

**ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON OIL AND GAS**

February 8, 2007

3:07 p.m.

MEMBERS PRESENT

Representative Vic Kohring, Chair
Representative Kurt Olson, Vice Chair
Representative Jay Ramras
Representative Ralph Samuels
Representative Mike Doogan
Representative Scott Kawasaki

MEMBERS ABSENT

Representative Nancy Dahlstrom

OTHER LEGISLATORS PRESENT

Representative Lindsey Holmes
Senator Joe Thomas

COMMITTEE CALENDAR

PRESENTATION: DEPARTMENT OF REVENUE - PPT UPDATE

HEARD

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

JONATHAN IVERSEN, Director
Tax Division
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: Provided the presentation on state revenue and the petroleum profits tax.

CHERIE NIENHUIS, Petroleum Economist
Tax-Economic Research Group
Department of Revenue (DOR)
Juneau, Alaska

POSITION STATEMENT: Provided a presentation and responded to questions regarding fiscal year 2007 projected revenue.

GARY ROGERS, Production Audit Manager
Tax Division

Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: Answered questions.

ACTION NARRATIVE

CHAIR VIC KOHRING called the House Special Committee on Oil and Gas meeting to order at [3:07:37 PM](#). Representatives Kohring, Samuels, Doogan, and Kawasaki were present at the call to order. Representatives Olson and Ramras arrived as the meeting was in progress. Representative Lindsey Holmes and Senator Joe Thomas were also in attendance.

Presentation: Department of Revenue - PPT Update

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CHAIR KOHRING announced that the only order of business is the presentation by the Department of Revenue (DOR) on the petroleum production profits tax (PPT) update.

JONATHAN IVERSEN, Director, Tax Division, Department of Revenue (DOR), offered his assistance in answering questions that were posed at the previous House Special Committee on Oil and Gas meeting [held January 25, 2007], and in updating information regarding the petroleum profits tax (PPT) and the oil revenue picture for the State of Alaska.

CHERIE NIENHUIS, Petroleum Economist, Tax-Economic Research Group, Department of Revenue (DOR), recommended to committee members the use of the Fall 2006 Revenue Sources Book issued by DOR, as a guide to sources of revenue for the State of Alaska in the near future.

MS. NIENHUIS began the presentation by listing the sources of projected income for fiscal year 2007 (FY 07). She identified income from the four major parts of oil revenue as: royalties, bonuses, and rents of approximately \$1.5 billion; production taxes of approximately \$2.1 billion; corporate income taxes of approximately \$650 million; and property taxes of approximately \$51 million. After adding the projected non-oil income of \$580.8 million, the unrestricted general fund budget for FY 07

totals \$4.9 billion, of which \$4,331.5 billion, or 88.2 percent, is oil revenue. The forecasted price for FY 07 was \$70.00 per barrel in July. By March, and continuing for the remainder of FY 07, the forecasted price is \$52.50 per barrel. This adjustment is the result of the decline in the price of oil. Ms. Nienhuis described variances in the forecast as the year-to-date changes from the fall forecast; for example, the actual prices of oil per barrel for FY 07 have been 3.3 percent above the forecasted prices and the Arctic North Slope (ANS) crude oil production has been at 1.4 percent below the forecasted production.

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REPRESENTATIVE RAMRAS referred to [pending] lawsuits against BP Exploration (Alaska) Inc. (BP), and inquired as to whether [the Trans-Alaska Pipeline (pipeline) shut down] and subsequent increase in production due to "flushing" is reflected in the variance of production volume. He defined "flushing" as an increase in production after a capped field is re-opened.

MR. IVERSEN advised the committee that DOR cannot comment on possible damages to the State of Alaska.

MS. NIENHUIS informed the committee that she believes the production decline [due to the pipeline shut down] is reflected in the volumes of the present forecast. Therefore, if the production continues at 750,000 to 800,000 barrels a day (b/d), the forecast will be accurate.

REPRESENTATIVE RAMRAS asked: "Has there, in fact, been flushing in the field ... after it had been capped for awhile because of the incident [pipeline shut down]?"

MS. NIENHUIS relayed that she will check with the DOR petroleum engineer to answer that question.

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MR. IVERSEN began an overview of the PPT by reviewing the PPT tax calculation general formula which is: $PPT \text{ Tax Liability} = [(Value - Costs) \times Tax \text{ Rate}] - Credits$. In this formula, the value equals the volume of oil and gas produced multiplied by the wellhead value. He described the wellhead value as the value of oil on the West Coast less transportation expenses. The cost factors in the formula are capital expenditures plus

operating expenditures. The base tax rate is equal to 22.5 percent plus the progressivity factor.

REPRESENTATIVE DOOGAN questioned if the capital expenditures are counted once, as a cost, and again as an additional 20 percent credit.

MR. IVERSEN confirmed that there is a deduction on the cost side and the credit against qualified expenditures is also allowed.

MR. IVERSEN continued with the presentation by defining the credits in the PPT tax calculation formula as 20 percent of capital expenditures plus 20 percent of eligible transition expenditures, also known as transition investment expenditures, plus a base allowance that is determined by the production volume of the company.

REPRESENTATIVE DOOGAN requested that Mr. Iversen give an example of an eligible transition expenditure.

MR. IVERSEN explained that transition investment expenditures are capital investments that were made five years prior to the passage of the PPT.

REPRESENTATIVE SAMUELS advised that the intent of the transition investments expenditures credit is that a \$2 credit of capital investment made today would be the equivalent to \$1 spent in the past.

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MS. NIENHUIS added that 20 percent of five years of expenditures credit can be taken over a seven year period; therefore the equivalent is not quite \$2 to \$1.

MR. IVERSEN described the PPT true-up payment as the difference between the estimate of taxes based on the PPT, which was effective on April 1, 2006, and the estimate of taxes based on the economic limit factor (ELF). He pointed out that from April to December 2006, the taxpayers have been paying taxes based on the ELF. Therefore, due at the end of March will be a true-up payment that DOR has estimated to be \$0.95 billion, and for FY 07, this difference is projected to be \$1.2 billion, which also includes the months of April and May 2006.

REPRESENTATIVE RAMRAS commented on the dramatic increase in projected oil tax revenue resulting from the passage of the PPT.

MR. IVERSEN spoke of several questions posed during the drafting of the PPT draft regulations and informed the committee that the final review is expected to be completed by the end of March. Expected implementation of the first round of regulations is anticipated for April and the second regulation project will begin in the spring of 2007.

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CHAIR KOHRING referred to a letter from Mahoney & Associates, LLC of Anchorage, Alaska (Mahoney), that outlines serious concerns about the proposed regulations. He requested that Mr. Iversen provide the committee with DOR's reaction to the concerns expressed in the letter.

MR. IVERSEN assured committee members that comments from all sources are considered during the drafting of regulations. Mr. Iversen then turned to the questions posed by Representative Ramras during the previous committee meeting of January 25, 2007. He began by addressing the question as to whether any new activity has been seen by small producers since the passage of the PPT. Mr. Iversen relayed that because exploration plans are made well in advance, the PPT probably will not have a dramatic effect for FY 06 or FY 07. However, some taxpayers have sought credits under AS 43.55.025, Oil and Gas Exploration Production Credit Program, enacted in 2003. Taxpayers have submitted approximately \$253 million in exploration expenditures for approval with tax credit claims of about \$91 million.

MR. IVERSEN then addressed the question regarding the complexion of oil and gas exploration since the passage of PPT. He noted that new explorations and exploratory drilling plans by smaller companies were discussed in a recent article published by the Anchorage Daily News. The smaller companies mentioned were: Eni Petroleum, FEX LLC, Alaska Venture Capital Group/Brooks Range Petroleum Corporation, Anadarko Petroleum Corporation, and Pioneer Alaska, Inc.

MR. IVERSEN continued with the following question: "If, when the state opens the envelope on March 31st and it discovers that PPT did not work ... does DNR [tax division] have a plan to remedy the problem with the legislature?" He advised the committee that to his knowledge no specific plan has been made, although a legislative remedy can not be ruled out.

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MR. IVERSEN, in response to the question of an estimate of BP's deferred maintenance cost for rehabilitating the inline transmission lines, commented that BP Exploration (Alaska) Inc. (BP) has estimated \$250 million in capital costs. Furthermore, BP has indicated on its web site that it will spend a total of approximately \$550 million over the next two years for "integrity management," including replacement of the 16 miles of pipeline. He reiterated that he could not comment on how BP's costs will affect state tax revenue.

REPRESENTATIVE DOOGAN asked if the state will still realize the \$1.3 billion surplus indicated in the governor's budget bill for FY 07.

MS. NIENHUIS assured Representative Doogan of her confidence in DOR's FY 07 forecast of \$4.9 billion in total revenue.

REPRESENTATIVE DOOGAN ascertained that the PPT tax calculation credits of 20 percent of capital expenditures and 20 percent of eligible transition expenditures are calculated per year.

MR. IVERSEN confirmed that the credits are calculated at 20 percent per year, but pointed out that amount can not be greater than 10 percent of the capital expenditures for the same year.

MS. NIENHUIS further explained by giving the example of a company that spent \$50 million during each of the five years of the transition period [five years prior to the passage of the PPT] would accrue a total of \$250 million in expenditures. The total expenditures the company would then be able to claim as a credit, if qualified, would be 20 percent of the \$250 million.

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REPRESENTATIVE DOOGAN inquired as to how the first PPT payments will be made in March if the regulations are not in place until April.

MR. IVERSEN informed the committee that DOR will do its best to coordinate [payments] with the taxpayers.

REPRESENTATIVE DOOGAN said:

I understand that one of the considerations in the regulation may be allowing the taxpayer some period of time to revise their taxes ... [and if so] we won't

know the true effect of the PPT for whatever that period is because there may be changes ... then we won't know until the end of that period what the real effect of the PPT is going to be ... Is that correct?

MR. IVERSEN reminded the committee that until the regulations are final the possibility of a revision period for tax returns is unknown. However, he assured members that reasonable terms, to address difficulties in the regulations, will be negotiated with the taxpayers.

CHAIR KOHRING requested that Mr. Iversen provide the committee with information on the proposed time limit [revision period] for filing amended tax returns. He further inquired about a possible change to the accounting method of the PPT, from calculations based on gross profits to calculations based on net profits, that is being considered by the Palin Administration.

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MR. IVERSEN informed the committee that he could not anticipate legislation proposed by the Palin Administration.

CHAIR KOHRING announced to the committee that Representative Gara has sponsored [HB 89], which addresses the issue of the PPT tax calculations based on gross versus net revenue. He then asked: "Is it clearly in the statute that [regulations] would allow [BP], if they choose to ... in fact, deduct those costs [to replace the corroded lines]?"

MR. IVERSEN replied that DOR has not made a determination about the replacement costs.

REPRESENTATIVE RAMRAS requested a further explanation of the relationship between the forecasted prices and the expected amount of the true-up payment from June to December. He asked the presenters to provide DOR's estimate of the amount of revenue that can be expected from the PPT component versus the ELF measurement through the remaining months of FY 07.

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MS. NIENHUIS explained that the true-up payment is the difference between the ELF and the PPT for the period of April 1, 2006, through the end of the 2006 calendar year. At the end of March, the taxpayers will calculate taxes under the PPT and

compare that amount to what has been paid under the ELF and the difference will be the projected true-up payment of \$950 million. Revenue from the production months of January through May 2007, is incorporated in the total estimate of revenue for FY 07 of \$2.067 billion and estimated revenue under the ELF is approximately \$860 million; therefore, the true-up estimate is \$950 million and the remaining amount is production [tax] from June through May.

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REPRESENTATIVE RAMRAS asked:

[What] is the specific month-to-month comparison [of the PPT and the ELF] when [the price of oil] was at \$78.00 [per barrel]? Maybe 80 percent of that variance between the PPT and the ELF was realized in the summer months of June, July, and August and only 20 percent of that variance is realized in the other eight or nine months that make up this fiscal year ... At \$55.00 a barrel WTI [West Texas Intermediate crude oil price], I don't think the economics of PPT were that much more remarkable than the economics of ELF.

MS. NIENHUIS confirmed that the difference between the ELF and the PPT was much greater during the period of higher oil prices. She further explained that the progressivity [component] of the PPT goes into effect when the net income per barrel of oil is about \$40.00. After an allowance for transportation cost is added, the state will see a tax rate increase when prices are about \$55.00 per barrel of oil. She suggested the committee members consider the graph on page 85 of the Fall 2006 Revenue Sources Book which illustrates the additional increase to revenue when oil prices are at, or above, \$55.00 per barrel.

GARY ROGERS, Production Audit Manager, Tax Division, Department of Revenue (DOR), addressed Representative Ramras' question regarding the effect of the PPT on exploration by pointing out that much of the recent exploration is due to the exploration production tax credit enacted in 2003. A period of months or years will pass, he continued, before the effect of the PPT is seen. However, since the inception of the exploration production tax credit, one quarter of one billion dollars in exploration tax credit claims has been submitted. He added that the sunset [expiration date] of the exploration tax credit legislation has been extended to 2016.

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CHAIR KOHRING requested that DOR provide the committee the following: a model or comparison of the estimated revenues from the PPT based on gross instead of net earnings, reaction to the questions posed by the authors of the letter from Mahoney, clarification of the statutes regarding the deductibility of the expenses for upgrading the network of pipes on the North Slope, and the response from the petroleum engineer to Representative Ramras' question regarding an [increase of oil production due to "flushing"].

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Oil and Gas meeting was adjourned at 4:00 p.m.