

SENATE FINANCE COMMITTEE  
February 1, 2008  
9:14 a.m.

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at [9:14:15 AM](#).

MEMBERS PRESENT

Senator Bert Stedman, Co-Chair  
Senator Kim Elton  
Senator Donny Olson  
Senator Joe Thomas  
Senator Fred Dyson

MEMBERS ABSENT

Senator Lyman Hoffman, Co-Chair  
Senator Charlie Huggins, Vice-Chair

ALSO PRESENT

Pat Galvin, Commissioner, Department of Revenue; Dan Dickinson, Consultant, Tax Division, Department of Revenue; Steve Porter, Legislative Consultant, Legislative Budget and Audit Committee, Legislative Affairs Agency

PRESENT VIA TELECONFERENCE

None

SUMMARY

SB 242 "An Act relating to lease expenditures that may be deducted for purposes of the production tax on oil and gas; relating to the retroactivity provisions of changes to the production tax on oil and gas enacted in ch. 1, SSSLA 2007; and providing for an effective date."

SB 242 was HEARD and HELD in Committee for further consideration.

[9:14:58 AM](#)

SENATE BILL NO. 242

"An Act relating to lease expenditures that may be deducted for purposes of the production tax on oil and gas; relating to the retroactivity provisions of changes to the production tax on oil and gas enacted in

ch. 1, SSSLA 2007; and providing for an effective date."

STEVE PORTER, LEGISLATIVE CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE, LEGISLATIVE AFFAIRS AGENCY provided a brief sectional analysis of the bill. He pointed out that the bill covers two issues; it removes the standard deduction contained in Section 1 and Section 5, subsections (k) and (l) from the Statute. This changes the law as passed from a standard deduction for three years, to a more normal deduction for operation expenses. He asserted that the legislation also moves the retroactivity date from July 1, 2007 to December 20, 2007, which is the effective date of the bill. He emphasized that, while the changes seem simple, the effective date change requires revisions to several sections. Co-Chair Stedman remarked that the standard deduction applies to the older and larger reservoirs, Prudhoe and Kuparuk, where most of the revenue originates.

[9:17:10 AM](#)

PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE elaborated on the issue revolving around the retroactivity of the entire statute, which would affect all fields and all tax payers equally. It reflects a provision discussed throughout the session and submitted by the Senate Finance Committee when the bill was ultimately passed. Co-Chair Stedman indicated that the Senate Finance Committee amended the retroactivity provision of the bill from twelve months to six months. Mr. Galvin commented that the standard deductions issue only affects the two large fields, Prudhoe Bay and Kuparuk. The standard deduction provision was initiated on the House floor, but did not contain a sunset when it moved to the Senate. He remarked that the Senate added the standard deduction provision with the sunset. The standard deduction affects the operating expenditure deductions for Prudhoe Bay and Kuparuk for the tax years 2007, 2008, and 2009. Mr. Galvin explained it limits and freezes the amount of applicable deductions. The standard deduction is based upon the claimed expenditures in 2006. He noted the Administration acknowledged these provisions were not part of the original proposed bill, and although they did not oppose the changes they were not pushing for or advocating any of them. The retroactivity provisions were not included in the original bill, only later added by an interim committee. He voiced that the Administration believed this provision unnecessary but recognized the inevitability of compromise to pass the bill. Mr. Galvin confirmed the Governor's support for the final bill in the belief that it is not appropriate to extract or amend the two pieces that are the primary components for many who supported the bill.

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Co-Chair Stedman requested further explanation on what the standard deductions actually target between operating expenses versus capital expenditures. Mr. Galvin explained that the taxable amount is calculated by taking the gross revenue at the field level then subtracting the operating expenditures and the capital expenditures. The capital expenditures provide a further credit to reduce the tax bill. Mr. Galvin continued that the standard deduction only applies to the operating expenditures, the normal day-to-day operation costs but does not limit the deductibility or the credits available to capital expenditures, such as new investments; therefore it would not cause any disincentive to new investment in further exploration or new development.

[9:22:37 AM](#)

Senator Elton requested more information about the fiscal note and the suggestion that adopting the present bill would be an \$800 million loss to the treasury. He also questioned how the \$800 million figure had been reached. Mr. Galvin indicated that the figure was based on the retroactivity aspect for the amount of tax receipts received during the period from July 1, 2007 to December 20, 2007. He noted that this indicates the different value of the taxes that existed before ACES was passed and what ACES provided. He reported that the figure is not based on any expectations on the standard deduction because, at present, there is no estimate.

[9:24:17 AM](#)

Senator Dyson questioned if the Administration, not proposing the idea of the standard deduction or retroactivity, considered this to be a good bill. Mr. Galvin stated the Administration recognized that the bill addressed some of the concerns raised regarding the ability to get up to speed and manage the auditing. He acknowledged that the Administration accepted that having a frozen number for a limited period of time provided comfort to many. He stressed that the Administration felt very strongly that the sunset provision had to be included because it would provide a different impact on the potential behavior on the type of investment that was desired and a limit on operating expenditures beyond 2010. He noted that the Administration was more concerned about the retroactivity provision, but it was recognized that compromise was necessary to get support for the bill. Mr. Galvin indicated that trying to return months later and extract these provisions would be a difficult undertaking. Senator Dyson questioned why this would be a problem. Mr. Galvin observed that this would not be in keeping with the "good faith" effort that was put in the bill to reach a compromise.

[9:27:08M](#)

Senator Dyson indicated he would like further discussion on the impact the provisions would have on the investment in the challenged or heavier oil. Mr. Galvin observed that the sunset provision was needed, so as not to see any disincentive to the investment in the heavier oils or higher costs oils. The Administration was looking at the "ramp up" time associated with making that type of investment. He remarked that the pursuit of heavy oil will require a lot of up front capital expenditures and higher operating expenditures leading out. The sunset provision on the standard deduction would allow for the "ramp-up", but would not hinder the deduction of those expenditures once they hit the operating side. Mr. Galvin noted that the potential risk on the part of the standard deduction to dampen this kind of investment was mitigated by the sunset provision to a large extent.

[9:29:20 AM](#)

Co-Chair Stedman inquired if the Administration helped in crafting any of the language and, if so, when. Mr. Galvin noted the standard deduction provision came out of the House. He revealed the Administration's ongoing discussions with proponents of a gross based tax, those uncomfortable with the implications of a net based tax, which it was felt would result in risk to the state. He remarked that the efforts to find a mechanism to reduce what was seen as "risks" formed the idea of a standard deduction and a standard expenditure provision. He noted the Administration commented on what they perceived as structural flaws in the proposal. Mr. Galvin reported that the standard deduction was initially introduced in the House Finance Committee; the only time it had a public hearing. He remarked that the Administration did not object to the standard deduction provision, at that time, in recognition that it addressed concerns, and was limited to a single number as opposed to a per barrel number, and included a sunset date. This had been a concern for the implications it would have in terms of motivations on production and the fact that it would sunset. Mr. Galvin noted that the provision failed in the House Finance Committee. He signified the provision did not include a sunset provision when it was passed in the House but the sunset was added back on the Senate Floor.

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Co-Chair Stedman observed that the Administration was active in crafting the language and reviewing the provisions. Mr. Galvin responded that the Administration was active in responding to the people drafting these provisions in attempting to minimize the potential negative impacts. He

expressed the Administration was able to reach a point of agreement.

[9:33:05AM](#)

Senator Thomas appreciated Mr. Galvin's review of the sunset provision. He inquired if a figure existed for the 2006 deductions and questioned if there was a ten per cent flexibly either way. Mr. Galvin explained that the standard deduction is calculated by taking the reported expenditures for 2006 for the two fields, but since there was only a nine month period of time it must be expanded (multiply by 133 percent) to get the number for the entire calendar year. He explained that the number then goes up three per cent for the three years it will be used. He remarked there has been an ongoing difficulty in providing numbers on a "field specific" basis. The public disclosure information provisions pertaining to costs were not retroactive, which made it impossible to show the 2006 amount. Co-Chair Stedman indicated that part of next presentation would address where to sort through these limitations.

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Senator Dyson believed that this has been a challenging process. He noted that the Chairman of the Committee wanted a lower base tax rate and championed the progressivity in which Senator Dyson agreed. Senator Dyson believed that the higher tax rate on the industry, and any negative effects, only happened when times were good and everyone was making money. The end result was a significantly higher progressivity and higher base tax rate than the Administration recommended. Senator Dyson acknowledged the discussion concerning possible negative impacts for the industry's investment and conceded that part of the trade off was to eliminate the floor on the taxes. Senator Dyson believed it would not make any difference in the near future. He questioned if the Department of Revenue and the Administration were comfortable with the combination of a higher base tax rate and a significantly higher progressivity than they originally recommended. Mr. Galvin acknowledged that the Administration and Department of Revenue supported the trade-off. Senator Dyson clarified his question to ask what the higher rate of progressivity did to attract and encourage more production. Mr. Galvin replied that the slope of the progressivity curve provides an incentive for those with a large amount of production in a field with high margins. He remarked that to invest in a field that will have a lower margin, with state participation in capital credits, when the production comes on line, will dilute the margin for their entire production portfolio. He cited that will reduce the progressivity for the production that they currently experiencing during high progressivity. He stressed that a double incentive is

created because it lowers the tax rate on their exiting production as well. Mr. Galvin pointed out that the investment decision also recognizes potential risks, such as; when prices come down will money be made at a stress price. He noted when the rate is driven by the progressivity it allows for that investment to be looked at from the lower prices and have positive economics. At the higher prices, the State of Alaska experiences more, but the economics are still positive due to the high prices.

[9:40:37 AM](#)

DAN DICKINSON, CONSULTANT, TAX DIVISION, DEPARTMENT OF REVENUE presented an overview of the two major issues in the bill, which are the change in the effective date for a number of the financial terms from July to December and the use of the three percent markup when calculating operating costs (SB 242 - Two Production Tax Changes, p. 2, copy on file). He agreed with Commissioner Galvin that questions on the "long term" effects are difficult to answer during the three year program that has been laid out. He explained that the first issue deals with the change in the effective date moving the major revenue sections, retroactively, from July 1, 2007 to the original effective date of the bill, December 20, 2007. He noted a number of clauses going back to April 1, 2007 and items requiring advance approval from the Department of Natural Resources were not changed. Mr. Galvin acknowledged that the Department of Revenue will be required to write regulations to define how producers will fill out their tax forms when there are two tax regimes. This bill will not change that but instead of being a fifty/fifty mix, there will be three hundred fifty three days under one regime and eleven days under the other (SB 242 - Change Effective Date, p. 3, copy on file).

[9:44:28 AM](#)

Mr. Dickinson commented on the effects resulting from the changes. He asserted that \$1.6 million more would be raised with the passage of the bill and an additional \$160 million would be collected by the change at the rate of 22.5 percent to 25 percent. He commented the major effect, involving more than half the dollars, is the result of the progressivity. Mr. Dickinson noted the change in credits would be determined on how the Department of Revenue writes the regulations (SB 242 Change Effective Date, p. 4, copy on file). Co-Chair Stedman requested a reminder on the volume and price used in this analysis. Mr. Dickinson reported that the fiscal note was based on \$71.65 per barrel and the volume of 730,000 barrels per day. He reminded the Committee that oil production does not follow a steady curve throughout the year. He pointed out the large drop (indicated on the slide) in ACES from 2008 to 2009 resulted from the Governor's proposal of not containing the

retroactivity that was later added by the Legislature (SB 242 Change Effective Date, p. 5, copy on file). Co-Chair Stedman remarked that the 2009 number used is \$64.55 per barrel, but some analyses have used a \$90 per barrel figure. He wondered if oil prices maintained a higher level, such as \$70 to \$80 per barrel, what the relationship would be between the Governor's bill and the final bill.

[9:49:03 AM](#)

Mr. Dickinson remarked that in breaking down prices, remaining constant at \$90 per barrel for FY 08 and FY 09, the major difference would be the change in the effective date. Co-Chair Stedman questioned if there would be a substantial increase in FY 09 numbers due to progressivity, the change in the base rate from twenty two percent to twenty five percent, and the credits moved fifty percent forward. He wondered if it would be possible to calculate the rate from the projected \$64.55 a barrel to \$70, \$80, and \$90 a barrel. Mr. Dickinson speculated that at \$94.55, a \$30 increment, then under the progressivity of .04 percent for every dollar, another 7.5 percent is added to the tax rate. This figure would be closer to a forty five percent tax rate. Co-Chair Stedman requested further calculations for FY 09 based on the figures of \$70, \$80, and \$90 per barrel. Mr. Dickinson replied that for FY 09, based on \$80 per barrel, the increase is approximately \$500 million. He will further research the statistics for the other requested per barrel figures.

[9:52:28 AM](#)

Senator Thomas inquired if the \$1.6 billion was the old or updated estimate. Mr. Dickinson replied that the figure was from the fiscal note. He continued commenting on the second issue dealing with the Kuparuk and Prudhoe Bay units that represent about seventy five percent of the volume being produced. The new rules used the FY 06 figures as a base then applied a three percent operating expense "mark up" for the calendar years of 2007, 2008, and 2009. Additional costs will be disallowed if the oil company's operating expenses are higher than the three per cent figures. He noted that lower operating costs would benefit from a higher deduction. The net tax began on April 1, 2006; therefore the base is determined by nine months of costs for the calendar year 2006. Mr. Dickinson observed in 2007, the base will be one hundred thirty seven percent of the 2006 amount. For the calendar year of 2008 and 2009, the allowance will be one hundred three percent of the prior year (SB 242 Kuparuk & Prudhoe Units Opex, p. 6, copy on file).

[9:55:10 AM](#)

Mr. Dickinson elaborated that "costs" is determined by dividing the fixed costs by the variable costs (Opex fixed or variable cost?, p. 7, copy on file). This distinction is important in determining how the three percent increase functions. He illustrated if the operating costs are fixed, then there is a one hundred three percent increase. If the operating costs are variable, then it would be a one hundred ten percent increase. He continued that if the 2006 costs were \$2 billion, then the three percent increase would raise the allowance to \$60 million in 2007, the 2008 figures would increase to \$121.8 million and 2009 to \$185.5 million.

[9:57:31 AM](#)

Mr. Dickinson observed that older fields are declining at roughly six percent a year, so the new law would factor in the decline rate to provide a new rate of one hundred ten percent (Opex variable cost with declining volumes, p. 8, copy on file). He maintained that the Department of Revenue is showing a smaller decline which would effectively change the unit costs per year from one hundred ten percent in 2007 to one hundred three percent in 2008 and to one hundred five percent in 2009 (Opex variable cost with declining volumes, p. 9-10, copy on file).

[9:59:14 AM](#)

Mr. Dickinson speculated on increasing volumes that may occur during facility sharing. He proposed that new producers would send oil for processing to existing production facilities, causing an increased flow beyond the facilities own field production. The variable and fixed costs, without cap, will end up costing the new producer more money (Variable costs without cap, p. 11 and Fixed costs with cap, p. 12, copy on file). He concluded that the state will receive more money and existing facilities will be held harmless but the new producer will not see any benefit which causes them concern.

[10:04:10 AM](#)

Senator Elton questioned the presumption that the \$10,000 reimbursement received by the facility operator really means anything. He inquired how the \$17,000 figure was obtained. He pointed out that this being a negotiable figure, the facility operator could still make a profit using an even lower figure. Mr. Dickinson agreed with Senator Elton that this is a capital charge, negotiated by the facility. The fixed cost is negotiable but the variable costs are not. He remarked that in the short term, it is possible to move with the incremental costs but if fixed or capital costs are never recognized then it will be harder to convince the facility to make additional investments. He elaborated that the problem concerns letting the owner of the facility make

a "fair" return for their original investment; the "fair" amount is the negotiated money with the new producer. He observed the facility owners may chose not to provide the use of their facility to new producers plus complications occur when older wells produce smaller amounts of oil than the newer wells.

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Mr. Dickinson pointed out that the new producer would provide money to the older facility as a reward for backing out the production of their less efficient wells. He reported the bottom line for the old producer would be to raise the price to about \$1.70 for every \$1 the facility owner receives. The net effect is that operating expenditure costs are variable and, when the cap is put on, variable costs are treated like fixed costs. He reported if the facility incurs new costs processing to the new producer, it can not be deducted. He observed that negotiations between the new producers and the older producing facilities can become burdensome as the operating expense limit will result in higher prices for the new producer.

[10:10:05 AM](#)

Senator Elton suggested it would be helpful to have the Department of Revenue provide information on the new expected production prior to the sunset date. Senator Dyson commented that much of the pressure concerning the gross tax or standard deduction was trying to limit the gaming of the system. He believed that the standard deduction with a limited life would entice the major facilities to produce the wells with the higher gross operating revenue and the least maintenance costs for this period to the sunset. He observed many opportunities available to "game" or "tilt" the system in their favor. Mr. Dickinson agreed that with a set of rules in place, it would be the goal of the oil company's tax departments to minimize their tax and reward the shareholders. He observed this can create new and specific opportunities in the next three years.

[10:12:14 AM](#)

Senator Dyson observed that it was in everyone's interest to have new producers and explorers gain access to spare capacity. He remarked that the owner of the facilities could hold any new production hostage with the negotiated rate. He questioned if information exists regarding other world-wide oil fields being able to serve both the public interest and the small producers without causing a disproportionate disadvantage to existing facility owners who invested all the money. Mr. Dickinson agreed but observed that existing facilities are also trying to maximize their income. If the facility makes more money processing someone else's oil,

they will do that to try and receive the maximum returns on their investments. Mr. Dickinson remarked that the Alaska is unique or "disadvantaged" in that costs are not fixed or variable but "lumpy." Flexibility is not always available on the North Slope to maximize or move around equipment or a station. Mr. Dickinson indicated that if the amount of production falls off more dramatically then the facility's ability to handle it, the result is excess capacity.

[10:16:21 AM](#)

Senator Dyson responded that there could possibly be a longer term strategy on the part of the facility owners to "starve" the smaller companies. He noted the new companies may not have the cash resources to hang on for ten years or obtain cash resources to build alternative ways. Senator Dyson believed that the older facility could prevent these new producers from selling their oil forcing the company into an uncomfortable financial situation or forcing bankruptcy. At this point, the facility would be in a position to pick up these leases at bargain rates. Mr. Dickinson agreed it was a valid argument but most of the new companies arriving in the North Slope were bettered capitalized and it really benefited no one if they failed.

[10:17:50 AM](#)

Mr. Dickinson presented an analysis of the two approaches of looking at the numbers. He compared the actual 2007 costs with the derived 2007 allowance and projected the effect at the end of the cap with comparison between 2009 and 2010 (SB 242 Kuparuk & Prudhoe Units Opex, p. 15, copy on file). He cautioned the Committee to remember that the numbers are averages and aggregates and therefore missing individual items. He explained that the whole point of having a net tax is that individual things make a difference; there is a distinction between more and less expensive items. Mr. Dickinson pointed out that on January 31, 2008, returns were required to be filed for December 2007 which now gives twelve monthly returns to discern the amount of operating expenses filed. This number can be compared to the number generated with the one hundred thirty seven percent number claimed for 2006. He remarked that the monthly filings by taxpayers are not always consistent on how much or what information is reported, so the information may not be readily accessible. Mr. Dickinson elaborated that if just one company in each of the two units clearly defined their costs and it is assumed these were the only costs allowed by the unit, then a fair number could be derived. He cited that the Department of Revenue believes this data remains confidential. The Committee, in order to compare the actual higher or lower costs, would need to go into an executive session to look at the documents (SB 242 Kuparup & Prudhoe Unites Opex, "One third done", p. 17-18, copy on file). Co-

Chair Stedman commented that an executive session was being discussed with the Commissioner.

[10:20:59 AM](#)

Mr. Dickson remarked that based on first half of the year the "as-filed" actual operating expenses, before the law passed, came within three per cent of what was allowed as the cap. If the three per cent works for the entire year, then this looks at roughly \$2 billion in costs (plus or minus \$60 million) which results, at a twenty five per cent tax rate, to \$15 million in taxes. Senator Elton questioned the accuracy of these figures. He wondered if the \$15 million is what has been filed or what will be paid in the future. Mr. Dickinson agreed that there is some ambiguity and that no one knows what to file. He remarked for the costs not covered in the three percent rule, the Department of Revenue has to write the rules and regulations and until they are written no one know what to file. Co-Chair Stedman inquired if this was the lease expenditure amendment.

[10:23:43 AM](#)

Mr. Dickinson observed that a second way to get to the number is to project what will happen in 2010. He referred to the graph showing the operating costs claimed. The upper line represents Kuparuk and Prudhoe Bay and the bottom line represents everything else (What would we expect between 2009 and 2010 for allowable opex?, p. 20, copy on file). He explained that the Department of Revenue forecasts show that in 2009 the numbers will be depressed but in 2010 they should rise again. He pointed out that further projections were available to read (What would we expect between 2009 and 2010 for allowable opex?, p. 21-25, copy on file). Mr. Dickinson concluded that in the final analysis, the Department of Revenue does not see a significant difference between the three percent cap and the company filing "actuals."

[10:26:12 AM](#)

Co-Chair Stedman felt it was important for the Senate Finance Committee to reflect on many of the earlier discussions, look at expectations on where operating expenses are going, the rate change, and finally, what is driving them. He recognized that the Committee must work with the Department of Revenue on these issues to get the best estimates available. He suggested that it will be necessary to explore what new fields are emerging with capital costs shifting over to operating costs.

[10:28:54 AM](#)

Mr. Dickinson referred to slide twenty-four pointing out that the first column refers to the North Slope operating expenses as estimated by the Department of Revenue for FY 2007 through FY 2011 (What would we expect between 2009 and 2010 for allowable opex?, p. 24, copy on file). The second column relates the three percent rule as applied to the North Slope through 2011 and the third column gives the implied increase operating expense in areas outside of Kuparuk and Prudhoe. Mr. Dickinson remarked that it is hard to tie the numbers together in a consistent fashion.

[10:30:54 AM](#)

SB 242 was HEARD and HELD in Committee for further consideration.

ADJOURNMENT

The meeting was adjourned at 10:33 AM