

SENATE FINANCE COMMITTEE  
November 6, 2007  
9:14 A.M.

CALL TO ORDER

Co-Chair Bert Stedman convened the meeting at [9:14:39 AM](#).

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Charlie Huggins, Vice Chair  
Senator Kim Elton  
Senator Donny Olson  
Senator Joe Thomas  
Senator Fred Dyson

MEMBERS ABSENT

None

ALSO PRESENT

Senator Thomas Wagner; Senator Gary Stevens; Steve Porter, Legislative Consultant, Legislative Budget and Audit Committee, Legislative Affairs Agency

SUMMARY

SB 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."

SB 2001 was HEARD & HELD in Committee for further consideration.

#sb2001

SENATE 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."

Understanding Alaska's Current Production Tax - How and Where Does the Cash Flow?

[9:17:34 AM](#)

STEVE PORTER, LEGISLATIVE CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE, LEGISLATIVE AFFAIRS AGENCY, outlined his work experience in the oil and gas industry. He worked in both the private sector as well as in government.

Mr. Porter emphasized that models are not designed as specific solutions to problems, but provide an order of magnitude for understanding of issues and the relative relationship between the elements of the models. He added that the model is only as good as the quality of the data input. He further pointed out that accuracy begins to diminish as the model is used to project further in the future.

[9:21:19 AM](#)

Mr. Porter addressed the model page 1 of handout titled "PPT Tax Calculation".

Mr. Porter referenced the DOR Spring Resource Book, which contained a broad statement of how PPT works. There are four main elements: value - costs x tax - credits. He emphasized that these four elements will be a part of future discussion regarding their effect on the revenue stream.

[9:23:03 AM](#)

Mr. Porter addressed pricing and referenced the spring forecast, which was \$54.72 per barrel of oil; the current projections from DOR is \$71.65. Future projections are raised by \$15 to \$20 dollars in out years. The long-term forecast, 2013 - 2014, is still closer to \$40 per barrel. These are only projections.

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Senator Elton questioned why the Department of Revenue's numbers differed from Mr. Porter's. He asked if this was because Mr. Porter was using a higher price per barrel cost projection. Mr. Porter did not know what the Department used for assumptions.

[9:26:00 AM](#)

Co-Chair Stedman directed attention to the calculations in the regarding Alaska North Slope (ANS) well head value. He pointed out that the ANS well head price is he \$14.9 billion.

Mr. Porter clarified that the department uses the ANS West Coast price for their calculations, which is the production tax value. He explained that he was addressing the total gross value before deducting transportation costs.

Mr. Porter pointed out, with regards to futures projections, it is important to understand why the Department of Revenue over estimates on volume and under estimates price. He explained the Department of Revenue is very conservative on price. The Department does not raise their projections as quickly as the price rises. Therefore, revenues projections are often lower than actual when there is a fast rising price, resulting in a "surplus". The Department also lags behind as price drops, but not as bad. The Department of Revenue generally over estimates volume. Volume estimates do not take into account problems. The Department also has a tendency to move production dates.

[9:29:10 AM](#)

Mr. Porter noted that the gross value calculated on the chart does include transportation costs. Later in chart (line 25) the itemized cost is deducted out.

Senator Huggins asked about royalty tax and the different rates, commenting that it was his understanding that there is a range from 12.5%-16%

[9:30:11 AM](#)

Mr. Porter responded by saying the older leases such as Prudhoe Bay and Kuparuk are at the 12.5% rate. He went on to say that newer leases operate under a higher royalty rate. He explained that there are also net profit share leases, which have a very specific calculation increasing the royalty rate. He explained that the vast majority of leases are 12.5; a blended late may be closer to +13 percent.

[9:31:09 AM](#)

Senator Huggins emphasized that when analyzing the tax structure, it is important to consider the impact on those with a higher royalty rate. Mr. Porter concurred and underlined the point by mentioning Pioneer's Oooguruk unit had a substantially higher number of net profit share leases.

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Mr. Porter addressed the calculation for net royalty value. He pointed out that royalty barrels are not taxed. He further explained that royalty barrels are taken out before the net value is established. What remains from the calculation are taxable barrels.

[9:33:21 AM](#)

Mr. Porter explained that the ANS wellhead price is determined post deduction of transportation costs.

[9:34:14 AM](#)

Senator Thomas asked for a summary of transportation costs. Mr. Porter pointed to the list on the chart noting the downstream

costs and added that there are also upstream costs. He deferred to the Administration for further clarification.

[9:35:05 AM](#)

Mr. Porter explained that the number under other deductions and adjustments was manipulated to reflect a .50 cent change from the spring forecast number.

[9:36:02 AM](#)

Mr. Porter explained that the numbers, with relationship to the value equation should remain consistent throughout the discussion for all proposals before the legislature.

He addressed the cost portion of the handout. He acknowledged there has been some debate as to how to manage the cost but clarified that his presentation would focus on what the costs are and how they impact the overall tax.

Mr. Porter explained that under PPT operating and capital costs are subtracted out after value is captured. The total operating and capital costs are projected to be \$4.3 billion. He observed that \$4.3 billion was the number that concerned the Department of Revenue because it represents a significant increase in costs. He said the Committee will need to deal with the issue very specifically to understand why the costs went up and how the increase will impact tax.

[9:37:58 AM](#)

Co-Chair Stedman reminded the Committee that Econ One would give a presentation and will address the operating and capital cost increases.

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Senator Huggins indicated that the costs are unknown because allowable costs have not been established. He maintained that the numbers representing costs are those of the producers, not necessarily what the state would allow.

[9:39:09 AM](#)

Mr. Porter affirmed. He indicated that one important and substantial element within the legislation is collection of data. The collection of data will provide the state information that will help in understanding current and future costs.

Mr. Porter explained the variables that went into the revenue projection for the original PPT. He made clear that the department underestimated price, overestimated production and underestimated costs. Mr. Porter maintained that price was the most significant variable in the inaccuracy of the revenue projection equation.

[9:41:11 AM](#)

Senator Elton reiterated the assessment by Mr. Porter regarding revenue projections. He asked if Mr. Porter was suggesting that the department's latest presentation was also a miscalculation.

[9:42:02 AM](#)

Mr. Porter did not know what the Department had presented. He emphasized that though numbers are important in a model, it is necessary to look for an understanding of the order of magnitude in relative relationship, not for an answer. He pointed out that he used the current numbers that he was given by the modelers and was confused why the numbers differed.

Co-Chair Stedman stated that the intention of the meeting was to provide understanding of the flow of the dollars through the system, not so much the exact variables. He reiterated that Econ One, Legislative Budget and Audit consultants, are currently working with the Administration. When the projections are looked at in detail the legislative consultants along with the Department of Revenue will be in sync on the numbers. He maintained that the purpose of the meeting was to lay some ground work to understand the interlinking of variables and to understand the magnitude of impact in manipulating any one piece.

Mr. Porter observed that the intent of law and intent of gathering information is to be closer to those numbers. He pointed out that the Department of Revenue, statistically, comes closer to the right price projection than the national modelers. He further clarified that though the modelers had some level of accuracy in price projection the reasons were incorrect. He

pointed out that the other two variables in forecasting projections, production and costs are more easily determined than price. With regards to production, he said, this is a "fairly tight" number, but further acknowledged that with older fields the number is a bit more difficult to determine due to the amount of "down time" and an aging facility. Costs can be more easily determined through a clear understanding, by the tax payer, of what is deductible. He maintained that the more definition that is provided to determine costs, the more accurate the calculation of costs will be.

[9:45:40 AM](#)

Co-Chair Stedman noted the Departments presentation from the previous meeting used FY 2009 numbers. He reiterated that the purpose of Mr. Porter's presentation is to provide a brief summary of "how things flow through". He further noted that the details will be presented for discussion by Econ One which will provide the same model and the same derivatives.

Mr. Porter explained that the reason the Department changed to FY 09 numbers after using FY 08 numbers is to provide a clean analysis free of partial years as well as other issues unique to FY 08. He stressed the importance of understanding that the numbers changed because the numbers used at the start of Special Session were the FY 08 and currently the FY 09 numbers are being used.

[9:47:20 AM](#)

Mr. Porter addressed the production tax value and noted that it is important in all future equations. He pointed out that the ACES proposal and PPT use the same number. He explained that it is the number used to get the per barrel calculation that is applied against the progressivity and is used to calculate the tax. The net tax is calculated against the equation of value - costs = net. The tax rate is applied against the net. Establishing net is the first step of the tax equation.

[9:48:12 AM](#)

Mr. Porter discussed the progressivity portion of the handout. He explained that the progressivity trigger point of \$40 is not the West Texas intermediate or ANS wellhead price is \$40. The trigger of \$40 represents cash flow: cash flow per barrel. The

price is determined by the equation: Production tax value divide by the total taxable barrels = per barrel cash flow. Every barrel of oil produced on the North Slope receives \$40 of cash flow before the progressivity tax is applied. He stressed the importance of this when looking at the relative relationship with the costs of oil on the North Slope. In-fill drilling is very profitable and productive and costs are low. As a result, the \$40 cash flow kicks in sooner than Westsak, which has higher costs.

[9:50:21 AM](#)

Co-Chair Stedman asked Mr. Porter to explain the columns on right hand side of the handout. Mr. Porter said the columns track the cash flow as the different pieces of the tax are calculated. When there is a deduction, cost or credit, the right column illustrates the resulting allocation to the State, the federal government and the producer.

[9:52:41 AM](#)

Mr. Porter explained that the elements of the progressivity tax are the trigger, which is the start point. The next number is the rate per price Index Dollar at .25% (ACES is set at .20%). The slope of the line illustrates how quickly the remaining cash flow, shared at 50/50, will be reached. The current PPT cap is set at 47.5% because the of 22.5% tax and 25% maximum progressivity. The ACES proposal has a 25% tax with a 25% maximum on progressivity, hence the 50%.

Mr. Porter addressed the per barrel tax value and reiterated the equation: total production tax value divided by total barrels equals the per barrel cash flow. He referenced the numbers on the chart. The result of a price forecast at \$71.65 and current production projections, there is a \$46.05 per barrel cash flow. With the trigger at \$40, the progressivity tax rate (1.51%) would be applied on \$6.05 of cash flow. He concluded the section by underlining that the 1.51% is a tax on the net, which equates to \$160,480,575.00 as shown in the revenue column and deducted from the producer column.

[9:55:51 AM](#)

Mr. Porter went on to say that by adding the base tax, plus progressivity, the result is approximately \$2.5 billion. This

amount is subtracted from the production tax value. The amount that remains represents the Pre-Credit Adjusted Revenue.

Mr. Porter referred again to the formula saying that the Value - costs x tax, portion has been addressed.

The next part of the presentation addressed exclusions and credits. There is a 30% per barrel exclusion, against total taxable barrels. He noted that this represents approximately \$69 million.

Senator Stedman recalled a number of \$30 million from Resources, but thought the 30% exclusion represented \$70 million.

Mr. Porter pointed out that the presentation is not designed to get into details of each of the credits, but stated he could provide detail if it was the desire of the Committee.

He continued his presentation with the Credits section noting that the projections used are from Department of Revenue. He stated that the capital credits are 20% of the capital expenditures. The capital expenditures are outlined. Every dollar of capital costs is deductible with the addition of a credit. He emphasized that the 20% credit is of substantial value to the explorer and the producer providing an incentive to spend capital in the state of Alaska and reinvest in the state.

Mr. Porter explained that the net operating losses (NOL) are a credit though there are no specific projections in the model. He explained that there is no analysis because, from the Department of Revenue standpoint, the operating losses are an in determinant number. He further stated that the net operating loss would not be large.

[9:59:17 AM](#)

Mr. Porter addressed the Transitional Investment Expenditure (TIE) noting that the chart illustrates a one year projection for FY 08. The credit would last for the next 5 years. He explained that the TIE credits are based on the amount of capital expended between April 2001 and April 2006. The applicant could take up to 20% of the amount in a credit in the future. The requirement to receive the 20% credit is an investment against 10% of current capital expenditure. He explained that the \$213 million on the chart is a calculation

representing the assumption of 10% of the FY 08 capital expenditures.

In response to a question by Co-Chair Stedman, Mr. Porter indicated that the statute says 10% per year, but to capture the full credit in the 5 years available, because of how the calculation works, producers would need to spend 2 for 1 to receive the credit.

Co-Chair Stedman said the Committee would explore the issue because of price appreciation on capital expenditure and operating expenditures. He recalled that during work on PPT there was an expectation of 2 for 1 of additional capital expenditures, not just inflation push to capture it.

Senator Huggins recalled that there must be production to claim TIE credits.

[10:01:53 AM](#)

Mr. Porter confirmed that there must be production in order to claim the TIE credits. He further clarified that the TIE credits are not transferable, but frozen until production is realized.

Senator Huggins stated that the TIE credits are an incentive to produce. Mr. Porter concurred.

Mr. Porter said that credits are in AS 43.55.023, AS 43.55.024 and AS 43.55.025. He noted that anytime there is a statutory reference to these sections, it is a reference to credits. He also informed that AS 43.55.024 outlines small producer credits of \$12 million. He related that DOR assumes up to 4 producers may claim the credit, which would represent \$48 million. He said it is an order of magnitude what can be expected in that category.

[10:03:35 AM](#)

Mr. Porter stated that exploration credits are the same way, an explorer can capture between 20% and 40% in credits depending on where the exploration takes place. If the well is further than 3 miles of any other well, and further than 25 miles from a unit, the explorer can acquire a 40% credit on capital expenditures. He commented that the interesting impact of

having a 20% capital expenditure credit is that the explorer can not receive both. The explorer can prove the capital expense and receive the 20% credit or spend the time to apply to the Department of Natural Resources (DNR) for the exploration AS 43.55.025 credit. He pointed out that because producers/explorers have an option of applying for capital or exploration credits, different conclusions can be drawn. For example, he noted that though a company may be exploring, they may opt to apply for 40% capital credit rather than a 20% exploration credit. He concluded that if the capital credits are a greater amount than exploration credits it should not be assumed that there is an absence of exploration.

Mr. Porter pointed out that the conclusion of calculations from the formula result in a percentage of take for the State, the producers, and the federal government.

Senator Elton asked for an explanation of state take including the municipal property tax. The state take is less than 39.98 percent with the municipal take subtracted.

[10:07:27 AM](#)

Mr. Porter said that was correct when determining what goes into the Permanent Fund for the municipalities.

[10:07:50 AM](#)

Co-Chair Stedman stated that 65.6 million is the current number for FY 08 in property tax that goes to the state as unrestricted funds. He pointed out that all property tax is aggregated even though some goes directly to the boroughs.

Senator Elton asked if the municipalities are getting \$300 million.

[10:08:47 AM](#)

Co-Chair Stedman responded that there is an analysis that illustrates how much each borough receives and offered to share it with Senator Elton after the meeting.

[10:10:00 AM](#)

Co-Chair Stedman asked Mr. Porter to make slight modifications to the handout

[10:10:41 AM](#)

In conclusion, Mr. Porter emphasized that models are based on assumptions of two principals: order of magnitude and relative relationship.

[10:11:12 AM](#)

CS HB 2001 (FIN) am was HELD in Committee for further consideration.

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ADJOURNMENT

The meeting was adjourned at [10:11:31 AM](#).