ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE
March 23, 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

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
03/21/07	(H)	Heard & Held
03/21/07	(H)	MINUTE(RES)
03/23/07	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

KONRAD JACKSON, Staff
to Representative Kurt Olson
Alaska State Legislature
Juneau, Alaska
POSITION STATEMENT: Presented Amendment 1 on behalf of Representative Olson, prime sponsor of HB 128.

DON BULLOCK, Attorney
Legislative Legal and Research Services
Legislative Affairs Agency (LAA)
Alaska State Legislature
Juneau, Alaska
POSITION STATEMENT: During the hearing on HB 128, answered questions.

JOHN IVERSEN, Director
Anchorage Office
Tax Division
Department of Revenue
Anchorage, Alaska
POSITION STATEMENT: During hearing of HB 128, answered questions.

JUDITH BRADY, Executive Director
Alaska Oil and Gas Association (AOGA)
Anchorage, Alaska
POSITION STATEMENT: Testified in opposition to HB 128.

MICHAEL HURLEY, Director
State Government Relations
ConocoPhillips Alaska, Inc.
Anchorage, Alaska
POSITION STATEMENT: Testified that HB 128 is duplicative since the 30 cents per barrel is already in place.

GARY ROGERS, Production Audit Manager
Tax Division

Department of Revenue
Anchorage, Alaska
POSITION STATEMENT: During hearing of HB 128, answered questions.

KEVIN BANKS, Acting Director
Division of Oil & Gas
Department of Natural Resources
Anchorage, Alaska
POSITION STATEMENT: During hearing of HB 128, answered questions.

JOHN NORMAN, Commissioner/Chair
Alaska Oil and Gas Conservation Commission
Department of Administration
Anchorage, Alaska
POSITION STATEMENT: During hearing of HB 128, provided comments and answered questions.

JASON BRUNE, Executive Director
Resource Development Council (RDC)
Anchorage, Alaska
POSITION STATEMENT: Testified in opposition to HB 128.

ACTION NARRATIVE

CO-CHAIR CARL GATTO called the House Resources Standing Committee meeting to order at 1:07:38 PM. Representatives Gatto, Johnson, Guttenberg, Edgmon, Kawasaki, Kohring, Wilson, and Seaton were present at the call to order.

HB 128-OIL & GAS PRODUCTION TAX: EXPENDITURES

1:08:01 PM

CO-CHAIR GATTO announced that the only 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 is CSHB 128(O&G).]

1:08:30 PM

REPRESENTATIVE SEATON moved that the committee adopt Amendment 1, labeled LS-0561\K.1, Bullock, 10/17/07, which read as follows:

Page 3, lines 22 - 23:
Delete "**the standard practices of the industry**"
Insert "**good oil field practice**"

REPRESENTATIVE WILSON and CO-CHAIR JOHNSON objected.

1:09:05 PM

KONRAD JACKSON, Staff to Representative Kurt Olson, Alaska State Legislature, presented Amendment 1 on behalf of Representative Olson, prime sponsor of HB 128.

1:10:02 PM

DON BULLOCK, Attorney, Legislative Legal and Research Services, Legislative Affairs Agency (LAA), Alaska State Legislature, told the committee that Amendment 1 was suggested by Mr. Iversen, Tax Division, Department of Revenue (DOR), and Robert E. Mintz, a contract attorney formally with the Department of Law. He said both men think using "good oil field practice" in place of "standard practices of the industry" will provide a better base from which to operate. Mr. Bullock stated that normally, taxes and royalty issues don't get to the cost of production; the change in the petroleum production profits tax (PPT) has generated that change. He concluded, "This goes back to expectations, and ... what's expected in return for the deduction, and how can the Department of Revenue determine whether a deduction's appropriate with the policies that you folks set."

1:11:48 PM

MR. BULLOCK, in response to Representative Seaton, said the term, "good oil field practice" is mentioned in the manual of oil and gas terms, as well as being used in certain cases. In further response, he explained that in addition to legal terms found in statute, there are also legal terms that courts have defined as necessary to define the law. He offered his belief that ["good oil field practice"] is a common law term that could have been developed in a contract.

1:12:52 PM

REPRESENTATIVE SEATON said "good oil field practice" sounds like a term that could be used in several places and have several different meanings. He asked if there needs to be a certain citation.

MR. BULLOCK said the aforementioned manual of oil and gas terms is a generally recognized resource. He continued:

> When I was researching this bill at the request of the sponsor, I spent quite a bit of time trying to find a universal standard, and there just isn't. And that's why it's important that the committee consider what kind of standard you want to apply. And this is the approach that the Department of Revenue feels that they can find the most information about, that they can say, "This is what we expect, and if you did what we expected, you get the deduction." So, if it was something less than what would be expected under this standard, then the deduction would be denied or adjusted.

1:13:56 PM

REPRESENTATIVE SEATON directed attention to the words, "**taking into consideration**", which appear on page 3, line 22, preceding the words proposed in Amendment 1. He asked, "Does that mean that they are required to follow the standards of good field practice that you just mentioned they would find as a standard?"

MR. BULLOCK responded:

> It means that they have to look at the standard when they're ... making their decision as to ... what's expected, they would take that into consideration and give it appropriate weight. They may find other standards that are also applicable. They may look at, perhaps, a standard operating agreement form to see what normally would be expected.
>
> ... This is ... trying to establish ... expectations: what kind of care is expected; what kind of avoidance of unnecessary costs could be anticipated. Like I say, this is a new area, and they felt that they needed some discretion and some area within which they can operate to be reasonable, because no doubt this type of expense will be appealed if the deduction's

just allowed. Obviously they want to make a good case ahead of time.

1:15:25 PM

CO-CHAIR GATTO commented that what is considered good maintenance in Saudi Arabia may be different than in another part of the world. He indicated that the term, "good" must apply in the Arctic.

MR. BULLOCK said it's not just a location issue; another consideration is what is in the oil itself. Some oil will be more corrosive, he said. He offered further details. He said the department needs the discretion because there is no "silver bullet standard."

CO-CHAIR GATTO related that good oil field practices are also determined by oil flow.

MR. BULLOCK said there are risks that can be identified that are within the scope of regulation of the government. The industry, he said, is actually the best source for what constitutes good oil field practices.

1:20:34 PM

MR. BULLOCK, in response to Co-Chair Johnson, said the aforementioned manual of oil and gas terms can be found in the legislative law library.

1:20:59 PM

REPRESENTATIVE WILSON asked if there is any reason that the committee could not take "that definition" and put it in the HB 128.

MR. BULLOCK said he thinks that would be possible, however whatever standard the legislature picks should reflect not only policy, but also what the legislature is "speaking to."

1:21:48 PM

CO-CHAIR GATTO commented on other variables.

1:22:29 PM

MR. BULLOCK, in response to Representative Wilson, indicated that he would try to incorporate the definition in the manual into the bill, as Representative Wilson had suggested.

1:22:56 PM

CO-CHAIR JOHNSON asked if there is any inconsistency in the makeup of the oils on the different North Slope fields.

MR. BULLOCK suggested that the oil companies could better answer that question; however, he surmised that there would be some differences.

1:24:04 PM

CO-CHAIR JOHNSON asked if it would be necessary to have a different standard for each field.

MR. BULLOCK responded, "It's not so much how big the bill's going to be, but how much the Department of Revenue has to do to decide how broad the standard can be applied. But the factors for applying the standard may be same." He offered examples.

1:25:20 PM

CO-CHAIR JOHNSON asked how the flow into a pipeline would be monitored if it is coming from several different areas. He offered an example in which too much money is paid on maintenance that is unnecessary because the standard was set to the lowest denominator. He asked, "So, are we going to be in a situation where we're getting tax credits for doing stuff we don't need to do, because we've set a standard that's for the worst-case scenario?"

MR. BULLOCK said if the presumption was overly strict for one field, it could be changed.

1:26:31 PM

CO-CHAIR JOHNSON explained that he does not want the presumption to be defined in court, but would rather have legislation crafted that is not incident driven but withstands the test of time.

1:27:26 PM

MR. BULLOCK responded that although there may have been a particular incident that brought the proposed legislation to mind, the bill has not been written to apply only in 2007. A good oil field practice would be looked at each time a tax return would be audited for the deductions; therefore, as technology improves, the good oil field practice would also "rise to a higher level."

1:28:04 PM

REPRESENTATIVE GUTTENBERG related he is under the impression that [Amendment 1] addresses Co-Chair Johnson's concern. He explained as follows:

> Standard on one field or one situation or one type of oil wouldn't be the right standard on another. So, if you ... go to this definition of ... good oil field practices, somebody could come in and say exactly that: "That used to be the standard, but ... this is a good practice." And, while there ... might be challenge by the department, they could say, "No, this is the oil; this is the content we have; this is the flow rate. That might have been the standard in another situation, but this is the good standard here." And they could justify that and come back with the argument.
>
> ... It goes both ways for both parties. They could come in and say, "The standard is not necessarily the best in every situation." ... Instead of being so rigid, simply say, "standard."

1:29:48 PM

CO-CHAIR GATTO suggested that the highest standard could be consistently applied, although it may be difficult to attain.

REPRESENTATIVE GUTTENBERG responded, "Sometimes the highest standard causes things to break prematurely."

1:30:04 PM

REPRESENTATIVE SEATON said he is uncertain that requiring "good oil field practices" to be taken into consideration will result in those practices being used. Problems in the past have resulted from some unexpected factor. He said, "If it was

something that could have been anticipated, it's already covered under gross negligence." He continued:

> So, I don't even know why we have gross negligence in the bill if we adopt this, because gross negligence is always going to be improperly maintained; it's going to be at least this standard if it ever arises to gross negligence.

REPRESENTATIVE SEATON asked Mr. Bullock to address his concern.

1:32:46 PM

MR. BULLOCK clarified that he had not meant to say that every time a tax return is filed a new determination would be made as to what good oil field practice is. He said that determination would be field specific and applied over several years. He continued:

> The state is giving up a dollar deduction for a dollar of cost in maintaining the field, and that works out to about 22.5 cents for every dollar that's spent. And if it's a qualified capital expenditure, that's another 20 percent out of that dollar. So, the real question is: What does the state expect? Does it expect for oil field practice to be the standard? So, are we willing to share the cost of poor maintenance or improper maintenance? Or are we going to say ..., "This is our money. We don't want you to spend money unnecessarily, so we're going to ask that you comply with good oil field practice, with how the industry defines it ...." And if it is and there's still a problem, ... we've set the standard as good oil field practice, even if it doesn't get us as much protection as we want from our revenue stream. So, what this is, is it's trying to use the industry's own standard to be reasonable and apply the state's expectations to these expenses, to say, "These are the ones we're going to share the cost in, and something less we choose not to share the cost."

1:35:02 PM

[Co-Chair Gatto passed the gavel to Co-Chair Johnson.]

REPRESENTATIVE WILSON asked:

> Since this happened up on the North Slope, has the department itself changed any of [its] regulations? I mean, are they looking at things a little differently than they did before? And if they are, maybe this is covered just in regulation ....

1:35:34 PM

MR. BULLOCK deferred to Mr. Iversen.

1:36:07 PM

JOHN IVERSEN, Director, Anchorage Office, Tax Division, Department of Revenue, in response to Representative Wilson's questions, said the department envisions two rounds of regulations, the first of which is waiting only for final review. Any substantive changes that are made to those regulations would need to be approved by the commissioner and lieutenant governor. He said, "That [first] round of [regulations] has not addressed the issue of lease expenditures in the context that we're talking about in this section, so, that would be the part of the second regulations ...." The second round of regulations will be considered through spring and summer [of 2007]. Regarding whether "the legislature needs to put this into a statute as opposed to what's in the law already," he explained:

> When we draft regulations, we're limited as to what we can say ... by what's in the statute - ... the regulations implement the statute. Any regulations that would be ... outside of the bounds of what's in the statute would be subject to legal challenge. If ... we were to write a regulation that expressly incorporates the language that's in this bill, as to improper maintenance, that would be subject to a legal challenge. That doesn't mean it would necessarily get shot down, but it would be more subject to legal challenge than if ... we were actually going off this express ... language in the statute. Stated another way: A regulation that we would draft like this does not find explicit basis in the statute. That doesn't mean we can't necessarily get there, it's just that if the legislature wants to make sure and clarify that these sorts of costs are going to be excluded, then the bullet-proof way to do it would be through a statute.

1:39:39 PM

[Co-Chair Johnson returned the gavel to Co-Chair Gatto.]

1:40:35 PM

CO-CHAIR JOHNSON removed his objection to Amendment 1.

1:40:38 PM

CO-CHAIR GATTO asked if there was any further objection to Amendment 1. [The objection by Representative Wilson was treated as withdrawn.] There being no other objection, Amendment 1 was adopted.

1:40:52 PM

JUDITH BRADY, Executive Director, Alaska Oil and Gas Association (AOGA), testified in opposition to HB 128. She said AOGA believes that the state is already protected and the proposed legislation would not survive a legal challenge. In response to Co-Chair Gatto, she said AOGA members have not had a chance to study the bill with the newly adopted Amendment 1, but she said with that amendment, the bill is certainly "moving in the right direction."

1:42:22 PM

CO-CHAIR GATTO noted that Ms. Brady would be allowed additional testimony at an upcoming meeting in order to respond to the bill, as amended.

1:42:41 PM

MS. BRADY remarked that all the issues that have been discussed during the last two hearings on the bill are issues that have been discussed during the prior year. She said there is precedent for people to change their opinions about legislation after being presented with another viewpoint.

MS. BRADY related that AOGA is concerned about adding a broad category of costs that cannot be deducted and will result in a constant adversarial relationship between the industry and the state, litigation, and a raised level of uncertainty about how to operate in Alaska. She said the proposed legislation is moving from an "incident-related concern about costs" to "a

place where you're going to ... end up requiring an audit of every single capital expense."

1:45:42 PM

MS. BRADY stated, "The concern of the sponsors now is exactly the concern of the legislators last year - and for very good reason." She continued:

> The PPT ... did two things: Number one, it raised taxes when prices are higher; and two, because there's this need for new investment in the state, they decided that the state would share some of the risk of the expense, and they would allow the deduction of lease expenditures, ... and they're immediately expensed before you come to the production tax value. And in addition, ... capital costs are eligible for 20 percent. And the purpose was to encourage reinvestment in Alaska. It did raise taxes, but it also raised very high concerns. There was hearing after hearing ... talking just about exactly what you're talking about: "Well, shoot, how are we going to know what's a real expense and what's not an expense? We could be expensed right down to the point where we don't have any ... tax money coming in; we could be expensed down to zero. ... How are we going to be able to audit this?" All of the things you're raising now were raised over and over ... again at that time, and ... they came up with more and more ... answers.

1:47:21 PM

MS. BRADY drew attention to "the lease expenditures part of the bill." She continued:

> They start out with saying that for purposes of this bill [PPT?], lease expenditures are the ordinary and necessary cost upstream of the point of production that are direct cost exploring for, developing, or producing gas deposits. So, that was the first ... requirement: Direct and ordinary.
>
> Then further back in that section they say, "And if the cost is disputed by working owner interests, the state ... doesn't have to pay that cost either. They were talking about the fact that working owner

> interests have very highly developed audit capabilities; they audit each other all the time to see about costs. And if you don't think that's true, there's about 4,000 categories of costs for Prudhoe Bay alone that are constantly audited by ... the four or five working partners.

MS. BRADY, in response to Co-Chair Gatto, characterized the 4,000 number as "pretty accurate." She said the interest owners' value is dependent upon reasonable costs. She said there are almost eight pages of discussion under lease expenditures that attempt to close the gap on decisions made as to what can and cannot be deducted.

1:49:30 PM

MS. BRADY recalled that just before the House passed the PPT bill, on August 6, 2006, BP discovered a leak at Flow Station 2 in the oil transit line. The company notified the authorities, implemented procedures to stop the leak, and began the process of suspending production from the entire field. The House was informed about the leak just before voting on the PPT bill and that legislation passed the House 29:10. She continued:

> But as more information came out, the level of concern regarding the effect of this bill heightened. Legislators did not want the State of Alaska to end up paying for the result of this bill, under the PPT, if the standard had been ignored - exactly the kind of thing you're concerned about today. And, as a result, the Senate ... super committee ... went over the whole lease expenditure piece again. ... They added and re-added and talked about lease expenditures would not include costs arising from fraud, willful misconduct, or gross negligence. And there was a lot of discussion at the time about whether to go to negligence and gross negligence, and it was decided - on much of the same information that Commissioner John Norman, the AOGCC, talked about the other day - to go with gross negligence. It was further decided that costs incurred for containment, control, cleanup or removal in connection with any unpermitted release of oil or hazardous ... substance would not be included as lease expenditure. So, ... bills related to an incident cannot be ... deducted.

1:51:27 PM

MS. BRADY, continuing her review of the history of the PPT legislation, noted that there had been two amendments containing "the same language that you are looking at today." There were questions regarding the definition of "properly maintained" and "diminished capacity," whether an auditor should make the decisions, what would constitute a red flag for the auditor, whether there has to be an incident like an oil spill, and whether every expenditure must be audited - whether or not there has been a spill. She continued:

> In response to this, Pedro van Meurs, who was the consultant, did two presentations to the Senate, ... talking about a way to do it. And on August 8, he had a white paper ... disallowing deemed capital costs, and he said, "Should companies receive tax deduction and tax credit, together with 40 percent of the value" - that was under the 20/20 - "for replacing a pipeline that was defective and not properly maintained?" And he said, "Well" - and it brings up a larger policy area, the gray area between betterment and repair, replacement. And so, what he suggested is you do not want to do a case by case audit; you do not want to be auditing every single expenditure. You don't have the time; you don't have the personnel; it will cost you more than -- it's not done. And the other thing is it's not done anywhere. So, he suggested that you disallow 30 cents per barrel for every barrel produced, regardless if there's any question, and that will take care of and adds about $45 million to $100 million a year in taxes, and that will take care of any kind of general maintenance that otherwise you'd have to do on an audit of every expenditure for. And that was what the Senate agreed to do. Instead of doing an audit on every single expenditure, they would take the 30 cents a barrel regardless ... if a company had an issue or not ... to keep the state whole.

1:53:59 PM

CO-CHAIR GATTO asked if the 30 cents to which Ms. Brady referred is related to maintenance or capital improvement.

MS. BRADY said breakdown is expected and the 30 cents would cover that; it would cover any miscellaneous maintenance or capital costs.

1:56:01 PM

CO-CHAIR GATTO offered his understanding that the 30 cents would cover capital expenses, not maintenance costs.

MS. BRADY responded that the Department of Revenue's source book for Fall 2006 states: "In order to protect the state from crediting companies for unmet maintenance obligation, the legislature specifically disallowed capital expenditures up to 30 cents per barrel under the PPT."

1:57:30 PM

CO-CHAIR GATTO surmised then that if there is no capital expenditure, "then you don't get this 30 cents for maintenance."

MS. BRADY replied, "You pay the 30 cents regardless."

CO-CHAIR GATTO said he would seek further explanation from an upcoming testifier.

1:58:16 PM

MS. BRADY recalled Mr. Norman, Commissioner, AOGCC, pointing out that the PPT protects the state from intentional negligence, willful negligence, gross negligence, and strict liability. The strict liability is encompassed in the language "any unpermitted release." Therefore, it doesn't matter the reason, it can't be deducted. Commissioner Norman went on to say that, therefore only simple negligence is left, which is when he made the point that simple negligence is when things happen. "If you were going to go into that level, you were talking about trying to bullet proof or zero tolerance for almost any capital expense," she said. If that's the case, she opined that the legislation no longer functions as a vehicle for sharing the risk. Therefore, the sponsors of the legislation and other legislators may want to review the protections that are already in place and be clear regarding whether the state is protected enough. She said that some of the conversation ends up about determining what's heavy oil or light oil and the state, in effect, becomes oil field operators. The aforementioned results in the costs, for the purposes of this legislation, being more than is secured from the taxes.

2:01:04 PM

MS. BRADY said that if the determination is that the state is protected enough, then the exercise of going through all this reasoning, yet again, has been helpful. However, if it's determined that the state isn't protected, then she suggested concentrating on standards that have legal meaning and limiting the application. Currently, there is no beginning for an audit as it isn't incident driven and [an audit] can be [caused by] any expenditure that catches the auditor's eye. Furthermore, there's no end due to the cascading. Ms. Brady expressed hope that the [committee] will decide that the state is as covered as it can be and that it cannot be bullet-proof. Moreover, the things that would be expected to be covered have been. If there is a change, then it must be done in such a manner that doesn't place the state and the oil industry in a permanent adversarial position. She expressed further hope that some of the answers will come from the Petroleum System Integrity Office.

2:03:23 PM

MS. BRADY, in response to Co-Chair Gatto, clarified that currently it's not incident driven and there is no action to start the audit so everything will have to be audited. She surmised that everything will have to be audited for improper maintenance because there's no "flag" to start the audit.

2:04:48 PM

CO-CHAIR GATTO surmised, "So, you're saying, 'Let the oil flow. When there's an incident that occurs, we'll know it.'"

MS. BRADY replied yes, adding that the state is already protected when an incident occurs. The language accomplishing such is already in place.

2:05:54 PM

MICHAEL HURLEY, Director, State Government Relations, ConocoPhillips Alaska, Inc., regarding the 30 cents, directed attention to a memo from Dr. Pedro van Meurs dated August 8. At the time the PPT was being developed, there was discussion about the incident at Prudhoe Bay. As a body, the legislature has the ability and obligation to determine what items can be deducted and what items cannot be deducted. The issue then became a question as to whether the state wants to address the matter on an incident-by-incident basis or develop some sort of proxy. He questioned, "Do you want to just develop some kind of a standard deduction to the deductions for maintenance that we know you're

going to screw up?" The aforementioned was debated. The ultimate choice was to take 30 cents a barrel and disallow the deduction. The aforementioned was what Dr. van Meurs explained and recommended in the August 8 memo. In fact, in the last paragraph of the last page of the memo, Dr. van Meurs said, "I believe that this would provide a good answer to possible public criticism that under PPT, we would provide 50 percent of the replacement costs of pipelines as a result of the Prudhoe Bay shutdown." Mr. Hurley related that ConocoPhillips believes HB 128 is duplicative because the policy call, 30 cents a barrel, has been made. Although the legislature may want to revisit that policy and may determine to approach on an incident-by-incident basis, Mr. Hurley stated that it's inappropriate to do both.

2:09:57 PM

MR. HURLEY, in response to Co-Chair Gatto, explained that a company will have "a bucket of costs" that a company will be allowed to deduct against its revenue. From that bucket of costs, 30 cents a barrel has to be taken out and can't be deducted. Therefore, that 30 cents is an amount that a company can't deduct.

2:10:51 PM

REPRESENTATIVE WILSON posed a scenario in which [production] is down to 750,000 barrels a day, which at 30 percent amounts to about $81 million a year. In such a scenario, she said she understood that a company can deduct the $81 million but nothing else.

MR. HURLEY replied no, adding that Dr. van Meurs' analysis used numbers that were in the $40-$50 million range. He explained that the maintenance costs to run the fields is in the hundreds of millions of dollars. For instance, if it was $345 million, that would be deducted against all of the company's revenue for maintenance. However, because of that [30 cents] provision, the company can only deduct $305 million. Therefore, instead of a company being able to deduct all of its costs, it can deduct fewer of its costs. In response to Co-Chair Gatto, Mr. Hurley confirmed that the 30 cents is the first thing that happens.

CO-CHAIR GATTO surmised then that if an incident occurs, [the funds] for it are already covered due to the 30 cents.

MR. HURLEY interjected that the [cost of an incident] would already be covered by that 30 cents. Additionally, if the incident is something that's not allowed in terms of good oil field practice within the unit and the other owners won't pay for it, then the state doesn't have to pay for it either.

2:13:42 PM

CO-CHAIR GATTO asked if such cooperation occurs with three oil companies.

MR. HURLEY confirmed that there are lots of times when oil companies don't cooperate.

2:14:02 PM

CO-CHAIR JOHNSON posed a scenario in which Mr. Hurley is the chairman of the board of ConocoPhillips. He then asked if Mr. Hurley, as chairman, would contest the expenditure on this particular incident.

MR. HURLEY informed the committee that ConocoPhillips has had discussions with the operator at Prudhoe Bay regarding its plans to fix and replace transit lines. [The operator] has made proposals to the other owners to fund some of those activities. He noted that those are currently under review and aren't yet approved.

2:14:59 PM

CO-CHAIR JOHNSON said that he understands the transit lines, and highlighted that "we're dealing with an incident here."

MR. HURLEY stated that at some point, the producers will complete their review of the incident and a decision will be made. However, at this point, only one authorization for expenditure (AFE) has been submitted to the other owners from the operators. He opined that it will be a long process to perform all the things discussed. All the discussions with the other owners about the technical feasibility, the cost, and the schedule haven't been completed. Furthermore, the analysis of the issues by the other owners hasn't been completed.

2:16:24 PM

CO-CHAIR JOHNSON questioned whether the cart has been placed before the horse, since there aren't regulations yet. He

related, "We are talking about a process ... as opposed to ... looking down the road. I'm ... a little uncomfortable looking that far."

2:16:51 PM

REPRESENTATIVE SEATON recalled the notion that good oil field practices would be applied at each tax return if not at every audit. He asked if that's something ConocoPhillips would contest through litigation as selective enforcement. The provision in HB 128 isn't incident driven and applies to an expenditure that may have resulted from improper maintenance. He inquired as to Mr. Hurley's perspective as to what he would expect as far as the tax auditing.

MR. HURLEY confirmed that to be one of the issues that concerns ConocoPhillips about how this particular disallowance structure is established because it is incident driven. He explained that the "first cut at it" would be when the company files its monthly production tax return and an auditor reviews it. The auditor will make some decision regarding good oil field practices, although that auditor may not have much expertise in that area. The auditor will then go to either DNR or the AOGCC in an attempt to get them to agree that things shouldn't have been done as they were. The aforementioned is of concern because an auditor who is reviewing something from a tax perspective is being asked whether [an incident] represents good oil field practice.

2:19:58 PM

REPRESENTATIVE SEATON questioned whether this is incident driven or investment driven. He opined that it's really investment driven because it's a tax audit. If there's a large expenditure, then review of that expenditure will occur to determine whether improper maintenance was the cause of that expenditure.

MR. HURLEY answered, "That's probably correct." He surmised that an auditor whose job it is to maximize return to the state would look for things that were improper maintenance. "It will be driven by their review of tax audits, rather than necessarily by any incident that actually occurred or didn't occur," he remarked.

2:21:06 PM

MR. IVERSEN noted that he has had discussions with the audit supervisor for the Oil & Gas Revenue Section, which will be the section to implement this. There are a number of different ways that these costs will turn up. For instance, it could be front-page news as is the case with the current incident. Another way that the costs show up is through an application for a credit for the expenditure to replace or repair whatever is broken. Yet another way the costs show up is in an audit that uncovers an uncharacteristically large cost figure or simply an uncharacteristic cost figure. When the auditor asks questions, if the auditor turns up something that seems to fall under improper maintenance, the auditor would confer with DNR and AOGCC, as appropriate.

2:23:31 PM

CO-CHAIR JOHNSON asked if Mr. Iversen envisions auditing every return.

MR. IVERSEN deferred to Mr. Rogers.

2:23:58 PM

The committee took an at-ease from 2:23 p.m. to 2:24 p.m.

2:24:55 PM

GARY ROGERS, Production Audit Manager, Tax Division, Department of Revenue, specified that if there was knowledge as to from where the costs were coming, the returns of those partners involved would be audited. Therefore, all returns would be audited. In response to Co-Chair Gatto, Mr. Rogers confirmed that his job is to audit every return, although he noted that sometimes the audits may be full-blown field audits while other times it may merely be a desk audit. The auditor uses his/her professional judgment and materiality comes into play, he related.

2:25:37 PM

CO-CHAIR GATTO remarked that it reminds him of sampling, which the Internal Revenue Service (IRS) does to determine who to audit. He related his understanding that there are certain red flags that [trigger an audit].

MR. ROGERS informed the committee that the division is in the process of developing the audit program for this new tax. In

the past, if there have been 14-15 taxpayers, the division has been able to review every taxpayer's return. Now with the complexity and volume of information as well as the increase in the number of expenditures and deductions, the division may not have the luxury of auditing every taxpayer's return. Therefore, the division may have to choose which taxpayers are audited and which aren't.

CO-CHAIR GATTO questioned whether one option might be to hire more people.

MR. ROGERS noted his agreement that hiring more people is an option.

2:26:45 PM

MR. ROGERS, in response to Co-Chair Johnson, explained that for a field audit, the auditors go to the taxpayer's offices and review documentation in their offices. However, for a desk audit the auditor may review the return filed and decide whether more information is necessary. A standard audit procedure, he related, is to actually go in the field and observe the facilities, the assets, the equipment and determine whether those exist and are in place. Mr. Rogers noted that he has done the aforementioned before, although it's not done very often.

2:28:04 PM

CO-CHAIR JOHNSON asked if any of the auditors receive special training that allows the auditor to determine what is and is not good oil field practice.

MR. ROGERS clarified that the auditors aren't engineers of any type, and thus the auditors would consult with engineers when they felt there was issue needing an opinion from the engineers. He informed the committee that the auditors do study oil and gas industry accounting practices, oil and gas industry joint venture auditing practices, and oil and gas industry financial reporting practices. In further response to Co-Chair Johnson, Mr. Rogers informed the committee that currently the division has an engineer on contract that assists with property tax. The division also uses the engineers at DNR and AOGCC. Mr. Rogers mentioned that he would anticipate needing outside expert contractors to perform the audits.

2:30:57 PM

CO-CHAIR GATTO directed attention to the term "gross negligence" and related that Blacks Law Dictionary defines it as: "willful, wanton, or reckless misconduct or such utter lack of all care as will be evidence thereof". "Does that mean if something happened, that really is the definition of gross negligence," he asked. He clarified, "If, indeed, we have some evidence, does it immediately default to gross negligence even if it isn't willful, wanton, or reckless or utterly lack of care or does it simply say ... if something happened, that's gross negligence?"

2:32:03 PM

KEVIN BANKS, Acting Director, Division of Oil & Gas, Department of Natural Resources, said that would be beyond his expertise. Mr. Banks related his belief that the language "evidence thereof" seems to indicate the need to determine that if the accident was caused by someone performing with utter disregard. Therefore, one would [seek information] regarding what someone did or didn't do in a particular situation. Negligence and the lack of good oil field practices is broader in scope and doesn't require that someone has done something with the willful intent to cause an incident.

2:33:41 PM

CO-CHAIR GATTO commented that "willful" is such a high bar.

2:34:27 PM

REPRESENTATIVE WILSON related her understanding that by the end of this month, the first tax return will be available and thus there will be real figures.

MR. IVERSEN confirmed that returns will be received at the end of this month, and thus more will be known with regard to the gross numbers. What's actually being claimed won't be known until there's an analysis of the returns, receipt of applications of credits, and goes through the audit cycle. The aforementioned will take some time. In fact, there's a three-year audit cycle and there's time for amended returns. He then pointed out that although the gross numbers in terms of gross receipts that were paid in total can be released, any information about the taxpayer can't be released because under statute it's confidential.

2:36:42 PM

CO-CHAIR JOHNSON asked if that confidentiality could be waived.

MR. IVERSEN replied yes, adding that the confidentiality belongs to the taxpayer who can waive it.

2:37:09 PM

JOHN NORMAN, Commissioner/Chair, Alaska Oil and Gas Conservation Commission, Department of Administration, pointed out that AS 31.05.010(15) references good oil field engineering practice in the definition of waste. That concept of failure to apply good oil field practice has been utilized and thus isn't a new practice. Furthermore, that concept exists throughout the regulations and generally would tie back into the American Petroleum Institute (API) standards as well as other professional standards.

2:39:14 PM

REPRESENTATIVE SEATON recalled testimony that [a red flag] could be raised due to an article in the newspaper or an application for a credit for expenditures to replace or repair something large or from an oddity in an audit. He asked if Mr. Norman views the legal language that specifies that good oil field practice will be taken into consideration means those are the standards that will be used or are they reviewed but not necessarily followed as a strict guideline.

MR. NORMAN answered that the black letter standards would be applied to the extent that they exist. He noted that in prior correspondence he has noted that in many instances such standards don't exist. He expressed the hope that in applying those standards, a measure of common sense would be applied such that the totality of the circumstances would be considered.

2:41:18 PM

REPRESENTATIVE SEATON inquired as to how Mr. Norman would make the determination that there was improper maintenance.

MR. NORMAN acknowledged that a newspaper article would identify an incident. However, he mentioned that normally there would be a time lag between the filing of a taxpayer's return, the claiming of a lease expenditure, and working through the different filters. Timing would be of concern because there is a need in oil field diagnostic to move quickly when looking for root causes. The earlier AOGCC is involved, the more accurate

the assessment would be, he opined. He noted that currently there are reporting requirements that come in daily, but matching it to a tax deduction would be somewhat awkward. He emphasized that AOGCC would do its best to work out protocol with DOR, but he expressed the need to have some retention of evidence in order to have the ability to review the situation and determine whether there's been good oil field practices.

2:44:22 PM

REPRESENTATIVE SEATON remarked that Mr. Norman had answered his question in relation to an incident. However, he expressed interest in how the AOGCC would address the application for a credit for expenditures to replace or repair. He related his understanding that the aforementioned would occur after the expenditure is made and then the application for the credit comes in with the tax payment. The aforementioned would then be after the repair or replacement occurred. Representative Seaton asked if Mr. Norman is saying that a new procedure would have to be established such that the replaced or repaired items would have to stay in place in order to allow AOGCC to determine whether it was replaced or repaired due to improper maintenance.

MR. NORMAN explained that generally speaking instances in which there would be gross negligence, willful misconduct, or careless disregard often self-identify. Those will be the most obvious and AOGCC would probably have received advance notice on those. If a contact came in from DOR, AOGCC would relate that it has an incident file and an investigative file. The more difficult situations will be equipment that breaks down, which could occur in the ordinary course of business. Those are more difficult because those aren't situations on which the AOGCC would have incident files. He said that the response of AOGCC is more incident- or event-oriented. Therefore, Mr. Norman opined that the legislation, with regard to gross negligence moves into a new area. This is a level of conduct that AOGCC previously hasn't monitored, which is ordinary maintenance. If some of AOGCC's specific regulations had been violated, AOGCC would've been aware as AOGCC inspectors are constantly checking things. However, there are other areas of maintenance that could become problematic because a question may not be presented to AOGCC until well after the event and thus it may be difficult.

2:49:33 PM

CO-CHAIR GATTO pointed out that the question of gross negligence, willful misconduct, and fraud is already included in

the PPT. This bill really only addresses the concept of improper maintenance not gross negligence. Therefore, the only word we're dealing with is "improper". He asked if everything is being driven by identifying what "improper" is.

MR. NORMAN replied yes. He said that the term "improper" can be identified, although there are subtle distinctions. He explained that generally there's an analysis in the concept of simple negligence. If between paragraph (6) and (19) the intention is even a broader standard than negligence, then it seems to move toward strict liability and therefore almost necessitates the guarantee of a perfect operation.

2:51:45 PM

JASON BRUNE, Executive Director, Resource Development Council (RDC), informed the committee that RDC is a statewide business association with a very diverse membership, including oil and gas, mining, timber, fishery, and tourism companies as well as regional Native corporations, local communities, and labor [organizations]. Mr. Brune then related RDC's opposition to HB 128, which he characterized as bad legislation. He further characterized HB 128 as bad public policy that's potentially precedent setting for other industries in the state. He emphasized that with the passage of the PPT, the state effectively tripled the production taxes on the oil industry in Alaska, which he said would likely result in over $1 billion in additional revenue to the state this fiscal year. In exchange for these additional taxes, producers are now allowed to deduct operating expenses in calculating these taxes. Additionally, the producers are allowed to take a 20 percent credit for capital investments as an incentive for improving the North Slope infrastructure. However, these deductions may not include costs arising from fraud, willful misconduct, or gross negligence. He related the definition he found for gross negligence, as follows: "a careless disregard for the consequences of an action or lack of action". He stressed that the definition refers to "lack of action."

MR. BRUNE opined that HB 128 proposes to disallow costs "related to the repair and replacement of property or equipment that was not maintained or was improperly maintained." He related his understanding that the aforementioned is already covered under the current gross negligent requirement. If this language is adopted, he questioned how the term "improper maintenance" would be defined as it's not defined in HB 128. In fact, the aforementioned was echoed in a February 16, 2007, letter from

Mr. Norman, AOGCC, in which he says, "Our main concern with this bill is the absence of a precise definition of improper maintenance. The bill proposes relying on standard practices of the industry to gauge whether there has been improper maintenance, but often there are not established industry standards to rely upon." The aforementioned brings up the question regarding what it would take for the state to declare improper maintenance. Mr. Brune questioned whether it would take a spill. He posed a situation in which two sets of pipe have the same maintenance history, but one develops a leak while the other does not. Would replacement of one pipe be allowable as an expense and the other not, he asked. He then questioned whether HB 128 will cause the producers to overcorrect and replace pipe more frequently than necessary in order to ensure they qualify for the deduction. By doing so, it would net back less for Alaska as these expenses would then be permissible. Mr. Brune related that RDC's members believe that HB 128 will exponentially increase disputes between the state and the producers. He stressed that passage of HB 128 will lead to endless litigation. In conclusion, Mr. Brune reiterated RDC's opposition to HB 128 and belief that the gross negligence standard is in place to satisfy the intent of the legislation. He encouraged the committee to give the PPT a chance to work before changing it.

2:56:59 PM

REPRESENTATIVE WILSON announced that because there are so many unanswered questions, she is withdrawing her co-sponsorship of the bill.

[HB 128 was held over.]

2:57:52 PM

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:57 p.m.