

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

February 22, 2006

3:34 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

All members present

OTHER MEMBERS PRESENT

Senator Gary Stevens
Senator Gene Therriault
Senator Hollis French

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

WITNESS REGISTER

BILL CORBUS, Commissioner
Department of Revenue
PO Box 110400
Juneau, AK 99811-0400

POSITION STATEMENT: Commented on SB 305.

MIKE MENGE, Commissioner
Department of Natural Resources
400 Willoughby Ave.
Juneau, AK 99801-1724

POSITION STATEMENT: Commented on SB 305.

ROBYNN WILSON, Director
Tax Division
Department of Revenue
PO Box 110400
Juneau, AK 99811-0400

POSITION STATEMENT: Commented on SB 305.

DAN DICKINSON, C.P.A.
Consultant to the Governor
PO Box 110001
Juneau AK 99811-0001

POSITION STATEMENT: Commented on SB 305.

ACTION NARRATIVE

CHAIR THOMAS WAGONER called the Senate Resources Standing Committee meeting to order at [3:34:45 PM](#). Present were Senators Seekins, Ben Stevens, Stedman, Elton, Fred Dyson and Chair Thomas Wagoner.

[3:35:39 PM](#) at ease [3:40:40 PM](#)

SB 305-OIL AND GAS PRODUCTION TAX

CHAIR THOMAS WAGONER announced that the administration would present SB 305.

[3:40:56 PM](#)

SENATOR AL KOOKESH arrived.

[3:41:08 PM](#)

BILL CORBUS, Commissioner, Department of Revenue (DOR), said the Profit-based Production Tax (PPT) embodied in SB 305 is the first major oil and gas tax legislation considered by the legislature since 1989. He stated:

The new statute will replace the broken ELF-based production tax. The new PPT will encourage badly needed investment in oil and gas exploration, development and production. It will provide special incentives for small companies proposing to explore and develop oil and gas in Alaska. And finally, it will enhance state revenues, particularly during periods of high oil prices.

He said that the study originally started with the prior administration when it retained Dr. Pedro Van Meurs in 1996. He acknowledged the numerous people in the Department of Revenue who had worked on this project.

[3:45:55 PM](#)

MIKE MENGE, Commissioner, Department of Natural Resources (DNR), explained how this legislation fits into the larger context of oil and gas development in Alaska. It should accurately reflect the geologic circumstances that fit a particular basin for which it was designed and this is a very good fit for Alaska. The state is looking at a diminishing population of perspective

targets; they will also be smaller and more difficult to find and, therefore, more costly to develop.

He said Cook Inlet is a very mature basin and the Interior has highly speculative basins in Nenana, Copper River and the emerging work in Bristol Bay. The tax is designed to create an environment to encourage smaller and mid-sized companies to explore. The administration's goal is to put more oil in the pipeline and more gas down its pipeline once it gets constructed. It wants to encourage an atmosphere of investment, further exploration and discovery that would set the stage well into the middle of this century.

The state lands have the potential of small discoveries, but federal lands have larger ones, particularly ANWR and offshore. He stated that the state needs this legislation regardless of what happens with the gas pipeline.

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CHAIR WAGONER asked Commissioner Menge to explain how the Oooguruk royalty reduction that the state granted a couple of weeks ago would be affected by the PPT.

COMMISSIONER MENGE replied that the authority granted to the department to negotiate a lower royalty was very broad in scope. It provided him with the flexibility of tailoring the royalty picture to meet the very specific issues related to that very geologically-challenged prospect. The PPT would take into consideration all potential issues over time and would, therefore, be more systematic. He would look at the cost of drilling, production, transportation and the historical aspects of the project that was not reflected in the current system. He explained that investments in the Oooguruk field were made under a very specific set of authorities and he would make sure that those assumptions and costs would not be violated. This would require a transition, particularly for Oooguruk. The PPT offers that kind of an opportunity. The department wants to retain the ability to change royalties site by site.

ROBYNN WILSON, Director, Tax Division, Department of Revenue (DOR), said that Dan Dickinson would explain the current production tax and its problems and she would give an overview of SB 305 after that.

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DAN DICKINSON, C.P.A. and Consultant to the Governor, explained what was wrong with the status quo. His presentation was titled

"Proposed Production Tax, Alaska State Legislature, Senate and House of Representatives Resources Committees, Dan E. Dickinson, CPA, February 22, 2006" and the minutes reference his slides. He said that in FY 2005 the state took in \$8.9 billion in restricted and unrestricted revenue. The largest piece of that was \$3.4 billion from oil - \$2.8 billion, or 88 percent, of that made up the unrestricted general fund budget. Of the \$3.4 billion, just over half were from royalties. About a quarter of those (restricted) went into the Permanent Fund and the School Fund. He said that the state received \$863.2 million from production taxes in 2005 and that his comments were focusing on those.

His next slide indicated Alaska oil production from the years 1965 to 2020 and in 1988, the height of production, 2 million barrels per day were produced and 1.6 million of those were from Prudhoe Bay. He termed Prudhoe Bay an elephant.

[4:02:43 PM](#)

He said that the Kuparuk field is the second largest field in the United States, but compared to Prudhoe Bay, it is small. He cautioned that tax policy should not be set on the expectation of finding another elephant.

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His next slide graphed the decline in oil production from 2 million barrels a day in 1988 to 850,000 barrels a day in 2006. While this was going on, oil prices were marching in the other direction. They started in the \$15 range and are now in the \$60 range. So while production was declining, the state did not necessarily feel its effects because it was seeing basically the same gross product. The volumes are leveling out a little, but SB 305 seeks to make them go up again.

He began talking about why the current production tax doesn't generate the kind of revenues the state should expect at the current prices. He observed that, as the result of an analysis the Department of Revenue conducted for a number of years, the Governor issued an administrative order a year ago that aggregated seven fields on the North Slope. He said the new production tax is proposed to start on July 1, 2006. So, that aggregation order would affect about 1.5 years of production, just under \$4 million. That DOR analysis led to the conclusion that the tax had deeper problems and he hoped the PPT would solve them.

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The first problem was investment. Over the last four years, not including tankers or pipelines, upstream exploration and capital facilities have cost the industry about \$1 billion. This was not sufficient to generate new amounts of production, but it kept the aging fields open and did involve some new fields. The question is if the lack of new production is due to the tax system.

His next slide showed how in 2005, the net value of oil at point of production was \$10,694 million, which was arrived at by subtracting the cost of tankering, pipelines and upstream costs from \$14,332 million. He explained that the current production tax ignores upstream costs. Instead, the state uses the Economic Limit Factor (ELF) as a proxy for them. It takes the same 2005 figures and starts with the gross value at point of production - \$12,843.60 million and figures the numbers this way:

- gross value at point of production - \$12,843.60 million
- times royalty rate of \$0.875 million
- equals the value net of royalty - \$11,238.15 million
- multiply the tax rate of \$0.15 million
- times the ELF rate of \$0.55 million
- equals a 2005 tax of \$927.15 million

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For the same year, 2005, the PPT tax would:

- start at the value net of royalty - \$11,238.2 million
- deduct the upstream costs of \$2,150 million, which equals a taxable value at point of production of \$9,088.2 million
- times the PPT of 20 percent, which equals \$1,827.6 million
- subtract tax credits of \$210 million
- results in a production tax of \$1,607.6 million

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MR. DICKINSON said the second problem was that production is falling on the North Slope and under that scenario the ELF also falls, but much faster. The Kuparuk field is a perfect example of how the ELF works. It went from producing a high of 300,000 barrels per day in 1990 to about half of that today. But in that same time period, the ELF went from .8 percent down to zero. It goes through the mid-range and reaches zero very quickly. Currently, North Star, Alpine and Prudhoe Bay have healthy ELFs of .8 percent, but both Alpine's and North Star's ELF will fall dramatically and hit zero in six or seven years as their production starts to taper.

The second major criticism of the ELF is that it is way too sensitive to the number of barrels and rate of production and as a proxy, it does not represent the kinds of costs involved when production falls. It does not encourage the investment necessary to secure future production.

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SENATOR THERRIAULT asked if he charted both oil and gas liquids.

MR. DICKINSON replied that his production figures include both oil and gas liquids, but Kuparuk has a very small amount of gas liquids. This brought him to another important point - that ELF works differently for gas than oil. One of the first things to do in an ELF calculation is to divide up the well days between oil and gas. Right now most of the gas that comes out at Prudhoe Bay is simply put back down in the ground. It doesn't count in calculating the ELF, because it is not sold. If half of the 8 BCF that were being moved that way were being exported, the gas ELF would suddenly increase and so would the oil ELF. If the gasline is put in place, one could ask if it makes sense to have a system that looks at the interrelationship between gas and oil differently than the current ELF does.

MR. DICKINSON said he was focusing on the oil ELF, but Mr. Marks would talk about the gas ELF tomorrow. He emphasized again that the ELF is outmoded because it focuses on well-productivity. New wells in the ground have multiple completions with laterals that go out, sometimes, for miles. So, while a well in Prudhoe Bay is producing 600 to 700 barrels per day, other wells at Alpine and Pt. Thompson will be producing 7,000 to 8,000 barrels per day.

SENATOR STEDMAN clarified that just because the ELF goes to zero doesn't mean the state's revenues go to zero. They are talking about 25 percent of the state's gross oil revenue and the ELF is only a multiplier that is applied to the severance tax to reduce it.

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SENATOR BEN STEVENS asked to go back to the current production tax slide and asked if the ELF he used could be applied to the entire North Slope.

MR. DICKINSON replied yes.

SENATOR BEN STEVENS clarified, then, that the applicable tax rate was really 8.25 percent, not 15 percent.

MR. DICKINSON replied yes.

SENATOR BEN STEVENS continued to discuss figures on the slide. He said the reality of the PPT is that the tax rate hasn't changed on the affected barrels of oil, but investment is being encouraged.

MR. DICKINSON replied:

As you observed, the rate is variable depending on the amount of investment and that's what we're saying. That's what's going to drive whether you are a high end, high percentage taxpayer or a low percentage.

SENATOR BEN STEVENS said it would be helpful if he could show that the change from status quo, which is 8.25 percent, to the proposed rate on the effective rate with PPT is 14.3 percent, an increase of approximately 6 percent on the severance tax.

MR. DICKINSON replied that was right for this particular example.

[4:34:56 PM](#)

SENATOR RALPH SEEKINS asked if the \$1.7 billion of additional investment in the next slide rolls into upstream cost deductions in the next year.

MR. DICKINSON replied that there would be no depreciation next year, rather you would get instantaneous depreciation and, "Clearly if you built new infrastructure, there would be additional operating costs, but presumably there would also be additional volumes to cover those."

SENATOR SEEKINS said it should be very clear that the depreciation is taken in one year and can't be expanded over multiple years, so there is no double-dipping.

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SENATOR KIM ELTON asked if investments that are eligible for credits cover exploration, development and operation costs.

MR. DICKINSON replied that the credit doesn't cover operational costs. It is about things that would have to be capitalized under federal rules and that includes exploration and intangible drilling and development costs.

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SENATOR BEN STEVENS asked if any of his presentations have an indication of the probability of success for the different investment scenarios.

MR. DICKINSON replied that he has run four basic scenarios at different price levels, but it's very difficult to come up with a figure to use for much the incentive will increase exploration and production. He said that Mr. Marks would run a model of that in a future meeting.

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SENATOR STEDMAN asked what the basis was for selecting the 20 percent tax.

MR. DICKINSON replied that Pedro Van Meurs would go into the credits in more depth with his presentation.

[4:42:25 PM](#)

SENATOR ELTON asked if Alaska should expect a premium because of its stability.

MR. DICKINSON replied that Mr. Van Meurs would observe in his presentation that in places where the resource is more challenged, the resource owner would do more to open it up. In Alaska, a \$7-premium for distance to market was used.

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SENATOR THERRIAULT asked if the administration had discussed whether frontier exploration should get a separate extra credit from low risk development.

MR. DICKINSON responded that was part of the discussion since the easy oil has already been developed and it is more expensive to develop heavy oil. The Governor did not want to pick out which development to encourage and which not to encourage and while the proposed tax would generate a very large credit, it doesn't take into account the different set of risks involved with each field. Looking at large known quantities of heavy oil and other challenged reservoirs on the North Slope, he thought that it was appropriate to have this credit apply to those expenses, as well.

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SENATOR THERRIAULT commented that there were still other levers to pull and a company could ask for assistance on a particular field if it had difficult circumstances.

MR. DICKINSON reflected that it seems entirely appropriate that a royalty reduction could look at specific leases.

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SENATOR BEN STEVENS said he saw a flaw in ranking the Gulf of Mexico as one of the most attractive regions in the world to make investments because of the uncertainty caused by hurricanes that happen there every year. It's an instability that is not related to any human error or action and an economist can't incorporate that into his analysis.

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SENATOR STEDMAN remarked that the ELF is not price sensitive and the royalty and tax system are regressive. When prices go up, the government take declines and the public becomes alarmed. Removing the ELF from the severance tax and plugging in a profit-sharing tax would make Alaska's take move up with rising prices instead of down.

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ROBYNN WILSON, Director, Tax Division, Department of Revenue (DOR), recapped that there is no incentive in the current tax system to encourage oil companies to reinvest in Alaska, that there is a low take at high prices and a high take at low prices - what is commonly referred to as a regressive tax. Also, the maturing of the North Slope leads to declines in tax revenues. She presented a power point entitled, "Petroleum Profits Tax (PPT), Overview, Alaska Department of Revenue, Before the Alaska State Legislature, Robynn J. Wilson."

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She said SB 305 tries to embody five key ideas. The first is to encourage investment, the second is competitive rates, the third is to encourage small companies and the fourth is to streamline some of the tax provisions.

The tax base under the current system is based on gross value and the proposed system is based on net. SB 305 suggests a 20 percent tax rate as compared to the current 12.25/15 percent scheme. Incentive credits are a third key component. The fourth element is a base allowance that is the equivalent of a standard deduction for individuals. The last component is a transition provision that recognizes some of the recent investments on the North Slope.

She started with a one-page comparison of the current tax system, which is based on gross and allows no deductions versus

the proposed tax on net. The value at the wellhead is essentially the same under the PPT. The current system takes the wellhead value times the tax rate, which gives the tax before the ELF. The PPT starts with the wellhead value and allows some deductions, which establishes a net taxable amount. That is what the proposed 20 percent is applied to. She said, "It follows logically that the tax rate under a net plan is going to be higher than the tax rate under a gross plan."

For the tax base, she said that operating costs and capital expenditures are deductible under lease expenditures for one year. The difference between operating costs and capital expenditures is that operating costs are the normal expenses that will benefit one year, but a capital item would be something that would benefit a number of years like a piece of equipment. She explained:

What is unique about this bill is that rather than having the producer write it off over a period of time, there's an immediate write off of the capital expenditures. That's a key element to keep in mind. So, everything is written off in year one.

Secondly, the operating costs must be direct, ordinary and necessary. Ordinary and necessary is a common test from the IRS code to make sure business expenses are necessary. The department is directed to write regulations, but given direction that substantial weight shall be given to industry practice and standards adopted by the Department of Natural Resources. The costs that are paid by producers that are billed by an operator under the terms of a unit operating agreement can be treated as a lease expenditure. This is a bit of streamlining looking at common industry practice.

SB 305 has an allowance for overhead and the formula would be established through regulation. It would include things directly related to exploration, development and production. Any lease expenditures would be reduced by any reimbursements a producer might receive from another taxpayer or the government, for instance.

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SENATOR THERRIAULT asked if SB 305 uses what the state now uses for its net profit leases in terms of what gets subtracted out to get to net profit.

MS. WILSON replied yes.

SENATOR THERRIAULT asked if any leases operating under net profit are actually paying a percentage of profit to the state.

MR. DICKINSON replied yes.

SENATOR THERRIAULT asked for a list of those at a future meeting. He asked if new language streamlines the current process.

MR. DICKINSON replied that the way it is getting streamlined, issues would only be fought once. Right now the DNR makes a calculation about what it takes to get oil from the North Slope to market and the DOR goes through a whole different process. The bill proposed to use the DNR calculation.

SENATOR THERRIAULT asked if the administration considered using a flat rate for the allowable overhead so that it's easy to understand and apply.

MR. DICKINSON replied yes, but he tried to mirror current industry practice. So if the rate is different in Kuparuk than Prudhoe, he wanted to capture that difference.

[5:07:00 PM](#)

SENATOR SEEKINS asked what kind of overhead expenses would be defined in regulation.

MR. DICKINSON replied that he would look at existing standards for each field and would like to be able to deduct actual costs, recognizing that they change every twenty years or so and should have some flexibility.

SENATOR STEDMAN asked if the capital expenditures would be capitalized in just one year, would a corporation still depreciate those expenses on its federal taxes - so companies would have two sets of books.

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MS. WILSON answered yes, but she noted that current state income tax rules for oil and gas companies require companies to have an Alaska-specific depreciation separate from the federal depreciation system. This, in effect, would add a third layer.

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SENATOR STEDMAN asked if a company takes its capital deduction in one year, would it be able to use the depreciation to increase its benefit going forward.

MS. WILSON replied no; double-dipping is not allowed. Depreciation is a non-deductible expense. But she pointed out that a piece of equipment can be written off in year one as a deduction, but the bill also provides for a credit of 20 percent of that. There is both a deduction and a credit. The credit is to incentivize investment.

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SENATOR ELTON remarked that companies get to pay significantly less as part of the state's deal.

MS. WILSON replied yes, that is the intent.

SENATOR ELTON asked if the allowance for overhead would include lobbying expenses or expenses for attorneys who may be disputing a tax decision by the state.

MR. DICKINSON answered yes and that the allowance is not specific, but should cover the costs of doing business.

SENATOR ELTON asked if the allowance could help pay for a corporation's attorneys while the state is paying for its attorneys on the other side in a tax dispute.

SENATOR BEN STEVENS brought up a point of order saying the answer to that question was on page 14. It says that litigation is not allowed as a deduction.

MS. WILSON referenced language on page 13 that said expenses had to be directly related to business and lobbying would be a hard sell.

MR. DICKINSON clarified that attorney fees would be allowed for personal injury cases such as in a car crash, but not for tax disputes.

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SENATOR SEEKINS asked if he took a \$100,000 piece of equipment and deducted 100 percent of it today and got a 20 percent bonus, what would he really save in terms of taxes not paid.

MR. DICKINSON replied that basically the state is picking up 40 percent of the cost of the piece of equipment in one year. If

that piece of equipment gets sold the next year, it gets added back in. "Basically, 20 plus 20 is 40 percent."

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SENATOR STEDMAN recapped that the bill is geared for development. A company would cut its risk by sharing it with the state and federal government. And the state is encouraging them to go out and drill because the probability of success is low. But the state would recoup its incentives by having more wells drilled, having more oil found and receiving enhanced revenues from those activities.

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MS. WILSON said the non-deductible expenses are covered in section 21 of SB 305, on page 13. They are depreciation, royalty payments (because it never gets in the base in the first place), taxes based on net income, interest and financing charges (administrative expenses that apply to all of their properties), lease acquisition costs and other costs for things like arbitration, donations and organizing partnerships.

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SENATOR SEEKINS asked if a company could deduct bids to acquire leases.

MS. WILSON circled back to determining value under the current system and emphasized this is one of the places the department is trying to streamline. Currently, when oil is taken to the West Coast and sold, the wellhead value has to be calculated to impose the production tax. Now they work backwards by starting with the sales price on the West Coast and take out the expenses for marine and pipeline transportation up the coast arriving at a wellhead value. Marine transportation particularly has been the subject of a lot of audit and contention. "It's just not a simple system."

SB 305 allows possible elections a producer can use to establish gross value. The first one is the royalty value through either DNR or federal royalties. This includes royalty settlement agreements accepted by DNR. The other option would be a DOR formula that estimates a value at a specific location - such as point of delivery into a common carrier pipeline. The formula may use other factors such as published prices, quality differentials, applicable transportation costs and inflation adjustments. In effect, the established body of law is maintained, but some elections are being allowed to simplify it.

There would be some timing restrictions. She clarified that the 20 percent tax is on net profits.

[5:23:44 PM](#)

SENATOR THERRIAULT said Pedro Van Meurs suggested 25 percent and asked why the Governor used 20 percent instead.

MR. DICKINSON replied that the Governor analyzed several different scenarios and looked at a balance of encouraging investment and state revenues. There is nothing magic about the scenarios.

CHAIR WAGONER asked if the committee could see a comparison of what 20 percent does in Alaska versus what happens in other countries.

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SENATOR THERRIAULT said the state would pick up more on the tax side, but it also credited more back on investments.

[5:28:04 PM](#)

SENATOR BEN STEVENS emphasized the need to focus on the effective tax rate, which currently is 8.25 percent after the ELF is computed. The proposed tax rate of 20 percent equates to about 14 percent. Statutory tax rates are meaningless until they have been applied in a formula.

[5:29:45 PM](#)

SENATOR THERRIAULT said they must be careful in comparing a new system with a broken system. He wanted to compare it to what was working.

SENATOR BEN STEVENS countered that the legislature doesn't know the applicable rate in Trinidad. It can only compare it to what the state has now.

[5:32:19 PM](#)

SENATOR STEDMAN said it's important to look at the international oil companies around the world and see what the split is between government and industry.

[5:34:01 PM](#)

MS. WILSON moved on to incentive credits that were found on page 4 in section 10. The credits are transferable and would mostly help small producers.

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SENATOR ELTON said he was struggling with the transferable credit.

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SENATOR THERRIAULT asked if the credit couldn't be used or the company didn't have income to offset it in one year, did the purchaser have to use it that same year.

MS. WILSON replied that the originator of the credit could carry it forward to next year. There is no limit on the carry forward; the credits do not expire.

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SENATOR BEN STEVENS asked if a credit is transferable only one time.

MS. WILSON replied that there is no limit on the number of times a credit can be transferred.

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She said that net operating losses (NOL) can be turned into credits, dollar for dollar, and be handled the same way. This language is on page 5, section 12.

SENATOR ELTON said that almost seemed like double-dipping.

MS WILSON clarified that the bill specifically allows for immediate write off of equipment and a credit. One way of looking at that is a double-dip, but the reason it was written that way was to provide incentive for investment.

MR. DICKINSON observed that the net operating loss works by giving the credit whether there is a loss or not. The notion is that the effect of buying a \$100,000 piece of machinery should generate a \$40,000 credit whether a company is drilling dry holes or producing tons of barrels.

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SENATOR ELTON asked if that means companies can have a net operating loss, but still gets a 40 percent plus credit that it can sell.

MS. WILSON replied no; that the 40 percent comes from the 20 percent deduction and the 20 percent credit. She likened the base allowance to the standard deduction on a personal income tax return. After the net taxable income is calculated, the producer is allowed a \$73 million deduction per year that is

taken month by month. This cannot be turned into a net operating loss.

CHAIR WAGONER asked for the rationale behind the \$73 million.

MS. WILSON answered that the rationale was \$200,000 per day translated into a yearly amount.

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SENATOR BEN STEVENS asked how many oil and gas companies operating in Alaska are currently earning less than \$73 million.

MR. DICKINSON replied that some mediums-sized companies have small leases that generate above \$200,000 a day at today's prices, but at lower prices, some of them might slip below that level.

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SENATOR BEN STEVENS asked how many oil and gas companies operate in Alaska now.

MS. WILSON replied 14.

SENATOR BEN STEVENS remarked that the state could easily see \$80 to \$100 per barrel oil on the immediate horizon and if all 14 of those entities are eligible for that deduction, you're talking about \$1 billion per year in income that is not going to be subject to a tax rate.

MR. DICKINSON responded that quite a few folks come nowhere near the \$73 million.

SENATOR BEN STEVENS rounded the number down to eight companies and \$500 million. If today's severance tax would be applied to that, it would equal \$40 million. "So, that's a \$40 million give-away to the industry."

[5:52:05 PM](#)

SENATOR STEDMAN said he interpreted the \$73 million to be a floor for everybody and when production was above that amount, the PPT would kick in.

MS. WILSON referred them to page 16 (i) that said, "Any month a producer that is qualified may deduct an allowance". So it is referring to company by company.

SENATOR STEDMAN asked what would happen to someone who was at \$74 million. Would just the \$1 million be taxed?

MS. WILSON replied that was correct.

[5:53:59 PM](#)

SENATOR BEN STEVENS asked if the \$73 million is a base allowance that applies equally to all taxpayers, why was it set at that number and why was it applicable to each ratepayer regardless of their liability.

MR. DICKINSON replied that the notion was to focus on profitability and \$200,000 per day was established as a base rate. Using number of barrels at extraordinarily high prices, you'd have a small company escaping any tax. "By putting it in dollars you basically avoided one of the errors of the ELF and you've made it more susceptible to high prices."

[5:55:41 PM](#)

SENATOR ELTON asked if Exxon would get \$73 million off its net profit.

MS. WILSON replied that a big company would get \$73 million off and a small company would get \$73 million off, but no more.

SENATOR ELTON said he thought that applying the allowance to everybody was a regressive element.

It seems like we're giving the major players a break, too; and that's taxable income that doesn't return to the state despite the fact that they may be some of the most profitable corporations in the world.

[5:57:49 PM](#)

CHAIR WAGONER said he thought they were trying to make the allowance a major incentive for small independents to operate in Alaska, but he thought it should have been thought through a little further to where it would apply to just them versus the majors.

MR. DICKINSON responded that if you're talking about the \$500 million, \$300 million of that would go to someone other than the big three. "The smaller the company, the larger the effect."

SENATOR BEN STEVENS commented, "It's a marginal rate with different marginal rates applied to each company individually. It's not an applicable tax equal across the board."

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SENATOR DYSON said the tail end of it is to keep production going on wells that might otherwise become shut in.

CHAIR WAGONER pointed out that that dynamic is taken care of with royalty reductions, such as those in Cook Inlet.

SENATOR STEDMAN reminded the committee that as the basin gets older, more, smaller producers would come in and this issue might encourage more companies to go forward.

[6:02:03 PM](#)

MS. WILSON said that current tax law requires monthly filing and that continues under the proposal. But the PPT has a safe harbor where if a producer pays 90 percent of his taxes each month and has a true-up on March 31, there is no penalty and no interest. The bill also contains options to use annualized amounts, but there is a tax filing on March 31 where the amounts are trued up. She viewed this as a streamlining feature.

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MS. WILSON went on to the transition provision. She explained:

Think back, then, to a basic business, the basic business invests in a piece of equipment or building or whatever. There's a recognition that that asset generates profitability for several years - the life of the asset. And so normally in accounting, how that's handled is that it's not written off in the first year, but there's a depreciation deduction that's taken year after year to offset the income - so that there's a matching of the income that's generated with the expenses that generated that income including the asset. However, in this bill, as I've noted before, there's an immediate write-off in year one of investments.

So, then the next question is well, what happens to the investments that a company has made recently, say within the last five years. Those are generating profits going forward. So, what you have then is - you've got income being generated with really no representation in the profit calculation that there was this investment. And so, what this basically allows, then is, in effect, a depreciation deduction for those assets that were invested in, say, last year

and the year before - to have them represented in the profit calculation. So, the way the bill is written, it allows the cost recovery of assets placed in service for the last 60 months. Those, then, are written off over the next six years. There is a price floor so that when the price of oil falls below \$40, and that's average per month, then, they can't take the deduction.

CHAIR WAGONER asked if they lose the deduction. "It's just delayed? There's no loss?"

MS. WILSON replied that was correct.

[6:06:58 PM](#)

CHAIR WAGONER said that seemed like a sweetheart deal.

[6:07:08 PM](#)

SENATOR THERRIAULT asked what if the price of oil was over \$40 for the full six years. "Are they not allowed any of this rebate?"

MR. DICKINSON replied that if the price never went over \$40, the companies would never recover. If it stayed under \$40 for six years and then went above \$40 for six years, they would recover.

Essentially, mechanically the way we described it is, you actually recover on a monthly basis. It's the first 72 months in which the price is over \$40 - you get to recover 1/72 each of those months.

SENATOR THERRIAULT remarked that they are not looking at a six-month period and that this could go forward forever.

MR. DICKINSON replied that was correct.

[6:08:12 PM](#)

SENATOR ELTON went back to Senator Seekins' \$100,000-asset example and asked if the credit that rolls forward on a 2002 purchase is based on the \$100,000 or if that asset has been depreciated to \$50,000, is the credit \$50,000.

MS. WILSON replied that the total amount is written off over six years.

It's not set up such that, let's say, a 2002 asset gets the full six years, but a 1999 asset gets five

years. It's just very simply anything purchased in the last five years will get a six-year recovery period. It's not set up as a credit; it is a deduction and it recognizes, in effect, depreciation deduction. So, they would get the benefit of 20 percent to that in total.

SENATOR SEEKINS asked if a total of \$20,000 could be written off on a \$100,000 piece of equipment in terms of the credit if the price of oil is above \$40 a barrel for one sixth and why was it not for one-fifth.

MR. DICKINSON replied that typical transition rules contain a fair element of arbitrariness. The companies asked the Governor for some aggressive transition rules and this is what was agreed upon as fair.

[6:10:57 PM](#)

SENATOR STEDMAN said he didn't have a lot of comfort with this section of the bill saying, "This is kind of a one-sided deal. And the effective date of July 1 of '07 is a little bit cleaner than starting to back up."

CHAIR WAGONER noted that oil companies have been receiving the benefit of ELF for the last five years. "To me this looks like more double dipping than everything else we've looked at!"

SENATOR BEN STEVENS said it would be interesting to compare the transition look back to the \$73 million floor on an annual basis.

[6:15:27 PM](#)

SENATOR ELTON said the look back provision helps the producers and not the explorers.

MR. DICKINSON said the administration hadn't addressed what would happen if a company were to totally go out of business and he would have to give that some thought.

[6:16:49 PM](#)

SENATOR DYSON said that he was worried that the net result of the credits and the floor would mean very little more revenue coming to the state, because a significant analysis shows that the state has not been getting a competitive share of oil revenues in the past. "All we will have gained in the intervening years is the increased investment that we hope produces more production. "

[6:18:13 PM](#)

SENATOR SEEKINS asked if oil companies had been able to take a depreciation credit on assets over the last five years.

MS. WILSON replied not against the production tax.

SENATOR SEEKINS remarked, "So, they have not been able to depreciate any of those assets against taxes owed to the state?"

MS. WILSON replied, "The depreciation deduction would apply and be factored in in the income tax."

SENATOR SEEKINS said, "So, in effect we're now going to give them credit for 100 percent of the asset that they've already written off a portion of against income tax."

[6:20:30 PM](#)

MS. WILSON replied that was correct.

MR. DICKINSON added that they are getting a 20 percent benefit. "So, it will be 100 percent of their depreciation, but in a 20 percent tax rate."

SENATOR SEEKINS countered:

We're giving them a 100 percent of the value five years back versus we're giving them 20 percent on a newly purchased piece of equipment. At least in my industry, I would have depreciated that piece of equipment down to a certain level already in terms of my tax liability and I don't know where they left - five years straight line? How are they allowed in the terms of their taxes?

MS. WILSON replied: "It would depend on the type of equipment."

CHAIR WAGONER asked what the maximum number of years allowable to take depreciation in the oil field was.

MS. WILSON answered that she didn't know the exact life at this point. The Alaska income tax structure has a different set of depreciation rules.

SENATOR SEEKINS remarked that he could understand the oil companies wanting some credit for what they had already spent,

but he didn't think it would take 100 percent of the last five years investment to be able to do that.

CHAIR WAGONER wondered how much depreciation had been taken off of the federal taxes.

SENATOR SEEKINS said he wanted to know what the dollar amounts were.

[6:22:25 PM](#)

SENATOR DYSON asked if the major benefit to the state was going to be investment in new equipment that increases production, why would it pay for investments that were just replacing old depreciated plants that were only maintaining current production.

MR. DICKINSON replied that was one of the areas that had restrictions. It is important to say for a very old field, especially where technology has been fairly innovative, that discouraging replacement by drawing a line about an upgrade versus a replacement could get the state into disputes that it didn't want to get into.

One of the lines we did draw is, it has to be an asset newly placed in service in the state. So, it doesn't have to be new; you can buy a second-hand asset, but we can't have everybody cross-selling to each other every year and say look at the credits we're generating.

CHAIR WAGONER asked if a piece of equipment gets a one-time credit.

MR. DICKINSON replied yes.

CHAIR WAGONER asked if company A buys a Solar Centaur generator and puts it at well 33 and at a later date takes it out of service - it gets rebuilt and company B buys it and transfers it to a different site, can company B take a credit, too.

MS. WILSON replied no and referenced page 7 where qualified capital expenditure was defined as "newly placed in service in the state". Cross-selling would not be allowed.

MR. DICKINSON added no, they would not get a credit because language also states, "that has been previously placed in service in the state".

[6:25:42 PM](#)

SENATOR ELTON asked for the dollar amount that accrues to this particular provision and how it was divvied up between explorers and producers.

MR. DICKINSON estimated that at \$1 billion per year, the exploration piece would account for \$100 million to \$150 million or roughly 15 percent.

SENATOR ELTON said he thought this allowed for cost recovery of assets placed in prior service and he assumed that an explorer would be investing far less in assets than a producer would.

MR. DICKINSON replied that intangible drilling costs is a great misnomer. When you go out and drill a well, you're paying a day rate on the rig. You don't acquire that. That's why so-called intangible drilling costs are being capitalized. The price of renting the rig becomes the cost of drilling the hole.

SENATOR ELTON continued then that would count as an asset that is applicable under the look back provision.

MR. DICKINSON replied that was correct. Under federal rules, that intangible drilling cost goes through the process of being capitalized.

[6:28:00 PM](#)

SENATOR THERRIAULT said it was portrayed to him that the administration ultimately split the difference on this provision and asked if it totaled \$10 million per year.

MR. DICKINSON responded that the discussion revolved around whether there should be a credit as well as depreciation. The credit is meant to incent things and it's hard to incent dollars that have already been spent.

SENATOR THERRIAULT asked him to go back five years and what the economics were when the investment was made. The price went up and oil companies were getting very favorable treatment under the ELF. It seems like they made a very good return on their investment.

MS. WILSON replied that from an accountant's point of view, one way of looking at it is to ask if the cost has economically been recovered. But she looked at it by asking how long the asset was generating profits. In a regular business, a piece of equipment

generates income for a given number of years. Any business may have a banner year where economically an argument can be made they have recouped that investment. From an accounting standpoint, that asset is still generating income.

SENATOR STEDMAN said he was becoming more uncomfortable about this provision the more they talked about it. Clearly the last three years had been fairly robust and unprecedented for the industry.

[6:31:05 PM](#)

MS. WILSON pointed out that additional revenue from the PPT would depend primarily on two factors, the price of oil and the amount gas producer investment in the state. She then presented the DOR forecast prices in graph form that the fiscal note projected.

[6:35:09 PM](#)

SENATOR BEN STEVENS asked for incremental graphs on different prices scenarios.

CHAIR WAGONER asked if the credits had been factored into her charts.

MS. WILSON replied yes.

SENATOR BEN STEVENS remarked, "Even with the credits applied in a transition provision, we're still looking at a 75 percent increase from the existing severance tax system at current prices."

MS. WILSON replied yes.

[6:35:53 PM](#)

SENATOR THERRIAULT referenced the \$40 projection and pointed out that no credit was being taken for the five-year look back and that the state would lose \$200 million if the price of oil was \$40.01.

MS. WILSON replied that was also correct.

SENATOR STEDMAN said he wanted to see where Alaska was compared to the rest of its competitors.

MR. DICKINSON replied that Dr. Van Meurs' graphs would do that in a future meeting.

CHAIR WAGONER thanked everyone for their comments and adjourned the meeting at [6:40:31 PM](#).