

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

March 21, 2007

1:07 p.m.

MEMBERS PRESENT

Representative Carl Gatto, Co-Chair
Representative Craig Johnson, Co-Chair
Representative Vic Kohring
Representative Paul Seaton
Representative Peggy Wilson
Representative Bryce Edgmon
Representative David Guttenberg
Representative Scott Kawasaki

MEMBERS ABSENT

Representative Bob Roses

COMMITTEE CALENDAR

Presentation: NCSL/USDA

- HEARD

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

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
02/22/07	(H)	Heard & Held
02/22/07	(H)	MINUTE(O&G)
03/01/07	(H)	O&G AT 3:00 PM CAPITOL 124
03/01/07	(H)	Moved CSHB 128(O&G) Out of Committee

03/01/07	(H)	MINUTE(O&G)
03/05/07	(H)	O&G RPT CS(O&G) 3DP 1NR
03/05/07	(H)	DP: DOOGAN, RAMRAS, OLSON
03/05/07	(H)	NR: SAMUELS
03/19/07	(H)	RES AT 1:00 PM BARNES 124
03/19/07	(H)	Heard & Held
03/19/07	(H)	MINUTE(RES)
03/21/07	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

DOUG FARQUHAR, Agriculture & Rural Development
National Conference of State Legislatures (NCSL)
Denver, Colorado

POSITION STATEMENT: Discussed the role of state legislatures in revitalizing rural America.

KEVIN BANKS, Acting Director
Division of Oil & Gas
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: Testified in support of HB 128.

JONATHAN IVERSEN, Director
Anchorage Office
Tax Division
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: During hearing of HB 128, answered questions.

ROBERT E. MINTZ, Attorney at Law
Kirkpatrick & Lockhart Preston Gates Ellis LLP
Anchorage, Alaska

POSITION STATEMENT: During hearing of HB 128, answered questions in his capacity as an attorney for the Department of Revenue and the Department of Law regarding production tax matters.

DON BULLOCK, Attorney
Legislative Legal Counsel
Legislative Legal and Research Services
Legislative Affairs Agency
Juneau, Alaska

POSITION STATEMENT: During hearing of HB 128, spoke as the drafter of the legislation.

ACTION NARRATIVE

CO-CHAIR CARL GATTO called the House Resources Standing Committee meeting to order at [1:07:08 PM](#). Representatives Gatto, Johnson, Edgmon, Seaton, Wilson, and Kohring were present at the call to order. Representatives Kawasaki and Guttenberg arrived as the meeting was in progress.

Presentation: NCSL/USDA

[1:07:27 PM](#)

CO-CHAIR GATTO announced that the first order of business would be a presentation from the National Conference of State Legislatures (NCSL) and the United States Department of Agriculture (USDA).

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DOUG FARQUHAR, Agriculture & Rural Development, National Conference of State Legislatures (NCSL), began by informing the committee that he has been with NCSL since 1991. In about 1998 he said he began working with USDA and the Kellogg Foundation regarding rural development issues. There is a wide diversity in rural America in that what is rural in some parts of the country isn't in others. Furthermore, the rural think tanks address ethanol and corn, but don't address mining, oil and gas, timber, and fisheries, he highlighted. Mr. Farquhar then turned to his PowerPoint presentation titled "Revitalizing Rural America: The Role of State Legislatures." He turned to slide 2, and emphasized that rural legislators are becoming rare and reviewed the redistricting proposals of Colorado, Nebraska, and Texas. He related that generally census data goes against rural legislators.

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MR. FARQUHAR pointed out that many states have created rural caucuses. These rural caucuses have been established to ensure that rural issues don't get lost in the legislative process and maintain services and resources for the rural areas. Mr. Farquhar moved on to slide 4 and opined that the federal farm policy isn't supporting widespread rural economic development and growth. For many states, the farm bill will be dramatically different, which he attributed to the lack of budget, the

country's trade partners saying that subsidies can't be given, and corn doesn't need subsidies. He highlighted that if there isn't a decision by September 30th and a farm bill isn't passed, it reverts back to the 1948 farm bill. He then opined that the natural resources economy isn't effectively addressed by the federal government but rather seems to be "locked up" in the Department of Interior, the Bureau of Land Management (BLM), and the U.S. Forest Service. He surmised that Alaska is very frustrated that the federal government controls most of the land in the state, which is an issue for all Western states. The aforementioned isn't effectively addressed in the rural discussions, and therefore he expressed the desire to work with the committee on that. He informed the committee that there's going to be a Rural Summit paid for by the Kellogg Foundation to discuss rural issues with Congress, but he's having difficulty getting the issue of federally controlled lands on the agenda.

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MR. FARQUHAR moved on to globalization, and suggested that there's no way to not integrate globalization into the rural economy because there are major impacts to rural areas. For example, the country's manufacturing base is moving overseas. Furthermore, the trade barriers that once existed are no longer. The basic barriers were tariffs or an individual at the port saying the item couldn't enter. Now, there must be an exact reason why an item can't enter and there must be lawyers and economists to support it.

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MR. FARQUHAR emphasized that trade agreements and states aren't in agreement with one another. Furthermore, [trade agreements] haven't been good for the states, from a state policy-making view. Although he acknowledged that [trade agreements] have been good for the economy overall, states need to be able to address situations when a state law is repealed because of trade agreements with other countries. With regard to changing rural policy, Mr. Farquhar expressed the need to frame issues for the rural economy, particular to the state. For instance, those in rural Alaska can't grow corn, and therefore there needs to be a new way to define rural development. He then shared a map of Alaska that highlights the extensive amount of lands held by the federal government in the state. The aforementioned has to be brought forward because rural development in Alaska can't be addressed the same as states with little to no federally controlled lands. Turning to slide 6, he highlighted the

federal laws that apply, which limit what Alaska and many Western states can do on federal lands.

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MR. FARQUHAR, referring to slide 7, emphasized that the economy in rural America is lagging behind. Furthermore, the natural resource economy is extremely difficult to maintain. He then directed the committee's attention to slide 8 titled "Counties with net out migration, 2000-03," which illustrates where people are moving out of and to. The map on slide 8 illustrates that people are leaving the rural areas and moving to the more urban areas. In fact, the only places growing in Alaska are around Anchorage, which he surmised that the committee members already know.

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CO-CHAIR GATTO inquired as to why Southeast Alaska doesn't prosper more. He asked if it's due to transportation issues.

MR. FARQUHAR answered that Southeast Alaska is a natural resource economy and much of the land is held by the U.S. Forest Service. There is very little land available in Southeast Alaska, over which the state has control. If the scenario was switched, there would be changes. For example, in Colorado counties where the federal government has allowed economic development to occur there has been expansion. In fact, the North Central portion of Colorado is experiencing a boom because of natural gas development. The aforementioned was a decision by the federal government, he emphasized.

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REPRESENTATIVE SEATON commented that on all of Alaska's resource-based industries, the market prices have been an issue. He echoed Mr. Farquhar's earlier comments regarding the impacts of trade agreements. Representative Seaton clarified that federal government ownership hasn't been the only problem.

MR. FARQUHAR said that goes back to his point about globalization. There are much cheaper areas to produce everything, especially when the areas [outside the U.S.] don't have to pay the costs required in the U.S. such as environmental studies, health care, etcetera. He pointed out that if a business has to purchase a certain product, it may be more economical to purchase it from another country. The

aforementioned really hits the rural economies. Mr. Farquhar said that although he doesn't have an answer, he emphasized that states often don't have people at the table when trade agreements are discussed.

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MR. FARQUHAR moved on to slide 9, which highlights that states can't give a preference to local purchasers. The question, he reiterated, is how can it be equal when those in the U.S. have to pay labor, health, and safety costs that aren't required in other countries. He then turned attention to the FRTC v. Natios case, which was the result of a Massachusetts law passed in 1980. The law said that anyone doing business with the country of Burma and the State of Massachusetts would be assessed a 10 percent penalty, fee, which would be used to educate people about the atrocities in Burma. Originally, Switzerland brought suit against the U.S. to overturn the Massachusetts law. The case ultimately went to the U.S. Supreme Court, which ruled that trade agreements are federal foreign policy and states don't have a role. Basically, the law was repealed. From a legal standpoint, most trade agreements don't give an individual the right to sue a state but a country can file suit against the entire U.S. This case dramatically changed the dynamic as it allowed an individual company to bring suit against a state over a trade agreement negotiated by the federal government on an international basis.

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MR. FARQUHAR then turned to the issue of local food preferences within a state. Although there are 20 states that have adopted laws with regard to local food preferences, those laws are all in violation of this trade agreement. He surmised that as long as there is no case or controversy, things are fine. [In relation to Alaska's position on this matter], he said that he still thinks about Canada's lumber dispute and salmon and questioned whether it will come back to haunt Alaska.

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MR. FARQUHAR moved on to slide 10 regarding U.S. exports and imports. He pointed out that 20 percent of all imports are coming into the U.S. In fact, Wal-Mart is the number one purchaser of products from China. He said that Wal-Mart is the one single company that has turned the Chinese economy around. The U.S. has about 12 percent of the world's exports, which is

agriculture and Boeing. He emphasized that the natural resource economy, on which Alaska is based, is not coming in from countries besides the U.S. Slide 11 titled "State Rural Agencies" relates the agencies being created in other states to address the aforementioned problems. He highlighted that in the late 1980s the Governor of North Carolina created the North Carolina Rural Economic Development Center. The goal of the center was to identify the problems in rural areas, bring those issues to the forefront, and obtain more federal resources into rural North Carolina. The Center for Rural Pennsylvania was created along the same lines as the North Carolina Rural Economic Development Center. He noted that rural areas are inherently not as well represented in Congress and they don't receive as much attention among the federal agencies. Therefore, one must determine how to bring the data forward into a rural context in order to discuss the problems. He then directed the committee's attention to slides 12-14, which highlights legislation regarding rural economic development in various states. The point, he said, is that state legislatures are beginning to take a role in rural economic development by providing tax incentives, enterprise zones, and loans. In fact, this year North Dakota is going to provide \$500,000,000 to fund farmer's markets.

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MR. FARQUHAR informed the committee that Canada and Idaho have taken an aggressive approach with regard to addressing their rural constituencies. Idaho put together a document profiling rural Idaho in an effort to provide the data necessary for rural areas to apply for grants and loans. He mentioned that many states are identifying a single state employee who is dedicated to getting federal money to rural areas. That employee's job is to design the data in a manner that's attractive to gain rural dollars. Canadians are very aggressive because their economy is based on trade, which will prove to be a difficulty for many of the states that have the same economic base as Canada. The aforementioned is something Alaska may want to consider. In conclusion, Mr. Farquhar inquired as to the types of topics and comments he needs to take to the USDA and the Kellogg Foundation to meet the needs of rural Alaskans.

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REPRESENTATIVE EDGMON pointed out that a key point lacking in the presentation was the cost of energy, which can make or break a company's decision for going into Bush Alaska. Furthermore, a

good portion of Bush Alaska and Alaska isn't connected via the road system and thus every component of rural Alaska is different than rural areas elsewhere.

MR. FARQUHAR noted his agreement that the price of oil has an enormous impact in rural areas, although it affects everyone. He mentioned that small businesses have had to relocate from rural areas to larger areas because of transportation issues. There is no easy answer, he opined.

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CO-CHAIR GATTO highlighted that general aviation is essential in Bush Alaska and the federal government just added \$.50 a gallon on general aviation fuel. For those in the Bush, that tax is devastating.

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REPRESENTATIVE WILSON related that her husband lives in the Bristol Bay area, which isn't even considered a village, where the cost of something is by weight [due to transportation costs] and thus it drives up the prices. For instance, a head of cabbage can cost \$9 in some areas. Furthermore, gasoline in some of these areas is \$6 a gallon. Although Southeast Alaska can obtain things by boat, it's not a dependable system. She then highlighted that the majority of land in Southeast Alaska is in the Tongass National Forest and there's plenty of forest that could be cut and it could renew itself. However, the federal government has cut back what logging can be done. Therefore, Alaska really needs relief with regard to economic development on federal land.

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MR. FARQUHAR returned to the production of ethanol and the high price of corn. However, the only reason ethanol is being made from corn in the U.S. is due to the \$.50 a gallon subsidy and a certain amount of ethanol comes in from Brazil. The ethanol made in Brazil is made much cheaper and the U.S. has a barrier on the amount of Brazil's ethanol that can be imported into the U.S. He related that his friends at the National Renewable Energy Laboratories who say that what is good [to make fuel] is wood. Furthermore, the wood doesn't need to be of great quality, as what's left after a fire can even produce fuel. Although it takes a while to get these technologies going, Wall Street is very excited about this. The natural conditions to

grow trees at a fast pace occur in Southeast, which could result in some exciting things. However, the situation remains that Southeast Alaska legislators have to represent those in Southeast Alaska while decisions are made in Washington, D.C. Mr. Farquhar reminded the committee that he is asked to speak about what state legislatures think about rural development and what's been discussed today is often what he brings up. He noted that in particular he specifies that state legislatures should be able to make the decisions. Furthermore, technology can provide some great opportunities, he mentioned.

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CO-CHAIR GATTO said that he discussed some options for rural areas with Mr. Farquhar. To that end, the presence of a windmill could be enormously beneficial. He then highlighted Galena, which is using nuclear to make steam to run a turbine. Furthermore, wood chips can be used as can fish oil for making biodiesel.

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MR. FARQUHAR commented that he didn't discuss healthcare and education via the Internet. In fact, the biggest thing for economic development has been the Internet and cell phones. Furthermore, there are rural school districts in Colorado that have closed their school buildings and provide instruction via the Internet in their homes. He related that he teaches courses on line for the University of Denver. Healthcare is taking that same path by utilizing the Internet. This is part of rural development, he emphasized.

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CO-CHAIR GATTO turned to the pharmaceutical industry and informed the committee that a French company contracted with American farmers to grow genetically modified corn that produced a drug to treat cystic fibrosis. The aforementioned was much less expensive than synthetically producing the drug. However, the genetically modified corn has to be confined and can't get out. Co-Chair Gatto opined that the aforementioned wouldn't be a problem in Alaska.

MR. FARQUHAR noted that there is controversy with genetically modified corn because if it gets out [there are problems]. The corn stock is designed to produce a lot and thus not much is necessary. Furthermore, it can be grown in greenhouses.

CO-CHAIR GATTO related his belief that an individual with one acre of land in Alaska could have a farming operation. He then related that he is searching for help in the really rural areas of the state.

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MR. FARQUHAR pointed out that there are some parts of the world that cannot get decent food, such as Bethel. However, that's not on the [USDA's] radar at all because it views rural areas as having bountiful food. In fact, New Mexico has initiated an effort to utilize farmers' markets from which fresh produce is shipped to rural areas that don't have fresh produce.

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REPRESENTATIVE WILSON inquired as to who is paying for it to be shipped.

MR. FARQUHAR answered the state legislature appropriated the funds.

REPRESENTATIVE WILSON then inquired as to what occurs when the majority of the legislators are in a railbelt and don't want to fund things for other areas.

MR. FARQUHAR said that such a situation exists in New Mexico. The problem is in relation to the extra dollars being paid in Medicaid dollars to rural areas without medical insurance. The effort in New Mexico was based on the public health effects of unhealthy people and that everyone pays for them.

REPRESENTATIVE WILSON interjected that the crux of the problem is that no Alaskan pays for state government.

[1:59:02 PM](#)

REPRESENTATIVE WILSON inquired as to what Alaska can do [to help with regard to rural economic development].

MR. FARQUHAR suggested that [the legislators] should keep feeding him anecdotes and keep having Co-Chair Gatto come to his meetings. He announced that in the last week of June, the Kellogg Foundation is holding a meeting in Washington, D.C., where it will talk to the rural caucus and discuss how to build up this rural agenda.

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MR. FARQUHAR, in response to Co-Chair Gatto, said that there probably would be an opportunity to make a presentation about a rural condition for which no resolution has been found. He informed the committee that he is being asked to get a speaker from the group in Alabama. With the exception of Idaho, who is very aggressive, most states step back thinking they can't do anything about [rural economic development].

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CO-CHAIR GATTO inquired as to whether there is any place back East that's considered rural. If so, what is considered rural, he asked.

MR. FARQUHAR related that five miles [from a major urban center] is considered rural.

2:04:07 PM

CO-CHAIR GATTO asked if the federal government is pulling back from rural development or are they advancing.

MR. FARQUHAR informed the committee that part of the 2002 Farm Bill included the Rural Strategic Investment Act, which would've provided funds to rural development and have meetings. However, the budget office cut it. There are a lot of disincentives in Congress for rural America. In fact, most congressmen from rural America are being defeated. Furthermore, some of the large [rural] advocates, such as Bob Dole, have stepped down. Demographics are against rural legislators, he said.

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CO-CHAIR GATTO surmised then that it's a shift for rural legislators to be replaced by those who are more urban in character.

MR. FARQUHAR noted his agreement, adding that every time redistricting occurs there are more seats from urban areas and urban suburban areas. Rural legislators have less clout, he pointed out. Therefore, the rural folks have to make themselves more known.

CO-CHAIR GATTO reviewed the situation in Alaska and related that a third of Alaska's population isn't on the road system and is scattered throughout the state. There isn't an answer for those rural areas to establish an economy to provide some self-sufficiency.

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CO-CHAIR GATTO mentioned that there are folks in the building addressing how valuable broadband is for education. He related his belief that education is going to have to change from brick-and-mortar schools. He emphasized that the state's entire future is the proposed natural gasline.

[A discussion ensued regarding the proposed natural gasline.]

[2:13:54 PM](#)

MR. FARQUHAR urged committee members to contact him when there are problems.

HB 128-OIL & GAS PRODUCTION TAX: EXPENDITURES

[2:15:15 PM](#)

CO-CHAIR GATTO announced that the final 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." [Before the committee was CSHB 128(O&G).]

The committee took an at-ease from 2:16 p.m. to 2:17 p.m.

[2:18:35 PM](#)

KEVIN BANKS, Acting Director, Division of Oil & Gas, Department of Natural Resources (DNR), began by relating DNR's support for HB 128. He then turned to paragraph (19) [on page 3, lines 19-23] of the legislation, which suggests a new category of costs that would be eliminated from a potential deduction in calculating the petroleum production profits tax (PPT) should there be repair or replacement or improperly maintained property.

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CO-CHAIR GATTO asked if DNR has a definition of the term "improper."

MR. BANKS related his understanding that John Iversen, Department of Revenue (DOR), has been working with Legislative Legal and Research Services, himself, and staff of the Alaska Oil and Gas Conservation Commission (AOGCC) to develop clear language. Mr. Banks related his belief that this is a provision of the petroleum production profits tax (PPT) that would not be used very frequently. He suspected that there could be a situation in which an auditor determines there has been some kind of failure, which would indicate that there's a problem. At that point the commissioner of DOR, under this provision, would be able to consult with DNR, the Conservation Commission, or the Department of Environmental Conservation (DEC) and ask whether something had occurred or whether the failure had occurred due to improper maintenance. After those conversations, the commissioner will be able to assemble an opinion regarding whether or not a facility had been improperly maintained. At this point, the commissioner of DOR could take it or leave it as he is only tasked with taking such into consideration when making a decision regarding whether the cost is deductible or not. He highlighted that DNR is now embarking on an effort, as a consequence of the events last spring and summer, to create the Petroleum Systems Integrity Office (PSIO). The PSIO will be responsible for collecting information regarding how facilities owned and operated by the [state's] lessees are being maintained. The PSIO will rely on the internal controls that the operators normally use in scheduling maintenance, various industry standards, as well as the operators' own internal controls for maintaining equipment.

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REPRESENTATIVE WILSON related her understanding that the department can already do what HB 128 says.

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MR. BANKS explained that [the department], as the landlord, will be extending the oversight over operations conducted by the lessees. The purpose of this organization is not to provide, on a routine basis, information that's relevant to a taxing authority of the state. He clarified that [the department] is going to assure that the facilities in operation in the oil field are being taken care of. When the commissioner of DOR comes to DNR and wants to know whether or not equipment has been

maintained appropriately. Once [the PSIO] is up and running there will be evidence to share to answer the aforementioned question. In fact, he suggested that a lessee knowing that potentially the cost of maintenance activities might not be deductible under taxes may have the incentive to provide the PSIO with information that they have properly maintained their equipment. The evidence DNR may collect would serve as a benefit to establish that the lessee or taxpayer had legitimate costs to be deducted.

2:27:05 PM

CO-CHAIR GATTO asked if this requires a person on-site or will the poor maintenance or nonmaintenance be based on the evidence of a leak, corrosion, or a pipe shut down. He noted his understanding that there can be a pipe shut down for a number of reasons, none of which are improper maintenance. Therefore, he questioned whether there is a test that would determine whether there is proper maintenance, improper maintenance, failure, et cetera.

MR. BANKS responded that as part of the routine function of the PSIO, PSIO staff will examine the records and documents provided by the lessees that illustrate the types of maintenance plans and equipment replacement planning in place. The PSIO will verify that the lessee did what it said it would do. There will also be occasional on-site inspections to ensure that equipment is in place that the lessees specify and meet the standard certification expected in the various settings utilized. The idea, he clarified, is to ensure nothing happens. Mr. Banks emphasized that the PSIO won't pursue a problem. However, pursuing a problem may be the result of a tax audit that reveals a failure due to improper maintenance. Under those circumstances, the commissioner of DOR may request that DNR help determine whether [the failure] was caused by an accident or gross negligence or something in between, which is what paragraph (19) attempts to address. At that point [the PSIO] can turn to its records and information to establish that.

2:30:11 PM

REPRESENTATIVE WILSON recalled that the PPT legislation included language that would cover the existing situation. Therefore, she questioned whether, because of regulations, BP's request for a tax credit could be disallowed, if the department so chose. She expressed interest in understanding what HB 128 is doing that's different.

MR. BANKS replied that the regulations regarding the implementation of terms like improper maintenance, gross negligence, and other aspects of this particular section of the PPT is the responsibility of DOR.

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JONATHAN IVERSEN, Director, Anchorage Office, Tax Division, Department of Revenue, said that there are a number of provisions in the PPT already that would be applicable to this sort of repair costs. Although there are a number of tools under the PPT to exclude costs, HB 128 would help to clarify whether costs attributable to improper maintenance can be excluded, in the absence of gross negligence. The legislation before the committee today makes it bulletproof, he opined.

[2:33:20 PM](#)

ROBERT E. MINTZ, Attorney at Law, Kirkpatrick & Lockhart Preston Gates Ellis LLP, explained that the current law has an area which is clear and an area that isn't. The area of existing law that is clear is the exclusion of costs due to gross negligence. However, gross negligence is a much narrower category than what this legislation is trying to address, which is the lack of maintenance or improper maintenance. The unclear portion is the general definition of lease expenditures or deductible costs, which are ordinary, necessary, and direct costs of exploring, developing, or producing oil and gas deposits. He said that in interpreting that general definition, current law directs the department to review typical industry practices and standards in the state that are reflected in the types of costs that may be billed under joint operating agreements. If the department reviewed this and determined that improper maintenance costs are typically disallowed by industry practice, then it would be firmer ground to disallow them. If the facts are otherwise, the department would have to rely on the gross negligence standard. Mr. Mintz specified his agreement with Mr. Iversen that legislation is appropriate if the legislature is interested in making clear that costs due to lack of maintenance or improper maintenance should be excluded.

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REPRESENTATIVE SEATON related his understanding that Mr. Mintz is excluding the lease expenditure portion of the enrolled version of House Bill 3001 on page 28 [which was passed in

2006]. Under that provision, there is another fallback so that if the other producers within that lease don't allow that those deductions were legitimate deductions or were caused by negligence, then the state automatically doesn't allow them as well or can exclude those costs as well. Therefore, there seems to be gross negligence and negligence as seen by the other owners on that lease. He questioned, "Can you tell me then, in reference to that, where is this new standard of improper maintenance come from our standpoint if the other owners of that lease don't consider that the improper maintenance was enough to not allow that to be deducted from the operator's costs that they're billing them. At what point does our standard of improper maintenance come in?"

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MR. MINTZ stated his agreement that if the costs were in a unit subject to a unit operating agreement that the department had approved or acquired under [AS 43.55].165(c) or (d) and the producers disallow the bill, it would be disallowed for tax purposes as well. He then related his understanding that Representative Seaton is proposing a situation in which HB 128 is passed, but there's a situation in which the costs are billed under an operating agreement and the partners don't dispute it, they pay it. The question is whether the state would have to allow it as a deduction, to which the answer is no because subsections (c) and (d) specifically exclude all of the items listed in subsection (e). He directed attention to the lead-in language to subsection (c)(1) on page 28 and subsection (d)(1) on page 29 of House Bill 3001. The language specifies that lease expenditures that are deductible are the costs that are listed other than items listed in (e) of the section, which is the list of excluded items.

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REPRESENTATIVE SEATON said:

That's what I was recognizing. All of these, whether it's the gross negligence standard or the ... strict liability clause of 16 if there's a spill. And then we have this third fallback that we're just talking about in lease expenditures. If they're disallowed by the other operators. ... I guess if we're talking about standards of the industry and we're talking about standards that are used, ... is your position that the other owners are going to automatically roll

over for these big high costs or you would expect them to roll-in and pay a good percentage of these high costs if they attribute them to negligent operation of the unit. If that's not the case, then what we're talking about a whole series that is beyond what they would disallow for negligence. Is that correct?

MR. MINTZ said he wasn't sure he could predict how the other owners are going to behave. However, he recalled that in one of the early hearings of [House Bill 3001] a representative from ConocoPhillips Alaska, Inc. (ConocoPhillips) discussed that its corporate policy in reference to bills is to challenge bills that they believe are due to gross negligence or the acts of an imprudent operator. He further recalled that the ConocoPhillips representative said that a determination had not yet been made as to the company's position related to the particular costs related to pipeline corrosion.

[2:41:49 PM](#)

DON BULLOCK, Attorney, Legislative Legal Counsel, Legislative Legal and Research Services, Legislative Affairs Agency, explained that under the PPT the producers are allowed to deduct the allowable lease expenditures in determining their tax. Under the 22.5 percent tax rate if there's a \$1 deduction, the state shares 22.5 cents of the cost. In addition to the deduction allowed in determining the amount of the tax to be paid, there is also a credit for certain qualified capital expenditures. The aforementioned provides [the producers] another 20 percent of their qualified capital expenditure. He highlighted that to be a qualified capital expenditure, it has to also be an allowable lease expenditure. This bill, he stated, presents the question of how much risk the state wants to be for certain costs. Mr. Bullock then turned to negligence, and pointed out that an entity would be negligent because it didn't do what was expected. Therefore, HB 128 requires the commissioner of DOR to determine what is good oil field practice. The legislation specifies that certain deductions for cost will be given, but a certain level of performance is expected. How much of a deviation from what's expected to be good oil field practice will be determined by the commissioner of DOR.

MR. BULLOCK then turned to the matter of depreciation. The PPT has some aspects of an income tax as it starts with a gross value at the point of production and the costs are allowed. However, the [costs] are all expensed and there's no

capitalization. This means that regular maintenance costs would be deducted over the year as they go, but if equipment isn't maintained, then there would be a disproportionate deduction to make up. Therefore, if the cost is one that could've been prevented, then the question with HB 128 is whether the state is going to share in the cost of something less than what the state finds to be an acceptable standard.

[2:45:23 PM](#)

CO-CHAIR GATTO posed a scenario during which the first three years there are normal maintenance costs of one, one, and one for a total of three. He then posed a scenario in which a company doesn't do maintenance until the fourth year when it's four, which would've been normal. In such a situation should the company be penalized for doing all of its maintenance in year four, or should the company be penalized for not doing maintenance during the first three years.

MR. BULLOCK explained that it's the history of the maintenance as well as whether the company should've done something in prior years that later resulted in extraordinary cost. The [question] is whether the company deviated from the standard of good oil field practice. This legislation has the following two aspects: it tells a producer what level of performance is expected, that they be consistent with good oil field practice; and if the producer doesn't [follow good oil field practices], the state doesn't want to share in costs that could've been avoided.

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CO-CHAIR GATTO posed a situation in which in year four a company only has an expense of three, and asked whether the companies should be rewarded for delaying maintenance to year four or should they be penalized for not doing one, one, and one.

MR. BULLOCK said, "You do that in the forms already in the bill [by] giving credit for development of new equipment. That is something you can consider." The narrow scope of HB 128 addresses the level of operation that's expected for the state to share the cost.

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REPRESENTATIVE SEATON commented that he is unclear with regard to the standard for life expectancy of something. He posed a situation in which something has a life expectancy of 20 years,

but in the 22nd year it breaks and causes the pipeline to be shut down. In such a situation, when does the amount of maintenance and something's useful life come into play with regard to improper maintenance and subparagraphs (B) and (C) in relation to a partial or complete shutdown.

MR. BULLOCK opined that the aforementioned is why the bill sponsor asked the commissioner of DOR to determine the expected standard. Still, it's logical to assume that toward the end of the useful life of property, it would require more maintenance. He mentioned the notion of normal wear and tear versus unusual wear and tear. He reminded the committee that it's a matter of what good oil field practice requires after [the useful life of an item]. One option is to insert presumption specifying clear examples of what should be done. He recalled that during the hearings in the House Special Committee on Oil and Gas, how often the inspection pigs were utilized was mentioned. As a policy, certain inspections could be required in addition to good oil field practice.

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CO-CHAIR GATTO read lines 19-23 on page 3, and opined it's an almost impossible standard to meet. He asked if there's any way to get to an easy standard.

MR. BULLOCK said that the committee is facing whether this is a high standard or merely the expected standard. The state is sharing in the costs through these deductions and credits. Therefore, it's a policy determination as to how much latitude the committee wants to allow. He pointed out that AS 43.55.165(a) discusses ordinary and necessary costs. The aforementioned is the rule of thumb. Subsection (e) being amended by HB 128 is where the legislature decides how much risk the state will take and what costs will be shared as well as for which expenditures, through leases expenditures and qualified capital expenditures, a credit will be allowed.

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CO-CHAIR GATTO recalled that the \$.30 was inserted for a specific maintenance reason. He asked if it would've helped to have never had that \$.30 cents or should it be higher.

MR. BULLOCK replied that there may be different reasons to have the \$.30. One of the ironies of the [\$.30 provision] is that if there are malfunctions and declining production and the volume

decreased, the \$.30 times the lower volume broadens the deduction that can be taken as it lowers the threshold.

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REPRESENTATIVE SEATON expressed concern that most all of the standards are fairly firm, save this one. "The industry," he opined, "is going to have a very hard time pinning down what proactively is going to be determined in retrospect if something happens ... to have been improper maintenance." He further opined that this standard will depend more on whether the state is running a surplus or deficit in the budget. The earlier suggestion of including some presumptions might help, he commented. He then turned attention to the language on page 3, line 19, where it says, "costs or that portion of the costs" and recalled that one of the commissioners that would be deciding that didn't seem to know what that standard is.

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CO-CHAIR GATTO announced that this Friday at 1:00, the committee will accept testimony on what constitutes proper oil field practices.

[HB 128 was held over.]

[2:55:50 PM](#)

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:55 p.m.