MINUTES
SENATE FINANCE COMMITTEE
SENATE RESOURCES COMMITTEE
March 4, 2006
10:03 a.m.

CALL TO ORDER

Co-Chair Lyda Green convened the meeting at approximately 10:02:11 AM.

PRESENT

Senate Finance Committee:
Senator Lyda Green, Co-Chair
Senator Gary Wilken, Co-Chair
Senator Fred Dyson
Senator Bert Stedman
Senator Lyman Hoffman
Senator Donny Olson

Senate Resources Committee:
Senator Tom Wagoner, Chair
Senator Fred Dyson
Senator Bert Stedman
Senator Ben Stevens
Senator Kim Elton

Also Attending: SENATOR GENE THERRIAULT; SENATOR GARY STEVENS; SENATOR GRETCHEN GUESS; JIM EASON,

Attending via Teleconference: There were no teleconference participants.

SUMMARY INFORMATION
ACTION NARRATIVE

AT EASE 10:29:03 AM.

SB 305-OIL AND GAS PRODUCTION TAX
HB 488-OIL AND GAS PRODUCTION TAX

The Joint Committee heard a presentation on the companion bills by a consultant to the Legislative Budget and Audit Committee. No action was taken on the legislation.

SENATE BILL NO. 305
"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."

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."

Presentation by Legislative Consultant Jim Eason
On
Proposed Oil and Gas Production Tax

10:43:15 AM

JIM EASON, Legislative Consultant, detailed his background in the petroleum industry and government. His testimony was outlined in a handout titled, "Presentation by Jim Easton" [copy on file].

Mr. Eason read a quote from Page 2 of the handout into the record as follows.

Who Said It … and when?

Since discovery of oil in commercial quantities on the Kenai Peninsula in 1957, two great interrelated responsibilities face the Legislature. One will be that of encouraging future exploration and greater production. Greater cost factors such as those incurred in reaching and developing inaccessible fields may affect Alaska's

competitive position in world markets. We will wish to consider how far to go in creating a favorable investment climate toward attracting new payrolls and realizing rental and royalty income for the state.

Mr. Eason attributed this statement to former acting Governor of Alaska Wade, on the occasion of Alaska's first State of the State address of January 1959.

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The Challenge

- Your responsibility is not unique - but you are relatively better situated because you have the benefit of historical perspective.
- Among your considerations, there is only one certainty - your numbers are wrong, but not necessarily bad
- Why are your numbers wrong?
  - Geological uncertainty
  - Production volume forecasts
  - Price forecasts
  - Failing to identify and quantify the range and magnitude of credits and deductions
- Not much control of these uncertainties - best judgment.
- Your choice of words, however, can reduce fiscal risk and provide greater certainty.

Mr. Eason stated that the legislators are not in a unique position in revisiting how to balance the states interests in promoting and benefiting from exploration of oil and gas. This history is almost 50 years. The questions have always been hard. However, the legislators have the benefit of the past 50 years' efforts that was not available to earlier state leaders.

Mr. Eason intended to discuss this history in his presentation, as several members might not be familiar with the major concerns of past efforts, particularly litigation that has shaped oil and gas law in the state.

10:48:07 AM

Mr. Eason qualified he is not an attorney and does not intend to interpret law. However, in his capacity as a State employee, he

attempted to "unravel some of the problems that had been created".

Mr. Eason announced that this presentation would contain "no numbers", but would instead focus on the language.

Mr. Eason stressed the one certainty of the proposals before the legislature is that the figures were incorrect. This is not necessarily a negative. However, some would advise on the best way to interpret those figures and understanding that the figures were incorrect would be important in considering this advice.

Mr. Eason stated that geological uncertainty is one reason the figures were incorrect. A unique combination of events must occur before oil and gas could form, and more unique events must occur for that oil and gas to migrate to a trap and be discovered by someone possessing the ingenuity to extract it. The vast majority of discoveries are not commercial.

Mr. Eason remarked that this situation would not change significantly with incentives. Exploration would expand and more discoveries would occur. But assuming quantification of this would be a mistake. Each legislator has a different level of reliability on the information provided.

10:51:04 AM

Mr. Eason listed another uncertainty as the production volume forecast. Significant modeling has been presented to demonstrate the Department of Natural Resources' and consultant's predictions. But in reality, the spectrum of production forecasting varies from: known reserves that have been producing for some time, to forecasting undiscovered resources. Forecasting known reserves could be relatively accurate, while forecasting undiscovered resources is highly speculative.

Mr. Eason reminded that the legislature is aware of the variations of price forecasts, as these are addressed each year.

Mr. Eason cautioned that the aforementioned uncertainties could not be controlled. Additional sampling and undertaking "things around the margins" could improve the reliability of engineering and geological assessments, "but you can't put oil where it isn't and you can't put gas where it isn't either".

Mr. Eason stated that focusing on the language of negotiations and statutory changes could assist in controlling expectations and economic assumptions.

Mr. Eason stressed the importance of reviewing and understanding past situations. His concerns with proposed language are based on the history of prior oil and gas relationships.

Mr. Eason emphasized his comments are not intended to imply that any of the past relationships are bad or one-sided, but rather are normal commercial relationships. A tension exists between the State as leaser and tax authority, and the lessee that pays the tax and royalty. This tension is inevitable.

Mr. Eason indicated that the language of any agreements could lessen this tension.

10:54:40 AM

Mr. Eason spoke of the inevitable tensions that would develop between statutory changes and the reaction those changes create.

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- Cook Inlet example - "wells" versus "completions"
- North Slope example - the disaggregation and aggregation issue.
- ANS Litigation History - the past can be the key to the future.
- The most costly words - the ANS royalty litigation.
- Where and how - "at the well" and in a multitude of ways.

Mr. Eason began with the situation involving resource development in the Cook Inlet. The economic limiting factor (ELF) has been in effect for several years. The assessment that ELF has not been sufficient for the State in recent years has become apparent. An obvious reason relates to disaggregation and aggregation effects. Previous problems also demonstrate how language could be used to produce a different result for affected parties.

Mr. Eason told of an incident involving producers operating in Cook Inlet whereby a policy was adopted to change the way wells were characterized resulting in a lower ELF. Agreement would be

likely among legislators about the definition of a well: "a hole in the ground" that could access oil, gas, water, etc. However, a practice developed to consider the number of completions inside a well to determine the number of wells present. That affects the calculation of ELF, and reduces the State's revenue.

Mr. Eason gave another example as the aggregation affect from the recent changes in Prudhoe Bay taxation for oil development activities. The matter of disaggregation that preceded this received less attention. For a number of years, the Prudhoe Bay development was treated as a "very large field", and then a practice began in which segments of that field were named as individual fields as they were newly delineated or extended. The issue is a question of interpretation. The decision makers "on both sides" involved were "differently positioned"; some ascertained these were not new fields, others contended they were. Forethought could have avoided this problem and early discussion could have resolved the dispute sooner.

Mr. Eason next addressed large problems and the lessons they could provide. The most famous was the ANS royalty litigation.

10:58:17 AM

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The Lessons

- Milestones in the ANS Litigation.
  - ANS field cost allowance settlement (1980)
  - TAPS Agreement - "just and reasonable rates" (1985)
  - Royalty Settlement Agreements (early 1990's)
- One common lesson learned - reasonable opportunity to revisit fiscal provisions critical to long term satisfaction
  - ANS field cost allowance history and magnitude
  - TAPS Settlement
  - Royalty Settlement Agreements

Mr. Eason provided a history of the ANS litigation. In 1959 as the State was considering a competitive leasing program the language of the federal leases was reviewed and regulations and a draft lease form were adopted based on the federal example. Shortly after drafting the lease form, the assistance of a consulting attorney from San Francisco was offered. This

attorney represented a famous law firm with offices located in the Chevron Building. With the participation of this attorney, some terms were changed, including terms pertaining to "value" and how price would be established. This created a situation in which the State could benefit relative to other leases, but it also introduced a "series of questions", which became an issue when production was beginning in 1977. The terms were costly and were based on how and where the State's royalty would be valued.

Mr. Eason said the issue appeared simple but was not, and resulted in litigation that lasted 17 years and cost "untold millions of dollars."

Mr. Eason defined the debate as whether the "State's oil" would be "valued at the well", as the language of the lease actually said, or that the value would be determined when the oil reached the "edge of the unit or field", as intended by the lease drafters. Also at issue was determining the allowable and reasonable transportation down the pipeline and on marine vessels, as well as how to value the different trades, exchanges, external sales and other transactions made before the oil reached "distant markets".

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Mr. Eason informed that immediately upon production in 1977, it became apparent that all the lessees operating on the North Slope had different interpretations of the language. The amounts they reported for their royalties reflected this. At the time, this was "unfathomable" for State officials to understand.

Mr. Eason related that the process began to settle this matter in the court. "Obviously, those few words grew into a host of separate issues." Over a number of years, the State and the defendants argued and attempted to resolve all the issues.

Mr. Eason told of several "milestones" achieved during this process. An early decision ruled that the State did have some obligation to participate in the payment of fuel costs and processing costs of oil if the oil was taken "in kind". This resulted from a provision inserted by the consulting attorney that allowed payment in kind, but failed to indicate the State's obligation for processing costs.

Mr. Eason continued that interest was expressed in the process of refining during the time of the aforementioned court decision. The judge's decision included a ruling that although the State must pay an in kind processing fee, doing so could violate the legislative direction and therefore the State must calculate the loss. As a result, the producers negotiated a settlement in 1980 called the ANS Fuel Cost Settlement. The State agreed to pay 43 cents per barrel for processing fees. Similar arrangements were made for gas production.

Mr. Eason pointed out that an "escalator" formula was adopted that provided for adjustment of the producer price index. Over time, that amount has increased to the current cost of almost one dollar per barrel. The State must determine how to proceed with future development of gas and oil.

Mr. Eason listed a second milestone of the litigation process as a determination of the method of calculating a tariff for the Trans-Alaska pipeline.

Mr. Eason surmised that most agree that the "State's decision may have been deficient in some respects." Whether this is true is subject to individual interpretation. The decision was made at a time when expectation was that Prudhoe Bay contained a certain amount of reserves, a certain amount of costs would be involved and that additional production could occur. The record of these calculations is limited. The decision resulted in a tariff recently determined to be high, and that could not be changed by the State for some time and which the State must defend in the event of other challenges. This has been a major impediment for third party lessees and other producers. Intentions were good, but the provisions were inadequate.

Mr. Eason noted that near the end of the litigation process, the State appointed a team of negotiators to attempt to resolve the outstanding oil and gas issues before the final court date. This resulted in a series of royalty settlement agreements reached with Atlantic Richfield Corporation (ARCO), British Petroleum (BP) and Exxon.

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Mr. Eason detailed that these agreements "substituted for the disputed value and price language of the lease" and created a new system in which the parties negotiated individual valuation

provisions for each contract. All three agreements were based on a "basket of crude oils and an evaluation of the differential movement of the averages of the daily spot prices for those crude oils month-to-month, adjusted for transportation, marine transportation, Trans-Alaska Pipeline System (TAPS) tariff, quality bank and other costs to move them back to the North Slope." These agreements also included a reopening provision, as each party realized "it was highly unlikely" that all parties would be satisfied in the long-term.

Mr. Eason pointed out that this was an entirely new system. The State had limited experience, in some cases because of the unique mixture of the baskets.

Mr. Eason asided that the North Slope lessees not involved in the litigation were offered a one-time opportunity to select one of the three settlements to apply to their calculation of royalty. That process has continued. A number of reopeners have occurred in all three of the major producer settlements. One pending reopener is beginning a second arbitration. Arbitration is provided in each settlement.

Mr. Eason relayed opinions "from both sides" judging the settlements as good, as producing fair value for the parties, and that the mechanisms adopted have worked and served well in identifying and resolving problems. Most of the decisions and compromises have been reached without formal arbitration.

Mr. Eason reiterated that the three settlements all included an arbitration procedure.

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Examples of Concerns

- Point of Production
- Definition of Gas Processing Facilities
- Definition of Gas Treatment Facilities
- The unknown relationship of terms to a stranded gas contract
- The unquantified but major deduction and/or credit exposure - "abandonment"
- Pending Questions

Mr. Eason next addressed his concerns with the proposed legislation, based on the prior litigation experience and the understanding of the impact of the language.

11:10:59 AM

Mr. Eason noted that value would be measured at the point of production. The point of production determines "where the obligation to the State begins" because the State would not be assessed a portion of the production costs for activities before the point of production. Postproduction is different.

Mr. Eason spoke to the complexity of activities within the processing facilities on the North Slope, which State officials had not focused on. The design and layout of gas treatment or processing plants is not standardized.

Mr. Eason cautioned against allowing producers to construct and operate these facilities solely for the benefit of changing the value.

Mr. Eason qualified that the legislature has been requested to not consider the implications of a possible natural gas pipeline proposal in context with this bill. However, the interrelationships and linkages between the terms of that contract could impact the interpretation and administration of this bill. The definitions for gas treatment plants and gas processing facilities are new. The State would be vulnerable without a full understanding of how the parties intend to administer this, as well as an understanding of how the facilities would be designed and built. This question has been posed in writing and to date an answer has not been provided.

Mr. Eason remarked that the processing and treatment facilities serve several purposes, which affect oil and gas. An allocation and attribution of cost is "sometimes just unique" to a particular facility. Understanding the impacts of this would be important. Because he did not have sufficient information, he could not advise on the implications on the costs of deductions and credits.

Mr. Eason identified another potential concern as the "breadth of the language allowing deductions for essentially all qualified expenses for exploration, production and development." Existing definitions of oil and gas terms demonstrate multiple

ways to assess exploration, production and development. An exact listing of the qualified expenses is essential.

11:14:32 AM

Mr. Eason informed that some independent processors share this position.

Mr. Eason stated this issue relates to tension between departmental regulations and legislative statute and would be worthwhile to establish. The cost ramifications could be significant.

Mr. Eason spoke of the likelihood that the State would be responsible for abandonment costs under the provisions in this bill. This was confirmed in a written response issued by the Department of Revenue, in which the Department indicated it did not have any estimate, nor had it modeled any estimates of those costs for the purposes of pricing. The reason was cited that the Department did not have empirical data necessary to calculate an estimate. The amount is significant.

Mr. Eason understood the legislature was considering allowing deductions and credits for exploration, production and development expenses for every well drilled and for capital facilities. Securing a "proxy for these kinds of numbers" is possible. The "number is large enough" for him to recommend doing this.

Mr. Eason asserted that the State has no obligation to participate in the cost of abandonment of the facilities currently in place. This cost is assumed and recognized by lease purchasers. Federal and State tax provisions allow certain deductions for abandonment expenses. This legislation would allow deductions and potentially credits for those costs.

Mr. Eason indicated the absence of public information regarding the 16 platforms located in the Cook Inlet. The US Geological Survey conducted a study two or three years prior on the platforms located along the coast of the state of California. Some of the facilities are large and sophisticated with loading facilities, which are unlike any that would operate in Alaska. Without defining the monetary reference, he stated that the smallest platforms operating near California "were at $10.3

million up to about $129 million". The majority, 12 of 23, were somewhat less than $30 million "but still big numbers.

Mr. Eason emphasized other factors must be considered in the decision to abandon, including transporting heavy lift vehicles to Alaska. Efficiencies could be achieved by having a number of abandonments done in the same season. However, the actual costs are unknown and would be significant. He cautioned against allowing a situation "on the revenue stream of a magnitude and timing that would be unfortunate."

Mr. Eason noted indications of companies' understanding of their responsibility for the cost of abandonment of facilities located in Alaska where they have net profit share leases. The Division of Oil and Gas records provide information about the actual abandonment cost calculated against net profit.

Mr. Eason related that "Endicott" had a net profit share allowance of $110 million in 1995 for abandonment of "those facilities". The Division contends the amount is high and that the amount reflected the cost of abandoning the island on which the facility was located. Questions were raised about whether the federal Environmental Protection Agency and other agencies would "require that" or whether the "island would be simply stripped of its armor and just be allowed to go back to nature."

Mr. Eason stated, "assuming the best case they were still looking at about $60 to $80 million. In the case of Endicott,

11:20:04 AM

Mr. Eason continued that the Division has other evidence from submitted applications for royalty productions. Although the identities of the companies were confidential and the specific allocations the companies estimate as "proper" could not be revealed, the "numbers that they have represent seven to 20 percent of the total facility plus well costs for these developments."

Mr. Eason referenced "North Star" as having "$75 million", noting, "the public information on that was… around a billion dollars for development." Therefore seven to 20 percent as estimated by the Department of Natural Resources, should be considered in terms of "the world" from "Swanson River, across Cook Inlet, to the North Slope, because there are a lot of

facilities that are going to have to be abandoned." Uncertainty exists of what the requirements would be, but "people's view" could provide an estimate in a "collective sense" to ascertain "what kind of exposure you've got there."

Mr. Eason indicated the attempts to identify and address "larger potential issues". The joint resources committees have posed a series of questions.

Mr. Eason qualified that some information was outstanding and would hopefully be received to provide greater clarification.

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Recurring Historic Themes

- The use of the unit operating agreements
  - Substantial weight (see Sec. 21, pg. 12)
- The adoption of royalty settlement methodologies (see Sec. 20, pg. 10)
- Arbitration

Mr. Eason noted that these themes have arisen in the context of settlement negotiations on behalf of the Department of Natural Resources, and unit negotiations "to create a unit" or discuss development plans, and in the context of royalty settlement agreements, which he helped negotiate for the State.

Mr. Eason asserted that a "slight red flag" arose as he considered this bill relating to the reference of the "unit operating agreement" as one indicator of cost. He was not concerned that the unit operating agreement would be reviewed, as current authority provides for this and all factors indicative to qualify deductions should be considered. However substantial weight should not be given to the one factor through legislative directive. He did not understand the implications.

Mr. Eason pointed out that the State has no authority to change the working unit operating agreements between parties or require renegotiation. He detailed the processes of these agreements and the multiple changes that occur.

Mr. Eason recommended legislative preference be retained.

Mr. Eason expressed additional concern with language included in Section 20 of the bill that references the royalty settlement

agreements negotiated by the Department of Natural Resources as one indicator of value. Currently the Department of Revenue has broad authority to assist its efforts in determining the value of the royalty that would be reduced by transportation and other expenses. Relative to the Department of Natural Resources, "it's an extraordinary position" because the Department had to rely on the terms of the contract, which were disputed. A settlement of this dispute was necessary if the State were to "get anywhere". The Department of Revenue is in a stronger position due to significant precedent, court reference and its decisions are "usually pretty strong and pretty well defended."

Mr. Eason stated that although the royalty agreements have "worked well and performed well, they have not performed as well financially over time." The Division of Oil and Gas and the Department of Revenue provided data that indicated that the first ten years of those settlement agreements, with the exception of a two-year period, the tax severance value has been higher. In the most recent period of 2001 through 2005, the difference has been consistent and about 40 cents per barrel more "on the severance tax side on average than the royalty side". This could increase.

11:26:50 AM

Mr. Eason was also concerned that because the linkages between this agreement and the potential gas agreement are unknown, the settlement methodologies referenced by the Department of Natural Resources also contain arbitration provisions. Whether this is relevant to the Department of Revenue at this time is uncertain. Arbitration, if it were used in a tax setting, would not provide the same protection as the State currently has. The arbitration provisions, although different for the three major settlements, remove the dispute from the "normal administrative and judicial arena where the Department of Revenue has some deference" and transfer the disputes to a "relatively unpredictable arena" with limited discovery. If the issue were highly technical, the case would be difficult to "make" because of differences in timing and record building relative to the status quo.

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Recommendations

- Take the time to confirm the lessees' AND the DOR's intent where there is an ambiguity

- Expect linkages and try to understand how they may affect or be affected by future events
- Take advantage of your "extra eyes".

Mr. Eason overviewed the recommendations and concluded his presentation.

Senator Therriault attempted to understand and appreciate the importance of the point of production. The location of the point of production would affect the transportation costs, a portion of which the State would be responsible for offsetting, or would affect the up field expenses that would be deducted from net income. Yet the State has no control over the structure of the processing equipment. He requested more information on the point of production. Two different systems exist: the royalty tax system and the taxable income system. The location of the point of production impacts the two systems.

11:31:41 AM

Mr. Eason replied that it was a "matter of law" with precedence established through the Department of Natural Resources and in court decisions. Senator Therriault described the issue correctly with regard to the location of the point of production determining value.

Mr. Eason suggested having an understanding of the current point of production for tax purposes and to determine whether the point would change for anticipated facilities for a North Slope "gas sale".

Senator Therriault cited a question the consultant had submitted to the Department of Law asking, "please provide and identify the point of production at each unit in the State under existing statutes, regulations, agreements - provide the same under the definition as proposed." A response was forthcoming. He surmised this request is to review the history and understand the complexity of the different fields. He asked if the witness suggested that this history could influence a determination as to where the point of production should be for future projects to alleviate some of the uncertainty.

Mr. Eason recommended the identification of whether or not the change of definitions and factual circumstances combined with the construction of new facilities would change the State's

obligation. It is a question of "relative effects". The changes are proposed without a full discussion of the rationale and the implications of potential linkages for an agreement "that everyone knows is finished and is waiting to see." With the exception of the negotiators, the producers' intentions for the location of point of production are unknown.

11:37:02 AM

Senator Dyson asked the range of the volume reduction per barrel that occurs between the wellhead and the edge of the field after "taking out" the water, municipal gas and other "things".

Mr. Eason could not provide an answer at this time. Water content is growing over time and other factors are occurring on a continuum. He deferred to an engineer currently involved in the measurement and processing.

Senator Dyson asked if the range is approximately ten to 30 percent.

Mr. Eason estimated "the low end".

Senator Therriault referenced Section 20 of the bill on page 11 and subparagraph (1) on lines 6 and 7 that provides "a royalty value determined under a royalty settlement agreement between the producer and the state, with adjustments if appropriate". Different methodologies are used by the Department of Revenue, the Department of Natural Resources, and the federal Department of Interior. The proposed method would be the "lower of all three" and he has been told the amount would be up to one dollar per barrel, which he considered substantial. He asked for an explanation of the variations over time.

Mr. Eason informed he has seen adjusted and unadjusted data on the "royalty side". The lessees would have authority under the agreement to adjust for certain errors and omissions, which is "bookkeeping" to account for physical measurements. Preliminary data indicated "some delivery timing issues on the tax side that really left sort of an apples to oranges comparison." He suggested that the database would include "some high numbers". The 2000 through 2005 period included some relatively high figures that were unadjusted. However, the finalized figures were approximately 40 cents per barrel on average.

11:40:57 AM

Senator Hoffman recounted statements asserting, "ELF isn't working". He asked the point the current system failed, whether it was when the price of oil exceeded $40 or $50 or another factor. He questioned the July 2006 effective date of this legislation and instead proposed a retroactive implementation.

Mr. Eason indicated this was a broader policy issue, which he deferred to the Murkowski Administration. This bill would change to a tax based on profits from the current tax based on production. The current system was adequate before the resource development at Prudhoe Bay was aggregated.

Senator Hoffman remarked that the policy question must be addressed; whether to make this legislation effective on July 1, 2006 or the date at which oil prices reached $50 per barrel.

Mr. Eason indicated that an analytical and mathematical examination of the issue could be undertaken.

Senator Elton referenced the witness' statements that this legislation must be "sorted through on facts" and that the legislature does not have all those facts. He asked if this related to the negotiations for a natural gas pipeline, which have been confidential and that decisions regarding oil and gas taxes should not be made without knowledge of the specifics of the negotiations.

11:45:37 AM

Mr. Eason corrected this was not his intention. Rather efforts to secure information would likely be successful. However, if that information were not received, the State would have additional "exposure". Changes to a tax structure would always result in exposure due to unforeseen factors but as many issues as possible should be resolved before changes were implemented. The outcome in 20 to 30 years would be difficult to predict. History has demonstrated this.

Senator Guess referenced the witness' assessment that the term "just and reasonable costs" had been discussed in the past and she noted the term "direct, ordinary and necessary costs" is utilized in Section 21. She asked if the consultant was

"comfortable" with those terms given past agreements and litigation or whether this would introduce new terminology.

Mr. Eason answered, "I'm never comfortable with those sorts of words," as they "invite disputes." However, he was unable to suggest better terminology. Each term has the potential for dispute.

Mr. Eason had greater concern with the "breadth" of the eligible cost of exploration, production and development because he could not identify any expenses that would not qualify. He anticipated that costs would be claimed that had not been considered, including abandonment costs.

11:50:09 AM

Senator B. Stevens appreciated the witness' comments about uncertainty in the numbers presented and factors beyond the ability of forecasting. Senator B. Stevens addressed the comments about change in valuation based on point of production and the concerns expressed with industry constructing or relocating facilities for the purpose of changing valuation. He requested a specific example.

Mr. Eason clarified that the practice more often involves "moving the facilities inside the facility" and defining the point of production relative to treatment and processing.

Senator B. Stevens understood the concept of moving the conceptual point of production. However, he interpreted the witness' comment to indicate moving the facility or constructing a facility to influence point of production.

Mr. Eason reported that all his experience with this matter has involved facilities built with the subsequent argument of the location of the point of production inside the facilities. The allocations made between oil and gas inside the facilities and normal handling costs could be structured to take advantage of the system to some extent. Modifications and improvements could be made to facilities that would produce a different result. This is not nefarious and is "technically immaterial", but provides an advantage. This is not wrong, but must be considered before regulations were changed because of the tax implications. The issue is that the State's responsibility for treatment and

other costs in the future is unknown. Facts must be established. Past administrations did not have this information.

11:54:38 AM

Senator B. Stevens appreciated the concerns related to uncertainty regarding the natural gas issue, but stressed that a gas plant does not exist. If one were constructed, those items would be presented to the legislature and addressed at that point. He directed attention to the impacts this legislation would have on oil production. He questioned why industry would construct a facility within a facility solely to affect valuation and not improve efficiency.

Mr. Eason clarified this was not the message he intended to convey. His assumptions presumed the changes did not affect operation.

Senator B. Stevens interjected to cite Mr. Eason's statements that the producer "built a facility within a facility" to change the point of production. He assumed this would require construction of a new facility. This is a conceptual point of determining point of production and what operations are included in the costs. That would affect valuation. He understood the intent of this bill is to establish a consistent point of production for all facilities to simplify past discrepancies.

Mr. Eason was not prepared to agree before receiving all the information.

Senator Dyson furthered the discussion. Some producers utilize the term "alignment". The negotiations with Governor Murkowski would put all facilities in alignment. When he and Senator B. Stevens had worked on the North Slope, they witnessed producers "squabble over accounting in every facility." The producers are now proposing that the State would have the "same interest" and information as the other owners. This would enable the parties to challenge the allocation of costs of gas processing. He asked if the State's interest in oil and gas royalty would be exactly the same as the other owners to ensure that the partners were equally attentive to this issue and that the State would not be taken advantage of.

11:59:25 AM

Mr. Eason replied this was not his experience. Even when aligned, natural tensions exist. This legislation should resolve some tensions but disputes would be inevitable. He elaborated on possible scenarios.

Senator Dyson assumed the producer would make every effort to maximize their profits and income. All owners of oil and gas must be vigilant. The witness was cautioning the legislature to be careful in setting up the agreements to prevent disagreements and vulnerability.

Mr. Eason affirmed.

Senator Wagoner reminded that the process of natural gas agreements has not reached that stage. The State is only dealing with oil matters at this point. The State could consider any options in addressing natural gas production in the negotiations.

Mr. Eason countered that the issue of natural gas is relevant. Decisions relating to gas are included in this legislation and would impact the outcome of negotiations.

Senator Wagoner was speaking more specifically to stranded gas.

Senator Stedman regressed to the ELF discussion and the timing of the formula and aggregation of fields, which was perceived as "game playing" to place the State at a disadvantage. However, he surmised the failure of ELF as more of a function of price causing the regressive mechanism to royalty and tax.

12:05:59 PM

Mr. Eason acknowledged that the ELF is a regressive system, but more related to volume than price and the large number of wells that must be operating to reach production. The formula has not been adjusted properly.

Senator Stedman remarked this information is different than information received in the past. He recognized that ELF is a "volume and number of wells issue" that does not consider price. Without accounting for price, he asked how this could respond to "a doubling, and tripling, and quadrupling of price without a failure of a regressive system."

Mr. Eason agreed it could not. As prices increase fields benefit from the current ELF structure.

Senator Therriault expressed that the problem with ELF began earlier, although the price acerbates the issue. The affect on the State's treasury is a function of price and a problem that could have been "livable" has now become significant. The crossover point of the existing system and proposed system is the concern because when prices are very low, the broken system would provide more income to the State.

Mr. Eason affirmed.

Senator Therriault referred to the conclusion of the presentation in which Mr. Eason recommended taking advantage of "extra eyes". This relates to a concern that much of the testimony to date from State agency personnel has not included the Department of Natural Resources. In attempting to understand this, he spoke to former employees of that Department. He asked the witness to recount his experiences and provide insight. The staff at the Department is "on the front line, day-to-day" dealing with producers on issues of lease language, unitization language, and the point where a pipe connects to the existing system. Over time a natural build up of friction could occur, which he did not necessarily oppose. He would expect this to exist, but would also expect it would be managed within the Department. He hoped to receive testimony from the Department of Natural Resources on this legislation.

12:10:41 PM

Mr. Eason emphasized the importance of the Department of Natural Resources involvement. Although this legislation is a tax issue, the Department of Natural Resources staff has talent and longevity and the legislature has invested heavily in recent years to strengthen the Division of Oil and Gas. The State's economic interests would benefit over time with this Department's participation. The viewpoints are different, which is no reflection of agency personalities. This staff has more direct facilities-related and unit-related experience. The issue is very complex and the Department of Natural Resources could assist in analyzing it.

Senator Therriault surmised the legislature should take advantage of the Department of Natural Resources experience, while being aware of possible prejudices.

Mr. Eason agreed. All participants have prejudices, which must be managed, although this was not a concern. He experienced a high degree of professionalism with this agency's staff.

Senator Therriault spoke to movable costs and costs of demobilization. Under the current system, the State has no obligation to participate in these costs and a policy call would determine whether this would change under a new system. If a decision were made that the State should participate in the costs, the degree of its obligation would be at issue. He questioned whether the State should share the cost for a facility that existed before this change was implemented and has been "mothballed" its entire productive life. Other facilities have operated for 30 years and would likely continue to operate for another 30 years, and the determination should be made whether the State would provide a pro-rated share of the eventual abandonment costs.

Mr. Eason replied that the provisions must be carefully written. Pro-rations are complex and could be calculated by engineers and other experts based on the number of barrels the facility produced or by another method. The legislature should make an informed decision.

12:15:14 PM

Senator Wagoner proposed that the State continue to not participate in abandonment costs. The producer's accounting systems includes the eventual removal expenses. To change the current system could "cloud the issue".

Mr. Eason replied that Senator Wagoner "probably outlined the two ends of the discussion as it moves forward."

Senator G. Stevens asked the implications of the witness' comments about lessons learned on the duration of a contract.

Mr. Eason told of examples of 30-year agreements that could not be revisited, including the TAPS royalty fuel cost settlement, which all parties agree could be improved if internal changes could be made. He knew of no agreement that satisfied all

parties unless provisions for some renegotiation were allowed. He spoke of his first job at a large gas field.

12:20:37 PM

Senator G. Stevens asked if the contracts between producers allow for re-openers.

Mr. Eason replied that resolution provisions are defined at the onset of the contract with "wordsmithing" attempted for the benefit of each party.

Senator Stedman pointed out that industry has the ability to deduct removal costs of platforms located in the Cook Inlet from federal income taxes. The issue is whether the State should allow a credit and essentially pay 20 percent of the removal costs.

Mr. Eason identified two issues: the deduction to oil value and the status quo.

Senator Stedman understood the 20 percent credit for capital expenditures could be used to offset those expenses, or could be sold.

Mr. Eason affirmed.

Senator Stedman surmised the State would indirectly pay 20 percent of the removal costs.

Mr. Eason corrected the amount could be potentially 40 percent.

Senator Stedman stressed the immediate issue is consideration of changing the laws and methods of taxing the oil and gas industry. A natural gas pipeline may never be constructed, as the State has already been waiting 30 years. However, the potential connections to future gas activities must be considered as well, and are of some concern. It is therefore difficult to "read more into this bill" than is specified. For example, this legislation would not commit the State to a timeframe in which alterations could not be made. If the bill were enacted, corrections could be made in the future to accommodate "other arrangements". He warned of the potential to make an incorrect decision due to "something that's on the table because it's not."

12:26:22 PM

Senator Wagoner gave Point Thompson as an example for the tax credit argument. The leases at that site should have been in development, if not producing, much earlier. Recently, the leaseholder was informed it must drill at least one well or submit a plan of intended activities. That directive has been delayed six months. He asked if these facilities would then become eligible for the credit under the provisions of this legislation.

Mr. Eason responded that Senator Wagoner, "touched on a prejudice" of his past experiences, which he detailed. The legislature changed leasing laws in 1978 and developed a program to attempt to increase development. Many efforts were undertaken; not all were successful. A successful venture involved establishing guidelines for lease offerings. Efforts failed in attempts for encouraging development in the areas east of Prudhoe Bay, including Point Thompson.

12:31:54 PM

Senator B. Stevens redirected the discussion to the issue of point of production. He asked if the witness had reviewed the sectional analysis of the bill prepared by Assistant Attorney General Rob Mintz of the Department of Law.

Mr. Eason answered that he had listened to a presentation on the analysis.

Senator B. Stevens pointed out the analysis of Section 31 explains the provision would redefine gross value at point of production. The interpretation is that "the oil point of production definition is essentially unchanged. If there's gas processing, the point of production for extracted liquids is downstream of processing." He asked if Mr. Eason agreed with this statement.

Mr. Eason answered "I certainly believe that I can take Rob Mintz' representation of it."

Senator B. Stevens continued to the analysis of the definition of gas processing and gas treatment in Section 33: "Gas processing has been redefined to gas processing is the physical

process that extracts liquid hydrocarbons upstream of a sales of gas treatment." Gas treatment as "downstream of point of production is the removing of hydrocarbons substance for conditioning of gas sale." Mr. Mintz has demonstrated that the movement of point of production on gas "has gone downstream for processing and upstream for treatment."

Senator B. Stevens asked if Mr. Eason agreed with this assessment.

Mr. Eason responded that although this is the language of the sectional analysis the question is what the options are for the facility's configurations and the possible impacts of the options. This is his concern. The definition alone is unclear in its application of how the facilities would be designed.

Senator B. Stevens disagreed. The definition of gas processing is to extract the liquid hydrocarbons, natural gas liquid (NGL). The definition of point of production on gas is "what is liquid and what is gas." He did not understand the concern about the point of production for the upstream that would convert the NGLs. At that point it "enters the sales system" and would become oil.

Mr. Eason replied that changing the point of production for what is considered oil and what is considered gas would have major impacts on value.

Senator B. Stevens asked what the impacts would be.

12:35:24 PM

Mr. Eason listed richness of the gas as one issue, the configuration of the facilities as another, and how the gas was marketed from the North Slope, would all be impacted. The stage in which liquids "come out" of gas could be controlled in a variety of ways in the design of facilities. The facilities are complex and must be understood. He was concerned with the attempt to adopt the relevant regulations into statute and the relationship to the status quo of existing facilities versus a facility designed for the future.

Senator B. Stevens qualified that the gas costs "aren't even on the table." The State captures value from the oil form at likely a higher value regardless of whether it is transformed into

liquid form. At current prices, the preference would be to liquefy all of the gas.

Senator B. Stevens requested Mr. Eason submit a written interpretation of the Department of Law sectional analysis.

Senator Wagoner asked Senator B. Stevens provide an example.

Senator B. Stevens listed Sections 30 and 33, as relating to point of production.

Senator Wagoner stated that point of production could be different.

Senator B. Stevens agreed, but stressed that these sections have defined the difference between liquid and gas. The liquids are "all NGLs plus oil." This legislation would stipulate, "all NGLs are priced at oil."

Senator Stedman noted testimony about the value of oil versus the value of gas. Oil is more valuable and is priced differently. The issue should be investigated further, as whether the gas is embedded in the oil should be clarified. A presentation to the Senate Resources Committee given the previous session by the University of Alaska identified the value of the different propane, methane, and butane in the gas. The advice was given to carefully review the structure to recognize the potential higher value of these gasses.

Senator Therriault encouraged Senator B. Stevens to explain his request to Mr. Eason.

12:40: 14 PM

Senator Therriault cautioned that moving the point of production for gas could result in more potential costs and could have an offset for oil production costs. This could impact the cost component for gas that is deducted from revenues from oil.

ADJOURNMENT

Senator Wagoner adjourned the meeting 12:51:42 PM.