

**ALASKA STATE LEGISLATURE**  
**SENATE RESOURCES STANDING COMMITTEE**

February 24, 2006

3:39 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

**MEMBERS ABSENT**

Senator Albert Kookesh

**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

**WITNESS REGISTER**

Robynn Wilson, Director  
Tax Division  
Department of Revenue  
PO Box 110400  
Juneau, AK 99811-0400

**POSITION STATEMENT:** Introduced Dr. Logsdon to the committee

Dr. Chuck Logsdon, Economist  
Office of the Governor  
Alaska State Capitol  
Juneau, AK 99801-1182

**POSITION STATEMENT:** Delivered a PowerPoint presentation on SB 305

Roger Marks, Economist  
Department of Revenue  
PO Box 110400  
Juneau, AK 99811-0400

**POSITION STATEMENT:** Delivered a PowerPoint presentation on SB 305

Dan Dickinson, Certified Public Accountant  
Consultant to Governor Frank Murkowski

**POSITION STATEMENT:** Delivered a PowerPoint presentation on SB 305

Robert Mintz, Assistant Attorney General  
Department of Law  
PO Box 110300  
Juneau, AK 99811-0300

**POSITION STATEMENT:** Delivered a PowerPoint presentation on SB 305

**ACTION NARRATIVE**

**CHAIR THOMAS WAGONER** called the Senate Resources Standing Committee meeting to order at [3:39:19 PM](#). Present were Senators Kim Elton, Bert Stedman, Ralph Seekins, Ben Stevens and Chair Thomas Wagoner. Senator Fred Dyson attended via teleconference.  
^#SB305

**SB 305-OIL AND GAS PRODUCTION TAX**

[3:40:10 PM](#)

CHAIR THOMAS WAGONER announced SB 305 to be up for consideration.

^Department of Revenue - Robynn Wilson, Director, Tax Division

ROBYNN WILSON, Director, Tax Division, Department of Revenue, introduced Dr. Chuck Logsdon, former chief petroleum economist for the State of Alaska. He has 25 years experience in petroleum economics and is currently a consultant for the governor's office on the gas line negotiations.

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^Dr. Chuck Logsdon, Consultant to the Governor on gas line negotiations

DR. CHUCK LOGSDON presented a PowerPoint presentation entitled Alaska's Production Tax, Theory and Practice. In 2005, the production tax brought in approximately 24 percent of Alaska's oil revenue. Royalties depicted in the chart on page 2 of the presentation include the Permanent Fund. The property tax depicted includes taxes shared by the municipalities. Royalties are 53 percent of the pie, the property tax is seven percent and the corporate income tax is 14 percent. The production tax is a tax on the severing of the resource from the state assessed as either a percentage of value or on a minimum cents per barrel or mcf, whichever is pertinent.

Things really started taking off when Prudhoe Bay was discovered in 1968 and the tax has experienced many modifications since

that time, he stated. Alaska added fields continually and peaked with Endicott and Lisburne in 1989, which put the pipeline output up to two million barrels per day. Since then the Alpine and Northstar have been the most productive oil fields.

Governor Murkowski's objective is to maximize government take and to maximize the value of the resource. However, it must be recognized that oil companies have a different objective and the two must meet to the benefit of each. Norway is the country with the tax system closest to the PPT and so the presentation will focus on the Norwegian Petroleum Directorate.

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Slide 13 shows the geological learning curve from the beginning of oil exploration in Alaska. The cumulative production curve of the North Slope is close to the maturity part of the learning curve and indicates a good time to encourage incentives and to spend money.

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The experts have repeatedly advised that taxes based on net are more economically efficient because they allow investors to recover their investment and a rate of return. This ensures a competitive area to invest in. Governments should style their fiscal system around their geology because some production is much closer to the market than others.

Studies show that investors did well during the period of 1992-1994 because of lucrative oil fields being in a high-priced environment. The bottom line on international comparisons is that Alaska is in the middle of the pack. Dr. van Mures' latest recommendation is that Alaska could take 25 percent of the oil revenue, make tax credits and allowances, and encourage the kind of exploration that matches the geology of the state. That is, the smaller fields that have not experienced much drilling should be scrutinized and perhaps explored.

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DR. LOGSDON said Alaska should think seriously about making its system work more like some of the profit-oriented systems in the world. The state has been reluctant to change the system in the past due to significant concern about low oil prices. Changing oil fiscal regimes is not taken lightly especially in a declining production environment.

DR. LOGSDON concluded the presentation by saying Alaska should change the petroleum production tax. The state would still get

its royalty share calculated before upstream cost deduction and would still have a piece of world-wide corporate income as long as the companies produce in Alaska. Alaska would also have a property tax. Alaska would generate more revenue as well as provide a significant incentive for investors to continue developing oil and gas.

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SENATOR BERT STEDMAN referred to slide 4 and a chart showing the growth curve and asked whether it compared to basic company growth charts like one would see in an economics classroom. He noted that previous testimony suggested the North Slope area might still be in the early stages of production.

MR. LOGSDON said economists and engineers do not have a good handle on the technology aspect of oil production. Exploration and development costs were lowered dramatically with the technology boost in the 1980s, using computers to evaluate geology. There were also advances in well-drilling technology overall. The reason for the shape of the growth chart is that companies tend to produce the big easy fields first and then they go on to the smaller challenging fields. One could argue that the North Slope is at the late growth phase or the early maturity phase.

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When the National Petrochemical and Refiners Association (NPRA) opened, Arco and ConocoPhillips drilled a lot of wells and found oil in small accumulations but a far distance from the existing collection infrastructure. There were issues of getting access to the area and that should be considered for incentive-type thinking.

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SENATOR BEN STEVENS said the ultimate goal was to lengthen the longevity of the life of the North Slope so that it would reach maximum potential of production of petroleum products. He said Norway has included the incorporation and exploitation of the gas reserves, which Alaska doesn't have. He suggested that developing the natural gas potential would lift the oil production line in Dr. Logsdon's growth chart.

DR. LOGSDON agreed that was the ultimate goal. The potential to generate resources from the gas preserves, once the pipeline is in, should easily be as much as Alaska has obtained from oil production.

BEN STEVENS maintained that the growth chart was not a fair comparison with Norway because it lacks the natural gas indices.

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CHAIR WAGONER asked the impact that SB 305 would have on prior tax legislation.

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DR. LOGSDON said the fundamental change would be in the way the PPT would be imposed. The critical element being added to the tax base is to allow deduction of upstream costs.

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SENATOR KIM ELTON asked Dr. Logsdon whether the existing incentives would still be needed.

DR. LOGSDON did not know. He said current incentives have had positive effects on developing Cook Inlet.

SENATOR ELTON asked whether the Department of Revenue has considered looking at the existing incentives to see whether they were still necessary.

DR. LOGSDON said past legislation doesn't carry the same impact as SB 305. The credits allowed under the PPT are an alternative to the current system.

MS. WILSON explained that the current credit embodied under Alaska Statute Section 025 would become an alternative credit to the PPT. The company would have to choose between the two.

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^Department of Revenue - Roger Marks, Economist

ROGER MARKS, Economist, Department of Revenue (DOR) said he wanted to discuss specific provisions in the bill that address the incentives for small producers and new investors both large and small. Small producers are very important in the mix of oil producers and add diversity and additional opinions on production potential. Small producers tend to drill more exploratory wells and are not afraid of risk.

With NPRA coming on and ANWR opening, there are opportunities for more investors. Shell has picked up several leases around the state and Anadarko is expanding on the western northern slope. SB 305 sets out to assist small companies and attract new investors.

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MR. MARKS provided committee members with an overview chart of the Cook Inlet producers, the North Slope producers and the combined statewide oil production.

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SB 305 would allow a mechanism for attracting new large-scale investors by allowing them to convert their losses to a credit by taking the tax rate (.2) times one million dollars, which would equal \$200,000, and that could be sold to someone else for immediate use. The credit would be sold at 90 percent of face value.

Buying credits is risk-free money and there are at least five producers in the state who would be in the market for the credits. Selling a credit at 90 percent of face value converts to \$180,000 for the seller and that monetizes the loss early on a net present value basis.

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The ability to sell credits is identical. A company that invests \$1 million dollars realizes a \$200,000 credit and they can sell that credit for 90 percent of face value and monetize the credit early.

MR. MARKS posed an example of an explorer with no assets coming to Alaska to explore. They spend \$10 million dollars and drill a dry hole. Under the current system the state would chip in nothing but under SB 305 that company would be able to convert that loss to a \$2 million dollar credit. With the PPT the state would be risk sharing.

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SB 305 would allow a mechanism to attract small investors with the \$73 million dollar allowance. Under the current system small fields pay no tax and this should continue because it encourages development of small fields.

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SENATOR RALPH SEEKINS referred to slides 4 and 5 and noted that under the proposition none of the current producers in Cook Inlet or North Slope would pay a tax.

MR. MARKS said it is a consolidated tax statewide and Chevron Unocal and Exxon would pay tax but the small producers would not.

SENATOR SEEKINS referred to slide 5 [North Slope] and said that ConocoPhillips, BP and ExxonMobil would be the only ones to pay a tax.

MR. MARKS responded that would depend on the price of oil.

SENATOR SEEKINS asked Mr. Marks the companies they expect to be attracted to the Alaska market.

MR. MARKS said the incentives could attract targets around Fairbanks, Nenana Basin and possibly Cook Inlet. The allowance, coupled with the ability to sell credits and sell losses should bring more small producers into the state. Larger companies don't have the appetite for the smaller targets, he said. Most of the North Slope is leased up already and besides, it is very expensive and very difficult for small producers to operate there. Basically the first 5,000 barrels a day at \$40 a wellhead or \$50 dollar market price would not pay any tax.

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SENATOR ELTON asked Mr. Marks to clarify whether it would be the first 5,000 barrels for all companies.

MR. MARKS said the way the bill works is that the first \$73 million dollars per year would go untaxed.

SENATOR ELTON asked the reason for proposing this statewide and not just for the frontier or heavy oil fields.

MR. MARKS deferred the question to later in the presentation. He said the goal in designing the allowance was a judgment of about a \$50 price; a 5,000 barrel-a-day field should pay no tax. At lower prices, larger fields would pay no tax. At higher production there would be a lower price threshold.

With a \$73 million dollar allowance and a \$53 dollar a barrel market price, the first 5,000 barrels a day would pay no tax. At \$30 the first \$12,000 barrel a day would pay no tax and at higher productions such as 20,000 barrels a day the price threshold would be at \$23 dollars a barrel to pay no tax.

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CHAIR WAGONER asked the reason the entire state was included instead of splitting off the major oil producers and focusing on the smaller producers.

MR. MARKS said when advantage is given to some companies and not others it creates a chance for monkey business.

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Cook Inlet is 80 percent gas and 20 percent oil. The industry there is evolving as there is a decrease in production and most of the assets are old, depreciated, and paid for. The new development is mainly looking for gas and there have been small discoveries. In addition, the prices are getting much higher because the RCA has granted UNOCAL the right to sell their gas at higher prices. Marathon is attempting to garner the same deal and so if that evolves it would be much more profitable.

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The taxes on gas may increase on existing fields as they realize the credits and deductions and the ability to market losses.

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The gas severance taxes in Cook Inlet and the North Slope are subject to a gas ELF, which is also broken. The formula, set up in 1977 is much simpler than the oil ELF and is still in place. [Mr. Marks referred the committee to slide 17 - a snapshot of the Cook Inlet gas ELF.] He explained the chart and said it proved that the ELF was antiquated and was giving producers seven times more than they should be recovering for operating costs.

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MR. MARKS concluded by stating the governor's administration promotes SB 305 and believes it would attract new investors to Alaska.

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CHAIR WAGONER posed a hypothetical scenario of a small producer in Cook Inlet with 35-year old platforms who currently pays the state a very low severance tax due to the reduction. The annual revenue is \$60 million. Production expenses are \$15 million, and annual capital costs are \$10 million. He asked the amount they would pay in production taxes and royalties under SB 305.

MR. MARKS did the calculations and replied they would pay \$5 million in taxes. He said you would subtract the \$15 million and the \$10 million from \$60 million, which equals \$35 million. You

would subject that to a 20 percent tax rate, which would be \$7 million. Then you would subtract 20 percent of the \$10 million capital, which would be \$2 million and that equals \$5 million. A rough estimate shows their tax would go from \$3 million to \$5 million. Actually, he said, there is that \$73 million dollar allowance and so in this case their tax would be zero.

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SENATOR ELTON asked whether he said the tax rate for that hypothetical company would go from \$3 million down to zero.

MR. MARKS said yes, if that was their entire operation in the state.

MS. WILSON noted they would also pay corporate income tax and property tax.

MR. MARKS added that company could sell their credit and get the \$2 million dollar credit as well.

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SENATOR BEN STEVENS asked what exactly the PPT would apply to.

MR. MARKS replied the PPT would apply to oil and gas in Cook Inlet and the North Slope. However, an upstream production such as capital costs to develop Point Thompson would be a deduction on the PPT for development of gas as well.

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^Department of Law - Robert Mintz, Assistant Attorney General and Dan Dickinson, CPA, Consultant to the Governor

DAN DICKINSON, Certified Public Accountant and ROBERT MINTZ, Assistant Attorney General, Department of Law (DOL) presented a sectional analysis of the bill for the committee. There are two different provisions; one that would change the production tax and the other is a miscellaneous collection of improvements, corrections, and clarifications to the bill.

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MR. MINTZ began by answering a past question of Senator Elton's regarding a potential for a producer to defer taking a deduction until the future. He said it would be hard to conceive of any advantage in deferring a deduction because the value would be the same in any given year.

MR. MINTZ began the presentation entitled Presentation on SB 305 & HB 488 before Senate and House Resources Committees. The core provision of the bill is AS 43.55.011(a). The tax would be on oil and gas together and would remain a monthly tax. It would be equal to 20 percent of the net value of the oil and gas. The definition of "net value" is under AS 43.55.160(a) and starts with the gross value at the point of production.

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CHAIR WAGONER asked Mr. Mintz whether any future change to the oil tax would affect taxes on the gas pipeline.

MR. MINTZ replied the bill is written as a law of general applicability that would apply the same to all oil and gas produced anywhere in the state. Any other distinctions would be addressed in the contract.

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MR. DICKINSON said the discussion is still ongoing regarding exactly what period each aspect of oil fiscal stability would have. As constructed, if the Legislature were to change the oil tax in the future there would be a need for additional drafting to address the gas tax.

SENATOR SEEKINS referred to slide 4 and asked Mr. Mintz what he meant by the words, "as adjusted."

MR. MINTZ said it was intended to net out receipts that should be credited against the expenditures.

Slide 5: Gross value at the point of production is currently defined but the bill would amend the definition slightly so that the point of production is moved downstream of a gas processing plant, which is different than a gas treatment plant. The bill does not change the fundamental concept of gross value at the point of production.

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Slide 6: Gross value at the point of production is calculated using the reasonable costs of transportation.

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SENATOR ELTON asked whether there would be a different net value for Cook Inlet oil than for North Slope oil because the transportation costs would be different since Cook Inlet doesn't go through the trans-Alaska pipeline system (TAPS).

MR. DICKINSON said that is correct. Even so, a company on the North Slope that just spent a lot of money on transportation costs in a year with high TAPS tariffs would see a very different price than someone with a low TAPS tariff using very old and depreciated transportation.

SENATOR ELTON asked Mr. Dickinson whether they back out profits that an owner might get for transporting the oil.

MR. DICKINSON said they do not.

MR. MINTZ added for the record that they were talking about gross value at the point of production.

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Slide 7: AS 43.55.150(d) provides for simplification of the calculation and the Department of Revenue (DOR) would be allowed to authorize a taxpayer to use a simplified formula to calculate gross value at the point of production. The most notable example would be if the taxpayer has a royalty settlement agreement with the Department of Natural Resources (DNR) that provides for a way to calculate value for royalty purposes.

MR. DICKINSON added over time the DOR and the DNR have developed different rules for different reasons but fundamentally they do the same calculation, which starts with the value it sold for and then deducts the cost to get to the wellhead.

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Slide 8: For net value start with gross value and then deduct lease expenditures, which are the total costs upstream of the point of production. They have to be direct costs of exploring for developing or producing oil or gas in Alaska.

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CHAIR WAGONER interrupted to say the reason for revamping the tax structure is because ELF wasn't working in all cases on the North Slope.

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SENATOR SEEKINS asked Mr. Dickinson whether he had information that identified the companies that have made substantial capital investments in the oil fields.

MR. DICKINSON responded half of the production comes from Prudhoe Bay. ConocoPhillips and ExxonMobil each own 36 percent, BP owns 18 percent and then there are smaller owners. Further

west ConocoPhillips owns 78 percent and Anadarko owns 22 percent so there are significant investments there.

SENATOR SEEKINS expressed interest in seeing a comparison of the companies that have invested heavily over the last five years and those that have not and whether the companies that did not invest would profit more than those that did invest.

MR. DICKINSON said that was right. That is the reason for creating the process to recover investment costs.

SENATOR STEDMAN noted an undoubtable correlation between capital expenditures and a majority market share.

MR. DICKINSON agreed.

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SENATOR ELTON asked Mr. Dickinson for an estimate of the cost to the state for the provision and also to compare that to a cost if applied to the depreciated value.

MR. DICKINSON said he would get the information together.

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Slide 10: In determining direct, ordinary, and necessary costs, the department shall give substantial weight to typical industry practices and standards that are reflected in joint operating agreements.

In particular situations the department may allow a producer to rely on the billings as equal to the lease expenditures. Subsection (d) gives a list of certain items that are not eligible to be deducted.

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Slide 12: AS 43.55.160(e) provides the concept to get to the net costs.

MR. DICKINSON clarified that the royalty owner would not share in any lease costs. Field cost deductions are for the lease-type operations and they allow for 20 percent of eight-eighths as the appropriate deduction.

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SENATOR BEN STEVENS said on the corporate side they would only be allowed to deduct 20 percent of seven-eighths.

MR. DICKINSON replied it would be roughly the same effect as the income tax.

MR. MINTZ said the third category of adjustments is if a producer purchased a capital asset and that purchase price was a deductible lease expenditure and then later sold the asset, the sale price is recaptured to get the net deductible of expenditures.

Slide 13: Transitional investment expenditures are capital expenditures from the previous five years. AS 43.55.160(a) also refers to subsection (i), which is where the \$73 million dollar allowance comes in and the producer has to be qualified to get the allowance. The purpose of the qualification is to make sure they don't multiply the number of producer entities so that each one gets the \$73 million dollar allowance.

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SENATOR ELTON asked whether the smaller companies would delay making the decision to take the \$73 million dollars until the last minute when they knew how much money they would end up making for the year.

MR. DICKINSON said a company that knew they would make between \$70-80 million would estimate 20 percent of the \$2 million and spread it over the 12 months. The alternative is they would assume that the first six months was covered and so they wouldn't pay anything until the final months.

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Slide 17 looks at qualified capital expenditures, which is defined in AS 43.55.024(a). It has to be lease expenditure and there are three established categories. It is limited to the purchase of new assets. The tax is a monthly tax but there are some annual aspects of it, namely within a calendar year lease expenditures that cannot be used within a month can be used in another month.

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CHAIR WAGONER asked whether platform demolition costs would be allowed for a credit.

MR. DICKINSON suspected they were considered intangible costs.

SENATOR ELTON assumed that would be covered as a deduction to get back to net value rather than credit.

MR. DICKINSON said it would definitely qualify as an operating cost.

MR. MINTZ said there was a sort of double-dip intended in the bill regarding capital expenditures because lease expenditures include both operating and capital expenditures and they are deductible in coming up with net value. The subset of lease expenditures, which are qualified capital expenditures, are also eligible for capital expenditure credit and that is deliberate to give additional incentive for the investment.

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Slide 20: Steps in calculation. The second part of the presentation is a flowchart that explains the fundamentals of how the tax is calculated. Slide 21 shows how to get to statewide gross value of producer's oil and gas. Slide 22 shows the flowchart of obtaining deductible lease expenditures.

Slide 23 shows the flowchart of the transitional investment expenditures for deduction. The total is divided by 72, which represents six years multiplied by 12 months a year.

Slide 24 demonstrates the flowchart for the \$73 million dollar allowance. Once a company demonstrates their eligibility for the allowance they can take up to \$73 million dollars a year and transfer that into a monthly allowance for the given month.

Slide 25 demonstrates the flowchart of how the total gross value minus adjusted lease expenditures, other deductions, and the allowance get to the net value of the oil and gas.

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Slide 26 addresses tax credits. One important point is that AS 43.55.160(m) says for purposes of the credits, an explorer is considered a producer because the DNR defines a producer as someone who owns a working interest. Some forms of exploration are undertaken before there is a lease or a permit. The bill allows for explorers that incur exploration expenditures to be able to treat those as losses and as capital expenditures.

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Slide 27 details a schematic of the transferable tax credit certificate process. The DNR holds the application process for the certificate and the DOR issues it. In order to have the process take place relatively quickly, there is a requirement that the department act within 60 days after receiving the

completed application. Once the certificate is issued, the buyer would be able to absolutely rely on that credit.

Slide 28 details the actual tax calculation. As for purchased credits there is a limitation on that. Each month the credit cannot be used to reduce the producer's tax more than 20 percent.

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Slide 29 demonstrates the tax payment scheme. Currently the tax on oil and gas produced in a given month is due at the end of the next month. That is retained but with a slight adjustment. Upstream costs might not always be known until after the calendar year and so the bill makes only 90 percent of the actual tax due at the end of the month. The remainder would be due March 31<sup>st</sup> of the next calendar year. If the producer pays less than the 90 percent there would be interest owed on the deficiency until it is paid. If there were an overpayment during the year, the department would not pay interest back to the producer.

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CHAIR WAGONER asked Mr. Dickinson whether there have been problems collecting on back interest in the past.

MR. DICKINSON responded there is an issue with the 11 percent compounding interest rate, which is very high. Companies should be able to learn sooner that they owe that money.

CHAIR WAGONER asked whether a true up every six months would negate some of that.

MR. DICKINSON said the reason for the March 31<sup>st</sup> true up is because a lot of the credits are going to be termed by the actual federal income tax treatment. Companies generally figure their federal taxes once a year.

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SENATOR BEN STEVENS complimented Mr. Mintz and Mr. Dickinson on their presentation.

CHAIR WAGONER recessed the meeting until 9:00 am on Saturday February 25, 2006 at [6:06:16 PM](#).

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