

**ALASKA STATE LEGISLATURE
LEGISLATIVE BUDGET AND AUDIT COMMITTEE**

Anchorage, Alaska
December 10, 2008
9:02 a.m.

MEMBERS PRESENT

Representative Ralph Samuels, Chair
Senator Lyman Hoffman, Vice Chair
Representative Mike Chenault
Representative Mike Hawker
Representative Mike Kelly
Senator Johnny Ellis
Representative Reggie Joule (alternate)
Senator Gene Therriault

MEMBERS ABSENT

Representative Mike Doogan
Senator Lyda Green
Senator Bert Stedman
Representative Kevin Meyer
Senator Charlie Huggins

OTHER MEMBERS PRESENT

Representative Paul Seaton

COMMITTEE CALENDAR

APPROVAL OF MINUTES

REVISED PROGRAM - LEGISLATIVE (RPLs)

EXECUTIVE SESSION

PRELIMINARY & FINAL AUDITS

OTHER COMMITTEE BUSINESS

ROUNDTABLE DISCUSSION GAS FISCAL DESIGNS: DAVID WOOD, DAN
DICKINSON, STEVE PORTER, LARRY PERSILY

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

DAN FAUSKE, CEO/Executive Director
Alaska Housing Finance Corporation (AHFC)
Department of Revenue

State of Alaska
Anchorage, Alaska

POSITION STATEMENT: Presented information and answered questions regarding RPL 04-9-1042.

MARK ROMICK, Director
Planning & Program Development
Alaska Housing Finance Corporation (AHFC)
Department of Revenue
State of Alaska
Anchorage, Alaska

POSITION STATEMENT: Presented information and answered questions regarding RPL 04-9-1042.

AMANDA RYDER, Director Division of Administrative Services
Department of Commerce, Community, & Economic Development
Juneau, Alaska

POSITION STATEMENT: Presented information and answered questions regarding RPL 08-9-0120.{

CHERYL SUTTON, Staff
to Representative Samuels
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Answered questions regarding the selection process for consultants hired by the committee.

DAVID WOOD, Ph.D.
David Wood & Associates;
Consultant to the Legislative Budget and Audit Committee
Alaska State Legislature
Lincoln, United Kingdom

POSITION STATEMENT: During the roundtable discussion, answered questions.

DAN DICKINSON, CPA;
Consultant to the Legislative Budget and Audit Committee
Alaska State Legislature
Anchorage, Alaska

POSITION STATEMENT: During roundtable discussion, answered questions.

LARRY PERSILY, Consultant to the Legislative Budget and Audit Committee
Alaska State Legislature
Washington, D.C.

POSITION STATEMENT: Provided comments during the roundtable discussion.

ACTION NARRATIVE

CHAIR RALPH SAMUELS called the Legislative Budget and Audit Committee meeting to order at [9:02:49 AM](#). Representatives Chenault, Hawker, and Kelly (via teleconference), and Senators Hoffman (via teleconference) and Ellis were present at the call to order. Representatives Joule (alternate) and Senator Therriault arrived as the meeting was in progress. Representative Seaton was also present.

APPROVAL OF MINUTES

[9:05:02 AM](#)

CHAIR SAMUELS requested the November 7, 2008, minutes be corrected on page 8 to reflect that the committee hired Bob Pawloski, not Mike Pawloski.

REPRESENTATIVE HAWKER made a motion to approve the minutes from the November 7, 2008 meeting, as amended. There being no objection, the minutes from the November 7, 2008, meeting were approved as corrected.

REVISED PROGRAM - LEGISLATIVE (RPLs)

[9:05:43 AM](#)

CHAIR SAMUELS turned the committee's attention to the RPLs before it.

REPRESENTATIVE HAWKER made a motion that RPL 04-9-1042, HUD - Neighborhood Stabilization Program, in the amount of \$19.6 million to the Alaska Housing Finance Corporation (AHFC) be approved.

CHAIR SAMUELS objected for purposes of discussion.

[9:06:36 AM](#)

DAN FAUSKE, CEO/Executive Director, Alaska Housing Finance Corporation (AHFC), Department of Revenue, State of Alaska, requested that Mark Romick be allowed to explain to the committee the nuances of this federal money.

MARK ROMICK, Director, Planning & Program Development, Alaska Housing Finance Corporation (AHFC), Department of Revenue, State of Alaska, explained that the Neighborhood Stabilization Program was part of the Housing and Economic Recovery Act of 2008 in which Alaska was allocated the minimum floor of \$19.6 million. There are a number of requirements associated with the money, he said. A specific formula directs how the money must be allocated around the state based on the areas of highest foreclosure, highest notices of default, highest areas of low/moderate income neighborhoods, and the highest risk of future potential foreclosure. According to the formula, those areas of highest need are the southcentral region, Fairbanks, and the Kenai Peninsula. Based on the formula that AHFC used, there is a distribution for all of those major areas as well as some of the outlying areas that had less of a need under the definition of the federal rules. These outlying areas were all put together into a "balance of state" category. He said AHFC used \$500,000 as the cutoff for inclusion in that "balance of state" category so that areas outside of those major urban areas would have a sizeable pot of money to apply for to actually accomplish something. The money can be used for the acquisition or rehabilitation of foreclosed, abandoned, or blighted properties. He noted that committee members have copies of the plan that was approved by the AHFC Board of Directors and submitted to HUD on December 1, 2008.

REPRESENTATIVE HAWKER asked how much abandoned, foreclosed, or blighted property there is in Alaska.

MR. ROMICK replied Alaska does have some foreclosed properties. He said Alaska is one of the 10 lowest states in total number of foreclosures. According to Realty Track, a national foreclosure tracking system, about 1400 properties of all types are in foreclosure or have been foreclosed on in Alaska, a relatively small number compared to the rest of the United States. He said there are abandoned properties, although AHFC does not know how many, and there are blighted properties that AHFC knows of. He stressed that AHFC is absolutely confident all of the money will be utilized.

[9:11:13 AM](#)

MR. FAUSKE added that according to the third quarter 2008 National Delinquency Survey, Alaska had 93,537 loans serviced with a total past due of 2.66 percent - 1.37 percent past due 30 days, .52 percent past due 60 days, and .76 percent past due 90

days or more. The foreclosure inventory at the end of the quarter was .88 percent and at the start of the quarter it was .43 percent. Seriously delinquent, 90+ days, is 1.64 percent, he continued. So, Alaska is well within any kind of historical norms. California is at 6.7 percent and Florida is similar. There are areas that AHFC will concentrate, but Alaska is not in any kind of serious foreclosure situation. He said he thinks it is important to accept the funds because there are things that can be done.

[9:12:29 AM](#)

REPRESENTATIVE HAWKER questioned whether Alaska really has a problem for which money is actually needed.

MR. ROMICK responded that on a national scale it is a problem that had money applied to it. In Alaska it is probably the opposite; the state does not have a big problem. He said Alaska has been given an opportunity to make some inroads into getting rid of abandoned and blighted properties in lower income neighborhoods and other places around the state, as well as making a significant stab at addressing some issues related to homelessness.

REPRESENTATIVE HAWKER asked what will ultimately occur with the property that AHFC acquires.

MR. ROMICK answered that to a certain extent it will depend on what is proposed to the AHFC. Funds will be made available through a competitive process and people will come to the AHFC and apply under one of the categories. He said that after talking to the nonprofits expressing interest thus far, AHFC will likely be able to produce about 186-200 new units of affordable housing in Alaska and those could be anything from a single family home that was purchased from foreclosure, rehabbed, and then resold, or the acquisition and renovation of a blighted or abandoned multi-family property.

[9:14:36 AM](#)

REPRESENTATIVE HAWKER commented that AHFC is essentially looking at getting into the turning of real estate.

MR. ROMICK said, "Basically, yes."

REPRESENTATIVE HAWKER asked what happens to the money once AHFC turns the real estate.

MR. ROMICK replied that under the bill there are some rules related to program income. For instance, if someone uses this money to buy a single family home and renovates and resells it, he or she must repay AHFC the amount of money received from the program. He said that under the bill there is a four-year window in which AHFC can then reallocate that money for other purposes within the state. After that period of time the money must go back to the federal government.

REPRESENTATIVE HAWKER asked whether the "acquirer" is AHFC or can an individual receive this money to buy property.

MR. ROMICK responded that, technically, AHFC could. The individual must then resell the property to an eligible household and repay to AHFC the amount of federal money that was used to buy and renovate the property. That money then goes back into the pool.

REPRESENTATIVE HAWKER inquired whether the individual can keep the profits.

MR. ROMICK answered, "If there were any, but it is very specific in the bill that nobody is going to make any money ... off the resale." He said this economic recovery act came out of the foreclosure crisis that is facing the United States. The intent of Congress was to take abandoned and foreclosed properties that are devaluing neighborhoods and the market-in-whole and get them into private hands as fast as possible. There are two particular themes that run through the bill, he continued. First, is that in the churning of these properties back into individual homeowner's hands, the banks should not make any money - a provision in the bill says no foreclosure can be more than 10 percent below market value. So someone has to sell the property at 10 percent discount on average. Second, is that any proceeds of the sale be recaptured by the federal government through the program income rules. Mr. Romick said he thinks the program is designed to be focused on nonprofit organizations that have a mission to provide affordable housing and to cover a nonprofit's administrative costs of managing the project or doing the rehabilitation.

[9:17:17 AM](#)

MR. FAUSKE added that this is not dissimilar from what is being experienced with the federal government through the Federal National Mortgage Association (Fannie Mae), the Federal Home

Loan Mortgage Corporation (Freddie Mac), and others, where the intent is honorable for what the government is attempting to do. For example, California has been allocated \$529 million, Florida \$541 million, Nevada \$71 million, and Ohio \$258 million. It is a fairness issue, he said, and he wishes there was more leeway as to what the monies can be used for in terms of the absolute problems facing particular states. On the Fannie Mae and Freddie Mac side, Alaska is about 140 basis points out of the market. He said he thinks this money can be put to good use, but the rules are what they are and AHFC is going to do its best to apply them diligently and effectively.

[9:18:50 AM](#)

REPRESENTATIVE JOULE noted there is often a lag time in Alaska on some of these national issues. Is a lag time anticipated on this particular issue so that it may come later, he asked.

MR. FAUSKE replied he does not view Alaska as immune. He said he thinks more of Alaska's issues will revolve around the state's economy and employment rates, and not on a financial collapse seen in other states. While Alaska's market has slowed, it is stable and market values are holding in the vast majority of the state. He said he does not anticipate a lag time unless it is accompanied by some other dramatic economic event. His assessment is that Alaska is in good shape and has a vibrant market, but the state should still be cautious.

MR. FAUSKE offered his hope that over time Alaska can come to some agreement with the federal government as to source of funds. He said that right now the tax-exempt market is basically shut down and experiencing tremendous upheaval. Down the road that affects municipal and state governments, student loan corporations, and others that access that tax-exempt market. "I think we have to get smart about leveraging and ... how we access capital and be prepared and ready to access that capital market," he said. He pointed out that in other states one of the greatest sources of revenue for city, municipal, and state governments is sales taxes based on the sales of automobiles - a problem that Alaska does not have.

[9:23:36 AM](#)

REPRESENTATIVE KELLY inquired whether AHFC considered declining these funds.

MR. FAUSKE responded that AHFC always has discussions as to whether monies would be harder to access and more cumbersome than they are worth. Although AHFC concluded there is a need for it, there was more discussion on what other uses the money could go towards, such as homeless situations, homeless trusts, and different types of grants. However, the federal government is fairly stringent as to what it wants this used for. So, yes, AHFC did analyze that aspect of it and concluded the money could be put to good use.

REPRESENTATIVE KELLY sought assurance that this program will not result in, yet again, making loans to people who cannot repay them. He said he is nervous about the program and would like more debate, but understands the deadline.

[9:26:52 AM](#)

MR. FAUSKE assured the committee that AHFC will apply its normal due diligence in its grant writing and evaluation of the projects that are proposed. He said AHFC will not hand out money without scrutiny. Additionally, AHFC wants to see the recipients be successful as it guides them through the process.

MR. ROMICK added that anyone approaching AHFC about purchasing single family homes for resale would have to use underwriting guidelines consistent with what AHFC uses for its own programs in regard to what a person can afford. Thus, it would be fixed loans based on people's actual income; there would be no subprime or variable rate lending. He said AHFC agrees wholeheartedly that there would be absolutely no purpose in re-creating the situation that got the country here in the first place.

[9:28:20 AM](#)

SENATOR THERRIAULT said he shared part of Representative Kelly's concern, but he would support this with Mr. Fauske's assurance that AHFC will be careful with how it puts the money out. He expressed his concern that the economic decline could be protracted and cause people to become overextended.

MR. FAUSKE again assured the committee that AHFC will be very careful.

[9:29:13 AM](#)

A role call vote was taken. Representatives Hawker, Joule, and Samuels and Senators Hoffman, Ellis, and Therriault voted in favor of approving RPL 04-9-1042. Representative Kelly voted against it. Therefore, RPL 04-9-1042, HUD - Neighborhood Stabilization Program, was approved by a vote of 6-1.

9:30:15 AM

REPRESENTATIVE HAWKER made a motion that RPL 08-9-0120, Payment in Lieu of Taxes (PILT) in the amount of \$3,638,623 to the Department of Commerce, Community and Economic Development (DCCED) revenue sharing be approved.

CHAIR SAMUELS objected.

9:30:47 AM

AMANDA RYDER, Director Division of Administrative Services Department of Commerce, Community, & Economic Development (DCCED) explained that the Department of Commerce, Community, & Economic Development (DCCED) is requesting \$3,638,623 for the Payment in Lieu of Taxes Program. She said this is a federal program designed to compensate boroughs for lost revenue and lost opportunities for development on federal lands within Alaska boroughs. The funding is distributed directly to organized boroughs and the funding being requested by DCCED is for unorganized boroughs, she said. The department will then distribute the money to communities in the unorganized boroughs based on a per capita basis.

MS. RYDER, in response to Representative Hawker, related that the federal government appropriated this funding in the \$700 billion economic stimulus package [of 2008]. The department was misinformed by the federal government that the funds would be coming in the fiscal year (FY) 2010 budget, so DCCED placed the funding in its FY 2010 budget. The department later found out that the stimulus package included funding for FY 2009.

REPRESENTATIVE HAWKER commented that this is definitely more than had been anticipated. He asked whether DCCED is taking steps to assure that the recipients do not rely on and expect this level of funding in the future.

MS. RYDER responded that DCCED is concerned that communities make good decisions in developing their budgets over the years and do not put this funding in their base. She said these funds are authorized through state fiscal year 2013. It is unknown

whether the funds will be re-authorized after that and the department will inform communities of this. When the community revenue sharing is sent out, the department will write letters to the communities discussing the implications of putting these funds into their base budgets. Also, Bill Rolfzen, the local government specialist in charge of the revenue sharing programs, will be informing each community by phone. Additionally, a local government specialist in the Division of Community and Regional Affairs (DCRA) trained communities in budget development, so local government specialists are very aware of these programs and that they need to inform their communities about the implications of putting this funding in their base.

[9:34:24 AM](#)

A role call vote was taken. Representatives Chenault, Hawker, Kelly, Joule, and Samuels and Senators Hoffman, Ellis, and Therriault voted in favor of approving RPL 08-9-0120. Therefore, RPL 08-9-0120, Payment in Lieu of Taxes, was approved by a vote of 8-0.

EXECUTIVE SESSION

[9:35:16 AM](#)

REPRESENTATIVE HAWKER made a motion that the committee under Uniform Rule 22 go into executive session for the purpose of discussing confidential audit reports under the authority of AS 24.20.301. There being no objection, the committee went into executive session at 9:35 a.m.

CHAIR SAMUELS brought the meeting back to order at 9:59 a.m.

PRELIMINARY & FINAL AUDITS

[9:59:15 AM](#)

REPRESENTATIVE HAWKER made a motion that the preliminary audit on the Department of Commerce, Community, & Economic Development Board of Public Accountancy 08-20056-09 be released to the agency and the board for response. There being no objection, it was so ordered.

[9:59:30 AM](#)

REPRESENTATIVE HAWKER made a motion that the following final audit reports be released as public documents: Department of

Administration (DOA), Governance Framework for Selected Information System Security Controls; Department of Health and Human Services (DHHS), Statewide Suicide Prevention Council sunset audit; and the Alaska Court System, Board of Governors of the Alaska Bar Association sunset audit. There being no objection, it was so ordered.

CHAIR SAMUELS noted that those motions were made with the understanding that the Legislative Audit Division will not post the security audit report itself to the web site.

OTHER COMMITTEE BUSINESS

10:00:08 AM

REPRESENTATIVE HAWKER made a motion that the committee amend its contract with Dr. David Wood & Associates for an amount not to exceed \$140,000.

CHAIR SAMUELS objected. He said the contract as fulfilled is slightly over [the authorized amount] and he wants to have enough to cover any extra work, such as questions from committee members that come in between now and the start of the next legislature on January 20, 2009. He said he is also extending the termination dates for Mr. Porter, Dr. Wood, and Mr. Dickinson until January 31, 2009, to provide transition time for the next committee chairman or legislature.

SENATOR THERRIAULT inquired whether the work that Dr. Wood has done so far has exceeded the \$75,000 that was already authorized.

CHAIR SAMUELS understood that it is a couple of thousand dollars over, mostly due to the phone calls made to Dr. Wood by committee members.

SENATOR THERRIAULT surmised that Chair Samuels wants to prepare for covering any additional work that is done between now and the new legislature.

CHAIR SAMUELS replied, "Yes."

SENATOR THERRIAULT asked whether Chair Samuels has had conversation with the committee's incoming chairman.

CHAIR SAMUELS responded he does not yet know who the incoming chairman is. He said he has had preliminary conversation with

Representative Dahlstrom regarding holding a meeting to hand off information on the variety of issues before the committee.

10:02:26 AM

SENATOR THERRIAULT inquired whether the current contract was specifically for Dr. Wood's report and presentation. He understood Dr. Wood is not necessarily expecting anything beyond that.

CHAIR SAMUELS answered correct, but the amount went slightly over because of committee members phoning Dr. Wood with questions unrelated to the report. Dr. Wood billed the committee for those questions at an hourly rate which totaled \$8000 above and beyond. He said that as committee chairman he is not going to assign Dr. Wood any new work; it will be the incoming committee's prerogative as to whether to extend the contract with more work. He said this would completely cover any questions on the report that come up now or during the first month of the new legislature.

SENATOR THERRIAULT commented that there is a wealth of information in the report and it is going to take some time to digest it. He asked how contact with Dr. Wood came about to hire him.

10:03:52 AM

CHAIR SAMUELS said it was very difficult to find somebody who had not done a lot of work for say, Exxon at Point Thomson, or who did not have a lot of baggage with committee members, or who worked for the administration. The committee looked to find somebody who was qualified but did not have a conflict or so much political baggage that he or she would be disregarded.

10:04:52 AM

CHERYL SUTTON, Staff, to Representative Samuels, Alaska State Legislature, concurred with Chair Samuels' explanation. She said the committee was looking for someone with no previous involvement in these issues and who had worked on worldwide fiscal design, particularly in gas. There is only a handful of such people in the world, she said, and it boiled down to Dr. Wood not having prior involvement, being more than qualified to do this work, and available to do the work.

10:05:24 AM

[CHAIR SAMUELS removed his objection.]

There being no further objection, the motion to amend the contract with Dr. Wood & Associates was approved.

CHAIR SAMUELS reiterated he would be extending the aforementioned contracts until January 31, 2009.

The committee took an at-ease from 10:06 a.m. to 10:12 a.m.

[10:06:00 AM](#)

The committee took an at-ease from 10:06 a.m. to 10:13 a.m.

ROUNDTABLE DISCUSSION

CHAIR SAMUELS announced that the committee would now turn its attention to the roundtable discussion.

[10:13:49 AM](#)

CHAIR SAMUELS related, "It's a decrease in total taxes by producing the gas."

DAVID WOOD, Ph.D., David Wood & Associates;, Consultant to the Legislative Budget and Audit Committee, Alaska State Legislature, suggested that perhaps the fiscal stability issue around the world is worth expanding upon. He reminded the committee that there are a number situations in which contracts have been signed with fiscal stability clauses and the expectation of the producers was that fiscal stability would be maintained. Over the past four years those guarantees of fiscal stability have been eroded, and consequently the producers have settled agreements to dilute the terms.

CHAIR SAMUELS posed a scenario in a net profit system like Prudhoe Bay in which all the money comes from one field. He recalled that hearing testimony that the problem with progressivity is "doing this on a barrel to oil equivalent." Chair Samuels inquired as to the other methods that could be used with the cost allocations in a net profit system in order to know what to take off of gas versus oil.

DR. WOOD explained that in most oil and gas fields more than one fluid is produced, and therefore it's quite common to have oil and gas come to surface from one well stream. However, the

critical point is that the two are sold as separate revenue streams in many cases. Therefore, [cost] allocations can be split on a volume basis or, more equitably perhaps, on an energy content basis. However, there can be more difficulties if there are "a lot of historic process facility." Again, it's a matter of being aware of the different revenue streams, of which there may be more than two. To look at an existing producing field, it does become a more complicated accounting matter, he said. However, it's not insurmountable as there are examples of such from around the world. He reminded the committee that the focus of his report was not Prudhoe Bay.

[10:18:35 AM](#)

DAN DICKINSON, CPA;, Consultant to the Legislative Budget and Audit Committee, Alaska State Legislature, offered that one example is from Alaska. In the late 1990s there was the Central Gas Facility which produces gas as part of the production process for which no charges accrue and the facility also produces natural gas liquids (NGLs) and gas that's sold for which the costs were deductible for tax purposes and royalty. In this process, how much was part of production or post production had to be determined for every piece of equipment and cost. After several years and lawsuits, finally a position was settled upon. Mr. Dickinson said:

It is very complex to do allocations because ultimately all allocations are arbitrary. ... allocations are done all the time and you simply have to figure out what makes the most sense, whether it's volumes or economics or some combination of the two and you come up with something that you hope won't produce bizarre results when the allocation is supplied over a wide variety of circumstances. So, we have some history with that.

[10:20:02 AM](#)

LARRY PERSILY, Consultant to the Legislative Budget and Audit Committee, Alaska State Legislature, inquired as to whether the allocation would be changed monthly as the split of British thermal units (Btus) between gas and oil changes as a field ages. He related his understanding that as a field changes there would have to be a system that updates the allocation, which could cause more problems.

DR. WOOD offered that if [the allocation] was done on a volume or energy basis, it would be fairly straight forward because each month the appropriate volumes or energy contents for the two streams would be available. Going forward, the allocations would be on that basis. Using such an approach builds in the fact that over time there will be changes.

CHAIR SAMUELS surmised that from the onset there's a flaw in a scenario in which the costs in a net profit system are allocated on a barrel of oil equivalent (BOE) basis, but the progressivity isn't [allocated] in that manner. He recalled that Dr. Wood cautioned the committee with regard to the BOE in the progressivity tax on gas. "So, if you do that when you're allocating costs in a net profit system, it's all about the costs, then how do you get to the next step then of a progressive system on knowing how much each one is making," he asked.

[10:21:49 AM](#)

DR. WOOD clarified that the problem isn't with the BOE, but rather the problem is that the two streams are being put together in the BOE. With an allocation of costs, the energy that's being split out can still be used. The opposite thing is being done, he said.

MR. PERSILY offered that by separating the two streams, the gas revenue is being taxed separately from the oil revenue. Therefore, the problem of the less profitable gas when it's combined with oil that drives down the oil tax is avoided.

MR. DICKINSON pointed out that Dr. Wood's first three examples retain the BOE equivalency, the [two streams] are separated so that if one goes negative it goes to zero but the other [stream] doesn't. Mr. Dickinson reiterated Mr. Persily's statement that the critical point is the separation, not the allocation method to achieve the separation.

[10:23:25 AM](#)

REPRESENTATIVE HAWKER surmised, then, that if there were a perfect alignment and consistency between the price equivalency and the energy equivalency, then "who cares." However, there's a disconnect that sometimes is extreme. The separation, he further surmised, is necessary so as to be able to address the lack of price equivalency with energy equivalency.

DR. WOOD concurred; the ability to treat the two streams separately, in cases of extreme disconnect, is the key.

[10:24:31 AM](#)

REPRESENTATIVE SEATON inquired as to how that applies to the cost allocation and the credit on cost. He posed an example in which there was a lower tax on gas and credits that are allocated against oil, which has a higher tax. In such a situation, he inquired as to how that would be justified so that industry isn't allowed to take costs from the lower tax rate against the higher tax rate in which the state would pay more.

DR. WOOD explained that in the case of new capital investment specifically focused on one stream, it would be appropriate that the investment credits would also be allocated to that particular stream. In the case of a shared facility that's being used for oil and gas, clearly there could be a situation in which one stream has preferential relief as a consequence of using the credits. Therefore, it becomes more complex in those situations, although such could be addressed in regulations.

[10:26:17 AM](#)

CHAIR SAMUELS recalled from the prior day's testimony that with current progressivity, the tax on progressivity of oil would be reduced by producing the natural gas unless some changes were made. He related his understanding that it would have to be reduced so that the entire total tax burden would decrease. Therefore, all the gas would be produced, but less money would be received.

MR. DICKINSON, referring to a handout entitled "Alaska Oil and Gas Taxes Additional Roundtable Examples," directed attention to [the slide entitled "How did we get here - 4 fold increase in tax UPDATED"]. He highlighted that between 2004 and 2008, the tax paid by industry increased by 11 times, a 1,100 percent increase in total taxes paid between 2004-2008. In that same timeframe, the tax base, the value times the volume, increased 2.2 times. Therefore, the taxes are five times higher in 2008 as they were in 2006 as a consequence of the tax changes. Over that same time period, the royalty increased by 2.3 versus 2.2 in the base test with no changes. The aforementioned confirms that fundamentally it is correct to assert that the progressivity and the other changes as a consequence of 2006-2007 reforms was a five-fold increase in the production tax.

MR. DICKINSON, referring to the slide entitled "Combined Progressivity Example 1," explained that it illustrates how progressivity might work for an oil producer and what would happen if gas was added and what would happen to the taxes under the current regime. He recalled that Ms. Davis presented something similar to the legislature back in January. The slide assumes .7 million barrels a day, which amounts to 255 million barrels for the year, which for oil translates into 255 million barrel equivalents. The Alaska North Slope (ANS) price used was the December 2007 price of \$79.72. The transportation cost to get the oil from the North Slope to the market used was \$6.00. Therefore, the gross value at the point of production was \$73.38, which when multiplied by the barrel equivalent amounts to \$18.7 billion of gross value at the point of production. Since only the royalty portion is being taxed, 87.5 percent is taken and thus there's \$16 billion. The upstream costs were \$4 billion. Therefore, the taxable value (PTV) amounts to \$12 billion. To determine the progressivity on that one must divide through by the barrel, which amounts to 223. The barrels divided through the dollars results in a progressivity base of \$53.98. He reminded the committee of the \$30.00 collar that isn't subject to progressivity, which results in [a progressivity base of] \$23.98. Once the starting rate of \$23.98 is multiplied by .4 percent it results in a progressivity rate of 9.59 percent that is then added to the 25 percent base rate, which amounts to a total rate of 34.59 percent. That total rate is multiplied by the PTV [of \$12 billion] and results in a total tax of \$4.2 billion.

[10:31:28 AM](#)

MR. DICKINSON then moved on to the slide entitled "Combined Progressivity Example 2," which assumes that some gas is being produced. For the example, the assumption is that the gas and oil will be equal amounts at about 4.2 billion cubic feet (bcf). Once the bcf is converted to a daily amount and then converted into a BOE, the result is the exact same amount of gas in barrel equivalent. He noted that numbers were designed to do so, with the 50:50 mix of gas and oil. He then offered the assumption that ring fencing existed and the gas was being produced in a stand-alone field. He noted that all of the figures were from the TransCanada application and the figures are a lot lower than the Black & Veatch numbers used yesterday. TransCanada used the Henry Hub price of \$6.00 and the \$.75 adjustment to reach the Alberta price, a tariff of \$2.88. Therefore, the gross value at the point of production is \$2.45, which when multiplied by the volume amounts to about \$3.7 billion and the taxable wellhead

piece is determined. He noted his assumption that there are no costs involved for gas. If this example were in Prudhoe Bay, fundamentally when gas is being produced there will be very small incremental costs. In response to Chair Samuels, Mr. Dickinson confirmed that he's assuming the gas treatment plant (GTP) is rolled into the tariff. In fact, the \$2.88 transportation to market tariff does include a component for the GTP in TransCanada's analysis. The notion is that 8.5 cubic feet a day [of gas] is being pressured and put back into the ground, and essentially some pipelines and removal of some of the components and [the gas] is ready to go into a gasline with minimal additional costs. Any additional costs would make the example more extreme, he related. He then continued his calculation by pointing out that there is \$3.5 billion of taxable value and the same calculation is performed in order to determine the nonroyalty piece, which results to an equivalent of \$14.70 BOE. The aforementioned, he clarified, means there is no progressivity because there's nothing over 30, which means that stand-alone gas would pay no progressivity.

[10:34:44 AM](#)

MR. DICKINSON, referring to the slide entitled "Combined Progressivity Example 3," explained that it calculates what happens if oil is being produced in Prudhoe Bay and then the gas is added. To determine the total annual barrel equivalents, the oil and gas as barrel equivalents are added together, which amounts to 511 million annual barrel equivalents. Then the two taxable values are added together, which amounts to about 15,300 billion. Mr. Dickinson then performed the same progressivity calculation on the combined barrel equivalents of oil and gas. The same process is followed such that the total barrels are taken and the nonroyalty portion is determined, which is then turned into a dollar per barrel amount of \$34.34 from which the \$30 collar is removed. Therefore, the starting point is \$4.34 multiplied by the .4 percent, which amounts to 1.7 percent additional that's added to the 25 percent rates. The aforementioned results in a total tax rate of 26.7 percent, which ultimately amounts to total taxes of \$4.1 billion. The taxes have decreased by \$69.4 million. "So, I was paying something for oil. The day I turned the gas on, the day ... we got the gas ... state revenues go down," he stated.

CHAIR SAMUELS surmised, though, that state revenues decrease for the tax portion, but the royalty portion would remain.

MR. DICKINSON noted his agreement that for this one piece, the revenues would decrease. He related the expectation for the revenues to increase for royalties and for property taxes. He further related his belief that income taxes will decrease in the aforementioned scenario.

CHAIR SAMUELS noted that Mr. Dickinson's examples use an ANS price of \$80 and a Henry Hub price of \$6.00. If those prices were more equalized in an environment with progressivity, he related his assumption that the problem would correct itself. "If there's a 6:1 ratio, there's not a problem. But every time it splits, there is a problem. Is that ...," he asked.

MR. DICKINSON acknowledged that there is a point at which the problem will fix itself. However, it's not 6:1 in the price but rather 6:1 in the PTV. The problem is that there is a huge difference in the transportation costs. In other words, \$6 barrel equivalent is being subtracted from oil. For the gas, \$6 multiplied by \$2.88 would be subtracted or something close to \$18 per unit. Even if those were 6:1, the subtraction wouldn't be. He then acknowledged that there are other equally rational numbers for which one can find months with a gain. He then highlighted that in the oil there is a higher rate times a lower tax base while on [the gas side] there is a lower rate times a higher base. There is nothing that automatically says there will be an increase until the size of each [stream] and the percentage being taken of each.

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CHAIR SAMUELS offered an example in which there isn't a gas pipeline, but instead a gas to liquids (GTL) or LNG plant. Therefore, there would be huge costs with relatively small transportation costs. He related his understanding that with a GTL plant, the Trans-Alaska Pipeline System (TAPS) tariff would be paid, the GTLs would be shipped, and there would be a huge cost to use this huge amount of gas. Furthermore, 40 percent of the royalty would be lost. "So, if that changed ... one of the examples was that your transportation for gas is so high that that's what kind of skews this. If your transportation was less, but you had to spend \$40 billion upfront on Slope work to build the GTL plant ...," he remarked.

MR. DICKINSON stated his agreement that there would be a huge cost deduction.

CHAIR SAMUELS pointed out that the transportation costs would be exactly the same as oil.

MR. DICKINSON added that the oil transportation costs would decrease because if the number of barrels in TAPS increased because most of it's a fixed cost. He offered to run such and provide an example in writing later.

[10:42:04 AM](#)

MR. DICKINSON, in response to Representative Seaton, offered his belief that should a process with a 40 percent gas loss be in place, the State would review point of production issues. If it wasn't a process they hadn't envisioned and the legislature hadn't thoroughly vetted, the rules in place now wouldn't necessarily be applied.

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MR. DICKINSON added that Senator Therriault was accurate in his comment yesterday that now gas has been incentivized, but Dr. Wood is also correct in saying that such a situation might be unstable.

[10:44:26 AM](#)

CHAIR SAMUELS observed that in the assumptions in today's prices a 6:1 ratio comes back into play and there is no progressivity. Therefore, if gas is at 6 and oil is at 36, this becomes less relevant because both are at the base.

MR. DICKINSON specified that the progressivity is the problem. The 6:1 doesn't matter because if neither gas nor oil triggers progressivity, then it's a non issue.

[10:45:04 AM](#)

MR. PERSILY, referring to the Combined Progressivity Example 3, pointed out that the state would really notice a loss of oil progressivity revenues, if the environment was such that oil was at \$120-\$140 a barrel and gas was at \$6 or \$7. In such a case, the state would lose a significant amount of money.

MR. DICKINSON said that he can't agree with Mr. Persily because the rates would be higher. In working with these models, he related that there are so many moving parts that one has to

"look and see." If oil is at \$150, the progressivity is so high ...

MR. PERSILY interjected, "that even when you factor in gas, you're still coming out with a lot of money in the bank."

MR. DICKINSON characterized it as a fairly complex set of interactions.

MR. PERSILY surmised:

So, it also depends not just ... at a very high oil price we're going to get so much progressivity. But, as you said, it's not so much the Henry Hub price of gas, but the price after tariffs. So, if it ends up costing \$4 or \$5 to move gas to market, that would lower the production tax value point of tax value on the gas, which would also then effect that bottom line quite a bit. Another one of the moving parts.

MR. DICKINSON noted his agreement. He then relayed that he had attempted to set up simplified formulas to isolate which factors are controlling. He said he wasn't able to summarize in a simplistic way such that he could say if "X" increases then "Y" decreases.

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REPRESENTATIVE SEATON questioned whether this is a restatement, the same effect, of the presentations from other consultants during which there was discussion about moving progressivity down the scale.

MR. DICKINSON answered that it's the same effect as the presentation that didn't address the interplay between oil and gas but rather the point at which incremental effects yield results counter to what is desired. In other words, incremental increases in revenues generate more tax than money to the company. He indicated [the example he provided today] is a sub-example of the aforementioned. The concern is about the incremental effects, which are different from average effects.

REPRESENTATIVE SEATON asked whether companies would only experience less revenue if there were low oil prices and very high gas prices, including a fairly low transmission price on gas. He requested a scenario in which the company is better off not producing gas if progressivity is applied.

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MR. DICKINSON declined to do so at this time, but offered to provide the answer in writing.

REPRESENTATIVE SEATON related his understanding that the combination of the two could reduce the state's take, but he said he didn't recall presentation of a situation [in which the companies would receive less revenues].

CHAIR SAMUELS recalled that yesterday Senator Therriault said that one could argue that this entire feature is an incentive to start developing gas. However, politically the question is how long will a system in which the gas isn't flowing but the [oil] is, in the amount of 300,000 barrels a day, last. The aforementioned then leads to a discussion regarding fiscal certainty and whether it's a stable system. He then requested that Mr. Dickinson run some numbers for a situation in which gas prices spike, but oil prices do not. He suggested that Mr. Dickinson prepare an interactive model in which members could plug in production numbers and prices such that members could run a suite of options.

MR. DICKINSON agreed to do so.

[10:53:51 AM](#)

REPRESENTATIVE KELLY surmised that there is a definite impact when one crosses the line between natural gas and oil. There seems to be the need for a placeholder for gas pricing, but the consultants have seemed to suggest [there should be clear lines]. Therefore, as the members listen to the presenters, there should also be some common notion with regard to the decision path regarding whether the current system will work as is or whether it needs to be altered. He expressed his hope that the administration is involved so as to be more efficient with this.

CHAIR SAMUELS cautioned the committee against addressing matters, such as the cost allocation method and fiscal certainty, one at a time as it may result in a never-ending debate. Therefore, he suggested members think of all the matters at once in the context of one fix.

REPRESENTATIVE KELLY concurred.

10:57:37 AM

REPRESENTATIVE SEATON expressed concern with the split allocation and trying to cost allocate and credit allocate. He asked that some general principles be laid out on the table with regard to cost and credit allocations.

MR. DICKINSON agreed that those issues should be reviewed. He said that although he hasn't reviewed these issues, it seems that credits should be reviewed but nothing done with them. He pointed out that credits are always in dollars. Currently, a credit can be generated for a new endeavor that is in the middle of the National Petroleum Reserve-Alaska (NPR-A) and be applied to oil that's being generated from Prudhoe Bay. If the legislature is comfortable with such ring fencing, such can continue. The critical point is what happens when two streams with different characteristics are combined and odd things result. The notion, he opined, is that once there is separation between oil progressivity and gas progressivity, it can ultimately be combined for the credit worth. Mr. Dickinson expressed the need to examine the notion of separating the two streams for purposes of determining the credit because there is no inherent reason to do so.

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DR. WOOD concurred, adding that the complication is primarily with existing fields that already have some historical equipment in place. The aforementioned will have to be addressed on a field-by-field basis. He pointed out that there are several different mechanism that can be and are used to allocate costs. Although credits complicate the process, they shouldn't invalidate the process, he remarked.

REPRESENTATIVE SEATON posed a scenario in which oil had a higher tax rate and gas had a lower tax rate. He inquired as to how to allocate those costs in order to ensure that the state isn't reducing the tax on something that's very profitable to compensate for something that isn't quite as profitable.

DR. WOOD pointed out that ring fencing is used in many parts of the world. If there's a chance that there will be a large discrepancy between the two streams and the equipment involved, usually some ring fencing would be applied to limit that.

REPRESENTATIVE SEATON asked how one would allocate the costs of infield drilling for oil and gas in a place like Prudhoe Bay if there are different tax rates on the two streams.

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DR. WOOD said it is difficult to answer specifically on Prudhoe Bay without having the opportunity to review the field. He said he believes that rules can be established that clearly specify that there are some restrictions on what can be allocated specifically to oil and allocated specifically to gas. It is a question of setting up a set of fairly generic rules and applying those. The fact that they are shared facilities should not necessarily be a problem.

MR. DICKINSON explained that there are two basic kinds of allocations. There is a volumetric allocation based on some count of something and there is an economic allocation. In the economic allocation, the driver would look at the total value of two sets of products, and if it is a 9:1 ratio then costs get allocated 9:1. Somehow "widgets" and "nonwidgets" must be on a same basis and throughout the world that is typically done on a dollar basis - what is the value. This sometimes has very bizarre results as values change dramatically. However, bizarre results can also happen if units are used and values change dramatically. The classic case is a joint process where one product is losing money and one product is making lots of money. So the losing product is shut down "and it turns out in the joint process you were making it and the only costs were what was selling it, so it shouldn't carry any cost." So, the debates go on and on, but every example will fall into one of those two baskets. Second, there is a fixed and a variable piece. The formulas can get very complex. Ultimately a formula is arrived at "that doesn't make sense to everyone" and then that is what gets applied.

[11:07:08 AM](#)

SENATOR THERRIAULT inquired whether there are regimes that use volume of Btus produced. Since each separate stream generates a fixed unit of Btus, would that be a sensible way to separate those costs, he asked.

DR. WOOD explained that different regimes use different systems. Some use volume, some use energy values or Btus. A case can be argued both ways. Anomaly situations can come up in both cases as Mr. Dickinson said. One must come up with a set of rules and

accept that there is going to be some anomalies for that, but overall it should be rules that achieve the long-term expectation, rather than saying that for this particular piece of equipment it does not work very well. He opined that in the longer term simple rules can be set up that will work using either volume or energy values and factoring in a whole range of different fixed variable costs.

SENATOR THERRIAULT suggested that the legislature not move forward in a piecemeal fashion. He said he thinks whatever the legislature does, if it is deemed sensible and politically possible, that it be viewed as a package that moves the state toward success in open season. Legislators are now getting information on how to evaluate the current system and are understanding that there is an incentive built into the current system to get gas into production at high oil prices, in which case the price of the tax is diluted.

[11:09:36 AM](#)

ADJOURNMENT

There being no further business before the committee, the Legislative Budget and Audit Committee meeting was adjourned at 11:09 a.m.