

**ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS**

January 24, 2007

6:58 a.m.

MEMBERS PRESENT

Representative Mike Hawker, Chair
Representative Anna Fairclough, Vice Chair
Representative Bob Roses
Representative Peggy Wilson
Representative Sharon Cissna
Representative Max Gruenberg

MEMBERS ABSENT

Representative Paul Seaton

COMMITTEE CALENDAR

PRESENTATION BY THE DEPARTMENT OF REVENUE:" Where did the fiscal gap go?"

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

JERRY BURNETT, Legislative Liaison/Director
Administrative Services Division
Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Attended for the Department of Revenue.

PATRICK GALVIN, Acting Commissioner
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: Testified as appointed commissioner of the Department of Revenue on the production profits tax.

MICHAEL WILLIAMS, Ph.D., Chief Economist
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: Presented an overview of revenue sources and forecasting.

DUDLEY PLATT, Petroleum Engineer
(No address provided)

POSITION STATEMENT: Speaking as an independent consultant to the Department of Revenue, answered questions regarding revenue issues.

ACTION NARRATIVE

CHAIR MIKE HAWKER called the House Special Committee on Ways and Means meeting to order at [6:58:48 AM](#). Present at the call to order were Representatives Roses, Fairclough, and Wilson. Representatives Gruenberg and Cissna arrived as the meeting was in progress.

Presentation by the Department of Revenue

[7:00:18 AM](#)

CHAIR HAWKER expressed pleasure to be back and reminded members that the House Special Committee on Ways and Means was first established four years ago when the state faced large budget deficits. The prior budget shortfall brought to the legislature's attention the "paramount importance" of Alaska's short- and long-term fiscal issues. The committee is charged with statutory responsibility to consider methods to control state spending, to identify ways to make government programs more efficient, and to propose new measures to raise additional state revenues. Chair Hawker announced that he wanted to focus on long-term fiscal planning with an eight-year horizon so as to leave the state on a "sound fiscal footing." He then related that the committee will likely address the issues of pension liability and the cruise ship tax.

[7:14:19 AM](#)

CHAIR HAWKER pointed out that the Revenue Sources Book, the Annual Report of the Division of Operations, and the Annual Report of the Alaska Tax Division, all prepared by the Department of Revenue, are public documents that provide good reference tools for the public and this committee. Another helpful document is the Alaska Taxable, prepared by the Department of Commerce, Community, & Economic Development.

JERRY BURNETT, Legislative Liaison/Director, Administrative Services Division, Department of Revenue, mentioned that another helpful publication was the Alaska Legislative Budget Handbook,

also referred to as "The Swiss Army Knife Guide to Budgets", prepared by the Alaska Legislative Finance Division.

[7:19:38 AM](#)

PATRICK GALVIN, Acting Commissioner, Department of Revenue, updated the committee on the implementation of the production profits tax (PPT) by noting that the first "true-up" payments are due at the end of March. These payments will provide the first indication of whether the state will receive the revenues it expects under the PPT.

ACTING COMMISSIONER GALVIN then referenced a committee handout titled State Revenue, Crude Oil Production & the PPT, dated January 24, 2007, and prepared by the Department of Revenue. He directed the committee to the section on page 6 of the handout titled "PPT True-Up Payment". He noted that the payments due through the end of March 2007 will be based on the former tax system because the Department of Revenue is still working on regulations for the PPT. Once the regulations are final, the oil producers are expected to recalculate their taxes in relation to what would have been paid under the PPT and make payment for the difference.

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ACTING COMMISSIONER GALVIN, in response to a query by Chair Hawker, agreed that the PPT was retroactive to April 1st and that from April 1st through the end of December, the industry has been paying taxes on the previous economic limit factor (ELF), and thus this catch-up payment under the PPT will be for the three calendar quarters ending in December 2006. However, he clarified that in the "revenue sense" those are not full quarters because the normal budgetary year starts July 1st; therefore payments for July are based on production in June. Since the PPT was retroactive to April 1st, the state is getting taxes for the production from April 1st through the end of May, which would normally not be captured this [2006-2007] fiscal year. Therefore, this fiscal year's budget gets an "extra two months" of production. Acting commissioner Galvin said that the Department of Revenue is estimating that just under \$1 billion in additional tax payments will be due under the PPT. He reminded the committee that these are estimates.

[7:26:31 AM](#)

ACTING COMMISSIONER GALVIN informed the committee that the regulations relevant to the PPT are being developed in two different packages. One package is moving more quickly than the other because the more complex elements of the PPT have been left for a subsequent regulatory package. He explained that the Department of Revenue held workshops in the fall of 2006 for industry and other stakeholders. Draft regulations were published in early December 2006 and the Department of Revenue received a number of comments from industry and legislators. Acting commissioner Galvin, referring to page 6 of the handout, noted that the issues raised during the comment period included methods of transferring tax credits, treatment of lease expenditures, allowable overhead rates, fencing losses, and calculation of non-payment penalties.

[7:29:23 AM](#)

ACTING COMMISSIONER GALVIN explained that since the regulations will not be final until just before or after first returns are due, the Department of Revenue is relying on communication with the taxpayers so they can make a good faith effort to meet initial expectations with their returns. He acknowledged that there will be some additional clarifications and adjustments to returns once the regulations are finalized. The Department of Revenue will be working with the taxpayers to see that this is accomplished as smoothly as possible, he remarked. Acting commissioner Galvin, referencing page 7 of the handout, noted that the Department of Law will review the regulations before submission to the Lieutenant Governor's Office for final approval. He said he expects the first packet of regulations to be finalized by late March or early April; with the second package to be finalized later in the spring.

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CHAIR HAWKER expressed concern about whether the Department of Revenue had adequate time to complete the regulation development process prior to the time the first tax returns under PPT are due.

ACTING COMMISSIONER GALVIN indicated that the Department of Revenue has been engaged in conversation with industry all along, and thus for "issues that have the greatest swing", the industry has an idea of where the Department of Revenue is going. He opined that the initial returns will be fairly close to "where we would expect them to end up once the regulations

are completed, but we do recognize there will likely be some adjustment period after the [regulations] are finalized."

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ACTING COMMISSIONER GALVIN, regarding whether the Department of Revenue has identified any technical problems in the PPT legislation, stated that there are some areas of concern that the Department of Revenue is reviewing, although it has not yet determined whether the problems can be resolved by regulation. Some of the Cook Inlet portions of the PPT bill are problematic in terms of identifying how to implement them in the regulations. He noted that the next few months will clarify whether these problems can be dealt with by regulation, or whether they will require some clarifying technical amendments.

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REPRESENTATIVE ROSES asked whether the producers are allowed to withhold their anticipated payments, or whether they must make the payments, then make the adjustments later.

ACTING COMMISSIONER GALVIN responded that the taxpayers are required by the PPT to make their payments at the due date. The Department of Revenue feels the taxpayers have been provided with "clarifying information" and have seen the draft regulations and the comments that have come in under the proposed regulations. Therefore, Acting Commissioner Galvin related that he expects the payments to be made in "good faith, based upon [the taxpayers] best ability to comply with the [PPT]". When the regulations are final, the Department of Revenue will "look at any modifications that need to be made", he said.

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REPRESENTATIVE GRUENBERG inquired as to whether there was anything the legislature or this committee could do to help expedite the resolution of some of these issues.

ACTING COMMISSIONER GALVIN assured Representative Gruenberg that at this point there is a "fairly good process lined up", with good communication with industry. If there is a role for this committee, the Department of Revenue will take advantage of the chair's offer to "use this committee in that capacity."

7:42:19 AM

MICHAEL D. WILLIAMS, Ph.D., Chief Economist, Department of Revenue introduced himself and directed the committee to pages 1-2 of the handout and informed the committee his testimony will cover state revenue and crude oil production. He pointed out that oil revenues currently make up 88 percent of state revenues. Future projections show declining crude oil production and undulating prices; as a result, "what happens is that oil revenues go up and down, and non-oil revenues continue to increase."

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CHAIR HAWKER asked if the presentation was based on restricted or unrestricted revenues. He noted that unrestricted revenues are available for appropriation by the legislature, while restricted revenues are constitutionally restricted from public spending and are largely dedicated to the permanent fund.

DR. WILLIAMS explained that his testimony will focus on revenue which the legislature "can actually allocate." Oil-based revenues include those from royalties, production, income, and property taxes, as well as bonus and rental income. Non-oil revenues include categories such as alcohol and tobacco taxes, fines, forfeitures, licenses, permits and investment income. Oil revenue dominates the Alaska revenue picture, with crude oil prices and production volumes being the "key factors in estimating oil revenue," he noted.

[7:51:07 AM](#)

DR. WILLIAMS, in response to Representative Gruenberg, explained that the Department of Revenue updates its revenue forecast in the Revenue Sources Book twice a year.

REPRESENTATIVE GRUENBERG, referencing the fluctuating price of oil and advances in computer technology, questioned whether it would be advantageous to provide information online so the Department of Revenue and general public could see the "latest and best" revenue figures. Dr. Williams replied that technically anything is possible, but he cautioned that forecasting future prices takes some time and effort. The big picture of oil production, price volatility and production decline may be more important than monthly updates.

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DR. WILLIAMS explained that he is planning on doing some long range scenarios in the future, which he thinks will be valuable for the committee. He did note that non-oil sources of income currently represent about 12 percent of general fund unrestricted revenue. The Fall 2006 Revenue Sources Book predicts that non-oil revenues will increase to about 23 percent of total revenues in about 10 years.

[7:59:29 AM](#)

DR. WILLIAMS, referring to the slide titled "Fall Oil Production Forecasts", emphasized that historically the Department of Revenue has overestimated production volumes. There are several reasons for this, including the maturity of the aging Prudhoe Bay field, and the difficulty of developing the heavy or "viscous" oil of Alaska's North Slope.

[8:02:55 AM](#)

REPRESENTATIVE GRUENBERG expressed concern regarding the deterioration of some of the oil production facilities and wondered if this deterioration has an effect on the Department of Revenue's ability to accurately forecast production.

DUDLEY PLATT, Petroleum Engineer, speaking as an independent consultant for the Department of Revenue, indicated that the forecasting process attempts to make adjustment for the production decline due to deterioration. However, it is still difficult to anticipate certain unexpected events such as the recent occurrences of anchors falling off a tankers, which caused high inventory levels in Valdez and backed-up production all the way through the North Slope.

[8:05:43 AM](#)

DR. WILLIAMS, in further reference to factors that influence revenue forecasting, paraphrased from the following written testimony [original punctuation provided].

Miscellaneous Events - there are two categories under this heading.

1. The first is **unexpected events** - here we have things like bullet holes in pipelines, earthquakes, anchors falling off of tankers, foul weather that causes power outages or delays tankers from loading oil.

2. The second is **volume accounting** issues - here we are dealing with database management issues attempting to reconcile volumes submitted by the producers.

Taken together these reasons have caused the Department to over-estimate volumes produced on the North Slope.

For FY 2007, the ANS production forecast has been revised downward to 740,000 barrels per day, which is a 12% decline from the 845,000 b/d produced in FY 2006. This reflects volume reduction from numerous unplanned events, including pipeline corrosion problems at Prudhoe Bay, Lisburne and Milne Point.

For the Fall 2006 forecast, the Department of Revenue continues to make adjustments to our production expectations from the North Slope. In the near term, we have incorporated revised reservoir performance analysis on declining fields, reviewed the uncertainty associated with the pace and scope of developing satellite fields and re-evaluated downtime for all fields due to current pipeline closures and related corrosion testing on the North Slope. For the longer term, we have delayed Point Thomson and associated satellite one year to maintain our assumed ten year lead time for development.

As I mentioned earlier, the North Slope is a mature oil province that is in decline. Its aging infrastructure will likely have additional problems as we look into the future and the harsh environment of the North Slope amplifies the likelihood of other occurrences. In addition, the development of fields containing viscous oil is providing challenges to the oil industry. These factors have been incorporated into our forecast and are the reasons for forecasting lower ... volumes.

North Slope crude oil production is characterized in three ways, each with discrete, albeit estimated confidence levels: (1) currently producing, (2) currently under development and (3) currently under evaluation. We do this so that you will have an understanding about the uncertainty associated with

the production forecast. We continue to forecast production of only those reserves that have already been discovered and at minimum are being evaluated for development.

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DR WILLIAMS, responding to a question about the accuracy of the projections, explained that fields characterized as "currently producing" are assigned a "confidence level" of 98 percent for the current year and of 90-95 percent throughout the remainder of the forecast period. Projects characterized as "currently under development" include those that are currently funded and are in the design and construction phase.

REPRESENTATIVE WILSON asked when the projects shown as "currently under development" on the slide titled "ANS Production Forecast by Category", would start producing.

MR. PLATT answered that very little will come on line in 2007. However in 10 years, the production will increase. He attributed much of the increase to the West Sak. He noted that projects do not always produce the amount of oil expected at the time expected.

[8:15:10 AM](#)

MR. PLATT, in reference to forecasting, told the committee the oil forecasting charts end at fiscal year 2010, and do not show the next 40 years. Development does not always happen when the forecasters think it is going to happen, and this makes it difficult to predict future production. MR. Platt stated the Point Thomson field is a case in point; delay of Point Thomson delayed other satellite fields that could have come through a common facility at Point Thomson.

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REPRESENTATIVE CISSNA acknowledged that certain events can change the forecast dramatically, but she questioned whether there are ways to increase oversight of certain elements, such as ships or pipelines, so as to increase the accuracy of the forecast.

DR. WILLIAMS opined that some type of oversight could perhaps have averted some pipeline corrosion issues. Other incidents,

such as the anchors falling off two new ships, cannot be predicted. In further response to Representative Cissna, Dr. Williams noted that there is a cost-benefit analysis to determine whether regulatory action is appropriate, but that "certainly if there had been some sort of review board in place that reviewed pipelines--for the last 10 years they would have made it all up just in what we lost in revenue last year."

[8:28:45 AM](#)

MR. BURNETT noted that the Department of Environmental Conservation and Department of Law have been looking into issues regarding regulation of pipelines.

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MR. WILLIAMS reminded the committee that oil production in Alaska has gone on longer than predicted 25 years ago due to technical advances in oil production. Moreover, oil companies continue to work on new techniques to increase production of heavy oil, for example.

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MR. PLATT, in response to chair Hawker, noted that the North Slope is a "huge petroleum basin"; basins contain numerous different sized fields. Basins like this generally have a "hyperbolic decline, not an exponential decline". This concept, as applied to Cook Inlet, will show a bend in production. Likewise, there is "no reason to think Draconian thoughts" and to think that this same type of decline will not happen on the North Slope.

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DR. WILLIAMS continued by discussing technically viable projects that are still being evaluated by the producers. These projects, although currently unfunded, have a "high chance" of being developed. He noted that the PPT creates a "fiscal framework" that provides incentives for exploration.

[8:39:08 AM](#)

CHAIR HAWKER asked whether he was correct in reading Department of Revenue forecast materials to indicate that "to meet the numbers in our forecast, we have to be bringing on within a

couple of years ... 44 percent more [production] on line than we have today."

MR. PLATT confirmed this perception, but noted there is a lot of uncertainty in oil price estimates. Mr. Platt said he believes he overestimated the linkage between high oil prices of the last three years and the incremental oil production that he expected through new capital investment.

MR. WILLIAMS reminded the committee that projects characterized as "under development" on the slide titled "ANS Production Forecast by Category", are funded, while those labeled "under evaluation" have not been funded.

MR. PLATT clarified that some of the projects in the "under development" category are funded, but some have not received corporate approval.

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at [8:43:01 AM](#)