

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS

March 18, 2005

8:34 a.m.

MEMBERS PRESENT

Representative Bruce Weyhrauch, Chair
Representative Norman Rokeberg
Representative Paul Seaton
Representative Peggy Wilson
Representative Max Gruenberg
Representative Carl Moses

MEMBERS ABSENT

Representative Ralph Samuels

OTHER LEGISLATORS PRESENT

Representative Beth Kerttula
Representative Berta Gardner
Representative Les Gara

COMMITTEE CALENDAR

HOUSE BILL NO. 52

"An Act relating to adoption and revision of a comprehensive long-range fiscal plan for the State of Alaska."

- MOVED CSHB 52(W&M) OUT OF COMMITTEE

HOUSE BILL NO. 63

"An Act relating to the oil and gas properties production (severance) tax as it applies to oil; establishing a minimum rate of tax for certain fields of five percent; providing for an adjustment to increase the tax collected when oil prices exceed \$20 per barrel and to reduce the tax collected when oil prices fall below \$16 per barrel; and providing for relief from the tax when the price per barrel is low or when the taxpayer demonstrates that a reduction in the tax is necessary to establish or reestablish production from an oil field or pool that would not otherwise be economically feasible."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 52

SHORT TITLE: LONG-RANGE FISCAL PLAN

SPONSOR(S): REPRESENTATIVE(S) GRUENBERG

01/10/05	(H)	PREFILE RELEASED 1/7/05
01/10/05	(H)	READ THE FIRST TIME - REFERRALS
01/10/05	(H)	W&M, FIN
02/18/05	(H)	W&M AT 8:30 AM CAPITOL 106
02/18/05	(H)	Heard & Held
02/18/05	(H)	MINUTE(W&M)
02/25/05	(H)	W&M AT 8:30 AM CAPITOL 106
02/25/05	(H)	Scheduled But Not Heard
03/18/05	(H)	W&M AT 8:30 AM CAPITOL 106

BILL: HB 63

SHORT TITLE: OIL SEVERANCE TAX

SPONSOR(S): REPRESENTATIVE(S) GARA

01/12/05	(H)	READ THE FIRST TIME - REFERRALS
01/12/05	(H)	W&M, O&G, RES, FIN
03/18/05	(H)	W&M AT 8:30 AM CAPITOL 106

WITNESS REGISTER

PETER NAOROZ, Staff to Representative Gruenberg
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Offered information on HB 52.

REPRESENTATIVE LES GARA, Sponsor
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Spoke as the sponsor of HB 63.

JUDY BRADY, Executive Director
Alaska Oil and Gas Association
Anchorage, Alaska

POSITION STATEMENT: Offered information regarding HB 63.

TOM WILLIAMS, Chair
Alaska Oil and Gas Association
Anchorage, Alaska

POSITION STATEMENT: Testified in opposition to HB 63.

ACTION NARRATIVE

CHAIR BRUCE WEYHRAUCH called the House Special Committee on Ways and Means meeting to order at 8:34 a.m. Representatives Weyhrauch, Rokeberg, Seaton, Gruenberg, and Moses were present at the call to order. Representative Wilson arrived as the meeting was in progress. Also in attendance were Representatives Kerttula, Gardner, and Gara.

HB 52-LONG-RANGE FISCAL PLAN

CHAIR WEYHRAUCH announced that the first order of business would be HOUSE BILL NO. 52 "An Act relating to adoption and revision of a comprehensive long-range fiscal plan for the State of Alaska."

[8:35:18 AM](#)

REPRESENTATIVE GRUENBERG made a motion to adopt CSHB 52, Version 24-LS0235\F, Utermohle, 2/24/05, as a working document before the committee. There being no objection, Version F was before the committee.

[8:35:25 AM](#)

PETER NAOROZ, Staff to Representative Gruenberg, Alaska State Legislature, offered the committee research from the Internet and the Alaska Municipal League regarding other states' fiscal plans. He related that the aforementioned fiscal plans include the following characteristics: looking beyond the current budget to address the "big picture"; setting goals and objectives, including value statements accounting for income, expenses, assets, and liabilities; focusing on the realities of the world, market, demographics of communities, concerns of the population, and sensitivity to future projections; and communicating "openly clearly, and [providing] a context for people to be educated and make an evaluation and judgment." He added that Oregon, Virginia, British Columbia, and Alberta have fiscal plans that include the aforementioned criteria.

[8:38:48 AM](#)

MR. NAOROZ, in response to Representative Seaton, replied that British Columbia and Alberta have specific sections [in their fiscal plans] dedicated to natural resources. He related his belief that Alaska is more "blessed" in terms of natural resources than any of the aforementioned locations.

REPRESENTATIVE SEATON noted that analyzing the aforementioned fiscal plans will be helpful.

[8:40:25 AM](#)

REPRESENTATIVE GRUENBERG moved to report CSHB 52, Version 24-LS0235\F, Utermohle, 2/24/05, out of committee with individual recommendations and the accompanying fiscal notes.

[8:40:34 AM](#)

REPRESENTATIVE ROKEBERG objected. He relayed that the bill does not "actualize" a long-range fiscal plan, which is where the legislature needs to apply its efforts.

[8:42:00 AM](#)

REPRESENTATIVE GRUENBERG said, "I would respectfully disagree," because the bill will make the legislature more likely to adopt a fiscal plan into law.

[8:43:29 AM](#)

A roll call vote was taken. Representatives Weyhrauch, Wilson, Gruenberg, and Moses voted in favor of reporting CSHB 52, Version 24-LS0235\F, Utermohle, 2/24/05, out of committee. Representative Rokeberg voted against it. Therefore, CSHB 52(W&M) was reported out of the House Special Committee on Ways and Means by a vote of 4-1.

HB 63-OIL SEVERANCE TAX

[8:44:13 AM](#)

CHAIR WEYHRAUCH announced that the final order of business would be HOUSE BILL NO. 63 "An Act relating to the oil and gas properties production (severance) tax as it applies to oil; establishing a minimum rate of tax for certain fields of five percent; providing for an adjustment to increase the tax collected when oil prices exceed \$20 per barrel and to reduce the tax collected when oil prices fall below \$16 per barrel; and providing for relief from the tax when the price per barrel is low or when the taxpayer demonstrates that a reduction in the tax is necessary to establish or reestablish production from an oil field or pool that would not otherwise be economically feasible."

[8:44:53 AM](#)

REPRESENTATIVE LES GARA, Alaska State Legislature, speaking as the sponsor, relayed his belief that oil tax reform is important. He highlighted the Alaska Constitution, Article VIII, Section 2, which states that the legislature's duty is to provide for the maximum benefit of its people. In response to Chair Weyhrauch, Representative Gara clarified that oil tax exemptions concern the means in which Alaska receives its fair share. The largest tax portion received from oil is the royalty tax preceded by the production tax. He added that the corporate and property taxes that are distributed through municipalities have not been very high. He explained that although the production tax is a 15 percent tax, also referred to as a severance tax, that applies to every field, HB 63 only addresses North Slope fields. The production tax is determined by the economic limit factor (ELF). The ELF is a number between zero and one [and to calculate the production tax] multiply the field's ELF by the 15 percent production tax.

[8:47:14 AM](#)

REPRESENTATIVE GARA said the field's ELF rate is determined by a formula that relies partly on the size and well productivity of the field. Therefore, the higher those factors, the higher the ELF. The largest fields, 0.8 fields, located in Prudhoe Bay, North Star, and Alpine pay a 13 percent production tax. In fiscal year (FY) 06, most fields in the state will pay 0 or less than 1 percent for [ELF], he said. He turned to a graph entitled, "ELF Now Exempts Blockbuster Fields", and pointed out that the right column details the production taxes Alaska fields pay. He offered that many believe the ELF was [initially] intended to give incentives and reduce the taxes of the producers of marginal, declining, and small fields. He offered evidence to the contrary highlighting the FY 06 production tax for Kuparuk, the second largest field in the U.S., which will pay less than 1 percent. Some of the largest fields in the U.S., including Milne Point, Endicott, West Sak, Tarn, Niakuk, and Meltwater will pay 0 percent in production taxes. He added that HB 63 does not apply to heavy oil, such as West Sak, because it's more expensive to produce. He related his belief that the production tax "shrinks" every year. According to the Department of Revenue's projections, in 1993 the average production tax on North Slope oil was 13.5 percent, in 2004 it fell to 7.5 percent, and in 2013 it will probably fall below 4 percent. Although the ELF will continue to fall, the Governor's

Aggregation Order will cause it to spike this year. He pointed out that about 10 percent of North Slope oil was brought from 0-1 percent production tax rates to the Prudhoe Bay rate. He reiterated that the ELF and the production taxes are declining. Even assuming stable oil prices or stable production, the state will continue to receive less revenue from its oil.

[8:50:03 AM](#)

CHAIR WEYHRAUCH said:

In the context of [Representative Gara's] presentation is ... as the ELF gets smaller every year is it ... providing an incentive to developing these fields. If there's an incentive issue here, is it fulfilling that strategic objective to bring more fields or more oil and gas online. And at the same time, while there's a production tax that ELF applies to, are there other taxes that are being limited in a similar manner. And is it minimizing the oil companies' general tax burden at all or not.

REPRESENTATIVE GARA opined that the ELF is far too generous to the oil industry, [considering that] the largest fields in the U.S. are paying a 0 percent production tax. However, he further opined that the philosophy "shelf the ELF", which means every field should pay the full 15 percent, goes too far. He explained that a field paying 0 percent production taxes pays the same rate when profit margins are thin and when prices increase. "Despite the name, the ELF ignores the biggest single economic determinant, and that's price," he said.

REPRESENTATIVE GARA opined the ELF "somewhat disregards" the production from the satellite fields, which are smaller fields located around large pools of oil, because the rationale is it's too expensive for processing facilities to be on every field. However, since 1989 most of Alaska's oil comes from fields that don't have processing facilities on them. For instance Tarn, the nation's 67th largest oil field, is a satellite field that requires two drill sites and three ten-mile pipelines to Kuparuk's processing facilities so there is a 0 production tax at Tarn.

REPRESENTATIVE GARA relayed that currently 25 percent of North Slope oil is either completely exempted or almost completely exempted from the state's production tax. In 2006, 250,000 barrels a day will pay less than a 1 percent production tax.

The governor's order effects about 100,000 barrels a day, which is about 10 percent of daily production, and does not include the margin effect on Prudhoe Bay. He added that according to the U.S. Energy Information Administration the price of oil will be \$30 per barrel for the long-term.

8:53:31 AM

CHAIR WEYHRAUCH asked whether the aforementioned order affected 10 percent [of the daily production].

REPRESENTATIVE GARA replied "roughly." In further response to Chair Weyhrauch, Representative Gara said the information is cited from the Department of Revenue.

8:53:41 AM

REPRESENTATIVE GARA informed the committee that according to the Energy Information Administration, "we're in a world" of \$30 per barrel oil over the long term. He related that British Petroleum (BP) says at \$20 per barrel "they're in the world of windfall profits." According to a BP press release, issued over half a year ago, profits above \$20 per barrel will be distributed to its shareholders and executives; he opined that this indicates oil at \$20 per barrel is quite profitable.

REPRESENTATIVE GARA turned to the chart entitled, "Thin Profit Margins?" which shows in FY 04 the oil companies North Slope profits totaled \$3.55 billion and the state's profit share was \$2.5 billion, and thus the oil companies exceeded the state's revenue by \$1 billion.

8:55:35 AM

REPRESENTATIVE GARA turned to the page entitled, "This Year's Profits?". That document details 2005 North Slope oil prices, which average \$42 per barrel. Therefore, an estimated gross revenue of \$12 billion was produced, of which the oil company's profits are an estimated \$5 billion and exceed the state's share by \$1.8 billion. The aforementioned state's share is estimated to be \$3 billion for the total production taxes, royalties, property taxes, and corporate taxes, he added. Representative Gara pointed to the Department of Revenue chart entitled, "Impact of ELF Changes on Oil Severance Tax with Price Sensitivity", which details the potential outcomes of severance taxes with and without HB 63 and the Governor's Aggregation Order.

[8:56:21 AM](#)

CHAIR WEYHRAUCH clarified that none of the slides [in the presentation] show the total tax burden to producers but only to the state's take on taxes.

REPRESENTATIVE GARA replied that thus far none of the slides show the tax burden to the producers, and therefore he said he will present an excerpt from the Wood Mackenzie study detailing Alaska's tax burden is lower than the rest of the world. In further response to Chair Weyhrauch, Representative Gara clarified that the aforementioned government take refers to the cumulative tax burden.

[8:56:39 AM](#)

REPRESENTATIVE ROKEBERG asked if the producers' gross profits in the aforementioned example meant the same reference as gross revenue prior to any other deductions.

REPRESENTATIVE GARA replied: "[Yes], it's not gross profit, it's total sales price, it's total revenue, and more than half of that's not profit." In further response to Representative Rokeberg, Representative Gara said the net profit figures are from the Department of Revenue, which should explain its methodologies for estimating the corporate tax cost. He reiterated that the aforementioned chart shows that at \$42 per barrel, even with the Governor's Aggregation Order, the oil companies are taking \$5 billion in profits from the North Slope.

[8:57:32 AM](#)

REPRESENTATIVE GARA turned to the slide entitled, "Healthy Profits" which details four Wall Street firms net profit margins in relation to their total revenue, which range from 7-18 percent with an average net profit of 10 percent. In 2005, at \$42 per barrel the North Slope producers will have approximately 40 percent profit margins. In 2005, if oil were to drop to \$22 per barrel, the producers would still take a "healthy" 25 percent profit margin. If oil were to "tank" down to \$15 per barrel, there would be a "modest" 6.7 percent profit margin, he highlighted.

[8:58:32 AM](#)

REPRESENTATIVE ROKEBERG related his belief that the profitability of any investment needs to be analyzed over the length of that investment, particularly for capital resourcing. He stated that comparing the quarterly or annualized profit margins of non-related industries is not a fair comparison because it offers limited values in terms of analyzing the true return.

REPRESENTATIVE GARA relayed that he is trying to offer every possible measure for the committee to assess whether or not Alaska receives its fair share for oil. He said:

[Alaska] is giving out a whole lot more money than the state gets, in terms of share. [Alaska] is giving out a very fair profit margin: 25 percent if oil were to tank to \$22 per barrel, [and] 40 percent this year. [Alaska] is exempting a quarter of [its] oil from the state's production tax. Those are three measures. There will be more, and whether or not you want to compare the profitability of Alaska's oil companies to other companies in the world, that's totally [subjective]. Last quarter Exxon earned the largest quarterly profit of any corporation in United States' history because the price of oil has been so high: BP last quarter [earned] \$4.4 billion in profits, ConocoPhillips [earned] \$2.5 billion in profits; just their last quarter's profits totaled about \$15.2 billion and that's about \$7 million an hour On the low end Alaska overtaxes ... and according to the Alaska Oil and Gas Association (AOGA), they say a high end estimate of what it takes to be profitable in Alaska is \$12.82 oil At low prices Alaska becomes very unprofitable.

[9:00:54 AM](#)

REPRESENTATIVE GARA, in response to Representative Gruenberg, replied that there is an additional profit North Slope pipeline owners receive for running the pipeline. He said:

I'm not the expert in whether or not the pipeline tariff is fair ...; I don't believe it is, and frankly the higher the pipeline tariff, the more profit goes to the companies and the less comes back to the state in terms of production taxes and royalties. It gets deducted from the money that [Alaska] get[s], so if

there is an overcharge in the pipeline, [Alaska's] losing revenue for it.

9:01:50 AM

REPRESENTATIVE GARA turned to the slide entitled, "Wood Mackenzie" which details Alaska's profitability according to the Wood Mackenzie study. The study details that at \$35 per barrel, from 53 oil-producing regions, Alaska is the 14th most profitable place and at \$16 per barrel it's the 15th most profitable of 49 regions. According to the study the government's take on Alaska's oil taxes is the 19th lowest out of 55 regions. For instance, the Alaska average tax on \$35 per barrel is about 58 percent, while the global tax is about 73 percent. He reiterated that as the price of oil rises, Alaska's relative share decreases because Alaska taxes "poorly" at high prices and over taxes at low prices.

9:03:12 AM

REPRESENTATIVE ROKEBERG asked why the presentation didn't include the Wood Mackenzie study page that details Alaska has some of the highest production costs in the world.

REPRESENTATIVE GARA clarified that the aforementioned study says Alaska's "raw costs" are higher than most places in the world. However, the total costs including production, development, exploration, and taxes for a company to do business in Alaska are among the least expensive and the most profitable in the world, because Alaska's tax is so low at high oil prices, he said. He reiterated that Alaska's [raw] costs are very high, but its low taxes are very competitive.

REPRESENTATIVE ROKEBERG related that he "does not agree" with Representative Gara's understanding of the Wood Mackenzie study.

REPRESENTATIVE GARA replied, "That's fine, and I hope that members of the legislature would maybe work on a study that we could discuss in public. I don't think it helps us at all to have a study that we can't talk about."

9:04:51 AM

REPRESENTATIVE GARA moved on to the slide entitled, "How the bill works - 5% "Minimum Tax", which details the two principal reforms of HB 63. The first reform "leaves the ELF as is" and it establishes a minimum 5 percent production tax. The second

reform imposes that oil above \$20 per barrel is in the "windfall profits range" and the production tax should increase accordingly and below \$16 per barrel, when oil becomes less profitable, the production tax shall be reduced including the fields with a 5 percent production tax. The second reform incorporates a price factor into the ELF and production taxes to reflect the reality that oil is very profitable at high prices and not at low prices, he added. He noted that if this legislation were to take effect at \$22 per barrel it could raise \$90 million; at last year's price it would raise another \$400 million, and this year's price would raise another billion. He highlighted that the oil companies upside reward would be protected if prices were to fall to \$10 per barrel because the state would give back roughly \$50 million to the oil companies.

[9:06:39 AM](#)

REPRESENTATIVE GRUENBERG asked if Alaska were to give money back to the oil companies wouldn't it be during a period when Alaska needed that money the most.

REPRESENTATIVE GARA clarified that at \$10 per barrel this legislation would produce \$50 million less in production taxes than not doing anything. He said, "If [the state] want[s] to have a system that slightly overtaxes at low prices and largely under taxes at high prices, we can leave things the same. But ... by over pricing at low prices, you're deterring production ... [and] development. You're telling companies that they have to take the risk that if oil prices tank they're going to lose money And I think we have to share some of the burden at low prices."

[9:07:48 AM](#)

REPRESENTATIVE GARA pointed out that the state and corporate shares equalized in range, for \$10-\$50 per barrel, prior to the Governor's Aggregation Order. Since the aforementioned order, shares were altered such that the state receives a slightly larger share than the corporate share. Representative Gara paraphrased Jay Hammond as follows, "That the intent of Alaska's oil tax system should have been to give the state roughly an equal share to industry" but Alaska isn't doing that now.

REPRESENTATIVE GARA reiterated that this legislation includes tax relief if oil drops below \$10 per barrel and a provision exempting heavy oil because it is more expensive to produce. In addition, the legislation includes a provision expanding upon

the Royalty Relief law [House Bill 28 of the Twenty-Third Alaska State Legislature] that if a company can prove the state's taxes are making a field "uneconomic," the state will reduce that field's taxes. In response to Chair Weyhrauch, Representative Gara said the provision would be an administrative mechanism. He reiterated that House Bill 28 and this legislation both address whether taxes are making fields economically feasible and if not, additional relief shall be granted.

[9:10:28 AM](#)

REPRESENTATIVE GARA opined that the oil industry tends not to respond to the legislation [favorably] and neglects to focus on issues such as the tax relief provision providing incentives for production and the fact that Alaska is more profitable than other places in the world. The oil industry responds to tax reforms by declaring "[the legislature] can't change taxes [on us] because a deal is a deal." He highlighted that the legislature passes about 400 bills per session and "A law is not a deal, a law is [the legislature's] policy judgment as to what is right and what is fair to Alaskans." He alluded that under "the deal is a deal argument" all fields would be paying the original 15 percent production tax and the ELF wouldn't exist, hence the "deal is a deal argument ... is a red herring."

[9:11:18 AM](#)

REPRESENTATIVE GARA, in response to Chair Weyhrauch, said:

[The aforementioned argument is a red herring because] it assumes that industry is allowed to come to the government get the best deal it can If it can get a bill that under taxes its oil, then you come up with a deal is a deal argument and you cement that into law forever ... government should work better than that. Government shouldn't have the worst law possible that is negotiated on the books ... by ... powerful industry lobbyists. If industry succeeds in getting ... [an] anti-public interest, pro industry bill and then says you can never change it, ... then there is really no reason for us to be here. In 1989, the same arguments you'll hear today were made then ... in various contents by various companies since the first time anybody ever suggested an income tax. But in 1989, they said ..., according to the Senior VP of ARCO, the changes would put a burden on the oil industry that will make them remove to other states or

countries, the money that would otherwise be spent on investments in Alaska.

REPRESENTATIVE GARA suggested that companies often oppose reforms by claiming reforms will drive the company out of business or force them to do business elsewhere. He related his belief that corporations have a legal duty to maximize the profits of its shareholders, and the legislature has a legal duty to maximize the tax revenue corporations pay to the state. He highlighted a newspaper article in which BP claimed it has too much money to invest, and therefore it returns excess money to shareholders and/or uses it to provide corporate bonuses. However, returning revenue to shareholders [contradicts] the idea that tax reduction provides incentives for returned investment in the state, he noted.

[9:13:45 AM](#)

REPRESENTATIVE GARA concluded his presentation by reviewing measures necessary for oil tax reform. He said:

[The state is] treating very huge fields ... as if they were marginal fields ... [and] exempting fields from production tax even when oil is \$50 a barrel At average and high oil prices, according to Wood Mackenzie, Alaska is one of the more profitable places in the world to invest [According to] the Department of Revenue's own projections, [Alaska] produces a very healthy profit margin of somewhere upwards of 25 percent, 30 percent, 40 percent at \$22 a barrel and above. So, [Alaska] is producing a healthy profit margin for companies even after they back out their exploration costs. [Alaska] rank[s] very well in the world [and it's] exempting oil from very large fields from the production tax. And ... the other option is to just do nothing. [The] other option is to sort of grapple over the crumbs and say [there isn't] enough money for our schools and we have to cut back on senior services, and the like; and I disagree with that. I think that we're making ourselves poorer. Every single year we sit by, [the legislature] is running the risk that [it's] sending a huge amount of money out of the state that could either be put into needed services or put into our savings account. [If nothing is changed this year] according to the Department of Revenue, let's say the standard is [to] equalize the share that the state

receives and companies receive in terms of profit ... [then Alaska is] sending out \$1 billion. [Alaska] didn't do anything last year [and] we sent out \$500 million in excess tax exemptions It's incumbent upon the legislature to do something about this problem now, every year that [the legislature] waits [it's] sending out a huge amount of money from the state. And my biggest fear ... is that [the legislature] will finally act on oil tax reform when oil prices go down to some low level, so [Alaska has] these couple years where oil is fantastically expensive and we're missing out. We're missing out on money we could put into our savings account, ... money we can put into our schools. I have the biggest fear that we're not going to get our act together on this issue until oil is back at \$30 a barrel or maybe until it tanks.

REPRESENTATIVE GARA then turned attention to old Alaska budget reports from the Alaska oil industry, which charged that Alaska's tax system isn't progressive enough. The aforementioned can be attributed to the fact that Alaska's tax system over taxes at low prices and vastly over taxes at high prices. Therefore, the oil industry and the state should come up with a system that doesn't deter or scare away investment at low prices. He offered that companies considering whether or not to invest in Alaska factor into their analysis the effect of oil at low prices. He highlighted that this legislation protects oil companies on the upside because the production tax will be capped above 25 percent. He reiterated that the legislation will protect business on the downside, protect the profit margin on the upside, and gives Alaska its fair share.

[9:18:04 AM](#)

REPRESENTATIVE GARA, in response to Representative Rokeberg, relayed that the heavy oil provision "can certainly be tweaked" and the heavy oil standard adopted in this legislation is the federal definition of heavy oil.

[9:19:39 AM](#)

REPRESENTATIVE ROKEBERG related his belief that production below 250 barrels per day zeros out a well, and therefore the proposed 5 percent minimum floor would be incentive to shut down a well. He added that the administrative action for royalty relief can

be a long process, which, in the mean time, can cause complications for the corporations.

REPRESENTATIVE GARA replied that the 5 percent tax is a modest tax and in a situation in which taxes are too high this legislation provides a system allowing companies entitlement to tax relief if they can prove it's needed.

[9:22:59 AM](#)

REPRESENTATIVE WILSON inquired as to the evidence necessary to prove taxes are making a company economically unfeasible.

REPRESENTATIVE GARA replied that the legislation specifies that oil companies are not entitled to tax relief unless they show clear and convincing evidence it's needed to make a field economically feasible. The aforementioned, he opined, is a fair method.

[9:24:47 AM](#)

REPRESENTATIVE ROKEBERG opined that there has never been one act of royalty relief under the current statute.

REPRESENTATIVE GARA related his belief that the aforementioned is the case because Alaska is a profitable place to do business. He highlighted the Wood Mackenzie study and the profit figures from the Department of Revenue which detail that the fields online are profitable under the current tax structure, and therefore not entitled to royalty relief.

[9:25:59 AM](#)

CHAIR WEYHRAUCH commented that the dialogue on this issue will be continued at another time, in order for other people to offer testimony.

[9:26:44 AM](#)

REPRESENTATIVE GARA summarized the Department of Revenue's analysis details, at each price level, the corporate profits and the state's revenue.

[9:27:39 AM](#)

CHAIR WEYHRAUCH surmised that the context of this legislation addresses that the state overtaxes at low prices and under taxes

at high prices. He asked for an explanation on the administrative order as it relates to the ELF.

[9:28:31 AM](#)

JUDY BRADY, Executive Director, Alaska Oil and Gas Association (AOGA), relayed that AOGA is a non-profit with 19 members that are involved in exploration, production, transportation, and refining of oil and gas products in the state.

[9:30:58 AM](#)

TOM WILLIAMS, Chair, Alaska Oil and Gas Association (AOGA), presented the slide entitled, "Oil and Gas: Vital to Alaska", which shows a pie chart detailing the FY 05 unrestricted revenue of which 88 percent is petroleum and 12 percent is non-petroleum. He said, "Oil is going to account for three-quarters of the pie ... through 2014 ...," and what determines that percentage is the price of the oil and how much is produced. He highlighted that the amount of oil produced requires significant new investments and Alaska will have to compete with opportunities elsewhere. Currently, Alaska receives four major sources of revenue from the oil industry: the royalty, production, property, and corporate income tax. In FY 04 the royalty based on ownership of the land generated \$1 billion that was placed in the general fund (GF) and \$500 million was placed in the permanent fund. In FY 04 the production tax generated \$652 million. The property tax is determined by the state's assessed value of the production, exploration, and transportation costs; he noted that oil companies receive a credit for local taxes paid against the state taxes on the same property, of which most goes to the municipalities. However, in FY 04 \$50 million went to the state. In FY 04 the oil and gas corporate income tax generated \$300 million and accounted for 88 percent of the total corporate income tax. In FY 04, the oil companies paid \$2.75 billion in taxes however, the state only counts a \$2 billion figure in the budget because the permanent fund and the municipalities' portions are not spendable. He suggested the amount of taxes paid accounts for a difference in perspective between the two entities. He added that only the \$652 million portion of the production tax is effected by the ELF. He said that even if the ELF makes the production tax zero for a field, the field still pays full royalty and property taxes, contributes fully to the owners' income taxes, increases the netback value by lowering tariffs, and creates more Alaskan jobs.

MR. WILLIAMS turned to the slide entitled, "Production Tax", which details the formula for the production tax: production tax equals the ELF multiplied by the base rate, which is then applied to the gross resource value. The gross resource value equals the netback multiplied by the taxable volume. He explained that the netback in FY 04 had the "same spot price" of \$25.00 for all the West Coast destinations, save the netback value at pump station one totals \$20.34.

MR. WILLIAMS said Alaska's leverage regarding the price of oil flows back to the wellhead value. The base rate during the first five years of production is at 10 percent for gas and 12.25 percent for oil; after those five years the rate is 15 percent. The oil ELF is calculated depending on the field's size and well productivity; hence, larger fields with more productive wells have larger ELFs and higher tax rates, while smaller fields and lower well productivity have smaller ELFs and lower tax rates.

MR. WILLIAMS turned to the slide entitled, "Why Have an ELF", which details that the original purpose of the ELF was for a high rate production tax early in a typical field's life while avoiding the adverse consequences as the field depletes. The severance tax is based on the gross resource value of where it is produced and none of the operating costs for extraction are deductible, he added. He said, "As operating costs rise during the life of the field, the profit margin shrinks [because] the resource is non renewable Production tax contributes to the total costs and tends to hasten the time when this break-even point [called the ELF] is reached"

MR. WILLIAMS turned to the slide entitled, "The Adverse Consequences of a High Rate", which shows columns representing four stages of the producer's gradual profit margin reductions as the consequence of high operational costs. The producers' responses to the higher operational costs are the "Do nothing stage" where the cost is relatively small so the producers don't respond. The second stage is the "Drive for efficiency stage" during which the costs are getting to be a significant fraction so the producer starts cutting costs wherever possible. The efficiency stage makes new investments harder to be competitive because the field is not as robust as its earlier years. The third stage is the "Harvest stage" during which capital opportunities are no longer possible and no competition exists to help the field maintain production. The fourth stage is the "Running in the red stage", which can occur because of low oil prices or the huge costs terminating the field, such as

dismantling and removing the facilities. He noted that it can be less expensive to run an operation than dismantling it, which is how running in the red happens.

MR. WILLIAMS, in response to Chair Weyhrauch, explained on the aforementioned graph that the color green represents one-eighth royalty share, red is the 15 percent severance tax, black is the operation costs, white is the producer's margin, and the hash marks represent the severance tax being "eaten-up" by the encroaching production costs. He explained that companies [bank] on receiving large profit margins early in a field's life or else they incur [phenomenal] costs with no return.

[9:42:50 AM](#)

REPRESENTATIVE SEATON asked if stage one shows any of the costs associated with production, infrastructure, and drilling.

MR. WILLIAMS replied no.

REPRESENTATIVE SEATON asked if the production costs are a large portion.

MR. WILLIAMS replied that the columns represent production, infrastructure, and drilling as a "sum cost".

[9:43:40 AM](#)

MR. WILLIAMS, in response to Representative Seaton, recalled that in the past taxpayers could show that there was a higher level of cost than what was originally assumed. In 1977, the Department of Revenue proposed that producers need a certain amount of oil production to breakeven and the passage of the ELF legislation increased the assumption to 300 barrels a day per well based on the Prudhoe Bay costs.

[9:45:15 AM](#)

REPRESENTATIVE SEATON asked, for comparison purposes, if there were [projections] available on the differences between the Department of Revenue's and ELF's assumptions.

MR. WILLIAMS replied no.

[9:45:48 AM](#)

MR. WILLIAMS presented the Department of Revenue's formula that was not enacted, which is one minus the production at the economic limit divided by the total production during that tax period. The aforementioned is the total percentage of costs to cover the production out of the ground. Subtract the aforementioned formula from 100 percent, which equals the percentage that's the operating margin available for the producer. The wider the operating margin, the higher the tax rate because the field is healthier. When the operating margin gets "squeezed" it lowers the tax rate because there is less to bare the costs. He turned to the slide entitled, "How ELF Avoided the Adverse Consequences" with four color-coded columns. The chart shows the difference between the ELF and the Department of Revenue's aforementioned formula. He reiterated that in 1977 the Department of Revenue used the aforementioned formula for simplifying assumptions to ease the cost burden to the administration.

[9:48:16 AM](#)

REPRESENTATIVE GRUENBERG highlighted that the bottom of the columns present the data as though all the costs are the same. However, he related his belief that there are at least two types of costs: those the producer can control and those over which they have relatively little control.

[9:48:47 AM](#)

MR. WILLIAMS said he wouldn't make a distinction between the costs. He related that some costs are controlled such as operating a field with fewer employees. However, eventually the fields, like those in Cook Inlet that have been producing over 40 years, have the minimum required for safety and operations and thus there is no control because one can't safely run the platforms below that. He added that the slide simply illustrates an evolution over time, the easy oil comes first and as the field depletes, it gets harder and more expensive to recover the resources.

REPRESENTATIVE GRUENBERG specified he was pointing out it's not as simple as presented.

MR. WILLIAMS replied "Fair enough."

[9:49:46 AM](#)

REPRESENTATIVE SEATON commented that the slide shows that the ELF reduces revenue to the state, and yet there are still healthy profits. He inquired as to why, under the stage 2 proposed scenario, would taxes need to be reduced.

MR. WILLIAMS replied that in 1977 the tax rate for Prudhoe Bay wells at 10,000 barrels per day, before the ELF, was 7.8 percent. The aforementioned represents a 10 percent rate, and therefore under stage 2 it was still viewed as an increase over the prior system. The ELF was in conjunction with the tax increase and the base rate increased to the 12.25 percent applicable to the first five years of production. He explained that "we were going" to raise the tax rate for Prudhoe Bay and the base rate for all fields, and use the ELF to adjust it appropriately. The stage 2 scenario, in the case of Prudhoe Bay, would have been a higher tax than that prior to the ELF.

[9:51:17 AM](#)

MR. WILLIAMS pointed out that the oil industry opposed the ELF because Prudhoe Bay's tax rate was increased from 7.8 percent to 11.7 percent. The owners of Prudhoe Bay opposed the hike in taxes while in contrast the Cook Inlet owners saw a reduction in their tax rates, and thus were less likely to complain except for the fact they had interests in Prudhoe Bay. He reiterated that industry opposed the ELF.

[9:52:10 AM](#)

MR. WILLIAMS relayed that the original ELF formula was driven by well productivity, which was changed in 1989 to add the field size, total daily production, to the formula. The field size is compared to a reference level of a 150,000 barrel per day field, any field larger than the aforementioned causes the ELF exponent to move toward one and smaller fields would move toward zero. Thus, larger fields have larger ELF's and smaller fields have smaller ELF's. The field size is the dominant factor in the formula, he noted. He recalled the example he offered the legislature in which the tax rate was based on 500 barrels per day: Prudhoe Bay's 375,000 barrels daily tax rate was 11.9 percent and Lizburn's 40,500 barrels daily tax rate was less than 0.2 percent, which illustrates the formula is extremely sensitive to field size.

[9:53:46 AM](#)

REPRESENTATIVE SEATON asked if the previous [change to the formula] was based on the production facilities having to fulfill certain volumes in order to be profitable.

[9:53:53 AM](#)

MR. WILLIAMS said the justification for adding field size as a parameter was primarily because large fields can realize economies of scale that small fields can't. He noted that other reasons for the changes to the ELF included obtaining more revenue for the state, providing incentives for smaller fields, and providing pro-development incentives for West Sak viscous oil. Furthermore, Prudhoe Bay and Kuparuk could afford it. He recalled one reason for the change was after the 1986 crash when oil was priced at \$10 per barrel, Prudhoe Bay was costing the state over \$140 million per year and the administration told the legislature "we shouldn't be giving that money away." He reiterated that the ELF would reduce rates for all fields except Prudhoe Bay and Kuparuk. He opined that the definition of "marginal field", as described in the 1989 ELF legislation, "was a rhetorical term ... and wasn't used with its dictionary definition ... if 100,000 barrel a day field that came in early and under budget ... was a marginal field." He recalled that the legislature was told the following: the ELF could go to zero under the new formula, smaller fields would pay less [tax] even with the same well productivity as larger fields, and the state would gain \$2.7 billion. Therefore, the 1989 ELF change worked exactly as it intended, he opined.

[9:57:20 AM](#)

CHAIR WEYHRAUCH asked if the methodologies were really fair and whether it's time to review [the ELF].

MR. WILLIAMS replied, "It's not a deal is a deal, that is a mischaracterization because ... ELF was enacted over the industry's objections, but ... the legislature sets the tax policy ... [which was] changed in 1989. Industry has acted in reliance on the new policy. [The legislature] can change it again but [the industry] has invested lots of money."

MR. WILLIAMS turned to the graph entitled, "Historical Effects on ANS Production from Different Kinds of Investment", which shows the production gain resulting from new investments since 1989. The graph's black portion represents the natural decline of the fields would have been, the yellow portion represents the actual production from the North Slope fields, which become less

important over time due to the contributions of wildcat exploration, heavy oil, and satellite production. The projections for the future detailed on the graph entitled, "Contributions of Different Kinds of Investments in Additional Oil Production" shows a color-coded graph, detailing black representing the natural decline, yellow representing the investments for existing fields, and the remainder of the chart details new investments in wildcat exploration, satellites and heavy oil production, and developing new fields that have already been discovered.

CHAIR WEYHRAUCH surmised that Representative Gara's point is that the oil companies are making the investments, but the state is not getting any return.

MR. WILLIAMS recalled 1981 when President Carter created a windfall profit tax in which 70 percent of oil profits were divided and appropriated such that the state received one-third, the federal government received one-half, and the oil industry received one-sixth. He recalled when the ELF passed the state was concerned about protecting its one-third and basically told the oil industry to work out its "disproportionate sharing" between the federal government. He said, "It's interesting how if you don't know your lessons in history ... how you can misdescribe what they are."

MR. WILLIAMS then turned to a slide entitled, "Point No. 5", which highlights that both historically and for the future more investment is crucial and a given tax change promises to impact different classes of oil investments differently. Therefore, any change made must be examined for "unintended consequences" because more production could be lost than gained by raising the tax. He said, "Sometimes its better to grow the pie than to take a wider slice out of it."

[10:00:11 AM](#)

MR. WILLIAMS related that the governor's ELF decision lumped together six smaller fields, which made them all larger for ELF purposes. Because of the field size component in the formula, aggregating the fields increased the ELF and raised the tax rates for all the fields to the same rate. He added that two of the aggregated fields are West Sak viscous oil. He noted that American Petroleum Institute (API) gravity is not the appropriate measure to judge viscous oil but rather centipoise is. Centipoise is the measure determining how viscous the oil is, meaning how slowly it transports from the ground into the

wells. He informed the committee that high viscosity oil is a function of its temperature and its characteristics. He said viscous oil also produces lots of silt and currently over 1,300 cubic yards of silt have to be dug out of the separators producing West Sak oil and be disposed of somewhere else, which is a very expensive process.

[10:01:23 AM](#)

MR. WILLIAMS related that AOGA opposes this legislation because it's a structural increase. The Department of Revenue's long-term forecast is \$25.50, which is a 27.5 percent structural tax increase. This legislation raises the cap rate two-thirds from 15 percent to 25 percent. The proposed 5 percent minimum is a heavy burden on satellite development. This legislation fails to protect the West Sak viscous oil because it uses the wrong measurement, he opined. He said the legislation is not very balanced because at the assumed high price of oil the industry's tax increases to \$500 million or \$1 billion, while the state offers a tax relief of \$50 million when prices are low. He related his belief that if oil prices drop, it's not likely that the state will give back \$50 million to the industry. He opined that if oil dropped \$12-\$15 per barrel, then two-thirds of the revenue accounting for 80 percent of the GF budget will disappear. He relayed that a structural increase of 27.5 percent makes Alaska's investments less competitive. Alaska has \$20-\$30 billion worth of investments to develop over the next decade; therefore, it's crucial for the state to remain at a basically flat production level of 850,000-900,000 barrels per day, which is going to take a huge amount of investment and those investments have to compete against opportunities elsewhere, he noted. He alluded to the fact that when the oil industry profits, so does the state government.

[10:04:15 AM](#)

MS. BRADY added the oil industries fought the introduction of the ELF because in 1989 it would raise an additional \$2.5 billion over the next ten years from Kuparuk and Prudhoe Bay. She relayed that a production plan was intended so that when 2.1 million barrels per day fell to less than 1 million, like it is today, there wouldn't be fiscal issue. Therefore, the state anticipated the drop in oil production and it taxed the huge fields then, and now those fields produce half of that amount. The satellite fields and heavy oil started production five years ago under the ELF proposals and already the state is proposing changing the rules again. She reiterated that the state

received the revenue it intended to get from Prudhoe Bay and the development of the new satellite fields. She said, "We have in-built price benefit to the state, that's why we don't have the prices right now from high prices ... ELF is working as well as you can expect a state tax system to work and many places in Canada look at Alaska as the model for taxation. We're going to make more money this year in oil revenues than we have since 1981, and at that time we were producing almost half million barrels a day more than what we are producing now."

[10:06:21 AM](#)

REPRESENTATIVE ROKEBERG asked what impacts would an adoption of this legislation have on the negotiations regarding the gas pipeline.

MR. WILLIAMS replied AOGA can't comment on that because it's not involved in the aforementioned negotiations.

[10:07:10 AM](#)

REPRESENTATIVE ROKEBERG asked if the legislation's proposed 5 percent minimum tax would not only have a heavy burden on satellite development but would also effect any well mirroring the ELF in terms of lower productivity. He further asked whether it would tend to be a disincentive for an early "shut-in" of a particular well notwithstanding the impacts on the entire field.

MR. WILLIAMS specified that the ELF works on a field basis as the average well productivity rather than on a well-by-well basis.

[10:07:57 AM](#)

REPRESENTATIVE ROKEBERG requested that the Department of Revenue execute an analysis on the effects of this legislation. He related his belief that the legislation would change state policy regarding the government's take on the low end. He recalled testimony stating that the state could lose two-thirds of its current revenue at the lower pricing scale. He then asked about the relative costs of production in Alaska versus other provinces.

MS. BRADY relayed that the state has procured Chuck Logsdon to analyze the Wood Mackenzie study. The aforementioned study used different fields and timelines than those in previous studies.

She surmised that the state will be interested in the different price scenarios used to determine internal rates of return. She related her belief that Representative Gara misspoke about the aforementioned study's operation costs and benefits for operating in Alaska. She said, "the look out the window test" shows a high level of reserves and a low level of investors in Alaska. In 2004, AOGA had 21 members and lost 2 large companies, Total and EnCana. If Alaska were as profitable as Representative Gara related, there would be 20 companies and every independent company in the world looking at Alaska. However, that isn't the reality, she added.

[10:11:28 AM](#)

REPRESENTATIVE ROKEBERG asked if public information could be used to compare Alaska with the Gulf of Mexico. He opined that both places are North American provinces with different government takes and economic profiles. He related his belief that although the capital costs may be similar because of the high initial investments, the tax regimes may put Alaska at a disadvantage.

[10:12:10 AM](#)

MS. BRADY replied, "[AOGA] can verify that ... [when the Gulf of Mexico] makes finds [they make] big finds ..., the government take is low; its about half of what Alaska's is and that makes a huge difference." She recalled the graph where the white represents the producer's profit margins, which have to be made up fast to compensate for the previous investments. She opined that the oil industry is similar to the movie industry because both need to make back the capital costs quickly. This country lets the companies take all the risk and then hopes to get the payback in a short period of time, she said. In 1986 to 2003, oil prices averaged \$17.70 and at that price the state received 46 percent; the government, state and federal, received 64 percent. Therefore, during that time the companies didn't make much and there weren't many new investments in the state. The state may have made an error by changing the ELF in 1989 and taking that "big of a chunk", she opined. Currently, the state is going to count on more investment than has been present since the early 1980's. The Department of Revenue says the state needs more investment than it's ever had because such investments would keep the loss of production to under 800,000 barrels per day, which is the least amount of production ever lost. She said that the state lost 1 million barrels daily from 1989 to 1999, another 400,000 barrels daily between 1999 and

now. The state needs to maintain a minimum loss less than 200,000 barrels daily or find more oil in order to be profitable, she explained.

[10:14:51 AM](#)

REPRESENTATIVE ROKEBERG asked if Ms. Brady is testifying that the ELF has or hasn't worked for creating an investment environment.

MS. BRADY replied that the ELF worked, but the rate may have been too high in the beginning after which there was a long period of low prices.

[10:16:04 AM](#)

REPRESENTATIVE ROKEBERG commented that since 1999 the investments in the industry have stabilized production levels, and thus policies are balanced because it has maintained the flow of production.

[10:16:27 AM](#)

MR. WILLIAMS answered that there were continuous investments in the larger fields like Kuparuk and Prudhoe Bay despite the change in higher tax rates. Since 1989, the oil industry has been able to stabilize production and level off with no decline after 1999 because of investments in large fields, satellites, heavy oil, and wildcat exploration. The aforementioned investments will continue to increase in the future in order to maintain a stabilized level.

[10:17:55 AM](#)

REPRESENTATIVE ROKEBERG asked if the heavy oil projections should be updated to FY 05 because the current production is below the projections.

MR. WILLIAMS answered that he doesn't know [if the current production is below the projections]. However, he agreed that the heavy oil projections need to be updated because of the technology breakthrough last August that allows drilling lateral wells.

[10:18:35 AM](#)

REPRESENTATIVE ROKEBERG asked if currently Alaska is about 50,000-75,000 barrels per month below its former production.

MS. BRADY answered, "I believe that is right."

REPRESENTATIVE ROKEBERG asked if the aforementioned decline was due to production glitches last year.

MS. BRADY relayed that generally there was a loss in production. She said she was unaware of the specific reasons.

REPRESENTATIVE ROKEBERG questioned whether it is a long-term trend.

CHAIR WEYHRAUCH announced that, if necessary, this discussion would continue during the summer.

[HB 63 was held over.]

ADJOURNMENT

[10:19:16 AM](#)

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at 10:19 a.m.