

**ALASKA STATE LEGISLATURE  
HOUSE RESOURCES STANDING COMMITTEE**

November 2, 2007

9:10 a.m.

**MEMBERS PRESENT**

Representative Carl Gatto, Co-Chair  
Representative Craig Johnson, Co-Chair  
Representative Anna Fairclough  
Representative Bob Roses  
Representative Paul Seaton  
Representative Peggy Wilson  
Representative Bryce Edgmon  
Representative David Guttenberg

**MEMBERS ABSENT**

Representative Scott Kawasaki

**OTHER LEGISLATORS PRESENT**

Representative Mike Chenault  
Representative Les Gara  
Representative Kyle Johansen  
Representative Mike Kelly

**COMMITTEE CALENDAR**

HOUSE BILL NO. 2001

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

- HEARD AND HELD

**PREVIOUS COMMITTEE ACTION**

BILL: HB2001

SHORT TITLE: OIL & GAS TAX AMENDMENTS

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

10/18/07	(H)	READ THE FIRST TIME - REFERRALS
10/18/07	(H)	O&G, RES, FIN
10/19/07	(H)	O&G AT 1:30 PM HOUSE FINANCE 519
10/19/07	(H)	Heard & Held
10/19/07	(H)	MINUTE(O&G)
10/20/07	(H)	O&G AT 12:00 AM HOUSE FINANCE 519
10/20/07	(H)	Heard & Held
10/20/07	(H)	MINUTE(O&G)
10/21/07	(H)	O&G AT 1:00 PM HOUSE FINANCE 519
10/21/07	(H)	Heard & Held
10/21/07	(H)	MINUTE(O&G)
10/22/07	(H)	O&G AT 9:00 AM HOUSE FINANCE 519
10/22/07	(H)	Heard & Held
10/22/07	(H)	MINUTE(O&G)
10/23/07	(H)	O&G AT 9:00 AM HOUSE FINANCE 519
10/23/07	(H)	Heard & Held
10/23/07	(H)	MINUTE(O&G)
10/24/07	(H)	O&G AT 9:00 AM HOUSE FINANCE 519
10/24/07	(H)	Heard & Held
10/24/07	(H)	MINUTE(O&G)
10/25/07	(H)	O&G AT 10:00 AM HOUSE FINANCE 519
10/25/07	(H)	Heard & Held
10/25/07	(H)	MINUTE(O&G)
10/26/07	(H)	O&G AT 10:00 AM HOUSE FINANCE 519
10/26/07	(H)	Heard & Held
10/26/07	(H)	MINUTE(O&G)
10/27/07	(H)	O&G AT 2:00 PM HOUSE FINANCE 519
10/27/07	(H)	Heard & Held
10/27/07	(H)	MINUTE(O&G)
10/28/07	(H)	O&G AT 2:00 PM HOUSE FINANCE 519
10/28/07	(H)	Moved CSHB2001(O&G) Out of Committee
10/28/07	(H)	MINUTE(O&G)
10/29/07	(H)	O&G RPT CS(O&G) NT 4DP 1NR 2AM
10/29/07	(H)	DP: SAMUELS, NEUMAN, RAMRAS, OLSON
10/29/07	(H)	NR: DOOGAN
10/29/07	(H)	AM: KAWASAKI, DAHLSTROM
10/29/07	(H)	RES AT 1:00 PM HOUSE FINANCE 519
10/29/07	(H)	Heard & Held
10/29/07	(H)	MINUTE(RES)
10/30/07	(H)	RES AT 9:00 AM HOUSE FINANCE 519
10/30/07	(H)	Heard & Held
10/30/07	(H)	MINUTE(RES)

10/30/07	(H)	RES AT 6:30 PM HOUSE FINANCE 519
10/30/07	(H)	Heard & Held
10/30/07	(H)	MINUTE(RES)
10/31/07	(H)	RES AT 9:00 AM HOUSE FINANCE 519
10/31/07	(H)	Heard & Held
10/31/07	(H)	MINUTE(RES)
11/01/07	(H)	RES AT 9:00 AM HOUSE FINANCE 519
11/01/07	(H)	Heard & Held
11/01/07	(H)	MINUTE(RES)
11/02/07	(H)	RES AT 9:00 AM HOUSE FINANCE 519

**WITNESS REGISTER**

DAN DICKINSON, Consultant  
 Legislative Budget and Audit Committee  
 Alaska State Legislature  
 Juneau, Alaska

**POSITION STATEMENT:** Provided a presentation on HB 2001.

STEVE PORTER, Consultant  
 Legislative Budget and Audit Committee  
 Alaska State Legislature  
 Juneau, Alaska

**POSITION STATEMENT:** Provided a presentation on HB 2001.

PAT GALVIN, Commissioner  
 Department of Revenue  
 Juneau, Alaska

**POSITION STATEMENT:** Provided a presentation on HB 2001.

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

**POSITION STATEMENT:** During hearing on HB 2001, answered questions.

MARCIA DAVIS, Deputy Commissioner  
 Department of Revenue  
 Juneau, Alaska

**POSITION STATEMENT:** Provided a presentation on HB 2001.

JERRY BURNETT, Director  
 Division of Administrative Services  
 Department of Revenue

**POSITION STATEMENT:** During hearing of HB 2001, answered

questions.

NANETTE THOMPSON, Unit/Tech Support  
Division of Oil & Gas  
Department of Natural Resources  
Anchorage, Alaska

**POSITION STATEMENT:** During hearing of HB 2001, answered questions.

BOB GEORGE  
Gaffney Kline and Associates  
Houston, Texas

**POSITION STATEMENT:** Provided a presentation on HB 2001.

RICH RUGGIERO  
Gaffney Kline and Associates  
Houston, Texas

**POSITION STATEMENT:** Provided a presentation on HB 2001.

#### **ACTION NARRATIVE**

**CO-CHAIR CARL GATTO** called the House Resources Standing Committee meeting to order at [9:10:43 AM](#). Representatives Roses, Wilson, Fairclough, Seaton and Gatto were present at the call to order. Representatives Johnson, Edgmon, and Guttenberg arrived as the meeting was in progress. Other legislators present were Representatives Johansen, Chenault, Kelly, and Gara.

#### HB2001-OIL & GAS TAX AMENDMENTS

[9:11:38 AM](#)

Co-CHAIR GATTO announced that the only order of business would be HOUSE BILL NO. 2001, "An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to the issuance of advisory bulletins and the disclosure of certain information relating to the production tax and the sharing between agencies of certain information relating to the production tax and to oil and gas or gas only leases; amending the State Personnel Act to place in the exempt service certain state oil and gas auditors and their immediate supervisors; establishing an oil and gas tax credit fund and authorizing payment from that fund; providing for retroactive application of certain statutory and regulatory provisions relating to the production tax on oil and gas and conservation surcharges on oil; making conforming amendments; and providing for an

effective date." [Before the committee was CSHB 2001(O&G).]

[9:11:53 AM](#)

CO-CHAIR GATTO informed members that Mr. Dickinson and Mr. Porter would present to the committee, after which the committee would break until 1:00 p.m. The committee would then hear from Commissioner Galvin and take a break at 3:00 p.m. so that Representative Wilson can attend another hearing. He said after the presentations, he would like to schedule a committee discussion on ACES or have a discussion then. A round table discussion with the administration and stakeholders would be held the following day.

[9:12:15 AM](#)

MR. DAN E. DICKINSON, Consultant, Legislative Budget and Audit Committee (LBA), Alaska State Legislature, said he would give a 10-minute explanation to flesh out a request to present some material he already presented but with actual numbers, rather than round numbers. He told members:

... When I sent my slides in [to committee staff], they said the numbers are wrong and two of your slides are mislabeled because instead of saying November 11, they say October 30th. That was intentional because that was the original slide but the version you got they were efficient and updated. So, all of yours will say November 2nd on them if you're looking at the pieces of paper but, on the slide, this was the original slide that was presented and, as you may recall, I used some very round numbers, \$7 and \$20. This slide was actually put together from home to call in with a presentation to make some illustrations here.

[9:16:16 AM](#)

The request that I received was to put in actual numbers. And so, let me go to the next slide and that's exactly what I've done here is put in actual numbers....

CO-CHAIR GATTO interrupted to welcome Co-Chair Johnson.

MR. DICKINSON continued.

Maybe repeating the points that I made earlier, what this is comparing is the [petroleum production profits tax] PPT, [Alaska's Clear and Equitable Share] ACES and the House Oil and Gas Committee substitute. Flipping back and forth, the barrels that I was using before were 244 million barrels for the year. In fact, the actual that was used in the current Department of Revenue's forecasting and that was used in the material that was presented to you by Econ One - that's 230.5 million barrels. Co-Chair Johnson asked that I pull out the oil price that day. I went to the Department of Revenue website and that was \$89.09 so that's a breathtaking number for those of us that have been looking at prices for awhile.

CO-CHAIR GATTO asked about this morning's price.

MR. DICKINSON thought the price was in the \$90s.

CO-CHAIR GATTO asked if the highest it reached was \$97.

MR. DICKINSON said two numbers are available: inter-day trading as opposed to the close out.

REPRESENTATIVE EDGMON asked if the lifting upstream costs of \$18.57 were higher than what DOR actually quoted.

MR. DICKINSON said the next slide would address that point and that some controversy surrounded that number.

[9:18:55 AM](#)

MR. DICKINSON continued:

I framed this just kind of as - some folks may have been following - Representative Doogan made the exact same point you did. He said, gosh, I thought costs would be closer to 20 - he said the costs were closer - were 15, how come you used 20? What's going on there? What I've got here are 3 comparisons and the ones on the left are numbers we can all look at. On the right is what was used by Econ One and you can see the numbers are very, very close. I don't want anyone to be misled. By doing it very simplistically, there are some pennies that are going to be different. I want to illustrate the point.

The Department of Revenue, currently estimating for FY 2008, \$4.2 billion in upstream [indisc.]. When it comes time to turn that into a dollar per barrel number, and I remember Secretary McNamara had a phrase he used - never express things on a per unit basis and when somebody expresses things to you on a per unit basis, be suspicious of why they are doing it. So, this may be an illustration of that.

But you need to divide through by the barrels. So, how many barrels were their daily volume - 722,000 barrels a day, 365 days in a year? So, you come up with 2.6, 3.5 million in barrels a year.

Now this is where it gets, perhaps, tricky. If you look at the taxable barrels, you're going to divide through by - take that number and multiply by .875. In other words, roundly speaking, it's not quite that number but, just for illustration, there's a 12.5 percent royalty. Those barrels aren't taxed so you simply divide through by taxable barrels and what you find is that you've got \$18.57 as the consequence of that division.

According to the statute, that's the number that you use. You take the total cost, you divide through by the taxable barrels. Now I think what's confusing is if you ask someone what are your costs per barrel. What does it cost to operate the field. They'll say here are our costs. Here are the barrels. divide that one through the other and you come out with a number that's 12.5 percent lower or \$16.25. And so, I think the problem is - and it was probably exacerbated by my trying to illustrate one barrel, is when you ask the question what are your costs per barrel, you'll get something that's closer to \$16.25. If you're trying to mechanically reproduce what's going in the statute, you will come up with a number that's 18.57, or roughly \$2 higher. If you take the two numbers that are used in the Econ One data, you'll come up with \$18.50 and I'm not sure what the - there's lots of small things in the model that I'm not replicating - it's very simplistic.

[9:19:37 AM](#)

REPRESENTATIVE EDGMON said he recalled a number of \$14.56 and

asked if that was from DOR. He also asked if Mr. Dickinson's calculations are different from DOR's or contain more up-to-date data.

[9:20:18 AM](#)

MR. DICKINSON explained that every number he has used comes from the Department of Revenue. He noted the numbers he was using were for FY 2008 and said he would have to see what numbers [DOR] was using. He said a lot of the data is based on a 10-year average - he would have to look at that number. He confirmed that his numbers come from the Department of Revenue.

[9:20:33 AM](#)

REPRESENTATIVE WILSON recalled DOR was using 2006 figures.

MR. DICKINSON said his understanding, looking at the graphs, is if 2006 numbers were used, his numbers are higher.

[9:20:55 AM](#)

REPRESENTATIVE EDGMON asked where the numbers would differ in that chart.

MR. DICKINSON asked if he wanted to know the implications.

CO-CHAIR GATTO clarified that Representative Edgmon was asking if 2006 was \$14 and 2007 is \$16, what changed to change the lift cost.

[9:21:02 AM](#)

MR. DICKINSON said all three things. The number of barrels have declined so, to the degree the costs are fixed, a smaller number of barrels divided through will raise costs per barrel. The second factor is that actual costs have increased. Oil field costs are inflated at \$90 per barrel as compared to \$60 per barrel in 2006. The mathematical implication of those go in the same direction.

[9:21:53 AM](#)

REPRESENTATIVE GUTTENBERG asked if the transportation costs were included.

MR. DICKINSON responded transportation costs are not included. He said the transportation costs of \$6.73 used on the previous slide were from DOR, although it was not in DOR's published forecast, which had costs at \$7.22.

[9:22:34 AM](#)

CO-CHAIR GATTO asked whether ocean transportation cost changes vary according to supply and demand of tanker space, fuel prices, or distance to a refinery.

MR. DICKINSON said all three of those factors affect costs. Fuel cost has a huge impact because that affects every tanker. The issue of tight demand affects only the tankers at the margin. Most of the fleet is on hold. Each one is owned by a subsidiary of an oil company. If two tankers are laid up, that [oil] might come in at a high price but it will only drive the average up a small amount. He believes the Puget Sound, Los Angeles, and San Francisco markets have been fairly steady recently. If one round trip takes longer than another, the cost will be higher.

[9:24:11 AM](#)

REPRESENTATIVE SEATON said he believes the state takes all of its value in royalty. He asked if there is any royalty implication in this figure.

MR. DICKINSON replied:

This is going to be the total royalty costs of the non-royalty barrels divided through by the non-royalty barrels, or the total cost divided through by all the barrels. In either way, you'd come up with the same number. Because the royalty costs are deductible for calculating the royalty, and the entire royalty is subtracted from what the PPT is applied to, I don't think there's any controversy about that. In other words, if you ask somebody what does it cost to ship a barrel? You'd say \$6.73. What does it cost to ship a taxable barrel - \$6.73.

[9:25:23 AM](#)

CO-CHAIR GATTO asked what it costs to ship a royalty barrel.

MR. DICKINSON replied \$6.73.

9:25:36 AM

REPRESENTATIVE GUTTENBERG asked whether the charge for diesel fuel differs for the tankers owned by an oil company and the independent tankers, assuming the tankers run on diesel fuel. He questioned whether that is part of the problem with vertical integration.

MR. DICKINSON said he believes clauses in both the royalty contracts and the tax would look at that if they were paying anything other than fair market value. Typically, the rule is they charge the same price other companies would charge. He noted that is a specific audit issue, and the effect, if any, is fairly small because of publicly reported numbers.

9:26:40 AM

REPRESENTATIVE GUTTENBERG stated:

If I may - just an observation and I meant to bring it up the other day - when we're talking about the topping plant, the difference between what they pay their contractors or for their BP pick-up or a Conoco pick-up on the Slope versus the difference between what they charge for others - but I think this is part of the problem that we're seeing in some of the tariff situations. What's the real cost? And the public is very cynical about this. It's the oil industry complaining about the price of oil and their prices are rising. They're scratching their head saying, huh? It doesn't make any sense to them at all. We know lifting prices haven't changed. Operating costs haven't gone up considerably and they're complaining about what they're selling it at the pump [for] and they're getting the money back. We should be a little cynical about that also.

9:27:30 AM

MR. DICKINSON continued with his presentation.

Using the \$6.73 and the \$18.57 upstream lifting cost figure, we derive a production tax value of \$63.79. Multiply that times the taxable barrels and the base for the tax base is \$14.70 billion in both the PPT case and the ACES case. The progressivity - I think we walked through that before - you knock off \$40 from

the \$63.79 to get to your starting place so that's \$23.79. You multiply each dollar in that. It's an additional quarter of a percent so there's 5.95 percent additional progressivity. That gets applied against the base for a total of additional dollars - in this example of \$874 million.

The original progressivity tax in the original presentation was 732 so it's been an increase and the increase has occurred. You had smaller barrels but you had higher starting prices and smaller deductions. So you kind of had three things moving and the net effect of them is, the ones that were increasing it, increased it more than the ones that the decline in barrels, which was a decrease in this example. The House Oil and Gas is going to be a slightly different calculation because their progressivity is based on the gross and, so, when you do this calculation your base is the same volumes but it's times a wellhead number, which doesn't have the lifting costs taken out. So, it's the gross value at the point of production as opposed to the production tax value, to use the technical terms in the statute. You then subtract a larger figure from that, \$50, and so the price index is \$32.36. The per dollar variation is between 2.5 and .2 percent, .225 so the progressivity factor, 7.28, that's multiplied times the base for a new progressivity number. Again, you'll see this one went up less than the others and that's because you're not taking - in my simplistic example when I was using \$20 to generate this, you've made a change but that change did not affect the House Oil and Gas Committee substitute.

[9:30:24 AM](#)

MR. DICKINSON continued:

[Slide 5] So, the next question on this - so what, what does that mean? I presented this diagram. This is the original and basically there's two things you could see from this. One was the fact that they are very close. As prices go up, the total tax before ... taking the credits, very close but when you're comparing the House Oil and Gas Committee CS what you'll see is - it is below ACES and then there comes a point at about \$77 where it surpasses ACES and then

at higher prices it is higher. Someone pointed out to me that this diagram was sort of hard to read or wasn't information filled. When I plotted out the new version using the daily price and the DOR cost of volume assumptions, you get a very similar drawing. House Oil and Gas is below the Governor's proposal. The crossover point moves up a little bit. It's in the - a later slide will tell you exactly what it is but it's right here in this range. And from that point on up, the House Oil and Gas version would produce more revenues before credits than the ACES plan.

[9:31:56 AM](#)

REPRESENTATIVE GUTTENBERG asked why, if everything changes with credits, the diagram doesn't contain a line that shows what happens with credits.

MR. DICKINSON explained he was trying to isolate one piece and illustrate it. If both bills had the same amount of credits, the lines would [go] lower but they wouldn't change in their relationship to one another. The House Special Committee on Oil and Gas restored TIE credits, to his understanding. Therefore, if the House Special Committee on Oil and Gas credits were plotted, they would be different than the credits under ACES. So, all of the effects were put together and reflected in DOR's fiscal note. He reiterated he was trying to isolate those pieces.

REPRESENTATIVE GUTTENBERG said the committee is trying to figure out what the government take is so it would be good to know what that real slope looked like.

MR. DICKINSON replied:

... we're so far from government take because we don't have federal taxes, we don't have state income taxes, we don't have royalties, we don't have property taxes. This is not - I apologize if anyone thought this was a government take figure.

[9:33:13 AM](#)

REPRESENTATIVE GUTTENBERG asked the graph would slide down or slide out if the credits were put in.

MR. DICKINSON said it would slide down with the credits; the slope would change with the royalties; the income tax would change the slope in the other direction; and the property tax would change the slope and slide down.

[9:33:53 AM](#)

MR. DICKINSON, in response to Representative Guttenberg, said many of those were produced for another committee at various points. He said when they were provided, people questioned how PPT fit in and there is only a minor difference. He noted some analyses break it down, some synthesize the information. He repeated his presentation breaks it down.

[9:34:38 AM](#)

REPRESENTATIVE GUTTENBERG said understanding what one is looking at and how it was built is very important. The economists are working on pure theory, which is great to hear, but sometimes members need real numbers or information that is policy driven.

MR. DICKINSON said he appreciates that but the problem is, "If you look at \$62 and say I want to get that up to \$63, you then have to open the hood and figure out which parameter you're going to change."

[9:35:24 AM](#)

REPRESENTATIVE SEATON referred to the bottom of the previous slide that speaks to the progressivity rate and base, and asked if the line that refers to tax only applies to progressivity or whether that shows the difference between 22.5 and 25.

MR. DICKINSON said those pieces only apply to progressivity.

[9:35:52 AM](#)

MR. DICKINSON then moved to Slide 6 and told members:

... What I originally did is ... I had a slide that had these lines on it - it had 6 different lines and each one looked just about the same and it was ACES versus the House Oil and Gas Committee substitute, once with the \$27 cost, once with the \$15, and once with the \$22 in between. You had 6 lines and ... it didn't communicate very much. What I tried to do was extract three points from that [Slide 7], which is on

the same graph where House Oil and Gas and the ACES bill, where would they overlap?

In other words, if you come down here to the left of where any of these points are, you would find that the ACES raises more revenue [indisc.] credits - I want to make sure that's clear here. Just using a simple example - just using this portion of it, ACES will raise more revenue than House Oil and Gas and the reason is ACES is a 25 tax percent rate before any progressivity and the House Oil and Gas is at 22.5 so they will be below. Then the progressivity occurs and at some point the House Oil and Gas Committee substitute goes above ACES and the question is where is that point. If the costs in the illustration I gave to you - you use \$27, that point is right here at about - it's ... \$79 and the total tax coming in is about 3.8 [indisc.] credits.

As you take out costs, the crossover point moves to the right and, so, if I use the actual costs of the Department of Revenue, that would move the crossover point up to something about \$10 higher, \$87 dollars when both systems would produce about \$4.4 billion in revenue. If you go all the way out to \$22, in other words a \$15 cost, the round figure, the crossover point is extremely high. It's above \$110 ANS. Maybe someday we'll be able to say that and it will sound natural - a couple of weeks from now but right now that sounds [like] a very, very high number. So, as the costs change, when you are comparing the ACES plan and the House Oil and Gas Committee substitute, where ... one raises ... more revenue than the other is very dependent on the costs that go into that.

Again, I'll repeat something that you've probably heard ad nauseum. You can make a gross that looks like a net if you define exactly what the costs are but then when the costs change, you no longer have an exact match here. Your gross is no longer reflecting your net. So anytime you take a gross piece and you fix a point where a different system allows that to be variable as it effects the outcome, you will change the relative of those two costs - the relative revenues or the relative costs over point.

So, I hope this slide has clarified, as opposed to

obscured.

9:39:43 AM

REPRESENTATIVE GUTTENBERG asked what happens when the credits are added.

MR. DICKINSON said he believes the crossover points would not change on the X axis but they would all drop on the Y axis.

9:40:16 AM

REPRESENTATIVE GUTTENBERG asked to what level.

MR. DICKINSON explained if one is talking about the TIE credits, the difference between that being fully allowed and not being allowed should be about 10 percent of the capital number, which is a \$200 million difference. In further response to Representative Guttenberg, Mr. Dickinson specified the angle will stay the same; it will just move down.

9:41:10 AM

REPRESENTATIVE FAIRCLOUGH opined that what members are trying to get on the record is that the government take would be less when credits are applied than what is on the graph before members. She added a taxing policy is not just based on revenue; it's also based on investment and actually monetizing resources. She stated:

The Representative has appropriately pointed out with credits not before us, it is over-inflating what Alaskans would see as the benefit of any of the three tax analyses that we're looking at. All three have variables that include advantages to encourage different kinds of exploration. One bill encourages more small companies to come in and invest. The original [economic limit factor] ELF encouraged the big three, per say, to have a better benefit to disallow the smaller investors to come in. So it's all - I think I'm going back to BP and Ms. Fitzpatrick's ... pace and time of the investments that companies come forward with - pace and scale with what we do.

So, I think the Representative appropriately points out that we're looking at a picture that is modified

in the sense that there are other things that negatively affect the cash flow in being able to monetize our resource.

[9:42:31 AM](#)

CO-CHAIR GATTO said the committee came looking for the science of numbers but is being asked to apply art to mentally calculate the credit variations across the board. The committee has been presented with a chart but must overlay parts of the chart. He felt it is asking a lot of members to include all of the testimony it has heard and then be shown a chart that demonstrates before credits.

MR. DICKINSON acknowledged that is a fair point and everything can be presented every time, however that might obscure what the committee is looking at in detail.

[9:43:41 AM](#)

REPRESENTATIVE SEATON asked if members are essentially looking at the base tax differential in the House Special Committee on Oil and Gas version and ACES and the progressivity.

MR. DICKINSON said that is correct.

REPRESENTATIVE SEATON asked, "And so if we were just looking at the progressivity without the change in base, then we're looking at this graph?"

MR. DICKINSON said that is correct. He added,

The bottom lines here are straight. If you plotted the straight lines that flow from there out here, the difference between them, that straight line and the reason it no longer stays straight, is the progressivity piece. But what people were interested in this conversation for producing this graph was this notion that when you're not in progressivity, when you're in the range to where investments may be affected, ACES takes more than the House Oil and Gas. They were concerned about that. But what they wanted to show was when prices go up, they felt it was appropriate to have a more assertive or a progressivity which took a higher share. So, it's try to combine those two pieces and those two pieces in isolation.

9:45:16 AM

REPRESENTATIVE FAIRCLOUGH referred to a previous comment made by Representative Roses about time and some of the particular things the committee is looking at today. She opined that the cross sections the committee is looking at to monetize Alaska's money are obscure because of the historically high price of oil. Alaskans could be shown a model right now that shows a state take of billions in progressivity if oil prices were at \$200 per barrel. That would show Alaskans the state was really "sticking it to" producers and would serve to provide a scenario that looks very good for government take. However, the reality is, in the time continuum of 50 years of investment of oil and organizations involved in this industry, the state must look at an average price closer to the \$30 range. She expressed concern that the legislature is considering building something in progressivity while looking at the \$100 per barrel price and losing sight of the average. She said the House Special Committee on Oil and Gas has made an attempt to tell Alaskans it is trying to balance at a low price per barrel but take more at the high end. She expressed concern that legislators believe that whatever tax policy it puts out is based on a realistic price of oil. She pointed out the price of the American dollar is on the decline, which is contributing to the inflated barrel price, as is instability in world regions with oil. She cautioned that many variables exist so it is dangerous to focus on progressivity as the one answer.

9:48:41 AM

MR. DICKINSON noted his agreement with Representative Fairclough's observation and said he anticipates a price correction. He added he recognizes the reason the proxy for costs built into the ELF system broke down was because no one graphed outside of their imagination. He suggested that the state should not count on extremes, but should be prepared for them.

9:49:39 AM

CO-CHAIR GATTO asked if he would be able to avoid an asymptotic line if the amount was brought out to \$1,000.

MR. DICKINSON said they will continue to separate, but they will cap out at some point. He believes the cap in both is at 50 percent so the production tax would be taking 50 percent, but

the split is not 50/50 because of royalty and everything on top. At that point, the total government take would be in the 80s.

9:50:14 AM

REPRESENTATIVE SEATON clarified that he believes the bills cap progressivity at 25 percent so it is the equal share concept through PPT that the legislature approved earlier. That was based on 25 percent in the base price and 25 percent in the progressivity. That was the basis for the equal share through half in progressivity and half in the base price. The PPT was adopted at 22.5 and progressivity is capped at  $X + Y = 50$  percent but it is capped at 25 percent in all bills. It is dependent on the base price: if that is 22.5, the cap will be at 47.5. The idea behind the 25 percent was that at high oil prices the state wanted to have an equal share so it was a question of where that would be reached.

REPRESENTATIVE WILSON asked to hear from Mr. Porter.

9:51:35 AM

STEVE PORTER, Consultant to the Legislative Budget and Audit Committee, Alaska State Legislature, recalled one of the questions was how credits affect the line. He said credits are the simplest model. He explained:

It really is \$1 out of one pocket into another so it truly does just drop the line. For every dollar of credit, it drops a dollar down so that line is exactly parallel. For every dollar of credit it would drop down a dollar. So the credits are simple. They just move the line up and down, do not change the slope of any of the lines. They are all in rough ratio to each other because you calculate the slope then you subtract the credits. It's just straightforward. The things that change the slope of the line ... the starting point doesn't change the slope of the line but it tells you how you are going to start.

Definitely the progressivity factor that the .225 or the .25 - that's going to change the slope of the line. How you affect the [operating expenditure] opex and [capital expenditure] capex - how much you bring into that and the level that you - whether it's gross or net, that's going to change the methodology and the slope of the line. It's similar to the difference

between multiplication and addition and subtraction. Multiplication is going to change the slope, addition and subtraction is just going to drop the thing up and down. So it's actually roughly, as you look at each one of the variables, we can talk conceptually about how they affect the relationship. That's something we're available to do.

9:53:16 AM

REPRESENTATIVE ROSES remarked that yesterday's testimony from Pioneer was eye-opening. He told members:

They talked about the fact that they had to go in and renegotiate the lease with the state and not only were they paying all of this but they were also paying 30 percent on the net. The progressivity we have is never going to get to 30 percent on the net. So there isn't a single company out there that had existing leases prior to this that's ever going to get as high as what the negotiated rate was for Pioneer. On top of that, we're giving them this additional boost so I'm trying to get my hands around how the fact that we hold some of those particular situations harmless and I don't know whether the cap takes care of that or not but it doesn't appear that it does. So I guess we're - I was struggling with this and thought these little dynamic changes of 2 percent here and .0002 here and .003 here and then I look at 30 percent and say we're not even in the ballpark. We're grappling over peanuts when the peanut farm is over here. So it sort of pales in comparison so when people say it's going to change the dynamic by raising this 2/10ths of a percent, and we saw somebody else get theirs raised by .3, not ... 2/100ths of a [percent], it just blows my mind. It just seems to me like we're arguing over some of the wrong points.

9:55:33 AM

REPRESENTATIVE SEATON said the 30 percent net cost share contract kicks in after [Pioneer] has recovered all costs, operating and capital. They also got royalty relief so that upfront their royalty is 12.5 instead of 5. That's a trade-off on net present value versus future. He was surprised to hear of 30 percent net profit sharing in addition to PPT, until he understood royalty reduction was given and the 30 percent net

profit sharing was a trade-off for the upfront royalty relief that doesn't kick in until costs are recovered.

REPRESENTATIVE SEATON pointed out that another difference does not show up on the graph because the [numbers] are static in time. Oil and gas will remain at that curve as will the curve for ACES, if one assumes increases in costs or inflation will move further to the right. One of the points discussed about time is that the trigger point being on the net accounts for all of the differences. That is not the slope of the line change or whether the tax is on wellhead versus net after costs. He continued:

That is not the determining factor of having this tax last for a long time and acquire the positions of having built into it the idea that it won't have to come back and be fixed because if you trigger it on the net, which ACES does, then those are taken in as whether you have inflation or whether you have increased costs in some fields. And so I just want to make sure that I'm understanding that right so if we look at those graphs and make some presumptions of 5 years from now with some inflation and everything else, those lines are going to move apart. But that wouldn't be the case if we keyed the gross progressivity on the net profit margin, the same as in ACES. Is that correct?

[9:58:47 AM](#)

MR. DICKINSON said yes, if one trigger is gross and one is net as costs change, the two will move further apart. He noted, in this graph, as costs increase, even with declining volumes and no inflation, the cost per barrel will be higher. The line will move to the left, not to the right.

REPRESENTATIVE SEATON clarified that ACES would move to the right and the gross trigger would keep it where it is.

MR. DICKINSON said that is correct. He added there are a number of net profit share leases on the North Slope. Pioneer is unique in that most of its oil is in the one lease. He pointed out:

The only other observation I'll make is also it then becomes deductible for PPT so the net effect, once payouts reach and those payments are there, then the

PPT will drop some. But, you're right, it's a much larger figure.

10:00:13 AM

REPRESENTATIVE FAIRCLOUGH stated, in regard to the comments specific to Pioneer, she met with Commissioner Galvin and some geologists to discuss those numbers. She learned that Oooguruk has been waiting to be developed for at least 40 years. Pioneer took a risk in stepping forward to produce it and was able to do that now because of the transition in basin holders that has allowed smaller explorers to come in. That facility agreement has allowed Pioneer to access a line at a much reduced cost rather than building new structures. She said the dynamics of who is investing in Alaska is changing as the statute matures so hopefully its tax policy will reflect that.

CO-CHAIR GATTO said hopefully the next Oooguruk will be able to take advantage of the infrastructure.

10:01:53 AM

REPRESENTATIVE WILSON said because of the dynamics occurring right now, legislators must be careful. North Slope activity is increasing so the legislature must be careful to do nothing to stop that.

10:03:03 AM

MR. DICKINSON replied the PPT does more than that. Instead of impeding investment, it makes it more attractive. He continued with his presentation., as follows:

... My last slide [Slide 7], everyone was hoping for, which is a little bit of algebra. Basically, some people think visually, some people in tables and some people think in equations. So I'm basically just trying to differentiate between the gross progressivity and the net progressivity. ...Let me start at the bottom with the net progressivity, which is the current law and how that works.

You basically have a rate. You start with R, which is the rates and it's a per barrel amount. It typically, in current law, it's .25. You multiply that times two other things. The first thing is to my mind how you get the total progressivity rate and so you multiply

that times the gross value at the point of production, minus all those upstream costs. You divide that through by taxable barrels so that this expression gives you a per barrel amount.

And then you say, okay, we're going to - not only will you get to recover your costs but before progressivity kicks in, you get to recover another \$40. This tells you how much the per barrel cash flow is from each barrel less \$40. Let's say that came out to be \$10. You then would take your rate, which is a quarter of a percent per barrel, and you'd come out you'd say okay, that's 2.5 percent. And then you'd take that 2.5 percent progressivity and you'd multiply that times the same thing that you calculate your total taxes against, which is your gross value less your upstream costs.

So that's how that currently works and that's how that works under ACES, and the only difference being that this 40 becomes 30, and the R - I guess I wasn't consistent in how I treated that - the R, instead of being .25 is .20. But the mechanics of it are the same. The equation looks the same.

The progressivity tax on gross is simpler. That doesn't mean it's right but it is simpler. I think, as everyone realizes, is all it means is you go and strike out - wherever you see an N here - a subtraction of costs, you strike that out and, probably partially to compensate for that, then this, the number that you subtract was up to 50.

So what it is, you take your per barrel rate, you say what's my gross value at the point of production, divide through by my barrels, find out what that is and knock out \$50. That gives me my index of the same thing. If it was a quarter of a percent, and that's \$10, you have 2.5 percent, and then you take 2.5 percent times the gross. So you're typically going to have a higher figure here and because costs are always going to bring that down. Whether this is high or not depends on whether the difference between 50 and 40 is larger than the difference between the costs and no costs.

I hope that's - now there's a third way of thinking

about that. As Representative Roses has - full equation and then for Representative Guttenberg's, you would then take this whole thing and add on the regular tax and then subtract the credits and the equation is a lot longer.

[10:07:34 AM](#)

REPRESENTATIVE SEATON pointed to two different functions in both of the equations. One is what you're taxing on at the end, G or G-N. The other is the trigger point, which is the middle sections and nothing prevents changing the trigger point from the lower equation into the upper equation and taxing on the wellhead instead of the net.

MR. DICKINSON said that is absolutely right. He pointed to the graph and said, "To put it in classic tax terms, this is your base and this is your rate, and there's no reason that you have to have the same figure in both."

[10:08:16 AM](#)

CO-CHAIR GATTO said the cross point is the intriguing number.

MR. DICKINSON told members the cross point will change, dependent on N.

[10:08:42 AM](#)

REPRESENTATIVE ROSES said the committee heard that due to progressivity on the gross, at a certain price and a certain cost, there would be no taxes on the base, therefore the cost would wash out and the progressivity would kick in. He asked for clarification.

MR. DICKINSON explained the progressivity does not affect the base calculation, nor can the progressivity go negative. If the per barrel amount is \$40, and \$50 is subtracted from that, that doesn't equate to a negative \$10 refund.

[10:09:39 AM](#)

REPRESENTATIVE ROSES said he thought that speaker's point was that if \$40 is the trigger point, but costs wash out to zero, no taxes would be paid on the base. However, with the gross, a progressivity tax would be paid but that isn't possible because the [progressivity tax] would only trigger in above that amount.

MR. DICKINSON opined that the opposite is true. He said the \$40 figure has nothing to do with the base. The state gets 22.5 percent of the net - that will never change. He said he shares Representative Roses' confusion about how that might work.

[10:10:43 AM](#)

CO-CHAIR GATTO said if the gross kicks in at \$50 and the cost is \$60, the company is not making any money. However the progressivity costs have still kicked in because it's a gross amount.

MR. PORTER explained that would occur in a high price environment for oil, where progressivity would kick in, and a company is spending so much capital that the net was spread to zero. He said he believes that is the only environment where that scenario could be possible.

MR. DICKINSON presented a hypothetical case of a company with existing production that makes a huge investment in a new field. Their net could be zero over all of their barrels because that new investment wipes out the tax on the original. However, those original barrels could still be taxed under gross progressivity. He said that might be likely if one of the current small players decided to make a huge investment.

[10:13:00 AM](#)

REPRESENTATIVE SEATON asked if gross progressivity was based on the trigger point of the net, that could never happen because the progressivity would not kick in without a profit margin of 30 or 40.

MR. DICKINSON responded that is correct. If any number goes to zero in the multiplication, the entire equation goes to zero.

MR. PORTER told members he and Mr. Dickinson are available to answer questions.

[10:13:56 AM](#)

REPRESENTATIVE ROSES asked:

After the bill came out of [the House] Oil and Gas [Committee], there was an article in the paper and there was some concern about the fact that because of the cost -

and that's why you were here to show the actual costs as opposed to the \$20...

MR. DICKINSON interrupted to clarify Representative Roses was referring to the actual estimated costs.

REPRESENTATIVE ROSES continued.

...exactly, well, the number based on what we think is the current cost. And there was an article that talked about the fact that under the House Oil and Gas provision that the state would get no additional revenue for 5 years based on the progressivity and the rate that they were in there. Did you follow that and understand what that meant?

[10:14:39 AM](#)

MR. DICKINSON explained that the fiscal note uses a forecast. Typically those prices start at \$70 and go down. In that case, the higher progressivity doesn't kick in, so the CSHB 2001(O&G) raises less revenue than ACES.

REPRESENTATIVE ROSES responded, "Under that prediction of a decline of prices."

MR. DICKINSON verified that is correct. He then explained that the second fiscal note forecast uses a nominal and real [number] and assumes a start point of \$80 and prices rise due to inflation. In that case, five years out the [barrel price] hits the \$90 range where the cross over occurs and that is the only time CSHB 2001(O&G) would raise more revenue than ACES. He said if today's price is used and one assumes that increases, the CSHB 2001(O&G) would raise more revenue today.

REPRESENTATIVE ROSES said the only way that would happen is if the stars were aligned properly.

MR. DICKINSON jested only one star would be needed to align with exactly what DOR said would happen.

MR. PORTER said if one asks about the impact of CSHB 2001(O&G), that version raises more money at higher prices and less at lower prices. The crossover point is roughly in the \$80 range, depending on a number of variables.

[10:17:32 AM](#)

REPRESENTATIVE WILSON said almost any scenario can be shown dependent upon what numbers are used. Legislators must base decisions on whether the prices are high or low and ensure the state is covered in either case. She expressed concern that if prices are low, developers will leave, which happened once before in Alaska. She opined that she does not want to repeat history.

MR. PORTER agreed that is very important and said it is also important to understand the relative significance of changing the numbers. He said he would compare a gross tax, which the state does not currently have, to a net tax, which is in both ACES and PPT and the relationship between the tax and progressivity. Each one of those elements substantially effects the economics of a project regarding taxes. If a company spent \$1 billion to get to the point of first production and 10 years, that is a huge front-end expense before it receives its first dollar. A gross tax would take a portion, maybe 20 percent, of that first dollar, which delays the amount of time that company can recover its costs. On a net basis, the company's cash flow is taxed, which helps the company recapture its money. The advantage of progressivity is that it gives the company \$30 (ACES) or \$40 (PPT) in cash flow before the state starts taking its portion of the windfall. If the state is trying not to impact the overall impact of a project, the progressivity on the top end will not affect the overall economics of the project as much as raising and lowering the base tax. He is a strong proponent of keeping the base tax stable and as low as is reasonable and in sharing in the income at the top end.

[10:21:53 AM](#)

REPRESENTATIVE SEATON noted that ACES has a fairly significant gross floor, 10 percent. That would be taken into consideration by a board when deciding whether to sanction a project. The committee has seen \$32 used as the stress point in models but now that has been kicked up to as high as \$75. He asked if setting the progressivity amount above that analysis point would prevent it from impacting a decision about sanctioning a project.

MR. PORTER replied:

... Especially if you're on - your trigger points on the net because you are giving them cash flow before you even start the progressivity. The problem with the gross floor on a percent basis is you really are

taxing that first dollar that they're trying to capture. I look at two things. If, in fact, West Sak is at 40, which I think the administration testified to, in that low environment that becomes very, very difficult. So a floor impacts your most marginal projects more than it does the very prolific projects, you might say. So that's the ones that you don't want to hit. To be very direct, that's a bad idea.

[10:24:13 AM](#)

REPRESENTATIVE SEATON said in looking at the give and take balance, the floor has been eliminated in CSHB 2001(O&G), which is a large percentage at low oil prices, yet the progressivity has been modeled to equal ACES so that it is not aggressive. He pointed out it is hard to tell the difference between the PPT and ACES line. He asked if Mr. Porter's understanding is the same.

MR. PORTER said Representative Seaton's analysis is correct, but needs to be qualified. He pointed out that although the lines are pretty close, the difference is significant in those out years as the difference amounts to hundreds of millions of dollars. He said the key is, when legislators look at progressivity, they need to figure out how much cash flow per barrel it wants to let the company recoup before it starts taking its windfall. Legislators will either determine the slope of the line depending on how quickly it wants to capture incremental value or decide to share the cash flow for every dollar in revenue. If legislators decided to set the number at \$120, at that point it would max out the state's share at 50/50. Legislators can do two things: choose the start point and choose the upper point where it wants to start sharing 50/50, and the slope will create itself. He emphasized he is speaking to net so that \$120 would represent the price per barrel less any costs.

[10:27:31 AM](#)

REPRESENTATIVE FAIRCLOUGH suggested the committee begin a round table discussion on the hot point issues so that the public can understand the different pieces going into the decision legislators are trying to make. She suggested beginning the discussion with net versus gross and continuing with the recognition of costs, the Governor's proposal, et cetera.

[10:29:54 AM](#)

CO-CHAIR GATTO said all of those issues could be resolved quickly if members knew what the price of oil was going to be. He said if one takes the historical average of a postage stamp, that would amount to about 20 cents, since the price has increased from 1 to 41 cents. However, no one can mail a letter for 20 cents. He thought, in trying to pick an historical average for oil prices short of a world wide recession, the average is unlikely to recur. He wished someone could establish a fixed price for oil from which to make decisions, but that can't happen. He noted the legislature is dealing with knobs and pulleys so that every time one issue is changed, everything else changes. Experts cannot predict the price of oil.

CO-CHAIR GATTO remarked that Representative Fairclough's idea of a round table discussion is superb because most public support appears to counter simplistic advertising. He opined that the committee should discuss the fact that the issue is barrels, not taxes, because changing the tax could result in fewer barrels.

CO-CHAIR JOHNSON said he agrees with the round table suggestion but asked that all committee members be present.

CO-CHAIR GATTO noted that three of the absent members are Democrats. Those members are in a meeting. He said he is so pleased that partisanship has not entered into this issue. He suggested taking a recess to wait for those members to return.

REPRESENTATIVE WILSON suggested taking a 10-minute break and informing the absent members of the plan.

REPRESENTATIVE ROSES suggested having the round table discussion after members submitted amendments, since there is a deadline for doing so.

CO-CHAIR GATTO reminded members that amendments were due at noon the following day. He said the committee could take a recess after the amendments are submitted so that members could review them.

[10:36:59 AM](#)

REPRESENTATIVE FAIRCLOUGH related her desire to have full participation and is willing to wait for the absent members to return. She clarified her desire is that people articulate the different positions on each issue, not advocate for any position. She said all legislators come to the table with a

different filter due to their different backgrounds. Her intention, she relayed, is to ensure all members have understood the testimony in the same way and to inform the public, not to participate in partisan politics. She further said she wants her constituents to know that all committee members believe this point in time to be very important for Alaska and they are trying to balance all of the issues put before them.

CO-CHAIR GATTO said he would also like the public to understand that the differences between the types of oil are as varied as the difference between soft and alcoholic drinks. The formula must adjust to the different types of oil because the expenses are very different.

[10:41:01 AM](#)

The committee took an at-ease from 10:41 a.m. to 10:57 a.m.

[10:57:17 AM](#)

CO-CHAIR GATTO called the meeting back to order. He announced the agenda for the remainder of the day would consist of a recess from noon to 1:00, at which time members would hear from the commissioner of the Department of Revenue and others. At 3:00 p.m. the committee will either recess or adjourn, depending on the amount of material covered.

CO-CHAIR GATTO invited members to begin an internal discussion for the benefit of the public, as well as members. He said members will meet at a second round table with the producers and the administration on Saturday. He asked Representative Roses to discuss ground rules.

[10:58:37 AM](#)

REPRESENTATIVE ROSES said his understanding is that this opportunity is not to be used as a press conference or to discuss members' opinions, but to get areas of concern on the table so that further clarification can be requested. That way future round table participants will be prepared for the line of questioning.

[10:59:58 AM](#)

CO-CHAIR GATTO explained that when Prudhoe Bay was young, the first barrels of oil had the consistency of a bottle of Coca Cola. As time went on, the lightest and thinnest oil had been

pumped and the consistency of the oil turned to that of syrup. The new oil, not yet available, will have a substantially thicker consistency. That oil will probably be developed in a decade because the technology does not yet exist to make development economically feasible. However, because that target is known, organization resources are focused in that direction.

[11:01:34 AM](#)

REPRESENTATIVE SEATON said he would lay out the issues in CSHB 2001(O&G) that he would like the experts to further clarify. The first is the exploration incentive credit (EIC) because he has not heard enough information on all standpoints.

[11:02:33 AM](#)

REPRESENTATIVE FAIRCLOUGH said she would like the producers and the administration to discuss progressivity, specifically about appropriating funds into the Constitutional Budget Reserve (CBR), the permanent fund, or a separate account, at the round table scheduled on Saturday at 9:00 a.m.

[11:03:58 AM](#)

CO-CHAIR GATTO opined that it is time the legislature repaid the funds it borrowed from the CBR, and thus he expressed interest in that being part of the discussion.

[11:04:21 AM](#)

REPRESENTATIVE GUTTENBERG said he thinks members already know what industry representatives are going to say at the round table, for example they want a partnership but it does not need to be balanced. He said he would like to get a definition of windfall profits, and discuss terms of behavior. The consultants have told legislators they do not have enough information from the course of the last 30 years to predict [oil companies'] behavior. He believes part of that behavior is influenced to a great degree by happenings elsewhere. He specified that he would like to hear from the administration about the evolution of the ACES bill, especially its change from the gross, and how it expects behavior to change. He also wants to know how the bill evolved from going to the gross to ACES.

[11:06:56 AM](#)

CO-CHAIR GATTO said he would also like to hear about the

evolution of ACES and its change from the governor's initial campaign promise.

11:07:19 AM

REPRESENTATIVE SEATON requested discussion about [AS 43.55].165(e)(6) and the BP situation. He would also like all of the participants to discuss expanding [AS 43.55].165(e)(6) to include criminal negligence, the fact that those costs would be non-deductible, and on the impacts of eliminating the section about unscheduled shutdowns and how audits would be handled.

11:08:56 AM

CO-CHAIR GATTO asked if Representative Seaton thinks it is necessary to discuss fines and penalties that have already occurred.

REPRESENTATIVE SEATON related his understanding that all bills have a retroactivity portion that deals with that issue so he doesn't think that would be built into new legislation. He then expressed interest in discussing how that issue can be handled in the most expeditious way for all parties.

11:09:51 AM

CO-CHAIR GATTO said legislators spent a lot of time trying to figure out best oil field practices. He asked about the 30 cents a barrel issue.

11:10:33 AM

MR. DICKINSON recalled that Representative Seaton characterized [AS 43.55].165(e)(6) as the BP issue. He pointed out if a cost is disallowed in Prudhoe Bay, half of that interest belongs to BP, almost one-quarter belongs to ConocoPhillips, almost one-quarter belongs to ExxonMobil and the remaining interests belong to small operators. One of the issues legislators wrestled with was working interest owners, specifically how an operator's criminal negligence would affect the tax return of the working owner. He said negligence issues need to be thought through.

11:11:35 AM

REPRESENTATIVE FAIRCLOUGH said she would like the administration to speak to the issue of confidentiality. The committee has talked about a wide variety of people who would have access to a

wide variety of information in both DOR and DNR. She questioned whether the administration would be willing to trim down the exposure because the producers have spoken to how confidentiality impacts their competitive edge on return on investment. She supports the Governor's attempts at transparency while providing confidentiality but wants to know how she plans to do that.

REPRESENTATIVE WILSON said that is her concern also. She added the data in ACES is wide open. She would like to know whether that can be narrowed down.

11:13:35 AM

REPRESENTATIVE SEATON said he wants to make sure the producers and the administration are aware that members have requested specific information, such as amendment language from possibly ConocoPhillips to tighten up the confidentiality issue.

MR. DICKINSON provided three observations on confidentiality. The first is that DOR would share forecast information with DNR but the time period for the forecast information is not specified. Currently, most oil revenue is taken in cash payments but, 20 years ago, most of it was taken in-kind. He pointed out that DNR was acting as an agent, selling oil and held several competitive sales. Although DNR has not done that recently, it retains that right. He noted if a company's potential competitors for sales in Alaska must submit all forward-looking information, legislators might consider whether DNR's marketing folks will be looking at that as they think about RAV.

MR. DICKINSON turned to his second concern: that on the forward-looking information, in a worse case scenario, auditors may find a document necessary to forecast or with the potential to forecast and say that should have been produced. However, DOR could wait to notify the company until the end of the time period, six years, and send the company a bill for \$2 million, which equals a fine of \$1,000 per day times six years. He said if the intent is to fine a company when it does not produce a document requested by the department, the \$1,000 per day fine should suffice [and the company should be notified immediately]. He opined that concern should be addressed.

MR. DICKINSON said his third concern addresses a technical issue. The current tax statute says the department can publish information as long as it's combined so that a particular

taxpayer's business cannot be identified. The ACES bill will eliminate that protection and instead requires that three taxpayers' information be combined so that BP's tax information could be combined with the two smallest taxpayers' information and be published. He said the same approach is used for the salmon pricing report so that if there are fewer than three taxpayers in a category, the information is not published. If, at some point, three can be combined statewide or one taxpayer represents more than 80 percent or two taxpayers represent more than 90 percent, the data will not be published. Second, the salmon pricing report remains under the general tax rule that requires the particulars of a taxpayer's data be disguised. He related his belief that rule should remain, but noted his agreement with the overall goal of clarifying what can be published.

[11:21:16 AM](#)

CO-CHAIR GATTO asked if that falls under the confidentiality provision.

MR. DICKINSON answered it falls under the publication and sharing of taxpayer data between departments provision. He said Representative Wilson's concern about the forward-looking information pertains to being more specific. It currently says, "anything necessary for a forecast." A taxpayer could consider information useful but not necessary to forecast. He suggested telling taxpayers to tell DOR for the next eight years what the following categories will be: capital and operating costs; exploration costs; and projected volumes. Where a unit exists, the state should be privy to any information passing between members of the unit, such as when projects get approved.

CO-CHAIR GATTO asked if Mr. Dickinson will be participating in the round table discussion.

MR. DICKINSON said he will not.

[11:23:04 AM](#)

REPRESENTATIVE FAIRCLOUGH asked if the House Special Committee on Oil and Gas extended the auditing period to six years. She noted that producers and the public have said allowing a bureaucracy additional time will only increase the longevity to produce a document. She pointed out that Representative Roses has requested that the administration provide facts at previous meetings on how often audits have been pushed out past the three

year timeframe. She added federal tax returns can be audited up to seven years after being filed. She has not seen a response and she would like an answer before looking at CSHB 2001(O&G).

[11:24:36 AM](#)

REPRESENTATIVE ROSES recalled he also asked how many times a situation has been pushed into jeopardy status.

MR. DICKINSON said no statute of limitations applies to situations like fraud.

[11:25:23 AM](#)

CO-CHAIR GATTO said the base rate could be a topic.

[11:25:32 AM](#)

REPRESENTATIVE ROSES said he is sure the administration will try to justify why the legislature should adopt 25 percent and a 10 percent floor but he does not have any questions about it.

[11:25:56 AM](#)

REPRESENTATIVE EDGMON said he does not expect the parties to be surprised by any questions at this point since the deliberations have been going on for 16 days. He thought Representative Roses characterized the situation most candidly when he said the legislature is in session because the price of oil is at \$96 per barrel, so the discussion is about money on both sides. He said the committee heard testimony yesterday about finding a sweet spot but he believes, as policy makers, legislators are looking at a fairly balanced viewpoint, that being the yield curve where it starts at the bottom end and goes to the top end so that both sides share in the risk and the reward. He pointed out the producers have talked almost exclusively about the risk side.

[11:27:54 AM](#)

REPRESENTATIVE SEATON pointed out that members heard a lot about underestimation of costs and possible underpayment of tax based on costs claimed that may not be appropriate. He was not sure whether the reporting requirements in the bill will cover all of that. He requested more information on what the penalties for underpayment need to be to get as close as possible to the estimated tax payments for the net present value.

11:29:27 AM

REPRESENTATIVE WILSON expressed interest in hearing more about the topping plant. She recalled asking how many barrels are involved right now and whether expanding its use to all operators on the Slope will significantly increase the number of barrels and impact the royalties the state receives.

CO-CHAIR GATTO said he would like to know whether the topping plant saves the producers or the state money.

11:30:46 AM

REPRESENTATIVE FAIRCLOUGH said she does not want to advocate for a large credit for a particular company. However, she related her belief that the EPA and environmental standards to reduce sulfur in diesel specific to the topping plant issue can be compared to land use issues. If one wants something to be done, one changes a behavior; in this case, at the state level on taxation, at a local level on land use policy. Sometimes unintended consequences occur. She continued:

So, I think that the federal government in the EPA ruling that mandates a reduction in sulfur and diesel, their intent is to take carbon monoxides and toxic chemicals out of the air. And so, I'd like to have a conversation of the dollars and cents, as Representative Wilson and you have both spoken to, but then I have to take a step back and say what was EPA's intent. If we're going to put 50 trucks, and I'm not certain if that is round trip or not because that means it could be up to 100 trips per day, on a road that the State of Alaska will have to maintain, so there will be costs allocated to that maintenance that aren't picked up by those trucks because the diesel that's hauling the trucks will contribute to the federal tax on fuel but what they are hauling will not. My point is there are air quality issues and other issues that will impact a decision of building something on the North Slope that goes beyond the finances and that is that EPA is trying to extract toxic poisons out of our air, which is a global issue. Again, it's weighing that balance.

I'm certainly not advocating for the credit but I am advocating for the consideration of there is more to the issue than dollars and cents when it reaches the general public and the benefit of the general public. The bottom line is that the intent from EPA is to get the toxins out

of the air and then we're going to, because of economics, choose to put hundreds of trucks on a daily basis. I wonder what the dialog will be and how much carbon we stick back in the air in putting the lower diesel fuel into service. I'm sure that you understand what I mean. I just know that there's a trade-off there.

[11:33:24 AM](#)

CO-CHAIR GATTO acknowledged both a social and economic cost.

REPRESENTATIVE FAIRCLOUGH said [oil development] creates an environmental cost, a health cost, and a global warming cost.

[11:33:44 AM](#)

REPRESENTATIVE SEATON asked if members received a three-page memo on the number of trucks and maintenance costs. He said he would distribute it if they did not.

[11:34:04 AM](#)

REPRESENTATIVE WILSON said she would like to know whether companies can deduct payments to the state from federal taxes and whether they could still take those deductions at the federal level if the state does not give them. She asked:

If we said we weren't going to use that as a deduction, do they still get to deduct it at the federal level? I would like to know that because that would make a difference in what I did too. If they're going to get it deducted at the federal level, then why would we give them a deduction for it?

MR. DICKINSON explained many expenses on the North Slope are deductible for the purposes of PPT, state income tax, and federal income tax. He pointed out a deduction does not provide 100 percent recovery of costs. He felt it is entirely appropriate, given three different taxes, to allow companies to deduct something from each. Generally, the deductibility on the federal tax will be very separate from the way the state treats it. The state income tax uses the same standard so it would probably be deductible state income tax whether or not it was deductible from the state production tax, unless the legislature specifically prohibited it.

[11:36:23 AM](#)

REPRESENTATIVE ROSES said he thought Representative Wilson's concern was not so much about the deductibility of expenses but whether or not the company was receiving a federal credit or a special write-off on federal taxes. Her concern was not about the state issuing credits on top of those credits, he suggested.

MR. DICKINSON agreed and said credits would add up more quickly but even a federal credit is not typically 100 percent.

[11:36:55 AM](#)

CO-CHAIR GATTO announced that the committee would recess until 1:00 p.m.

[1:22:28 PM](#)

CO-CHAIR GATTO reconvened the meeting and asked Mr. Gavin to give his presentation.

[1:22:38 PM](#)

PAT GALVIN, Commissioner, Department of Revenue, gave the following testimony:

Thank you, Mr. Chair. Today I wanted to just pick up some loose ends and cover some things that we haven't had a chance to cover in the previous testimony. Some of this is in response to issues of concern that have been raised to us or questions that people have asked us to pursue.

And I've broken this down organizationally into four different topics. I've got the first one - an explanation of credits. There was a lot of discussion about the way that the credit system works between new companies coming in, current companies who are currently producing, and then when we start talking about the exploration incentive credit program, all the numbers start to blur and so what I've tried to do is capture as neatly as I can, in just a few slides, some of the distinguishing characteristics of the credits as it relates to new entrants, existing explorers or existing producers and the EICs. And so that's one section.

The next section I wanted to do is just run through

from the administration's vantage point, the House Oil and Gas CS and give you our comments in terms of things that we would like to see changed in the CS when you consider moving something out of this committee. I'm going to walk through those and, in the process of that, identify maybe some other directions on the issues that were being addressed in that CS.

The next area is talking about transportation deductions. This is something that hasn't come up in this committee yet and it was an issue that's come up through a number of legislators who have asked about how the tax system deals with the transportation deductions associated with pipelines that have tariffs with maybe distinctions between what are the actual costs versus what are the applied tariff costs and how that relates to the tax system. So, I've got a description of that and hopefully I'll have some expertise on the phone to help me with that.

And then finally, there's been a lot of discussion about progressivity, about ways of calculating it, about net versus doing it on a gross basis. The House Oil and Gas CS is on strictly a gross basis and there's been talk about doing some sort of a mixture. And so I wanted to bring the Gaffney Kline guys back and give you an opportunity to just ask them about these different options and I've had them respond to some of the ideas that I've heard from different members and to give you an idea of their perspective on the different options that have been discussed.

[1:25:36 PM](#)

REPRESENTATIVE FAIRCLOUGH said a copy of the slide in front of members is not on their table.

COMMISSIONER GALVIN said the slide he is showing is just a navigational slide; copies of the remainder of his slides are in members' packets.

[1:26:15 PM](#)

CO-CHAIR GATTO asked if someone would be showing up with a packet of information for members.

COMMISSIONER GALVIN said it was distributed to members and is entitled, "The Credit Story."

CO-CHAIR GATTO informed members that Ms. Thompson, Division of Oil and Gas, will be on-line and available to answer questions.

1:26:30 PM

COMMISSIONER GALVIN said Ms. Thompson is the expert on the transportation deductions. He then continued his presentation:

[Slide 2] So turning to the credits, I hope this is helpful. I put this together this morning after thinking about the way that this is rolled out over the course of the days that you've been working on this and realizing that it kind of comes disjointed and sometimes it's difficult to understand how they all fit together. And to this is an attempt to kind of bring that together in one place to hopefully better understand how these parts work.

CO-CHAIR GATTO informed members they should have a copy of a letter that was to accompany a chart on the structure that was previously received.

1:27:25 PM

COMMISSIONER GALVIN continued:

So what I'm going to go through are two different scenarios where you have a development project that is being undertaken by a new entrant, somebody who has no current production, no current tax liability and then look at a similar project if it were undertaken by what I am referring to as an incumbent, somebody who currently has production and is currently paying production tax and has the opportunity to transfer credits directly. And then, separately, we'll talk about the exploration incentive credit program and how that treats different activities.

1:28:10 PM

So, in the first example, a new company comes in, and a prime example of this would be Pioneer. They come in with a new project and let's just, for the sake of explanation, think about their project costing \$200

million in development costs. Under both PPT and ACES, they get a 20 percent credit that's going to be taken off at the bottom of any tax liability. Both of them get the same ... under PPT and ACES it's still the same and so it's worth \$40 million to them in the end with a \$200 million project. In addition to that credit, as they're experiencing those costs, they're deducting it from zero revenue and so they're experiencing a loss in the amount of \$200 million. And then they apply their tax rate to - that they are allowed to apply against that loss - and that results in a net operating loss. Under both PPT and ACES, they are allowed to carry that forward one year and it turns into a credit the following year. It turns into a transferable credit that is the same as if they had earned it the following year.

[1:29:36 PM](#)

CO-CHAIR GATTO asked if a company starts out with a cost of \$200 million and gets a 20 percent investment credit worth \$40 million, the company's loss would equal \$160 million.

COMMISSIONER GALVIN said that is correct; although he has the numbers in reverse order. A company would first deduct the \$200 million from revenue, which results in a \$200 million loss. Taxes are calculated on that. A 20 percent rate can be applied under PPT, and then the credit would be calculated. Commissioner Galvin said the main point of Slide 2 is that under the PPT, the tax rate a new entrant is allowed to apply to an operating loss is set at 20 percent.

[1:31:00 PM](#)

COMMISSIONER GALVIN continued with his presentation.

And you'll see on the next slide [Slide 3], if they were an existing producer the tax rate would be 22.5 percent. What we're doing with ACES is we're going to have the same rate apply for either one of them - and you'll see that as we go through. So now we've got the incumbent situation - same project, \$200 million, company gets a 20 percent net credit at the end for \$40 million. But, in this instance, the company has production. They have a tax liability and so that \$200 million is just added to their capital costs for the year and it just reduces their tax base that their

tax rate is then applied against. It reduces their taxes to the tune of \$45 million, 22.5 percent. Under ACES the tax rate is higher so it amounts to a \$50 million value. The other additional thing to note is when you are with an incumbent, they are going to also likely have the eligibility for the TIE credit ... 10 percent in addition so they get another \$20 million. ACES doesn't allow that.

1:32:09 PM

So, comparing them side-by-side, ACES - new entrants, incumbents - for a \$200 million project, the new entrant is looking at a total credit under PPT of \$80 million and under ACES it would be \$90 million, the primary difference being that they get to write their net operating loss off against their actual tax rate as opposed to the 20 percent, sort of the artificially lowered number under PPT. With the incumbent, they're looking at ... what I missed in this is the TIE credit so you can add 20 on to these. Under the PPT one it would be \$105 million, including the TIE credit. The primary distinction I wanted to make was to show that under PPT, the new entrant for the same project gets an \$80 million credit, while the incumbent gets the \$85 million credit plus the TIE credit. Under ACES we're going to bring them both and let them both have a \$90 million credit so we're trying to create equal value between the incumbents and the new entrants.

1:33:52 PM

REPRESENTATIVE SEATON asked if those calculations are based on the assumption that progressivity has not been reached.

COMMISSIONER GALVIN said that is correct.

REPRESENTATIVE SEATON related his understanding that if progressivity was reached, the amount of deductions allowed for new entrants and incumbents would definitely differ.

COMMISSIONER GALVIN said yes, but one has to remember that progressivity is going to be based on the taxpayer's blended margin, so it would not necessarily be what the progressivity would calculate for this project. Each taxpayer and each incumbent will have a different progressivity number.

1:34:55 PM

REPRESENTATIVE SEATON asked if, for instance, the progressivity in either ACES or PPT was calculated on net and amounted to 10 percent, the incumbent would be able to subtract another 10 percent while the new entrant would not be affected because that entrant would be in the net operating loss category.

COMMISSIONER GALVIN said that is correct.

1:35:33 PM

COMMISSIONER GALVIN continued with his presentation, as follows:

And then the last slide I wanted to go over [Slide 5] because it is very confusing, is the exploration incentive credits program. I focused here on the credit for exploration wells. Just as a side note, the credits that are allowed under the EIC program are in exchange for the 20 percent credit that they would normally get under the ACES or PPT. So, when we talk about 30 percent or 40 percent credit under the EIC, it's substituting for the 20 percent credit that you get otherwise under ACES or PPT.

1:36:43 PM

So in this particular instance, we've got an exploration well program that costs \$100 million. And there's two tests that are going to decide how much of a credit they are going to get. The first one, under A, is if they are three miles from an existing well. I have existing well in quotation marks because it's important that there's a change in the definition of existing well between PPT and ACES that says an existing well is one that has been drilled within the last 25 years but does not include a well that's been drilled within the last year and a half. And so what that allows is for companies to come in with a drilling program under ACES and drill a series of wells in one area and get full credit for all of the wells of that program. Under PPT, they are only allowed the wells they drill in a single year. After that, those wells are considered existing wells when they come back the following year and so they don't get any credit for that delineation well and the rest of the wells they need in order to establish whether

or not to pursue the project.

So within these two tests, you look at the well and the first question is: Does it meet the first test, three miles from an existing well? The answer is yes and they qualify for at least the first part of the credit. Under PPT that credit is 20 percent, which is the same amount that they would get if they weren't applying the EIC program, just under the existing tax law. And so there is no reason to believe or to expect they are going to avail themselves of this program when they already have the underlying program that gives them the exact same value. And so, the recommendation under ACES is to move that percent up to 30 percent to provide some attractive value to it. The folks from DNR explained the value to the state of having them use the EIC program because it makes information that is generated by that program available to the state and ultimately to the public that otherwise wouldn't be and that there's a value there and that's why we're providing the increase in value of the credit if they decide to use that program - it's an exchange. We're buying the information exchange for a higher credit.

[1:39:24 PM](#)

If they meet both tests, three miles from a well and 25 miles from a unit, then they are going to qualify for a 40 percent credit - so again, 40 percent in exchange for the 20 percent that they otherwise would get under the tax code.

[1:39:43 PM](#)

REPRESENTATIVE ROSES asked if the commissioner is saying that information is so valuable we are willing to spend \$10 million of every \$100 million to get it.

COMMISSIONER GALVIN said DNR is saying yes, that is the value they place on getting that information.

[1:40:05 PM](#)

REPRESENTATIVE SEATON asked if there is also a difference in the value of credits taken under EIC as opposed to PPT. His understanding is the PPT credits cover more costs and are

broader so that a company would receive less value under the EIC for the three mile distance because of the base.

COMMISSIONER GALVIN said that is correct. He explained the definition of what is an allowable or qualified expense under the EIC program is more narrowly drawn toward the well or the seismic program. The tax provision has a broader definition of capital expenditure.

[1:41:09 PM](#)

REPRESENTATIVE SEATON questioned whether that narrower definition reduces the value of the credit, whether that has particular value to the state and whether there is any reason to retain that distinction in the base amount against which a credit is applied.

COMMISSIONER GALVIN said he believes the distinction should be retained because of the value exchange that has been identified. That will give 30 percent of the costs of a particular type that go directly toward the acquisition of that information. Also, that will establish what DNR is willing to pay in order to get that information. He continued:

When we talk about the 20 percent rate they would fall back to otherwise, we take a broader view of basically any capital expenditure they make in association with production or exploration. Since we are not tying it to the acquisition of the information, the actual either drilling or seismic project, we can have a broader view and a lower rate. I think if you end up taking the - what is referred to as the 023 definition of what qualifies for your credit - and just referenced that and used that as your 025 amount, we'd end up paying a lot more because we'd have a broader pool of costs that now we're paying at the 30 or 40 percent rate. That's not the exchange that we had originally set up. I think the distinction still makes sense.

[1:43:26 PM](#)

REPRESENTATIVE SEATON asked that DNR staff attend tomorrow's meeting to help determine whether that percentage has been adjusted. He noted that keeping dual sets of books, one on EIC and one on PPT, becomes problematic for everyone. He is wondering if a trade-off could be made so that the program is

more efficient.

1:44:10 PM

REPRESENTATIVE ROSES asked Commissioner Galvin:

A few moments ago I asked you the question was it worth \$10 million out of every 100 for you to get the information and the answer was yes. Now I'm going to ask the question the other way. If there was a choice between the EIC and the other credits, you said the reason we bumped it up to 30 was to make this an enticement so we could get the information. Is the exclusion of those additional deductions going to be worth the \$10 million that you are putting up to the oil companies or are they going to want to try to stick to the original, given an option?

COMMISSIONER GALVIN said that is not an evaluation that can be made in the abstract right now. Different companies will be in different situations, particularly with an incumbent. An incumbent may be looking for a potentially qualifying drilling program. They may have other values for drilling infrastructure in the area as a starting point for another project down the road. Their capital expenditures associated with that drilling program may not be directly related to the information from that location. The company may be looking into moving the infrastructure out to that spot as an interest in something else further down the road. Under the 023 program with 20 percent across the board, those equivalents are made. Under the 025 credit program, the state wants to know the costs associated with the acquisition of information that it will get. That will limit it to the cost associated with that drilling program.

1:46:06 PM

COMMISSIONER GALVIN continued his presentation, as follows:

So the next area is a reflection of the previous discussion, in terms of those net losses that under the PPT, the incumbent is going to get the 2.5, the new entrant will get 20 percent. Under ACES it makes them the same. And so, at the very bottom you see the difference in values between an incumbent and a new entrant. Under PPT, the incumbent is getting more value than the new entrant on either of the categories. Under ACES it makes them equal and also

between PPT and ACES we're providing more value for this whole exploration program across the board than under PPT. So we're trying to get all the numbers in one place to try to show where the move is going from PPT to ACES.

[1:47:14 PM](#)

REPRESENTATIVE SEATON asked if the difference between PPT and ACES is that deductible costs are allowed to be deducted at a higher tax rate.

COMMISSIONER GALVIN specified that the primary difference between the incumbents and the new entrants is the tax rate issue.

CO-CHAIR GATTO asked if the state should raise the taxes higher in order to give the new entrant an opportunity.

COMMISSIONER GALVIN replied, "If they're only worried about credits, yes. But I think they're also worried about how much they are going to pay us on the backside."

[1:48:13 PM](#)

COMMISSIONER GALVIN referred to the topics page and told members he wanted to walk through the [provisions] in CSHB 2001(O&G) that DOR would like changed. He told members he would reference sections from the original ACES bill, HB 2001, and compare that to CSHB 2001(O&G) when discussing sections he would like to see reinstated.

[1:48:51 PM](#)

COMMISSIONER GALVIN explained:

The first one goes to Section 1 of the original bill and that's a section that deals with legislative intent language. This legislative intent language is intended to reference that the legislature intends the change in the statute of limitations language to incorporate the regulatory interpretation of a particular potential event. That potential event is where a taxpayer files a tax return and somewhere down the road there is a decision by some sort of a regulatory body that affects the credits or the valuation that they put into that tax return and

retroactively brings it back and says it is different for the tax year that you had filed at some previous point.

[1:50:18 PM](#)

Under the existing regulations they are required to then alert the department and file an amended tax return to say hey, our rates changed, our valuation changed by this ruling. The statute of limitations on that amended tax return starts then because they've just filed a new tax return. This legislative intent is merely to say when we change the statute of limitations from three to six years, it also captures that instance where they have filed an amended return due to a regulatory decision. That's the interpretation that exists within our regulations and it's just merely to capture that when you change the statute of limitations, you're incorporating basically that interpretation.

[1:51:07 PM](#)

CO-CHAIR GATTO asked if, when an amended return is filed, the six-year clock is zeroed out for the entire return or the amended portion only.

COMMISSIONER GALVIN replied only for the amended return.

[1:51:31 PM](#)

CO-CHAIR GATTO said that might be the right approach but he wanted to clarify that the zeroing out of the six-year clock would apply to those amended portions only.

COMMISSIONER GALVIN said he would have someone check on that.

[1:51:54 PM](#)

CO-CHAIR GATTO asked if, under IRS rules, when a company files a 1040X, an amended return, the statute of limitations also zeroes out for the amended part.

COMMISSIONER GALVIN said that is correct otherwise everyone would wait to file until the statute of limitations was about to expire.

[1:52:39 PM](#)

CO-CHAIR GATTO said he understood the section that required the change but wanted to make sure the filers were not being penalized.

COMMISSIONER GALVIN told members that section was removed in response to a concern raised by AOGA as it read this provision as encapsulating an interpretation of how interest would be calculated retroactively but was referencing the wrong regulation. When PPT regulations were adopted several months ago, an existing regulation that dealt with this aspect was repealed and replaced with new PPT related language. The AOGA position was based on the previous regulation.

[1:53:30 PM](#)

CO-CHAIR GATTO asked if this section was in the ACES bill but deleted in CSHB 2001(O&G).

COMMISSIONER GALVIN replied affirmatively.

[1:53:34 PM](#)

CO-CHAIR GATTO inquired as to where that section is located in CSHB 2001(O&G).

COMMISSIONER GALVIN said the original bill had this legislative intent in Section 1, but Section 1 was not included in the committee substitute so it disappeared. He expressed the need for that intent to be put back in the bill.

[1:54:11 PM](#)

REPRESENTATIVE ROSES referred to responses to committee members' questions in a letter from DOR dated 10/30/07. An answer to a question he asked is on page 2, which was about extending the statute of limitations to six years and about frequency. He noted the response says desk audits are done for the four to five small taxpayers so they are not affected. However, for the six or seven taxpayers that undergo full blown audits, extensions occurred about 85 percent of the time. He asked Commissioner Gavin,

...Out of the 85 percent of the times that you've done it, has it taken it out to the full six years or does an extension mean one day, five days, a week, a month?

I guess the question that I'm asking is you're asking for six years but is four enough, is five enough? The point is, we want to give you what you need but you also do not want to create a situation by where if you got the time they might take it. We want efficiency as much as we can get it.

COMMISSIONER GALVIN clarified that it is the administration's intent, and remains a big part of what it is requesting in terms of audits, et cetera, to complete the audits as expeditiously as possible.

[1:56:21 PM](#)

REPRESENTATIVE FAIRCLOUGH asked how the history was compiled to come up with 85 percent. She noted that, so far, DOR has only been able to audit ELF on a gross tax basis and questioned how DOR determined six years for a net tax.

COMMISSIONER GALVIN admitted DOR does not have experience with a net tax so it is extrapolating from its experience with the current tax system. Under that system, audits are conducted for transportation costs and other aspects of the tax calculation. From the experience of the group and the audit supervisors, they recommended an increase from three to six years to avoid having an extension be the normal course of business. In terms of whether empirical evidence was used to make that determination, DOR has not had enough experience to collect empirical evidence.

[1:57:57 PM](#)

REPRESENTATIVE FAIRCLOUGH asked:

... In the experience that we have - that is having the department estimate a need for an additional three years, is there any way you could articulate for us what the specific triggers were that caused the extension because three years on a gross - I mean do you not have the appropriate personnel? I guess that's what comes to mind first because I did hear from the other side of the coin, per say, that feel like a liability hanging out there for an additional three years is not advantageous to good business practices. They have to carry larger liabilities on their books for potential loss of revenue in future years. So I'm trying to balance your request - and understanding [that] bureaucracy and government don't

move as fast as the private sector in some instances.

COMMISSIONER GALVIN asked a staff member to join him to provide a more detailed description of discussions with the auditors and their experience and, particularly, whether the extension was requested because of "bureaucratic crawl" or because companies need more time.

[1:59:58 PM](#)

JONATHON IVERSEN, Director, Anchorage Office, Tax Division, Department of Revenue, introduced himself.

REPRESENTATIVE FAIRCLOUGH asked whether the answer is "yes" or "no."

MR. IVERSON said it is yes.

[2:00:21 PM](#)

CO-CHAIR GATTO said it seems to have taken a fairly long time to reach the end of the auditing cycle under the gross tax situation. That would mean that under a net tax situation, [the process] will be stretched out beyond the statute of limitations. He asked Representative Fairclough to rephrase her question.

[2:00:51 PM](#)

REPRESENTATIVE FAIRCLOUGH noted DOR has recommended an increase in the statute of limitations on the auditing function from three to six years. She recalled that Representative Roses asked how often the problem was a matter of fact. To which the response was there has been an 85 percent history showing non-compliance and having to extend past the three-year deadline. She clarified that her question is if DOR only has experience under ELF, and extensions were required 85 percent of the time, what is causing the delay in completing the audits, and how did DOR ascertain that three years would help when, with a gross tax system, the three-year limit needs to be extended.

MR. IVERSON referred to DOR's 10/30/07 letter and read, "For the largest taxpayers, where we conduct full audits, we need extensions for 85 percent of those taxpayers." He explained in general, 15 to 20 taxpayers pay oil and gas production taxes annually. The state has a handful of large taxpayers. Of those taxpayers, 85 percent extend past the three year deadline,

therefore 3 or 4 taxpayers need waivers. Those waivers would be for six months to one year.

[2:03:06 PM](#)

MR. IVERSEN continued:

... The first question, if I'm interpreting it right, is what is driving the need for an extra three years; a couple of things. The first is that we are going to be relying on, to the extent that it's going to be helpful - and we plan on using these in audits - joint interest billings and joint interest audits as an input into our audit function. These would be the audits that are conducted by working interest owners in a unit on the operator - in other words, to determine if they've been billed appropriately under the operating agreement. Those audits take time in the first instance anywhere from a year to a few years - two or three years ostensibly. From there there's going to be issues that are exceptions that are going to have to be worked out between the parties. What we would like to do in order to benefit from those is have that time on the front end to be able to actually use those joint interest audits and joint interest billings and be able to see how those are resolved as a means to feed into our audit process. If a joint interest audit is completed after two years, and then there's exceptions still lingering, we would only have the benefit of that joint interest audit on the very tail end of our audit cycle if we're on a three-year statute of limitations, which puts us in a very compressed timeline.

In addition, we are dealing with, as Chairman Gatto pointed out, we are dealing with a net tax world now so we are looking at an increased bucket of costs. So that additionally adds into why we need the additional time.

[2:04:42 PM](#)

REPRESENTATIVE FAIRCLOUGH asked if DOR looked at joint interest agreements under the audits it did under ELF and whether that entailed auditing four or five companies and required, on average, a six-month extension.

MR. IVERSEN said the primary driver for the extensions under the ELF audits is the fact that several exchanges of requests are necessary to get the information to do the audit. Sometimes it is in the taxpayer's interest to make sure it gets the information to DOR to substantiate its tax return so that DOR does not have to estimate the amounts.

[2:06:27 PM](#)

REPRESENTATIVE FAIRCLOUGH referred to a response in DOR's 10/30/07 letter that says one corporation refuses to comply with the extensions based on its corporate philosophy. She noted:

What I want to make sure of is that's not how we're reacting to the six years to penalize all producers or all people filing tax returns because one individual taxpayer is refusing to extend like you would like.

MR. IVERSEN said that is certainly not the case. The DOR is not basing its request on the acts of a single taxpayer. The purpose of DOR's request is to get the information it needs out of the joint interest audits and have adequate time to address the upstream costs that are not addressed in the ELF audits.

[2:07:22 PM](#)

CO-CHAIR GATTO stated a properly filed tax return has no need for an extension. He said he doubts whether the legislature could pass any legislation to address the timeline for the one entity that is causing so much grief. He added a six-year timeline would not be a penalty for those taxpayers who have properly filed their returns.

MR. IVERSEN nodded affirmatively.

[2:08:24 PM](#)

REPRESENTATIVE WILSON admitted that she is amazed that a company can get away with [non-compliance] by saying it has a different corporate policy.

COMMISSIONER GALVIN clarified the issue is that when a company says that, the state is put in the position of facing the statute of limitations so it has to file a claim against that company based on the information it has at that time. That creates a less than optimal situation for either party because

the claim is based on a worst case assumption.

[2:09:21 PM](#)

REPRESENTATIVE WILSON surmised then that a lawsuit occurs.

COMMISSIONER GAVIN said the audit supervisor first works with the company. If the point comes when the state has to make a claim, the next step is the administrative appeal process. If no resolution occurs, the next step would be to take the case to court.

REPRESENTATIVE WILSON asked if that happens in every case.

COMMISSIONER GALVIN said it happens every time a company refuses to give an extension.

REPRESENTATIVE WILSON asked if it is always the same company that refuses to give an extension.

COMMISSIONER GALVIN replied:

Only when that company - when their tax return isn't completed by the time you get to the statute of limitations. So it's not every time that they file a return that we end up backed up to the statute of limitations, but every time that we do get backed up to the statute of limitations, we have this experience.

[2:10:43 PM](#)

REPRESENTATIVE WILSON said she is appalled by that situation. She then said DOR has asked for more auditors, not because it would help get the audits done sooner, but because it doesn't have the information.

COMMISSIONER GALVIN said an extension might be requested for a variety of reasons. It could be that DOR has a difference in opinion about whether a particular cost should be credited. That dispute would require additional discussion to resolve the dispute, the deadline kicks in and the case moves into the formal appeal process. It's not necessarily that DOR doesn't have the information, sometimes more time is needed for negotiation and agreement.

[2:12:06 PM](#)

REPRESENTATIVE SEATON related his understanding that Commissioner Gavin is saying the net tax will have more costs to review. However, if the audits required of the partners in joint interest agreements become the starting point for the state audits, the joint interest agreements must first be completed, which could take two years. In addition, the filing date for federal purposes is in October, almost a year later.

COMMISSIONER GALVIN said that is correct.

[2:13:11 PM](#)

REPRESENTATIVE FAIRCLOUGH asked:

... If the taxpayer who refuses to file the extension has submitted at the same time that the one - that another large taxpayer submits to say yes, it's all right for the extension, whose tax return gets finished first?

COMMISSIONER GALVIN said at the risk of generalizing too much, it is more likely the taxpayer who offers the extension will finish first because the process will continue in an informal way. The one who doesn't grant the extension ends up in a more formal process with additional procedural requirements. That creates barriers to resolving the issue.

[2:15:00 PM](#)

REPRESENTATIVE FAIRCLOUGH commented that if big business is choosing to be confrontational, a time or money advantage must be involved or it would change its business practice.

COMMISSIONER GALVIN replied:

... You asked me whether they are resolved in a more timely manner. ... I don't know whether they would end up calculating that they ended up with a better outcome by going through the formal process. It may have taken longer but they may feel like they got a better outcome because they formalized it and didn't compromise in an informal way.

[2:16:00 PM](#)

REPRESENTATIVE WILSON noted it costs the state more to go

through the extra steps and asked if anything can be changed to prevent that scenario from occurring.

COMMISSIONER GALVIN said either you have a deadline or you don't; when you have a deadline both parties are forced to deal with that deadline. It would be a mischaracterization to say they are in the wrong when they refuse to give an extension. Any company has the right to force the process to the next step. He expressed concern that unintended consequences would result if this issue was addressed as if a company that refuses to grant an extension is always in the wrong.

[2:17:47 PM](#)

REPRESENTATIVE WILSON asked if the time period is extended from 3 years to 6 years, a company's approval of an extension will be unnecessary.

COMMISSIONER GAVIN said the state will not be faced with the need to get an extension at the third year.

REPRESENTATIVE WILSON asked if the state will face the same problem later down the line.

COMMISSIONER GALVIN said he didn't know, but added that DOR expects to have its audits done within that timeframe.

[2:18:41 PM](#)

CO-CHAIR GATTO asked if a national association of auditors sets standards that might apply to this type of situation or provide parameters from which to work. He said he thought those standards might include a standard fine when the deadlines are exceeded.

MR. IVERSEN informed members that standards that govern both accounting principles and petroleum accounting do exist. He related that to his knowledge, those standards do not include a specific timeframe. Regarding penalties, DOR can only authorize them by Alaska statute.

[2:20:28 PM](#)

REPRESENTATIVE ROSES noted the committee has a deadline for submitting amendments and his are based on CSHB 2001(O&G). He told members the legal drafters believe the amendments should apply to the original ACES bill. He asked which bill the

committee will be working from.

[2:21:00 PM](#)

CO-CHAIR GATTO said he will address that question as soon as the meeting is over.

REPRESENTATIVE GUTTENBERG said he asked Co-Chair Gatto the same question during the break and was told the amendments should be drafted to the CSHB 2001(O&G) version. He opined that the drafters should be informed of which version.

The committee took an at-ease from 2:21 p.m. to 2:41 p.m.

[2:41:22 PM](#)

CO-CHAIR GATTO reconvened the meeting and told members the committee will be working from the CSHB 2001(O&G) version.

[2:41:58 PM](#)

COMMISSIONER GALVIN continued with his presentation, as follows:

So turning to the economic terms, the base rate within the CS is 22.5. The administration feels strongly that it should be 25 percent as a base rate. On a tax floor, the original bill included a 10 percent tax on the gross for the Legacy fields. We still believe it is the state's interest to have that protection on the downside when you have low prices. We recognize that if the legislature chooses not to have that floor in exchange for higher progressivity, that's a choice of the legislature but, if so, it should be traded out for that upside and it should be greater than what is proposed in the original bill.

[2:42:56 PM](#)

CO-CHAIR GATTO noted the two sections are not married so each would have to be dealt with separately.

COMMISSIONER GALVIN responded:

Right, but we recognize that it is a bit of a choice in terms of if you protect yourself from the risk associated with low prices, to a certain extent, you can be expected to ask less on the upside. But if

you're dropping that risk, you're going to accept the risk of the low prices and take that on, then you're trading that off for more on the high side and we would also expect that it would be the intent to save that money to cover those times when we might have lower prices.

[2:43:48 PM](#)

CO-CHAIR JOHNSON asked if the state gets more revenue at the high end through progressivity under CSHB 2001(O&G) using the current system.

COMMISSIONER GALVIN said all the consultants agreed that CSHB 2001(O&G) brings in less than ACES will until 2012. At an \$80 price, the CS would exceed ACES after 2012 based on the combination of the whole package included in the CS, including progressivity and the credits.

[2:44:59 PM](#)

CO-CHAIR JOHNSON asked if Commissioner Galvin had information about the difference between the progressivity on the gross and the net.

COMMISSIONER GALVIN said from the administration's perspective, when looking at the impact of progressivity on the variety of fields and the variety of players, it recognizes the value of having the progressivity triggered off of the margin. Gaffney Kline made an extremely compelling argument about the value of achieving two primary objectives: to bring in revenue and to positively impact the investment drive to attract the more challenged fields. That is done by having it set on the margin. The rate is a balance between the low and high end. The CS is fairly close to the original ACES with just a little bit more on the upper reaches. If the committee is going to be looking at a proposal where the administration's proposal is rejected to protect the state on the floor side, it would highly recommend taking more on the upper end. If the committee presents a proposal where it rejects the administration's proposal to protect the state on the floor side, it recommends the CS take more on the upper end.

[2:46:39 PM](#)

CO-CHAIR JOHNSON asked if the same would apply to the 22.5 versus the 25, so that recouping it on the progressivity side

would accomplish the same goal.

COMMISSIONER GALVIN related that the administration's belief is when the price comes down to a level where progressivity is not kicking in, the rate should be 25. That's the appropriate rate given the investment opportunities according to the models.

[2:47:16 PM](#)

REPRESENTATIVE ROSES asked if escalators were built into marginal rates, the administration would retain that view. He said progressivity is now fixed at one rate based on the margin. He questioned whether the administration would feel the same way about 25 if the margin was a certain amount at \$30 or \$40 or \$80.

COMMISSIONER GALVIN said it would because that is the appropriate place for the system to land when it gets down to where new projects start when they are dealing with smaller margins without progressivity yet.

[2:48:17 PM](#)

REPRESENTATIVE ROSES recalled that three of the four experts the committee has heard from about that issue and one of the reasons the House Special Committee on Oil and Gas did what it did was:

The philosophy was if you're working off of the net or working off of a margin, you get to share a greater amount of the profits on the higher end and you take less of the profits on the lower end and you're willing to take a little bit more risk when you're taking risk.

Representative Roses expressed concern that if it gets down to that lower end, the legislature will be back for more discussions anyway.

COMMISSIONER GALVIN said the principle is one that is commonly accepted. When talking about what the rate should be, Pedro Van Meurs said 25 percent is the right number. The administration's consultants said 25 percent is the right number. The previous administration said 25 percent was the number. The administration, he related, believes the collective analysis proves 25 percent is the number. He questioned:

Again, is that the steady state where projects are

burgeoning until they get to where their profit margin reaches a point where they should be paying more? We feel strongly that 25 percent is the right number to start with.

2:50:09 PM

REPRESENTATIVE GUTTENBERG said legislators are dealing with a world with many corporate models for structure. It looks to him like the different versions being presented use a "one size fits all" concept with differences in how the credits would apply. He asked if it would be simpler to draw a line to separate the Legacy fields from the new fields that are farther away because even though the operating expenses might be higher on the legacy fields, their volumes are exponentially higher.

COMMISSIONER GALVIN specified that the starting point would be that distinction. He explained that a variety of new fields and some of the long-term existing fields outside of the legacy fields and they have economic structures and challenges that are more diverse than the legacy fields. He said:

However, as we move forward in time and we look at the evolution of those legacy fields, what we see is the legacy fields themselves become a microcosm of the rest of the North Slope in that they are going to be moving into smaller fields...decisions on smaller developments that have those same challenges that we see outside of the Legacy fields.

And so when you end up taking the analysis to that level and you say okay, let's just isolate the Legacy fields and say what system should we have just within these, you end up making a similar line and - call it a line in the sand ... and you say okay, well, geographically we can describe the Legacy fields. But when you get inside those fields and you're trying to distinguish those new developments that you're trying to encourage and help along with a tax system that doesn't overly burden them while still hitting the fields at the rate that we want to hit the existing production, then you no longer have the ease of just drawing a line on a map and saying this unit is going to be under one and this is going to be under a different one because those fields now are distinguished no longer by ... horizontal separation. Now you've got vertical and you've got just the

essence of the product, of the resource. When we looked at ways of distinguishing that in-field development, what we found was there were just physical limitations of being able to distinguish one type of development from the existing production and treat one differently than the other and we just hit a wall there in terms of what we -

So, just backing up, we could come up with one system for the Legacy fields and a separate one for everything else that may be more dynamic and this one is more static. But in doing so, you're back to the same choice. Are we going to sacrifice, in some sense, the flexibility of the system within that and potentially jeopardize that new investment? It's a choice that's a very difficult one to make when you actually see the economic results resulting in a lack of investment.

[2:54:39 PM](#)

REPRESENTATIVE GUTTENBERG said credits are already delineated by mileage from an existing well. He pointed out:

There is a phenomenal economic advantage to be in-field drilling between directional drilling and ... multiple holes in the same place - multilateral - and then laterals off the laterals and laterals off those that you could still use the same model, whether the pads are there and the few places where there's more than 3 miles, 6 miles between - because that's what you're talking about. If you're more than 6 miles between drill pads, there might be that little gap between the two of them - it's 3 miles. It just seems like the infrastructure is there in place, the knowledge is there in place in some ways now that they are now drilling on the same pad and they have been able to get to different structures down below.

COMMISSIONER GALVIN said that is exactly right. Companies are drilling off of the same pads to access different resources, so distinguishing characteristics, like distance from infrastructure, cannot be used. Once the resource comes into the system, it integrates with the existing production.

REPRESENTATIVE GUTTENBERG said that was his point also.

COMMISSIONER GALVIN said the bottom line is that the companies that are exploring and developing within the existing field have an economic advantage because they have the infrastructure there. The question is how to recognize that in the tax system, which is to do it off the margin and recognize that it will be more profitable for them rather than for a company that needs to put infrastructure in place.

[2:57:22 PM](#)

COMMISSIONER GALVIN returned to his presentation, as follows:

Now turning on the economic side to something that was added - this is a new area that was not part of the original bill that was a desire to provide a tax treatment for gas that's produced in a part of the state outside of Cook Inlet that's going to be used within the state and to ensure that they get the same type of a tax treatment that is available for gas produced within Cook Inlet. In the [House] Oil and Gas version, and it was particularly focused on - I think Nenana was the primary - there's the Nenana Basin - we've got an exploration license in that area, that that was the target and the language was used by expanding what is, within the Department, referred to as "Middle Earth," the part between Cook Inlet and ... you've got the North Slope, you've got Cook Inlet, and you've got Middle Earth - that's everything else. ... And what we recognize is that this isn't complete and it's not complete for a variety of reasons. We've got a project that's being proposed and I know that people are talking to a number of you where they are looking at taking gas from the North Slope and liquefying it and trucking it down to Fairbanks to deal with the market there. That gas is being produced on the North Slope and so it doesn't qualify for this. Similarly, if Cominco wanted to pursue - they have gas possibilities at the Red Dog Mine, and they wanted to produce that gas and use it for their purposes at the mine site, they're above the cut-off line currently for the North Slope and so they would face the higher rates.

[2:59:29 PM](#)

CO-CHAIR GATTO asked if any distinction is made between shallow gas versus conventional gas.

COMMISSIONER GALVIN said that trying to make a distinction by depth becomes problematic because, for example, in Cook Inlet the gas is both fairly shallow and fairly deep. On the North Slope the gas is probably deep in one situation and shallow in another. That distinction would not help in this regard. Many legislators are concerned about addressing disparate treatment for Cook Inlet versus other places. He related that DOR believes the way to address that is to say if gas is produced for in-state use, it gets the Cook Inlet tax treatment. That would apply statewide, he noted.

[3:01:19 PM](#)

CO-CHAIR JOHNSON noted that staff has compiled a list of all of the questions that have been asked in Legislative Budget and Audit Committee, the House Special Committee on Oil and Gas and the House Resources Standing Committee. He said he would like to verify which ones have been answered to date. He then said he has some questions about the broad definition of "gas produced for in-state use" and that he would like DNR to come up with a definition of "below 64" that would not include the North Slope.

[3:02:35 PM](#)

REPRESENTATIVE FAIRCLOUGH asked if the administration has prepared an amendment to address the in-state use issue.

COMMISSIONER GALVIN said he will provide that shortly for members' consideration.

[3:03:18 PM](#)

REPRESENTATIVE SEATON said he would like to know whether the administration has worked on distinguishing between commercial and residential use versus industrial use.

[3:03:34 PM](#)

CO-CHAIR GATTO announced that the committee would recess until 5:05 p.m.

CO-CHAIR GATTO reconvened the meeting at 5:25 p.m.

[5:25:02 PM](#)

MARCIA DAVIS, Deputy Commissioner, Department of Revenue, told members she was filling in for Commissioner Galvin because he is attending another committee meeting. She told members:

As I understand it, we're in the process of describing what is bullet point number 2, which are the adjustments from the administration's view we would like to see addressed in a CS that would come from this body. We are down to - I think you had closed out what I'll call the economic terms and I'd like to raise as the next point of concern of the administration the carry-forward loss rate. I believe that was discussed briefly in the House Oil and Gas [Committee] and Representative Samuels made a closing note that they had intended to capture this and had run out of time.

And so, what we would counsel this body to do is, regardless of the base tax rate you arrive at, whether it remains at 22.5 or is our recommended 25 percent, we'll make sure that it matches in the carry-forward loss rate.

The other issue regards the DOR procedures for issuing credit certificates and, again, because we've switched out of doing it over two years, we don't need the provisions that talk about splitting certificates into two certificates. But there is a piece in the section in the Governor's bill that we want to not lose and that is the extension of time for the administration to issue certificates. Right now it's at 60 days instead of - we've asked for 120 days and the reason we have is because we are getting those submissions and they have a lot of information. We need to make some initial determinations and qualifications and we are getting pressed because we don't really have any [indisc.] to say gee, you got your information late to us or whatever. There's no authority for us to go beyond 60 days so our auditors and our administrative staff would like 120 days to process those. And we'd like that timeline to run from the date that that taxpayer is in good standing. Again, because we're requiring them to file annual reports, if for any reason they had failed to file their annual reports or resisted filing them, for the state to then issue tax certificates at the same time while they're not providing what they are supposed to provide for us.

We want those linked.

5:27:21 PM

CO-CHAIR JOHNSON asked Ms. Davis if the administration's adjustments will be presented to the committee in the form of amendments.

MS. DAVIS said they will.

5:27:39 PM

MS. DAVIS continued discussing the administration's desired changes, as follows:

The next item is the administration does believe that an oil and gas tax credit fund would be an administratively better way to approach providing the funds necessary to provide refunds of the exploration credits and the capital credits. While currently we are having to submit to the appropriations and keep coming back and trying to, it's a very disruptive process for the legislature and also for the individuals we are trying to provide an incentive to, which is to assure them that when we hit our deadline and we give them their certificate and it's appropriate for them to get that cash refund, that we don't say sorry, no can do, we're still in an appropriations cycle and there's no funds.

5:28:26 PM

REPRESENTATIVE GUTTENBERG asked, recognizing that the administration does not want to wait for a legislative appropriation, whether there would be reporting requirements to keep the legislature informed of what happened.

MS. DAVIS said it is her understanding that DOR has to report and account for the flow. The funds are not dedicated so DOR needs to keep the legislature informed of the inflow and outflow.

5:29:00 PM

CO-CHAIR GATTO asked if the administration is seeking a separate account with a name on it.

MS. DAVIS deferred to a staff member to answer that question.

[5:29:17 PM](#)

JERRY BURNETT, Director, Administrative Services Division, Department of Revenue, said the answer is yes, it would be a separate-named fund. In the original bill, an annual appropriation would be made to the fund as a percentage of production tax revenues. Payments would be made directly from the fund.

[5:30:02 PM](#)

MS. DAVIS continued:

The next item is TIE credits and the administration is concerned about the TIE credit language that is in the current House bill committee substitute from Oil and Gas. We also don't necessarily like what we did in ACES, which was to completely eliminate them. As we've been learning and seeing what the legislative body has been discussing, we actually like the change that the Senate had in their version. The reason is, we heard from the small producers since we drafted ACES, and their concern about being cut off from the ability to use TIE credits for their '06 and '07 expenditures that puts them on an even footing with the incumbents that had production and could use them in those years. So we like the revised language that the Senate has on that that changes ACES so we would be proposing to put that language in place of what's there now in the House committee substitute.

[5:30:59 PM](#)

MS. DAVIS explained that exploration incentive credits (EIC) existed prior to PPT so they were not changed when PPT was enacted. The administration has proposed some enhancements to the EIC program. She deferred to Ms. Thompson to describe the key enhancements.

[5:31:41 PM](#)

NANETTE THOMPSON, Unit/Tech Support, Division of Oil & Gas, Department of Natural Resources, told members the bill as originally proposed would expand the program and make it available to more wells. Also, the enhancements were designed

to better define the data that the state would receive and to make sure it is received.

MS. DAVIS said one other key change the administration wants is to increase the base credit from 20 to 30 percent and that is better than what is available under the capital credit program.

[5:32:32 PM](#)

CO-CHAIR GATTO asked if the changes were "costed" out.

MS. DAVIS said they were by determining the incremental difference in costs if the change had been in place last year.

[5:32:56 PM](#)

CO-CHAIR GATTO asked if DOR could make that determination in the Gaffney Kline model.

MS. DAVIS said she did not know whether the exploration credit was broken out in detail, but she said the staff that worked on that will arrive shortly and be able to answer that question.

[5:33:13 PM](#)

MS. THOMPSON said the other reason to increase the base credit from 20 to 30 percent is that the administration realized there might not be enough value because of the additional requirements involved in applying for an EIC.

MS. DAVIS continued:

The next area is the penalties for failure to report. The House picked up the reporting requirements and left out the two penalty sections and we would like to see those restored so that there is some enforcement on the reporting requirements.

[5:34:01 PM](#)

CO-CHAIR GATTO asked if the failure to report carries a penalty with interest.

MS. DAVIS said it does.

REPRESENTATIVE FAIRCLOUGH said she believes an amendment is being drafted to address that issue.

[5:34:24 PM](#)

MS. DAVIS continued:

Another key area of difference between the House committee substitute and the original ACES structure was lease expenditures are described and what our language sought to accomplish was have regulations define what ... allowable lease expenditures [are] as opposed to leaving the burden upon the agency to start to look at the universe of costs that are being claimed and start to pick out the ones that they are disallowing because before it was self-implementing.

What the House bill has is currently that same language, which says lease expenditures are anything that are reasonable, direct - you know, et cetera that meet these broad adjectives and then it comes in and it's up to us to then pick them back out through regulation. What we're suggesting be done and what was in ACES is essentially say they need to be reasonable, direct, et cetera, and be embodied in the department's regulations. That certainly places the monkey on our back to get the regulations out by the first of the year and provide the guidance to industry as to what those lease expenditures are going to be.

[5:35:33 PM](#)

CO-CHAIR JOHNSON asked if committee members will have an opportunity to get a list of the anticipated amendments to check that there is no duplicity for the legal drafters.

MS. DAVIS said that effort will be made.

[5:36:07 PM](#)

MS. DAVIS continued:

One other aspect of the changes, the role of company operating agreements - whereas the House CS did, in fact, remove .165(c) and (d), which ... created this whole collateral process for the department to have to assess and decide whether they were going to accept them - kind of rubber stamp them. In the ACES bill, knowing that that was going away, we still wanted to

hardwire a mandatory review by the agency in consideration of operating agreements, industry practices so that language got left out. So we think that might have been inadvertent on the [House] Oil and Gas Committee substitute but we will be proposing that that language come in to ensure that those items are taken into consideration by the department.

Finally, in definitions, in the CS they dropped out the definition of "unit" probably because the legacy language went away but, in fact, if the EIC credit language does come in we'll need a unit description because DOR's view of units is statewide, whereas DNR's definition would only pertain to state lands.

With respect to the final one, it's actually going to get toward this transportation deduction issue and again, I may resort to Nan Thompson on the phone for the intricacies regarding the FERC language. But what we're recommending is a change to Section 150. This was not in our ACES bill and what we feel needs to go into Section .150 (a) and (b) of DOR's net tax structure. In order to derive a net tax value, you need to deduct transportation costs and the way the statute is currently written in .150, it reads more like the royalty language in the sense that it hard wires the tariff and it presumes the tariff is the right charge to be deducted. The reason it was done in royalty was through contract and settlement agreements.

DOR is not similarly constrained. It is our job to assess what is a reasonable cost for transportation and, therefore, we're looking at .150 (a) and (b) to restore that balance so that what we deduct from the revenue to derive the taxing value is a reasonable charge for transportation. So some change is going to have to be made to the bill to get there.

[5:38:38 PM](#)

MS. DAVIS said those are the broad changes the administration would like to see made. The bill would also need statutory conforming language, depending on which language is included or removed. She said the administration's goal is to present appropriate amendments that will be grouped and that can be read as a cohesive whole. She said she would contact DOR's

progressivity experts to come discuss that topic.

5:40:19 PM

REPRESENTATIVE SEATON asked if the amendment about assessing transportation charges will look at the Regulatory Commission of Alaska's (RCA's) settlement regarding reasonable fees.

MS. DAVIS said no. The administration is looking at the existing statutory language in .150, which requires that a finding of three criteria be met. Before the state can deviate from a FERC established charge, it would have to prove that the parties are affiliated, that the transport contract is not an arm's length transaction or not representative of market value, and that the transportation method is not reasonable in view of alternative methods. She explained that elsewhere in DOR's tax code, when it tries to establish the appropriate value of, for example, diesel on the Slope, it looks at whether the transaction is an arm's length transaction. If not, it reverts to a different average price from the closest locale. That is the only criteria so DOR is looking to reestablish its ability to consider whether the charge is reasonable. Currently, the statutory hurdle is very high because DOR has to meet all three criteria.

5:42:21 PM

REPRESENTATIVE GUTTENBERG stated, in this instance, the state is unable to change FERC's tariff rate to what RCA has determined to be reasonable. He asked if the state could use a rate established by a regulatory agency on the calculated transportation costs.

MS. DAVIS said DOR could look at the regulatory agency's finding as evidence of reasonableness.

REPRESENTATIVE GUTTENBERG noted the amendment has already been written.

5:43:12 PM

CO-CHAIR GATTO asked, if the TAPS line has established a rate that is well outside of what anyone expected, how that is paid. He questioned whether it is paid first and then challenged.

MS. DAVIS explained that a shipper would be required to pay the approved rate and then follow the procedures in place, in that

case FERC's procedures and for intrastate transport the RCA's procedures. The rate payer would file an appeal and allege that the rate was not authorized by statute. From the state's perspective, when shipping royalty oil, it would be in the shoes of a shipper. If the state is acting as the sovereign, it incurs the tariff costs when deducted for tax purposes.

[5:44:43 PM](#)

REPRESENTATIVE SEATON asked what the administration is proposing regarding TIE credits.

MS. DAVIS said the proposal is to include all five years of prior investments from the '01 to '06 time period, so it is a single number accumulated during that time period as any particular producer's TIE credits.

[5:45:28 PM](#)

CO-CHAIR GATTO asked if that covers a six-year time span.

MS. DAVIS said it is considered to be five years. With that bucket of credits, the producers will be allowed to look at their expenditures in '06 and '07 and, to the extent they can carry 20 percent of that bucket of five-year costs forward as a TIE credit for each year, they can do so provided the 20 percent number is not in excess of 10 percent of their total capital credits. The incumbents can realize the benefit of that because they had production in '06 and '07 and DOR will allow those credits. A group of explorers that invested and spent money during that five year time period have a bucket of [credits]. She furthered:

What we're proposing be done is that the amount that they could have carried forward in '06 and '07, based on how much money they've expended in those two years, because they have to spend money to have some benefit there, we're going to allow them to carry forward for that time period that captures the value, and it's benchmarked against how much they spent in '06 and '07.

So that will be locked in time. It's as though that ability to use TIE credits gets vested by virtue of the investments they made in '06 and '07.

[5:47:16 PM](#)

MR. BURNETT noted in the PPT bill, companies were required to spend twice the amount they could claim in credits. When these companies spent in '06 and '07, they relied on being able to take advantage of this provision. He said it's a fairness issue since the companies with tax liabilities were able to take those credits against their tax liabilities.

REPRESENTATIVE SEATON surmised that would mean the proposed amendment still has a January 2008 "drop dead" date so that those credits that couldn't be used in '06 or '07 fade away, except for those companies that didn't have production to write the credits off against.

[5:48:25 PM](#)

MS. DAVIS explained:

It fades away for everybody. After January of '08, except for what got vested in either got used or didn't get used because they couldn't. No one else can reach back into that bucket and dig out 20 percent and carry it forward into '08, '09, and '10, so no one will be carrying TIE credits beyond '08.

[5:48:50 PM](#)

REPRESENTATIVE SEATON asked if TIE credits stop in '08, except that those companies without production can carry them forward for the investment equal to 10 percent in '06 and '07 and the effect would be minimal.

MS. DAVIS replied yes. In order of magnitude, DOR's ability to forecast the value of the TIE credits hinges in part on producers voluntarily telling DOR about them before they file to collect. Based on DOR's knowledge, the value of the credits that could still be used in the future by non-producers is \$60 million. Based on what DOR knows about the large producers, another \$700 million could be used in '08.

CO-CHAIR GATTO noted that is a substantial change.

[5:50:26 PM](#)

REPRESENTATIVE FAIRCLOUGH asked Co-Chair Gatto to take committee members' amendments prior to [the administration's] amendments. She opined that the administration should have found a sponsor

for its amendments.

[5:51:11 PM](#)

CO-CHAIR GATTO said he intends to group the amendments according to subject.

[5:51:28 PM](#)

REPRESENTATIVE FAIRCLOUGH asked that each committee member be given the opportunity to submit an amendment so that one member does not use all of the allotted time.

[5:51:53 PM](#)

BOB GEORGE, Gaffney Kline and Associates, told members:

Much as we have warned against the issue of taking snapshots on anything, I would just like to add before we go on here is what we have is a work in progress coming up. We've been looking beyond where we were two or three days ago when we did a presentation on the nature of the ACES' PPT structure and how different alternatives, particularly on the progressivity, impacted things.

We've taken that one step further and looked at one additional idea that's come forward on the way the progressivity may be handled. We are also in the process of looking at further alternatives on that but have not quite got there yet so I beg your indulgence while we progress that at the moment. But, we'd like to share with you at this point what we have got and what things are looking like from there.

CO-CHAIR GATTO asked if they intend to produce more or whether they are working against a deadline.

[5:53:59 PM](#)

MR. GEORGE said it was their intention to do their best to serve everybody's needs in a rapidly changing landscape. He continued:

What I'd like to do is I'm going to [indisc.] three or four slides from last time as a link on from where we were and then I have just a couple more slides dealing with this additional progressivity component and then

Rich has got some dealing with another issue in relation to it.

The slides I put up last time looked at a portfolio of investments and compared the outcomes on it under PPT as it currently exists. The progressivity portion of that on which I will focus in here increased the tax rate on the profitability as expressed in net cash flow per barrel by 1/4 of 1 percent for every dollar that that net cash flow per barrel exceeds \$40. I have called it an amendment here - I guess the correct term is the wording in the House Oil and Gas CS - maintain the basic PPT rate of 22.5 percent based on the net cash flow per barrel, but added an additional tax of .225 for every dollar that the gross value at the point of production exceeded \$50. That rate was applied to the gross value at the point of production.

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I again would just add in here what I have used as some illustrative examples. They are not intended to portray any forecast of revenues or the fact that the DOR's strong recommendations for a 25 percent base rate. I used 22.5 percent in mine, merely because that was the existing PPT rate. I showed this slide before, where under the existing PPT system, if we had a portfolio of investments and each incremental investment was economically a little more challenged than the previous one, and my definition of economically more challenged was that it had a smaller margin than the previous one, the progressive nature of PPT and under the net system meant the more challenged investments actually got some assistance from the PPT structure and therefore concluded that within a single system, such as PPT, you could co-exist opportunities of different profitability and the system would accommodate and adjust to that.

I showed also this slide, where with the House Oil and Gas CS progressivity proposal, that assistance given to the lower margin properties was significantly taken away. I have added one more slide that was in fact shown in front of the Senate Judiciary the following day but had not been prepared when we presented in front of you, and also showed that if that margin - and as you move from the existing reservoirs to

investments X, Y, and Z, if that margin was caused entirely by an increase in the production costs at the field, as opposed to some part of the margin being caused by a squeeze in the price as well as increased production, then you could actually get a regressive structure getting out of it, such that the more marginal fields were actually being taxed at a higher rate ... than the more profitable fields. It's just the mathematics of the way it works out. So the conclusion there was there was a difficulty with the structure that is a pure gross progressive margin on top. That was the one additional slide looking at that.

MR. GEORGE continued:

We've then gone on and looked at a further idea that has been out there and what I have termed in here, the net gross progressivity, whereby the rate of tax is calculated on the net cash flow per barrel, but it is applied to the gross value at the point of production. For the purposes of this example, I maintained a progressivity slope that produces about the same amount of petroleum tax revenue after capital investment after the House Oil and Gas one.

So the net, again to be clear, the net gross progressivity structure has a rate that is based on the net margin but is applied to the gross and, in this case, I took away the net in excess of the point at which the base rate kicks in in order to maintain a reasonable slope in there. If you took the whole of the net margin, you'd have to have a much lower slope than is actually possible in there.

[6:00:14 PM](#)

So what I've put up here now is, again, that same base slide that I've shown before based on PPT. And then when you apply the sort of net gross progressivity, it provides, in that snapshot, a very similar result in there. Again, it maintains the progressive feature, not quite as much as on a pure net system, but largely the same based on the fact that the rate itself is being set off profitability. Even though it's actually been applied to a higher tax base, that is the gross value at the point of production itself.

I looked at these as well in a couple of additional

ways here and I looked at the effective tax rate, and by effective tax rate, I mean the additional progressive tax being taken, divided by the profitability and I've got three colored bars on there that are variously annotated as NN, NG, and GG - NN for a pure net system - a tax calculated on the net margin applied to the net margin. The NG, which is this new addition in there, is a rate calculated on the net margin but applied to the gross value at the point of production, and the GG, which is the pure gross system we looked at previously. The effective tax rate, particularly on the gross-gross one, can be seen to raise much, much more quickly on there, because everything has been applied off the gross.

I have isolated, in this particular example, just the effect on the most marginally challenged field in there so I sort of subtracted out that on the basis of just looking, if I can go back up on here, on to field Z on there, I just looked at the effect that was taking place on field Z alone if you develop that incrementally to everything else in there.

On the pure gross system, the rate rises much more rapidly and challenges the properties, the more marginal properties, much more rapidly than if you base it on the net. Basically, these are two slides with the same basic information but where, on the gross system, some of the margin squeeze is caused by lower value per barrel at the point of sale, so it actually does lower the total gross value at the point of production as well.

[6:03:22 PM](#)

The conclusions, such as we might draw at this point in time from them, I think the first one is to caution that any of this needs to be tested on a much broader portfolio of properties and example fields as we were just really looking at the structure in this case, but with that caution. The gross progressivity structure, which is based on oil price and the gross value at the point of production, does hit the lower profitability fields harder to the point where you can actually get a regressive feature coming in on it there, although again, we note in that proposal there, the main portion of the tax that will be collected, which is

actually from the base rate, is actually based on profitability.

The gross progressivity, where the rate is based on the net cash flow per barrel, that's the sort of so-called net gross one, does damp that issue reasonably significantly it would appear. It still has some increase on - it has a rising impact on the real profit because it's based on gross at the point of production but does produce results that are much closer to the net system in there.

I think that was basically all I had to add at this point on it and, as I say, right now we're also looking at this further, at additional ways of looking at the slopes on the net gross system.

[6:05:11 PM](#)

CO-CHAIR JOHNSON asked if Mr. George and Mr. Ruggiero would be attending the round table discussion.

MR. GEORGE said either he or Mr. Ruggiero would attend.

[6:05:45 PM](#)

RICH RUGGIERO, Gaffney Kline and Associates, provided the following testimony:

Thank you, Mr. Chairman and Representatives. As we were giving our previous presentations - particularly Representative Seaton asked many questions and raised concerns that we really take a look at and understand that if you end up with a progressive system based on net margin, what would be the contribution that the state would be making to investments at certain points along, if you will, the graph or the plot of the production tax rate that you might put in place.

So one of the things that I was asked to do this morning is to use the words "find an exit ramp" for when the speed starts getting up there and you're getting up high on that progressivity slope, is there an exit ramp that might be sensible for the state to take and for you all to take as you deliberate on this bill as to where you would want the off ramp, if you would, with respect to topping out the state's

contribution in any investment scenario.

What I wanted to do, because I found this quite enlightening myself, is if you actually start playing with some of the nuances of the system that you have, you start to find that there are a few kinks and corners or elbows as we've talked about them, that have some interesting things happen at those inflection points. And so we wanted to go through and talk about what those look like, give an idea of how they come about, why they come about, and therefore you'll have this as background as you deliberate and then further questions tomorrow at the round table.

A couple of things I wanted to do in here is talk about a progressive system, and especially in a progressive system what happens when the net margin changes by a dollar. Remember we're talking about margin and not price so this is when the net profit before tax changes by a dollar a barrel. What is the impact if an operator should choose to make an investment before he finishes out that tax year.

What we have depicted here is a hypothetical system. This would be initially based on the net-net and then Representative Seaton, about an hour ago, asked if we could take a look at the net gross so I'll have that on the last slide. I was able to get that plotted up for him.

But anyway, we're talking about a basic structure where you'll start out with some base rate, so from zero margin you'll have a base rate up to a kick off point and, for this example, using \$30 net margin per barrel is the kick-off point. The slope, in this case using a .4 slope for the entire range, and then you cap off at some maximum. We chose to do that at 50 percent for this illustration.

What you also have then is a contribution when figuring out the production taxes to be paid as you do have an investment credit that sits in there right now at 20 percent. When we start talking about the tax deduction that would be available to a company if they should invest and write it off in the year in which they spend the money, they would not only get a tax break on the production tax, but they would also be

receiving the investment credit.

So a way of looking at this is that the tax credit is on top of the marginal tax rate that they would be receiving or the tax break they would be receiving for the investment. I've got some examples to run through this for us.

[6:09:52 PM](#)

REPRESENTATIVE ROSES referred to the previous slide that contained a 25 percent base with a \$30 margin kick-off at .4 and asked how those numbers were arrived at.

MR. RUGGIERO said he had a range of .1, .2, .3, .4. He used those numbers because it tops out at about \$100 per barrel, which is in today's range.

[6:10:24 PM](#)

MR. RUGGIERO continued:

To kind of show - I'll take you through a simplistic example. But, as it says up here, let's just assume there's a company that on a net basis, that is after their operating expenses have been covered, they have \$1,000 available as pre-tax cash flow. If we go ahead and say - they can be anywhere along that slope - if I go back up, having a position of \$1,000, they could be anywhere from just barely making a margin because they have lots of barrels. For example, I could be making a \$1 margin on 1,000 barrels or I could be all the way at the other end making a \$1,000 margin on one barrel. That situation could put you anywhere on the curve.

What I do say up here is that if the margin is such that the per barrel margin is under \$30, the production tax savings then associated with making a \$100 investment, so at that point making a \$100 investment, they would have an associated tax savings of 25 percent. That's because they're on the baseline. If we then go all the way above the top end, where it caps out, so if there's a margin that's significantly greater than \$92.50 per barrel, then the production tax savings for making that \$100 investment would end up being 50 percent or \$50.

But here is where it gets interesting. If I'm somewhere between \$31 per barrel and \$92.50, when I make that investment and we run through the math, the production tax savings could be anywhere from 25 percent, or \$25, to over 100 percent, basically the state writing a check for the investment and I'll show you how that happens.

[6:12:21 PM](#)

MR. RUGGIERO continued:

What I want to do is take a look at four cases at each one of these points and I'll explain them in order as A, which is where I'm on the base rate, so that's a margin below 30. We'll then go to case B, where I'm much above the \$92.50 point where it caps out. Then I'll choose two different points, C and D, on the slope to show you that the change of each of those points is not identical, and I will talk through that.

If we first go to a taxpayer who is sitting at Point A, basically to do the math on the net-net system, you'd take the \$1,000 revenue, you'd go up on the graph at the margin, and we're going to assume here that we've got 40 barrels so the margin is \$25 per barrel, the tax would just work out to be that \$1,000 times the 25 percent rate, which would be a \$250 tax.

But let's say now, right here near the end of the year, looking at things I think this is a good time to invest \$100 up there. What that does is it takes my net cash flow before taxes down to \$900, because I've invested that \$100. Because I had 40 barrels, my margin is now down to plus or minus around \$22 a barrel. And you can see my tax rate though, at that margin, is still 25 percent so my tax is 225 and, if I come down to the bottom, what I've actually saved in taxes overall is \$25 over my \$100 investment so the marginal tax savings investing at that point is \$25 or 25 percent.

[6:14:07 PM](#)

MR. RUGGIERO continued:

If I go all the way, as you remember, to Point B,

which is up there at about \$120 per barrel, I actually ran this case at \$125 and then you can see that the investment of the \$100 brings me down to \$110 a barrel. It's similar math but because the tax rate at both points - both the cash flow before I invested and the cash flow after I invested - is \$50, it's no surprise that the marginal rate turns itself out to be \$50 as well. So if I'm already capped out, at that point the state's contribution to a \$100 investment would be \$50.

[6:14:39 PM](#)

But now let's move to Point C, which is on the low end of the slope. This is where the math gets a bit more interesting so if I confuse anyone, please stop and ask me questions. I'm going to take that \$1,000 and I'm going to put me initially at a \$50 margin. That means I have 20 barrels, I'm making \$50 a barrel, I've got \$1,000. If I go up that curve at the base rate of 25 percent plus the progressivity, it said my tax at that point would be 33 percent. So multiply it out. If I don't invest, my tax bill will be \$330. However, now I decide to invest and actually it takes my cash flow back down to \$900 and I still have those 20 barrels. My net margin comes down to \$45 and now if I work that through the base plus progressivity calculation, I'll find out that my tax rate is 31 percent and my overall tax bill is now \$279. So if then go down and look at my tax savings for having made that investment, I take the \$330, I subtract the \$279, which is \$51 divided by the \$100, and I found at that point, even though the overall production tax rates were between 31 and 33, marginal savings available to a company for making that \$100 investment would be a 51 percent contribution by the state.

[6:16:11 PM](#)

Now let's move up the slope, which is not far from where we're at today. If I start at \$85 per barrel - again starting with 25 percent base tax at a kick-off point of \$30 per barrel - I've got \$55 above the index. I put my slope on, I find that my tax rate is 47 percent or I'd have a tax bill prior to investment of \$470. Again, subtracting the \$100 because I make it as investment, I'd go and find out that my net

margin per barrel is now 72. That makes my tax rate 43.6 percent, or my total taxes would be \$392. When I then subtract the \$392 after investment from the \$470 before investment, you find that my tax savings is 78 percent and that overall, then my marginal rate, because it's a \$100 investment, is 78 percent. In this case the state's contribution would be 78 percent of the investment.

So here we have situations, and I know that they're made up numbers, but I can put someone in that \$1,000 cash flow before tax position anywhere on the curve and, depending where on the curve, there would be a different contribution by the state towards any investment that they made.

[6:17:43 PM](#)

If we actually - instead of just looking at distinct points - but let's take it as a curve, what I've plotted up here is the bottom line - is the arrow that points to no investment. That's basically the tax rate that would be paid on the \$1,000. If I invest, depending on where I am on the net margin curve or the X axis, you then have to follow the top line and that is the marginal tax rate that would apply at each point along that system. So, you can see that right before we hit the max rate, the way the mathematics works, ... is you actually get to an 82-83 percent marginal rate on a \$100 investment at that point.

What I then did - that line if you remember was a \$100 out of \$1,000. That was 10 percent of pre-tax cash flow being reinvested in the business. So what I did is I actually ran this at a 1 percent reinvestment rate, a 5 percent reinvestment rate, a 10 percent reinvestment rate, and a 10 percent reinvestment rate.

What you see is the reinvestment rate gets higher. We still have the same general effect but as the reinvestment rate gets higher, the curve tends to flatten out and extend in time. The reason that it extends is that the more that you reinvest, then the more your net margin comes down after the investment and that actually brings you back down below that 92.5 point where you max out on the total tax.

[6:19:40 PM](#)

REPRESENTATIVE SEATON asked if 20 percent is reinvested, the rate would be longer but lower.

MR. RUGGIERO said that is correct. The marginal rate for investing at 20 percent is a little less than it would have been if you'd only invested 10 percent at that point. The impact continues on for much longer because of the size of the investment.

[6:20:15 PM](#)

REPRESENTATIVE SEATON asked if the marginal rate is on the investment dollars or on the entire \$1,000.

MR. RUGGIERO said two impacts are taking place. When the investment is made, it reduces the taxable base. In this case, the taxable base was reduced from \$1,000 to \$900. At the same time, a double impact occurs because not only did the tax base decrease from \$1,000 to \$900, the tax rate applicable to that amount decreased from 47 to 43. That creates a compounding effect. It comes in two parts: part because the capital spending can be deducted in the year in which it is spent and part because it takes you down the tax curve.

[6:21:21 PM](#)

MR. RUGGIERO continued with his presentation, as follows:

If you then put the 20 percent tax credit and make that available, and you plot that above these curves, and I did this just above the 10 percent curve that we've been working with, you'll see that when we get near the \$80 to \$90 net margin range, the contribution overall from the state could get as high as 104 percent.

[6:21:56 PM](#)

REPRESENTATIVE SEATON asked if federal income tax is included.

MR. RUGGIERO said it is excluded. This [graph] only shows the production tax and the tax credits for investments. He said [the federal tax] would increase the overall government take or the government share of any investment made by one of the oil companies.

[6:22:29 PM](#)

REPRESENTATIVE SEATON asked if Mr. Ruggiero was referring to the government contribution to the cost when he spoke of government share.

MR. RUGGIERO said adding the federal and state income tax impacts into this, the number would get larger.

[6:22:55 PM](#)

REPRESENTATIVE WILSON asked if Mr. Ruggiero is saying the legislature needs to be very careful about the progressivity number because the state's risk could be higher than intended.

MR. RUGGIERO replied:

Representative Wilson, the questions were being asked so we went and started marching our way along the curve and saying were there any anomalies that we can see and yes, there was an anomaly and so what we're doing is just bringing it to your attention so that you can choose how to use that in your deliberations.

REPRESENTATIVE WILSON questioned whether the answer is yes.

[6:23:43 PM](#)

MR. RUGGIERO said he has a few more slides to show but no matter what progressive type of system is used, that issue must be dealt with. He continued with his presentation. He explained:

Again, we kind of put up a question. Is there some sort of cap mechanism that you may want to put - location on here again is just for use of illustration, but you may want to say that the state's share or the state's contribution toward an investment at any point need not exceed a certain level.

[6:24:29 PM](#)

CO-CHAIR JOHNSON referred to Mr. Ruggiero's answer to Representative Wilson's question and asked if he was saying that regardless of the progressivity system used, an anomaly will occur.

MR. RUGGIERO said a double contribution will always occur if progressivity is based on the net margin where both the tax base and tax rate are changed. It will have a compounding effect, which is the anomaly, he remarked.

[6:25:02 PM](#)

CO-CHAIR JOHNSON recalled that in Mr. Ruggiero's previous presentation, he heard of two changes the administration would like to see made to ACES, perhaps a third. The legislature has 30 days, with 14 days left, and Mr. Ruggiero is presenting changes to his original plan. He suspected the legislature will have to return again to address this issue. He said he sees red flags everywhere and questioned whether ACES was not well thought out.

MS. DAVIS explained that because ACES is built on the backbone of PPT, the administration is trying to build in refinements and understandings that take place with time and study. During the last go-around, this body worked very hard to understand PPT and establish a progressivity structure. What ACES proposes at this time is a tweaking of the numbers of the progressivity structure. The current form of ACES merely contains a change in the trigger price and the change in the slope, so no structural changes were made to progressivity. Ms. Davis explained that what has come about through the continuing study is the effort to educate members on the linkages with capital credits and on how changes affect investment. She said DOR was asked to identify anything it has seen in its course of study. What staff has been discussing today is the aspect of what exists with PPT so, if nothing is done, those things remain. She said if this body does not want to discuss aspects of the current law or the content of the amendments that is its choice.

[6:27:52 PM](#)

CO-CHAIR JOHNSON said he believes the PPT needs to be given time to work. In two weeks, the committee has been presented with three changes. The existing information [about its impact] conflicts and consultants present dueling information. He is not comfortable with it.

[6:29:18 PM](#)

CO-CHAIR GATTO opined that 85 percent of the state's revenue is based on oil. Every year the state will discover something about the oil industry that it did not anticipate. As a result,

the state is at a disadvantage. If the state discovers something it did not anticipate that is an advantage, he is willing to face that too if it was not in the plan. He admitted that he does not think the legislature's actions in the next 15 days will be the end of the story. He likened the situation to studying for a law exam. He is hopeful, with PPT or ACES, the legislature finally reaches a point where the changes that need to be made are like fine tuning an engine. He believes at this point the legislature is working on a 1972 small block Chevy with bad valves.

[6:31:21 PM](#)

REPRESENTATIVE ROSES commented:

Earlier I asked you to go back to a slide and I asked you why you picked 25 percent and .4 and I didn't know whether that was something that you had generated for the Senate or if it was something that you generated on behalf of the administration to coincide with the compass piece saying if you're going to drop the 10 percent floor, then you've got to be more aggressive on the progressivity. That's why I asked if this was just a simple snapshot, a perfect example, or this actually was fitting what had been requested, either through the administration as part of their new proposal or whether it was something you created for the Senate in their Judiciary Committee as part of their process.

So that's why I asked the question and I think it goes along with what Representative Johnson was suggesting that this was the administration's proposed new change to ACES and that's why I asked. I don't know that it was. That's why I asked the question. I didn't want to make that assumption.

[6:32:17 PM](#)

MS. DAVIS told the committee that the administration does not have a formalized cap proposal. It has not talked about language. It knows the issue exists and simply wanted to bring it to the legislature's attention when developing tax policy. She believes legislators are owed the service of getting this information. She repeated the administration does not have an amendment to address this issue.

6:32:56 PM

REPRESENTATIVE ROSES said he was not referring to the cap proposal. He was addressing the 25 percent and .4 scenario.

MS. DAVIS replied, "We don't have it. There have been a huge number of pieces floating through with everybody having different options. I didn't know what the number was until it showed up here."

REPRESENTATIVE ROSES thanked her for the information.

6:33:40 PM

MR. RUGGIERO told members he chose the number to show that it can be over 100 percent. Within the realm of prices over the next few months, the state could be operating near that peak where it could be contributing over 100 percent of anything spent by a number of the companies.

6:34:07 PM

REPRESENTATIVE WILSON assumed he did not know that ahead of time so showed the committee how various numbers would change the outcome.

MR. RUGGIERO said the model is not a snapshot but a model of a cash flow program from the Prudhoe Bay drilling program. By modifying the numbers in the cash flow model, the inputs were changed. The model was not created to illustrate marginal impacts seen with this type of a fiscal structure. He explained:

But it was then going back and playing with the fiscal structure - and in, actually, this came about because in running that, we'd step through 1/10th of a progressivity, 1/10th of progressivity and every now and then we'd see things jump big, instead of a small jump. That's the type of thing - the engineer - you go hmmm, something happened, I've got to figure that out.

That's when we started - and then the questions that came from Representative Seaton about the participation that we then started looking into and saying there is a compounding effect just looking at the state tax that is apparent. And then we haven't

even started to model what that means from adding the federal and the corporate income tax into it.

[6:35:49 PM](#)

REPRESENTATIVE WILSON expressed concern that the state could be jeopardized because it is taking on much more risk than it wants to. She believes a cap is necessary.

MR. RUGGIERO said the legislature needs to assess whether that is a risk and decide whether it wants to use state money to back the oil companies' investments. He believes one point overlooked in the discussion is that if the state is ever contributing a marginal 80 percent that will be on 10 percent of the taxable cash flow. The advantage is if the state contributes 82 percent to that investment to encourage it, the other 90 percent of their cash flow is attracting a high tax rate as well. If the price increases to where a company makes an additional \$100 but no more barrels are produced, the marginal tax paid on that increase is also 82 percent.

REPRESENTATIVE WILSON commented that the amounts are tremendous.

[6:37:45 PM](#)

REPRESENTATIVE SEATON told members:

I think everybody needs to realize that in PPT we were putting together a tax plan and we were asked to tie that up for 35 years and we said wait a minute, we're designing a new tax plan and somebody wants us to tie this up for 35 years. We don't know what all the consequences of this tax plan are going to be and so we said no. This is one of the reasons because what we did in PPT is we said we're going to contribute - we did a net-net. We didn't out of this committee. This committee said that progressivity should be on the gross, which means this effect does not come in because progressivity does not kick in additional state participation into the cost.

When it went through the process, it got turned into a net progressivity. Nowhere was this ever discussed that turning that progressivity into the net doubled the state's risk of participation and capital into the program. The problem is that our participation into the program through deductions and credits is meant to

say we want to get projects sanctioned. So we went to these levels where they're going to influence decisions to go forward with the projects but the progressivity feature comes at high prices where you're beyond that analysis beyond those decisions to sanction.

So if we do the progressivity on the net, we are now learning we are contributing a massive amount of capital, which will have absolutely zero effect on project sanctioning because it's outside of the realm where those analyses are made. So I specifically requested the analysis of state risk and Pedro Van Meurs brought this up to us in a little 30 second comment he made when we were first here. He said ... exactly the first day - was asking about progressivity and he said your risk to the state having net progressivity is high and if you have net progressivity and you have it keyed to the net - in other words to the profit margin, you doubly risk yourself.

So I don't think any of us really concentrated on what that meant and so I understand Representative Wilson's concern because, you know, how long has it been since we did PPT and I never caught it. I never realized that - but we were never looking at - we knew we went up and capped at 25 percent to try to harvest an equal share, about 25, 25 percent in the base rate and then another 25 percent in the upper rate, which is a 50 percent split. But we never got around to thinking at a 50 percent tax rate, that means before credits, we're contributing 50 percent of the costs and then you add 20 percent credits on top of that and then you can add the corporate income tax contribution deductible against that on top of that and all of a sudden we are up into a range where those are things we didn't consider.

[6:41:36 PM](#)

So I'm very happy that we're here today looking at the tax, PPT, or ACES. This is not a function of ACES. This is a function of PPT and what we came forward in that and looking at it and seeing that - do we want to take that additional risk and get no gain because we're not going to get any projects sanctioned when

we're talking about making contributions when the price of oil is \$100 per barrel.

There's lots of money on the table. We've got to remember if it's \$100 a barrel and we're getting \$5 billion out of the production tax, that means they're getting another \$5 billion so it is not as if more cash taken out of the progressivity and putting on costs is going to gain us anything. I'm very comfortable that we're here talking about these issues that weren't addressed when we went through PPT and I hope that we look for solving those problems as we go forward. Sorry for taking so long.

[6:42:27 PM](#)

CO-CHAIR JOHNSON said he thought Mr. Romero said [the state] is encouraging production, increasing investment and generating no more money in the big picture. He thought Mr. Ruggiero also said even though we may be risking in this marginal area, once we get into that price structure we're generating a lot of money. This can be translated onto many fronts: employment, housing, taxes, and other benefits to the state. He further stated:

I think your answer to her [Representative Wilson] was the most telling thing I've heard. One snapshot, yea we get gamed a little bit, they invest a lot of money or more money. We get jobs for that - all the things that go along with that. On the other end of that, when we're at those prices, the treasury doesn't do so bad either.

[6:44:26 PM](#)

MR. RUGGIERO said he hoped no one believes he was saying the oil companies are "gaming" the system. He said it can be viewed as a problem or an opportunity. One thing this tax system could encourage is if a company is near the top end, it might decide to invest \$120 million into a heavy oil test well because it can do so with the state's contribution. Part of the state's contribution would be to R&D work, which is actual in-the-field testing. That would lower the technology risk and raise the possibility of investment in the higher cost, low market value heavy oil development. He noted the amount could be as high as 35 billion barrels.

6:45:30 PM

CO-CHAIR JOHNSON asked how that would be a problem.

MR. RUGGIERO repeated it is not a problem; some may see it as an opportunity. He said in a previous presentation, he discussed five goals. Goal number 2 is that a highly progressive system will actually encourage investment in the Legacy units. He continued:

And it's this impact, because of where they find themselves on this curve, they should be interested in investing in that point in time because of the contribution that the state's making. If you design a system like this, in a way, as a state you're saying you have faith in their ability and their capability and the rest actually spend that money wisely and bring more barrels in for the state.

6:46:29 PM

MS. DAVIS explained part of the purpose of bringing this forward is to recognize the positive aspects and realize this as an embedded opportunity. She said it requires a conscious decision so that the full magnitude of the incentive that's being created for industry is understood. She pointed out the House Special Committee on Oil and Gas was very concerned about quantifying impacts to investment and whether it would be enhanced. DOR's ability to answer those questions requires a precise understanding of each element of the PPT structure, as modified here does. With that understanding, committee members can test their own personal resolve and decisions about what level of state support should be involved.

6:47:42 PM

REPRESENTATIVE FAIRCLOUGH asked if the DOR forecast reflects the \$90-plus per barrel cost of oil.

MS. DAVIS said DOR just completed a Delphi protocol, where an economist and industry experts are brought in. They developed a near and long term forecast, which should be released within days. She said she was not at liberty to say what the numbers are but they reflect the current market conditions. So, DOR does reflect near terms to some extent but it does not assume that price will remain.

6:49:15 PM

REPRESENTATIVE FAIRCLOUGH said she believes if one looks at the history of revenue projection, the state has been overestimating the price per barrel and production that goes through on a continuous basis.

Several members clarified that DOR was underestimating the price.

REPRESENTATIVE FAIRCLOUGH said she truly believes Alaskans need to get their fair share for their resource through a taxation mechanism that encourages exploration and development. She wants the pipeline to be used maximally. She asked for Mr. Ruggiero's opinion on the future outlook on crude oil.

6:51:38 PM

MR. RUGGIERO replied:

What I would say is what we're presenting today, and even what we presented a couple of days ago to this committee, is not to be predictors of where the price is. We're firm believers that ... as Mr. George said, we'd be on his private island right now if we could predict prices that well.

What we've been trying to bring forward is 1) views, perspectives and a little bit mixed in recommendations based on the fact that the three-legged stool of production price and cost is always going to be tilting one way or another from where you thought it was going to be. Because of that, what you want to do is think about, as you put your fiscal structure together, what is the structure, what are the mechanisms - if you would, where are the bail-out points or where are the pressure relief valves in that system, such that you don't have to worry about whether or not DOR gets it exactly right because the system that you will put in place will help Alaska overall to react properly to however those three things change. ... I think all we're trying to show here is not to say that you should pick something to happen at 92. You may pick it to happen at 62, you may pick it to happen at 162. That's your choice.

This effect that we show on the slide will help happen

regardless of where you pick your kick-off points; your capping points are the rest. It's just something you're going to have to deal with unless you go to a straight increased royalty - straight gross tax, which I highly recommend against. But if you pick a system that meets the goals of the state, gets equitable or fair share at high prices, but at the same time encouraging investment where you want the investment, then these are the type of issues you are going to have to deal with.

[6:53:33 PM](#)

REPRESENTATIVE FAIRCLOUGH commented that no matter whether the price of oil is \$10 or \$100 per barrel, it is important to have a model that is good for Alaskans, the state, employment and businesses. She said she didn't want to get caught in a "rabbit hole" by failing to recognize that extremes may occur on either end. She again asked Mr. Ruggiero for his future forecast on the price of oil.

MR. RUGGIERO spoke about an ongoing piece of work from a California university which charts the predictions of renowned experts in the oil and gas business. The most accurate predictor, with twice the accuracy of any other predictor, was the five-year forward strip on the NYMEX.

[6:55:17 PM](#)

REPRESENTATIVE GUTTENBERG said one of the experts tracked in the report is named Yergen (ph) and he was wrong more often than right. He said the graph raises concern about the state's involvement, but the expectation was that production would increase as the result of an increase in development. That's the goal. He pointed out that in some years the liability may be high but eventually the production curve will rise. He asked if that is the balance Mr. Ruggiero is referring to.

MR. RUGGIERO said that is exactly correct. If the state chooses to believe the oil companies are doing a good job, backs them and provides this incentive that should lead to significant production.

[6:56:58 PM](#)

REPRESENTATIVE ROSES said the discussion has been about a cap on the credits at a certain level. He asked:

Don't we also have a cap on the progressivity at this point and what would happen worrying about the effect on the progressivity of investment if there were no cap on the take? Because in the bills we have right now, we have progressivity built in but when it gets to 25 percent it stops. It doesn't go beyond that. But if the price continues to go, there's less take even though the price is higher. Does it have an effect on whether or not this cap changes if you didn't stop the cap on the progressivity?

MR. RUGGIERO said the shape of the curves on the graph occur because of the cap. That curve occurs at the 50 percent overall, or 25 percent progressivity added to a 25 percent base. If that was allowed to continue, the curve that is very steep and high would continue to track way above the progressivity curve if it continued to go up as well. He has heard people say when the progressivity caps out, the state does not make any more money. He explained it actually means that every incremental dollar is shared 50/50 with the oil company. Therefore, as the price increases to where it goes off the right hand side of the plot, the progressivity has capped out but the state's share continues to grow with each dollar of additional margin that's realized.

[6:58:41 PM](#)

REPRESENTATIVE WILSON asked Ms. Davis if she asked that other anomalies be looked for by the model makers.

MS. DAVIS said the process has been iterative. Mr. Ruggiero and Mr. George have been working with DOR economists to try to identify these effects. She said the only other concern that has been raised is whether or not anything needs to be done as the result of this effect. She added:

Frankly, it is properly the remit of the legislature to look at this and decide what level of investment we want to provide as a state - co-investment, so to speak, as a state, encouraging this kind of future investment.

As we've modeled, all of our models have taken into account in any given - we've stated what our assumptions are so this effect is embedded in part and

parcel of everything we've presented. We just haven't gone in and extracted it as an independent slide. Frankly, these gentlemen have been working very hard and fast and furiously in the last day and one half to help us understand how to portray it. So, hopefully, after this point, if there's a structure that this group decides on, we would be able to back into, again, just letting folks know what this effect is so they have a comfort level that they like where that is.

7:00:40 PM

REPRESENTATIVE WILSON said she was thinking about the state's overall goals and one is to increase production.

7:00:53 PM

CO-CHAIR GATTO said he considers tonight's meeting an investment in tomorrow, when the committee considers amendments that deal with progressivity.

7:01:22 PM

REPRESENTATIVE EDGMON questioned whether a similar model is in use in other places around the world or whether Alaska is moving into uncharted waters.

MR. RUGGIERO said other regimes have progressive systems that address this type of issue. The structure of those systems is a little bit different. That is why it is not always easy to see where these types of events will occur.

7:02:36 PM

REPRESENTATIVE EDGMON questioned whether this situation has variables that differ from other tax regimes, but it is not entirely unique regarding a cap with a progressivity feature.

MR. RUGGIERO said the last two [models] that he was involved in dealt with rate of return. Because of some of the features seen here, S curves were created. The S curve along the X axis would be the actual rate of return already realized with the tax rate up the Y axis. Part of the reason for the rate of change and the rest was to address some of the issues with respect to the delta movement up or down on the curve and the state's participation in that.

7:03:33 PM

CO-CHAIR GATTO noted several other states have mature fields. He asked if the legislators in those states were wrestling with these questions five years ago and resolved the issues to their satisfaction.

MR. RUGGIERO said he did not know.

MR. GEORGE thought the systems in those states are based on a royalty and severance tax, which would be a gross system.

7:04:23 PM

MR. RUGGIERO told members:

If I can, Mr. Chairman, continue? We've actually addressed a lot that's on this slide but I just wanted to put it up and I think this goes right to your point, Representative Roses. You can choose when you eventually do set up, whatever it is, the structure that you are going to vote on as a House. But, as you change base rate, as you change kick off points, as you change slopes, as you change caps, any change in any of those, including the investment credit rate, will lead to a different answer on the previous slide. Each time you change one of those variables, the plots are going to change ever so slightly. That's why I said, we did this to be illustrative, and what you can know is that as you choose something, this is just an issue you need to affirmatively address as to how you want it to be handled once you get there.

The other thing is - before you adjourned, I guess that was about 3:30, Representative Seaton said, geez, I have an idea, can you run this for me? So, this is a slide I just threw into the presentation. It is the previous slide with two additions. It's the lower two lines. The one that's listed as net gross, which is the solid blue, it is actually the lowest-most line that is sloping from left to right. And then we have a 30 percent credit above that. I was kind of listening with my ear to the discussion that was going on here and I think Marcia threw the task over the shoulder - you know, should you do a 30 percent credit or not and said those Gaffney Kline guys would be

here.

So, I went ahead and put it up there just to see what it would do. Even off the recommendation of Representative Seaton that we look at, for the base tax, whatever that is, it's a base rate times the net margin that's made. But then to look at a progressivity factor, which is based on the net margin per barrel, but applied to the gross value realized. And so, what we did is we ran through the same examples at \$1 increments all the way from the bottom to the top, that same sort of \$1,000 question of revenue before cash flow and do I invest or do I not invest that \$100. And what you'll see is because of the nature of it being based on gross, you get a slightly different kick off point and the slope of it is much more shallow as far as the state's participation. This has to do with basing it on the gross value overall before costs.

What you have in there - it eventually will cap out at 75 percent but it gets far into the future when it does that because of the much slower growth of it. But as you put any investment credit on top of it, be it 20, be it 30 - I just did this as an extreme, based on the discussion I'm going in here, and I put 30 percent and you can see that because the base progressivity on a marginal basis continues to grow, when you put the cap on it the overall would continue to grow. At roughly \$135 margin, you can see that the marginal rate just based on the progressivity based on the gross, is at roughly 63, 64 percent and that would put the overall with the 30 percent investment credit, a contribution in the 92 to 93 percent range. So that at least gives an early indication of the difference between, call it the net-net system, as Bob showed earlier, and then the net-gross system, which is the progressivity calculation based on the net margin but applied to the gross value at the point of production.

[7:08:26 PM](#)

MR. RUGGIERO continued:

This is the last slide. One of the things we were asked is if you were to do something with a cap, stir

up the gray cells in the back of the brain and say what would you come up with? I guess from personal experience, the idea of something like an AMT came to mind. If you should choose to cap, for whatever reason, the contribution of the state, and I guess I need to be clear this is not Gaffney Kline's recommendation that you do so, but, as we said, we presented an issue, one of the ways you can choose to deal with it is to cap it off. And so what we've got up here is basically is you can calculate your tax the normal way. You have your wellhead value, you subtract your costs, you then subtract your investments. You get a net margin or a net cash flow per barrel. You find the tax rate, you calculate the tax due.

The other way you could do it, for example, based on where I had my suggested line, is you can calculate the tax payable without any deduction of the capital - or the qualifying capital expenditures but, for those qualifying capital expenditures, apply a fixed rate or a fixed credit rate, if you will, overall, then compare with that credit applied against the tax without the investment deduction against the total tax to be paid with the investment deduction and you could have it pay the greater or, like an AMT.

There probably are some other mechanisms that could be looked at, that could be used, if that's something you wish to do. This is a mechanism that can be easily carried out with the data that would be available at the time of return.

[7:10:31 PM](#)

REPRESENTATIVE GUTTENBERG noted the production side of the equation is not on the board. Industry representatives told members they do not chase investments without production on the other end. He questioned whether the state should take on risk if the industry has not sanctioned a particular project.

[7:12:27 PM](#)

REPRESENTATIVE SEATON said the discussion is about stimulating the oil industry's behavior to invest in projects that are economically viable. Whenever the state gets into a situation where it pays 100 percent, it risks stimulating investments that

make no sense. He thought the goal behind PPT was to put in a base rate that is deductible and give tax credits, so that the state would be investing 45 or 50 percent of the capital costs. If the state is in a situation where it is putting up all of the money for investment via tax credits and tax deductions, it could be participating in projects that are occurring for tax purposes only. He opined that the legislature needs to develop mechanisms that stimulate investment in economical projects. He fully agrees with state participation but does not believe the state should be a 100 percent owner. He noted when federal corporate income tax is considered, an oil company might get \$1.25 or more back from the state and federal government for each dollar spent on a project.

[7:15:38 PM](#)

REPRESENTATIVE FAIRCLOUGH said she looks forward to seeing an amendment that will address the issue Representative Seaton raised. She agreed that "if there is not skin in the game, you can lose value for those who are contributing," but she also agreed with Representative Johnson that jobs, especially in rural Alaska, are very important. She stated that she has repeatedly heard Alaska has a maturing basin on the North Slope and that the state is in a transition period in which it wants to encourage smaller explorers to start producing barrels of oil. She asserted:

And so, we will need to carefully balance the look at those costs because as, at least from one economist's perspective, the conversation has been that in this transition we will see more exploration after the puddles, per say, the smaller fields that are under ... 500,000 barrels per puddle - it's a pretty big puddle for anyone to step in - and that the major players will move to explorations that may be more risky but looking for the elephant projects. Hopefully that will still be in Alaska but - the bottom line though that I remember from everything we've heard over the last 16 days is it's about the rocks, as far as the risk and investment goes when producers and explorers are out there looking for fines.

So, I think that I look forward to seeing Representative Seaton what you have, because I think you make a valid point and I will be looking at how we balance that so that we make sure that the new explorers that don't have production that we do sort

of want to participate in that incentive with how do we make that differentiation between those costs versus the big players and keeping the playing, as the administration has so admirably put forward, to make sure it's flat and fair for all who want to enter the market. Thank you Mr. Chairman.

[7:18:06 PM](#)

CO-CHAIR JOHNSON asked Mr. George and Mr. Ruggiero if they have both worked for oil companies and presented projects to a board or acted as advisors.

[No response was audible.]

CO-CHAIR JOHNSON asked what a board of directors would say if they presented a project that cost \$100 million with little chance of hitting oil, but provided a tax deduction.

MR. GEORGE said the board of directors would look at the after-tax impact when making an investment decision.

CO-CHAIR JOHNSON asked if the after-tax impact would be production of oil.

MR. GEORGE said if the board is looking at an exploration play, it will balance off the reward if successful on an after tax basis. The board would also look at the cost if not successful on an after tax basis.

[7:19:59 PM](#)

CO-CHAIR JOHNSON asked if the board would want to go ahead with a project that might not produce oil under this scenario. He elaborated:

You've got a chance where we're going to go out and invest \$100 million. We may not hit a barrel of oil - no bookable reserves, none of the things that our stock shareholders are going to look at, but we're going to get a tax deduction that may or may not because we do live in an environment where things can change around here in this state, that we may or may not hit oil. Can you tell me what that board of directors would tell you?

MR. GEORGE said that question cannot be answered without looking

at numbers. The answer depends on the size of the prize relative to the size of the investment and the risk involved. He thought Chevron showed a slide during its presentation that showed the calculation. Chevron would look at the after-tax effect.

CO-CHAIR JOHNSON asked, "So, there's a board of directors out there for an oil company that are going to take a risk that they may not find oil or a very low risk they may find oil, based upon getting a tax credit?"

MR. GEORGE replied the decision will move with the net benefit after tax and the net cost after tax.

CO-CHAIR JOHNSON asked Mr. Ruggiero if he agreed.

[7:20:29 PM](#)

MR. RUGGIERO said that depends on where you were when, because different circumstances come into play. He said when the PPT credits were opened up in the UK, people were actually buying small pieces of a field so that they could purchase the PPT liability, which would be cover for the exploration they would do. He said boards of directors do make decisions based on tax credits to lower the risk of risky exploration.

[7:21:20 PM](#)

CO-CHAIR JOHNSON said he thought they were in the job of finding oil. He said he couldn't think of any other business that would do that.

MR. RUGGIERO opined that a board of directors would spend money just to receive a tax credit. They are not in the business to spend money just because it is government money. He explained that oil companies have to keep track of internal metrics. He believes an oil company's most valuable asset right now is its employees. He furthered:

Just because there's a tax credit, the number of people it will take just to drill - let's call it a wildcat exploration well in this state, especially on the northern part of the state - would take away valuable assets from other operations. I do not see any of the board of directors, just because you're giving a little tax credit, going out there and spending your money just because of that tax credit.

No. They would have to take a look at it with respect to the rest of their portfolio. They'd have to look at it - are they getting value for the people involved? They'd have to look at it as - and they'd still want a chance at success before they would do that.

CO-CHAIR JOHNSON thanked Mr. Ruggiero.

[7:22:54 PM](#)

CO-CHAIR GATTO said he suspects that is a matter of how to calculate the risk and how to estimate the reward and then evaluate which projects are the best. A lot of guesswork is involved so a decision would depend on the ratio. He said the calculation is what is so hard and that is why good employees are so valuable.

[7:24:13 PM](#)

REPRESENTATIVE EDGMON inquired about the next day's agenda.

[7:24:57 PM](#)

CO-CHAIR GATTO announced the next meeting would begin at 9:00 a.m. and a group discussion would take place.

[HB 2001 was held over.]

#### **ADJOURNMENT**

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 7:25 p.m.