

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

February 25, 2006  
9:05 a.m.

**MEMBERS PRESENT**

Senator Thomas Wagoner, Chair  
Senator Ralph Seekins, Vice Chair  
Senator Ben Stevens  
Senator Bert Stedman  
Senator Kim Elton

**MEMBERS ABSENT**

Senator Fred Dyson  
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
02/24/06	(S)	Presentation by Administration
02/25/06	(H)	RES AT 10:00 AM SENATE FINANCE 532

**WITNESS REGISTER**

Robert E. Mintz, Assistant Attorney General  
Oil, Gas & Mining Section  
Department of Law  
1031 W 4<sup>th</sup> Ave, STE 200  
Anchorage, AK 99501

**POSITION STATEMENT:** Delivered a PowerPoint Presentation on SB 305.

Dan E. Dickinson, CPA  
Consultant to Governor Murkowski  
PO Box 110001  
Juneau AK 99811-0001

**POSITION STATEMENT:** Delivered a PowerPoint Presentation on SB 305.

Commissioner Bill Corbus  
Department of Revenue  
PO Box 110400  
Juneau, AK 99811-0400

**POSITION STATEMENT:** Summarized SB 305 for the Governor.

**ACTION NARRATIVE**

**CHAIR THOMAS WAGONER** called the Senate Resources Standing Committee meeting to order at [9:05:18 AM](#). Present were Senators Kim Elton, Ralph Seekins, Bert Stedman, Ben Stevens, and Chair Thomas Wagoner.

^#SB 305

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

[9:05:29 AM](#)

CHAIR THOMAS WAGONER announced the committee would start where they left off the previous day on SB 305.

^Department of Law, Robert Mintz, Assistant Attorney General, Division of Oil, Gas and Mining

ROBERT E. MINTZ, Assistant Attorney General, Oil, Gas & Mining Section, Department of Law (DOL), informed the committee that he would go through the details of SB 305 that he didn't get to earlier.

Section 1 expresses legislative intent with regard to Section 11. That section adds a few words to an existing provision of the production tax act that has been there for a long time. It deals with the concept of what is called "prevailing value." AS 43.55.020(f) says where there is a sale of oil and gas and the price is below market value, the department can require tax to be paid on the market value. The question is what if there is no sale at all, for example, if the same company that produces it refines the oil and gas. The department has always used the concept of prevailing value to come up with the market value. There was a challenge to this application a few years ago that was upheld in a public hearing. While Mr. Mintz wasn't aware of any continuing live controversy, if the Legislature does amend the production tax, it would be a good idea to clarify that point to avoid future challenges.

[9:07:41 AM](#)

When it comes to calculating gross value at the point of production in section 152, the bill would allow simplified formulas to be used. In that case, there probably wouldn't be any issue about comparing prevailing value to something else anyway. That is covered in Sections 1 and 11.

Sections 2 and 3 amend the income tax statute, AS 43.20, to clarify that the production tax still remains deductible for income tax purposes and is not added back to federal taxable

income for income tax purposes. This has always been the way production taxes have been treated and because this production tax changes from gross value to net value, it is important to make sure the traditional treatment continues in the future.

The tax laws have strong confidentiality provisions to protect taxpayer information. Some exceptions exist in connection with an official investigation or proceeding of the department. There are few instances when due process considerations for a taxpayer would argue in favor of that taxpayer having access to some particular information that may have been obtained from another taxpayer. An example of that is prevailing value, which in some cases is determined in part by transportation costs. If a certain taxpayer is assessed a tax based on prevailing value and the transportation cost element that went into that calculation is based in part on transportation costs of other taxpayers, the taxpayer whose tax is being determined may have to find out what the basis of that was - in order to have an idea whether it's correct or if it should be challenged. This part of the bill confirms that where it's necessary to determine the taxpayer's liability, he can have some access to information that is obtained from others. The department may allow that without violating confidentiality statutes.

Sections 4 and 16 amend AS 43.05.230 and 43.55.040 to clarify rules for using one taxpayer's information to determine another taxpayer's tax.

[9:10:25 AM](#)

The bill also says that the department would impose appropriate limitations on the use of that information to make sure it is only used for the purpose of determining the tax. The bill would also subject recipients of that information to potential criminal penalties, the same penalties that apply to state employees who violate the confidentiality provisions.

[9:11:10 AM](#)

Section 5 is the core of the bill and was discussed at length the previous day. Section 6 amends AS 43.55.017(a) to conform language to the internal revenue code (IRC) to which it refers. There is no substantive change here.

[9:11:59 AM](#)

SENATOR BEN STEVENS asked Mr. Mintz whether expiration expenses were considered development costs.

^Dan Dickinson, CPA, Consultant to Governor Murkowski

DAN DICKINSON, CPA and Consultant to Governor Murkowski, responded the IRC talks about tangible drilling costs. Even though they propose to delete the word "exploration," it really refers to using a rig to create tangible drilling costs and they want to make sure it corresponds to the proper IRC code. The short answer is, he said, yes it will still include exploration drilling.

[9:13:18 AM](#)

Section 8 is a conforming change that gets the grammar and syntax consistent with the changes. Section 9 deals with an issue that only applies to small production. The overwhelming bulk of oil and gas produced in Alaska comes from state oil and gas leases and the royalty share of those leases belongs to the state and is tax exempt. The issue that Section 9 deals with only applies to a small minority of production, which does not come from state oil and gas leases.

In case of leases on private land, such as Native Corporation Land, the royalty share is taxable. The tax is assessed on the producer but the producer can charge back that tax to the royalty owner. The bill provides a default definition of what the value is for tax purposes. If the royalty owner and the lessee want to create an agreement for royalty tax share, they can. The default definition basically takes the total statewide tax of the producer divided by the non-royalty barrel, which gives the tax-per-producer barrel and then multiply that tax rate times the number of private royalty barrels.

[9:16:09 AM](#)

MR. DICKINSON explained the formula with two examples: The scenario is a producer with two leases - one a state lease, the other a private lease. Each lease produces 100 barrels and both of the royalty shares are 12.5 percent. After all the netback, the value of the wellhead is 10 dollars. To calculate the taxes, take the private royalties where all the barrels are taxable. In the state lease, only the non-royalty barrels are taxable.

[9:19:39 AM](#)

MR. DICKINSON explained the problem with the formula is that the private producer and the royalty owner need to work things out. In the absence of that, Section 9 creates the rule.

SENATOR BEN STEVENS asked Mr. Mintz the amount of state production that falls under Section 9.

MR. MINTZ said he did not know but speculated it was a small percentage. The only significant private lease production is Arctic Slope Corporation and Cook Inlet Region Incorporated.

MR. DICKINSON added there are additional federal royalties, which are exempt just like the state. The private royalty share is under one percent currently. As the exploration pushes west, the percentage could increase.

SENATOR BEN STEVENS asked whether private royalty share includes both private landowners and federal land.

MR. DICKINSON said they are different. Federal land is like state land and is not taxable.

[9:21:57 AM](#)

MR. MINTZ said Section 10 repeals and reenacts AS 43.55.020(e) to simplify the three-tiered system where flared gas was either tax free, taxed, or subject to a penalty. The bill changes flared gas to two categories; if the flaring is authorized it would not be taxable, if it were not authorized, it would be taxable and treated with the same formula as all the other oil and gas to find the net value. There is already and would still be a penalty on flared gas that is wastefully prepared.

MR. DICKINSON added Section 10 attempts to bring administrative simplicity to the tax. Much time is spent cross tracing records and tracking down the tax and this makes it cleaner and simpler.

[9:24:38 AM](#)

MR. MINTZ continued Section 12 is the tax credit section that was discussed previously. He asked Mr. Dickinson to comment.

MR. DICKINSON gave a brief explanation of Section 12. Subsection (a) allows the annualizing as well as looking at monthly actuals. Subsection (b) deals with loss carry-forwards. Subsection (c) talks about non-refundable credits. He said they tried to create a situation where the market could be developed and credits could be traded but the state would not be in the position of refunding or paying out for the use of the credits.

CHAIR WAGONER asked whether there was danger of creating a market flood of credits. He asked at what point the credits cease to be sold.

MR. DICKINSON responded at high and moderate prices, the market would not be flooded. At low prices, there would be a danger of falling demand.

CHAIR WAGONER asked what would happen to all of the credits if production were to stop. He asked whether the state would become liable to fund the credits.

[9:28:53 AM](#)

MR. DICKINSON responded the credits would not be refundable. In fifty years, there may well be an overhang of unused credits.

CHAIR WAGONER asked whether that would then result in a bonus to the state.

MR. DICKINSON said perhaps.

[9:29:22 AM](#)

SENATOR KIM ELTON asked whether a discussion was held regarding time limits for the credits.

MR. DICKINSON said yes. They wanted to limit the number of restrictions on the credits so as to allow them to monetize close to the value with an eye on protecting the state's revenue. A limit on the use of credits was imposed but not a limit on time.

SENATOR ELTON said it has been noted that it would be an unstable situation if the state reimbursed for the credits at 100 percent. He asked whether that was a larger problem than having the state not collect revenues at some point.

MR. DICKINSON said yes and no: financially dollar for dollar, no. Paying out a dollar or not receiving a dollar has the exact same effect on the state treasury. If the Department of Revenue falls short of its projections, and it were paid out, there would have to be a specific authorization. In the event of a price crash and huge pressures on the budget, the Legislature would be approached with a supplemental bill asking to supplement the credits, which would probably not be the best scenario. One scenario would require an appropriation and the other would not.

SENATOR ELTON said he assumed that scenario would be less beneficial to the smaller companies and more beneficial to the larger ones since the major companies will be buying tax credits that the smaller producers accumulate.

[9:32:51 AM](#)

MR. DICKINSON said that was correct with some exceptions.

CHAIR WAGONER commented it would still be very beneficial to the smaller producers and explorers.

MR. DICKINSON agreed. He said what Senator Elton was saying was the restrictions on them would harm the sellers more than the purchasers.

SENATOR ELTON said the smaller companies would be getting 90 cents on the dollar instead of 100 cents on the dollar and so it could be more beneficial to the smaller producers to get 100 cents on the dollar.

CHAIR WAGONER said that is not going to happen.

SENATOR STEDMAN said it was more about cash flow and protecting the state's interest. Allowing the smaller and larger companies to trade the credits allows the market to set the value. He said the state should move in the direction of a free-flowing market that would allow them to trade the credits back and forth.

[9:35:09 AM](#)

MR. DICKINSON summarized subsection (e) referred to the eighty percent limit on uses of credit certificates. Subsection (f) refers to the ability of the department to investigate or audit a tax credit claim after the drilling season. The audit adjustment goes to the seller of the credit. Subsection (h) is very important and defines "qualified capital expenditure."

[9:37:51 AM](#)

MR. MINTZ turned the committee's attention to Sections 13, 14 and 15 and said they mainly conform the tax return requirements to the changes in the production tax. The \$25 a day filing penalty is repealed. There was at least one case where a producer with a very small interest in a field whose tax payments were supposedly being taken care of by the operator but weren't. Over time the penalties added up to several million dollars, so there is a limited discretion to waive the penalty.

[9:40:07 AM](#)

Section 17 amends AS 43.55.080 to conform the statute to the Alaska State Constitution. Sections 18 and 19 conform and update language for AS 43.55.135 and .150(a). Section 20 regards the

change in calculating the gross value of oil and gas at the point of production.

[9:41:25 AM](#)

Section 21 is another core part of the bill and refers to determination of net value on which the tax is based. Sections 22 through 29 amends AS 43.55.200 and 43.55.300 concerning conservations surcharges. The two substantive changes are that the conservation surcharges could be taken as credits against the production tax only to the extent that there is a positive tax. There wouldn't be any refunds. Second, for the production tax purposes, gas is currently tax-free if it is used on a leaser property and the bill would make oil tax-free if used on a leaser property and it would also be free from the conservation surcharge.

MR. DICKINSON explained because of the change in the definition of oil and gas, the natural gas liquids that are currently defined as gas would now be defined as oil.

[9:43:48 AM](#)

MR. MINTZ continued Section 30 and 32 provide for a new definition of "gas." Section 31 redefines "gross value at the point of production." The point of production is intended to be downstream of gas processing and upstream of gas treatment and so the two need to be defined.

Section 33 defines "gas processing" and "gas treatment." Gas processing is the physical process of extracting liquid hydrocarbons from a gaseous stream. Gas treatment is removing non-hydrocarbon substances and conditioning gas for the sales line.

MR. DICKINSON explained a diagram regarding well fluids and mechanical separation.

[9:48:24 AM](#)

MR. MINTZ continued Section 34 repeals ELF. Sections 35 through 40 are complicated due to applicability and timing. The month of production determines everything under the production tax statute.

Transition provisions relate to several provisions that are based on a full calendar year but SB 305 is designed to start on July 1, 2006 so adjustments have to be made toward a half calendar year.

[9:51:08 AM](#)

CHAIR WAGONER asked the reason the bill was so different when it was previously presented by the governor's office. He expressed concern over the gap in revenues during the change of start dates.

MR. DICKINSON replied that changes should be made in a forward manner so that companies can plan ahead for the change in taxes. The changes reflect that Governor Murkowski was looking at the bigger picture, he said.

[9:54:37 AM](#)

SENATOR ELTON observed that Mr. Dickinson's argument seemed against the claw-back provision. He said, "We're forward looking when we start the tax and we're backward looking when we apply the credits."

MR. DICKINSON argued long-term investments generally take past things into account.

[9:55:27 AM](#)

MR. MINTZ noted the provisions that have to do with the production tax begin on July 1, 2006 and other provisions would take effect immediately. As a transition item, the department may develop and adopt PPT implementing regulations immediately. The term "alternative credit" would begin to be used. He concluded the presentation.

^Department of Revenue, Bill Corbus, Commissioner

[9:56:56 AM](#)

BILL CORBUS, Commissioner, Department of Revenue (DOR), wrapped up the presentation and advised the committee that the administration strongly encourages timely enactment of the bill. He gave a list of reasons that Governor Murkowski supports the move. It will replace a broken ELF based severance tax, encourage badly needed oil and gas production investments, provide special incentives for small explorers, and will provide enhanced revenues for the state.

[9:58:46 AM](#)

COMMISSIONER CORBUS explained Governor Murkowski had two targets for Dr. Pedro van Mures in preparing the PPT legislation, increased state revenues based on what producers are paying in similar oil producing regimes, and increased incentives to explore and invest in the 50 to 150 million barrel range. His final proposal was a 25 percent tax rate and a 20 percent tax

credit. The Governor wanted to tilt toward more exploration and investment and so he reduced the tax rate to 20 percent. Governor Murkowski feels that more exploration would mean more money to the state over time than the 25 percent tax rate.

[10:00:58 AM](#)

MR. CORBUS reminded the committee that the Governor has negotiated a good thing for the State of Alaska. The tax rate of the producers will be increased 100 percent and the producers have agreed to build the gas line.

[10:01:41 AM](#)

CHAIR WAGONER thanked Commissioner Corbus and asked Mr. Dickinson for a report of investment dollars.

MR. DICKINSON responded he would get together with Ms. Jackson to cover all of the requests they have received and get back to the committee on Monday, February 27, 2006.

There being no further business to come before the committee, Chair Wagoner adjourned the meeting at [10:03:27 AM](#).

#