

SENATE FINANCE COMMITTEE
November 7, 2007
9:22 A.M.

CALL TO ORDER

Co-Chair Bert Stedman convened the Senate Finance Committee meeting at [9:22:56 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 Lyda Green; Senator Gene Therriault; Senator Gary Stevens; Senator Thomas Wagoner; Barry Pulliam, Senior Economist, Econ One, Research, Contractor, Legislative Budget and Audit Committee.

PRESENT VIA TELECONFERENCE

None

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 and HELD in Committee for further consideration.

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."

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

9:23:12 AM

Co-Chair Stedman stated EconOne would be presenting on production cost increases. The Committee will reference the original Petroleum Production Tax (PPT) expectations as well as the results of the PPT legislation. The Administration will discuss credits and how they affect the PPT calculation.

BARRY PULLIAM, SENIOR ECONOMIST, ECONONE RESEARCH, CONTRACTOR, LEGISLATIVE BUDGET AND AUDIT COMMITTEE, highlighted his extensive history of working with the state on oil and gas matters. He explained that he previously analyzed expected revenues during past PPT and Economic Limit Factor (ELF) discussions. The PPT system was a change from the old system, which moved from a gross-based tax where value was measured at

per barrel value at the well head; to a net tax system that considers both capital and operating costs. The change required examination of upstream costs and estimating future costs.

[9:28:07 AM](#)

Mr. Pulliam pointed out that the Department of Revenue (DOR) conducted the analysis in order to provide a fiscal analysis of the PPT bill. The Department has estimated that the current system would produce less revenue due to anticipated increased costs. EconOne was asked to determine why estimates differ and whether the cost increases seen in Alaska (DOR) estimates are reflective of trends elsewhere.

Mr. Pulliam said that EconOne interviewed DOR employees to determine what process was used to collect data, particularly related to the PPT returns. During the discussion it became clear that the information could not be released.

[9:32:12 AM](#)

EconOne also looked at information available in the public domain relating to costs throughout the world and Alaska. Mr. Pulliam prepared a written report, "Report to the Alaska Legislature on Production Cost Increases" (copy on file).

AT EASE: [9:33:09 AM](#)
RECONVENE: [9:35:11 AM](#)

Mr. Pulliam explained that page 1 of the handout, "Summary of Costs", shows the cost forecasts that were used in the fiscal note for HB 3001, or the current PPT system. The fiscal note information for HB 2001 is depicted on the bottom section. The information is expressed in two different ways, total cost for capex and opex and then on a taxable barrel basis.

Mr. Pulliam addressed total costs first. In the fiscal note projection for FY 2008, capital and operating costs were anticipated to be about \$1.1 billion each. Those costs appear to be roughly in line with the spending levels through FY 2005. Current estimates of roughly \$2.1 billion each for capex and opex for FY 2008 are depicted in the lower graph. The forecast for the next several years are at that same range.

Mr. Pulliam explained that the costs were developed by reviewing information available from 2002-2005. Estimates going forward are based on DOR's review of what has been coming in under PPT and on discussions with taxpayers.

Mr. Pulliam addressed the numbers based on the taxable barrel basis. The total under the fiscal note for HB 3001 is about \$9.26 billion; under the fiscal note for HB 2001 it's about \$18.85 billion. He explained that the total is arrived by taking the total cost used in forecasting and dividing by the taxable barrels. The state gets tax revenue on taxable barrels - production less royalty barrels. The entirety of the costs reflects the cost to produce all barrels, which gets "netted out" against taxable, non-royalty barrels. He noted that the figures are all averages.

[9:42:42 AM](#)

Mr. Pulliam reported that there is broad consensus among industry analysts that costs for producing oil have gone up, which is dramatically related to the increase in oil prices. He referenced page 2, "Platt's ANS Crude Oil Price; January 2000 - September 2007". He noted that between 2002 and 2004, oil prices were within a range of \$25-\$40 per barrel, as expected. From 2004 to date, oil prices have doubled and production and exploration are now a much more profitable business and have therefore increased.

[9:45:19 AM](#)

Mr. Pulliam reviewed page 3, "NYMEX Futures Price for December 2011 Delivery; January - December 2005, Latest Quotes". The red bars depict the futures price for each month of 2005. This graph indicates what expectations were for prices long term. The expectations increased significantly during the year. The blue line reflects the most current futures price at approximately \$80 per barrel. Expectations regarding prices drive investment and production decisions.

Mr. Pulliam reported that as expectations have risen, a high demand has been placed on services for oil production and prices have gone up.

[9:48:21 AM](#)

Mr. Pulliam turned to page 4, "IHS/CERA Upstream Capital Cost Index; 1Q2000 - 1Q2007". He explained how the index works. Between 2000 and 2004 costs for upstream capital have gone up about 10 percent, which is roughly consistent with the overall inflation rate. A large increase took place in 2005. He noted that an IHS/CERA press release suggests a flattening out of capital cost increases currently due to the ability to respond to the higher demand for oil production and services.

[9:50:24 AM](#)

Mr. Pulliam reviewed page 5, "IHS/CERA Upstream Capital Cost Index vs. West Coast ANS Price; 2000 - 2007". He said if prices continue to rise, it will push up costs as service firms try to respond to increased demands for services.

[9:51:52 AM](#)

Mr. Pulliam explained page 6, "Average* Oil Drilling Rig Daily Index; 1Q2002 - 2Q2007". The graph depicts on-shore drilling rates, but not those in Alaska. Costs doubled from 2002-2003 to 2006.

[9:53:13 AM](#)

Mr. Pulliam turned to page 7, "Average* Oil Drilling Rig Daily Rates Index vs. West", to show the relationship between crude oil prices and rig rates.

[9:53:48 AM](#)

Mr. Pulliam reported that page 8, "Average* Operating Costs", was constructed from data prepared by the Department of Energy. The graph shows cost increases beginning in 2003 and 2004, but not as dramatic as the capital costs. Operating costs may not be increasing as quickly as capital costs.

[9:55:08 AM](#)

Mr. Pulliam explained that page 9, "Average* Operating Costs for 10-Well Oil Lease Index' 2000-2006", depicts the relationship between ANS price and operating costs. He emphasized that there is not a lot of available information that applies to Alaska's costs.

[9:55:55 AM](#)

Mr. Pulliam reported that page 10, "ConocoPhillips Reported Production Costs Per BOE; 2003 - 2006", shows production costs in Alaska and in the Lower 48. ConocoPhillips costs don't include capital costs, but rather operating costs. Production costs for Alaska were in the \$3-4 range up until mid-2005 when oil prices rose. That information is consistent with DOR's information and other comparisons. In 2006 there was a 63 percent increase from the prior year. Corrosion issues on the North Slope may have been a factor, as were production declines.

Co-Chair Hoffman asked if most costs were corrosion related, would costs come down in the future. Mr. Pulliam offered to address corrosion issues later in the presentation.

Senator Elton inquired if production costs per barrel for ConocoPhillips might rise higher than for ExxonMobil because of a greater level of exploration. Mr. Pulliam was not sure because much of the exploration would be capitalized and the graph depicts operating cost numbers.

[10:00:53 AM](#)

Mr. Pulliam addressed page 11, "BP Reported Costs Per BOE; 2002-2006". The Alaska costs are higher than anywhere else reported in the world. The increase in 2006 is about 82 percent and, relative to ConocoPhillips, much greater. Production costs in the United States include Alaska, and the slope would be flatter without that data included.

[10:02:33 AM](#)

Mr. Pulliam explained page 12, "BP and ConocoPhillips Reported Alaska Production Costs Per BOE; 2003-2006". In 2006 there was a much greater increase in BP numbers. This graph does not include capital expenditure, property tax, or production tax.

[10:03:24 AM](#)

Mr. Pulliam talked about "Corrosion/Integrity Management Costs" on page 13. Exxon does not break out Alaskan numbers in their public reporting, so the only comparisons are with ConocoPhillips and BP. Not much line item detail is specified;

the information is a summary. The oil transit line replacement was about \$260 million and was probably already spent. Another \$550 million net will be spent for "integrity management" in 2007-2008. Integrity management is money that is being invested and spent on facilities to avoid an incident such as happened in 2006. It's not clear if that money will be spread out into the future or if BP is speaking as a working interest owner or as an operator.

[10:07:47 AM](#)

Mr. Pulliam commented further on corrosion integrity management costs, which would put pressure on costs in Alaska due to an increased need for resources from a fixed pool. Higher costs will be reflected in the Department of Revenue Cost Forecast.

[10:10:00 AM](#)

Mr. Pulliam turned to page 14. He concluded that DOR current forecasts are based on unaudited taxpayer returns under PPT. These costs may be reduced after review and audit. Forecast costs used in DOR's fiscal note to HB 3001 are in line with publicly reported information specific to Alaska during the 2002-2005 period. Costs have increased in recent years with increases in expectations of future crude oil prices. The level of increase is likely to be mitigated over the long run. The increase in costs filed with the SEC filings for Alaska, relative to the Lower 48, reflect expenses associated with corrosion repair and integrity management efforts.

Mr. Pulliam continued to say that corrosion repair and integrity management efforts are likely to increase costs reported for Alaska, even for non-corrosion repair services. DOR forecasts likely include costs related to these efforts. DOR cost estimates now include cost/price sensitivity. A proper determination of the actual costs will require examination of supporting materials. Examination should include a review of unit-by-unit information, both during the PPT period and several years prior to the implementation of PPT.

[10:15:12 AM](#)

Co-Chair Stedman reported that Senator Wagoner had joined the meeting.

Co-Chair Stedman suggested sorting out the unknowns surrounding corrosion costs and integrity management costs.

Mr. Pulliam agreed. He thought the state should take the opportunity to understand how the \$550 million relates to net or to gross and the length of spending as it relates to deductions.

Senator Thomas recalled that there were underestimates of costs and prices that contributed to the inaccuracy of PPT. He maintained that things aren't much better now due to lack of specifics. He wondered how to gather the information needed to better predict future finances.

[10:17:46 AM](#)

Mr. Pulliam responded that there is better information now than when estimates were first made last spring. There are now monthly PPT filings, and more "real time" information regarding costs. This information must be shared and approved between interested parties in joint/shared fields. The state gets no information until after the taxes are filed, and is not privy to "line level detail" that would be forward looking.

Senator Thomas asked if that is typical of a relationship that exists between an oil producing nation or state and industry.

Mr. Pulliam was not sure. He thought that Alaska was more like foreign countries that rely heavily on oil production. The information is shared regularly with the owners of the field. Under lease agreements there could be a disclosure of information requirement.

[10:22:14 AM](#)

Co-Chair Stedman asked if, in the fiscal note on HB 3001 (PPT), an adjustment for actual production and actual price is made, the vast majority of the variance lies in the operating and capital cost adjustment. Mr. Pulliam replied that in August the Department of Revenue put out a status report that stated that in FY 08 the current forecast showed about \$800 million less in revenues than expected under HB 3001. That was mainly due to different levels of anticipated costs.

[10:23:36 AM](#)

Co-Chair Stedman asked if the \$800 was "in operating and capital in transition credits."

Mr. Pulliam affirmed, but pointed out there is more weight to capital because that's where credits come into play. With the transition credits, there is a normal 20 percent credit on capital. He gave an example showing that the capital piece is the biggest piece of the \$800 million difference that was forecast.

Senator Huggins termed it a "two-edged sword for Alaska". For a worker on the North Slope it may be good news as reflected in a larger paycheck. A merchant could also benefit by capital construction improvements. He wondered to what extent workers' wages would be reflective in rising costs. Mr. Pulliam thought that wages would be a part. On the operating side it would not appear that wages would be a major portion; more likely it would be equipment and labor force related.

[10:26:32 AM](#)

Senator Huggins spoke of the state's doing a better job of checks and balances and oversight over the industry, causing prices to rise. Mr. Pulliam agreed that having more requirements in place could cause cost increases.

Senator Huggins voiced concerned about "wildcatters" and a disincentive effect on new explorers. He wondered how important incentives might be.

Mr. Pulliam thought incentives were important. Being on a net system puts Alaska in right place incentive-wise. Capital credits are also a big incentive, along with the ability to trade or sell credits. Costs have gone up because the price environment is higher and the margins are a lot bigger.

[10:30:53 AM](#)

Senator Thomas asked a question about higher rig rates nationwide impacting everyone equally. He requested more information about rig rates.

Mr. Pulliam replied that information about rig rates for Alaska is not available. He returned to page 10 to describe the

relationship between the Lower 48 and Alaska. He suggested not putting a lot of stock into the fact that Alaska's rates are lower because each company has a different portfolio. Trends are more important, such as where Alaska production costs rise more quickly in 2006 specific to events taking place within the state.

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

ADJOURNMENT

The meeting was recessed at [10:35:28 AM](#).