 2005, 16,445,000 barrels of NGLs were put in TAPS.

2:10:10 PM

> 83. For sales of credits by the smaller interests, estimate the price at which those credits will no longer have a market among the big three?
>
> Credits may be used in the year of expenditure, carried forward to following years, or transferred

(they are fungible). If transferred, the credit cannot lower a severance tax rate below 80 percent of what it would otherwise be [AS 43.55.024(e)]. These credits will have market value that would not exceed 20 percent of their face value ($1,000 in capital expenditures would save $200 in State severance taxes). A company generating them but unable to use them would face a choice - sell them or use them the following year (if they have taxable income). Use the next year reduces the value of the credits due to discount rate. Oil companies typically try to use a 15 percent discount rate but will often settle for less, say 10 percent. This means, all other things equal, they would be willing to sell a $1,000 credit ($5,000 capital expenditures) for $900 (10 percent discount rate) or more. Conversely, another company would be willing to pay up to $999 for the credit to save $1,000 in State severance tax.

If we assume a billion in spending, assume that 10 percent of that was for little companies that would want to sell their credits, so $200 million in credits are for sale. With our 20 percent limit, that implies that if the big three had a billion dollar in tax obligations, that market could absorb all the credits. As our fiscal note shows, if the price of oil is $40 [$60] or above, all of the credits would be usable in the immediate year. If oil falls below $40, then we expect that the credits would be fully utilized within two or three years. While the time-value of money means that those certificates would be discounted, we believe that the certificates would still be marketable.

2:12:28 PM

84. If aggregation at Prudhoe Bay had been implemented on July 1, 2001 [the start of the claw back period], how much more would the State have received between then and the actual aggregation date?

The State would have received $430.4M additional revenue.

MS. WILSON drew attention to the table included with question 84 on page 9 of the question and answers. The table assumes that all taxpayers are paying under the aggregated ELF.

2:13:08 PM

> 85. Why are the status quo lines in the three graphs presented by Ms. Wilson flat once the forecast price effect is adjusted for? Wouldn't falling production and ELF move those down?
>
> The status quo drops from $378 mm in 2009 to $291 mm in 2012. It looks flat because of the scale on the graph.

2:13:34 PM

REPRESENTATIVE BERKOWITZ asked if Ms. Wilson has matrixes with numbers in them that could be made available to the committee.

2:13:45 PM

MS. WILSON replied yes. She related he belief that question 85 references the three charts in her presentation before the committee the week before last.

2:14:00 PM

REPRESENTATIVE ROKEBERG asked if the actual numbers have been published.

2:14:14 PM

MS. WILSON specified that the department is working on the numbers and the modeling.

2:14:47 PM

REPRESENTATIVE BERKOWITZ asked if the model will be available to the [committee/legislature].

2:14:54 PM

MS. WILSON replied no, noting that the model contains confidential taxpayer information nor is it readable by more than a few individuals.

2:15:19 PM

REPRESENTATIVE BERKOWITZ questioned why a model would have confidential taxpayer information. He then indicated that it would seem up to the legislature to determine whether the model is user friendly or not.

2:15:35 PM

MS. WILSON commented that the model is so user unfriendly that she doesn't even use it. She opined that the commissioner will provide the chair with a letter on this matter.

2:15:59 PM

CO-CHAIR SAMUELS opined that generally speaking the department has done a fairly good job providing the committee with the information it has requested.

MS. WILSON said that she has attempted to provide as much information as possible. However, since modeling takes some time, other information has been provided [while the modeling continues].

2:16:37 PM

MS. WILSON continued with the following questions and answers:

> 86. What will the actual cost to the investor be for these upstream investments and what is the total government underwriting, state and federal, all tax types included. Is it different for large companies and small companies?
>
> After state and federal tax, the investor would bear about 38 percent of the marginal capital. There is no reason to think it would differ appreciably between large and small investors.

2:17:20 PM

> 87. Lord Browne famously said two years ago that any profits over $20 a barrel were being returned to shareholders as they weren't needed in BP's business. What tax rate, credit rate would be needed to have a cross over [unspecified period] at $20 [presumably Brent].

With a  20 percent credit, it would take a tax rate of about 51 percent to affect a crossover at $20 Brent.

2:17:49 PM

REPRESENTATIVE BERKOWITZ said he would like to know some of the assumptions that lay behind that determination. He recalled that under the current 20/20, the crossover point would be about $26 or $27 and thus he surmised that [the tax rate] would have to reach about 51 percent in order to have a crossover point.

MS. WILSON offered to expand on the answer in the final document with the assumptions.

2:18:13 PM

MS. WILSON continued with questions 88 and 89 and their answers:

88. Please explain how the conservation surcharge is affected by oil price and what affect this bill has on the surcharge.

a. The conservation surcharge is a 3 cent per barrel charge on all oil produced less royalty barrels, so therefore it is not sensitive to price.

b. There will be changes in the quantity of oil subject to both production tax and conservation surcharges under the bill. One change will be positive, one negative. The positive change is that natural gas liquids extracted by gas processing and blended in the TAPS stream that are now taxed as gas, will be treated as oil under the bill. The negative change is that oil that is used in lease operations will not be taxed or subject to surcharge under the bill. Oil may be used to make fuel for lease operations and perhaps used for other production purposes. The overall result is an expected increase of the total surcharge amount of $444,000 per year, based on FY 2005 amounts. (See Question 82.)

The bill should not affect the assessment or collection of the surcharge, other than the quantity-of-oil effects described above. Any surcharge paid will be allowed to be credited against production taxes, but that would only reduce the amount of tax collected, not the amount of surcharges collected.

2:19:51 PM

89. Why are we including gas in the PPT calculation?

The bill includes gas in the PPT calculations because it is a stand-alone bill. The bill does not require implicitly or explicitly that a Stranded Gas Contract be subsequently concluded. Therefore, a PPT law would be entirely functional in case a Stranded Gas Contract is not presented to the Legislature or in case the Legislature rejects such a Contract.

The ELF system for gas is "broken" just as the ELF is "broken" for oil. The gas ELF does not encourage reinvestment and it is not sensitive to price.

It should be noted that under high gas prices, the Alaska State take for gas would increase significantly relative to the status quo. This would be beneficial in case significant gas reserves would be developed outside the scope of the Stranded Gas Development Act.

The inclusion of gas in the PPT is therefore a strong incentive for producers to conclude a Stranded Gas Contract that is in the interest of the State of Alaska. Including gas in the PPT enhances the bargaining position of the State for a good Stranded Gas Contract.

2:21:09 PM

REPRESENTATIVE BERKOWITZ highlighted that the economics for gas and oil are different, and therefore inquired as to why the tax is the same.

2:21:26 PM

MS. WILSON specified that one of the principal reasons is related to the problem of allocating cost to both oil and gas, and therefore this legislation attempts to balance the differing aspects and provide some simplification. Ms. Wilson said that although to do accounting to allocate equipment to both oil and gas can be done, it was a policy choice not to do so in this legislation.

2:22:09 PM

REPRESENTATIVE BERKOWITZ asked if other jurisdictions treat [oil and gas] identically.

MR. DICKINSON said that oil and gas is frequently treated differently. In further response to Representative Berkowitz, Mr. Dickinson said that he couldn't say that other jurisdictions treat [oil and gas] identical in all aspects. However, there are jurisdictions that treat capital credits [the same] irrespective of whether its oil or gas. He offered to provide further information on this to the committee.

2:22:56 PM

CO-CHAIR RAMRAS drew attention to question 1 and the bright line in regard to the cost allocations for exploration and development. He then inquired as why there is such a disparity in those amounts. He opined that much of what is desired is to spur exploration and then [allow] economics to drive the development. He also inquired as to the definition of exploration and development within the legislation.

2:24:14 PM

MS. WILSON pointed out that the internal revenue code draws a clear line between exploration and the intangible billing costs, which include development, well drilling, et cetera. Therefore, she suspected that federal rules should be reviewed in order to get the breakdown.

2:24:59 PM

MR. DICKINSON said there is no definition of [the terms exploration and development]. He explained that there is a development in which the producer is discussed and from which there is expansion in order that the language applies to an explorer also. Mr. Dickinson noted that over the years, much energy was spent in attempts to determine whether delineation wells were production or exploration. The decision was that the aforementioned doesn't matter.

2:25:34 PM

CO-CHAIR RAMRAS questioned whether [finds] in an existing oil patch are considered exploration or development. He then recalled that [the legislature] is supposed to be encouraging frontier exploration and keeping that separate from legacy fields. Co-Chair Ramras asked whether exploration and

development should be distinguished or does DOR want them to be kept together.

2:27:07 PM

MR. DICKINSON answered first by acknowledging that the legislature is free to decide this matter. He encouraged everyone to think about why frontier exploration is better than other means of obtaining oil. If a player has leased land with facilities that are under utilized, the question becomes whether a different fiscal system should be created than for a frontier explorer. The question then further becomes where to draw the line, he said. The administration would advise that no gains are made by attempting to determine whether [dollars spent] are exploration dollars or production [development] dollars.

CO-CHAIR RAMRAS specified that he would like to have definitions of the following terms: development, exploration, and production. Co-Chair Ramras said, "To some extent BP's development dollars will be when it's good economics, but it feels like to me - part of what we're charged with - is to encourage and incentivize exploration." The aforementioned, he said, are different activities.

2:29:20 PM

MR. DICKINSON acknowledged that everyone's dollars are based on economics. He clarified that his point is that there are many ways to achieve getting oil into the pipeline, and the question is in regard to how much energy should be expended in regard to determining the economics of certain situations.

2:29:54 PM

CO-CHAIR RAMRAS related that one of the central messages he took from Mr. Johnston's testimony yesterday was that taxes don't matter, but credits do. If the aforementioned is correct, then he would estimate the ratio of exploration dollars to development dollars to be 40:60. Co-Chair Ramras opined that in spite of the credits, the economics are either there or not when taking an existing field to exploit it using new technology to extract more hydrocarbons.

MR. DICKINSON suggested that the committee consider the costs of the exploration well that discovered Prudhoe Bay versus the tens of billions of dollars that have been spent to develop Prudhoe Bay. He then suggested the committee think about a situation in

which a developer sinks four wells and finds one 50 million barrel accumulation. In the aforementioned scenario, the developer's costs will be much higher in relation to the amount of production. In some sense, [a developer] would like exploration costs to be as low, in relation to what is spent on total development, as possible.

2:32:06 PM

CO-CHAIR RAMRAS related his understanding that the aforementioned examples are precisely the argument for making the exploration credits much higher than the development credits. Co-Chair Ramras indicated that all would agree that 20 percent is appropriate for development credits, but he highlighted his understanding that Mr. Dickinson had just argued that exploration credits should be 50 percent.

MR. DICKINSON replied that such is the philosophy [the administration] articulated and to which the legislature agreed under SB 185. He acknowledged that an argument for additional focus on exploration can be made, but [the administration's] point is that a focus on all aspects of getting the oil out of the ground will yield a better result. "As a policy matter, we think it's good to support it through the full cycle and as a practical matter maybe I'm over-focusing on this, as an ex-bureaucrat, is creating these valueless distinctions which then everyone gets to spend their time arguing about. And you step back ... and you go what was that all about? It seems, to us, not a useful exercise," he explained.

2:33:39 PM

REPRESENTATIVE CRAWFORD related that it has been suggested and seems to be the will of many that [the legislature] should incentivize wildcatting. He said he didn't know how the need to incentivize wildcatters could be more clear because wildcatting isn't related to the economics of a particular field.

2:34:44 PM

MS. WILSON commented that she agrees with incentivizing all production. However, under this legislation the credits under [AS 43.55].025 are an alternative credit and for certain exploration costs provide a 40 percent credit.

2:35:26 PM

REPRESENTATIVE SEATON surmised then that the PPT looks to incentivize anything, including wildcatting, that is an expenditure to produce more oil and fill the pipeline.

MR. DICKINSON agreed with Representative Seaton's assessment. He said that he also agreed with earlier comments regarding that it's more effective to intervene earlier. "The point is if you are making the switch from net to gross and you are financing, if you will, through a high marginal rate, it makes sense, from our point of view, to give the credits also across all the production, legacy fields, new fields," he clarified.

2:37:11 PM

The committee took an at-ease from 2:38 p.m. to 2:46 p.m.

2:46:56 PM

MR. DICKINSON then turned the members' attention to his PowerPoint presentation entitled, "Point of Production for Oil and Gas." He began with slide 2, which addresses the question of why it matters whether something is called oil or gas. Under the current rules gas is taxed at 10 percent and is taxed on a gas ELF, which only uses the amount of production from the well. However, oil is taxed at 15 percent times an ELF, which includes well productivity and a field size factor. Mr. Dickinson highlighted that state statute includes the principle of free use of gas for production operations. He explained that the notion is that since oil is of higher value and gas is available for fuel, it can be used to power the operations. Presumably, that shows up as more oil production. He noted that post production use of gas is taxable. Mr. Dickinson emphasized that it matters [whether something is referred to as oil or gas] because there is a conservation surcharge of $.03-$.05, which is levied on every barrel of oil, but not gas. Therefore, there are several tax implications regarding whether something is referred to as oil or gas.

MR. DICKINSON, continuing on with slide 3, said that under the proposed rules [whether something is referred to as oil or gas] won't make nearly as much difference.

2:50:04 PM

MR. DICKINSON pointed out that both oil or gas will be taxed at 20 percent of the net. Furthermore, the proposed rules propose the free use of gas and oil for production purposes. of the 20

oil and gas states with significant production, about 7 provide the free use of gas and oil whereas the remaining 14 only deal with the free use of gas. He explained that because the conservation surcharge is creditable against the tax itself, from the taxpayer's point of view the conservation surcharge doesn't matter as much. Mr. Dickinson related that perhaps oil and gas should be referred to as produced hydrocarbons because the distinction between oil and gas is minimal.

MR. DICKINSON moved on to slide 4, which specifies that the distinction between oil and gas is important because the point of production for gas is driven by the point at which it's finally separated from oil. He reminded the committee that for oil there is no real change [created by this legislation]. The aforementioned leads to slide 5 regarding why the point of production matters. He explained that under the current rules the costs incurred downstream of the point of production are deductible for calculating production tax. "The state bears no costs upstream of the point of production," he specified. He then related that the same effect holds true for royalty, save for the defined field cost allowance.

2:53:48 PM

REPRESENTATIVE ROKEBERG related his understanding that these changes don't have anything to do with the royalty calculation.

MR. DICKINSON agreed, adding that the only reason the royalty calculation has been brought into this is that there are some parallels. In fact, the commissioner has be authorized to adopt this methodology.

MR. DICKINSON then continued with slide 6. He explained that this legislation specifies that [the state] will share in the upstream and downstream costs. Therefore, if the method used to account for the costs were identical, the point of production would not matter. However, that's not the case as [the legislation] allows upstream costs and encourages upstream investments necessary to find and extract oil. Switching from gross to net causes there to be two different cost regimes. Downstream is a traditional set of costs that include depreciation while upstream, under this proposed legislation, is a world in which capital costs are deductible for their full amount and qualify for a 20 percent credit. Whether [an entity] is upstream or downstream determines under which regime the entity falls. He stressed that [the administration] has made the decision that those costs are borne by the state, and

therefore upstream of the point of production lots of costs are being allowed.

2:57:54 PM

MR. DICKINSON, continuing with slide 7, highlighted that access to facilities is problematic. As the state allows support for a facility, deductions, and credits, it changes the negotiating dynamic because a small producer now has options that it didn't before. Mr. Dickinson emphasized, "We believe, on this point of production, the way the costs are handled is very important." When defining gas processing facilities, as upstream facilities, the state picks up the full capital costs immediately. Under the old scheme gas processing costs were downstream of the point of production and the entity was paid for those, he noted.

2:59:35 PM

CO-CHAIR RAMRAS inquired as to the cost to build a gas processing plant. He asked if would cost about $3 billion.

MR. DICKINSON specified that it would probably cost several billion more than $3 billion to build the largest gas processing plant in the world. Therefore, the central gas facility won't be a typical plant. In further response to Co-Chair Ramras, Mr. Dickinson estimated that it would take about two construction seasons to complete construction of such a facility.

CO-CHAIR RAMRAS surmised, "We would be required to take the cost of a processing plant, cut it in two. And then the state would then be handicapped by 20 percent of that amount as we took it out ... as a credit against whatever was being generated at the point at which we build the gas processing plant, which is many, many, many years from now."

MR. DICKINSON indicated his agreement with Co-Chair Ramras' understanding.

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REPRESENTATIVE CRAWFORD inquired as to whether the central compression point (CCP) lies upstream or downstream from the point of production.

MR. DICKINSON said that at this point, the production facility is upstream of the point of production. He explained that all that [the CCP] is doing at the production facility is taking gas

and putting it back in the ground. However, the central gas facility is where the gas goes to have the valuable liquid hydrocarbons stripped out of it. The 8.5 bcf a day is then sent to the CCP to be returned to the ground.

CO-CHAIR RAMRAS posed a scenario in which the gas pipeline isn't built for 10 years and, given inflation, the cost could be $5 billion 10 years from now. He estimated that this one component could result in a $500 million credit a year over two years because it's upstream of the production of the facility.

MR. DICKINSON agreed. However, he pointed out that if inflation is that high, the project won't be built unless the gas prices have also risen. Mr. Dickinson expressed that he didn't want to confuse the central gas facility with the kinds of gas processing that could be occurring in other smaller units.

CO-CHAIR RAMRAS said that he is just trying to monetize the credit not define it.

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REPRESENTATIVE BERKOWITZ surmised then that the aforementioned $500 million credit, were it producer owned, could be taken against the producer's oil profits.

MR. DICKINSON replied yes. In further response to Representative Berkowitz, Mr. Dickinson explained that if a third party built a facility, the third party would take the credit and monetize it by sale or as payment for the tariff is received, a loss would have to be shown. He offered to take the question and work it out because a third party doesn't typically build a gas plant.

REPRESENTATIVE BERKOWITZ, speaking from the state's perspective, surmised that it would be preferable to have a third party build the facility.

MR. DICKINSON answered, "All other things being equal, we would of course prefer these to be built without any support." However, the view is that insufficient investment is occurring and thus there is the desire to incentivize the investment.

REPRESENTATIVE BERKOWITZ commented, "This sends a very strong economic argument for the state against linkage."

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MR. DICKINSON again offered to review Representative Berkowitz's point regarding an entity with no production making these types of investments. However, he opined that having the credit will result in either the construction of new facilities or the more efficient use of existing facilities because of economic incentives. Mr. Dickinson then moved on to slide 8 regarding the outcome of combining production and post production facilities under the current rules and the proposed rules. In the central gas facility both post production activity, gas processing, and production activity, conditioning gas for pressure maintenance, occur. The aforementioned necessitated allocating the costs in the plant because there are varying deductible and nondeductible costs. Under the proposed rules the costs of both [the post production activity and production activity] would be deductible. Therefore, the controversies with regard to the accounting process and determining how to allocate the costs within the central gas facility wouldn't arise. This has resulted in the decision that the costs of gas processing will be treated as upstream costs, although they would've been deductible in the past.

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MR. DICKINSON moved on to slide 9 and specified that the definition of oil is "when this product is in condition of pipeline quality." The aforementioned is further defined in statute as "Good and merchantable condition", which isn't a controversial standard. The issue arises with gas, particularly gas that's produced in association with oil. The point of production [of gas] is the "first point accurately metered downstream from the point of final separation." The question then becomes why one wouldn't apply the same standard to gas as is applied to oil. If the same standard is applied, when the gas is in a good and merchantable condition is the point of production and when the costs should be borne. However, the difficulty is that gas isn't as clean as oil, as it's sometimes sold with various hydrocarbon liquids and impurities that are later processed. Therefore, there isn't a standard of good and merchantable for gas and thus it seems inappropriate to establish such a standard. On the other hand, the choice could be such that on the North Slope in Alaska, the point of production would be when the matter reaches the pipeline. The aforementioned would mean that gas treatment is part of the production process and thus those costs should be borne.

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REPRESENTATIVE BERKOWITZ asked if Mr. Dickinson has assessed what difference that will mean to the state.

MR. DICKINSON said that he has run some models reviewing various points of production and the output of those models could be shared with the committee.

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REPRESENTATIVE BERKOWITZ asked if there is a list of the models that have been run.

MR. DICKINSON replied no. He explained that it would be more accurate to say that certain variables have been placed into a model as questions were asked. A series of discrete projects with a fully documented model hasn't been performed.

REPRESENTATIVE BERKOWITZ related his belief that unless the legislature specifically asks for a model, it doesn't receive it. Therefore, he indicated that there may be a range of models that perhaps the legislature should request that may be available, although not disclosed.

MR. DICKINSON expressed that he has been honest with regard to whether models have been performed on various scenarios. The hesitation, he explained, comes from the possibility of models being originally created under a different context with different variables than the question.

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MR. DICKINSON continued with slide 10 regarding the result of combining gas processing and gas treatment. Under current rules both gas processing and gas treatment are post production activities, and therefore there would be no allocation of costs necessary. However, under the proposed rules it may require an allocation of costs. Although the decision could be to move gas treatment upstream of point of production and deal with those costs differently than transportation costs, the legislation views the gas treatment as more like a transportation cost.

REPRESENTATIVE CRAWFORD recalled discussion a few years ago regarding putting gas into the existing pipeline as a liquid. If the aforementioned was pursued, how would this legislation impact that, he asked.

MR. DICKINSON related his understanding that if gas was going through a manufacturing process to create the oil, the point of production for that oil would be at the same place it is currently.

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MR. MINTZ pointed out that this legislation defines gas processing as a physical process by which liquid hydrocarbons are extracted from a gaseous stream. However, he said he understood the gas to liquids process to utilize chemical processes that he didn't believe would be considered gas processing but would rather be considered a downstream activity.

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REPRESENTATIVE CRAWFORD inquired as to the impact on the government's take if a gas to liquids approach is utilized in the future.

MR. DICKINSON, providing a quick analysis, said that gas would be produced and it would be a manufacturing process, post production process, and thus the state would bear the cost of it. Under this legislation, the state wouldn't bear the capital costs, but a reasonable allowance would have to be available for the cost to ship it to market.

REPRESENTATIVE CRAWFORD asked if it would be taxed at the oil rate.

MR. DICKINSON clarified that it would be taxed at the PPT rate under the proposal and at 10 percent under the existing system.

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MR. DICKINSON moved on to slide 11, which traces through the current point of production with the central gas facility in Prudhoe Bay and how that impacts costs. Currently, there are six separation centers where the separation between oil and gas occurs. When oil is finally metered or measured prior to delivery to TAPS, the lease automatic custody transfer (LACT) meter is the point of production for oil. However, something comes out of the separation facilities such that at the inlet of the central gas facility is the point of production for gas. The aforementioned is the first time after separation that [the gas] can be accurately measured. He then turned the committee's attention to slide 12, which is similar to the flow illustrated

on slide 11. However, the point of production for gas has moved from the inlet to the central gas facility to when the products leave the central gas facility [after] final separation.

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CO-CHAIR SAMUELS surmised, "Royalties are not moving it, for tax purposes only."

MR. DICKINSON said that's correct.

CO-CHAIR SAMUELS then inquired as to how far into the process of developing a field would the central gas facility be built. He also inquired as to whether it would be cheaper to utilize an existing central gas facility or build such a facility.

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MR. DICKINSON said when a field starts up very little gas, as compared oil, is produced. Therefore, the central gas facility will be the last facility built in the field as gas handling needs increase.

CO-CHAIR SAMUELS assumed that for the company that builds a central gas facility, it's positive and some of the profits will increase. "How much of a concern should there be on the $500 million credit? How much are we going to go up," he asked.

MR. DICKINSON said that the positive economics that come from the credit should impact [the construction of a gas handling facility]. If it makes sense from the producer's point of view to build a gas handling facility, it should for the state as well, he said.

CO-CHAIR SAMUELS asked if there was discussion regarding cost recovery of the central gas facility over a longer period of time in order to mitigate some risks.

MR. DICKINSON recalled that there was no such discussion.

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MR. DICKINSON concluded with slide 13, which defines two of the goals that are being worked toward. He highlighted that the goals are to have simplified definitions that will not lead to low value-added conflicts and to incentivize all production activity.

[HB 488 was held over]

3:23:34 PM

**ADJOURNMENT**

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 3:23 p.m.