

**ALASKA STATE LEGISLATURE  
HOUSE STATE AFFAIRS STANDING COMMITTEE**

July 26, 2006  
10:16 a.m.

**MEMBERS PRESENT**

Representative Paul Seaton, Chair  
Representative Carl Gatto, Vice Chair  
Representative Jim Elkins  
Representative Bob Lynn  
Representative Jay Ramras  
Representative Berta Gardner  
Representative Max Gruenberg

**MEMBERS ABSENT**

All members present

**COMMITTEE CALENDAR**

HOUSE BILL NO. 3005

"An Act providing for an additional production tax on oil when the price index on oil is above a certain amount; and providing for an effective date."

- HEARD AND HELD

**PREVIOUS COMMITTEE ACTION**

BILL: HB3005

SHORT TITLE: PROGRESSIVE TAX ON OIL

SPONSOR(s): STATE AFFAIRS

07/25/06	(H)	READ THE FIRST TIME - REFERRALS
07/25/06	(H)	STA, FIN
07/26/06	(H)	STA AT 10:00 AM CAPITOL 106

**WITNESS REGISTER**

CHERIE NIENHUIS, Petroleum Economist  
Tax Division  
Juneau Office  
Department of Revenue  
Juneau, Alaska

POSITION STATEMENT: Answered questions on behalf of the division during the hearing on HB 3005.

## ACTION NARRATIVE

**CHAIR PAUL SEATON** called the House State Affairs Standing Committee meeting to order at [10:16:34 AM](#).

### HB3005-PROGRESSIVE TAX ON OIL

[10:16:50 AM](#)

CHAIR SEATON announced that the only order of business was HOUSE BILL NO. 3005, "An Act providing for an additional production tax on oil when the price index on oil is above a certain amount; and providing for an effective date."

[10:17:26 AM](#)

CHAIR SEATON directed attention to handouts in the committee packet, including, "Projected Government Takes with Sliding Scale Tax DOR Forecast Production (FY 2007-2030)" - provided by Econ One Research, Inc. ("Econ One"), and the fiscal note. He referred to the sponsor statement and asked the committee to remember that every committee - both Senate and House - that has passed a production profits tax (PPT) or a change in tax structure has included a progressivity element. Some progressivity elements have been "on the gross," while others have been "on the net." He continued:

What came out of [the House Resources Standing Committee] was .3 percent on the gross .... Of course, that was in conjunction with a total rewrite of the PPT for the initial part of the tax, which would have raised it from the ... [economic limit factor (ELF)] that we have right now - which is basically an average of a little less than 6 percent statewide - to the ... 20-20 or 22.5 percent on the net. So, those two were in conjunction when this econ ONE data went forward.

And also, from the Senate side we got passed over here a progressivity of .2 on the gross during the regular session, going out of [the House Finance Committee] we were looking at .25 on net at \$35 a barrel. And the \$35 dollars a barrel roughly corresponds with \$50 a barrel. There will be some questions about what index to use, and the differences between those indexes. What came out of [the House Resources Standing

Committee], which several members here sit on, was using West Texas Intermediate, and part of the reasoning for that was that would be [an] index that - no matter what happened with ... producers on the North Slope ... - could not be influenced or changed as an index. So, it was viewed as more of an independent index, and that's what we've incorporated here at this point.

10:21:08 AM

CHAIR SEATON said HB 3005 starts with the progressivity at .35 percent, and there is a \$50 WTI index. He asked the committee to remember that the WTI is only the index trigger; the tax is on wellhead value of Alaska crude. He continued:

And then that increases between \$50 a barrel and \$150 a barrel at the .35 percent, and then it caps at \$150 a barrel. And the reason it's constructed that way is that if we look at our production tax now, the production tax is 15 percent. That's modified by ... all fields in Alaska, but the actual production tax on gross is 15 percent. So, if you add 15 percent, plus 35 percent, you get that equal split or equal share that all the bills have decided, "Okay, this is where we want to cap the production tax." Because if you didn't cap that, let's say there was something really crazy and that the price went to \$300 or \$400 a barrel for a short period of time - for a month - you'd actually end up taking 100 percent of the value in the production tax. So, that's why it caps at an equal share. ... So, the 35 percent, which would be captured at the highest rate by this windfall property or progressivity tax, would add to the 15 percent of the current production tax - even though that's not paid. If we had said, in conjunction with the tax as paid - in other words that ELF - it would have meant that those fields that were paying no production tax under ELF could actually end up paying more tax on progressivity than fields such as Prudhoe Bay, which is paying about 9 percent.

... So, what we didn't want to do is make this bill into a recapture of ELF for some fields, so that's why we used the entire production tax of 15 percent, ... combined with 35 percent gave us the equal share.

CHAIR SEATON noted that the bill has a retroactive date of April 1, [2006], and the payment is due 30 days after the effective date of the tax, not the retroactive effective date, and it can be made at that time, no interest due. However, if the company wishes to split the payment up into 6 equal payments after that effective date, then the interest would be due on the unpaid balance, as required by law.

10:24:59 AM

CHAIR SEATON, in response to a query by Representative Gatto, clarified the value of .35 percent.

10:26:48 AM

REPRESENTATIVE GARDNER directed attention to a sentence in the sponsor statement that read: "It may be paid in a lump sum without interest or remitted in six equal monthly payments with any unpaid balance accruing interest at the rate proscribed in AS 43.05.225." She pointed out that "proscribed" means "prohibited," and she suggested the word the sponsor meant to use is "prescribed."

10:28:34 AM

CHAIR SEATON noted that the previously mentioned Econ One handout was done in conjunction with "a 20-20 PPT," and he stated that "under the PPTs that we've been considering, ... gross taxes are deductible from the net profit." He said, "If this is used in conjunction with a net profit tax scheme, ... then this can be used in conjunction with that." He stated:

The intention of introducing this bill is not to circumvent, to supplant, or replace a comprehensive bill ... which is used, based on the net or on the gross. If we're able to arrive at that consensus ... I'm all in favor of it; but if we're not able to arrive at that consensus, what I think the committee is wanting to do is have a bill that we can go forward with ... [which would capture] some of the high oil prices. And that's just what this bill deals with. It only deals with capturing some of the ... windfall profits that were derived from high oil prices going back to April 1. So, it doesn't change the ELF system, it doesn't change the production tax system, it doesn't make a change to net or anything else, but it can be used in conjunction with either system.

And, again, that was obvious because we had progressivity proposed from the Senate on the gross, which passed over to us during the regular session [and subsequently] passed out of [the House Resources Standing Committee] ... on the gross progressivity in conjunction with a present profits tax. And then, ... if it's decided to change this to net, we of course had several other bills that later came with progressivity on the net, in conjunction with the net profits tax. So, hopefully what we'll be doing is looking at some of the elements of progressivity very deeply and figuring out what analysis the committee wants on all of these things.

[10:32:05 AM](#)

REPRESENTATIVE GRUENBERG asked for confirmation that the intent is that if the legislature cannot reach agreement on all the other related bills, [HB 3005] could be passed as a standalone bill.

[10:32:26 AM](#)

CHAIR SEATON answered that's correct. He said he thinks there is unanimous agreement in the legislature that some progressivity is needed to capture the high oil prices.

[10:33:22 AM](#)

REPRESENTATIVE GRUENBERG asked for confirmation that there were no amendments on the House floor to eliminate the progressivity concept.

[10:33:44 AM](#)

CHAIR SEATON responded that there were some amendments to modify the progressivity element, but there were no amendments proposed to take it away.

[10:34:02 AM](#)

CHAIR SEATON directed attention to another handout in the committee packet, which shows the Alaska North Slope average monthly wellhead price per barrel and the Alaska North Slope average monthly volume in millions of barrels for January - May 2006. The information on this portion of the page was supplied by the Department of Revenue. Chair Seaton noted that by using

that information, his office figured the average value multiplied by the average volume to arrive at the approximate monthly value, and multiplied the monthly value times the West Texas Intermediate (WTI) minus 50, then multiplied that by .35 percent to produce the total tax due. That information, he noted, shows at the bottom of the page. He reviewed the examples shown on the page. He noted that the last figure on the page is his "estimated max tax."

[10:38:20 AM](#)

CHAIR SEATON directed attention to a [two-page] handout from the Energy Information Administration, included in the committee packet, which shows the monthly WTI spot price and is the index that would be used for HB 3005. He said the index that is used throughout the bill is WTI minus \$50. He offered an example, which he clarified upon request from committee members.

[10:41:41 AM](#)

REPRESENTATIVE GATTO recalled hearing that the volume [of oil] was less than anticipated, and he said he would like to know if there was shut down sometime in June or July to account for it.

CHAIR SEATON mentioned a pipeline that had been recently shut down due to a leak.

[10:42:43 AM](#)

CHERIE NIENHUIS, Petroleum Economist, Tax Division, Juneau Office, Department of Revenue, offered her understanding that "there is still some oil that is being shut in," but she said she doesn't know the extent of it. She said she believes the department is approximately 2 percent off its forecast for fiscal year 2006 (FY 06), and "a lot of it was due to the shut in wells."

[10:43:05 AM](#)

REPRESENTATIVE GATTO asked if, absent the shut-in, the oil is in continual decline and, if so, at what percent.

[10:43:24 AM](#)

MS. NIENHUIS answered yes, but said she doesn't have the exact numbers available.

[10:43:51 AM](#)

CHAIR SEATON referred back to the handout showing the information from his office and the Department of Revenue, and talked about fluctuation in volume of oil. He said he doesn't know the cause of the fluctuation. He indicated that the handouts are rough estimates, and he said the committee could look forward to hearing from representatives from Econ One and possibly from the Department of Revenue for further information.

[10:45:07 AM](#)

MS. NIENHUIS said each field has a different wellhead value, which has to do with quality bank and feeder pipe deductions and additions. She said the information presently before the committee is a rough average with which the committee could work.

[10:45:58 AM](#)

REPRESENTATIVE GATTO asked Ms. Nienhuis if she has heard the slogan, "No decline after '99." He said that certainly has not occurred, and he asked if there is some factor that has been identified to explain the decline.

[10:46:34 AM](#)

MS. NIENHUIS said she believes the reason for the decline in production is that the state has not appropriately incentivized the oil companies to "invest back in our fields in Alaska." Without that investment, she said, there will be a natural decline in field productions over time.

[10:47:35 AM](#)

MS. NIENHUIS, in response to a follow-up question from Representative Gatto, said exploratory drilling has not been happening at the rate that the department would like. She said the department would like to not only see exploratory drilling take place, but also to not have the companies penalized for "drilling a dry hole." She stated, "By having capital credits, we believe that we will appropriately incentivize someone to go out and take a chance, ... drill that well, and ... see if there's more oil."

[10:48:18 AM](#)

REPRESENTATIVE GATTO responded, "We want to incentivize oil coming out of the ground, not sticking holes in the ground." He expressed concern over the idea of incentivizing to drill dry holes.

[10:48:58 AM](#)

MS. NIENHUIS said the cost of drilling a well - approximately \$20 million - would prohibit a company from doing so with the advance knowledge that it would be a dry well. She explained, "If the state picks up 40 ... or 60 percent of it, [the oil companies] still are out some \$10 or \$8 million." Furthermore, she said most companies have to answer to their shareholders, and to be drilling dry holes for the purpose of having a tax decrease would not make a lot of sense.

[10:49:56 AM](#)

CHAIR SEATON stated that under the existing ELF, there is a tax advantage for having more wells producing, because the average volume per well is a "big multiplier of how you reduce your taxes." "So," he said, "people could actually spend money ... and keep wells that [are] producing hardly anything to lower their tax rate under ELF." He said he is not saying that everyone is trying to do this, but he said he thinks this is one of the reason that the legislature is trying to change the tax structure.

[10:50:37 AM](#)

MS. NIENHUIS confirmed that Chair Seaton's statement is correct - the more producing wells oil companies have, the lower the ELF is. She mentioned the relationship of the wells and volume. However, she explained, "There's a difference between a developmental well, which is a well that is within a field that you know is producing, versus a wildcat well, which is one where someone goes out to an area ... [where] they believe there's oil but ... the certainty is less."

CHAIR SEATON explained that he just wants to make certain that the committee understands that one of the reasons that ELF is broken is the legislature has given incentives to drill wells in order to lower a company's tax rate. He offered further details. He concluded, "It doesn't matter how many wells you get the profit out of, the tax rate is based on the profit, and the more wells you put in that ... are costing you money, you lose money, as well."

MS. NIENHUIS confirmed that's correct.

CHAIR SEATON said, "Once you're at zero, you can't go any lower than zero, ... and most of the fields are zero in Alaska, under ELF."

[10:52:35 AM](#)

REPRESENTATIVE GATTO stated:

You are mostly looking at your tax rate. And the accountants, if they say, "Hey, drill a \$15 million well," but then our rate for everything drops by a percentage point, then it's just arithmetic: Go spend the \$15 million and reduce our ... overall taxes. So, ... what we're really working on now is we don't want ... you to have a lower tax burden by gaming the system by saying, "I know what my accountants are telling me to do." Rather, we're looking to increase production. And so, I guess the question - and it isn't a question, it's kind of a statement and an understanding - [is] that when we work on something like this, we don't have enough information on what it costs to do something in return for what you save. ... What will be the end result of doing something? Because we always have the law of unintended consequences where somebody sees something and you go, "That was never the intention." So, we're depending on you to come back and say, "Here's what I know."

[10:53:49 AM](#)

MS. NIENHUIS related that there has been a presentation by the oil companies that addresses the amount of capital spending that has been made over the years. She offered her understanding that it was in 2001 that the companies boosted their spending by quite a bit, and the production decline leveled out a little bit shortly thereafter. She stated, "As much as we'd maybe like to build a tax around increasing or maintaining productivity or production, the reality is the increased or maintained production has to involve additional capital spending. And in order to incent additional capital spending, that's why we're doing these credits - or at least the PPT proposes credits."

[10:55:02 AM](#)

CHAIR SEATON refocused on the fact that HB 3005 would deal only with prices above \$50 a barrel, which is "outside the target range of where the oil companies are making their decisions on whether to sanction projects or not." He emphasized that oil companies won't say what their exact range dollar amount is, because it is proprietary information.

[10:57:03 AM](#)

REPRESENTATIVE GRUENBERG suggested that the legislature ought to look for ways to ensure as much of the oil is recovered as possible in order to be competitive. He asked Ms. Nienhuis to comment.

[10:58:31 AM](#)

MS. NIENHUIS said she thinks that in future years there will be additional "heavy oil" coming on line, which she said is typically more expensive to produce. Regarding recovering as much oil from known fields, she said it would be appropriate to allow additional technological improvements through incentives, in order to have greater access to oil that is currently harder to produce. She predicted that within the next five to ten years, technology will have advanced to the point where some of the heavy oil can be recovered less expensively than it is recovered currently.

REPRESENTATIVE GRUENBERG asked if there is any way to speed up the process.

[11:00:13 AM](#)

MS. NIENHUIS said she thinks it is important to get back to the original proposal of providing some incentive for oil companies to keep and spend their money in Alaska. Currently there is no such incentive, other than the couple of credit systems in place, and those don't include fields that "are not three miles apart from each other."

[11:00:41 AM](#)

CHAIR SEATON told the committee that Pedro van Meurs, Ph.D., relayed to the House Finance Committee that if Alaska taxes on the gross and uses incentives, then in the next couple of years, technology will reduce the cost of recovering the heavy oil and, if that happens, there will be a better chance of "leaving money on the table." He explained, "Because they're going to lower

their cost, but will have had to generate a tax structure on gross based around the current cost, and so when the costs go down, we're not taxing on the profits - which they get more off if their costs go down - we're taxing on a system that we have instituted under a high-cost regime." He said the entire purpose of the [Alaska Oil and Gas Conservation Commission (AOGCC)] is to ensure that the state recovers the maximum hydrocarbons throughout every field in Alaska, and it determines how much gas can be taken out and how much must be left. Chair Seaton said this subject goes far beyond the scope of HB 3005. He reiterated the purpose of the bill.

[11:03:20 AM](#)

MS. NIENHUIS confirmed that what Dr. van Meurs said is correct. She offered further details.

[11:04:49 AM](#)

CHAIR SEATON said he thinks consideration needs to be made so that credits are self-adjusting, because if the price is \$100 per barrel, the state doesn't "need to be giving capital credits to incentivize heavy oil, because heavy oil is very economic at \$100 a barrel."

[11:05:59 AM](#)

REPRESENTATIVE GRUENBERG asked if there is anything besides tax credits that could incentivize the complete development of the known fields. He suggested that might include additional money for research, grants, or partnerships, for example.

CHAIR SEATON responded that the two methods of incentivizing are through tax credits and allowing the cost to be deducted in taxing on net instead of on gross.

REPRESENTATIVE GRUENBERG said he thinks he speaks for those people who have concerns that taxing on the net is too easily manipulatable.

[11:07:49 AM](#)

CHAIR SEATON noted that HB 3005 uses a tax on gross, thus the committee doesn't need to worry about that concern at present. He brought attention to a one-page handout in the committee packet, which is an excerpt of information produced by the aforementioned Dr. van Meurs related to progressivity, dated 5

March 2006. The handout shows Dr. van Meurs' "Option 2 - Basic Production Tax based on a windfall profits style formula," using WTI minus 50, multiplied by 0.25 percent. Chair Seaton turned to another handout in the committee packet entitled, "Gross vs. Net - Heavy Oil," which he said was distributed at the House Finance Committee meeting. He noted that the shipping and pipeline costs are shown on the handout. He indicated that the numbers on the page are averages that were presented by the [Department of Revenue] and relate to the "costs of those things that we deducted earlier to get down to the ... \$7 dollar difference between WTI and wellhead."

CHAIR SEATON asked committee members to submit any requests they may have for analysis or other information, so that it can be produced by the next meeting.

[11:10:08 AM](#)

REPRESENTATIVE GRUENBERG said he would like to see all of the other progressivity provisions that have been introduced, whether in the form of committee or floor amendments, so the committee can contrast and compare them to the bill.

CHAIR SEATON referred to page 1, line 9, and said HB 3005 does not include royalty oil.

[11:12:59 AM](#)

REPRESENTATIVE GRUENBERG observed that the bill seems to be related to tax on oil, and he asked if the committee would like to consider such a bill related to tax on gas.

REPRESENTATIVE ELKINS [shook his head no].

CHAIR SEATON said he would like to keep the issue simple by sticking with the topic of oil. He indicated one of the biggest reasons is because the state is currently earning money on its gas pipeline, whereas there is no gas pipeline built as yet.

[11:14:13 AM](#)

REPRESENTATIVE LYNN concurred.

[11:14:18 AM](#)

CHAIR SEATON directed attention to page 2, [line 3], which read, "(2) more than \$150 a barrel, the oil price index is 100", and

he explained the relationship between that language and the previously discussed .35 percent. He stated:

What we're wanting to do is have that ... 150 be the amount that generates 35 percent, because the 35 percent plus the 15 percent base production tax gives us the equal share that every bill that's gone forward has maintained.

CHAIR SEATON said [subsection (c) on page 2] outlines what steps would be taken if the WTI "goes away." He reviewed Sections 2 and 3 of the bill.

[11:17:10 AM](#)

REPRESENTATIVE GRUENBERG said he would, at some point, like to hear an explanation of [page 2], lines 19-24.

[11:17:52 AM](#)

REPRESENTATIVE GATTO questioned the use of the word "may" on page 2, line 22.

[11:18:40 AM](#)

CHAIR SEATON noted that on page 3, line 6, there is a designation that [Section 1] of the bill is retroactive; however, he said he would check on the word "may" with the bill drafter.

[11:19:36 AM](#)

MS. NIENHUIS said the bill, as a stopgap measure to capture high oil prices, is a good plan. She said she thinks there are still problems associated with the existence of ELF; some fields wouldn't be paying anything but the increased tax. She stated:

On the last page of the fiscal note, you'll see at \$40 there's no difference between the status quo and the tax on the bill, because it doesn't exceed the price threshold in which the additional tax kicks in. [At] \$60 you can see there is an additional amount from this additional tax, and so that would basically be the difference between the status and the tax on the bill - so, \$500 million or so, in FY 07.

[11:20:40 AM](#)

CHAIR SEATON mentioned a spreadsheet by which comparisons could be made.

[11:21:26 AM](#)

CHAIR SEATON upcoming on bill.

[11:21:51 AM](#)

REPRESENTATIVE GRUENBERG, in response to Representative Gatto's previous question regarding page 2, line 22, referred to a provision in the Administrative Procedures Act, and he requested that a copy of AS 44.62.240 be distributed to the members before the next meeting.

[11:22:40 AM](#)

REPRESENTATIVE GARDNER said she thinks the explanation the committee has had on that point is adequate.

REPRESENTATIVE GATTO said he would like to see that administrative code.

[HB 3005 was heard and held.]

#### **ADJOURNMENT**

There being no further business before the committee, the House State Affairs Standing Committee meeting was adjourned at [11:23:29 AM](#).