

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

March 2, 2006

3:35 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 Hollis French  
Senator Gretchen Guess  
Senator Gene Therriault

**COMMITTEE CALENDAR**

SENATE BILL NO. 305

"An Act repealing the oil production tax and gas production tax and providing for a production tax on the net value of oil and gas; relating to the relationship of the production tax to other taxes; relating to the dates tax payments and surcharges are due under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the treatment of oil and gas production tax in a producer's settlement with the royalty owner; relating to flared gas, and to oil and gas used in the operation of a lease or property, under AS 43.55; relating to the prevailing value of oil or gas under AS 43.55; providing for tax credits against the tax due under AS 43.55 for certain expenditures, losses, and surcharges; relating to statements or other information required to be filed with or furnished to the Department of Revenue, and relating to the penalty for failure to file certain reports, under AS 43.55; relating to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue, under AS 43.55; relating to criminal penalties for violating conditions governing access to and use of confidential information relating

to the oil and gas production tax; relating to the deposit of money collected by the Department of Revenue under AS 43.55; relating to the calculation of the gross value at the point of production of oil or gas; relating to the determination of the net value of taxable oil and gas for purposes of a production tax on the net value of oil and gas; relating to the definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making conforming amendments; and providing for an effective date."

HEARD AND HELD

**PREVIOUS COMMITTEE ACTION**

BILL: SB 305

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

02/21/06	(S)	READ THE FIRST TIME - REFERRALS
02/21/06	(S)	RES, FIN
02/22/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/22/06	(S)	Heard & Held
02/22/06	(S)	MINUTE(RES)
02/23/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/23/06	(S)	Heard & Held
02/23/06	(S)	MINUTE(RES)
02/24/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/24/06	(S)	Heard & Held
02/24/06	(S)	MINUTE(RES)
02/25/06	(S)	RES AT 9:00 AM BUTROVICH 205
02/25/06	(S)	-- Reconvene from 02/24/06 --
02/25/06	(H)	RES AT 10:00 AM SENATE FINANCE 532
02/25/06	(S)	Heard & Held
02/25/06	(S)	MINUTE(RES)
02/27/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/27/06	(S)	Heard & Held
02/27/06	(S)	MINUTE(RES)
02/28/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/28/06	(S)	Heard & Held
02/28/06	(S)	MINUTE(RES)
03/01/06	(S)	RES AT 3:30 PM BUTROVICH 205
03/01/06	(S)	Heard & Held
03/01/06	(S)	MINUTE(RES)
03/02/06	(S)	RES AT 1:30 PM BUTROVICH 205

**WITNESS REGISTER**

MIKE MENGE, Commissioner

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

**POSITION STATEMENT:** Commented on how the PPT would affect the Oooguruk field.

BILL VAN DYKE, Director  
Division of Oil and Gas  
Department of Natural Resources  
400 Willoughby Ave.  
Juneau, AK 99801-1724

**POSITION STATEMENT:** Commented on PPT versus royalty reduction in the Oooguruk field.

TIMOTHY RYHERD, Commercial Analyst  
Division of Oil and Gas  
Department of Natural Resources  
400 Willoughby Ave.  
Juneau, AK 99801-1724

**POSITION STATEMENT:** Commented on PPT versus royalty reduction in the Oooguruk field.

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

**POSITION STATEMENT:** Answered the Legislature's questions on the PPT for the Administration.

SHARON NIENHUIS, Petroleum Economist  
Department of Revenue  
PO Box 110400  
Juneau, AK 99811-0400

**POSITION STATEMENT:** Compared various PPT ratios and prices.

#### **ACTION NARRATIVE**

**CHAIR THOMAS WAGONER** called the Senate Resources Standing Committee meeting to order at [3:35:24 PM](#). Present were Senators Stedman, Dyson, Kookesh, Elton, Ben Stevens and Chair Wagoner.

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

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CHAIR WAGONER said first they would discuss the Oooguruk unit royalty modification versus PPT comparison and then take up the

Administration's answers to the questions that the Legislature asked on the PPT.

MIKE MENGE, Commissioner, DNR introduced Bill Van Dyke, the Director, Division of Oil and Gas, and stated that he would let MR. VAN DYKE go through the comparison.

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BILL VAN DYKE, Director, Division of Oil and Gas, DNR, said the effect of PPT capital credits, the transitional credits and the loss-carry forward provisions would be very powerful for a project like Oooguruk that is a new capital-intensive project. It would give Pioneer a positive instead of negative cash flow - assuming that Pioneer would be able to sell the credits.

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SENATOR SEEKINS arrived.

MR. Van Dyke said under the PPT scenario, the state gets an opportunity to collect some revenue from Oooguruk where under the current ELF (economic limit factor) it does not collect a production tax. He explained that the royalty was reduced to 5 percent until the net profit share leases pay out under the current system.

He said the financial information for the project remains confidential and correct inputs and assumptions make all the difference when doing the modeling. The Division assumed a project in the range of \$500 million and a fee for sharing a facility at Kuparuk and Pioneer's own operating costs that would all be allowed for deductions. The estimated ultimate recovery was in the range of 50 MB to 90 MB, depending on reservoir performance and production rates were estimated to be 15,000 barrels to 20,000 barrels per day. He said the project is offshore, so its costs are a bit more expensive.

He modeled a couple of different oil prices and discount rates and assumed that the credits Pioneer earns could be used by them or sold for 100 percent of face value (although, in reality, they would probably have to be sold at a discount). He cautioned that these figures would not work for Oooguruk, but not for any other project.

MR. VAN DYKE said he assumed Pioneer had about \$45 million in transitional credits for this project, because it has been

spending a lot of money up there on engineering, fieldwork and exploratory wells.

He explained that the Oooguruk project has four net profit share leases and they overlay a "sweet spot" in the field, which will be where the development takes place. The PPT doesn't really effect the net profit share calculations in any way. There would not be a production tax today using the ELF; likewise he has assumed that under a PPT, if Pioneer pays any tax, it would not be a deduction under the net profit share accounting system.

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MR. Van Dyke explained that Oooguruk was given a royalty reduction because Pioneer would not have gone ahead without it. The state gave up \$45 million to get the project on line. He said the first of four models was a base case without royalty modification and with no PPT on the project a year ago; case two was the royalty modification that was awarded; case three was a hypothetical case that the chairman requested supposing the royalty modification had not been granted and just the PPT was in effect; and fourth, a project with a royalty modification and a PPT.

He said the royalty reduction, which went from 12.5 to 5 percent, sounded like a lot, but it didn't affect the rate of return very much (up about 1.3 percent). His model comparisons showed that the PPT was a more powerful tool than royalty reduction. He advised:

They would not reap a windfall by any means, for this project. This is a really challenged project. It's my belief Pioneer - they want to get their foot in the door. They were willing to come up to Alaska and at least start a project that wasn't the greatest project in the world, but it got them on the Slope; it got them up there as an operator. And they have bigger and better plans elsewhere on the Slope.

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SENATOR ELTON referenced the case 1 versus case 4 model and asked if there could be another line stating how much the state is getting now along with how much less the state would be getting.

MR. VAN DYKE replied that with the royalty reductions in place, the state was still collecting about \$168 million from the field

in income tax, royalty and property tax, as well as the net profit share payments.

TIMOTHY RYHERD, Commercial Analyst, Division of Oil and Gas, DNR, commented on the chart comparison, but his comments were indiscernible.

MR. VAN DYKE clarified that Mr. Ryherd said under the base case, the state gets \$130 million to \$500 million and royalty reduction takes a little off of that. The PPT would actually take off of the upfront credits. "But, there certainly is still a fair amount of revenue coming into the state."

CHAIR WAGONER thanked them for their presentation and announced that the committee would go on to the Administration's answers to the Legislature's questions.

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ROBYNN WILSON, Director, Tax Division, Department of Revenue (DOR), introduced Sharon Nienhuis, Petroleum Economist, DOR, who worked on the model to provide information on some of the Legislature's questions.

She also provided a letter with some specific tax and price scenarios and said she would highlight some of the information that would be provided and answer questions and they go along. She then turned the presentation over to Ms. Nienhuis.

MS. NIENHUIS said the department was asked to provide some additional scenarios with different tax rates and different credit rates and to provide a similar analysis to that which Roger Marks presented on February 23. His analysis included annual revenues to the state under three different oil prices - \$20, \$40 and \$60. He provided that at the 20/20 scenario and under the status quo.

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She presented graphs of three scenarios - 25/20, 30/20 and 30/15 - and the status quo at \$20, \$40 and \$60 per barrel. She used the same cost and volume assumptions that Mr. Marks used in his February 23 presentation, but her volume scenario was without the gasline or future oil finds. The revenues were in today's dollars and not inflated.

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SENATOR DYSON asked if her estimate of investment credits in the out years took into account the increased production because of the addition of incentives.

MS. NIENHUIS replied no. She followed the department's fall 2005 revenue forecast. She tried to not model things that would lead to modeling error. She reminded them that at \$40 oil, the transition provision (five years of credits taken over six years) doesn't kick in.

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SENATOR STEDMAN said it was hard to get any information out of the charts and asked how it could be best used to find the balance point between the tax rate and the tax credit.

MS. NIENHUIS replied they would get to those models relatively soon.

SENATOR STEDMAN said that it was easier for him to look at percentages versus dollars.

MS. NIENHUIS agreed to provide percentages.

CHAIR WAGONER thanked her and said they would go on to the written questions.

MS. WILSON explained that the House Resources Committee and Chair Wagoner had submitted a list of 31 questions for the Administration to answer and she would begin answering them now.

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1. Identify values/amounts for the "look-back" or transitional section per year according to the actual, by type (exploration, development, production), by company.

The Department of Revenue model uses \$1 billion per year as capital costs, so the transitional period would be about \$5 billion. Of the \$1 billion, about 10 percent is exploration and about 90 percent is elements of production. These annual costs are based on compilations of historical data. The attached Excel files outlines public data regarding investments.

2. How are mob, demob, and platform abandonment costs treated – as tax credits or deductions?

Mobilization costs are capitalized for federal tax purposes as Intangible Drilling Costs. As such, they are a capitalized expenditure for PPT purposes, and therefore, are deductible and creditable. We understand that demobilization and abandonment expenditures are both expensed as incurred. This would mean that these costs are deductible, but would not generate a credit.

3. Is there a "rating" for political stability - or one that reflects instability?

We do not have any information on a quantification of the risk of political stability.

4. What loss of revenue is incurred by moving the effective date from January 1, 2006 to July 1, 2006 on both 20/20 and on 25/20?

Using a combination of our spring forecast and YTD actuals, the average ANS price between January 1, 2006 and July 1, 2006 was \$58.62.

- The loss of revenue using the 20/20 system would be about \$480 million in additional tax.
- The loss of revenue using the 25/20 system would be about \$770 million in additional tax.

5. Section 9 - what amount is involved in this section?

A very small amount, probably no more than 1 percent of total state revenue from oil and gas. It is limited to three areas: [1] Alpine and its satellites; [2] the National Petroleum Reserve Alaska; and [3] Cook Inlet.

6. Was there consideration of phasing out the \$73 million deduction over a certain period of time?

No, it was not considered.

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SENATOR STEDMAN asked if the 1 percent was looking forward or backward.

MS. WILSON replied backward.

7. Of the current 14 producers in Alaska, which would pay a severance tax after employing the proposed \$73 million standard deduction?

With the merger of Chevron and Unocal, there are now 13 producers in Alaska. Of the 13 producers, BP, ConocoPhillips and ExxonMobil will pay severance tax at most price levels after employing the \$73 million standard deduction. At high oil and gas prices, and given our cost assumptions, Anadarko and ChevronUnocal will also pay severance tax after deducting the \$73 million dollar allowance, given the production volumes reported publicly by those companies.

8. Which other tax regimes - worldwide - have a progressivity structure?

TO BE PROVIDED

9. How many private royalty owners are there in Alaska - all areas, not just the North Slope (i.e., Nenana Basin, Kenai Peninsula, native corporation holdings, etc).

We do not have information on the number of private royalty owners in Alaska, which would include private oil and gas leases that are not in production. Homesteads staked under certain (but not all) federal homestead laws included oil and gas rights, and any of the owners of such parcels might enter into an oil and gas lease.

10. Provide a graph showing the status quo, the PPT, and the gas line contract terms.

This question appears to query the relationship between tax under the status quo, the PPT, and the gas line contract terms. At this time, gas line contract terms are not public information.

11. Provide information on the effect of previous incentives - the costs.

Claimed expenses under SB 185 (AS43.55.025) total \$104.8 million and claimed credits total \$33.6 million. A claim was received by the Department of Revenue last week, thus the totals were updated from the \$95.5 million and \$29.0 million figures previously provided for claimed credits.

12. What is the rationale for offering the same amount of credits for non-state lease lands where the state receives no royalty tax benefit? Was there discussion of a reduction in the credit to offset this?

The rationale is that the incentives have the potential to result in higher severance taxes, taxes that are assessed on any oil or gas production within Alaska's sovereign territory. Given the overall economic benefit of increased production of oil and gas (and particularly gas in the Cook Inlet where significant private lands occur), an incentive for exploration and development even in the event that a field would pay no taxes after incentives makes sense.

13. Why should Point Thomson be incentivised?

We believe the development of Point Thomson may be critical for the development of the gasline. Accordingly, incentivizing Point Thomson may well incentivize the gasline.

Point Thomson is particularly problematic for two reasons. First, it is a high cost field since it is a high-pressure gas condensate reservoir; and second, we do need the gas reserves to underpin the gas pipeline economics. By providing incentives, the goal would be two-fold. First, any incentive to encourage Point Thomson improves the economics of the gas pipeline. Second, incentives may encourage early production of the liquids, which requires expensive infrastructure to handle the high-pressure production.

14. Can you provide better definitions for "point of production" and "oil" and "gas" and has the State litigated these terms?

We're not clear whether this question seeks more explanation of the definitions in the bill or is requesting that we consider modifying those definitions. Please clarify. Regarding past litigation, in general the point of production and the definitions of oil and gas have not been major subjects of litigation under the production tax statute. In contrast, there has been considerable litigation of related concepts, though not necessarily the phrase "point of production," in the royalty context.

In the tax context, there was at least one dispute decided at the internal DOR appeal stage relating to point of production, but most of the controversy in this area played out in the development of regulations defining "gas processing plant" rather than litigation. The use of the term "gas processing" in the bill is consistent with existing department regulations, but under current law, gas processing

generally is considered an activity occurring downstream of the point of production, while under the bill it is considered an activity occurring upstream of the point of production.

15. What steps must be taken to make the tax credits refundable rather than transferable?

This would require a language change to Section 12 at Sec. 43.55.024(d) and (e). We are available to work with drafters on the exact wording.

16. On Page 13, line 24 of the bill, what does "payment in lieu of" tie into for oil?

Section 21 [Sec. 43.55.160(d)(1)(B)] clarifies that payments in lieu of property taxes are deductible. Sec. 43.55.160(c) presents the general rule that lease expenditures are deductible. Lease expenditures would include property taxes. Sub-section (d) provides clarification for items that are not clear, such as "payments made in lieu of property taxes."

17. Does the limit on transferable tax credits in section 12, (subsection (e) limit the amount of tax credits that a single taxpayer can take against their own production tax in a single year?

Section 12 (Sec. 43.55.024(e)) limits the amount of tax that can be reduced through purchased credits. There is no limit on credits utilized by a taxpayer that were generated by that same taxpayer.

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SENATOR BEN STEVENS said he thought there was a limit stating the taxpayer couldn't take his liabilities down to zero.

MS. WILSON replied that was correct. The limit is on purchased credits. She explained more that if a taxpayer has its own credits and reduces its tax down to some number, then this limit applied at that level. The order of credits was not specified in the bill, but that is how she would expect it to be applied.

SENATOR BEN STEVENS asked if that could be clarified in regulation.

MS. WILSON replied yes.

CHAIR WAGONER directed, "Let's make it easy to get there in language."

MS. WILSON responded that she would be happy to work with the committee on drafting language.

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18. The State of Alaska has relied on the services and expertise of multiple outside law firms to handle disputes over oil and gas issues. Have you conferred with such counsel in the drafting or review of this legislation? If so, have they assessed the impacts of the legislation on the State's legal position in past agreements, current disputes, or future disputes?

Yes, such counsel (not all of them) has been consulted and such assessments have been discussed but have not generally been generated in formal written form.

SENATOR ELTON asked if the discussion resulted in changes to the bill.

MS. WILSON responded that she would add clarification about that.

19. Have you asked the Department of Law to review this legislation in light of the 6<sup>th</sup> Circuit Court of Appeals' decision in Cuno v DaimlerChrysler that is now pending before the United States Supreme Court?

The Department of Law has examined this question. As a Sixth Circuit decision, it has no direct precedence for Alaska. It is currently before the U.S. Supreme Court and many analysts believe that it will not be sustained in its current form.

20. Please provide information regarding the expenditures that will qualify for the transition credits – including the depreciation method chosen under the federal and state income tax systems.

It appears that this question relates to the transition provision in Section 21 [Sec. 43.55.160(g)], which allows a deduction for capital expenditures made over the last five years, deductible over the next six years. The capital expenditures that qualify for transitional treatment are the same type of expenditures that qualify for ongoing credits. These are defined in Section 12 [Sec. 43.55.024(h)]. These

expenditures include exploration expenses and those expenditures that are capitalized for federal tax purposes. Exploration expenses include geological and geophysical exploration. Expenditures capitalized for federal tax purposes include intangible drilling costs. The capitalized expenditures are subject to a variety of useful lives under federal and state income rules. See Question 59 below.

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SENATOR STEDMAN asked if she had the actual dollars amounts they were dealing with.

MS. WILSON replied that she had totals, but not depreciation schedules for all of that equipment by specific company doing business up here.

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SENATOR DYSON said it looks like a consistent pattern of the state giving longer depreciation schedules than the feds. He asked if that works to the state's advantage or to the companies' working in Alaska.

MS. WILSON replied that it is to the state's benefit, because under the federal rules, companies can write off an asset quicker and on an accelerated basis.

SENATOR DYSON asked if the state has considered reducing the depreciation period in order to encourage more investment in the kinds of equipment that would increase production.

MS. WILSON replied no.

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SENATOR STEDMAN asked if there had been discussions about accelerating the tax rate to stimulate exploration and development.

MS. WILSON replied that those tools were at their disposal. The state uses a worldwide combined method for income tax purposes. This means that all of the income worldwide for oil and gas companies is combined in a pie and the state gets a piece of it. When addressing depreciation methods, they are addressing not just what would happen with the particular production company doing business in Alaska, but depreciation methods for the whole corporate groups in every other state and for our country - potentially.

21. Have any of the definitions in sections 30-33 been the subject of disputes with tax and/or royalty payers in the past? To the extent they have, please provide the definitions the state asserted in those disputes.

See question 18 above.

22. Please provide an identification of the point of production at each unit in the state under existing statutes, regulations, agreements, and court decisions. Provide the same under the definition as proposed.

TO BE PROVIDED

23. Please provide an identification of 'gas treatment' and 'gas processing' facilities in the state under the existing statutes, regulations, agreements, and court decisions. Provide the same under the definition as proposed.

TO BE PROVIDED

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SENATOR ELTON wanted to know if the definitions should be in statute or regulation.

24. What standard will be used to determine whether oil or gas is of 'pipeline quality' under the definition of 'gross value at the point of production?'

This term only appears in the definition of "oil." It was not in the old definition, nor the new definition of "gas." The standard for "pipeline quality" has not changed under the bill. The standard is based on a series of court cases.

25. Provide a historical analysis of the results of valuation methodologies adopted by the Department of Revenue, Department of Natural Resources (under all agreements), and the Department of the Interior.

TO BE PROVIDED

26. Will abandonment costs be eligible for deductions or credits under the legislation? If so, what estimates of the timing and costs of those activities does the Department project?

See Question 2 for deductibility of abandonment costs. With regard to costs, we are aware of no field having ever been abandoned in Alaska, and so we do not have any empirical data on costs.

27. How will AS 43.55.160(j) protect the State from a proliferation of corporate entities and/or companies claiming the tax-free allowance?

TO BE PROVIDED

28. Provide the number of exploration and delineation wells estimated to be drilled over the first ten years of your economic models. Include the technical and economic success rates projected in the modeling.

Five exploration wells per year are included in the model. The Department of Revenue assumes \$100 million is spent on exploration per year. With average costs of \$20 million dollars per well, this comes out to five wells per year. Delineation wells are separate and included under development expenditures. The model assumes there are four finds of large oil accumulations - reserves in place that would be on the order of 500 million barrels. There are four relatively small fields that are characterized as being "heavy" oil. These fields would pay no production tax under the current system because their Economic Limit Factor [ELF] would be zero. We did not include a "success rate" in our model.

29. Provide estimates for undiscovered resources in Alaska. Include the breakdown between technically recoverable and economically recoverable resources to the extent possible.

TO BE PROVIDED

30. Provide a historical analysis of the effective tax rate on each field in production on the North Slope over the past twenty years.

See Attachments A1 and A2. These tables contain effective tax rates since 1986 for all Alaskan fields on gross value at the point of production. The effective tax rate shown on these tables is the ELF x 12.25 percent for the first five years of production, and ELF x 15 percent thereafter. We note the effective rate varies between 15.0 percent, for Prudhoe Bay through 1987 (when the so-called "rounding

rule" rounded the ELF up to 1), and 0.0 percent for a number of fields for a number of years.

31. How will Net Profit Share Leases be affected by this legislation? Will the gross costs of exploration and development go into the Development Account—or those costs net of the credits and deductions?

TO BE PROVIDED

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32. It's been reported that the gas line contract will propose the state take its gas production tax share in the form of gas. How does that work in this bill?

In the gasline contract the state has indeed proposed taking deliveries of gas in place of a production tax; this is not reflected in the PPT bill which will stand on its own, gasline or no. Under the PPT, if the producers sell gas, those revenues would be part of the net profit calculation. Under the gasline, they would not. Instead the state would receive a percentage of the gas, which it would monetize through marketing. Note that the costs of developing (for example - Point Thomson) or running (for example - Prudhoe Bay) a field that produces both oil and gas would go into calculating the oil profits for the PPT.

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SENATOR ELTON asked if she made an adjustment for what it costs the state to monetize its gas that it's taking in lieu of cash.

MS. WILSON responded that she would have someone get in touch with him about that question.

33. Of the pre-PPT credit provisions (or claw back), what is the cost to the state for legacy fields and what is the cost to the state for frontier regimes?

See question 20.

SENATOR ELTON asked how much of the \$5 billion that the look back costs the state would be accrued on the legacy fields and versus the frontier regions.

MS. WILSON responded that she didn't have that information, but she would research it.

34. Of the pre-PPT credit provisions (the claw back), how many investment credits were sold under SB 185 and how do we ensure the person who holds the credit, not the original recipient, gets the credit?

Sale of credits under SB185 do not effect the ability of the seller to claim those credits as Transitional Investment Expenditures (that is to qualify for the claw back.)

35. If we have a gas pipeline in 2015, what will the ELF tax "take" be on North Slope gas and what will the "take" be under the PPT? What will the "take" be under PPT if we take gas in lieu of the production tax (the take would, I assume be the day-to-day value of the gas less the state's cut in selling the gas on the marketplace)?

Without getting into price sensitive forecast, or the confidential draft gas contract, we can make the following observations about the comparison: The upstream costs are covered in the PPT, so the difference could be as simple as:

- (a) Under the PPT, a taxpayer would pay 20 percent of the gross value at the point of production, that is sales revenues less the tariff charged by the Gas Treatment Plant and the tariff between the North Slope and the point of sale would be paid to the state (without taking into account the effect of the \$73 million dollar allowance).
- (b) Under the gas contract, the state will receive some percentage of the gas and then pay the tariff charged by the Gas Treatment Plant and the tariff between the North Slope and the point of sale. If the state owns part of the pipeline, then the state will also receive that portion of the tariff, which is profit accruing to the owner.

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36. Is current production tax deductible from corporate tax? If no, is this impact in the models presented by the Administration?

Yes, current production is deductible from corporate tax.

37. Referring to Section five, what oil and gas is exempt from taxation – just what is discussed in Section 10?

The oil and gas royalty amounts paid to the state and federal government are exempt. (AS 43.55.900 (13) "ownership or right to which is exempt from taxation" means any ownership interest of the federal government or the state.")

Section 10 simplifies treatment of flared gas. Under current law there are three categories of gas - gas used in production operations which is exempt from tax, gas produced in excess of that needed for safety purposes which is taxable, and gas flared beyond the amount authorized for safety which is taxed and subject to a penalty. Currently there is no 'free use of oil' to produce more oil in statute. The bill exempts from tax any oil or gas used in production operations, unless the Alaska Oil and Gas Conservation Commission determines that it was waste (instead of used to produce salable hydrocarbons), in which case it is taxed.

38. Referring to Section 6, will there be any impact to current state taxes or municipality taxes from this change?

No, there should be no impact to current state or municipal taxes. This language change simply makes the description of Intangible Drilling Costs consistent with Internal Revenue Code language, which is how this item is interpreted currently.

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39. Why was the payment for taxes and surcharges changed from the 20<sup>th</sup> day to the last day of the month? What is the economic impact of this change?

There is no economic impact and this just clears up current language. Under AS 43.55.020, payment for the tax is "due" on the 20<sup>th</sup>. However, the tax is not "delinquent" until the last day of the month. The significance of this is that according to AS 43.05.225, interest is assessed only when a tax "becomes delinquent." Thus this bill makes the due date the end of the month and in Section 7 establishes that "an unpaid amount of tax that is not paid when due in accordance with this subsection becomes delinquent."

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SENATOR ELTON asked if the tax would still be delinquent from the last day of the month.

MS. WILSON replied yes.

40. Do other nations with a net profit system have the 90 percent payment of taxes with the sure-up provision the following year? What is the economic impact of this change?

TO BE PROVIDED

41. What are the penalties for under-payment when sure-up is more than 10 percent of the taxes owed?

If the taxpayer does not pay 90 percent, then interest will be due on the difference between the tax paid and the 90 percent amount.

[4:55:14 PM](#)

CHAIR WAGONER asked how many lawsuits the state had been in over interest accrued on the tax penalties. The dispute he was most familiar with was pretty drawn out.

MS. WILSON replied that she was aware of some in the income tax safe harbor area, but she didn't know if any of those had been litigated.

CHAIR WAGONER said he wasn't referring to those, but to the true-up and whether they had to pay the full 90 percent on time to the state. The state assesses a penalty that accumulates pretty fast and that caused some litigation at one point.

MS. WILSON responded that under current law, production tax has no safe harbor clause to the 90 percent rule. She offered to research this issue further.

42. Referring to Section 10, why does the Alaska Oil and Gas Conservation Commission's (AOGCC) role change from focusing on excess needed for safety reasons to whatever they determine to be waste? Does this provision provide more power to the AOGCC on what is included/excluded for taxation?

Under current law, as applied by DOR regulation, the categories of flared gas recognized by DOR are different from, although related to, the categories recognized by AOGCC. The bill will simplify the categorization and harmonize it completely with AOGCC's. This simply creates one standard administered by AOGCC in place of two standards administered by two agencies.

43. Why does it seem the credits and incentives are on production along with exploration if our focus is to provide incentives for exploration?

The bill is based on the expectation that investment, both exploration and in existing fields, will increase production.

[5:00:11 PM](#)

44. Can the carry-forward amount be used for a credit for more than the first year after the loss?

Yes, the credit carry-forwards can be used indefinitely. There is no time limit on the credit carry-forwards.

[5:00:14 PM](#)

45. Is it the case that any allowable expenses for the exploration, development, or production of gas can be deducted from oil revenues in determining net value? If so, could the expenses of a gas line be included in these deductible expenses?

Expenses are allowable only if they are "upstream" costs. A gas line is "downstream" and so would not be a deductible expense.

[5:02:11 PM](#)

46. Why not use generally accepted accounting principles (GAAP) versus setting up our own system of defining revenues and expenses?

GAAP are useful for determining whether an item of expenditure can be classified as an "expense." GAAP does not differentiate between expenses incurred specific to a lease and those expenses that are indirect to a lease. For example, GAAP does not distinguish between wages paid to a lease-based worker, and an employee in the home office.

[5:02:58 PM](#)

47. Which credits can be applied to multiple years?

There is no time limit for credit carry-forwards under the bill or for the optional credit codified in AS 43.55.025. However, any dollar of investment can only generate one credit, and that credit can only be used once.

[5:03:29 PM](#)

48. Can a tax credit be sold in any year or just the year after it was accrued?

Once the credit has been turned into a Credit Certificate, it can be sold at any time. A person can apply for a Credit Certificate at any time, but the bill allows the Dept. of Revenue a period of time in which to issue the Credit Certificate. [See Section 12, Sec. 43.55.024(g)]

49. What is the estimated economic impact to the state of the ability to sell tax credits?

TO BE PROVIDED

50. Referring to Section 16, what is the current system and why do we need this change in confidentiality?

The bill codifies current practice embodied in regulations in our treatment of taxpayer information. The only change here is that the bill makes clear that any person receiving information released under current department practices, is subject to the same criminal penalties that apply to a state employee.

The current confidentiality law is very general in its exception language - information must be kept confidential "except in connection with official investigations or proceedings...." The Department believes that current law does allow disclosure under the circumstances specified in the bill, but there has been some question about that, and it would be desirable to clarify the meaning of the law, as the bill does. In addition, there is the new provision on penalties, referred to above.

51. In what circumstances would oil and gas taxes go straight into the Constitutional Budget Reserve Fund (CBRF).

Additions to the Constitutional Budget Reserve Fund are made for any oil and gas taxes collected in resolution of a dispute. That means that amounts collected because of an audit assessment, or subsequent settlement, are additions to the CBRF.

52. Referring to Section 18 and 19, why change from "shall" to "is"?

This change is made in accordance with the state style manual.

[5:07:08 PM](#)

53. Why does the bill offer multiple methods to determine gross value? Who will choose a methodology?

The bill does not directly allow a taxpayer to elect alternative methods; it just allows the Department to authorize use of an alternative method. The election referred to would be an election between using an alternative method or just calculating gross value according to the usual rules - NOT an election among several different alternative methods. In implementing this provision, the Department will no doubt develop criteria for when a particular alternative method would be appropriate. I don't think we can predict now whether there might be circumstances under which more than one alternative method might be appropriate and under which the Department would authorize a taxpayer to elect among several alternative methods.

SENATOR ELTON assumed it authorizes the department to select among alternatives that could be negotiated with the taxpayer.

MS. WILSON that was not the intention, but it was to simplify methods of coming up with value.

[5:09:07 PM](#)

54. Section 21, page 1, line 8 - Why is this clause constrained to Dec. 1, 2005?

TO BE PROVIDED

55. Section 21, provision (h), which US CPI does the Administration plan on using?

This would be established by regulation. The Department has not evaluated the various CPI's at this time.

56. Are the current oil conservation surcharges deductible from any other taxation? If no, what is the policy reason to make them a credit in SB 305 and what is the economic impact?

Yes, current oil conservation surcharges are deductible from corporate income tax.

#### Other Questions

57. Do any other state taxes have a "standard deduction"?

- a. Seafood Marketing Assessment (ASMI) tax is imposed only on processors/exporters that process or export fisheries resources with a value of \$50,000 or more in a calendar year [AS 16.51.120(g)].
- b. Mining License Tax is not imposed when net income is less than \$40,000 in a fiscal year [AS 43.65.010(c)].
- c. Gaming tax exempts gross receipts of less than \$20,000 from paying the additional fee under AS 05.15.020(b).
- d. Alaska's Estate Tax follows federal rules, but the most recent exemption (FY05) included estates valued at under \$1.5 million.

[5:11:49 PM](#)

58. How many Net Profit Share Leases (NPSL) are in the state and how much are they paying in royalties?

Out of 19 NPSLs, seven are paying royalties. These seven include five in the Milne Point Unit, and two in the Duck Island Unit, and they began paying in 2001. The total of NPSL payments received in calendar year 2005 was \$81 million. Total receipts from NPSLs from 2001-2005 were \$254 million.

Out of 19 NPSLs, seven are paying net profit share payments (*in addition to royalties and production taxes*). These seven include five in the Milne Point Unit, and two in the Duck Island Unit, and they began paying in 2001. The total of NPSL payments received in calendar year 2005 was \$81 million. Total NPS receipts from NPSL's from 2001-2005 were \$254 million. Net profit share payments are not deductible for PPT purposes or for the current production tax. Royalties and production taxes are deductible for NPS purposes.

Royalties, however, are paid on net profit share leases according to each individual lease contract. For example, one NPS lease in Duck Island Unit has a twenty percent (20 percent) royalty rate. Other NPS leases may have the standard royalty rate of 12.5 percent or another negotiated royalty rate. Royalties and production taxes are due from a net profit share lease as long as there is production, even when there is no net profit share payment from the property.

Attached is an Excel table of producing and non-producing NPS leases showing the lease number, the net profit share rate and the royalty rate for each lease. (See Attachment B)

59. What are the depreciable lives for O & G equipment for federal and state income tax purposes?

	Federal	
Alaska		
Equipment for exploration and production including drilling, gathering pipelines, pumping equipment, separation equipment, platforms	7	11
Offshore drilling	5	6
Pipelines, excluding gathering and transmission lines	15	17.5
Vessels, barges, other water transportation equipment	10	14.5

60. Please provide the tax calculation under the bill, with the following assumptions:

--Gross value           \$60M  
 --Opex                   15M  
 --Capex                 10M

Gross value	\$60M
Less: Opex	(15)
Capex	
<u>(10)</u>	
Tentative net profit	
Before standard deduction	\$35M
Less: standard deduction*	<u>(35)</u>
Net Taxable income	<u>\$ 0</u>
Tax	\$ 0
Capital investment credit available for carry forward	
(20% of \$10M)	\$5M

\* this calculation assumes that taxpayer has not reached \$73M limit for the standard deduction.

SENATOR STEDMAN asked if the capital carry-forward would be 20 percent of \$10 million.

MS. WILSON replied yes.

[5:15:48 PM](#)

61. Are net profit lease payments included as a direct cost under 43.55.160?

Net profit share payments under NPSLs would not be deductible lease expenditures because they are in the nature of lease acquisition costs. Lease acquisition costs are not deductible per Section 21 [Sec. 43.55.160(d)(2)(E)].

62. Are lease bonus payments eligible for capital credit under 43.55.024 and/or are they included as a direct cost under 43.55.160?

Lease bonus payments are neither deductible nor eligible for capital credits. Lease bonus payments are in the nature of lease acquisition costs which are specifically not deductible per Section 21 (Sec. 43.55.160(d)(2)(E)).

63. How are payments for "spec 3D" handled? Are they credit eligible under 43.55.024 or only allowed as deductions under 43.55.160?

We understand "spec 3D" to be certain seismic exploration costs. Exploration costs are allowed as deductions under Section 21 of the bill [Sec. 43.55.160(c)]. Such costs are also eligible for credits under Section 12 (Sec. 43.55.024) by reference to definition of "qualified capital expenditure" at Sec. 43.55.024(h).

64. Please explain the taxation or exemption of royalties.

Public royalties (paid to federal or state jurisdictions) never enter into the base of gross value. This is so because AS 43.55.011(a) levies the tax on oil except the "ownership or right to which is exempt from taxation." This phrase is then defined in AS 43.55.900(13) as follows:

"any ownership interest of the federal government or the state."

These sections are not changed in the bill.

Because the bill changes the tax to a tax on net profits, it is necessary to specify deductions. Royalties are specifically disallowed as a deduction under Section 21 [Sec. 43.55.160(d)(2)(B)]. Royalties paid to state and federal jurisdictions cannot be deducted because they are not included in the starting "gross value." Private royalties cannot be deducted because the related production is subject to tax.

65. Under Section 21 [Sec. 43.55.160(d)], "direct costs... include..." Does the word "include" serve to restrict the list of allowable expenses to only those items included below in (A)-(C)?

No, Sec. 43.55.160(d) provides additional clarification for the general rule stated at sub-section (c). Sub-section (c) provides the general rule that lease costs are deductible. Sub-section (d) addresses only those items that may have been questionable under the general rule. Additionally, we note that under AS 01.10.040(b):

"When the words 'includes' or 'including' are used in a law, they shall be construed as though followed by the phrase 'but not limited to.'"

[5:18:48 PM](#)

MS. WILSON said that the rest of answers would be provided next week.

[5:19:29 PM](#)

SENATOR STEDMAN asked to go back to question 24 and asked if those court cases were settled by a judge or if they were negotiated settlements between the department and the industry.

MS. WILSON replied that they were actual court cases and she offered to get more information on that issue.

CHAIR WAGONER noted there were no further questions and adjourned the meeting at [5:21:05 PM](#).