ALASKA STATE LEGISLATURE
JOINT MEETING
SENATE RESOURCES STANDING COMMITTEE
SENATE FINANCE COMMITTEE
March 6, 2006
3:36 p.m.

MEMBERS PRESENT

SENATE RESOURCES

Senator Thomas Wagoner, Chair
Senator Ben Stevens
Senator Fred Dyson
Senator Bert Stedman
Senator Kim Elton
Senator Albert Kookesh

SENATE FINANCE

Senator Lyda Green, Co-Chair
Senator Gary Wilken, Co-Chair
Senator Con Bunde, Vice Chair
Senator Fred Dyson
Senator Bert Stedman
Senator Lyman Hoffman
Senator Donny Olson

MEMBERS ABSENT

SENATE RESOURCES

Senator Ralph Seekins, Vice Chair

SENATE FINANCE

All members present

OTHER LEGISLATORS PRESENT

Senator Gretchen Guess
Senator Hollis French
Senator Gary Stevens
Senator Gene Therriault
Representative Beth Kerttula

COMMITTEE CALENDAR

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."

HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 305
SHORT TITLE: OIL AND GAS PRODUCTION TAX
SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

02/21/06	(S)	READ THE FIRST TIME - REFERRALS
02/21/06	(S)	RES, FIN
02/22/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/22/06	(S)	Heard & Held
02/22/06	(S)	MINUTE(RES)
02/23/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/23/06	(S)	Heard & Held
02/23/06	(S)	MINUTE(RES)
02/24/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/24/06	(S)	Heard & Held

02/24/06	(S)	MINUTE(RES)
02/25/06	(S)	RES AT 9:00 AM BUTROVICH 205
02/25/06	(S)	-- Reconvene from 02/24/06 --
02/25/06	(H)	RES AT 10:00 AM SENATE FINANCE 532
02/25/06	(S)	Heard & Held
02/25/06	(S)	MINUTE(RES)
02/27/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/27/06	(S)	Heard & Held
02/27/06	(S)	MINUTE(RES)
02/28/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/28/06	(S)	Heard & Held
02/28/06	(S)	MINUTE(RES)
03/01/06	(S)	RES AT 3:30 PM BUTROVICH 205
03/01/06	(S)	Heard & Held
03/01/06	(S)	MINUTE(RES)
03/02/06	(S)	RES AT 1:30 PM BUTROVICH 205
03/02/06	(S)	Heard & Held
03/02/06	(S)	MINUTE(RES)
03/02/06	(S)	RES AT 3:30 PM BUTROVICH 205
03/02/06	(S)	Heard & Held
03/02/06	(S)	MINUTE(RES)
03/03/06	(S)	RES AT 3:30 PM BUTROVICH 205
03/03/06	(S)	-- Meeting Canceled --
03/04/06	(S)	RES AT 10:00 AM SENATE FINANCE 532
03/04/06	(S)	Presentation by Legislative Consultants
03/06/06	(S)	RES AT 3:30 PM SENATE FINANCE 532

WITNESS REGISTER

Daniel Johnston, Owner
Daniel Johnston & Co, Inc.
60 Shady Lane
Hancock, New Hampshire 03449
POSITION STATEMENT: Delivered Presentation entitled Alaska's Proposed Production Tax – PPT 20/20

ACTION NARRATIVE

CHAIR LYDA GREEN called the joint meeting of the Senate Resources Standing Committee and the Senate Finance Committee to order at 3:36:58 PM. Present were Senators Fred Dyson, Bert Stedman, Kim Elton, Thomas Wagoner, Donny Olson, Con Bunde, Gary Wilken, Ben Stevens, Lyman Hoffman and Gary Stevens.

SB 305-OIL AND GAS PRODUCTION TAX

3:36:58 PM

CO-CHAIR THOMAS WAGONER announced that the presentation would begin.

DANIEL JOHNSTON, Owner of Daniel Johnston & Company and Legislative Consultant to the international petroleum industry, introduced himself.

3:38:42 PM
MR. JOHNSTON reviewed his credentials and said he advises governments on issues like the petroleum production tax as well as teaches classes on resource development for different universities. He also does arbitration work involving litigations and mediations. He said it was his strong opinion that minerals and resources were a gift from God and that his mandate was to help the State of Alaska design a fair system.

3:42:27 PM
MR. JOHNSTON continued reviewing his credentials and said that much of the presentation would be addressing fundamental taxation theory. Future generations will ask whether the Legislature designed the system right and negotiated the best contract with the information and tools of the present date, he stated.

3:44:40 PM
Senator Albert Kookesh joined the meeting.

3:45:45 PM
MR. JOHNSTON advised the committees of his disclaimer prior to the presentation. He highlighted the exorbitant amount of material that he had to study and said he needed more time in order to provide a more thorough report. He reserved the right to correct, amend, change, and add to what he called his preliminary report.

Slide 6: Conclusions
Alaska has every right to change the system and is not the only region considering or making changes these days. Alaska may have more justification to change than most due to the following:

- Because the ordinary regressive effect of the royalty
- The ordinary regressive effect of a severance tax
- The inefficiencies of ELF's field production rate element
- The inefficiencies of ELF's daily well production rate element

3:50:29 PM

The new system should increase revenues to the State of Alaska and enhance exploration activity. These are not mutually exclusive objectives. Increasing taxes on existing production is relatively inelastic and the proposed credits work well for exploration.

The new system should be a well-designed modern system and should be flexible, progressive, simple, and transparent.

3:55:02 PM
The ELF tax itself as is structured is a progressive tax but it only just barely counterbalances the regressive effect of the 12.5 percent royalty, in which case as a whole is effectively neutral and that is not enough. Alaska must develop a system that could handle extreme prices in case oil goes up to $200 a barrel.

3:56:58 PM
Trying to craft one system to fit all situations may be impossible. Exploration is extremely different than production from existing fields. With fields like Prudhoe Bay there is little margin for error.

4:03:12 PM
The producers want fiscal certainty but Alaska must be extremely careful. It is such a long-term contract that no wonder they want certainty but companies operate regularly with much less certainty than is being demanded.

4:05:09 PM
Much of the debate revolves around government take. With the gas pipeline project, a government take statistic is much less meaningful because the project is so large.

4:07:57 PM
Crafting language to avoid leakage deserves appropriate terms on the front end so it is important to "get the deal right." Numerous issues were left un-addressed due to lack of time to prepare presentation.

4:11:15 PM
MR. JOHNSTON related what he called "The Indonesian Story" wherein the country changed their tax structure and suffered through production challenges.

4:13:56 PM

MR. JOHNSTON related "The California Story" wherein the state designed their royalty and tax rates poorly and lost a large amount of revenues.

4:17:20 PM
Slide 9: What Criteria?

- The system must be progressive
- There must be a fair division of profits
- There must be no unhealthy dis-incentives

It must be simple and transparent

4:18:24 PM
Slide 10: Alaska is Unique
Boundary conditions make Alaska unique due to it being landlocked the Arctic creates high transportation costs. There are also issues of sovereignty.

4:20:32 pm
One objective is that Alaska must fix the ELF and obtain a fair share of the profits. In order to do so Alaska must craft a modern state-of-the-art system and magnify exploration activity. Alaska must craft a progressive tax yet reduce risk exposure for the oil companies.

4:23:21 pm
Slide 11: Fiscal System Analysis and Design – things to consider

- Expected field size distributions
- Petrophysical characteristics
- Well deliverability
- Estimated success probability
- Data quality and quantity
- Post discovery costs
- Climate

4:28:38 pm
Slide 11: Contract terms

- Type of system
- Timing
- Royalties
- Cost recovery limit
- Government take
- Contract stability

4:34:26 pm
Slide 12: Government Take

The petroleum industry hates government participation because the company takes all the risk yet the government takes a piece of the pie. Some companies report short of what they extract from the ground in order to keep more of the oil revenues.

4:42:49 pm
Slide 13: Do credits work?

MR. JOHNSTON said that he believed the credit system worked and that he leans toward enhancing credits but he is still researching that effect. He offered a few examples of crediting and the effects of the intricacies involved.

4:49:12 pm
Slide 14: BP Graph of Production vs. Tax Rate

MR. JOHNSTON showed a graph of how lowering the tax rate in 1993 encouraged rapid growth in production. He said something else had to have happened in order for such a dramatic increase in production.

4:51:57 pm
Slide 15: UK Petroleum Taxation History

MR. JOHNSTON presented a history of the effect of taxation. He said small increases or decreases in taxes have very little effect on production.

4:55:01 pm
Slide 16: UK Drilling Activity

MR. JOHNSTON said the graph confirms the fallacy of the claim that the reduction of government take enhanced production. This demonstrates that something is wrong with BP's conclusions of the 1993 event.

4:56:16 pm
Slide 17: Risk vs. Reward and the PPT Credit Plan

One critical aspect of the PPT is the fact that it was designed in part to encourage exploration by providing credits and allowing companies to sell or trade them and any tax loss carries forward. This aspect reduces the risk for explorers and the state takes on added risk. Mr. Johnston's slide listed several examples of other countries risk versus reward factors.

5:02:34 pm

Slide 18: Summary of Key Fiscal Elements of PPT 20/20%

MR. JOHNSTON recapped the 5 main components of the PPT as presented by Robynn Wilson on February 22, 2006.

- PPT rate/base
- Tax credit rate/base
- Net operating loss
- Base allowance rate/base
- Transition provision

5:05:53 pm
Slide 19: Summary continued

The proposed structure shifts some risk from the industry to the State of Alaska. The shift is multi-dimensional.

- By shifting the tax base from net production to profits
- By providing a liberal definition of profit
- By applying a 20% credit on capital expenditures
- By allowing credits to be traded
- By allowing TLCFs to be traded
- By providing the 73MM allowance

5:10:01 pm
MR. JOHNSTON compared the allowance to designing one saddle to fit every farm animal and said he did not know if it would work. The 73MM is difficult and awkward, he stated.

5:12:00 pm
Slide 20: The "Lookback Provision"

MR. JOHNSTON questioned the fairness of the provision but noted there was some logic in it due to the losses suffered through ELF.

5:14:28 pm
Slide 21: Flow Diagram

MR. JOHNSTON presented a flow diagram that was based on Roger Marks' presentation assuming 20 million barrels at $50 per barrel.

5:18:34 pm
Slide 22: Regressiveness and Marginal Take

MR. JOHNSTON presented a spreadsheet comparing different prices per barrel as an illustration of why royalties are regressive and the logic behind government take.

5:21:25 pm
Slide 23: Variations on Government Take Calculation

MR. JOHNSTON presented a spreadsheet that illustrated differing levels of government take.

5:24:21 pm
Slide 24: Wood Mackenzie Treatment Of Government Participation: Global oil and gas risks and rewards

Slide 25: Dr. van Meurs treatment of Government Take:
A page taken from Dr. van Meurs presentation "Proposal for a Profit-based Production Tax for Alaska."

Slide 26: Take Calculations With & Without Factoring-in Participation

Without factoring in the government participation element the universe of fiscal terms is distorted by around 5 percentage points. Alaska looks worse than it should if this element is excluded. Mr. Johnston showed an accompanying graph.

Slide 27: ConocoPhillips Government Take, Cost, and Tax Graph

MR. JOHNSTON recreated a graph from the ConocoPhillips presentation of February 27, 2006. The graph compares low and high costs with both low and high tax.

5:30:28 pm
Slides 28-30: Government Participation

Many systems provide an option for the national oil company to participate in development projects. Under most government participation arrangements, the contractor bears the cost and risk of exploration and if there is a discovery the government backs in for a percentage.

MR. JOHNSTON described the government take in India, Columbia, and China.

Slide 31: Efficiency and Flexibility in Fiscal System Design

If a system were designed efficiently and flexibly theoretically it would be a more stable contract.

5:34:06 pm
Slide 32: Typical Regressive System & the Regressive Signature

MR. JOHNSTON displayed a typical graph on government take statistics.

5:36:16 pm
Slide 33: Regional Distribution of Petroleum Fiscal Systems

MR. JOHNSTON displayed a global graph demonstrating regional distribution of petroleum fiscal systems. Most have a progressive element of some sort.

5:37:39 pm
Slides 34-38: Effective Oil Severance Tax Rate – Government Take

MR. JOHNSTON provided a series of graphs, some of which were taken from Dr. van Meurs and Mr. Marks presentations.

Slide 39: Industry Statistics:
Slide contained Mr. Johnston's disclaimer regarding the dated material.

5:39:29 pm
Slide 40: Weaknesses of Government Take

- Does not adequately capture signature bonuses
- Does not address how government takes
- Says nothing of timing
- Does not measure contract or system stability
- Does not differentiate between diverse work programs

Slides 41-43: More Dated Industry Statistics

- Database table 8
- World averages for oil and gas
- Average state take for deepwater projects

5:43:27 pm
Slides 44-47: International Petroleum Exploration and Development Contracts Graphs

MR. JOHNSTON overviewed a series of graphs detailing the royalty tax system for many different countries. The graphs include data on how systems changed when oil prices fluctuated, the risk

components, world average government take, and comparative yields.

5:49:47 pm
Slide 48: Contract Duration

MR. JOHNSTON advised that the accompanying graph was developed in response to a statement made by one of the oil company representatives claiming that typical contract duration was 50-60 years. The average contract term is 25 years.

Slides 49-50: Libya's Latest License Round

Graph of Gross revenue split into government revenue and contractor revenue, "Not worth discussing," he stated.

5:52:35 pm
Slide 51: Expected Value

MR. JOHNSTON displayed a graph of probability of success and risk analysis. The PPT would reduce risk exposure by 50 percent and so companies can justify smaller prospects.

Slide 52: BP Presentation on PPT (28 February 2006)

Slides 53-54: Ringfencing

MR. JOHNSTON defined "ringfencing" with several examples.

Slides 55-56: Alaska PPT 20/20% Approach

MR. JOHNSTON highlighted the comparison to ELF.

This signifies the end of the presentation and the beginning of the question and answer period.

6:00:29 pm
SENATOR BERT STEDMAN asked Mr. Johnston whether he could provide material on a smaller comparative group rather than worldwide averages.

MR. JOHNSTON replied yes. Dr. van Meurs and Mr. Marks used comparative presentations of countries where producers were actively involved.

SENATOR FRED DYSON asked Mr. Johnston the risk and the likely outcome if the tax rate were set too high for the Legacy part at Prudhoe Bay.

6:03:54 pm
MR. JOHNSTON replied the risk was placed on the oil companies but if the risk is too high, it's easy to change the contract. On the other hand, if the tax rate were too low, it would be hell to change.

6:04:30 pm
SENATOR DYSON asked what the likely outcome would be if the oil companies walk away from the gas negotiations.

MR. JOHNSTON said it depends on the tax rate increase. In today's price environment it would not have much of an effect on production, although there would certainly be projects that they would put on the back burner.

6:08:33 pm
SENATOR STEDMAN asked whether he had a feeling for the magnitude of risk involved.

MR. JOHNSTON replied the magnitude is such that "you should only pay for the additional risks that you take." Some big companies feel they are subsidizing someone else's exploration but that is not true.

6:11:02 pm
SENATOR DYSON asked him to talk about how the "look-back" should be different for Cook Inlet and the Legacy fields.

MR. JOHNSTON replied that it would be fair to treat the two differently and they just need to make sure of what they are trying to obtain. For example, they want to incentivize exploration at Cook Inlet and so that makes sense.

There being no further business to come before the committee, Chair Wagoner adjourned the meeting at 6:14:11 pm.