

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON OIL AND GAS

February 22, 2007

3:03 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

Representative Nancy Dahlstrom

OTHER LEGISLATORS PRESENT

Senator Tom Wagoner
Representative Bob Roses

COMMITTEE CALENDAR

HOUSE BILL NO. 128

"An Act relating to allowable lease expenditures for the purpose of determining the production tax value of oil and gas for the purposes of the oil and gas production tax; and providing for an effective date."

-HEARD AND HELD

HOUSE BILL NO. 89

"An Act providing for the use of petroleum production and other facilities by additional entities; amending the powers of the Alaska Oil and Gas Conservation Commission; relating to oil and gas properties production taxes and credits; providing for production tax adjustments to increase the amount of tax at high oil prices, reduce the amount of tax at low oil prices, and reduce the amount of tax on the production of heavy oil; relating to the determination of the gross value of oil and gas at the point of production; and providing for an effective date."

-HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 128

SHORT TITLE: OIL & GAS PRODUCTION TAX: EXPENDITURES

SPONSOR(S): REPRESENTATIVE(S) OLSON

02/12/07 (H) READ THE FIRST TIME - REFERRALS
02/12/07 (H) O&G, RES, FIN
02/22/07 (H) O&G AT 3:00 PM CAPITOL 124

BILL: HB 89

SHORT TITLE: OIL & GAS PRODUCTION TAX

SPONSOR(S): REPRESENTATIVE(S) GARA, CRAWFORD, GUTTENBERG

01/16/07 (H) PREFILE RELEASED 1/12/07
01/16/07 (H) READ THE FIRST TIME - REFERRALS
01/16/07 (H) O&G, RES, FIN
02/22/07 (H) O&G AT 3:00 PM CAPITOL 124

WITNESS REGISTER

KONRAD JACKSON, Staff
to Representative Kurt Olson
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Introduced CSHB 128, Version M, on behalf
of the prime sponsor Representative Olson.

DON BULLOCK, Attorney
Legislative Legal and Research Services
Legislative Affairs Agency (LAA)
Juneau, Alaska

POSITION STATEMENT: Answered questions on HB 128.

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

POSITION STATEMENT: Answered questions on HB 128.

GARY ROGERS, Production Audit Manager
Tax Division
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: During hearing of HB 128 answered questions
on petroleum tax issues.

JUDY BRADY, Executive Director
Alaska Oil and Gas Association (AOGA)
Anchorage, Alaska

POSITION STATEMENT: Testified in opposition to HB 128.

REPRESENTATIVE LES GARA
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Speaking as the sponsor, introduced HB 89.

TOM WILLIAMS, Tax Attorney
BP Exploration (Alaska) Inc. (BP)
Anchorage, Alaska

POSITION STATEMENT: Expressed concern with HB 128.

ACTION NARRATIVE

CHAIR VIC KOHRING called the House Special Committee on Oil and Gas meeting to order at [3:03:22 PM](#). Representatives Kohring, Doogan, Kawasaki, Olson, and Samuels were present at the call to order. Representative Ramras arrived as the meeting was in progress. Representative Dahlstrom's absence was excused. Senator Wagoner and Representative Roses were also in attendance.

HB 128-OIL & GAS PRODUCTION TAX: EXPENDITURES

CHAIR KOHRING announced that the first order of business would be HOUSE BILL NO. 128, "An Act relating to allowable lease expenditures for the purpose of determining the production tax value of oil and gas for the purposes of the oil and gas production tax; and providing for an effective date."

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REPRESENTATIVE OLSON moved to adopt CSHB 128, 25-LS0561\M, Bullock, 2/22/07, as the working document. There being no objection, Version M was before the committee.

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KONRAD JACKSON, Staff to Representative Kurt Olson, Alaska State Legislature, sponsor of HB 128, reviewed the changes embodied in the proposed committee substitute. Version M changes the language on page 3, line 21, such that the commissioner of the Department of Natural Resources (DNR) and all of the board members of the Alaska Oil and Gas Conservation Commission

(AOGCC) are part of the consulting group. On page 3, line 22, the language relying on was replaced with taking into consideration in order to make the language more general and ease the adoption of the regulations. Mr. Jackson noted that on page 3, line 24, the language subparagraph (A), beginning on line 24, improperly maintained property or equipment was and replaced with property or equipment that was not maintained or was improperly maintained, for the purpose of clarifying subsection (a) to ensure "not maintained" or "not maintained at all" is also established as criteria. In addition, on page 3, line 27 the language a lack of was added to clarify subsection (b) such that improper or no maintenance is included. The final change was on page 3, line 29, where subparagraph (C) was replaced with the following language: incremental operating expenses incurred as a result of operating facilities or equipment at diminished capacity when that diminished capacity is caused by the lack of or improper maintenance of property or equipment. These changes were implemented after discussions between the sponsor of the Senate version of this bill, Senator Wagoner, and Representative Olson. Also consulted were the DNR, the Department of Revenue (DOR), and the AOGCC. The effects of the changes, Mr. Jackson explained, are to tighten some loopholes in the petroleum profits tax (PPT). In the sponsor's opinion, as the PPT is currently written, the people of the State of Alaska would ultimately be responsible for the cost of repairs due to "improper or no maintenance." Mr. Jackson emphasized that it is not the intention of the sponsors of HB 128 or the companion bill SB 80, to open discussion of changes to the tax structure of the PPT.

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REPRESENTATIVE OLSON commented that the issues addressed in HB 128 were not settled before enactment of the PPT last year.

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CHAIR KOHRING asked if there has been a legal opinion written on whether the retroactivity or negligence issues addressed in the bill are constitutional.

MR. JACKSON deferred to Mr. Bullock.

DON BULLOCK, Attorney, Legislative Legal and Research Services, Affairs Agency, Legislative Affairs Agency, responded that there are precedents of retroactivity of taxes; for example, the PPT

is retroactive, and Version M is drafted to coincide with the PPT.

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CHAIR KOHRING further asked if the committee should not move Version M until inquiries into the pipeline shutdown [on August 8, 2006 by BP Exploration (Alaska) Inc.] by the Department of Environmental Conservation (DEC) and other agencies, are completed and the issue of negligence has been established.

MR. BULLOCK noted that the timing issues need to be taken under consideration. He pointed out that the first filing of the PPT for taxpayers is April 1, 2007, which begins the period of time for audits and the filing of amended tax returns. As directed in Version M the commissioners of DOR, DEC, DNR, and the board members of AOGCC are the knowledgeable parties who will apply the standard of expected practices of the industry and make a determination of what is the expected behavior for maintenance.

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MR. JACKSON, in response to a question, informed the committee that the sponsor of HB 128 is not concerned with the determination of gross negligence, fraud, or misconduct. Instead, this bill is one more tool to enable the State of Alaska auditors to audit taxpayers' returns. Mr. Jackson, in response to a question from Chair Kohring, said that he believes a federal investigation into [BP's] negligence is in progress.

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CHAIR KOHRING again asked the about the possibility of proceeding with HB 128 after the results of the federal investigations into the [pipeline shutdown] are known.

MR. JACKSON responded that the legislative process, promulgation of regulations, completion of tax audits, and filing of amended returns will take time and by then the existing deadlines may not allow for more delay.

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REPRESENTATIVE SAMUELS related his assumption that the state will perform an inquiry into whether BP reached the gross negligence or willful misconduct standard and will file suit for the state's lost money. He recalled that then attorney general

David Marquez indicated that the state would move forward with an investigation. Representative Samuels inquired as to the status of the state investigation.

MR. BULLOCK informed the committee that the same issues can be dealt with by various forms; therefore, it is not unusual for DOR to be looking at the same issues as DEC. Other departments of the state and federal agencies are not contingent "one on the other" he said. With regard to tax, it is important for the state to determine what the legislature can appropriate. Therefore, time is of the essence, he opined.

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REPRESENTATIVE OLSON highlighted that CSHB 128 is not new as it was proposed in August, 2006.

REPRESENTATIVE RAMRAS related the definitions of "improper" and "maintain" from Black's Law Dictionary. He went on to say that as a co-sponsor of HB 128, he is pleased with the language in the bill and believes the court system will determine the appropriateness of the term "negligence" in future proceedings.

REPRESENTATIVE DOOGAN recalled that the phrase "improper maintenance" in the original bill was of concern for DNR and asked if that language had been removed or improved in Version M.

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MR. JACKSON assured the committee that the intention of the sponsor is to give to the commissioners of DOR, DNR, DEC, and the board of directors of the AOGCC the authority to determine the meaning of "improper maintenance" and whether credit deductions will be allowed.

MR. BULLOCK added that the additional language in Version M makes clear that to "do nothing" is also "improper maintenance", and expense deductions may not be allowed.

REPRESENTATIVE RAMRAS related the definition of "res ipsa loquitur" from Black's Law Dictionary.

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REPRESENTATIVE SAMUELS recalled that during testimony last year on the PPT, the Alaska Oil and Gas Association (AOGA) wanted

defining language added to the bill. The legislature rejected these additions to the PPT on the basis that future adjustments, if needed, were easier to correct by changes to the regulations rather than in statute. He asked:

Are [BP's] expenses going to be allowed or are they not going to be allowed? What do the regulations say and what is position of the Department of Revenue on the piece of legislation? ... We specifically wanted the regulators to have the control so that they could be more flexible.... If [the expenses] are going to allowed or not going to be allowed, are there any more regulations regarding the commercial involvement between BP and ExxonMobil [Corporation] and between BP and Conoco[Phillips Alaska, Inc.]? ... If Exxon refuses to pay BP does that automatically kick them out of our system where we would not be allowed until that lawsuit between those private entities is resolved? If Exxon and Conoco determine that there is a problem, what is going to happen commercially between the parties and does that play into the regulatory environment for the state?

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JON IVERSEN, Director, Tax Division, Department of Revenue, informed the committee that the first round of regulations for the PPT has been adopted by the commissioner of DOR and is now subject to review and change by the Department of Law (DOL) and the lieutenant governor. However, this round of regulations does not expressly address the deductions that are at issue in CSHB 128, Version M. Alaska Statute 43.55.165 addresses exclusions due to gross negligence and ordinary and necessary expenses, and will be addressed in the next set of regulations. Furthermore, he said, regulations are not written to address any specific instance or event [such as the pipeline shutdown].

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REPRESENTATIVE SAMUELS asked when the second set of regulations will be written and reviewed.

MR. IVERSEN stated that the completion of both rounds of regulations will take eight months to one year. The first round, which addresses the structure for filing, will be done by March, and implemented in April. Round two will address the lease expenditure issue. The DOR has not made any conclusions

about the deductibility of BP's [pipeline shutdown] cost. At this time, BP has not submitted claims for expenditure deductions. In addition, Mr. Iversen emphasized, claims are confidential information unless under appeal to the State of Alaska Superior Court. Referring to the commercial relationship between the parties, Mr. Iversen said that he could not comment on possible litigation; however, DOR will consider whether costs due to a non-operating working interest owner, or another party, are allowed under that agreement.

GARY ROGERS, Production Audit Manager, Tax Division, Department of Revenue, in response to a question, explained to the committee that in the PPT legislation, DOR is allowed to draft regulation regarding joint interest operating agreements. The auditors will take under consideration the fact that one party is refusing to pay until a legal dispute regarding allowable expenses is settled. The DOR auditors may need some legal advice from the Department of Law; however, the fact that parties are involved in a lawsuit is something that an auditor has the authority to examine.

MR. IVERSEN assured the committee that DOR supports CSHB 128, Version M.

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REPRESENTATIVE KAWASAKI asked, "How much power does [DOR] tax division have to currently allow or disallow the deductions like the ones we are addressing here in today's bill?"

MR. IVERSEN answered, "At this point the regulations have not been drafted ... it is based on the language of the statute and our regulations will be implementing and interpreting that."

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REPRESENTATIVE KAWASAKI then inquired as to whether taxpayers are assessed penalties for disallowed deductions.

MR. ROGERS explained that the auditors will review deductions claimed, the unit operating agreements, and the joint interest billings to obtain as much source information as possible. He remarked:

Our normal audit process is to propose adjustments, write an assessment report and if it appears to be contentious we will get the Department of Law for

review prior to issuance. ... We issue the assessments and they go up through the appeals process. Tax law is something ... that is always open to some interpretation, which is why we audit.

REPRESENTATIVE DOOGAN asked Mr. Bullock about the possibility of drafting a bill to directly address the problem of BP applying for deductions to repair the corroded transmission lines.

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MR. BULLOCK responded that the Constitution of the State of Alaska contains a prohibition against local and special acts. He continued to say:

The section that this bill proposes to amend is in Section 25 of the PPT bill. Transition language that was enacted at the same time as the PPT says that notwithstanding any contrary provisions of the Administrative Procedure Act regulations adopted by the department to implement, interpret, make specific or otherwise carry out the provisions of sections of the act that include this deductibility of lease expenditures may apply retroactively to April 1, 2006. If the DOR expressly designates in the regulations that the regulation applies retroactively to that date, some of these regulations may be applied retroactively if they state that in their [regulations].

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MR. IVERSEN, in response to a question regarding the possible redundancy of this bill, replied that he is unable to answer because the DOR has not begun the second phase of drafting regulations. He went on to say that the second phase involves the concepts that are currently in statute, which are: gross negligence, typical industry practices, ordinary and necessary business expenses, and expenses that would or would not be allowed. In response to a question from Representative Samuels, Mr. Iversen further explained that the existing statute does not expressly give the authority for DOR to write regulations that specifically apply to the present situation with BP and its corroded transmission lines [pipeline shutdown]. He stated that DOR supports CSHB 128, Version M, because it will more clearly define the authority given to the DOR.

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JUDY BRADY, Executive Director, Alaska Oil and Gas Association (AOGA), provided testimony which she said represents all the members of AOGA. She began by noting that the PPT was passed with the first goal of increasing taxes due to the state during periods of higher oil prices. This, she continued, has been accomplished; in fact, BP's projected tax revenue has increased from \$180 million to over \$500 million in nine months. The second goal of the PPT was to encourage new oil and gas exploration and production by offering credits from the state to taxpayers, thereby sharing the risks and costs. The resulting tax structure in Alaska is unique in the world. There were many questions raised about the PPT: what standards of review will be used, what costs are included, how to decide if a cost was appropriate, how the credit should be used, what the tax rate should be, and when should the progressive factor apply. On August 6, 2006, BP discovered a leak and closed Flow Station 2 of the Trans-Alaska Pipeline System (TAPS). The authorities were notified of the leak and BP suspended production for the entire field. The Alaska State Legislature House of Representatives was informed of the problem prior to passage of the PPT; however, further details of the spill raised lawmakers' concern that under the new law the State of Alaska would have to pay for the costs of a spill. As a result, the legislation regarding the identification of lease expenditures and the standards for review were closely scrutinized.

MS. BRADY continued her testimony by pointing out that final standards are based on the words that have meaning in law: fraud, willful misconduct, or gross negligence. Also not included in lease expenditures are costs of containment, control, cleanup, or removal associated with any unpermitted release of oil or hazardous substance. On August 9, 2006, the Senate Special Committee on Natural Gas Development reviewed an amendment similar to Version M, and addressed these similar difficulties: what does improperly maintained mean, what does diminished capacity mean, is there an industry standard, does an auditor decide, how can commissioners without special expertise make these determinations, does there have to be an incident like a spill, or does the state begin to regulate costs of maintenance in any circumstance. Ms. Brady pointed out that this, and a similar amendment, did not pass last session. She referred to another amendment based on a written opinion from Dr. Pedro van Meurs that suggested that maintenance costs are a reasonable deduction from PPT; however, a solution may be to have a 30 cents per barrel of oil exclusion, which is to be paid

by every producing taxpayer whether there is an incident or not. The exclusion will mean that individual decisions would not have to be made about improper maintenance as the exclusion would be the gross negligence standard. This amendment was adopted. Ms. Brady pointed out that the legislature is not debating whether or not to again amend the PPT to drop the 30 cent per barrel exclusion. What is being proposed, she continued, is a per-activity decision about whether maintenance was proper in addition to the flat surcharge. The PPT was passed and industry would like to work with lawmakers to understand and implement the existing law. The AOGA is concerned about CSHB 128, Version M. for the following reasons: the state is already protected from being inappropriately charged with lease expenditures that are the result of a spill; there are potentially significant implications for the entire state; it is an ex post facto law; and it creates ambiguity of language related to cost and credits. She also noted that the bill is being written based on the assumption that the transition lines [at Prudhoe Bay] were improperly maintained by BP. This assumption constitutes a judgment of conduct by BP and Atlantic Richfield without ruling by the court or the results of federal and state regulators. The members of AOGA believe that companies, like individuals, are innocent until proven guilty. She then commended BP on its long and successful history in Alaska.

MS. BRADY reiterated AOGA's concerns about HB 128. She remarked:

AOGA's concerns are as follows:

1. The state is already protected from being inappropriately charged with lease expenditures as a result of spill incidents under the current law. It specifically disallows costs arising from fraud, willful misconduct, or gross negligence. This bill, in contrast, would introduce a completely new subjective term for judging whether maintenance related costs would be lease expenditures and this new term would be "improperness" of the maintenance in question. The already existing statutory terms, willful misconduct, gross negligence, ordinary necessary costs, direct cost of exploring, developing, producing, are already clearly defined.... To the extent that the concept of improper maintenance is encompassed by any or all of these other, already existing, statutory terms it is superfluous; to the extent it may mean something different than the term that is already in statute the concept of improper

maintenance is ambiguous.... These implications go statewide. Prudhoe Bay marks the 30th anniversary of the start of production; Cook Inlet has fields [in production] for 40 or 50 years. Corrosion is not a problem unique to the fields on the North Slope. But is a challenge everywhere you have structures and facilities made of iron and steel. ... There are operations in the [Cook] Inlet area that will need to be replaced or significantly repaired in order to remain in operation. ... HB 128 does nothing to protect them from claims that they were improperly maintained ... the uncertainty could lead to fields of facilities being permanently shut in instead of remaining in production.... The third [concern] is that ex post facto legislation is forbidden under the federal and Alaska constitutions. I will quote Black's Law Dictionary "[Ex post facto] is a law passed after the occurrence of a fact or commission of an act which retrospectively changes the legal consequences or relations of such a fact or act." We know that HB 128 has two sections that are retroactive and, again, that is something the Department of Law will have to take a look at.

House Bill 128 refers to the standard of practice that is never used in terms of how you decide how something was done or not because it changes all the time. ... The question of what costs are deductible is central to the concept of the PPT as an incentive to investment and new production. ... If HB 128 passes the question of what costs are deductible become open at each audit. Auditors will be obligated to test each cost submitted under a standard of improperly maintained or diminished capacity. ... The legal analysis will be huge, costly, and will not get you where you want to go.... AOGA wants to avoid long years of court battles over the application and interpretation of statute and regulations... We [the state] need to be able to write legislation and regulations that are clear and workable.

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REPRESENTATIVE RAMRAS thanked Ms. Brady for her testimony and then remarked:

The reason we [passed] the PPT is because we were looking for the "fiscal certainty on oil" piece. ...

I have asked BP repeatedly to do the right thing.... Frankly, I find that the behavior of BP and their posture now to charge off these expenses or to count on litigation is reprehensible behavior. I do not think that they are demonstrating good corporate citizenship and I do not think that they are honoring the intent of the PPT. HB 128 may not be necessary if BP will step up and do the right thing and recognize that there was a gap in maintenance and that they behaved poorly and that they should own up and take care of the lines and not charge them off as a special PPT credit. I hope this bill moves to the floor so we can have whatever litigation test that we are going to have. ... I would encourage AOGA to go back and pass, without dissent, a request to have BP pledge to do the right thing in this case and that would address and remedy this problem.

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MS. BRADY responded by saying that to assign guilt and write law before the Department of Transportation & Public Facilities (DOT&PF) and DEC release findings creates a very serious problem. Until the facts are known about what happened on the North Slope, she stressed, it is irresponsible to pass a law at this point, especially a law that creates chaos and serves to negate the process of law that is already written.

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REPRESENTATIVE RAMRAS recalled that the Exxon Valdez oil spill settlement (EVOS) determined that ExxonMobil Corporation employees were responsible for their actions. He noted that sometimes a large organization has to pay the price for one weak link in the chain.

REPRESENTATIVE OLSON opined that there is a pattern of poor maintenance by BP on the North Slope and system wide.

REPRESENTATIVE DOOGAN asked Ms. Brady to explain how the 30 cent per barrel of oil tax credit exclusion will offset the costs of the [pipeline shutdown].

MS. BRADY replied that the purpose of the 30 cents per barrel tax credit exclusion is to tax for capital expenditures that are a part of everyday operations. This tax exclusion acts like a flat tax and is a common remedy in other parts of the world.

MS. BRADY referred to a memorandum from Dr. Pedro van Meurs to Senator Wagoner dated August 5, 2006. Dr. van Meurs wrote:

Another concern that is regularly expressed is that the state should not permit the deduction of costs related to replacing equipment that is becoming defective or gathering lines that need to be replaced because of corrosion or other problems. The argument is that these assets should have been maintained in the first place. It should be noted that most oil and gas fields' assets will have to be replaced after the technical life of such assets has expired. Therefore, such replacements are reasonable lease expenditures and are required to protect the health and safety of the workers and to protect the environment. Nevertheless, it is possible to exclude them from the lease expenditures if this is politically desirable. ... Companies that re-invest strongly are therefore harmed less by this provision than typical harvesters.

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MS. BRADY concluded by advising the committee that, unlike HB 128, the 30 cent per barrel tax credit exclusion will pay for assets that need to be replaced, except in a case of gross negligence.

[HB 128 was brought up again later in the meeting.]

HB 89-OIL & GAS PRODUCTION TAX

[4:19:15 PM](#)

CHAIR KOHRING announced that the next order of business would be HOUSE BILL NO. 89, "An Act providing for the use of petroleum production and other facilities by additional entities; amending the powers of the Alaska Oil and Gas Conservation Commission; relating to oil and gas properties production taxes and credits; providing for production tax adjustments to increase the amount of tax at high oil prices, reduce the amount of tax at low oil prices, and reduce the amount of tax on the production of heavy oil; relating to the determination of the gross value of oil and gas at the point of production; and providing for an effective date."

REPRESENTATIVE LES GARA, Alaska State Legislature, sponsor of HB 89, informed the committee that there are two major ways to tax oil. The first is by taxing the taxpayers on the profit from production and the second is to tax on a percentage of the sales value of the oil. The latter system is known as "taxing on the gross." With budget deficits approaching, he explained, "taxing on the gross" is the best way to obtain the maximum possible benefit for Alaskans from resource development. He said he believes there are several reasons to support HB 89. First, when compared to the world average tax rate on oil, the PPT will result in tax revenue to the state of about \$1 billion less per year. Secondly, Alaska's political stability is a benefit to the producers; there is no threat of a coup or nationalization of assets. Additionally, the PPT allows the North Slope producers to deduct the cost of developing gas production facilities before the production of gas begins. The estimated cost of the development of the gas field is \$9 billion; therefore, a 40 percent gas line development deduction is estimated to equal between \$200 million and \$300 million per year. This amount will be subtracted from oil tax revenue during the development years. Representative Gara observed that once a gas pipeline is built there is no reason to give a company a subsidy for developing its gas field, as there will be no risk to do so. Finally, the development and exploration deductions allowed under the PPT are unknown, unpredictable, and will impact revenue income for the state. The PPT is a profit-based tax that allows the opportunity for companies to deduct costs, thereby reducing tax revenue due to the state. Representative Gara described HB 89 as a law designed to determine a tax rate closer to the world average, to provide fair incentives for new exploration, and to address the problem of facilities access. Regarding the problem of facilities access, he reported that initial data from DNR suggests that more oil can be developed on the North Slope if independent companies had access to the existing processing facilities. The North Slope processing facilities are filled to capacity with high water content oil from older fields. ConocoPhillips Alaska, Inc., ExxonMobil Corporation, and BP own most of the facilities and are unwilling to provide access to their competitors who are producing higher oil content oil from newer fields. This bill, Representative Gara acknowledged, may not be the best way to address the facilities access issue. However, HB 89 includes production incentives, one of which is a tax exemption of the first 7,500 barrels per day produced by smaller fields. Representative Gara said that the tax rate set by HB 89 is designed to raise tax revenue at higher oil prices. The tax rate begins at 15 percent gross tax when the price of oil is at

\$35 per barrel of oil. For every \$1 increase in the price of oil per barrel there is an approximate increase of one-third in the tax rate percentage. If the price of oil falls to below \$20 per barrel, the tax rate percentage will decrease proportionately. In conclusion, Representative Gara urged the committee to consider the following: HB 89 seeks to tax the oil producers at the world average in a verifiable way; it will not encourage surprise deductions for questionable expenditures; and it will not require hiring a team of accountants for implementation and enforcement. The PPT, Representative Gara emphasized, will increase tax revenue in the short term; however, it provides for a \$4 million subsidy to build the gas pipeline. This subsidy, he cautioned, will come at a time of reduced state revenue; furthermore, it is only available to major North Slope lease owners.

CHAIR KOHRING stated his support of the concept of HB 89; however, he said he is strongly opposed to greatly increasing taxes to the oil producing industry. He announced that HB 89 would be held over for public testimony.

HB 128-OIL & GAS PRODUCTION TAX: EXPENDITURES

CHAIR KOHRING returned the committee's attention to HB 128.

TOM WILLIAMS, Tax Attorney, BP Exploration (Alaska) Inc. (BP), informed the committee that he was previously employed by the State of Alaska and he wrote many of the original oil and gas tax regulations. In addition, he and former Alaska Attorney General Wilson Condon developed the theory that the value of oil and gas is different than the price at which the producers sell it. As former commissioner of DNR, Mr. Williams related that he was responsible for administering all tax laws for the state, but he said he is here today to represent BP and to testify regarding HB 128. Mr. Williams expressed his belief that the decline in the production of oil is a long-term menace for the state. The future challenge that faces the oil and gas production industry and the state is how to deal with the decline. The only answer is for the producers to spend more money in the following ways: to recover more from the existing fields; to explore for new fields; to explore for heavy and viscous oil; and to explore for natural gas. Mr. Williams explained that the reason the state developed the economic limit factor (ELF) tax, instead of a flat tax on the gross revenue, was to compensate for the higher cost of extracting oil from older oil fields. Early production at Prudhoe Bay began with an average of 1.2 million barrels a day from 120 wells; production

now averages about 400,000 barrels a day from about 1,000 wells. Mr. Williams pointed out that more gas and water is mixed with the oil from older fields, which increases production cost. With the passage of time, the ELF is no longer an accurate representation of the economics of oil production. This is especially true, he said, during periods of higher oil prices because the costs of production do not vary in direct proportion to the cost of oil.

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REPRESENTATIVE RAMRAS acknowledged Mr. Williams' expertise and then asked:

How much money are we talking about addressing here with HB 128? ... What is the dollar amount on the table that we are discussing if we use just as a hypothetical number \$200 million ... [after] you get the federal deduction and then the question is about taking the second deduction as a credit to be applied ... How much [in savings to BP] are we talking about if [BP's deduction] is \$200 million?

MR. WILLIAMS responded that BP's share of the deductions and credits associated with the cost of inspection, business resumption, and replacement of the oil transit lines will result in a total deduction of around \$11 million in 2006.

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REPRESENTATIVE RAMRAS requested that Mr. Williams provide computations of the cost to the industry in 2006, 2007, and 2008 as a result of the impact of HB 128.

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MR. WILLIAMS answered that there would be an \$11 million savings for BP from the PPT. He advised that the value of the deduction from federal income tax is a savings of 35 percent of \$11 million.

REPRESENTATIVE DOOGAN asked Mr. Williams to also include in the computations requested by Representative Ramras an estimate of the portion of the costs that are credits.

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MR. WILLIAMS reminded the committee that tax materials are confidential and the disclosure of BP's tax records is limited.

REPRESENTATIVE DOOGAN opined that that the full disclosure [of BP's tax position] is in the interest of all parties.

[4:50:00 PM](#)

MR. WILLIAMS said:

If the \$11 million were all capital expenditure and this is purely a figure that reflects the value as a deduction, then 20 percent of the capital expenditure is also a credit. So that would be \$2.2 million, that is the most it could be, that is assuming that the \$11 million figure is only the value of the deduction and does not already include the credit and assumes that all of the money that gave rise to the \$11 million figure was capital in nature, to the extent that there is operating cost there; those would not give rise to a credit.

REPRESENTATIVE SAMUELS asked:

If your [unit agreement] partners disallow their ... portion of the expense, is BP then on the hook for the entire amount? ... Would BP be able to deduct the entire thing and pass the expenses on to them ... do they pay a portion of the total expense? If [Exxon and Conoco] refuse to pay what happens to your tax bill?

[4:51:31 PM](#)

MR. WILLIAMS explained that if a taxpayer has incurred an expenditure, the expenditure can be deducted. If the unit partners have not paid, an expense has not been incurred. He stressed that BP wants to calculate the right amount of taxes and deductions and pay its share. He then returned to the subject of the PPT and assured the committee that the PPT is working as intended. The regulations are being finalized and the process by which credits and deductions are calculated is in place. The industry knows what the requirements are and will be able to comply with the PPT on March 31, 2007. At this time, he said, the revenue BP paid under the PPT increased to over \$500

million. Mr. Williams noted that the primary purposes of the PPT were to increase the tax rate and to encourage new investments by the taxpayers; however, the industry does believe that the tax rate is too high. This belief is supported by the fact that Alaska has adopted the highest marginal tax rate in North America.

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CHAIR KOHRING pointed out that Alaska's tax rate of 22.5 percent is far above Louisiana's tax rate of 12.5 percent.

REPRESENTATIVE SAMUELS stated that the purpose of the PPT is to increase the state's tax rate when oil prices are high and to decrease the state's tax rate when oil prices are low.

MR. WILLIAMS confirmed that under the PPT, if the price of oil is \$20 per barrel, tax revenue for the state is zero.

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REPRESENTATIVE DOOGAN, referring to the graph provided by Mr. Williams, asked if Alaska's 61.5 percent marginal tax includes royalty income.

MR. WILLIAMS confirmed that this figure includes royalty income. He then expressed his concerns with HB 128 and the draft CS. Referring to page 3, paragraph (19) subparagraph (A), he noted that costs related to the repair and replacement of property or equipment that was not maintained or was improperly maintained are disallowed. He pointed out the difficulty in interpreting the term "related". When there is the potential for ambiguity, he said, investments become too risky or uneconomical for investors to make. Mr. Williams pointed out that subparagraph (B) creates a penalty or disincentive against spending money to maintain the operational capabilities of facilities that are shut down; therefore penalizing a producer for getting a closed oil field back into production. A similar disincentive to industry is written in subparagraph (C), which disallows the expense of incremental operating expenses incurred as a result of operating at diminished capacity. Mr. Williams suggested that a better way to deal with improper maintenance is to create standards by a regulatory agency.

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REPRESENTATIVE DOOGAN asked:

Don't you suppose that when there was a mishap that closed down the production capability of half of the largest oil field in North America, that the decision by the operator about whether or not to open it back up again would be made on a basis other than what the State of Alaska tax law might be?

MR. WILLIAMS reminded the committee that a business can not ignore the laws of economics or the tax implications of its decisions.

[5:08:45 PM](#)

REPRESENTATIVE RAMRAS suggested that those who are testifying in opposition to HB 128 should contact Mr. Suttles, President, BP Exploration (Alaska) Inc.

MR. WILLIAMS assured the committee that the executives at BP will take action to fulfill the promises that have been made [regarding the pipeline shutdown] to the U.S. Congress and the people of the State of Alaska. He continued to say that HB 128 creates law that may be in effect for 30 years and should not be enacted as a reaction to a specific incident.

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REPRESENTATIVE RAMRAS expressed his belief that HB 128 will become the law of the land precisely because of BP's decision to submit the costs of [the pipeline shutdown] for credit under the PPT.

[5:11:49 PM](#)

REPRESENTATIVE OLSON remarked:

Had the lines been pigged, the feeder lines that failed, since [BP] took them over from [Atlantic Richfield Oil Corporation (ARCO)], we wouldn't have HB 128. ... When was the last time the feeder lines were pigged, and were they pigged since you took them over from ARCO? Please get an answer and provide it to our chair.

[5:13:02 PM](#)

CHAIR KOHRING stated that he concurred with Ms. Brady's and Mr. Williams' comments. However, considering the cost of litigation and the proposed legislation, BP might consider looking to pay the costs [of the pipeline shutdown].

[5:14:28 PM](#)

MR. WILLIAMS assured the committee that he only represents BP and that his remarks are meant to call attention to the future impact of HB 128 on Alaska. Mr. Williams closed by strongly recommending that lawmakers wait for a five year period under PPT to see what happens before making changes.

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REPRESENTATIVE DOOGAN stated that he feels HB 128 does not just apply to [the pipeline shutdown] but must address what the state must do in similar situations.

[5:18:47 PM](#)

REPRESENTATIVE SAMUELS stated that he still has questions for the Department of Law and Mr. Iversen of the Department of Revenue regarding HB 128.

CHAIR KOHRING announced HB 128 would be held over with public testimony open.

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Oil and Gas meeting was adjourned at 5:21 p.m.