

HOUSE FINANCE COMMITTEE  
November 7, 2007

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [9:09:10 AM](#).

MEMBERS PRESENT

Representative Mike Chenault, Co-Chair  
Representative Kevin Meyer, Co-Chair  
Representative Bill Stoltze, Vice-Chair  
Representative Harry Crawford  
Representative Richard Foster  
Representative Les Gara  
Representative Mike Hawker  
Representative Reggie Joule  
Representative Mike Kelly  
Representative Mary Nelson  
Representative Bill Thomas Jr.

MEMBERS ABSENT

None

ALSO PRESENT

Representative Kyle Johansen; Representative Lindsey Holmes;  
Representative Bob Roses; Representative Nancy Dalhstrom;  
Representative Kurt Olson; Representative Bob Buch;  
Representative Paul Seaton; Pat Galvin, Commissioner,  
Department of Revenue; Steve Porter, Legislative Consultant;  
Barry Pulliam, Senior Economist, Econ One Research; Rich  
Ruggiero, Consultant, Gaffney, Cline and Associates Inc.;  
Bob George, Consultant, Gaffney, Cline and Associates Inc.;

PRESENT VIA TELECONFERENCE

None

SUMMARY

HB 2001 An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to the issuance of advisory bulletins and the disclosure of certain information relating to the production tax and the sharing between agencies of certain information relating to the production tax and to oil and gas or gas only leases; amending the State Personnel Act to place in the exempt service certain state oil and gas auditors and their immediate supervisors; establishing an oil and gas tax credit fund and authorizing payment from that fund; providing for

retroactive application of certain statutory and regulatory provisions relating to the production tax on oil and gas and conservation surcharges on oil; making conforming amendments; and providing for an effective date.

HB 2001 was HEARD & HELD in Committee for further consideration.

#hb2001

HOUSE BILL NO. 2001

An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to the issuance of advisory bulletins and the disclosure of certain information relating to the production tax and the sharing between agencies of certain information relating to the production tax and to oil and gas or gas only leases; amending the State Personnel Act to place in the exempt service certain state oil and gas auditors and their immediate supervisors; establishing an oil and gas tax credit fund and authorizing payment from that fund; providing for retroactive application of certain statutory and regulatory provisions relating to the production tax on oil and gas and conservation surcharges on oil; making conforming amendments; and providing for an effective date.

[9:13:09 AM](#)

Representative Gara asked about the changes between various versions: ACES (HB 2001), CSHB 2001 (O&G), and CSHB 2001 (RES).

STEVE PORTER, LEGISLATIVE CONSULTANT referenced the sectional analysis depicting a side by side comparison for the three versions.

Vice-Chair Stoltze asked for a brief history of Mr. Porter's professional experience regarding oil and gas tax issues. Mr. Porter outlined his 21 years of experience with oil and gas issues both in the private sector as well as in government. He has worked as the deputy commissioner for the Department of Revenue, Tax Division and also as a negotiator on gas related issues; most recently before present employment he worked for Senator Steadman. As a result of his experience he felt he had a good understanding of the economic relationship between tax, reserves and price.

[9:16:04 AM](#)

Mr. Porter identified specific areas of change in CSHB 2001 (RES). The title has been changed in each version of the bill to represent changes made in each committee. The current title includes a retroactive clause. of the tax,

with intent language on how to dedicate the funds. In addition, there are changes to the tax for gas being used in the State (Cook Inlet), to provide a benefit to consumers. Mr. Porter noted that his presentation did not site sections but rather the statute in which the changes are made.

Mr. Porter referenced the following statutory changes:

AS 38.05.035(a)

This change adds a requirement for Department of Natural Resources (DNR) to furnish information to Department of Revenue (DOR). This change enables DNR and DOR to better forecast and understand the impact of change in the industry. All three bills concur on this change.

He noted that the next several changes were conforming amendments.

[9:18:51 AM](#)

Representative Gara requested an explanation of the information sharing provision as compared from ACES. Mr. Porter observed that a great deal of language was both taken out and added back. He promised to explain the changes when addressing the statute regarding information sharing.

He provided an overview of changes: PPT structure provided a value (production and tax), minus cost, multiplied by the tax, minus the credits. He noted that the tax portion is in AS 39.25.011, credits are outlined in AS 29.25.023-025, and AS 39.25.165 and .170 outlines information and lease information. He went on to explain that these various issues are addressed throughout the bill.

[9:20:42 AM](#)

He continued to explain changes in AS 39.25.110(42), Page 10 Line 6. This section makes auditors exempt. This remains unchanged in all versions of the bill.

Representative Hawker asked for detailed supporting documents from the State.

Mr. Porter resumed addressing changes in AS 43.05.230(a); tax payer confidentiality. The intent is to allow DOR to share information with the public by aggregating tax information from 3 companies. This language shows up in section 65 but under AS 43.05.230(h) is where it is first cited because it falls under an umbrella statute regarding confidentiality.

[9:23:15 AM](#)

AS 45.55.230(h) - provides the vehicle to change from three years to six years. The change was necessary for the Department of Revenue to have six years to complete their tax assessments.

Mr. Porter directed attention to the tax sections in AS 45.55.011 noting that it had been restructured slightly. In current law, there is a format change but the result is the same. AS 45.55.011(e) identifies how the production tax and the progressivity tax are computed. The language is in AS 45.55.011(g) & (h).

[9:24:37 AM](#)

AS 43.55.011(f) in the ACES version inserts a tax floor. The tax floor provision was deleted from the House Oil & Gas version (HO&G) and the House Resource Committee Version (HRES) concurred with this change.

Representative Gara referenced Page 11, Section 15. He recalled that the value of the oil was assessed monthly under PPT, in HO&G this was changed to yearly. The HRES changed the assessment back to monthly, but the change was not reflected in the language. Mr. Porter believed the intention was to retain the HO&G language. Mr. Porter said he would seek clarification and added that regardless of the potential language error it would not change the formula.

[9:26:40 AM](#)

Mr. Porter reiterated previous comments on AS 43.55.011 (f).

AS 43.55.011 (g) establishes the base tax rate at 25%, the progressivity factor at .2 and the tax cap at 50%.

Representative Nelson asked for clarification regarding the rate indicated. Mr. Porter apologized that he did not have time to edit the version before the Committee and noted there were typos.

[9:28:46 AM](#) AT EASE

[9:31:53 AM](#) RECONVENED

Mr. Porter clarified that the aforementioned provision, establishing rates, was deleted in HO&G. The progressivity language is in 43.55.011(o).

In AS 43.55.011(h), the ACES version sets progressivity on a calendar year basis instead of monthly and establishes the subtraction factor to 30 instead of 40. The language was deleted in HO&G and progressivity was placed in AS 43.55.011 (o), HRES concurred.

AS 43.55.011(j) & (k) are technical changes without sustentative impact.

AS 43.55.011(l) is a conforming reference that results in a basic technical change.

AS 43.55.011(m) changes "for" to "on". This is a technical change that was deleted in HO&G and was reinserted in HRES.

AS 43.55.011(o) as established in HO&G, is progressivity rates: .225% based on the gross value, starting at \$50; HRES expanded that language to establish progressivity at .2, starting at \$30 net and increasing to .3 above \$40, and .4 percent above \$50. There was an amendment that implied a cap but it did not clarify a cap. He recommended that the Committee address this discrepancy.

[9:35:14 AM](#)

Co-Chair Chenault asked for more information regarding the gross/net trigger points. Mr. Porter explained that there are two portions of the progressivity tax, one is the trigger amount, which is based on the net. The trigger amount allows companies \$30 dollars in cash flow before the progressivity tax kicks in. The other factor is a per barrel value. Instead of taking production tax value, which is minus operating and capital expenditures, it returns to the gross value of production.

Representative Gara commented on the impact of cost increases on the net tax trigger price. He went on to comment on the different points of view and opined that the aforementioned provisions seem to satisfy all sides. He asked Mr. Porter if there is a downside reflecting the costs percentage of the gross value. Mr. Porter replied that in theory the net cash flow would be shared and provided an example. He noted that the net trigger works well between economic projects. He explained that the new tax increased the curve slightly and that there is not a pure sharing of cash flow.

[9:39:52 AM](#)

Co-Chair Chenault summarized the impacts of the new provisions in HRES regarding progressivity. Mr. Porter clarified that progressivity affects two things: the percentage grows higher, and is disproportionate from the cash flow relationship. He reiterated that it is no longer a pure net relationship.

[9:40:56 AM](#)

Representative Kelly referenced the production tax. He asked if the companies would be able to claim the

progressivity tax piece as a deduction with the net trigger and gross progressivity provision. Mr. Porter responded that it would not change their ability to claim deductions. He added that the provision would impact the economic analysis slightly in respect to cash flow. He did not know the percentage of loss of value (in tax take) that would result.

Representative Kelly asked for a comparison of the five bill versions - PPT, ACES, HRES, HO&G and Senate Judiciary. Co-Chair Chenault agreed and added that he would like to see how the net trigger works on the gross and its effect. Mr. Porter responded by offering to provide a chart illustrating the progressivity curve on the deductibility piece.

Representative Kelly asked if the mechanism changed the ability to deduct expenses and what effect this would have in the different models.

Representative Gara followed-up and requested the fiscal impact of each of the 5 bills, with a comparison sheet.

[9:45:49 AM](#)

Mr. Porter continued with his presentation: AS 43.55.011(p)(referenced in title change) - allows for gas produced in the State to receive the same tax treatment as Cook Inlet gas. Co-Chair Chenault asked if there was a cap. Mr. Porter did not think so. Co-Chair Chenault suggested that Cook Inlet Basin is the example to follow to allow constituents around the State access to the gas. Mr. Porter added that the current draft would allow the gas to be brought from the North Slope. Representative Gara noted a provision in PPT deflated the amount of gas in the Cook Inlet. He described this provision as an urban "PCE". Representative Nelson added that it is like PCE "plus". She clarified by saying the natural gas not only covers much of the need for electrical use, but would also cover heating cost. Co-Chair Chenault pointed out that many people still use oil rather than natural gas because of the lack of availability.

Representative Thomas commented that PCE does not cover schools or businesses.

[9:49:34 AM](#)

Mr. Porter pointed out that ANGDA has been considering evaluation of compressed gas projects in the Yukon and Southeast Alaska. The HRES version could help rural communities through pilot projects.

He continued his presentation: AS 43.55.020(a) establishes installment payments consistent with changes in the

production tax. This language was deleted in the HO&G, HRES concurred.

Mr. Porter explained that AS 43.55.020 (g), (h), & (i) have minor language changes. HRES established a new section (i). The provision provides for civil penalties on installment payments to accrue at 5% of the difference between the amount due and the amount paid.

Representative Gara cited two terms used in the bill: "underpayment" and "understatement" and asked if there was a difference. Mr. Porter did not know. Representative Gara pointed out that in many of the State's provisions, negligence needs to be proved in order to get the penalty payment. He said he understood that this was not the case with regard to the 5%. Mr. Porter observed that this would be best discussed when he addressed the provision in his presentation. Representative Hawker asked for a comprehensive list of all penalty provisions for the State of Alaska regarding filings on production taxes.

Representative Kelly suggested that answers to questions and requests should be directed to the Committee Chair, rather than be the responsibility of Mr. Porter. Co-Chair Chenault agreed.

[9:54:54 AM](#)

Mr. Porter resumed his presentation: AS 43.55.023(a) addresses credits. He informed the Committee that the Department of Revenue wanted to shift the credits and allow the applicant to take half in one year and half the next. This was deleted in the last two versions. He went on to say that these deletions will be consistent in other areas of the bill that address credits.

AS 43.55.023(d) is a conforming amendment regarding transferable tax credits. The provision also extended the timeframe from 60-120 days for the Department to approve the applications. The HO&G version deleted the language and reverted back to PPT language; HRES reestablished the ability to obtain a gas payment, but did not change the timeframe back to 120 days.

AS 43.55.023(e) contained conforming references that were deleted in the last two committees.

AS 43.55.023 (g) added conforming language related to the purchase of certificates. This was deleted in HO&G and reinstated in the HRES version.

Transitional Investment Credits (TIE) were repealed in Sec. 65 of ACES and reinstated in the HO&G version. There was a five year time frame that had been reduced to three years. In effect, the provision reduced the credit that could be captured. The provision remains in HRES.

[9:57:48 AM](#)

Representative Gara asked about the TIE credits. He asked which bill provided the compromise allowing the credits to the new explorers, but not the major companies. Mr. Porter explained the provision was in the Senate Judiciary Committee (SJUD) version. The language attempted to delete the TIE credits entirely, effective January 1, 2008. The provision did allow for explorers to apply credits in the future.

Representative Gara asked if it was unwise to allow credits for investments already made. Mr. Porter explained that, in order to capture the credit in the future, a company would have to spend capital at twice their previous rate. He added, the formula allows 10% per year until 2013.

[10:01:32 AM](#)

Representative Hawker emphasized that the TIE credits outlined in PPT are purchased, not given.

Mr. Porter outlined changes in AS 43.55.023(o), which clarifies that tax credits are not available to tax exempt entities.

Co-Chair Chenault asked about the Alaska Retirement Management (ARM) Board. Mr. Porter explained that the ARM Board is excluded from the provision and summarized language in AS 43.55.023 (m), HRES. The ARM Board can not get a credit for their exploration, but they can purchase credit to capture the incremental value.

AS 43.55.024(a) provides that AS 43.55.024 credits can not be applied against the tax floor, AS 43.55.011 (f), to lower the obligation for legacy fields. This was deleted in HO&G and HRES.

Mr. Porter discussed AS 43.55.025(a). Under ACES the credits could not be applied to reduce the tax on the floor; HO&G deleted the language; and HRES reinstated the ACES language, but increased the exploration credits from 20% to 30%.

[10:04:59 AM](#)

Mr. Porter reviewed AS 43.55.025(b), which requires a well be "completed or abandoned" prior to receiving credit. In

addition, the provision exempts costs arising from gross negligence and any violation of Health Safety & Environmental statutes and regulations. The HO&G version deleted the ACES language. HRES reinstated the ACES language and added "suspended, completed or abandoned".

AS 43.55.025 (c) establishes additional requirements of DNR approval in advance, and verification subsequent to drilling the well in order to receive the credit. The ACES language was deleted in HO&G and reinstated in HRES with a percentage change from 20% to 30%.

AS 43.55.025(f) defines the data that would be necessary to be submitted to receive an exploration credit. It also reduced the confidentiality period from 10 years to 2 years and provided that two certificates would be issued: one-half the credit immediately useable and one-half delayed. The HO&G version deleted all these provisions. The original ACES language was reinstated in HRES with the following changes: provided the DNR commissioner the discretion to grant extended confidentiality under certain circumstances and made the certificates immediately available.

[10:07:27 AM](#)

AS 43.55.025(h) provides that the AS 43.55.025 tax credits cannot be applied against the tax floor in AS 43.55.001(f). The HO&G version deletes the ACES language, which was reinstated in HRES.

AS 43.55.025(k) changes the definition of preexisting well, in ACES, to a well spudded within 150 days rather than 120. This language was deleted in the HO&G and was reinstated in the HRES version.

AS 43.55025(l) allows DNR to purchase seismic data with credits for 5% of the investment expenditure. This was deleted in HO&G and reinstated in the HRES version.

Mr. Porter reiterated that the language in AS 43.55.025(m) was added in HRES only. The provision allows the ARM Board to purchase transferable certificates for which the Department is authorized to issue cash refunds.

AS 43.55.028 creates the Gas Credit Fund and establishes the amount of reserves to be deposited into the Fund. The language was established in ACES, deleted in HO&G, and reinstated in HRES with the additional language: maximum annual limit of \$25 million on the purchase of certificates with the exception that the maximum does not apply to the ARM Board.

AS 43.55.030(a) amends tax payer requirements on filing. This language is retained in both HO&G and HRES.

AS 43.55.030(d) in ACES established \$1000 a day penalty for not filing required reports. This language was deleted in HO&G and reinstated in HRES.

[10:10:06 AM](#)

Mr. Porter continued:

AS 43.55.030(e) adds reporting obligations for explorers that do not have production. The HO&G and HRES versions adopted this language.

AS 43.55.040 grants powers and duties of the Department of Revenue to require producers and explorers to file reports that are "considered necessary" for forecasting and provides penalties for not doing so. The HO&G version deleted the penalties portion. The HRES version reinstated the ACES language with additional requirements on the penalty prohibiting the department from compromising on the penalty for less than 50% of the assessed penalty.

AS 43.55.075 extends the time frame for the Department to file an assessment from 3 years to 6 years. There were no changes in HO&G or HRES.

Representative Gara asked if the provision increased the time allowed the Department to file an audit or make a claim for underpayment from 3 to 6 years. Mr. Porter replied that it was the assesement itself. Under ACES, the assessment determines the dollar amount owed if there is a difference. Representative Gara asked if "assessment" was the legal term used to describe the determination of a claim. He further questioned if the tax assessment period was six years in the current version of the bill. Mr. Porter affirmed that the Department has six years to complete its tax assessment in the current version of the bill.

[10:12:39 AM](#)

AS 43.55.110 allows the Department to require electronic filing. This provision remained in all versions.

\*\*\*Mr. Porter observed that, in the HRES version, AS 43.55.150(a) inserted new language for determining the actual transportation costs of the gas outlining three contingencies. Current law requires all three contingencies be met. The current language changes that to; if any one of the contingencies is met the Department will determine what is reasonable.

AS 43.55.150(b) establishes new language, added in HRES, stating that transportation costs filed with the Regulatory Commission of Alaska must be adjudicated.

AS 43.55.160(a) clarifies how production tax values are calculated in Cook Inlet. HO&G changed language reverting to PPT language with conforming references. HRES added information related to AS 43.55.011(p) provision which allows the tax to be the same as Cook Inlet (in state gas use).

AS 43.55.160(b) clarifies the loss carried forward. This language was deleted in HO&G and HRES concurred.

AS 43.55.160 (f-i) addresses the allocation of costs between leases. The language was deleted in the HO&G, HRES concurred. Representative Gara questioned the practical application of that deletion. Mr. Porter recommended that Mr. Dickinson address the methodologies of Cook Inlet.

Representative Gara asked if ACES was concerned with artificially reducing the value. Mr. Porter did not remember those discussions.

[10:16:56 AM](#)

Mr. Porter continued:

AS 43.55.165(a) outlines the type of costs associated with lease expenditures and standards by which the Department can determine allowable costs. HO&G deleted ACES language and reverted to PPT language with conforming references. HRES concurred.

AS 43.55.165(b) addresses language additions and deletions regarding direct costs. The current language in HRES changed "in the state" to "on the premises of the lease or property from which oil or gas is recovered".

[10:18:26 AM](#)

AS 43.55.165(b) describes the types of costs that qualify as lease expenditures and provides standards for the Department to determine which costs are allowed.

Mr. Porter noted that section 53 amended section 52.

AS 43.55.165(e) establishes the list of disallowed costs. Mr. Porter read from the handout the list of costs in the ACES version. The HO&G concurred with ACES. The HRES added to the list of disallowances. Further language was added amending the departments responsibility to write regulations to cover the allocation of costs under AS 43.55.011(p), the instate gas use clause.

[10:20:17 AM](#)

AS 43.55.170 (a) deletes qualifying language regarding payment or credit with no changes to either version.

AS 43.55.890 allows the department to disclose tax information aggregated from three or more taxpayers. HO&G and HRES concurred.

AS 43.55.900 defines the following terms: "nonunitized reservoir", "pool", "producer", and "unit". HO&G deletes "nonunitized reservoir" and "pool". HRES version concurred and added a definition of "used in state".

[10:21:24 AM](#)

Effective dates 1/1/08 for ACES version and HO&G. HRES version changed the effective date to 1/1/07

RECESSED: [10:22:50 AM](#)

RECONVENED: [10:50:32 AM](#)

Commissioner Galvin, Department of Revenue noted that the intent of ACES was to gain the needed tools to implement the tax system and ensure the state receives an equitable share. He noted two provisions in the bill: the need for auditors and clear rules for what is and is not allowable and the 10% gross tax.

Commissioner Galvin noted that he was before the Committee to discuss the current version of the bill.

He explained that the intent section identifies retroactivity and designates revenue received from the provision into a fund. The Administration sees this as an opportunity to acquire and save funds. He said the administration supports any attempts at savings of additional funds received from the tax. He went on to say that equitable share can be generated in a number of ways. He said the progressivity piece allows for the opportunity to gain and save when prices are high so funds can be used during a time of low prices.

[10:55:44 AM](#)

Vice-Chair Stoltze questioned if there is a strong commitment to saving a significant portion of the revenues. Commissioner Galvin stated that the Administration has been clear in their commitment to saving additional revenue for the future.

[10:57:21 AM](#)

Representative Crawford stressed the need to diversify from a one time resource to a recurring resource. He stressed the importance of investments that would provide for generations in the future.

[10:58:23 AM](#)

Commissioner Galvin acknowledged the desire of the legislature to find the balance of protecting the state when oil prices are low and ensuring the state gets a fair share when oil prices are high. He noted that the progressivity mechanism weighs the risk preference and can be structured in a number of ways depending on current prices. He cautioned that the focus should be on the representational price range as a realistic expectation rather than the current high price.

[11:01:12 AM](#)

Representative Gara expressed skepticism that the high price of oil would remain and asked for an average of the last three years. Commissioner Galvin said the average price was \$50 per barrel over the last three years. He said that forecasted prices are based on previous patterns and look at \$60 dollars a barrel over the next few years. He emphasized the prudence of remaining with a conservative approach.

Representative Gara asked for the last two year average fiscal year oil prices. Commissioner Galvin said he would provide the information to the committee.

[11:04:38 AM](#)

Commissioner Galvin spoke to the tax rate for gas. He asserted that new gas projects would have a disparity in treatment under the PPT structure. Therefore, the Administration supports the Cook Inlet provision in the current HRES version. He felt a cap was unnecessary as it only applied to gas used in the state. He underlined that the gas that fills state demand would receive the preferential treatment.

[11:06:48 AM](#)

Representative Crawford asked the Commissioner if there could be problems selling in state gas, with a different tax rate, out of state. Commissioner Galvin acknowledged that there could be constitutionality issues. He further commented that there is no in state gas sold out of state now and would not be for the near future.

[11:08:14 AM](#)

Representative Gara described the in-state gas tax provision as a subsidy and requested an estimate of the cost to the state in a decreased tax take. He underlined the point by saying that the discounted tax rate benefits those communities on the road system. Commissioner Galvin disagreed with the characterization of subsidy by explaining that part of the tax is due to the economics of the field and part is subsidy.

[11:12:20 AM](#)

Representative Gara reiterated his point regarding the cost to the state in a decreased tax take. He went on to point out that only certain areas will receive the benefit creating inequity statewide.

[11:12:56 AM](#)

Vice-Chair Stoltze spoke in support of reducing consumer costs whenever possible.

[11:13:41 AM](#)

Representative Nelson, in response to Representative Stoltze, pointed out that she did not think anyone wanted to take away the subsidy. She noted that Tanana [corrected from Nenana] is looking at retrofitting homes and businesses from diesel to propane. She questioned if a gas pipeline would power these communities by propane rather than diesel. Commissioner Galvin responded that it would be possible. Representative Joule asked for a chart of where these prospects are in the state. Commissioner Galvin said he would provide studies done by DNR and ANGDA.

Co-Chair Chenault suggested that all subsidies should be evaluated and pointed to PCE and other subsidies.

[11:18:23 AM](#)

Commissioner Galvin focused on TIE credits. He explained that the Senate version added clarifying language representing the intent of the ACES bill (Explorers that have qualified for TIE credits by making expenditures after enactment of PPT, would be frozen and could be used once production was realized). The House version reverts to the existing TIE program with a limit on past expenditures that qualify. The full five years would allow a billion dollars of TIE credits to be taken. The current version would allow \$750 million available in credits. He noted that there had been discussion regarding the benefit of allowing a credit on past expenditures. He suggested that providing an additional 10% credit for an existing producer is not creating an equal playing field with explorers.

Commissioner Galvin spoke to transferable credits. He pointed out that an explorer has to find a way to capture the value of the credit. Currently there is a \$25 million opportunity for the state to provide cash for the credit; they would have to find a producer to buy anything beyond that amount. The state would realize the full value of the credit on the books. The Administration feels that it is better to cut out the transaction, and allow the explorer to get full value from the state. The mechanism to ease the bookwork would be the creation of a fund that would be filled by production tax revenue and then used to pay the credits generated by new explorers. The HRES version caps the ability to provide the full value of the credit at \$25 million per explorer. It provides the beginnings of an alternate path that would bring those explorers to the ARM Board with the ability to purchase credits at a discounted amount. The Administration supports lifting the cap and providing the full value to the explorer.

[11:23:30 AM](#)

Commissioner Galvin addressed the penalties provision and expressed the desire to have all the penalties recognized in one place. He noted that with all the changes the intent was confusing. He further discussed lease expenditures and allowable deductions. Representative Gara discussed penalties for underpayment. He expressed a number of concerns regarding the ability of the state to properly audit a profits tax.

[11:27:27 AM](#)

Commissioner Galvin said ACES provides for costs to be identified and defined in regulation. The language was removed in HRES. He spoke in support of restoring the original language.

[11:28:39 AM](#)

Representative Hawker expressed concern with the original language because it would be dependent on the implementation of regulation. He expressed concern regarding the use of regulation to enact legislation.

Commissioner Galvin emphasized that regulation allows for the department to define the parameters for individual tax payers and thus reflects the intent of the legislature. He pointed out that the legislature has the power to address the issue if the regulations are not in alignment with their intent.

Commissioner Galvin clarified for Representative Kelly that he was referring to costs on lease expenditures in HB 2001 section page 41, line 11.

[11:34:39 AM](#)

Commissioner Galvin spoke to the allowable lease expenditures section. He said that provisions have been added in a number of versions to restrict costs to those incurred in the state. He said the Administration does not support that restriction and noted the difficulty in implementation. He asserted that in terms of policy, the state does not have the capacity to support all activities related to oil and gas. The Administration supports a system that recognizes that some costs are incurred out of state.

[11:37:36 AM](#)

Representative Gara said the point of the provision was to limit gaming of the system. Commissioner Galvin argued that the statute is clear that costs must be directly related to oil and gas produced in Alaska. Companies would have to justify their expenditures. He felt that the Department could resolve the problem through the audit. Representative Gara argued that the expenses would be claimed and that the state would have to make the argument through litigation. He felt that the state's definition and the oil companies would differ. Commissioner Galvin maintained that audits would be done and enforced. Representative Gara spoke in support of restricting proportioning of costs. Commissioner Galvin agreed. He explained that there is an allowance for overhead that must be demonstrated through documentation. On top of that the state would provide 3% on capital expenditures and 9% on operating expenses.

[11:46:06 AM](#)

Representative Gara asked for clarification on the percentage allotted for indirect costs. Commissioner Galvin reiterated the 3% on capital expenditures and 9% on operating expenditures. He cited the HRES version on Page 40, Line 15: reasonable allowances.

Commissioner Galvin addressed the corrosion issue. He said there is a broadly accepted principle that cost for repair of improperly maintained equipment should not be a deductible cost. In order to address this specifically, language could be added to say: If "improperly maintained". The commissioner pointed out that this language would be put to a test and it would require extensive analysis to determine. He emphasized that the proposal brought forward is more objective than subject.

The Department would identify an unscheduled event and those costs would be excluded. He further noted that this was more easily implemented with auditors rather than engineers. This method of addressing the issue was removed from the present

committee substitute and was replaced with Page 41, Lines 3-6, (HRES) extending the costs that arise out of willfulness, misconduct or gross negligence.

[11:52:02 AM](#)

Representative Hawker agreed with the addition of language. He referenced Lines 4 - 6 and expressed concern that "failure to comply" was overly broad. He pointed out that the language regarding leases, permits etc., restrictions and penalties are already outlined in a lease contract. He opined that perhaps this was a reaction to Exxon and the Point Thompson lease. Commissioner Galvin recognized the concern. He clarified that it is more a matter of implementation. He explained the difference between resolving lease violations and a statutory violation providing for a penalty in fees.

Representative Hawker emphasized that non offensive violations and egregious violations are treated the same under the provision.

[12:00:19 PM](#)

Commissioner Galvin, responding to Representative Hawkers comments, discussed the difficulties of determining violations.

[12:01:52 PM](#)

Representative Gara referenced Page 41, Lines 3 - 6, and asked how the original ACES language compared. Commissioner Galvin stated that the reference to the Clean Water Act and "criminal negligence" was added. Representative Gara asked about language regarding unscheduled interruption of service. Commissioner Galvin said the language was on Page 42, Line 30, subsection (19).

Representative Gara asked if this language applied, would the State have to prove criminal negligence for the BP shutdown. Commissioner Galvin said they would have to prove that all the costs claimed were due to criminal negligence.

Commissioner Galvin referenced Page 41, Paragraph 8. The section deals with what is excluded from lease expenditures. He emphasized the department does not oppose inclusion of "criminal negligence" language.

[12:05:57 PM](#)

Co-Chair Chenault asked about the current status of audits. Commissioner Galvin said the first tax returns came in before April 1. He said the accounting and auditing system is set up for the fall for the federal packages. That

information will provide the starting point for auditing personnel and developing strategy. Co-Chair Chenault asked how the strategy would be developed and how the regulations pertain. Commissioner Galvin explained that the regulations were developed under PPT and put in place in January/February. He noted that there were some issues regarding the details of the costs outlined in the joint interest billings. He pointed out that the Department has brought the issues before the Legislature so that the regulations are written to the legislative intent. The bulk of the audit strategies would remain regardless of the changes. The decision regarding which costs incurred in the calendar year 2006 are going to be allowable under PPT will affect what happens in 2007. Transition language will need to be put in place if provisions are going to be retroactive.

The cost issue, Page 43, Line 10, new Section 20, makes clear that costs are excluded for the reasons described earlier.

[12:11:11 PM](#)

Representative Hawker asked about new provision 19 regarding topping plants. Commissioner Galvin explained that the Department was asked if the expenditure for the construction of a manufacturing plant was an appropriate deductible expense. The Administration determined that it is not an appropriate lease expenditure as the plant is not directly related to production.

Representative Hawker asked how a fair transfer price would be determined. Commissioner Galvin clarified that the transfer price would be fair market value of the product.

Representative Hawker explained the relationship of increased revenue by decreasing costs through a topping plant. He thought the provision would discourage investment capital in the fields. Commissioner Galvin did not share the concern, noting that companies would not consider this when determining operation costs.

Representative Hawker reiterated the operating expense and cost of fuel, which he thought precludes making investing in the field.

[12:20:00 PM](#)

Representative Crawford commented that the language was too specific and asked if it could be replicated in other areas of the state. Commissioner Galvin acknowledged that there are other topping plants on the North Slope and that it could replicate itself in other ways without the language.

Representative Kelly did not think it was a good idea to put something in statute that can be addressed in regulation.

[12:23:00 PM](#)

Representative Thomas referenced the retroactivity clause and asked what the anticipated cost of heating fuel would be for the consumers. Commissioner Galvin responded that there is no direct relationship between the increased production tax and the price of heating fuel. Representative Thomas worried about the increases to taxes applied to the oil tankers. He noted that it is likely the transporters will increase price to make up for tax increase and this would be passed on to consumers. Commissioner Galvin said that the increased tax goes to the producers. He reassured Representative Thomas that the tax increase would not impact the consumer.

[12:28:49 PM](#)

Representative Joule disclosed that he holds shares in Native Corporations. He asked if the drilling information from private land had to be made public. He said that this could leave businesses at a disadvantage. Commissioner Galvin clarified that this only applies if a business chooses to participate in the incentive credit program.

[12:34:55 PM](#)

Co-Chair Meyer understood that the Administration requested that the effective dates and retroactivity language be "cleaned-up". He worried about a legal challenge to the retroactivity language. He asked the preference of the Administration. Commissioner Galvin said the legal advice from the Department of Law is that as long as they act in the same taxable year, they would be in solid ground. The original recommendation of January 1<sup>st</sup> noted that the Administration recognized the value of starting at the beginning of the year.

Co-Chair Meyer asked when regulations would be completed. He went on to say that one of the current problems is that the regulations for PPT are not in place. Commissioner Galvin advised that when PPT was passed, the bulk of the regulations were in place within six months. There were still issues that needed to be resolved and the proposed bill addresses those issues. He thought regulations would be in place within six months of passage.

Co-Chair Meyer worried that this was the third tax change within three years. He wondered if it would be revisited within the next couple years with further changes. Commissioner Galvin hoped and expected that the tax law that

passes would be in place long-term and did not expect that the tax system would be revisited.

[12:40:37 PM](#)

Representative Hawker referenced non-state land issues brought forth by Representative Joule. He thought that the substance gives the State an unfair advantage against private land owners when the private land owner is required to disclose to the state information that can be revealed to the public. He expressed concern that mandatory disclosure is discriminatory. Commissioner Galvin reiterated that it is optional for companies to participate in the additional credit, which requires the submission of data.

[12:43:37 PM](#)

Representative Hawker pointed out that the provision would establish the "shelf life" of 24 months. Commissioner Galvin maintained his point that the owner had the option of using the credits.

[12:44:29 PM](#)

Representative Hawker maintained that the state would pay for bad data and never get the good data. Commissioner Galvin responded that one of the changes in the EIC section is the requirement that the companies come to DNR ahead of time and file for the credit.

[12:45:22 PM](#)

Representative Gara observed that deductions increase as the tax rate increases. He suggested that, as long as you are in a reasonable range of taxes, increasing the deduction rate is an additional incentive to invest. Commissioner Galvin agreed. Representative Gara expressed a concern regarding progressivity at \$50 - \$55 a barrel. Commissioner Galvin clarified that there is a range across fields with a 52 percent average for all. He went on to say that within those fields there are lower cost fields that will have a lower margin and others where progressivity kicks in at a higher rate. Representative Gara asked about the relationship between production decline and increased progressivity. Commissioner Galvin pointed out that there are two moving parts: operating expenditure and capital expenditures. He explained that capital expenditures would be the reflection of new investment to increase production. With regards to the numbers changing the question is whether the increase is due to the \$8 per barrel of additional investment or because the operating expenditures have gone up by \$8 per barrel. Representative Gara asked for the best estimate of where the progressivity "kick in" would be over the next few years.

[12:49:24 PM](#)

Representative Gara asked if raising the base rate from 22.5% to 25% would provide additional incentives through deductions. Commissioner Galvin said yes.

Representative Gara cited the Department's August report identifying that PPT is projected to bring in \$800 million less than what was projected. Last year the legislature was told that PPT would raise more than ELF starting at \$26 per barrel, but the old system would raise more than PPT until oil hits \$46 dollars a barrel, not \$26. He further stated that the progressivity kick in was going to be around \$55 per barrel, but under the commissioners analysis it might not be until oil \$63 per barrel. He maintained that PPT was broken.

[12:50:58 PM](#)

Co-Chair Chenault noted that questions should be submitted in writing so that they can be shared with the other members.

[12:53:24 PM](#)

Commissioner Galvin discussed fiscal notes. He noted that the projected revenues, with the forecasted prices, would result in \$2.97 billion, which would be \$1.05 billion more than PPT. He also pointed out the additional \$244 million that would be received from retroactivity in 2007. He further noted the percentage increases in the analysis with different dollar amount projections. He underlined that the fiscal note reflects the production estimates that have been used throughout the special session. The production forecasts for the fall are currently being updated to provide an official number to the Office of Management and Budget (OMB). He said new fiscal notes incorporating new production forecasts would be available by the end of the week.

Co-Chair Chenault asked if the ACES version was reflected in the current fiscal note.

Commissioner Galvin observed that ACES is not in the fiscal note.

Representative Chenault requested that all bill versions be reflected in a fiscal note.

Representative Gara concurred on that request and asked for a side by side analysis.

[12:58:12 PM](#)

Representative Hawker asked for a more thorough analysis of the consequences of various options. Commissioner Galvin agreed. Representative Kelly also asked for more information.

RECESS: [1:01:42 PM](#)

RECONVENED: [1:41:13 PM](#)

BARRY PULLIAM, SENIOR ECONOMIST, ECON ONE RESEARCH, presented the Report to the Alaska Legislature on Production Cost Increases (copy on file). He briefly outlined the changes from ELF to the PPT net system. He noted that the difference between the gross system and the net system required looking at operating expenditures (OPEX) and capital expenditures.

[1:44:06 PM](#)

Rep. Joule asked Mr. Pulliam if he was still under contract with Legislative Budget and Audit (LB&A). He confirmed he was hired by LB&A along with Dan Dickenson and Steve Porter.

Mr. Pulliam addressed the first slide. He explained that cost projections were pulled from a number of sources. He showed how the total costs of the fiscal note on HB 2001 break out to \$1.1 for capital and \$1.1 for operating costs, totaling \$2.2 billion.

[1:48:25 PM](#)

Mr. Pulliam explained that the cost figures are not based on a particular version, but have been used for projections of the ACES version.

[1:50:15 PM](#)

Representative Gara asked for clarification regarding the cost projections. Mr. Pulliam said it was his understanding that the numbers reflected in the handout are those that are being used for all versions. He clarified that the calculations use the average cost for the North Slope, not including royalty oil. Representative Gara asked for the cost per barrel for all oil and asked if the numbers were overstated by 1/8. Mr. Pulliam explained that the amount per barrel reflects the amount that is deductible in calculating the tax. He explained that the cost per barrel for the North Slope would be \$16.50 per barrel on an eight/eighth's basis.

[1:52:31 PM](#)

Mr. Pulliam discussed the department's current estimates for HB 2001. He explained that the information from the department is total cost information. More specific data was not available due to tax payer confidentiality.

[1:55:53 PM](#)

Representative Kelly asked what the projected costs would be. Mr. Pulliam noted that flat costs are being forecasted for the next several years. The relationship between cost and price is built into the forecast.

Representative Gara revisited the issue of the \$16.5 cost per barrel. Mr. Pulliam noted this is a forecast number based on a gross cost and has not been audited.

Representative Gara assumed that costs would be overstated by the industry. Rep Gara referred to the assumption that costs are lower for bigger fields and higher for smaller companies. He agreed with the assumption and reiterated that the department did not share specific field information.

Representative Gara asked if in the case of \$98 per barrel oil, everything above \$18.85 would be profit with the exception of what is paid in taxes. Mr. Pulliam noted that there is the cost of moving the oil. In addition TAPS tariffs are estimated at \$25 on \$95 barrel of oil, which would leave a \$75 margin for which you would pay taxes.

[2:00:39 PM](#)

Representative Hawker, as a point of clarification, emphasized that within the tax formula are excluded costs that cannot be deducted, which would be taken from the margin.

[2:01:22 PM](#)

Mr. Pulliam addressed the question of increased costs. He said the costs of production have gone up due to both actual and expected prices of crude oil. He pointed to the chart that denotes the cost increase in crude oil from 2000 - 2007. In the past there have been spikes in crude oil, but the chart highlights the steady increase. He underlined that it is the projected expectation that drives investment

[2:04:26 PM](#)

Mr. Pulliam discussed future prices, which went from \$45 a barrel to \$80 per barrel. The expectation of oil prices have shifted upward. Increased activity puts pressure on available services, which then increase production costs.

[2:06:02 PM](#)

Co-Chair Meyer questioned what the appropriate price would be based solely on supply and demand. Mr. Pulliam could not answer, but explained that a great deal depends on geopolitics. He noted additional variables that come into play on the price of oil and the costs to produce it.

[2:10:12 PM](#)

Mr. Pulliam said companies are more likely to pursue new and heavy oil at higher prices and margins.

Co-Chair Meyer noted that a gas pipeline would assist consumption. Mr. Pulliam explained that the demand would not ease, but the pace of increase would stabilize. If consumer behavior changes and demand falls it would put the pressure back on crude oil.

[2:12:32 PM](#)

Mr. Pulliam reviewed the upstream capital cost put together by HIS/CERA. He pointed out that the chart illustrates a 10 percent increase from 2000-2004 associated with upstream production. The chart further demonstrates the large increase in costs in 2005. He noted that the increase was level with inflation in the economy. He explained that there is some tapering off in 2007 due to the ability of companies to respond to demand.

[2:15:38 PM](#)

Representative Hawker asked if anything is attributed to the point in inflation, specifically the huge increase in 2004. Mr. Pulliam reiterated that the increase is due to supply constraint of equipment and services to meet the demand. The shortage can be attributed to increase demand for services with constraint of available rigs and the time it takes to build additional equipment. It takes time and planning to produce needed equipment.

[2:19:49 PM](#)

Representative Hawker noted that the past three years should have allowed the supply industry to meet demand. Mr. Pulliam explained that expectations have changed for the price environment. The supply industry operates on these expectations and thus will meet the demand to the point of constraint. The closer to the constraint point the higher utilization rates and the decision to meet demand further is based on whether the prices will remain in the long run.

[2:22:31 PM](#)

Mr. Pulliam reviewed the chart illustrating the relationship between the rising prices of ANS with the rise in upstream costs. He reiterated that actual prices play a role, but the process of forming expectations is what influences investors.

[2:24:11 PM](#)

Mr. Pulliam provided information regarding rig rates for the lower 48 states. Co-Chair Chenault noted that the chart refers to drilling rigs available in the lower 48, which does not require the lead time as a rig designed for Alaska. Mr. Pulliam said that rigs in the lower 48 can be moved between states, while they cannot be used in Alaska. He noted that rig rates would be a bit more difficult to determine. He pointed out that in 2002 - 2006 there was a doubling of rig rates, which started to come down in 2007. He observed that suppliers are catching up with demand, which then influences price and costs. He expected the same would happen in Alaska with a bit more of a challenge due to logistics.

[2:27:18 PM](#)

Mr. Pulliam referenced the chart illustrating the oil drilling rig daily rates vs. the West Coast ANS Price. The information is based on federal reports on operating costs for a variety of different type of lease operations. Where the capital expenses are dramatic, the operating costs reflect a steady increase.

[2:29:10 PM](#)

Mr. Pulliam referred to reports by BP and ConocoPhillips, specifically the production costs, which is considered an operating expense. Co-chair Chenault asked if the numbers reflected what was real for Alaska. Mr. Pulliam clarified that there would be lower average cost for large fields than small scattered fields in Alaska.

[2:30:54 PM](#)

Co-Chair Meyer asked why there is a spike in production costs for Alaska. Mr. Pulliam did not have a definitive answer. He noted disruptions in 2006 in Prudhoe Bay and added that there are costs associated with the disruptions. He explained that the information on costs can not be extrapolated from the filings as costs are simply "production costs" and not detailed.

[2:32:19 PM](#)

Co-Chair Meyer mentioned that the costs to extract the oil are greater since 2005. Mr. Pulliam said the numbers

indicated are in line with what DNR is using in its estimates.

Co-Chair Meyer said it looks like costs stayed relatively stable in the lower 48, compared to the drastic increase in Alaska. He asked if this had to do with location and bringing drills to Alaska. Mr. Pulliam noted that the transportation of drills would fall under capital. He elaborated that an increase in labor force, specific to Alaska, would have an impact on costs.

Representative Gara questioned the accuracy of the numbers used to forecast operating costs last year. He pointed out that ConocoPhillips's operating costs were at \$6 while the modeling was done at the \$4. Mr. Pulliam clarified that the department based their forecast on costs through 2005 as 2006 information was not available. He believed, based on the numbers available at the time, they were the correct numbers.

[2:40:56 PM](#)

Co-Chair Chenault noted other factors effecting costs, including those associated with the shut down of Prudhoe Bay and the volume of oil that was deferred. Mr. Pulliam acknowledged that the repair numbers and greater level of activity, increased costs for facility maintenance.

[2:42:20 PM](#)

Mr. Pulliam referenced the next slide [B.P. production costs per BOE 2002-2006] and pointed out that B.P. does breakout spending cost in Alaska. He addressed the slide comparing B.P. and ConocoPhillips production costs per BOE. He noted the increase in costs for BP from 2005-2006 and said this was likely due to the repair costs from the shut down. In response to Representative Hawker, Mr. Pulliam stated that the numbers are based on calendar year were consistent for all represented. He explained that the information was taken from the 10-K's and 20-F which are end of the calendar year numbers.

Mr. Pulliam mentioned the corrosion expenses and management costs. Publicly available information from BP states that they will spend \$260 million to replace transit lines. In addition, the 20-F filing says they will spend \$550 million on integrity management over 2007-2008. It is uncertain whether the \$550 million is just for the 07/08.

[2:49:40 PM](#)

Representative Gara continued his questioning about increased costs. He pointed out that prior and after the shut down, costs were rising. Mr. Pulliam agreed that costs

are going up and that the shut down is just another layer of costs. He also explained that the integrity management piece increases costs significantly.

Representative Gara thought that the costs were continuing to rise and asked if it was wise to have a model representing flat costs. Mr. Pulliam responded that the higher cost scenario component is built on increased costs, over the \$60 dollar barrel based on the PPT filings. He did not know if the forecast would ultimately provide the exact correct numbers.

[2:53:30 PM](#)

Representative Gara asked if they are using flat costs in the model. Mr. Pulliam said they were forecasting overall costs unit to unit.

Representative Kelly commented on all the variables involved in the cost projection. Mr. Pulliam acknowledged that every fluctuation creates unanticipated results. Representative Kelly understood the difficulties for industry and noted the intention for the special session is to determine a rate that is fair for all Alaskans and encourages investment.

Mr. Pulliam recommended that members remember that costs have gone up as have the price of oil per barrel. The margin is greater and the margin of error is larger.

[3:00:39 PM](#)

Mr. Pulliam referenced the final two slides concluding his presentation.

[3:02:16 PM](#)

Co-Chair Chenault noted the handout from Marcia Davis to address concerns voiced by Representative Hawker.

RECESSED: [3:03:03 PM](#)

RECONVENED: [5:19:44 PM](#)

DAN DICKINSON, CONSULTANT, TAX DIVISION, DEPARTMENT OF REVENUE compared ACES to current law, HO&G, HRES. See attached spreadsheet. He noted that the base rate has gone back and forth between the bills from 22.5 - 25 %. The HRES version is at 25%.

Mr. Dickinson reviewed the progressivity feature. He noted that the starting point has varied from \$30-\$60. He observed that the HRES version did not supply a cap, which results in

the unintended consequence of a government take of 90 percent at \$190 a barrel.

TIE credits exist in current law and were removed under ACES. The HO&G version allows going back to 2003 rather than 2001. The HRES version retained this change.

Mr. Dickinson discussed exploration credits predating PPT. The base credit was raised from 20 to 30 percent. The old language was left in because anything that qualified for the 20% would qualify under AS 43.55.023 of the new rule.

[5:28:03 PM](#)

Mr. Dickinson addressed General Administrative costs: Aces provides a list of disallowable administrative costs titled Bad Act I. The HRES version retains the ACES language. He noted the colors on the chart are as follows: Red indicates PPT language (current law) and yellow is if it was in ACES and is retained in other versions.

Mr. Dickinson explained that HRES adopted the Governor's proposal, keeping well data confidential for 2 years. The HRES version adopted the Aces language for defining "pre-existing well". The definition being that if within 2 drilling seasons wells were active they could receive the 30% credit in the next year. Under current law if a company found something in one year and went back the next, it would not longer qualify for the credits. The next provision regarding seismic data allows the commissioner of ddnr to acquire seismic data anytime before 2003, purchased with a 5% credit. This was original ACES language and is retained in HRES.

[5:30:41 PM](#)

Mr. Dickinson discussed the state purchase of credits, which was a new idea in the Governor's bill. Where there is a cap in the current law and in the HO&G version. There is no limit in the HRES version. Unlike all other versions, the HRES version allows the ARM board to purchase credits and the state then would purchase from the ARM Board.

Language regarding allowable lease expenditures from the ACES bill was adopted in the HRES version. The difference from current law is that legal expenses from disputes between state and taxpayers can not be deducted. The ACES & HRES versions disallow any dispute resolution costs.

Mr. Dickinson outlined the language regarding the "corrosion issue": In current law, .30 cents a barrel is disallowed. The intent of the language was to find a quick and easy method of addressing the issue. The Governor left in the current language, but added that unscheduled events are

disallowed. The HRES version reverted back to PPT language. Additionally, topping plant expenses are not allowed in any bill versions.

[5:34:04 PM](#)

Mr. Dickinson outlined the sections on information sharing. A set of forward looking information is required to be supplied with a penalty of up to \$1,000 a day. Mr. Dickinson expressed concern over the wording "necessary to forecast". The disclosure of tax information under current law says it must be aggregated to prevent the identification of returns. Both ACES and HRES removed the requirement and added that tax information only needs to be aggregated with two other producers. The Department of Natural Resources is allowed to share royalty information with the Department of Revenue (DOR) and allows DOR to share tax information with DNR. The penalty provisions that apply to individual departments carry over to the department who receives the information.

Mr. Dickenson went on to explain changes:

The statute of limitation section was extended to 6 years in all versions.

The provision making DOR and DNR auditors exempt was not in PPT, but is in all other versions of the bill.

The Governor's effective date would be January 2008, as is HO&G. The HRES version changes back to 2007 with a retroactive piece for loss carry forward, TIE credits and redefinition of cost to April 1, 2006.

[5:36:59 PM](#)

Mr. Dickinson addressed the last page of his presentation that outlines new provisions in the HRES version. He clarified for Representative Gara that this piece relates to the TransAlaska Pipeline (TAPS). The first issue regarding downstream costs is to replace "and" with "or" when linking the 3 criteria. He concluded that an auditor could conclude the criteria are met because only one, rather than all three, need to be met.

The language adds another audit issue defining what information can be used and under what circumstances.

[5:40:47 PM](#)

Mr. Dickinson explained that gas ceilings through 2022 are a new issue. In current law there are ceilings in the Cook Inlet for gas sales. The HO&G version expanded language to deal with non North Slope sales. The HRES version expanded language to clarify that if any gas is sold outside the

North Slope it is subject to the same ceiling as Cook Inlet. The rate and price that was in effect between April 1, 2005 and March 31, 2006 is the rate that applies.

Additional penalties were added in HRES bill. The estimated monthly payments currently have penalties, which are just the application of interest. The estimated monthly payments cannot be underestimated without penalty.

[5:42:35 PM](#)

Mr. Dickinson continued his presentation outlining the four provisions in the intent section added to the HRES version:

One is an overall statement of intent. The ACES language establishing the statute of limitations is retained. The next puts (allocates) half the money received from retroactive provisions into PERS and public education fund. The final language puts for that the tax savings from gas ceilings outside Cook Inlet should be passed on to the consumer.

[5:44:17 PM](#)

Representative Gara asked about penalties for underpayment of taxes, if they applied to just the estimated underpayment or to total payments for the year. Mr. Dickinson referenced page 18, Section 25. He interpreted it to apply to the installment payments, further noting that the final payment in March is not considered an installment payment. Representative Gara asked if there was any provision dealing with underpayment of taxes. Mr. Dickinson said there is nothing added, but current law has penalties for "willful neglect" of the law. Representative Gara asked what would happen in the situation where the state could not prove "willful neglect". Mr. Dickinson explained that there would be no penalty beyond the application of interest. He further clarified that as of March 31 the rate would be 11%, which is the Alaska statutory rate.

[5:47:46 PM](#)

Representative Kelly referenced AS 43.55.011 and asked for clarification regarding non Cook Inlet gas. Mr. Dickinson acknowledged the confusion of his statement that "the provision applied to everything except the North Slope". He corrected his statement after noting that the provision applies to everything outside the Cook Inlet used in the state.

[5:49:19 PM](#)

Representative Gara referenced page one of the handout noting the 50% cap and asked if Mr. Dickinson knew what the

price of oil would need to be to meet that cap. Mr. Dickinson did not know the answer. Co-Chair Chenault said he saw it modeled at \$107.50 per barrel.

[5:50:53 PM](#)

Representative Gara asked about the two progressivity features: the \$30 net price and the language from HRES that added a percentage of the gross. He asked Mr. Dickinson his opinion on the provision and further questioned if added percentage on gross would have an impact on investment.

Mr. Dickinson thought that having the tax measured on the net will always help the investment incentive. It does so in that progressivity does not kick in until costs have been recovered. He concluded that applying the progressivity to gross has the same effect as raising the tax rate.

He noted a Line 9, Page 1, "apply to" should include "gross".

Representative Gara further questioned the differences between progressivity on the net vs gross. He cited comparative examples and asked why it would matter whether the percentage was on gross or net. Mr. Dickinson said the state take would increase differentially because the tax base of the company making the investment would be much larger than the company not making an investment.

[5:56:09 PM](#)

Mr. Dickinson clarified the phrase "disallow bad acts I". He explained that there are two lists one in AS 43.555.02 and one in AS 43.55.023. He suggested the lists be made the same.

**GAFFNEY, CLINE & ASSOCIATES**

[5:58:41 PM](#)

RICH RUGGIER, CONSULTANT, GAFFNEY, CLINE AND ASSOCIATES INC., presented Alaska's Equitable Share. The first section outlined the four goals of the fiscal system design and the four proposals presented. The second part illustrated the way in which a representative portfolio of projects would look and how investment decisions might appear under the various proposals. In addition they offered an opportunity to review an analysis of infield drilling that was presented to other committees.

Representative Gara asked about the progressivity model and how that affected rate of return and profitability. Mr.

Ruggerio recommended that a background would be provided in order to help answer the question.

Mr. Ruggeri addressed the handout: Goals for the fiscal design (copy on file.) He observed that the challenge of addressing these goals is to know how much to take while encouraging investment through giving back (credits).

He addressed goal 3: Encourage new investment outside legacy units. He noted that the current provision provide a healthy environment to encourage investment.

[6:03:35 PM](#)

Mr. Ruggeri observed that Alaska is favorable for new investment. Additional liquid carbons that can be put down the TAPS would extend the life of Trans-Alaska Pipeline System. He asserted extending the life of TAPS should then extend the life of the legacy fields.

[6:04:27 PM](#)

Mr. Ruggiero discussed the slide: Key Point Easily Misunderstood.

The margin to price relationship changes with time and with project addition. Costs increase when fewer barrels are produced. He also gave an example of a heavy oil project where operating costs are higher in addition to a market price quality deduction.

He cautioned that when looking at what might be considered a negative for producing heavy oil, it is important to look at individual projects and how they fit into different models.

[6:06:57 PM](#)

Mr. Ruggerio addressed the next slide: Regime comparison comparing the four systems; PPT, ACES and Senate committee substitute. The chart illustrates how the base tax increases with price increase, where and how progressivity kicks in, and how that impacts corporate income tax and producer profit.

Mr. Ruggiero addressed the summary of terms based on the net margin: base, kick-off, progressivity and cap. The chart illustrated the percentages and dollar amounts in each bill version that determine base tax and progressivity.

Representative Gara referenced the chart and asked if a 50% tax cap was common world wide. Additionally, he inquired if there would be a detriment to industry to raise the cap at extreme high prices. Mr. Ruggerio informed him that the world average is in the high 60's.

[6:11:15 PM](#)

BOB GEORGE, CONSULTANT, GAFFNEY, CLINE AND ASSOCIATES INC. elaborated that with royalty added and federal and state income tax the percentage can be closer to 70%. He cautioned that with Alaska it is important to look at the totality of the tax package.

Mr. Ruggiero referenced the next chart pointing out when the tax would reach a 50% cap. He also clarified the earlier question noting that the House version reaches the cap at \$92 net margin. With current costs projections that would be a \$115 per barrel market price.

Co-Chair Chenault asked about the property tax inclusion in the model. Mr. Ruggiero stated that it was left out because it was insignificant.

[6:13:53 PM](#)

Mr. Ruggiero highlighted the slide that included the four fiscal systems. The system is plotted against margins with current oil prices above the weighted average of cost.

He noted that the Senate, House and ACES versions start with a base rate of 25% with PPT at 22.5%. He pointed out that progressivity kicks in at different rates and caps out at 50% in the Senate and ACES versions and at 47.5% with PPT.

Representative Gara asked the estimate of what progressivity would need to be under the House version to raise a similar amount of revenue to the Senate version. Mr. Ruggiero offered to provide that information.

[6:17:11 PM](#)

Mr. Ruggiero addressed progressivity impacts. He said the use of progressivity creates a sizeable difference between the effective rate and the marginal rate of tax in relation to investment decisions.

[6:19:46 PM](#)

Mr. Ruggiero highlighted the following slides and posed the example of each scenario of a company deciding to reinvest:

Taxpayer A - low margin business

Taxpayer B - high margin

Taxpayer C - low on the slope

[6:22:25 PM](#)

Mr. Ruggiero continued:

Taxpayer D - High on the slope

The handout calculates the math based on variables in each scenario.

Mr. Ruggiero further outlined his point through the next slide C & D New marginal tax rate higher. He informed the committee that this chart indicates the effect of progressivity on investment.

[6:24:24 PM](#)

Co-Chair Chenault pointed out that the models are not based off the current HRES version. He noted the leeway given to the presenters in lue of timeframe with the drafting of CSHB 2001 (RES).

Representative Kelly suggested that another curve be added to reflect the HRES version.

Mr. Ruggiero offered to run the House committee substitute with a 50% cap, but noted that there is no cap in the HRES version. Representative Kelly said that was an oversight and the 50% cap should have been in the bill. Mr. Ruggiero offered to oblige the request.

Mr. Ruggiero addressed the next slide - Progressivity and Goals 1, 2 & 3. He provided examples of the relationship between variables: production, investment and margin. He maintained that base rate plus progressivity, and the cap is a self-correcting mechanism.

[6:30:15 PM](#)

Representative Gara questioned the slide, "likely zone of operation". He asked if at \$50 per barrel is the State the largest investor on the North Slope. Mr. Ruggiero responded that when investment credits equal 50%, anything above that point, the State is the largest investor of any project.

[6:31:30 PM](#)

Mr. George explained that the net tax is based on cash flow retained by the company rather than a simple tax on profits.

- Profitability as typically described. This slide provides a simple overview of the portfolio of profitability.

- PPT based on \$53/bbl profit. This slide extrapolates out components of the PPT. He presented examples on the next several slides.
- Misconception of the net progressivity

[6:34:23 PM](#)

Mr. George presented - Understanding how "net" works. The presentation exemplified net effect on the tax rate when a company reinvests in lesser profitable field. The blended rate brings the rate down.

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Mr. Ruggiero commented on the slide titled: The Impact on the lower margin Fields is more noticeable. The effective rate on some lower-margin fields may even be lower than the basic rate (22.5% PPT) of 17.7%. This is manifested in the blended rate being lower than the weighted average rate. He underlined that this is the rate companies would consider when deciding whether to invest.

Mr. George offered to illustrate how that aspect of the portfolio would change within various versions of the bill.

Representative Gara asked how with a 25% tax rate could a field pay for less than 25%. Mr. George explained that if the field was the only one in the portfolio it would pay 25%. He elaborated that adding a less profitable field to the portfolio lowers the overall rate and brings down the blended rate.

Representative Gara asked if the reduced rate is due to the amount of money spent developing the less profitable fields. Mr. George responded that his description was one of capital investment effect. He elaborated saying it is the overall costs of production that brings down the tax rate of the portfolio as a whole. Representative Gara asked if that result is due to the progressivity factor. Mr. George replied that it was entirely due to the progressivity factor.

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Representative Kelly commented that the portion of the benefit in terms of credits is there whether you have progressivity or not. Mr. George agreed that it was the progressivity factor.

Mr. George mentioned the blending of the margin slide.

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Mr. George presented a slide explaining the function of capital investment as a function of the spending and production. He provided calculations expressing different scenarios.

[6:48:09 PM](#)

Mr. George further explained how the margin from which the tax is calculated is reduced through capital expenditure.

[6:50:44 PM](#)

Mr. George spoke to the investment credits. The affect of investment credits is to lower the tax rate further.

[6:51:40 PM](#)

Mr. George presented the slide: Tax Structure as applied under various structures. He explained that under PPT, progressivity reduced the effective rate on the less productive fields. Under ACES the tax rate on existing fields would go up, but would retain progressivity. The ACES version established a higher base rate of 25% rather than Pot's 22.5%. Though the progressivity percentage is shallower at .2%, the starting point is at \$30 rather than \$40.

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Mr. George addressed the Senate Judiciary version: He explained that the Senate Judiciary version starts at the same point as ACES, but has a progressivity of .4%. He elaborated on the point that though this results in an overall larger take, the less profitable field benefits from a lower rate. In the HRES version the progressivity sets the rate from the net cash flow per barrel, but taxes the Gross Value. The effective rate becomes higher than a "pure net" system with the same progressivity feature, but the progressive taxation of different profitability fields is maintained.

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In Conclusion Mr. George reiterated earlier comments that a net tax is a tax on a company's retained cash flow. In addition, all versions of the bill would allow fields of different profitability within the same company to have different effective tax rates. In closing, on the point of net tax, he maintained that more aggressive net progressivity provides a greater differentiation on the effective rate.

Co-Chair Chenault asked if this is a bad thing. Mr. George said that when looking at encouraging investment it could be

a good thing. He went on to say that progressivity allows producers the choice between taking cash flow to reinvest to lower the rate.

Co-Chair Chenault surmised that marginal fields receive a larger break than greater producing fields would receive. He felt that this is what is desirable as the larger fields produce less.

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Representative Gara asked if it is an accurate assessment that the higher base with a higher progressivity does more to encourage investment than the lower base and lower progressivity. Mr. Ruggiero responded that in general principal it is, however, different prices get different answers. He underlined the importance of looking at individual company portfolios information regarding existing operations and what the perceived new investment opportunities could be.

Co-Chair Chenault asked if low base tax with a higher progressivity is better for the investment climate in Alaska. Mr. Ruggiero said there are two possible results: At a lower base rate linked with net operating loss carry forward, new explorers would have greater out of pocket expense. He said that the expressed scenario would be beneficial is in smaller projects as a lower rate can mean higher profitability. Mr. George added that the steeper the progressivity the more strength you give to the investment piece whereby a producer lowers the rate thru investment.

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Representative Kelly asked about the producing of heavy oil within the legacy fields. In response to a question by Representative Kelly, Mr. Ruggiero referenced earlier examples and explained that a stand alone (outside a legacy unit) would pay 27.5; being inside the legacy unit the rate would be 17%. Representative Kelly commented that a company producing both light and heavy oil would have an effect of lowering the total tax rate for the producer. Mr. George agreed that less profitable components bring down the rate.

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Mr. Ruggiero addressed the question: Where is the tipping point in the tax that plays into economics? He commented that industry does not really supply that answer, but one thing known is that wherever industry can get more oil out of the ground that means greater profitability. The other point made is that there are many variables that come into play. All companies run economic models to decide what to pursue and what not to pursue.

[7:06:26 PM](#)

Mr. Ruggiero addressed infill drilling. He presented overall observations based on testimony from industry. Gaffney Cline agrees that there is a significant upside in the amount of existing main fields as expressed in BP testimony. He asserted that the economics of the reinvestment are extremely profitable.

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Mr. Ruggiero extracted from AOGA testimony: "the greatest challenge facing Alaska is the ongoing decline". In other parts of the AOGA testimony he pointed out that there is current investment in those fields in, infill drilling, contributing 70,000 barrels a day.

He spoke to a statement that he made at the round table that 70% of the upside comes from existing light oil. He presented a BP slide to maintain his point.

[7:09:31 PM](#)

Mr. Ruggiero referenced a hand out on Prudhoe Bay from BP: Prudhoe Bay infill drilling results. The chart outlined the relationship between costs per barrel produced.

He drew several conclusions from the information:

It is getting costlier to find according to BP data.

The oil is harder to find and more expensive to find. He referenced calculations in the handout.

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Mr. Riggerio said different sources had different numbers on the per barrel produced calculations. He emphasized the numbers are related to in-fill drilling only.

[7:12:37 PM](#)

Representative Gara asked if the quote from Pioneer noting costs at \$14 per barrel reflected both operating and capital costs. Mr. Ruggiero explained that it represents the capital costs only. He also confirmed a statement made by Representative Gara that the incremental production in Prudhoe Bay is at 4.90 per barrel.

Representative Gara followed up by asking for overall production in PB. Mr. Ruggiero reiterated that they did not have access to that data.

Mr. Riggerio confirmed additional assumptions made by representative Gara that the blended rate (capital and incremental) would render an amount less than \$4.9. He added that the economic choices companies are facing are not based on past finding costs, but on its future projections.

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Mr. Ruggiero presented a chart: 5 year Prudhoe Drilling Program. He pointed out that for every dollar BP spent on an infill well another two dollars were spent on injection and surface facilities - base case is 300% Capital expenditures. The result is a \$3.7 billion dollar program to produce the wells.

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Mr. Ruggiero referenced a chart and explained that 50% of production in Prudhoe is the result of a 5 year infill drilling program, which is incremental. On an after tax basis using 300% capital expenditures the after tax rate of return on the investment (in-fill drilling only) is a little over 60 percent.

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Mr. Ruggiero acknowledged that these numbers are high and may be questioned. His organization ran numbers with a lower price at \$50 North Slope with high progressivity, 300% capital expenditures, 200% operating expenditures, 25% discount rate. He maintained that adjusting the variables to higher stresses on the model, the calculation still results in a 56 % rate of return.

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Mr. Ruggiero offered to demonstrate the model. Representative Gara asked him to demonstrate the impact on profitability with the HRES and SJUD versions.

Mr. Ruggiero demonstrated the model with different variables per Representative Gara's request. The result was still a rate of return at 64%.

Representative Gara asked for an explanation of "rate of return". Mr. Ruggiero said it represents the amount of interest earned.

Mr. Ruggiero clarified that 300% capital expenditures represents the amount necessary to invest to produce the infill wells.

Representative Gara asked if the model could show the difference of a 22.5% and a 25% tax application.

Mr. Ruggiero explained that the change is minimal due to the fixed numbers of the past.

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Mr. Ruggiero maintained his point that robust numbers remain even with the variable of price decreasing and costs increasing and provided examples.

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Representative Gara asserted that even at \$50 per barrel a 37% rate of return is a healthy percentage. Mr. Ruggiero agreed.

Mr. Ruggiero cautioned that the model is representative only of infill drilling. He stressed that it is not the whole picture but is half of the field.

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Mr. Ruggiero spoke to the potential of heavy oil at different rates of decline and the effects on return.

[7:30:03 PM](#)

Mr. Ruggiero spoke to North Slope Potential asserting that production drives revenue. He referred to a chart depicting the relationship between decline rate, produced barrels and industry investment. He then introduced additional variables of net present value (NPV) at 10% and undiscounted NPV; cash flow with no time value of money impact. The calculations were presented in the chart.

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Mr. Ruggiero made note that in the chart the abandonment rate was set at 250,000 barrels per day. This can be arrested with investment in a new well.

Mr. Ruggiero addressed the final chart: Delaying TAPS Abandonment; Impact of abandonment rate on North Slope Recovery. He concluded that even at the highest projected decline rate of 15% and abandonment rate of 250,000, there is still the potential recovery of 1.4 billion barrels.

He emphasized the importance of investment and reinvestment in new fields, within the legacy fields, should not be underestimated.

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In summary Mr. Ruggiero said that Oil companies must show "reasonable certainty" about future investment and expected production to be able to book oil in the ground as reserves. He concluded that even with decline rate scenarios at 6% and 3% companies are able to book reserves. He maintained that if a company chose to not pursue infill drilling it would bring down booked reserves which would effect stock investments.

He also reiterated goals and pointed out that all proposed legislation meet the goals of the legislature. In addition if reinvestment is attained there would be a significant increase in barrels available from existing assets alone.

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Representative Gara asked Mr. George to elaborate on the credit system. Mr. George responded that it is a generous provision in a number of ways. For explorers, the immediate ability to monetize operating expenses and the 20% is available in only one jurisdiction. The ability is rare and attractive to the various companies. Similarly, the rate that you can deduct costs, 100% the first year, is not very common. He offered examples.

Representative Kelly asked if there was anything about the combination of credits that was of concern. Mr. Ruggiero responded that there is a possibility under a unique set of circumstances, of prolonged period of time that we would be at a predictive margin (80-90pb) above cost predicted to be there multiple years in advance such that the oil companies could make sizeable investments. In such a case, there could be a possibility that the state would pay over 100% of the investment cost. A choice of capping the State contribution might be a consideration in that case. He cautioned that the other concern is that if there is \$1 or \$2 incremental dollars moving up or down the curve, the result is the same.

He further noted that if the variables come together as mentioned, the state would have the ability to contribute in that way because the return rate would be high.

Representative Kelly commented on the plan. He asked if the administration had been adequately consulted early on. Mr. Ruggiero replied that they were asked for the worldwide view on the perspective approximately a month before presenting ACES. The views provided then are substantially the same as the ones presented. He commented that the administration did not tell them what to say and that they continue to provide advice based on their knowledge.

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Co-Chair Meyer applauded the presentation. He asked, considering the unique components of drilling oil in Alaska, are the proposed tax rates competitive for reinvestment. Mr. George responded that one of the key features on the structure of the tax is the high reinvestment incentive. It is a tax based on cash flow taxed out of the state rather than based on pure profitability. In terms of how companies will look at Alaska, companies will closely scrutinize the profitability of the margins. The system as structured does provide incentive. Companies look at political stability and exploration, but the reinvestment opportunities are substantial within the legacy fields. He further noted that the investment credits pose a significant incentive.

Mr. Ruggiero added that most companies do not just consider the tax rate and provided the example of West Africa's history and tax rate. If taxes are raised at the top end high progressivity assures the state gets a fair share. He noted that when there is a progressivity take the profitability to companies is \$100 profit per barrel.

The positive aspects of the Alaska system are an incentive within the system. He provided the example of the incentive to invest in the lesser profitable fields.

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Co-Chair Meyer agreed that the current tax system based on net, works for Alaska. He maintained that a gross tax system provides no incentive for reinvestment. He emphasized that the net is the best way to go. Mr. Ruggiero agreed.

Co-Chair Meyer asked about the existing Legacy fields and the price on heavy oil. Mr. Ruggiero pointed out that there is a posted price for oil of certain quality. He went on to say when crude meets those specifications, and then it is at market value. Heavy oil is less valuable and the market places a discount on that crude. Co-Chair Meyer asked how models could be run if the future is in heavy oil whereby providing less than market price. Mr. Ruggiero noted that it could be modeled with adding one more line in that indicates the crude quality adjustment. He referred to a chart that provides an example of a crude quality adjustment.

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Representative Gara noted that his constituents want to know why PPT underperformed. Mr. Ruggiero responded that the three components in making a prediction: price, amount of production and associated costs.

Mr. Ruggiero further pointed out that one of the provisions in the bill is the data exchange. He said that forecasting from the oil companies is critical for the state to forecast accurately.

Representative Gara asked why the information exchange provision would help. Mr. Ruggiero said if the companies share the information regarding capital expenditure this can assure revenue in the future.

Representative Gara asked if the information would provide accuracy regarding projected return. Mr. Ruggiero replied that was a difficult call due to all the variables the state uses to make that prediction.

[8:01:39 PM](#)

Co-Chair Chenault expressed concern about the \$800 million dollar shortfall and how it is being represented. He pointed out the variables that created higher costs and less production which impacts the actual number. Mr. Ruggiero agreed that increase in costs both operating expenditures and capital expenditures, decline rate which raises the per barrel costs and a significant change in market place affect and create real numbers as apposed to what is predicted. Co-Chair Chenault asked for information regarding all aforementioned components.

He also requested how many the barrels of oil were differed (not produced) due to costs. He further underlined that the positive side of those barrels being produced in the future is that with projected prices the state will receive a greater benefit.

Representative Kelly addressed the Administration's desire to adjust progressivity if the 10% floor is removed. Mr. Ruggiero understood that if the floor is removed it would need to be captured thru a progressive system. The percentage change in the progressivity comes closer to accomplishing the loss from the removal of the floor.

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Mr. Ruggiero clarified the requests made by the committee. Mr. George agreed to provide the information.

[8:07:47 PM](#)

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ADJOURNMENT

The meeting was adjourned at 8:09 P.M.