

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

March 14, 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

MEMBERS ABSENT

Senator Albert Kookesh

OTHER MEMBERS PRESENT

Senator Gretchen Guess
Senator Gene Therriault
Senator Hollis French
Senator Lyda Green

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
03/02/06	(S)	Heard & Held
03/02/06	(S)	MINUTE(RES)
03/02/06	(S)	RES AT 3:30 PM BUTROVICH 205
03/02/06	(S)	Heard & Held
03/02/06	(S)	MINUTE(RES)

03/03/06 (S) RES AT 3:30 PM BUTROVICH 205
 03/03/06 (S) -- Meeting Canceled --
 03/04/06 (S) RES AT 10:00 AM SENATE FINANCE 532
 03/04/06 (S) Presentation by Legislative Consultants
 03/06/06 (S) RES AT 3:30 PM SENATE FINANCE 532
 03/06/06 (S) Heard & Held
 03/06/06 (S) MINUTE(RES)
 03/07/06 (S) RES AT 3:30 PM BUTROVICH 205
 03/07/06 (S) Heard & Held
 03/07/06 (S) MINUTE(RES)
 03/08/06 (S) RES AT 3:30 PM BUTROVICH 205
 03/08/06 (S) -- Meeting Canceled --
 03/09/06 (S) RES AT 3:30 PM BUTROVICH 205
 03/09/06 (S) -- Meeting Canceled --
 03/10/06 (S) RES AT 3:30 PM BUTROVICH 205
 03/10/06 (S) -- Meeting Canceled --
 03/11/06 (H) RES AT 10:00 AM CAPITOL 106
 03/11/06 (H) -- Meeting Canceled --
 03/13/06 (S) RES AT 3:30 PM BUTROVICH 205
 03/13/06 (S) Heard & Held
 03/13/06 (S) MINUTE(RES)
 03/14/06 (S) RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

BARRY PULLIAM, Senior Economist
 Econ One Research, Inc.
 Suite 2825
 Three Allen Center
 333 Clay Street
 Houston, TX 77002

POSITION STATEMENT: Answered questions relative to Econ One presentation on 3/13/06 regarding SB 305.

DR. TONY FINIZZA
 Econ One Research, Inc.
 Suite 2825
 Three Allen Center
 333 Clay Street
 Houston, TX 77002

POSITION STATEMENT: Answered questions relative to Econ One presentation on 3/13/06 regarding SB 305.

OTHER MEMBERS PRESENT

Senator Gretchen Guess
 Senator Gene Therriault

ACTION NARRATIVE

CHAIR THOMAS WAGONER called the Senate Resources Standing Committee meeting to order at [3:35:25 PM](#). Present at the call to order were Senators Stedman, Seekins, Elton and Chair Wagoner.

SB 305-OIL AND GAS PRODUCTION TAX

CHAIR THOMAS WAGONER said they would finish Econ One's presentation [that began yesterday] with questions.

BARRY PULLIAM, Econ One Research, Inc., said that Slide 76 was reformatted to make it more understandable. The yellow highlights showed the effective tax rates under either a 20/20 or a 25/20 plan. The pricing goes in \$10 dollar increments from \$30 WTI to \$80 WTI. The next chart was in the same format, but instead of showing the effective tax rate, it showed the government take statistics. The next slide showed the effective tax rate as a function of price. These calculations included the 6-year transition and the \$73 million exemption.

[3:44:52 PM](#)

SENATOR STEDMAN said in its presentations several days ago, the industry used a base price trend starting at \$30, going up about 2 percent a year, for its forecasting and modeling. He thought the legislature had to decide what trigger point to use, as well, regardless of whether it was 25/20 or 20/20. He asked if \$30 was a relatively low trigger price and a \$50 price relatively high.

[3:45:00 PM](#)

SENATORS FRED DYSON AND BEN STEVENS arrived.

[3:45:23 PM](#)

MR. PULLIAM replied that was a good range in general, but the trigger price also depends on where the base tax rate starts. For instance, the threshold would start at a lower point with a 20/20 trigger point than if it were at 25/20.

SENATOR STEDMAN said that one of the legislature's consultants, Daniel Johnston, discussed using a tide-water comparison in a previous presentation to benchmark Alaska against competitors around the world and that could be done a couple of ways - comparing it to Alaska's historical ELF average or to world averages. The tidewater analysis basically moved the total government take up by about 7 percent. He asked him to explain

factoring that in so the state doesn't put itself inadvertently at an economic disadvantage.

MR. PULLIAM replied that he understood Mr. Johnston's analysis and explained that Econ One's government take calculation looked at the percentage of divisible income that each of the parties get - in other words, what is left over after costs. The calculations he used today were based on a well-head valuation with costs of production subtracted.

In adding the variant of "tidewater take," Mr. Johnston was trying to adjust for the fact that ANS, unlike a lot of other crudes, is produced a long way from the market that it gets sold in. He was trying to bring oil to the point of sale and so he suggested adding on costs of shipping to the well-head value. It puts the government take for ANS on the same basis with crudes worldwide.

He said that Econ One's figures don't make that adjustment and so, for that increment, he decided to move the oil, essentially, to Valdez, which is the load port. Using that adjustment, the 7 percent is not that high. It also varies with price. At \$30 it would be about 7.5 percent; at \$40 the difference reduces to 5 percent; at \$50 it goes down to 3.5 percent; at \$60 it goes to 3 percent; at \$70 it goes to 2.5 percent; and at \$80 it goes to 2 percent.

[3:52:40 PM](#)

SENATOR STEDMAN asked if he thought comparing Alaska oil to the oil in the rest of the world was relevant.

MR. FINIZZA replied that the government takes listed in his chart were doable compared to competition in the rest of the world.

MR. PULLIAM added that government take is a measure of what return will look like area to area, but it's not the whole picture. It doesn't measure political risk, for instance.

[3:56:22 PM](#)

SENATOR GUESS asked for the cost assumptions made in the model.

MR. PULLIAM replied that for a starting point, Econ One looked at DOR's cost assumptions and assumptions from other sources, which caused him to modify DOR's assumptions somewhat. He brought more costs forward into the first 10 years than Mr. Johnston did. This was largely to account for fields that are

under development and will be coming on in the next 10 years. Most of the development costs are upfront, after which would follow ongoing costs of operation and capital.

Econ One started with an assumption about pricing downstream WTI (West Texas Intermediate). They assumed that ANS (Alaska North Slope) traded for \$2 a barrel below WTI and that ANS would be placed on the West Coast. They backed that off from the estimated DOR transportation costs of just under \$2 a barrel. From that they backed off estimated TAPS tariffs based on the volume estimates for the throughput. The TAPS tariffs are in place now and DOR projected them to change downward after the TAPS settlement agreement expires in 2009. Upstream, costs for operations were also backed off. Those were \$3 a barrel for large fields and, he inserted, all of the costs were grown over time for inflation. For smaller fields and heavier oil, he assumed costs were \$5 a barrel. Costs for ongoing production on the North Slope in the larger fields was assumed to be \$3.50 a barrel and for the heavy oil fields, \$8 a barrel.

SENATOR GUESS asked if this model had no costs for exploration, development or production of gas.

MR. PULLIAM replied that was correct, although the DOR had four different volume scenarios; two of them assumed the gasline was developed and two of them did not. In the ones that assumed the gasline was developed, the department put in the additional costs associated with Pt. Thomson and, after 2030, of developing gas resources outside of Prudhoe Bay and Pt. Thomson.

[4:01:23 PM](#)

SENATOR STEDMAN asked if Slide 77 could be narrowed from 2007 to 2016.

MR. PULLIAM replied that could be done.

[4:02:44 PM](#)

SENATOR THERRIAULT asked if Econ One moved what Mr. Johnston used for tidewater into the governmental take side.

MR. PULLIAM replied yes. It was included as a part of revenue, because at the wellhead, oil is not as valuable as it is at tidewater or at the point of loading. That more closely matches ANS with world crudes. But, he clarified, if the producer owns the transportation asset, that should be taken into account.

SENATOR THERRIAULT said TAPS is fairly generous to the producers.

MR. PULLIAM responded that the issue is when the producer owns the transportation asset and is earning a profit on it. If the profit is earned is in excess of a competitive rate - what the market would allow - then one should take that into account in the analysis. That is an issue in the current settlement.

SENATOR THERRIAULT said he wanted to make sure he had not put that profit for operation of the transportation system back into the producers' side. That would get complex and he didn't think it was necessary to run the exercise.

MR. PULLIAM assured him that they hadn't attempted to do that.

SENATOR THERRIAULT referenced a conclusion regarding exploration impacts on page 26 from yesterday saying that at low prices, a 25/20 plan helps explorers more than a 20/20. He wondered if, in a low-price scenario, it makes sense to have the tax at 25 percent and if there would actually be more risk for the government considering all the variables. He obviously wanted to control the downside risk for the state and going to a minimum tax mechanism to protect the downside to the state was being considered.

MR. FINIZZA responded that the producer is better off with 25/20 because the government shares the negatives that are likely at low prices. To lower government risk, he advised starting with the 20/20 combination. If they want the 25/20 at a higher price level, they could simulate that with the sliding scales. He emphasized that it's precisely at low prices that the state should help the explorer and he didn't think taking away the credit at lower prices was a good idea. He wanted the state to recognize the importance of striking the right balance.

[4:09:34 PM](#)

SENATOR ELTON followed up on Senator Therriault's question by asking what happens to incentives for exploration at 20/20 with progressivity added.

MR. FINIZZA replied that progressivity would start at a much higher threshold level - most of them are centered around \$45 and higher.

[4:10:47 PM](#)

CHAIR WAGONER asked what would happen if you take away the \$73 million at low prices and increased the credits to 30 percent. Would that create a robust climate for explorers?

MR. FINIZZA replied yes, but he didn't know what the right credit number would be. The state runs the same risk of paying the bill if exploration doesn't pay off.

MR. PULLIAM added that in considering raising the credit to 30 percent, it is important to remember that it applies to all capital invested. So, a relatively small amount of that capital is exploration; most of the capital they are talking about regardless of how much exploration the state gets, is for continuing development in the larger fields. Currently, exploration is one-twelfth of development dollars for the larger fields.

[4:12:44 PM](#)

SENATOR FRENCH said he was concerned that they were designing a system that would drop taxes at low prices and that may mean something different to an explorer than a producer or the state. He asked what the breakeven point was for the producers.

MR. PULLIAM replied that it was fairly low for existing production. The big issue on the North Slope is separation of water and gas from the oil and the gas/oil and water/oil ratio has risen dramatically over time. Just dealing with that is a big part of the operation. To continue getting the oil out, companies have to continue to invest capital.

SENATOR FRENCH asked if fields on the North Slope would be profitable somewhere below \$20.

MR. PULLIAM replied some of them would. That low of a price would stimulate the flow to where it is currently projected.

SENATOR FRENCH asked if fields are profitable north of \$20.

MR. PULLIAM replied yes; forecasts indicate that Prudhoe Bay would shut down at a \$23 price for oil.

[4:16:45 PM](#)

SENATOR THERRIAULT said he has heard concerns from his colleagues that allowing everyone the \$73 million allowance might result in an unnecessary windfall for the major producers. Majors could move through it very quickly and maybe it should be limited to barrels of production.

MR. PULLIAM responded that it's possible the \$73 million allowance might incent too many companies and they might think about linking it to production of first barrels out of a field instead of to the companies. He suggested giving the credits to the companies upfront would benefit exploration more.

[4:21:18 PM](#)

SENATOR THERRIAULT asked him to expand on linking the credit to the field instead of to the companies.

MR. PULLIAM said that often companies partner with other companies and the \$73 million allowance would encourage that, but tying the allowance to new production would eliminate a lot of it.

SENATOR THERRIAULT asked if it was workable to limit the allowance to companies based on total volume in state.

MR. PULLIAM replied that he thought it was. As long as it's tied to volume the state has more certainty about what the value will be. If it's tied to the company, the state loses some of that certainty. The assumption now is that the equivalent of approximately seven companies would qualify. The \$73 million exemption is worth \$14.6 million in tax per year at the 20 percent rate, so as more companies come in, the state would have higher total deductions. If the allowance were tied to volume, that wouldn't happen.

[4:24:26 PM](#)

CHAIR WAGONER asked if the allowance could be tied to volume versus exploration.

MR. PULLIAM replied that the state is already giving credit on exploration and that could be raised in lieu of the \$73 million allowance. But the difference is that you don't get the \$73 million until oil starts to come on line. He suggested instead of making it a dollar amount, making it a volume amount. It could be initial volume out of a field, which would give a bigger economic boost to exploration and development. It could also be done by using a specific volume per year coming out of a field. Giving the credit upfront boosts the producers' economics; but at a cost to the state, which would forego revenues early on.

[4:26:42 PM](#)

CHAIR WAGONER said if the allowance is based on volume, the limit would either be driven by a maximum allowable barrels of oil or a maximum allowable barrels of oil and a figure that defines the ceiling, because of fluctuations in prices.

MR. PULLIAM agreed and added that it could float with the price of oil and so the value of that exemption would change as the price changes. Another way is to deem what the value of that production is for purposes of this particular credit.

SENATOR THERRIAULT asked if his modeling in Section 20 on valuation methodologies had the sophistication to run the impacts of the different valuation methodologies.

MR. PULLIAM replied yes. He noted that the royalty settlement agreements are valuation mechanisms that rose out of a contract between the producers and the state. Periodically the parties can renegotiate them if they are unhappy and that has been done. If they can't agree, the case is taken to an arbitration panel and most recently the state has been in arbitration with a producer over a deduction.

He explained that currently, RSAs cover one-half of the royalty; the other half of royalty barrels the state takes in kind and sells and those are not subject to RSAs. RSAs cover a quarter of the value of what the state gets and if the state uses those RSAs to determine its tax values, they will govern three-quarters of the value it gets. Some think that is a good thing - more efficient, less auditors, less fighting about things. But, he advised using caution in doing that because there would be more oil at stake and both the state and producers would be looking at it more closely. They may end up having negotiations more often - and ending in arbitration more often.

[4:32:18 PM](#)

SENATOR THERRIAULT said he appreciated his note of caution and that's why he wanted the tools from him while he was in town to quantify what amounts are potentially in play.

[4:33:01 PM](#)

SENATOR STEDMAN said he was thinking along the same lines and wanted the dollars by volume broken down into state take versus everybody else.

SENATOR ELTON said that Mr. Pulliam seemed to suggest that they may be creating an incentive to challenge royalty values in

Section 20 and he asked him to include a short discussion on that.

MR. PULLIAM responded that he didn't know how to quantify that. He could say, though, "You are incenting them and I would expect to see more frequent attempts to renegotiate those values." Each of the agreements is governed today by a reopener provision - some of them go year by year and some are three years long.

[4:35:40 PM](#)

SENATOR BEN STEVENS said he found this discussion on Section 20 fascinating because he remembers receiving cautionary advice on the valuation method for royalty settlement agreements from the legislative consultants, Ms. Robson, Mr. Eason and now Mr. Pulliam, who all developed and agreed to royalty settlement agreements.

[4:36:53 PM](#)

SENATOR THERRIAULT said it's because they know it's an area of disagreement that he wanted to know what type of dollars the state would likely be arguing about.

CHAIR WAGONER said it was about 42 cents a barrel.

MR. PULLIAM said he hadn't worked on the settlement agreement; but as part of the reopener process, he advised the state on evaluation methodologies. The commissioner has the option of looking at the agreements for valuations. If it moved from the option to look at valuations to the requirement to look at them, that should be carefully looked at.

[4:39:20 PM](#)

SENATOR THERRIAULT said he wanted to know what kind of money is at play with different valuation methodologies.

MR. PULLIAM replied that he didn't have the information to look at additional methodologies right now, but said he would get it for them.

SENATOR THERRIAULT referenced page 27 of yesterday's presentation that talked about the timeline for exploration and development and production. It indicated that Alaska has a long lead-time and companies have a lot of capital tied up before oil finally flows. But, the allowance of credits in the PPT allows immediate recoupments and that has changed the economics of the lead-time fairly dramatically, because the state is picking up a lot of those dollars.

MR. FINIZZA replied yes and he supported that by illustrating a positive cash flow chart using the PPT.

4:44:06 PM

SENATOR THERRIAULT asked how the PPT would affect the economics of the gas line.

MR. PULLIAM replied that it would have a positive influence because it allows capital costs for exploration and development to be deducted immediately.

4:45:53 PM

SENATOR BEN STEVENS commented that Econ One has showed what the risk to the state treasury is on the downside. Charts 16, 17, 18 were forward-looking projections from individuals who have a great deal more foresight into the future price of oil, and all but one of them were over-projections. So, as the state makes its projections on future impacts based on current prices, he remembers that after every cresting wave there is a deep trough. He continually thinks about the fact that the state is in a short-term harvest mechanism in trying to grab more money off the table at today's rates but he asked them to think about what that would do to the state treasury when prices were down at the other end of the spectrum. He said, "At some point we need to keep in mind that charts like that come from international energy agencies - to know that we're going to be wrong and we'd better be wrong on the safe side." He then thanked Mr. Pulliam and Mr. Finizza for their useful information.

4:49:52 PM

SENATOR STEDMAN said he thought it was a mistake to concentrate on total dollars and he would rather focus on getting more volume down the pipe.

SENATOR THERRIAULT agreed and said that the current system has no price sensitivity on the upside. He has said on a number of occasions that no matter what mechanism the legislature picks, the system takes care of itself on the downside. The State of Alaska is not interested in seeing the oil industry dry up and blow away within its borders.

The industry will vote with its dollars. And since we are not interested in seeing the industry leave our borders, we'll be back at the table to make adjustments. There's an automatic protection on the

downside, because it's in nobody's interest to have the industry go away.

[4:53:49 PM](#)

SENATOR STEDMAN asked how tight the government take numbers were on Slide 77.

[4:55:38 PM](#)

MR. PULLIAM replied that pricing and volume are the big assumptions. The costs are deducted and as long as those are reasonably modeled, that defines the pie. Under the PPT, the state will know what it's getting without much variation. The size of the pie would change if they were far off on the costs, but he thought the numbers were fairly tight.

MR. FINIZZA reminded them that they were talking about changing only a piece of the state's revenue system to make it more progressive. All the other pieces were generally regressive. So, there is very little hope to change the government take numbers very much by changing the "tail."

[4:56:21 PM](#)

SENATOR BEN STEVENS said he found it fascinating that he said the severance adjustments would have a minimal impact on total government take because of the other three components.

MR. FINIZZA replied yes and that was evidenced by his chart. The major components of the state's revenues are royalty, property tax, state income tax and federal tax. Only the PPT is going to be progressive as prices go up.

SENATOR BEN STEVENS reiterated:

The point that struck the tune was the fact that we really have little impact on, unless we have major substantive change that has to do with property tax, corporate tax and royalty modifications, to significantly alter that government take, in terms of the state's take of that piece.

MR. PULLIAM agreed and added that whatever the state takes, the federal government gets less.

[5:00:46 PM](#)

SENATOR FRENCH asked if a too aggressive PPT would scuttle the gasoline deal.

MR. PULLIAM replied that he didn't think there was a relationship between the oil tax rate, once it's set, and the decision on gas, but he asserted the credits would impact the gasline project. However, if the state did something onerous, like pulling every last dime off the table it could, it might still have a project that is economic on its own, but people might be more concerned about having the state a partner.

SENATOR FRENCH asked if any of the scenarios would drive companies away from the gasline project.

MR. PULLIAM replied that he didn't think either the 20/20 or the 25/20 would drive them away from an economic standpoint. He didn't know about 30/20; that might sour someone in general on doing business in Alaska.

MR. FINIZZA concurred.

SENATOR THERRIAULT asked if that was partially because the credits allowed for gas could be charged against the income for oil that is allowed under the PPT.

[5:06:20 PM](#)

SENATOR BEN STEVENS interrupted to say that they are talking about issues that are purely speculation. They are talking about issues that are in the contract that they haven't seen yet.

CHAIR WAGONER agreed and adjourned the meeting at [5:07:25 PM](#).