

MINUTES
SENATE FINANCE COMMITTEE
April 19, 2006
1:08 p.m.

CALL TO ORDER

Co-Chair Lyda Green convened the meeting at approximately [1:08:00 PM](#).

PRESENT

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

Also Attending: DAN DICKINSON, CPA, Consultant to the Office of the Governor;

Attending via Teleconference: From an offnet location: ROB MINTZ, Assistant Attorney General, Oil, Gas and Mining Section, Civil Division, Department of Law.

SUMMARY INFORMATION

SB 305-OIL AND GAS PRODUCTION TAX

The Committee heard from a consultant to the Office of the Governor and continued discussion on a committee substitute adopted at the previous hearing. The bill was held in Committee.

#SB305

[1:08:40 PM](#)

CS FOR SENATE BILL NO. 305(RES)

"An Act providing for a production tax on oil and gas; repealing the oil and gas production (severance) tax; relating to the calculation of the gross value at the point of production of oil or gas and to the determination of the

value of oil and gas for purposes of the production tax on oil and gas; providing for tax credits against the tax for certain expenditures and losses; relating to the relationship of the production tax on oil and gas to other taxes, to the dates those tax payments and surcharges are due, to interest on overpayments of the tax, and to the treatment of the tax in a producer's settlement with the royalty owners; relating to flared gas, and to oil and gas used in the operation of a lease or property under the production tax; relating to the prevailing value of oil or gas under the production tax; relating to surcharges on oil; relating to statements or other information required to be filed with or furnished to the Department of Revenue, to the penalty for failure to file certain reports for the tax, to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue as applicable to the administration of the tax; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the tax, and to the deposit of tax money collected by the Department of Revenue; amending the definitions of 'gas,' 'oil,' and certain other terms for purposes of the production tax, and as the definition of the term 'gas' applies in the Alaska Stranded Gas Development Act, and adding further definitions; making conforming amendments; and providing for an effective date."

This was the 12th hearing for this bill in the Senate Finance Committee.

At the previous hearing on this bill, the Committee adopted CS SB 305, 24-GS2052\p, as a working document.

Co-Chair Green noted information requests were made at the previous meeting, including a comparison spreadsheet of the various bill versions under consideration.

DAN DICKINSON, CPA, Consultant, Office of the Governor, noted that not all the requested information was included but would be forthcoming. He outlined a document titled "Structure of the Senate Finance CS for SB 305" [copy on file], which references page numbers of the committee substitute and reads as follows.

Calculate the tax base:

Calculate the gross value at the Point of Production
(May use a Royalty Settlement Agreement) (150(d))
page 17

Take the Gas Revenue Exclusion (160(a)) page 18
Subtract lease expenditures including qualified
capital expenditures to arrive at the net "Production
Tax Value" page 18

Apply the three tax rates:

Base PPT rate: 22.5% applied against the Production
Tax Value (.011 (e)) page 3

Private Royalty Rate applied against gross value at
point of production (.011 (f)) page 3

Progressivity: .001 * index applied against the
Production Tax Value (0.11 (g)) page 4

Index = ((Production Tax Value/Barrel of oil
Equivalents) -45) (.011 (h)) page 4

To arrive at tax liability before credits

Apply the five credits

5,000 a day barrel equivalent credit, capped at
\$14,000 million (non transferable) (.170) page 23

TIE credit equal to 1/2 of current investment (with
other limits (.024 (i)) page 10

Alternative Exploration Credit of up to 40% (SB 185
extended) (.025) page 11

Qualified Capital Expenditure of 25% (.024 (a)) page 7

Any loss at the end of the year converted to a Carry
Forward Credit (.024 (b)) page 8

To arrive at tax liability after credits

Estimated monthly payments, must be trued up for prior year
in by 3/31 of each year (.020 (a)) page 5

If any month is estimated at less than 95%, interest due
(.020 (a)) page 5

Taxpayer can either use annualized or monthly actual costs,
and can opt for the whole year at any time - however - must
be one way or the other for all effects. (.024 (a)) & (160)
page 7 & 22

Mr. Dickinson explained the five credits could be applied to
reduce tax liability.

Mr. Dickinson stressed that a number of the credits had been categorized as deductions in previous versions of the bill. The intent was to make the various incentives into credits. Once done, these incentives for investments would be applied against the base. This method would be "cleaner".

Mr. Dickinson commented on the progressivity, which is based on net and would be calculated on the price of oil. Credits for investments could be timed against higher oil prices. This would preferably be annualized rather than calculated on a month by month basis.

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Mr. Dickinson directed attention to a spreadsheet titled "Comparison of PPT Bill Versions - Highlights" [copy on file], dated 4/19/06. This is similar to previous spreadsheets, with the exception of an additional column to represent the Senate Finance draft committee substitute. Various provisions of the bill versions are listed as rows on this spreadsheet and several are referenced as follows.

[1:18:59 PM](#)

Credit Rate

Senator Hoffman noted the introduction of the 25 percent credit rate compared to the rate of 20 percent included in the Governor's original version of the bill and the legislation under consideration in the House of Representatives. He asked why the higher credit rate is being considered in the Senate Finance committee substitute.

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Mr. Dickinson responded that a 25 percent credit rate would offset the increased tax rate proposed in the committee substitute Version "P" and would attempt to retain the balance achieved by the "20/20 proposal". More investments could be expected with the allowance of higher credits.

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Private royalty tax rate

Mr. Dickinson noted the changes to the private royalty tax rate in each bill version. Version "P" provides "5% of oil & 1.67% gas/ Report from Commissioner .011 (f)" and is contained on pages 3 and 28.

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Senator Bunde asked for additional explanation of the change from gross to net, as he had concerns about "gaining possibilities". He qualified that he did not begrudge oil companies for attempting to earn as much money as possible for their shareholders.

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Mr. Dickinson described this as "tax planning opportunities".

[1:23:00 PM](#)

Senator Bunde compared this to the legislature's duty to obtain the maximum revenue for the State.

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Mr. Dickinson responded that some operations are more difficult and costly to develop, while others only entail the expense of transporting the resource. This committee substitute recognizes the costs and attempts to equalize the tax for those more expensive situations. Progressivity would therefore not be driven by the price of oil, but rather the price minus costs. He described the motivation for producers to claim their credits during months with higher prices to maximize the tax reductions. This could add a significant layer of complexity, which should be considered against the anticipated results.

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Senator Bunde expressed concern that the State could lose any savings that would have been achieved from the restructured tax system.

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Mr. Dickinson acknowledged the tradeoff between accuracy and simplicity. The cost of administering this system could be

higher but would be offset by the changes that would occur. This would not be a "one-to-one tradeoff", although the Department of Revenue would be required each year to request an appropriation for these activities.

AT EASE [1:28:20 PM](#) / [1:31:29 PM](#)

Mr. Dickinson returned to the first handout, pointing out that the five credits would only be applicable to the base Petroleum Production Tax (PPT). The credits could not be applied to the progressivity portion of the tax.

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Co-Chair Green announced that the committee substitute and information presented to the Committee at this meeting would be posted on the Senate Majority website.

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Special gas progressivity?

Mr. Dickinson pointed out that the committee substitute contains no special rules to address progressivity on natural gas. In calculating the progressivity, all activities of the producer would be considered. A producer that only produces gas would not reach the threshold in which progressivity is triggered. Producers' activities are either mostly gas development or include gas development as a small portion of their "portfolio".

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Transition

Mr. Dickinson noted that Version "P" contains transition provisions similar to the Senate Resources Committee substitute with the exception that the Senate Finance version provides a seven-year deadline to recoup past investments. The credit rate for past investments would remain at 20 percent

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Base Allowance

Mr. Dickinson informed that all producers would receive an exemption on the first 5,000 barrels produced. For large producers, such as Conoco Phillips, the exemption would equal less than one percent of total production. The percentage would be higher for small producers. This committee substitute inserts a maximum exemption amount of approximately \$14 million. This calculates to approximately \$62 million compared to \$72 million as proposed in the original bill.

Sunset of Base Allowance

Mr. Dickinson stated this provision would lapse in 2016, or ten years. Before the date is reached, the commissioner of the Department of Revenue would submit a report to the legislature and make a recommendation whether to extend or amend the exemption.

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Safe Harbor

Mr. Dickinson remarked that the current committee substitute reflects a 95 percent threshold, as does the Senate Resources Committee substitute, although the Senate Finance Committee version provides for an annual "true up" rather than monthly true ups.

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Senator Hoffman calculated that under this scenario producers would pay 95 percent of the estimated tax and would pay 11 percent on the five percent remaining.

Mr. Dickinson affirmed.

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Effective Date

Mr. Dickinson pointed out that the effective date of the new tax structure would be July 1, 2006 under the provisions of Version "P", which is the same as proposed by Governor Murkowski.

Transitional Payment

Mr. Dickinson announced the transitional periods are also the same as contained in the original bill.

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Spill Surcharge Total

Dan Dickinson noted the five-cent surcharge would remain unchanged from current statute, the original bill and the House Resources Committee substitute.

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Co-Chair Green qualified that this provision is subject to amendment.

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Surcharge Treatment

Mr. Dickinson stated that like the Senate Resources Committee substitute, the credit would not be transferable under Version "P". These are different than proposed by the Governor.

SB 185 Credit

Mr. Dickinson informed that the Administration would request an amendment to this provision, relating to legislation passed the previous legislative session, to provide for a reporting process before the credit automatically lapsed.

Mr. Dickinson pointed out that SB 185 provided that \$20 million in credits could be given for activities located in Cook Inlet. Unfortunately, the language was unclear in addressing a situation in which more than one producer submitted credits and the total amount was higher than \$20 million. Options include granting the credits based on earliest submission, dividing the credits between the producers, and other remedies. The latest committee substitute version of SB 305 would stipulate that notice would be given to producers at the time \$20 million in credits had been granted. In the following calendar year, the State would pay out any additional credits after which the program would end. Although credits totaling more than \$30 million could be granted, this method is rational and would

provide the necessary incentive. The Administration is supportive of this language.

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Abandonment

Mr. Dickinson explained this relates to a definition of "an extended period of disuse" previously considered. The Administration had requested clarification of this term and was satisfied that it had been removed from the language of Version "P". Abandonment, restoration and other actions that a producer must undertake upon completion of a lease are considered a normal business expense and recognized as such in the committee substitute provisions.

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Senator Stedman requested further explanation, specifically to platforms located in Cook Inlet.

[1:43:01 PM](#)

Mr. Dickinson responded that according to Department analysis of property tax values, once five platforms are no longer producing, they would be dismantled and removed. The expense of these activities is considerable, and because the platforms cause no real navigational hazard, removing multiple stations in conjunction with one another is most cost effective.

Senator Stedman asked if the credit would or would not apply for these activities.

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Mr. Dickinson answered that the credit would not apply. Credits apply to investments made with an expectation for future benefit. Abandonment would not garner future benefit. This bill version removes the specific prohibition contained in the Senate Resources Committee substitute stipulating that abandonment costs would be prorated for a platform that produced both before and after enactment of this legislation.

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Senator Stedman surmised that a normal tax deduction would be allowed, but that the 25 percent credit would not be allowed.

Mr. Dickinson affirmed.

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Co-Chair Wilken recalled a presentation given to the Committee on April 1 by the Department of Law. Co-Chair Wilken requested Mr. Mintz review the changes contained in Version "P" and report on their impact as well as voicing any additional concerns.

Co-Chair Wilken also requested that EconOne, a consulting firm contracted by the legislature, conduct an analysis of the fiscal changes proposed in this committee substitute.

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ROB MINTZ, Assistant Attorney General, Oil, Gas and Mining Section, Civil Division, Department of Law, testified via teleconference from an offnet location that he would provide the requested analysis.

Co-Chair Wilken excused himself for a prior commitment.

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Mr. Dickinson would also perform a comparison in conjunction with EconOne.

[1:49:01 PM](#)

Credits Usable

Mr. Dickinson remarked that the credits would be usable against the PPT only and that the progressivity factor could not be reduced through credits.

Credits Refundable?

Mr. Dickinson announced that the credits would not be refundable under the provisions of this bill version.

Credits for Annual Loss

Mr. Dickinson stated that an explorer with little or no production could carry the credits forward at the same tax rate.

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Credits Transferable

Senator Stedman clarified that the committee substitute retains the 80 percent limit, or 20 percent maximum reduction of PPT tax owed using purchased credits.

Mr. Dickinson affirmed.

[1:50:16 PM](#)

Point of Production

Mr. Dickinson noted that the point of production has remained constant in all versions of the bill, although efforts were underway to reduce ambiguity.

DNR Royalty Value

Mr. Dickinson reminded that since the gross value at point of production is already calculated through regulations of the Department of Natural Resources, the question was raised as to whether these figures could be utilized in this capacity so administrative efforts would be reduced. The Senate Resources Committee substitute provided that the commissioner [department not specified] would make a determination based on the fiscal interest of the State. The Administration recommended language providing that "a tradeoff between efficiency and making sure that there was no bias downward."

Co-Chair Green understood this would prevent bias toward understating a producer's tax liability.

Mr. Dickinson agreed.

[1:51:25 PM](#)

IRC sec. 482 as a tool

Mr. Dickinson informed that Version "P" does not contain provisions to utilize the federal Internal Revenue Code section

482 for addressing transfer pricing. However, language is included to provide that in the instance of transfer pricing, or a "non-arms length transaction" amounts above fair market value would not be a direct cost and therefore would not be deductible. This method would achieve similar results, but would be "more usable".

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Catastrophic Oil Spill Deductible?

Mr. Dickinson stated that this committee substitute version does not mention this issue. Therefore, unless related costs were "an ordinary and necessary expense" they would be deductible.

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DNR Gets Exploration Data

Mr. Dickinson pointed out this and the remaining provisions were not contained in earlier versions of the bill. This provision, however, was included in the language of SB 185 adopted by a previous legislature. It stipulates that data relating to exploration activities in which credits are received must be submitted to the Department of Natural Resources. The information would be held for ten years then become public to allow other explorers opportunity for review. The inclusion of this provision in Version "P" would make it applicable to all exploration data.

020 (f) Sales Language

Mr. Dickinson indicated Mr. Mintz would detail this provision, which is intended to more accurately reflect current practice.

NPSL Regs After Industry Practice

Mr. Dickinson explained this relates to determination of upstream costs and provides that industry practices would be utilized. If those practices were unclear or ambiguous, Department of Natural Resources regulations would be consulted.

Gas

Mr. Dickinson mentioned this pertains to Gas Revenue Exclusion.

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Senator Hoffman asked if the separate severability clause in this legislation would cause problems.

Mr. Dickinson deferred to legal counsel

[1:54:08 PM](#)

Senator Stedman, referencing the five credits listed on the first handout, clarified that the third and fourth credits were mutually exclusive. He understood that if a producer qualified for the Alternative Exploration Credit, it would not be eligible to receive the Qualified Capital Expenditure credit.

Mr. Dickinson affirmed that a producer could not receive credit under both categories.

[1:55:09 PM](#)

Mr. Dickinson next spoke to a spreadsheet titled, "Oil Production January 2000 - January 2006" [copy on file]. This depicts the percentage of production from individual leases, although it includes all units located in a portion or entirely on State or federal interest lands. A small segment of leases are exclusively in private ownership.

Mr. Dickinson pointed out that private royalty interests for oil are less than 1 percent of the total. The five to six percent from private leases on gas production would increase to about ten percent. However, production in Cook Inlet is less than five percent of the total North Slope production. The North Slope has no gas production on private leases.

Mr. Dickinson qualified that this spreadsheet does not relate to the bill before the Committee. It is intended to demonstrate the small percentage of private leases.

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Mr. Dickinson then directed attention to pages 2 through 11 of the Division of Oil and Gas 2004 Report titled, "Incentives and Credits" [copy on file]. Line 26 of page 6 of the committee

substitute Version "P" lists four statutes. Those statutes are detailed in this handout.

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Mr. Dickinson referenced a line graph titled, "Per Barrel Progressivity Surcharge" [copy on file] that utilizes the year 2010 as an example to demonstrate the progressivity impact of the provisions of the House Resources Committee substitute, the Senate Resources Committee substitute and the Senate Finance Committee substitute. It calculates the amount per barrel that would be paid in tax based on the Alaska North Slope (ANS) price. At an average price of \$70, each barrel would be assessed \$5 in additional tax under the provisions of the House Resources Committee substitute. The additional tax would be approximately \$3.50 per barrel under the progressivity provisions of the Senate Resources Committee substitute, and approximately \$1 would be the amount assessed under the provisions of the current Senate Finance Committee substitute.

Mr. Dickinson pointed out that this model incorporates approximately \$15 in costs. The profit made per barrel at \$70 ANS price would be more accurately \$55. Due to different factors in the various bill versions, the "driver" is more or less predominant; with the Senate Finance Committee substitute version resulting in the least impact.

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Senator Bunde noted that the progressivity tax would "plateau" at prices of \$120 per barrel under the provisions of the House Resources Committee substitute. He asked if the provisions of the other bill versions would reach a maximum amount.

Mr. Dickinson answered that the other versions do not provide for a maximum percentage.

Senator Hoffman asked if the example provided of 2010 represents the "base case" or a high or low volume scenario.

Mr. Dickinson understood this data to represent a low volume scenario. The volume would likely not affect the data portrayed on this chart.

[2:03:47 PM](#)

Senator Hoffman asked what the projected production level is for 2010. He agreed that the impact of progressivity from the different bill versions on prices between zero and \$50 must be reviewed, as it is the most likely price range during the next several years.

Mr. Dickinson reported the estimated the production rate for 2010 is 780,000 barrels per day.

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Senator Stedman appreciated the demonstration of the dollar amounts. He requested a similar chart depicting percentages that includes a comparison to the status quo.

[2:05:06 PM](#)

Mr. Dickinson indicated he would provide a more detailed version at a later meeting.

[2:05:32 PM](#)

Mr. Dickinson outlined a spreadsheet titled "Production Tax Value" under 160" [copy on file] that demonstrates the effect of the "tax holiday". It shows the percentage of taxable profit that would be "shielded" under this provision included in some form in all versions of the bill. All bill versions provide that smaller operators with production of less than 5,000 barrels per day would have no tax liability. Generally as production increases, the exemption decreases. He detailed the comparisons between each provision and their impacts on various producers.

[2:10:45 PM](#)

Mr. Dickinson concluded his presentation by addressing a spreadsheet and line graph titled "Distribution of Future Case Flows Under SQ and Variations of the Senate Resources SC PPT Proposal FY 2007 - 2030" [copy on file]. This incorporates the 20/25 provisions of the Senate Resources Committee substitute and drafts of the progressivity factor included in the Senate Finance Committee substitute. An additional chart would be prepared to further demonstrate this information.

[2:12:34 PM](#)

Senator Stedman recalled the change in "government take" amounts should decline about 1.1 percent varied over price ranges.

[2:13:14 PM](#)

Senator Bunde calculated the net tax at approximately nine percent under the 20/20 formula and approximately 12 percent under the 25/20 formula. He asked the net tax under a formula of 22.5 percent.

[2:14:00 PM](#)

Mr. Dickinson relayed that Senator Stedman had also requested this information, which would be prepared.

[2:14:14 PM](#)

Senator Bunde pointed out that the Committee had not discussed the impact of a change to the credit rate.

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Senator Hoffman noted the difference in government share between the original 20/20 proposal and the progressivity factor contained in Version "P" would begin at the point oil prices exceed \$40 per barrel. He asked if this is accurate for the net value calculation.

[2:15:39 PM](#)

Mr. Dickinson replied that the government share at a price of \$50 per barrel would increase from 60.7 percent to 61.7 percent under the progressivity provisions of the Senate Resources Committee substitute.

[2:16:15 PM](#)

Senator Hoffman understood that the progressivity percentage would start at a significantly higher amount under the Senate Finance Committee substitute.

[2:16:31 PM](#)

Mr. Dickinson responded that the percentages would be identical at a \$40 per barrel price. Divergence would begin at prices of \$60 per barrel.

[2:16:50 PM](#)

Senator Hoffman concluded that the differences resulting from the various progressivity provisions in the bill versions would not be in effect at prices less than \$50 per barrel.

Mr. Dickinson answered that the graph utilizes a "North Slope" model. However, progressivity could begin at a lower per barrel price for a producer with considerably low operating costs. The trigger price listed in the committee substitute is \$45 per barrel. The production costs would be deducted from the price of oil; therefore if the production cost per barrel was \$5, progressivity would be applicable at an actual price per barrel of \$50.

AT EASE [2:17:51 PM](#) / [2:20:52 PM](#)

Co-Chair Green noted the distribution of additional information.

Mr. Dickinson detailed the two tables, one depicting "Proposed Progressivity (\$ per barrel additional Tax)" and the other depicting "CSHB 488 (\$ per barrel additional Tax)" contained on a one-page document [copy on file]. He noted the first table pertains to the Senate Finance Committee substitute, Version "P" and the other to the legislation approved by the House Resources Committee. These tables list the amount of the progressivity tax based on the price per barrel less the production cost per barrel.

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Senator Bunde told of reports of production cost of an average of \$12 per barrel and as high as \$20 per barrel. The progressivity provision of this committee substitute would increase the tax on a per barrel price of \$60 approximately \$1.56 compared to an increase of \$4.50 under the provision of the House Resources Committee substitute.

Mr. Dickinson furthered that the provisions of the House Resources Committee substitute would not take into account

investments made. The progressivity would be "insensitive to cost" and would only rely on the price.

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Senator Bunde continued that the price of oil would be at least \$70 per barrel before the Senate Finance Committee substitute progressivity provision would be in effect on production in fields with higher costs.

Mr. Dickinson affirmed, but clarified each taxpayer would be assessed the progressivity tax based on their average production costs. Progressivity would not be assessed on a "field by field" basis.

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Senator Bunde asked if the Committee would entertain comments from affected producers. He requested testimony representative of a large producer and testimony representative of a small producer. He invited written statements.

[2:29:16 PM](#)

Co-Chair Green announced the ambitious timeframe for this legislation.

AT EASE [2:29:30 PM](#) / [2:31:08 PM](#)

Co-Chair Green invited producers' written reaction to the committee substitute.

#

ADJOURNMENT

Co-Chair Lyda Green adjourned the meeting at [2:32:24 PM](#)