

SENATE FINANCE COMMITTEE
February 4, 2008
9:10 a.m.

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at [9:10:14 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

Fred Triem, Petersburg; Kevin Mitchell, Vice President, Finance and Administration, ConocoPhillips, Alaska; Marilyn Crockett, Executive Director, Alaska Oil and Gas Association (AOGA)

PRESENT VIA TELECONFERENCE

None

SUMMARY

SJR 14 Proposing an amendment to the Constitution of the State of Alaska relating to appropriations from the budget reserve fund.

CSSJR 14 (FIN) was reported out of Committee with a "no recommendation" and with a new fiscal note by the Office of the Governor.

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.

[9:11:44 AM](#)

SENATE JOINT RESOLUTION NO. 14

Proposing an amendment to the Constitution of the State of Alaska relating to appropriations from the budget reserve fund.

No one from the public was present to testify on SJR 14.

SJR 14 was set aside for the moment.

[9:12:30 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."

Senator Elton MOVED to ADOPT Amendment 1, labeled 25-LS1350\A.1, Bullock, 1/29/08.

Co-Chair Stedman OBJECTED for discussion purposes.

Co-Chair Stedman reported that the amendment was a technical change. After HB 2001 was enrolled, some sections were renumbered; SB 242 conforms to those changes.

There being NO OBJECTION, Amendment 1 was adopted.

[9:14:39 AM](#)

FRED TRIEM, PETERSBURG, testified against the retroactive component of the bill. He related that his opposition is based on historical reasons. He shared a story about taxation during the early colonial days when the Crown imposed unfair and vexatious taxes. When the Declaration of Independence was written in 1787, a clause was included regarding enacting retroactive laws. He suggested having a prospective tax at a higher tax rate. He concluded that the Alaska legislature should not enact retroactive laws.

[9:23:35 AM](#)

Senator Thomas asked Mr. Triem if he would feel the same about a rebate. Mr. Triem thought that would not be a retroactive tax. He described his opposition to retroactive taxation. Senator Thomas pointed out that the bill was a compilation of many opinions and was in response to a tax

rate that some felt was not right. He thanked the testifier for his comments.

[9:25:11 AM](#)

Senator Huggins thought that many Alaskans felt the same as Mr. Triem. He reminded the committee that HB 2001 had an effective date of January 1, 2008.

[9:26:54 AM](#)

KEVIN MITCHELL, CONOCOPHILLIPS, VICE PRESIDENT, FINANCE AND ADMINISTRATION, ALASKA, pointed out that there are two components to the bill, the removal of the standard operating cost deduction at Prudhoe Bay and Kuparuk, and the removal of the retroactive implementation of the bill.

Mr. Mitchell addressed retroactivity first. He said that the decision to retroactively apply tax increases is a policy call of the legislature. It is a question of fairness to those taxpayers. Retroactive tax increases send a very clear message to investors. It's a message that the Alaskan fiscal environment is an uncertain one. He maintained that investment decisions need to be taken with care. Retroactive tax increases are bad tax policy. The response by investors is to take a cautious approach, especially with regard to longer-term investments. Long-term investments face more fiscal uncertainty by their nature. A track record of retroactive tax increases adds further to that uncertainty. He gave an example of property taxes made retroactive, as a bad idea. He testified in support of SB 242 because it corrects a wrong.

Mr. Mitchell addressed standard deduction for operating costs at Kuparuk and Prudhoe Bay. The standard deduction is a tax targeted on Prudhoe and Kuparuk, which is unfair and creates uncertainty for investors who cannot assume that all investments and all taxpayers will be treated alike. He opined that the current tax policy is not fair to those old fields with increasing need for maintenance activity. He maintained that the tax law encourages producers to reduce costs since actual costs are increasing at a rate greater than the 3 percent escalation allowed for in the current production tax law. The increases are a function of higher activity levels and industry cost escalation. He spoke of great opportunities for investment and development at Prudhoe and Kuparuk. The standard deduction does not encourage that investment, as incremental operating costs are not deductible. He remarked that in light of the legislature's propensity to increase taxes, the sunset provision of 2010 does not provide much comfort.

Mr. Mitchell spoke about unintended consequences of the standard deduction. Almost 70 percent of operating costs

are manpower related. With the tax law that is in place today, the industry is incentivized to reduce those costs at Prudhoe and Kuparuk more so than ever before. Standard deduction is also having unintended consequences on facility sharing agreements. The cost to new producers for access to Kuparuk and Prudhoe facilities increases significantly because of the tax effect. Incremental costs associated with processing and handling new production is no longer deductible. The revenue received for facility sharing is taxable. That increases the taxable margin per barrel which increases the tax rate that's applied to all production for those facility owners. That additional cost is passed on to the new producer seeking access to those facilities.

Mr. Mitchell concluded that ConocoPhillips supports the removal of the standard operating cost deduction from the production tax law.

[9:33:08 AM](#)

Co-Chair Stedman asked about the 3 percent deduction modeling presented by Mr. Dickinson previously. Mr. Mitchell responded that he had not looked at that in detail. He reported that from 2005 - 2006, ConocoPhillips' operating costs increased by around 45 percent. From 2006 - 2007 it was not a similar high level of increase, yet still higher than at a 3 percent rate. Without the regulations in place, it is difficult to know the base line at this time.

Co-Chair Stedman requested more information about the "activity level". Mr. Mitchell responded that those are maintenance and repair activity - continuing costs on old fields. A lot of the work is not discretionary and must be done for safety's sake.

[9:35:24 AM](#)

Co-Chair Stedman asked for comment on the marginal tax rate at \$90 per barrel and who benefits from it. Mr. Mitchell replied that the marginal rates differ depending on whether one is talking about an increase in price or volume, or a change in costs. In general, at current price levels the marginal government take is around 80-85 percent. Some of that is driven by the effect of progressivity. The marginal take for an additional dollar per barrel of revenue ends up being somewhere in excess of 80 percent.

[9:37:33 AM](#)

Co-Chair Stedman suggested framing that answer in layman terms. He gave an example of revenue generated from additional production using 80 percent for marginal government take; the industry would get 20 cents, the federal government and the state would get 80 cents - the

federal portion of that would be roughly a marginal corporate tax rate of 34 percent, so that the state number would be in the high 40's. He concluded that for each marginal barrel not produced, the state treasury is the biggest loser as far as net incremental dollars. Mr. Mitchell agreed, but thought the state share would be even larger because the production tax is deductible against federal tax. That would reduce the federal piece at the expense of the state. Co-Chair Stedman emphasized that it is in the state's best interest to target marginal production.

[9:39:28 AM](#)

Co-Chair Stedman noted concern with the standard deduction because it does not encourage marginal production. He reported hearing conflicting information about how the 3 percent cap on operating expenditures affects Prudhoe Bay and Kuparuk, especially regarding new entrants or independents.

Co-Chair Stedman asked about the 3-year time horizon. He thought it could as easily be extended as terminated. He asked Mr. Mitchell to ask ConocoPhillips' economist about cost escalation in operating and capital expense around the world. In retrospect, both the Administration and the legislature should have paid more attention. He also requested current thoughts on operating and capital cost appreciation globally, and for price appreciation information for 2007 and 2008.

[9:43:01 AM](#)

Senator Thomas pointed out that Mr. Mitchell drew attention to the relationship between operating cost and capital expenditure, because the more capital one invests, the more facilities are being built or expanded. The increased operating expense tax would have a detrimental affect on expansion and exploration. Mr. Mitchell agreed that additional capital investments usually bring additional capital costs. Senator Thomas asked if oil industry taxes around the world are decreasing. Mr. Mitchell replied that taxes are going up. Senator Thomas asked if profits are going up. Mr. Mitchell replied that income reported by ConocoPhillips in Alaska in 2007 was lower than in 2006, despite a higher price environment. Profits decreased primarily due to taxes.

[9:44:59 AM](#)

Senator Huggins addressed unintended consequences of the standard deduction, which were not known at the time that AGIA passed. He requested information about solutions for unintended consequences. Mr. Mitchell replied that there

have not been any conversations on that subject between the Administration and the producers. Senator Huggins emphasized that the legislature needs to push for a resolution to the problem.

[9:47:17 AM](#)

Senator Dyson requested that the Administration participate in the conversation about unintended consequences.

Co-Chair Stedman agreed. He stressed that the marginal tax issue also needed to be addressed. Senator Dyson also wanted input from the Administration about the zero fiscal note, which he thought did not make sense. He thought the fiscal note should reflect the consequences if the bill passes. He recalled reluctance to reopen the discussion on HB 2001.

Co-Chair Stedman reported that the fiscal note from the Department of Revenue was for about \$800 million, not zero. He agreed to find out more about the impact to the treasury.

[9:50:26 AM](#)

Senator Thomas asked if the standard deduction was an onerous provision to the industry. Mr. Mitchell talked about how the tax bill was based on a net tax structure and not a gross tax structure. The standard deduction removes some aspects of the true net tax and it becomes more like a modified gross tax.

Co-Chair Stedman reported that it costs about \$25 per barrel to get the oil out of the ground and shipped out. With market value at \$75, there is a \$50 profit. The marginal tax would be around 80 percent. He countered that it shifts more toward gross, rather than pushing the marginal tax rate up. Mr. Mitchell agreed. He explained that the standard deduction, to the extent that actual costs are higher than the cap on operating costs, becomes another tax increase over and above the increase in progressivity and other factors.

[9:53:38 AM](#)

MARILYN CROCKETT, EXECUTIVE DIRECTOR, ALASKA OIL AND GAS ASSOCIATION (AOGA), read from a written statement:

AOGA is a trade association for the oil and gas industry in Alaska. Our 16 members account for the majority of oil and gas exploration, development, production, transportation, refining and marketing activities in the state. My testimony today reflects the full consensus of the members of AOGA, with no dissent.

It is no secret that AOGA opposed the provisions addressed in this bill during the 2007 Special Legislative Session. And it should come as no surprise, of course, that we do support the repeal of these provisions now. In fact, just in the first three months since the passage of ACES, we have already seen some companies announce reductions in their investment plans. Unfortunately, this is a trend we expect will continue.

In considering the merits of SB 242, it's important to take into account how it will impact the real-world situation that Alaska faces. The greatest challenge that confronts this generation of Alaskans and the next is the ongoing decline of oil production, which has been, is today, and promises to remain the cornerstone of the finances of state government.

Production decline is eroding this cornerstone. Even with the massive investments made in the past, North Slope production declined an average of 6.2% a year from FY 1997 to FY 2007, and Cook Inlet oil production declined at 8.0% a year. Without those investments, decline would have been approximately 15%.

There are three categories of investment that can slow the rate of decline on the North Slope, or at least keep it from getting any worse. These are, first, investment in exploration to discover new fields; second, investment in existing fields to prevent their decline from accelerating; and third, investment in innovation, technology, and new infrastructure to allow development of the vast but challenging resource of heavy and viscous oil that has already been discovered.

To be sure, exploration plays an important role in Alaska production. But even when exploration succeeds in discovering a commercially viable field, it will take years from the time of its discovery until the time production from it begins. But the challenge of declining production confronts Alaska today – not eight, ten or a dozen years from now. By its nature, investing in exploration can make a significant contribution toward solving the challenge of declining production in the longer term, but not the shorter term when results are urgently needed.

Investment in heavy and viscous oil development is also a solution in the mid to long term. The first well ever drilled to test production from the Ugnu Formation was only drilled in 2007 in the Milne Point Unit, and it is still being tested and evaluated to gain a better

understanding of the physical characteristics of the Ugnu oil. There are plans to use the results of these tests and evaluations to plan and develop a pilot project for producing Ugnu oil. Until then, West Sak will continue to be the only commercial heavy/viscous opportunity.

This gets us to investment in currently producing fields. Fortunately, there are investments that can be made, and are being made, in these fields to slow their decline. In the short term, this is in-fill drilling – that is, drilling new wells into the portions of a reservoir that are between the wells that have already been drilled. This accelerates the drainage of oil from the rock that currently lies in between existing wells. In-fill drilling last year contributed some 70,000 barrels a day to production from the Prudhoe Bay field. To put this into perspective, a 70,000 barrel per day field would be the 4th largest stand-alone field on the North Slope today.

There are also major investments being made, and yet to be made, in “renewal” of the surface facilities for existing fields. For instance, the gathering centers and flow stations for the Prudhoe Bay field have been in service for over 30 years now. If Prudhoe Bay and the other producing fields are to continue producing in the decades to come, their original production facilities will need to be overhauled or replaced. Also, as increasing amounts of heavy and viscous oil come into production, even relatively new facilities that were designed for comparatively light “conventional” oil will probably need to be modified, refitted or replaced in order to minimize operating problems in handling that heavy/viscous oil. Regardless of the stimulus or purpose for making them, renewal investments in production infrastructure present a very similar cash-flow pattern as there is for investments in the original infrastructure to develop a field. And consequently, tax policy affecting the initial development infrastructure equally affects renewal as well. Let’s first examine repeal of the standard deduction, embodied in AS 43.55.165(k) and (l).

According to the Department of Revenue’s Fall 2007 Revenue Forecast, 64-68% of future production will come from the Prudhoe Bay and Kuparuk fields and their satellites – the very fields which are subject to the standard deduction limitation. This production is absolutely critical to the state and, if anything, we should be doing all we can to ensure aggressive efforts are undertaken to stem the decline from these fields. Unfortunately, limiting the deductibility of expenses

incurred to carry out these functions does nothing to encourage this needed investment.

DOR is reportedly forecasting a relatively small gap between 2006 costs and costs for future years. We maintain that the recent acceleration in the cost of doing business in the oil patch doesn't support the notion that costs will increase only modestly in the near-term. Indeed, worldwide, industry analysts continue to project steadily increasing costs. Further, just last week, one north slope operator projected the cost of operations in the Prudhoe Bay and Kuparuk fields at \$450 million dollars over the amount for the standard deduction.

Some have argued that since the standard deduction applies only to operating expenses, capital expenditures are not affected. The reality is that the fiscal impact of anticipated operating costs is a critical component of decision-making when it comes to capital expenditures. As individuals we consider this anytime we make a purchase—whether it be a vehicle or an appliance. As legislators consider capital budgets, a keen eye is focused on what the operational impact of that capital expenditure will be.

So long as the standard deduction is in place, decisions on capital expenditures in these fields will be impacted. Further, given the hundreds of millions of dollars at stake, little comfort can be taken in the 2009 review of this provision. Prudent decision-making today must be conservative and cannot be based on the "chance" that the standard deduction will be eliminated during the 2009 review.

Turning now to retroactivity, let's look at the history of implementation of retroactive taxing provisions. When enacting the original Petroleum Production Tax (PPT) the Legislature increased the tax by over \$800 million during the last nine months of 2006 alone by applying it retroactively back to April first of that year. Then, during the last Special Legislative Session this past fall, again, the Legislature made the additional tax changes retroactive.

In two short years, the industry has been subjected not only to significant changes in its tax structure, but changes which have been applied retroactively. We are not aware of any other oil producing region which has retroactively applied changes to its tax regime.

Not only is this bad tax policy, it sends a dire warning to current and new investors, who have no assurances that the government tax regime in place as they make investment decisions will remain in place

and, if changes are pursued, that those changes won't be made retroactive after they've made important investment decisions.

In addition to the impact on investment decisions, there are very real, practical impacts dealing with retroactivity with which the State and industry are currently grappling.

Under the current ACES law, retroactive calculations of tax are required and it is not clear how many aspects of the calculation should be applied. Specifically, the tax is a yearly tax and as such the statutory rate change from 22.5% to 25% creates complexity and uncertainty about how this should be calculated. We have asked, but not yet received clarification about what the tax rate is for 2007. The mechanics of the calculation simply do not allow you to apply one percentage the first half of the year and another percentage for the second half of the year since the tax is calculated for the full year against 100% of a producer's production, sales, and expenditures.

Additionally, the new law only allows 50% of the 20% capital credit to be used in the first year. So, in 2007 this applies to only half the year. The retroactivity requirement makes it difficult to apply this provision of the law. During the first half of the year you should be able to receive and use 100% of the credits earned. But the question then becomes how to calculate how much can be used during the second half of the year, since this is a yearly tax and credits are earned for the year.

These issues have come up repeatedly during the workshops being held by the Department of Revenue over the past two months on development of its implementing regulations but the Department has not identified a solution to clarify a way forward and comply with the law as enacted.

In conclusion, SB 242 provides an opportunity to ensure that the majority of new production needed to stem the decline of Alaska production in the short-term comes to fruition. We encourage the Committee to move this legislation. Thank you.

[10:04:15 AM](#)

Co-Chair Stedman requested information concerning the cost of \$400 million that was presented in Anchorage.

Senator Thomas wondered how it is known whether a reduction in investment is due to the tax change or if it is due to a new "find" somewhere else in the world. He questioned if

the reduction in investment is verifiable. Ms. Crockett thought that some of it was verifiable. She gave an example of a project that would not work due to the tax change, and others where it would not be known.

Senator Thomas agreed that it is difficult to verify such projects. Ms. Crockett responded that expenditures in older fields are known.

[10:09:34 AM](#)

Senator Elton thought that even if some decisions had been made to not invest, those decisions could be business decisions. He summarized that there is an \$800 million impact on the retroactivity and a \$450 million difference between the standard deduction and what actually occurs, for a net effect of \$1.2 billion. One of the ways to encourage passage of this bill would be to cancel investment in order to save \$1.2 billion. Ms. Crockett talked about how investment decisions are made. She reiterated that the 3 percent and the retroactivity provisions are the factors which would drive the investment decisions.

Co-Chair Stedman reported that the state forecast for FY 08 is for 730,000 barrels of oil a day, at \$72.60 per barrel, which equals \$19.4 billion in gross revenue. If oil was at \$90 per barrel, there would be \$24 billion in gross revenue. It costs \$25 to get oil out of the ground and to market. He summarized that some concerns such as termination of projects and postponement of projects would be addressed at future meetings. He reported that he had trouble connecting the "no impact on capital costs of the 3 percent operating cap" and the goal to slow the decline of oil production. He hoped to get clarification through these discussions.

[10:14:34 AM](#)

Senator Huggins requested more information about unintended consequences for small explorers and developers. Ms. Crockett spoke about the facility access issue. She sensed that the Administration has been talking to the producers and to the smaller independent companies to see if there is a way to address this without having to legislate it. She thought that no one intended that an independent company bringing a new field on line was going to have to pay an extreme premium in order to access the facilities. She did not believe there was an attempt to limit the deductibility of the companies that own the facilities.

[10:16:52 AM](#)

Senator Huggins spoke of the rationale behind the bill. He maintained that it was not about money, but rather about poor techniques used to set public policy. He recalled the

special session debates about removing the "taint of PPT", which he supported. He noted the lack of debate about standard deduction. He maintained that the public process was circumnavigated. The Administration did not oppose the issue, though they did not claim to know the consequences of standard deductions. The sunset provision anchored some votes. Senator Huggins maintained that this bill is about "doing the right thing" on behalf of Alaskans. He showed a photo depicting the Cadet Honor Code at West Point. He concluded that the honor code should be followed as it applies to this situation.

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

AT-EASE: [10:23:06 AM](#)

RESUME: [10:23:38 AM](#)

SENATE JOINT RESOLUTION NO. 14

Proposing an amendment to the Constitution of the State of Alaska relating to appropriations from the budget reserve fund.

Co-Chair Stedman noted the intention to move SJR 14 forward.

[10:24:46 AM](#)

Senator Olson MOVED to REPORT SJR 14 out of Committee, as amended, with individual recommendations and the attached fiscal note.

CSSJR 14 (FIN) was reported out of Committee with a "no recommendation" and a new fiscal note by the Office of the Governor.

ADJOURNMENT

The meeting was adjourned at 10:25 AM.