ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE
February 21, 2007
3:37 p.m.

MEMBERS PRESENT

Senator Charlie Huggins, Chair
Senator Bert Stedman, Vice Chair
Senator Lyda Green
Senator Lesil McGuire
Senator Bill Wielechowski
Senator Thomas Wagoner

MEMBERS ABSENT

Senator Gary Stevens

COMMITTEE CALENDAR

SENATE BILL NO. 80
"An Act relating to allowable lease expenditures for the purpose of determining the production tax value of oil and gas for the purposes of the oil and gas production tax; and providing for an effective date."
HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 80
SHORT TITLE: OIL & GAS PRODUCTION TAX: EXPENDITURES
SPONSOR(s): SENATOR(s) WAGONER

02/09/07	(S)	READ THE FIRST TIME - REFERRALS
02/09/07	(S)	RES, FIN

WITNESS REGISTER

MARY JACKSON
Staff to Senator Wagoner
Alaska State Capitol
Juneau, AK 99801-1182
POSITION STATEMENT: Explained CS SB 80(RES), version M.

DON BULLOCK, Attorney
Legislative Legal and Research Services Division
Legislative Affairs Agency

Alaska State Capitol
Juneau, AK 99801-1182
POSITION STATEMENT: Drafted SB 80.

JUDY BRADY, Executive Director
Alaska Oil and Gas Association (AOGA)
121 W. Fireweed, Ste 207
Anchorage, AK 99503
POSITION STATEMENT: Commented on SB 80.

JOHN NORMAN, Chair
Alaska Oil and Gas Conservation Commission (AOGCC)
Department of Administration
333 W 7th Ave. Ste. 100
Anchorage AK 99501-3539
POSITION STATEMENT: Commented on SB 80.

ACTION NARRATIVE

CHAIR CHARLIE HUGGINS called the Senate Resources Standing Committee meeting to order at 3:37:44 PM. Present at the call to order were Senators Green, McGuire, Wagoner, Wielechowski, Stedman and Chair Huggins.

SB 80-OIL & GAS PRODUCTION TAX: EXPENDITURES

3:38:29 PM
CHAIR HUGGINS announced SB 80 to be up for consideration.

SENATOR WAGONER moved to adopt CSSB 80(RES), version M, dated 2/21/07 as the working document. He objected for purposes of discussion.

MARY JACKSON, staff to Senator Wagoner, came forward to explain the CS. She said it amends the PPT legislation that was passed last August and it does that by not allowing for costs of repair or replacement of improperly maintained or not maintained facilities. She stated:

> Senator Wagoner believes that the citizens of the state of Alaska should not be responsible for costs that are associated with bad maintenance and 16 other members in the Senate agree with him and thank you for that.

For the record, she said, that neither Senator Wagoner nor Representative Curt Olson, sponsor of the same legislation in

the other body, ever intended or do intend to have this turn into a vehicle for a gross tax. Current statutes set out some costs that are already not allowed as lease expenditures and this bill inserts a new provision on page 3, line 19. The Department of Natural Resources (DNR), Department of Environmental Conservation (DEC), Department of Revenue (DOR) and AOGCC all worked on the language.

3:41:00 PM
She went through the changes for committee. The first change adds the DNR commissioner on page 3, line 21, because that department handles the leases and has a great deal of expertise in this area. It just made good sense to include them as part of the consulting group. The term “the chair of” was deleted in front of the “AOGCC” and the reason for that was so that any member of the AOGCC could be included as part of the consulting group.

The term “relying on” was deleted and replaced with “taking into consideration”. It was thought by members of the departments that this language was a little more general in nature and easier for them to work with.

Clarifying language was added in (A), (B) and (C) on page 3 so it didn’t just say “improper maintenance”; it says “improper or no maintenance”.

3:43:00 PM
CHAIR HUGGINS asked who they envision being the commissioner on page 3, line 20.

MS. JACKSON answered the commissioner of DOR.

SENATOR WAGONER added the reason it says just commissioner is that it is a tax bill and, therefore, in his purview.

CHAIR HUGGINS asked her where it says “no maintenance” in the bill.

MS. JACKSON replied that clarifying language is on page 3, line 24 and 25 and says “(A)related to the repair and replacement of property or equipment that was not maintained or was improperly maintained;”.

SENATOR STEDMAN said the deductions are listed starting on page 2, line 1. He asked how “wilful misconduct, or gross negligence” interplayed with the proposed new language on page 3, line 24,

that talks about items that were “not maintained” or “improperly maintained” that sounded like they were related to negligence.

SENATOR WAGONER answered that basically wilful misconduct and gross negligence require a higher level of proof on those items than the ones in the amendment.

CHAIR HUGGINS pointed out that the amendment language was in addition to and not replacing wilful misconduct language.

SENATOR STEDMAN asked where the line is drawn on the cost for repairs and if all items would be audited or just large items that come to particular peoples’ attention.

DON BULLOCK, Attorney, Legislative Legal and Research Services, answered that everything on the PPT return would be subject to audit by the Department of Revenue. “Obviously, it would make good management sense to put their efforts where they’ll most likely find errors or parts of the return that need to be corrected.”

He thought the departments would set internal standards by regulation, because this language takes into consideration the standard practices of the industry and recognizes that there are things one would normally do in maintaining a field to avoid repairs.

> So, the job that the commissioner will have is to determine what those standards are and then to look at what was actually reported on the return and determine the significant variance if any from the standard that the commissioner has decided should be applied.

3:48:00 PM
SENATOR STEDMAN asked if the state has any idea what it is facing in terms of pipelines and facilities not being maintained or improperly maintained.

MR. BULLOCK replied that the scope won’t be known until the commissioner establishes what the standards are and then makes the decision as to how far away from those standards one can go.

SENATOR WIELECHOWSKI asked what the mechanism is for resolving a dispute regarding a decision that is made by the commissioner in regards to language on page 3, line 19.

MR. BULLOCK replied that he was a hearing officer in the Department of Revenue for 13 years and the formal appeal function is now to an independent body. Generally, he expected the first filing under the PPT to happen on April 1. Statutory authority exists for someone to amend a tax return within three years of the date it was filed. The DOR also has a period of three years in which it can audit the return. It would then issue a notice to the taxpayer of the adjustment it found. If the taxpayer disagrees with that amount, he would file an appeal generally initially at an informal level where he would get together with the people who did the audit. This would be the first chance to explain why the taxpayer thinks he is entitled to the deductions he took. They might continue to consult afterwards with other commissioners and the AOGCC as to what standard should be applied.

He said the next formal level of appeal could involve such things as expert witnesses that would speak to the issue of what standard practices would be and if what was done was reasonable and if the deduction should be allowed. After that the issue would go to Superior Court and on up the ladder.

SENATOR WIELECHOWSKI asked if it would go to the Alaska Supreme Court.

MR. BULLOCK replied yes, unless there is a federal issue involved.

SENATOR WIELECHOWSKI asked if the state could have a situation where a report is filed April 1 and then gets amended three years later, and therefore, the state would not know the true expenses for that amount of time.

MR. BULLOCK replied yes and that is similar to the federal system where the taxpayer has the opportunity to correct a return for three years and the department has the same amount of time to correct it through the audit process.

CHAIR HUGGINS asked if the term “not maintained” was a common term that most people would come to grips with.

MR. BULLOCK replied:

> Arguably, improperly maintained as was stated in the earlier draft of this legislation would have covered the failure to maintain it at all and this is just to make sure that as you get into malfeasance or

> nonfeasance issues, that just as one proceeds to say it's the belt and the suspenders both. It's just to insure that there's no unnecessary room.

CHAIR HUGGINS asked if he as a professional was confident with that term.

MR. BULLOCK replied, "It's not a matter of legal interpretation. Plane meaning would apply to this – to these terms."

CHAIR HUGGINS equated it to maintaining a vehicle by changing the oil to making sure the lube job is done. But if you didn't check the air pressure in your tires and one was 28 lbs. versus 30, would that be splitting hairs and would it be quickly dismissed.

MR. BULLOCK replied:

> I think when they're looking at this deduction, they're going to develop a link between what the error was and what the result of the cost was. An example of 'not maintained' versus 'improperly maintained' with your car is if you didn't ever change the oil, you didn't maintain your vehicle. If you put the wrong oil in - put the automatic transmission fluid in your oil pan instead of the oil - then you are improperly maintaining – you took some effort toward it. So, it's a matter of doing nothing as well as the matter of doing even what you should have done, but doing it poorly.

CHAIR HUGGINS asked if "not maintained" was defined somewhere.

MR. BULLOCK replied it's what it is on its face. "It's either maintained or it's not maintained."

3:56:00 PM
SENATOR WAGONER said:

> This is not saying that BP is not going to be able to write off these expenses or the other companies involved. What this is is another tool to put in the toolbox to give this a review to see if we think those should be allowable expenses or not. And I don't want anybody to think right now that this is going to be a punitive act to make sure that all this is not a write off. It may very well be or a portion of it may be

allowed. That isn't the point of this. The point of this is just to give it a final review by a committee that are able to bring to the table during the audit process certain skills and to take a good hard and final look at this.

BP, in a letter the other day, stated that they plan to write off up to $11 million in credits. Well if they have 28 percent of the field that leaves about another $29 million there that the other companies can write off. So, that's almost $40 million. That's a pretty good size chunk of change. So that's one of the reasons for this bill - to give that a good review and see if that is allowable or not.

CHAIR HUGGINS asked Mr. Bullock to restate the piece about clarification and regulations so everybody understands this is not a stand-alone issue.

MR. BULLOCK clarified that he is participating in this meeting at Senator Wagoner's request along with people from the DNR, DOR and AOGCC. They are discussing their authority to define in regulations and to make the determinations as to what the standard practices were.

MS. JACKSON inserted that Mr. Norman, Chair of the AOGCC, spoke directly to this issue and he would be better able to expound on it. He talked about developing a standard for reasonable and prudent operators, which would fit within this framework.

CHAIR HUGGINS asked Mr. Norman if he had anything to add to that.

MR. NORMAN said certain standards providing specificity and guidance should be developed so they could be relied upon. Certain standards are in place, but they are generally voluntary guidelines enacted by the American Petroleum Institute and societies such as the American Society of Corrosion Engineers. This would have to be fleshed out in the regulations the department promulgates.

He said currently, there are no standard practices that apply across the board to refer to. In other cases, they are evolving just as new technological innovations evolved and types of equipment that were not in use five years ago. Promulgating regulations will take a fair amount of work.

4:00:00 PM
SENATOR MCGUIRE referenced a letter dated February 15, 2007 from Doug Settles saying she could see where the legal argument was going. So, she commented to Senator Wagoner that the distinction would be:

> If the argument on BP's part was that they were already going to replace certain pieces of equipment, certain parts of equipment that would have been a standard practice and so forth - is there a place in your bill that takes that into account? In other words, that would be the kind of deduction that they would have anticipated to upgrade and expand and go forward with a regular capital expense. Here what you want to do is exclude those parts, those expenses, that go towards improper maintenance or lack of maintenance. Where does that line fall and do you think you have taken care of it in here?

SENATOR WAGONER responded:

> The partial answer to that question is, in my mind, would BP and the other partners - would they be replacing that 30 inch line with a 20 line had not these corrosion problems come up. It's not the ordinary thing to do to replace a line like that. If it was, I think we'd be looking at replacing the TAPS line and downsizing it, so we've got a more efficient flow. Because what they are doing is taking pumping stations off line and putting in new compressors and new pumps. But they aren't downsizing the line. That line would have functioned very well at 30-inch versus a 20-inch had not the corrosion been so bad that they decided to take it out. That's in my mind, anyway.
>
> Excuse me – follow up – the good thing about it is this panel of seven people aren't going to have to sit and make the decisions. That's why this bill is setting this up. It's really not our job to do that. It's the Department of Revenue's.

SENATOR MCGUIRE commented that she wanted to get that on the record because she thought that would be the point of delineation.

SENATOR STEDMAN said he and a lot of other people worked long and hard for months on PPT and recalled that the 20 percent

credit was put in place to stimulate development and expansion of the state's oil basin. The intent was to increase the flow of oil in the TAPS and to share in the cost of exploration and development with the industry. That is a little different twist than rebuilding infrastructure in an old basin. He added:

> But in looking at the – dealing with the older basin issue, we had put in roughly a 30 cents a barrel cost for just normal maintenance of equipment – that just wears out over time. So, the normal maintenance issue would be dealt with. I'd like you to stop there for a minute because that's kind of just putting some of these pieces together for someone that didn't recall or wasn't interested in the other PPT bill, the old PPT bill, but there's two pieces and I'm just kind of curious how that 30 cent exclusion plays into the issue of improperly maintained. Clearly, hopefully, there is no such thing as not maintained and we're just dealing with poorly maintained. I'd just like to hear your thoughts on that.

MS. JACKSON responded that Senator Wagoner developed the 30 cent per barrel (BOE) with Dr. Van Meurs who had provided a memorandum to Senator Wagoner on that issue. The gist of it was how to make the PPT closer to a gross tax system. This was part of the third PPT bill (HB 3001) in August of the second special session.

SENATOR WAGONER agreed that the BOE was put in place to bring the bill closer to a gross bill instead of a net bill.

4:07:00 PM at ease 4:10:31 PM

JUDY BRADY, Executive Director, Alaska Oil and Gas Association (AOGA), said her testimony today had the consensus of the association with no descent. She testified:

> As pointed out earlier just last August in a third special session, the legislature passed a final version of the Petroleum Production Tax, which was set out to both increase tax revenues to the state in times of higher prices and to encourage new exploration and production. That and the tax offered new credits and shared the risk of certain categories of costs. So, we're all pretty sure that it certainly did its job in terms of a higher tax. The letter that was referred to earlier from BP's president, Ed

Settles, talked about their tax nearly tripling from $180 million to over $500 million for the first nine months of 2006. Not surprisingly, many legislators were enthusiastic about the higher taxes for this state and not so enthusiastic about the credits or the concept of the state sharing some of the risk by providing incentive for certain categories of costs.

And those of you who were involved in this and many of you were, there were literally dozens of concerns about the new approach – what standards of review should be used, what costs should be included, how to prevent the state from being gamed by the companies, how to prevent the companies from being gamed by the state, how the credits could be used, what the tax rate should be. And on August 6, BP discovered the leak at Flow Station 2 with an oil transit line in the Prudhoe Bay. It notified the appropriate regulatory authorities and implemented procedures to stop the leak and clean the spill and began the process of suspending production from the entire field.

The House of Representatives was informed just before its vote on final passage in third reading to enact PPT and it passed 29 to 10. As more information was released, the level of concern regarding the effect of the spill under the proposed new tax legislation heightened. Legislators did not want the State of Alaska to end up paying for the result of the spill under the PPT if standards had been ignored. As a result, the section on lease expenditures, what they would not include, as well as the standards came in for close scrutiny [indisc.]

There was discussion of a lot of other standards, various words were used and finally settled on lease expenditures would not include costs arising from fraud, wilful misconduct or gross negligence. All of those words have meaning in law with lots of court cases behind them. It was further decided that costs incurred for containment, control, clean up or removal in connection with any unpermitted release of oil or a hazardous substance would not be included.

On August 9, the Senate Special Committee on Natural Gas Development reviewed a new amendment with almost the same language as SB 80, which is in front of you

today. The language was introduced twice, first as Amendment 9 and then as Amendment 13. Its difficulties were immediately apparent - what does improperly maintained mean – what does diminished capacity mean – who decides in the first place? An auditor? Does there have to be an incident like a spill? If so, that's already taken care of under unpermitted releases. If an incident takes place, does that mean the state can decide what maintenance costs are appropriate under every circumstance? And if no incident takes place, does that mean the state can decide what maintenance costs are appropriate under every circumstance?

Both legislators and State Department of Revenue personnel expressed concern about the difficulties and after a discussion, neither amendment was adopted. Instead, the Senate Special Committee adopted an amendment proposed by Dr. Pedro van Meurs and he explained in the hearing on August 9, according to the minutes, that maintenance is a reasonable deduction for PPT, but sometimes [its] hard to decide which expenditures fall into that classification. The simplest solution is to take some base expenditure and over the next 20 or 30 years disallow a floor for the capital expenditures. A flat 30 cents per barrel exclusion, which sets a floor for maintenance costs according to Senator Wagoner and avoids the problem of a case by case decision as to whether maintenance, repair or replacement is required because equipment or facilities have been improperly maintained, was adopted.

Amendment 13 requiring case by case decisions as to the reason for the repair or the replacement, almost identical to SB 80, was not adopted. Dr. van Meurs favored using a proxy in order to have clarity and certainty and to avoid disputes. Now the legislature is again debating the same amendment that failed on August 9 and the same problems with it exists. I would note that the legislature is not debating whether or not to amend the PPT legislation to drop the 30 cent a barrel proxy cost which [indisc.] for every producing company whether there is an incident or not.

4:16:00 PM
What is being proposed here is a per-activity decision every time of proper maintenance in addition to the

flat surcharge that was intended as a proxy for such a decision. However, it may be helpful that this amendment be debated again. For PPT to function effectively, it is important that both legislators and the industry understand how the legislation works and why it should work as intended. If either side feels gamed, we will not be in court forever regardless of what kind of tax it is.

AOGA opposes SB 80 for four reasons. First, we believe that the state is already protected from being inappropriately charged with lease expenditures as a result of spill incidents under the current law. Second, SB 80 has unintended, but potentially significant implications that will extend far beyond Prudhoe Bay, particularly troublesome in Cook Inlet. Third, this is an ex-post facto law that is forbidden under the federal and state constitution. And fourth, and continually troublesome, is SB 80, because of the ambiguities of its language, it creates ambiguity throughout the entire PPT legislation related to costs and credits.

Before going into our specific concerns, we'd like to express our general concerns with the premature and possibly unwarranted assumptions regarding the Prudhoe Bay oil leaks. SB 80 is aimed directly at Prudhoe Bay. There have been lots of comments about what was done and not done and appears to be based on the assumption that because corrosion on a Prudhoe Bay transit line was more severe than expected and those lines were improperly maintained.

This is to judge BP's conduct and that of Atlantic Richfield, as the operator of the eastern side of the Prudhoe Bay field before the BP/Arco merger in 2000, without having the decisions of the federal and state regulators and/or the courts. We like to believe that companies like individuals are innocent until proven guilty. There certainly does need to be the level of concern and scrutiny exhibited they industry and the state and federal regulators. What we hope to avoid is legislation based on an assumption of wrong-doing that will not only not solve a problem, but will create new ones.

Real shortly here I'll go through our four concerns. We believe the state is already protected from inappropriately being charged with lease expenditures as a result of spill incidents under the current law. The PPT laws already specifically disallow costs arising from fraud, wilful misconduct and gross negligence. SB 80 in contrast would introduce a completely new and subjective term for judging whether maintenance-related costs would be lease expenditures. And this new term would be the improperness of the maintenance in question. All of the other terms are common law terms, specifically the law of court and the judicial precedents, that establish their meaning go back literally thousands of years. To the extent that the concept of improper maintenance is encompassed by any or all of the other already existing statutory terms, it is superfluous. To the extent it may mean something different from the term already in the statutes, the concept of improper maintenance is ambiguous because there is nothing to guide taxpayers or tax administrators about which of the existing terms it is different from and in what ways it is different from each of them. And in effect waiting for this to go to be spelled out by regulators by three different departments turns the whole question of whether the PPT as an act that is supposed to encourage new production over to regulators.

Implications extend statewide. Corrosion is not a problem unique to the fields on the North Slope. It's a challenge everywhere. Sometimes you can slow it down a great deal, but you cannot stop it completely. That means the older an iron or steel structure or facility is the greater the cumulative effects. Prudhoe Bay will mark the 30th anniversary at the start of this year; in Cook Inlet the number of fields will have their 40th and a few even their 50th. And our members with Cook Inlet interest are concerned that this legislation, which seems aimed at a particular situation that rules on the North Slope, will affect them as well.

4:21:00 PM
There are operations in the Inlet area that will eventually need to be replaced or significantly repaired in order to remain in operation. When these facilities and structures are eventually replaced,

there is nothing in SB 80 to protect them from claims that they were improperly maintained – unless the costs of repairing or replacing them are limited or disallowed altogether. This uncertainty over whether the costs will be fully recognized as deductions and whether the tax credits or capital portions of these costs will be fully allowed could lead to fields and facilities being permanently shut in instead of remaining in production even longer.

Third, ex-post facto legislation is forbidden under both the federal and Alaska Constitutions. Section 10, Article 1 of the US Constitution declares that no state shall pass any ex post facto law. And according to Black's Law Dictionary, an ex post facto law is a law passed after the occurrence of a fact or commission of an act which retrospectively changes the legal consequences or relations of such a fact or deed – and certainly SB 80 does this. We are going to be assuming that you have talked to the Department of Law or will about this issue.

The last one is SB 80's ambiguity that threatens the effective implementation of the PPT. With respect to providing clarity about how taxes work, SB 80 promises to create ambiguity between its improperness standard and the other well-defined statutory standards already in place for determining which expenditures are proper under PPT. With respect to providing certainty about what a taxpayer owes, the ambiguity under SB 80 promises countless disputes about whether maintenance was improper or not and, to the extent it was, how much of the cost repairing it or otherwise dealing with the situation should be disallowed.

The question of what costs are deductible is central to the concept of the PPT as an incentive to new investment and new production. The tax rate under the legislation is extremely high. The trade off was in part related to cost sharing and credits. AOGA has already testified that we believe the tax rate is too high and now we are replacing the position and testifying that along with the high tax rate the determination of cost and credits will spiral off into a black and never-ending hole of litigation. I will tell you that we have done this before from the 70s, 80s, and 90s we've spent millions and billions on the

table because of disagreements about what words meant and if we do that again after having just got through with the last 10 years, then shame on us.

4:24:00 PM
We strongly believe that SB 80 is a step backwards in achieving effective clarity in the PPT. We all are concerned about declining oil and gas production. That's the only reason the legislature took such a huge leap to make this law that is unique in the world, that has a very high tax rate in times of high prices and also where the state takes some of the risk. There is no other reason to do that if we weren't concerned about production. That's why we're so concerned about having a gas pipeline as well. To add language that deliberately adds new ambiguity is truly a step backwards in this whole movement towards increasing production and making Alaska a place where people can do business with surety that they know what's going to happen in a fiscal sense. That concludes my remarks.

4:25:00 PM
SENATOR WAGONER mentioned that Ms. Brady brought up the fact that there are some lines in Cook Inlet that are 50 years or older. He said the first two platforms were set by Shell in Cook Inlet and are 50 years old. To this date they have not had a problem of the magnitude of the one on the North Slope. The oil is different, but the lines are pigged on a scheduled basis, chemicals are injected and those lines are very operable to this day. They haven't seen the necessity of resizing those lines, putting new lines in or anything else.

I don't know when, if ever, those lines will need to be replaced. And that gets to the crux of this whole amendment. And I just checked on that last week, because I happened to know the people who set those platforms.

SENATOR MCGUIRE thanked Ms. Brady for her comments. She added that an amendment already clarifies that costs arising from fraud - wilful misconduct or gross negligence - will be a part of that. She thought failing to maintain at all or improperly maintain structures was gross negligence.

If anything, the bill here – it's just something to consider, Judy - but maybe [it's] a clarification of

> an earlier statement made by the legislature. Gross deviation – is deviating from the standard of care that somebody would not normally do and I think the argument could be made if it's proved or not – I'm not the judge or jury here – that the line was not maintained or improperly maintained. That would likely be gross negligence. That was just something to add. You talked a lot about going back in time and ex post facto laws and things like that. One other thought would be that it's a clarification of an earlier statement we made as a legislature.

SENATOR WIELECHOWSKI asked Ms. Brady if she considered BP's actions to be gross negligence in this matter.

MS. BRADY replied her point was that there are three standards in the law as it stands now and BP will have to play against them for it to use the credits and deductions. These standards have a long history in law and any company wanting to use the credits will have to play against them.

SENATOR WIELECHOWSKI asked if it is industry standard to not inspect lines for over a decade.

MS. BRADY replied that right now people are making assumptions and asking questions about issues that are being looked at by regulators with both the expertise and the authority to look at them. There will be decisions about what was done or not done in the proper place and at the proper time.

4:30:00 PM
CHAIR HUGGINS asked Mr. Bullock to comment on his view of what "not maintained" or "improperly maintained" means.

MR. BULLOCK recapped there were discussions of gross negligence, which is a higher standard of negligence. This bill offers a lower standard and it comes down to what extent a poor decision was made and should the state shoulder the cost. Prior law when the tax was on the gross value at the point of production had elements like what was the sales price at the refinery, what were the transportation costs from Valdez to the refinery, what was the pipeline tariff. There was a prevailing value backstop, that if somebody made a bad decision, like underpricing the oil relative to other sales, that the prevailing value of that oil would be the applicable standard rather than the state sharing in the cost of a mistake or sharing in a negotiation.

He said this language is similar in that it sets up a standard which the commissioners will decide. If there is a variance from the standard practice, perhaps the state shouldn't share the cost of the decision to vary from the standard practice.

> This bill doesn't say that BP didn't maintain their pipeline. What this bill says there's a problem, and that the commissioner will look at it and say this was fully expected - at the end of the life of a field - it's expected that the pipelines might be changed or downsized. I don't know what the answer is, but what this bill does is it allows the commissioner to make that decision and really make a decision as to whether the state should share in the burden of these costs or not.

4:32:00 PM
CHAIR HUGGINS asked him to comment on the retroactivity of the standard.

MR. BULLOCK replied that tax law has exceptions, but he couldn't quote them. The PPT, itself, was a retroactive law - passed in August and made retroactive to April 1 of 2006.

CHAIR HUGGINS asked about the case where the standard was not maintained to the occurrence.

MR. BULLOCK replied AS 43.55.165(a) allows lease expenditures that are ordinary and necessary and even under that standard the issue is raised of whether an extraordinary repair would be an ordinary expense. The 18 exceptions from allowable lease expenditures are already in the statute and they are effectively provisions where the legislature has taken the step of saying if there's any doubt as to ordinary or necessary, these are not ordinary and necessary and may not be deducted.

SENATOR MCGUIRE remembered that civil gross negligence is a conscious disregard of a known risk.

MR. BULLOCK agreed.

SENATOR MCGUIRE explained that her argument earlier that to the extent that an ex post facto law were espoused, it seemed that the earlier version of the bill on page 2, line 6, discussing costs arising from fraud, wilful misconduct and gross negligence seems to dovetail with page 3, lines 24-25. She asked if

something is not being maintained at all or being maintained improperly and a conscious disregard of a known risk can be shown, where the standard is being lowered.

MR. BULLOCK replied that it's the awareness of the risk. He used the analogy of shooting a bullet into a train or into a field as having a different risk. Foresee ability is used in defining gross negligence as opposed to simple negligence.

SENATOR MCGUIRE asked if this is where the commission would ask whether or not not maintaining it at all or improperly maintaining a line consciously would be a known risk. Has anyone done it successfully?

MR. BULLOCK replied that part of the issue is identifying the standard that says the state expects certain things have to be done and if those things aren't done, it doesn't necessarily mean it's gross negligence. It goes back to torts and what would the reasonably prudent person do.

4:36:00 PM
SENATOR GREEN asked if no incident takes place and changes or repairs are made, would that be reviewed by this panel. "Are we doing something that would deter or discourage someone from doing aggressive repairs, replacement - maintenance?"

MR. BULLOCK speculated that current law lists 18 things that can't be deducted or limits them to 30 cents. That obviously tells the department to look for those things first to see if a return is inconsistent with the expectations of the law. If they find things in that group, they would pursue it further. In the case of a major capital expenditure that might be subject to this provision, they may look at an extraordinary expense more carefully to see if it fits in with the reasonable, ordinary and necessary expenses that are lease expenditures.

SENATOR GREEN went to page 3, line 19, that talks about the commissioner in consultation with the commissioner of DEC and DNR and the AOGCC and asked if that meant that all of 18 things are going to go through a different review group.

MR. BULLOCK explained that the standards all have standards within them as to whether or not they are deductible. This one says the state is concerned with how a field should be operated.

> What this does in particular – what is the industry standard for taking care of it. And these other

> commissioners each come to the table with their expertise that can help the commissioner of Revenue determine what the reasonable standard is before the commissioner then determines whether there was a variation from that standard. It's unique, you know - this consultation with the other commissioners relates to developing the standard of what should have been done.

SENATOR GREEN asked without this language, would everything through 18 just be done however they do it with their tax review panel now.

MR. BULLOCK replied yes. It's basically a tax issue like any other tax issue. There are deductions you can have and deductions you're not allowed to have. This case deals with what the standard is and if it has been varied. It involves more than just the Department of Revenue conducting an audit.

SENATOR GREEN asked if it's still for purposes of tax.

MR. BULLOCK replied yes. This is a deduction to get to the taxable value of oil that is subject to the PPT.

SENATOR WIELECHOWSKI asked if an oil company or producer was maintaining their lines, running pigs and inspecting lines, but the line was old, then potentially they could write that off under this bill. However, if they failed to inspect their lines or improperly maintained those lines, the state is saying that can't be deducted. "Alaskan residents shouldn't bear the burden of having to pay it. Is that an accurate framing of what we're trying to do here?"

MR. BULLOCK replied:

> It is, but you always keep in mind whatever the standard that these commissioners expect would be normal would be the starting point. They'd say what should have been done and then in fact, what wasn't done – and if what wasn't done – does it amount to not doing maintenance or doing what would be expected to be normal maintenance, but they didn't do what was expected.

SENATOR WIELECHOWSKI said there are probably millions of miles of pipeline across the world and they had probably been in existence for decades. So, there is probably a well-established

body of how they are taken care of. He asked if that was fair to say.

MR. BULLOCK replied that he couldn't speak to that. That's why this legislation is directed at the people who would be in a better position to answer that question.

SENATOR MCGUIRE followed up on Senator Green's comment saying that a concern she has is this might become a general deterrent to general maintenance for the existing operators as well as those who might want to come to Alaska and invest. She asked Mr. Norman after this issue is resolved with BP, was it his intent and did he think it was prudent to set out guidelines for what is proper maintenance. She asked if a log that should be kept, for example. She asked what could be done in the future to set up some kind of parameters by which resource development companies could have some expectations.

4:44:00 PM
MR. NORMAN responded:

> The way I would perceive this is there's no question - this will be a difficult assignment because in looking for improper maintenance, substandard maintenance. Some maintenance operations will be obvious, but as has been discussed by the committee already, many of those will fit under subsection (6). They may even rise to the level of wilful misconduct – and I want to add a disclaimer here. I am not speaking to any specific situation and so I do not want to prejudge any situation at this point because should the legislature enact this and task us with this assignment, then I want to be able to look at it without having previously expressed any opinion as to any particular maintenance situation as to equipment. I think you can appreciate that.
>
> But the point I want to make is that the obvious cases of improper maintenance, very obvious ones, will certainly be picked up already under subsection (6) and I would expect them to rise to the level of gross negligence and in some instance, perhaps even wilful misconduct.
>
> What we're looking at right now under subsection (19) is beginning to slice the bread pretty thin and it is a very difficult assignment that will be presented to

us, one which we will do to the best of our ability. The way that I would approach it if it is presented to us would be to begin work on promulgating regulations to address the question that was put to me to try to give some predictability. But I have to say right now on the basis of having practiced law for many years that I do not believe it will be possible to foresee every situation, every compressor, every pipeline, every improper additive of lubricant and so forth and I think that we would have to fall back upon some of the general standards – and there are many – that exist in case law.

The standard of the prudent operator is a standard that is repeated. Also the standard of good and workmanlike manner are in accordance with best engineering practices. These again are general standards that would lead us in some instances to cases – I know the FERC has its own definitions of prudent operations that they do apply to pipelines. So we would do our best to incorporate some of those definitions and also we would look at the API, American Petroleum Institute, and other professional organizations that have committees of experts that works on what constitutes maintenance. But again, having said all of that, technology is constantly evolving and whatever standard you lay down today may not hold true five years from now.

As I indicated in my letter also, there would be a question about the time that a particular decision was made to configure a system in such a way that sets in motion a chain of events and that may not be the best standard in light of today, 2007, but perhaps at the time the decisions were made, that was a good standard. So, there are an awful lot of subtleties and nuances once you get outside gross negligence, wilful misconduct, obvious maintenance, and we would do our very best to do exactly what the question anticipated. And that is to try to describe in regulations some standards that would give predictability. But I know before we even start that it would be an impossibility to anticipate everything that might go wrong.

We would also try to do it with a measure of common sense and try to avoid the temptation to apply hindsight because we do not live in a perfect world

and things don't always go right. I do know there are some parallel decision makers that would be looking at the same things. Certainly for federal income tax purposes certain deductions would have to be classified one way or another and the federal government would have an interest in this certainly over and above the PPT for state corporate income tax purposes.

Again, decision makers would have to make a decision as to whether this is an allowable deduction and finally under applicable unit agreements, which exist on virtually most of the field in Alaska, each operator has a partner and for purposes of determining whether you can allocate these expenses across the different partners, the question normally is asked. There are different standards in different operating agreements, but the question does come down to – was this conduct that would rise to the level of what would have been done by a prudent operator.

In some agreements, ordinary negligence is recognized as something that does occur and it's negligence outside that standard that is disallowed. The reason that that has developed in the law is that often operators would be reluctant to assume that responsibility if they knew they were going to, in effect, become an insurer of a perfect result. So, that's something that would be on my mind as chairman of this commission if this passed and we set about as best we can. And I want to underscore, we would do our best to implement it, but we would try to strike a proper balance. We would try to incorporate and reach out to adopt professional well thought-out standards and we would look at the case law, specifically definitions of the prudent operator standard and the good and workman like manner standard that have been repeated. And then by applying those, we would make our best judgment and render advice to the commissioner of Revenue.

4:52:00 PM
SENATOR GREEN quoted Mr. Norman's letter on page 2:

One can never lose sight of the fact that significant technological advances have occurred as a result of innovations which at the time were departures from

> standard industry practices. Also engineers sometimes learn more through failure than success. Often there is no indication something is being done improperly until a failure has occurred that is through analyzing the failure that root cause can be determined and changes made going forward.

MR. NORMAN said what he was trying to indicate with those words is that if this assignment is given to them, they will undertake it and carry it out to the best of their ability, but they would do it in an atmosphere where they apply common sense.

> That paragraph that was just quoted was intended to remind all of us again that life and technology is a constantly evolving learning experience and so what we would do, perhaps, foresee-ability is a term that is familiar to lawyers and that is one of the basic elements in conducting a negligence analysis – is - was this foreseeable. And if a prudent operator or an operator functioning and carrying out operations in a good and workmanlike manner could not be said to have foreseen this particular outcome, then it would be unfair to penalize that operator. And that's what I was attempting to address here. I don't know that I wrote that as clearly as I perhaps could have, but that was the tone - I was trying to give some balance to this, which would be a fairly difficult assignment for us.

4:54:00 PM
CHAIR HUGGINS referred to the statement in his letter:

> We do, however, wish to point out some of the practical difficulties that may arise in determining whether maintenance has been improper.

He asked if defining the term "not maintained" simplifies or complicates his life.

MR. NORMAN replied that it simplifies it. It covered the instance when something is simply not maintained period - to use the analogy of a car that might call for a particular weight of oil and a frequency for changing it; and should you fail to change it, you risk damage to the engine. Not changing the oil at all is an easier call than if someone added 40-weight oil when 30-weight is called for.

CHAIR HUGGINS thanked everyone for their comments. He emphasized how important getting this bill right is to all the players. He agreed with Senator McGuire about the importance of predictability and people being able to understand what the state wants so they can meet those expectations and declared, "We want to be customer friendly, not scaring customers away." He then adjourned the meeting at 4:58:00 PM.