**ALASKA STATE LEGISLATURE**
**SENATE RESOURCES STANDING COMMITTEE**
February 28, 2007
3:46 p.m.

**MEMBERS PRESENT**

Senator Charlie Huggins, Chair
Senator Bert Stedman, Vice Chair
Senator Gary Stevens
Senator Lesil McGuire
Senator Bill Wielechowski
Senator Thomas Wagoner

**MEMBERS ABSENT**

Senator Lyda Green

**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 |
| 02/21/07 | (S) | RES AT 3:30 PM BUTROVICH 205 |
| 02/21/07 | (S) | Heard & Held |
| 02/21/07 | (S) | MINUTE(RES) |
| 02/28/07 | (S) | RES AT 3:30 PM BUTROVICH 205 |

**WITNESS REGISTER**

JASON BRUNE, Executive Director
Resource Development Council (RDC)
Anchorage AK
**POSITION STATEMENT:** Opposed SB 80.

JOHN NORMAN, Chair
Alaska Oil and Gas Association (AOGA)
121 West Fireweed Lane
Anchorage, Alaska 99503
**POSITION STATEMENT:** Commented on SB 80.

KEVIN BANKS, Acting Director
Division of Oil and Gas
Department of Natural Resources (DNR)
Anchorage AK
**POSITION STATEMENT:** Answered questions on SB 80.

JONNE SLEMONS, Acting Coordinator
Petroleum Systems Integrity Office (PSIO)
Division of Oil and Gas
Department of Natural Resources (DNR)
Anchorage AK
**POSITION STATEMENT:** Commented on SB 80.

JOHN IVERSON, Director
Tax Division
Department of Revenue
Anchorage AK
**POSITION STATEMENT:** Commented on SB 80.

JOHN NORMAN, Chair
Alaska Oil and Gas Conservation Commission (AOGCC)
Anchorage AK
**POSITION STATEMENT:** Commented on SB 80.

BERNARD HAJNY, Manager
Production Tax and Royalty
BP Exploration Alaska
**POSITION STATEMENT:** Commented on SB 80.

TOM WILLIAMS, Senior Tax and Royalty Counsel
BP Exploration Alaska
**POSITION STATEMENT:** Commented on SB 80.

ROBERT MINTZ, Attorney
K&L Gates
Department of Revenue (DOR)
Department of Law (DOL)
**POSITION STATEMENT:** Commented on SB 80.

**ACTION NARRATIVE**

**CHAIR CHARLIE HUGGINS** called the Senate Resources Standing Committee meeting to order at 3:46:14 PM. Present at the call to order were Senators Wagoner, Wielechowski, Stedman, Stevens, McGuire and Huggins.

## SB 80-OIL & GAS PRODUCTION TAX: EXPENDITURES

CHAIR HUGGINS announced SB 80 to be up for consideration.

JASON BRUNE, Executive Director, Resource Development Council (RDC), said he represents diverse resource businesses including oil, gas, mining, timber companies and more. He said they do not support SB 80. It is bad public policy and potentially precedent-setting for other industries around the state.

He said that predictability is important for his members and this does not allow predictability. He stated:

> With the passing of the PPT legislation last year, the state effectively tripled the production taxes on the oil industry in Alaska. This likely will result in over $1 billion in additional revenue to the state this fiscal year. In passing this legislation, the producers are now allowed to deduct an operating cost from these taxes. In addition, they are also allowed to take a 20 percent tax credit for capital investments as an incentive for improving North Slope infrastructure. Further, as statute currently reads, lease expenditures may not include costs arising from fraud, wilful misconduct or gross negligence. SB 80 would preclude lease expenditures associated with improper maintenance of property or equipment.

3:49:45 PM

> What exactly is improper maintenance? SB 80 does not define it. In fact, industry guidelines on maintenance often change. In many instances, because of new information, often times this new information is gleaned from miscues. These miscues do not imply that the facilities were not properly maintained. Unfortunately despite the best of intentions, accidents do happen even with proper maintenance.

MR. BRUNE said he agreed with the AOGCC's letter from Mr. Norman last week on its concern; one of which is that the definition of "improper maintenance" is very difficult to find.

> Expenses may not include costs arising from gross negligence. Gross negligence implies a careless disregard for the consequences of an action or lack of action. The state already has the protection it needs and SB 80 is, therefore, unnecessary.
>
> Another large concern SB 80 creates for my members is the potential for the endless litigation that it creates. Even if 'improper maintenance' is defined, our members feel this will just add to the potential for ongoing disputes between the state and the producers.
>
> RDC members strive to responsibly develop Alaska's natural resources. As we strive to do this, I request you do not move SB 80 out of committee and give last year's PPT legislation a chance to work before changing it. Thank you for the opportunity to comment.

3:51:21 PM
SENATOR WAGONER asked if his membership would be in favor of the State of Alaska allowing expenses incurred by not properly maintaining a pipeline of this nature. Would they be in favor of the state giving up $40 million to $116 million, he asked, for the cost of this project.

MR. BRUNE replied that a process is already in place for determining gross negligence.

SENATOR WAGONER repeated his question.

MR. BRUNE replied if it is determined as gross negligence.

SENATOR WAGONER stated that there is a difference between gross negligence and improper maintenance.

3:53:04 PM
SENATOR WIELECHOWSKI asked if the meaning of "improper maintenance" were changed to "negligently maintained" would that satisfy some of his concerns.

MR. BRUNE replied that even the American Petroleum Institute has a difficult time determining what industry standards are for

pipeline and corrosion maintenance. It is a vague term and he probably wouldn't support it even with that change in verbiage.

SENATOR WIELECHOWSKI asked him if he would support any changes.

MR. BRUNE replied that the PPT bill that passed last year has a foundation in it that prevents items like this from being written off and that's what it was intended to do.

SENATOR WAGONER referenced a letter in his file from BP saying it is going to write off these expenses against the credits of the PPT bill, and therefore, he didn't think the PPT in its current form prevented these items from being written off. He added this is not a tax bill, but an amendment to a tax bill that clarifies the state did not want to allow these costs.

MR. BRUNE responded:

> I think the question is, whether it is improper maintenance or not, I think... the question needs to be asked if what transpired last year didn't happen, and they were just replacing the pipes, would those expenses be allowed to be written off. If in another location, pipes that have a history similar to the ones where we had issues are replaced, are those going to be allowed to be written off? What is the definition of when it's appropriate and when it's not? That's where the predictability is very difficult and where the certainty isn't there.

SENATOR WAGONER asked if he had an example.

MR. BRUNE replied, "Since PPT just came in to play less than six months ago, no."

SENATOR WAGONER retorted that Mr. Brune had made reference to other places where that had happened and the pipe was downsized and he wanted an instance where that had actually happened.

MR. BRUNE explained, "I was referring to a future potential if that were to happen. My apologies."

SENATOR WIELECHOWSKI mused that there would be a lot of disagreement whenever expenditures were calculated and that the better course might be to go to the gross. He asked if he would support that.

MR. BRUNE replied that he couldn't say because his diverse membership has different feelings on that.

CHAIR HUGGINS went to Mr. Banks and asked him to explain the message in the last paragraph of his February 15 memo that says: “may also be difficult for agencies to define or establish improper maintenance or improperly maintained.”

3:56:38 PM
KEVIN BANKS, Acting Director, Division of Oil and Gas, said the memo addressed a couple of things. First, the question of what they could look at in terms of language like “standard industry practices” and “improper maintenance.” His memo suggested to Senator Wagoner and the committee that they would look to practices undertaken by a reasonable and prudent operator under the same or similar circumstances. Furthermore, “improper maintenance” might be indicated by an unanticipated failure.

> It’s not necessarily a failure that would be by itself - the only evidence you’d want to rely on to indicate improper maintenance. But you’ve now got an event that’s caught your attention. Now, the way I see this bill working is that the Department of Revenue, upon finding some what an auditor may regard as improper costs paid to reverse a situation that’s caused by improper maintenance or something like that would come to the commissioner of Natural Resources for advice. In that consultative role, I imagine that the Department of Revenue commissioner could either have the choice of asking or not – and also has the choice of taking that advice or not.
>
> The Department of Natural Resources may be in some position to help make that case, because we will have, I hope shortly, a fully staffed Petroleum Systems Integrity Office. And the role that office will have is to develop, with industry, internal controls and quality assurance programs for each of the facilities for the pipeline and so forth. And that means that the PSIO would review these maintenance and repair programs that the company has implemented and in a sense certify, if you will, whether or not those programs meet industry standards just as we know them from people like the American Society of Mechanical Engineers and other third-party certification organizations.

> You may decide whether or not the internal controls and quality assurance program that is implemented by the company based on their own experience and their own familiarity with their equipment is suitable. And it strikes me that that kind of, if you will, certification would be evidence of facilities that are properly maintained in that case, because we would have determined that the company is doing what it should as a prudent operator and is formed by the kinds of standards that may be implemented as part of their quality assurance program as proper maintenance. And so costs spent to do that in that sense, I think, we would be advising to our commissioner, of the Department of Revenue, in that instance, that those are costs that would be acceptable.

4:01:49 PM
CHAIR HUGGINS asked if SB 80 was adopted in its present form and the PSIO matured, what would the cause and effects be to his organization's operations.

MR. BANKS replied that he didn't think there would necessarily be conflicts. In its present form, words like "improper maintenance" would be developed and further defined in regulation by the Department of Revenue.

> Those regulations would conform to a certain degree to the same kinds of things that our Systems Integrity Office would be examining. For example, a reliance on third-party certification organizations or reliance on terms like 'the prudent operator' in performing actions in similar circumstances. That basically is the same kind of measures that our quality assurance people would be looking to.

CHAIR HUGGINS asked if SB 80 would modify what he is doing or would he be doing the same thing without it.

MR. BANKS replied he would be doing the same thing without it.

4:04:23 PM
CHAIR HUGGINS said he wrote a note to himself that he had heard Mr. Banks say he did not want to be a part of determining standards and measures by going through the process of developing case law.

MR. BANKS said he couldn't recall making any comment related to that.

CHAIR HUGGINS asked for his thoughts on how case law might affect this.

MR. BANKS said he couldn't help him with that.

CHAIR HUGGINS again referenced Mr. Banks memo that stated the Division of Oil and Gas has no standards currently that would provide information from which to make a decision on corrosion and maintenance of the facilities and equipment.

MR. BANKS replied that after discussing this with his staff that the standards for corrosion control are either in their infancy or not particularly well-developed at this point. It is his intention for the PSIO to develop measures for corrosion control and maintenance - turning to third-party certification organizations to the extent possible - and relying on the internal control and recommendations that industry in Alaska may also be developing for itself.

CHAIR HUGGINS asked Ms. Slemons to comment on how she thought SB 80 would affect her office.

4:06:09 PM
JONNE SLEMONS, Acting Coordinator, Petroleum Systems Integrity Office (PSIO), Division of Oil and Gas, Department of Natural Resources (DNR), responded that her assessment of SB 80 is similar to Mr. Banks'. One of the PSIO's primary functions would be to assist the Department of Revenue in making a determination as to whether certain claims should be deducted from taxes. She would do that by sharing the quality assurance plans already approved for the various unit operators. It is not a perfect science. The division would not rely on a single quality assurance standard, but it would do its best with every available standard and guideline including the internal guidelines established by industry looking into the near term, the mid term and the long term. Carrying out those plans can be said to be reasonable and prudent. The state would be putting it on the table in advance; industry would be signing up to do it; and that's what the office will be inspecting to. Where those plans are ignored and compliance is an issue, that could be identified as a case of improper or not maintenance.

CHAIR HUGGINS thanked her and went to a letter from the director of the Tax Division, John Iverson, and asked him what this last

paragraph meant: “The department supports SB 80 with the caveat that the bill not limit the department’s discretion to deny deductions or credits under current law.”

4:08:19 PM
JOHN IVERSON, Director, Tax Division, Department of Revenue, replied his concern is that the department has a certain amount of discretion under standards that are currently in existence in the PPT statute. For instance, he can deny costs based on the gross negligence standard, costs that weren’t necessary business expenses and costs that would not be properly billed from an operator to another working interest owner in the context of a negotiated unit operating agreement. He did not want this law to end up confining them only to a standard of improper maintenance. That is why he suggested to the drafters that the standard be changed from “relying on” industry standards to "taking into consideration” - so he has the ability to look at things other than industry standards on improper maintenance in case those standards either aren’t appropriate or simply don’t apply.

4:10:38 PM
CHAIR HUGGINS asked him to clarify paragraph 4 of the same memo that says, “The department concern is not with the intent or necessity of SB 80; it is with implementing the bill.”

MR. IVERSON replied:

> What I’m getting at there is that if the legislature deems it’s fit to insure that costs for improper maintenance be excluded from deductibility or from credit that the legislature needs to pass language saying so. What I’m saying in that context is that were we to pass a regulation that expressly incorporates the language of SB 80, that language would not find explicit support in the statutory language and thus be subject to legal challenge. If the legislature wants to make this more of a bullet-proof solution, I recommend statutory language or else we will be arguably subject to a greater legal challenge after we pass the regulations having this language.

4:11:53 PM
SENATOR WIELECHOWSKI asked if SB 80 is passed, would the state be subject to less litigation.

MR. IVERSON replied that he wouldn't go that far. He didn’t think there was a way to get out of litigation over excluding any of the costs whether gross negligence or improper maintenance is used.

SENATOR WIELECHOWSKI asked if the state would be avoiding one layer of litigation.

MR. IVERSON replied that might be closer to what he was getting at. If the division passes a regulation that explicitly incorporates the language in SB 80, that regulation itself would be more easily challenged than if would if it found explicit support in statute.

CHAIR HUGGINS thanked him and went to Mr. Norman and asked him to clarify his memo to Senator Wagoner dated February 16.

4:13:26 PM
JOHN NORMAN, Chair, Alaska Oil and Gas Conservation Commission Association (AOGCC), replied that in that memo he was pointing out there is no precise definition that would tie “improper maintenance” to standard practices. “There are some ways we could get at it, but it is not quite as neat just simply saying that the practices employed complied with standards. There is no readily available manual on the shelf.”

If the AOGCC were given this task he would probably follow the lead of the other two agencies that will promulgate some regulations “to give some specificity to this.” He said that already subsection (6) addresses a disallowance of costs that might result from wilful misconduct or gross negligence – which cover the obvious things.

MR. NORMAN said that new subsection (19) - to have any meaning - has to intend something different than what is already embodied in (6). So, he would now be looking at something like “ordinary negligence” or - said differently - “a mistake.” He was trying to point out in his letter that mistakes are made; engineering isn’t a perfect science. He was trying to bring some balance to the concept as they embark on it.

CHAIR HUGGINS asked him to clarify the first paragraph on the second page of his memo that says:

> Finally, 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.

MR. NORMAN replied that there are numerous examples. One of the best known is Sir Alexander Fleming experimenting in his laboratory and letting it get filthy, but in the course of the experiment, he noticed certain bacteria were being killed in the Petri dish. It turned out that he had inadvertently discovered penicillin.

He has heard from the operators that they felt they had the corrosion situation under control using their additive. Perhaps they would have set a standard if it had worked, but it didn't. He didn't know what kind of negligence it could have been. People have experimented. Some things have worked and some things haven't. You don't want to make people fearful of trying things because that's where innovation happens.

4:19:53 PM
CHAIR HUGGINS referenced the second paragraph on the second page of the same memo that says: “We understand and agree with the intent of this legislation.” However, the last sentence says, “We do however wish to point out some of the practical difficulties that may arise in determining whether maintenance has been proper or improper” and asked him to explain.

MR. NORMAN replied at that time he was speaking as if this bill passed and the commissioner of DOR had asked for advice on standards for maintenance. He was trying to figure out how he would approach that because there often are not any totally uniformly accepted industry standards that could be used as a guideline.

He envisioned, in a dispute between the DOR and the taxpayer, this would call for “frontloading our efforts” because often in an administrative proceeding you put your evidence into the record and an administrative law judge will make a decision on it. Presumably the state would have “to fire its best shot” upfront if it felt the operator had employed less than standard practices of the industry. Consequently, the state would not have the opportunity to later address this issue at the trial, because there would be no trial.

MR. NORMAN said he didn’t want to leave any stone unturned in efforts to support the DOR if it asks him for advice and advised

> We're now down beyond the real easy calls, because I think they will jump out – they'll be filtered out by subsection (6) – gross negligence. So we're now down to the calls about a mistake may have been made here. Was there a mistake? Yes, there was a mistake made and now we have to point it out and then presumably if the taxpayer disputes it, they will come forward with their expert and say, 'No, based upon what was known then.'

MR. NORMAN said the date stamping of the decisions and the state-of-the-art-at-the-time were just some of the practical difficulties regulations for standards would have to overcome. If this passed, he would promulgate regulations taking the lead from other agencies and try to lay a good foundation for decision making – so it wouldn't be "arbitrary and capricious decision making." To do that he would start by looking at the American Petroleum Institute standards, specifications and recommended guidelines and those of other well-known professional societies like the National Association of Corrosion Engineers, the American Institute of Mechanical Engineers, and other international standards organizations.

MR. NORMAN recalled that Senator McGuire asked if he could adopt regulations that would give predictability and assurances for standards of conduct to new investors coming into Alaska. He remembered his answer was:

> No, we will never be able to give 100 percent assurance of that because it's evolving technology and it's virtually impossible to anticipate every single failure that is going to occur and then be able to go back and to be able to promulgate regulations that would address that. It often is a learning process.
>
> So my intention in writing this was to indicate we're ready, we're willing, we're able to work on this. We do understand the intention of it, but it is not a simple assignment.

4:25:19 PM
SENATOR MCGUIRE thanked him for looking into that for her and said it doesn't look like government is doing its job if it doesn't put together some standards. In law you have rules of evidence that set out the basis for which evidence can be offered and accepted in a court room. It allows predictability for both the defense and the prosecution.

She remembered a time when DNA evidence was a new concept and very controversial. Often judges would disagree about whether it would be allowed in or not because it was new science. Whatever industry you're in you're going to be dealing with new technology and it just makes sense to have rules or guidelines by which the state's industries can conduct themselves. Otherwise the lawyers win.

SENATOR MCGUIRE stated that these businesses are dealing in nations that have different governments – some are dictatorships, some are democracies. Democracies should be able to come up with some level of predictability. She said this meeting illustrates why a gross tax at a lower rate would have been the better way to go. The problem is that when you try to create deductions the idea is to incentivize. But the better way to do it is through individual legislation, because you end up "getting wrapped around axel" trying to cover deductions that would work for everybody.

> That's just a little soliloquy, but in the meantime, your job in this is why you do get paid the big bucks - and as a lawyer, I think, it is to promulgate a series of regulations based on what you can do – the best you can do – based on the American Petroleum Institute, what other states have done, other democratic nations have done – and leave a provision in there for innovation. Innovation, to me, is different than complete lack of maintenance. If you're trying at something using a different type of parasite and it fails, that is dramatically different to me than sitting back and saying we just won't maintain at all. And I'm not implying here today, and I've made this very clear, I'm not implying that anyone ever did that. But to the extent that there is a simple lack of maintenance, that is very distinct from maintaining in a way and using best efforts based on innovation and technology that you think is moving forward.

MR. NORMAN responded that he understood what she was getting at. And if this passes, he would promulgate regulations and look at prevailing generally accepted standards. Senator McGuire put her finger on a key point, he said, because under a gross tax – where we are now - you get your slice of the gross no matter what happens.

He illustrated this concept with an example in which he is the owner of a mall. The mall has a theatre and he has a profits lease with it. It says in lieu of a fixed rent he will take a percentage of the theatre's profits each year. If the theatre owner hires a kid to run the popcorn machine and he overheats the machine and starts a fire, ordinarily the mall owner would look at a number of things. One of them would be the IRS Code under which the owner of the theatre would be allowed to claim a deduction for that barring something that was intentionally or grossly negligent. An experienced employee wouldn't fall in that category.

Another thing he would look at would be the state corporate income tax and existing partnership agreements. Most partnership agreements do not say that the operating partner is liable for ordinary negligence or making a mistake as opposed to gross negligence or wilful misconduct.

> So gross negligence and wilful misconduct are already covered under here. So presumably I'm thinking in terms of ordinary negligence – is the term that I would use. Because if it's something that goes beyond that, then it gets already filtered and caught up in subsection (6) and never filters down to section (19). But somebody is going to make a decision and say well this is probably not wilful or gross negligence, but still something went wrong here and that's where I envision a question being kicked over to us and then we would look at it and then we would look to the standards and have to apply them.
>
> We can pull in a lot of these codes, but the point I was trying to make is as you pull in these codes, you may make operators - you may constrain their latitude to experiment. And that may or may not be good. But they may think that if we guess wrong and we don't follow strictly the API standards – these are normally recommended practices – that there may be a problem here.
>
> Once we get done with defining as many potential problems and the codes, and then continually updating those as those codes are done, we're still going to be left with a residue of situations that are simply not defined – that are new situations, a first impression – and that's where the cases fall back upon the terms of generally, as I've mentioned, willful misconduct,

gross negligence - or if it's not that, then you look and say what would a prudent operator do under the same or similar circumstances. And another standard that's applied is was the conduct of operations performed in a 'good and workman-like manner.'

I'll give you a case cited that's interesting because it's a side-by-side. The federal fourth was asked to construe a case where there were two side-by-side agreements and in the one, the operator had the common clause that said we will not have any liability to our partners except for gross negligence or wilful misconduct and at the same time, the partners were suing that operator for not behaving as a prudent operator. And the court was able to work through those and reconcile them and there is some brief discussion with citations to scholarly articles in the Rocky Mountain Mineral Law Institute volumes and law review articles concerning application of these terms.

But I think at the end of the day if we don't define these standards, we're going to wind up asking ourselves, 'Was this what a prudent operator would have done under same or similar circumstances – was it done in a good and workman-like manner?'

4:36:27 PM

The cite on the case before me – this particular case is a Utah case, 1990 and the case is Archer v. Grynberg and that citation for that particular reference is 738F-Supplement449....

MR. NORMAN said these issues often go to the courts and the courts have to ask what a prudent operator would do. They work through an analysis. Another phrase they often use is "in accordance with good oil field engineering practices." That would probably be his starting point if he had to find an operator guilty of waste. He'd ask, "Was this accident an act of God or did this come about because the operator failed to employ good oil field engineering practices?" He said he wasn't necessarily looking in the rear view mirror, but he was thinking ahead five or ten years to things that haven't gone wrong yet.

SENATOR MCGUIRE said she was thinking that also.

4:38:23 PM

CHAIR HUGGINS said PPT was a net tax and it had multiple pages of exclusions to include the IRS. He asked if that was accurate.

MR. NORMAN replied that he wasn't thoroughly familiar with the PPT.

CHAIR HUGGINS said that was fine, but he recalled the ELF was on the gross and in the end people said it was broken. But just because it has a title one way or the other doesn't mean one is successful and the other isn't. He thanked Mr. Norman for his comments.

4:39:48 PM
MR. NORMAN added one final point. He supported Ms. Slemons' comments and said that the AOGA is cognizant of the activation of the PSIO coordinator. He mused that a lot of its assigned duties would be extremely useful to his office if the two offices could coordinate, he could avoid having to "staff up" on some of the disciplines he doesn't currently have.

CHAIR HUGGINS thanked him again and asked BP representatives to come forward.

BERNARD HAJNY, Manager, Production Tax and Royalty, BP Exploration Alaska, thanked the committee for being able to testify on SB 80 and introduced Mr. Brune, Director, Resource Development Council, and Tom Williams, BP Senior Counsel for Tax and Royalty in Alaska. He related that Mr. Williams worked for the state in the years before during and after the construction of the oil pipeline and the start of oil production on the North Slope. He was Director of Petroleum Revenue; he is known as the father of ELF by many and personally wrote nearly all of Alaska's oil and gas tax regulations and many of the key statutory provisions of the state's tax laws.

MR. HAJNY said they are tax professionals and would, therefore, offer their perspective on SB 80 as people charged with complying with PPT, not on pipeline corrosion, operation or pigging issues.

4:42:53 PM
TOM WILLIAMS thanked the committee for allowing him to testify.

SENATOR WAGONER stated this bill is about improper maintenance on an oil line, not about taxes. He thought it would be more important for the committee to hear from BP about how the maintenance on this line was handled.

SENATOR McGUIRE interjected that their lawyers wouldn't let them do that.

MR. WILLIAMS resumed his comments and asked them to look at BP's presentation. He said the PPT is working for the State of Alaska and working in three senses of the term.

> First, it's working in the sense that the PPT regulations by the Department of Revenue clarify in several crucial ways how the pieces of the PPT fit together. Taxpayers know what is expected of them when they compute and make their monthly estimated installment payments and in making the annual true up on March 31 of the following year. This is a very complicated tax and it was a lot of work to put the pieces together.
>
> Second, the PPT is working in the sense of providing a major increase in state production tax revenue. For BP, its production tax nearly tripled from about $180 million for the last nine months of last year to over $500 million for those months. This is fully in line with the legislature's expectations about the PPT's revenue effects.
>
> Third, PPT has promised to work in response to the question on my slide that asks, 'Will Alaska attract sufficient investment to stem production decline?' The bulk of the known and likely opportunities in Alaska for investing in production are concentrated in the existing fields – that is investing to slow their decline, to increase the ultimate recovery from them and to discover ways to develop and produce the 20-plus billion barrels of heavy and viscous oil that are known to exist.

4:45:06 PM

> The PPT is significantly better suited for this future than the ELF ever was. In addition, through its credit for capital expansions, the PPT provides an investment incentive that was absent from the old ELF-based tax. Even though the PPT structurally has promise in attracting the new investment that would be needed to deal with the threat of declining production, BP

believes the PPT is suboptimal for the state because the tax rate is too high.

4:46:35 PM
He showed the committee a graph on which Alaska was at the wrong end of the spectrum relative to other major jurisdictions that have oil and gas. He continued:

Investments in Alaska have to compete successfully against opportunities elsewhere and by lowering the PPT rate, Alaska would increase the competitiveness of its investment opportunities. The resulting increase in production will, we are convinced, increase the total revenues from Alaska's property and income taxes and royalties by more than any reduction in the PPT.

[Back to the first page of his handout]
SB 80 and the CS for it would introduce unnecessary uncertainty. We agree with the AOGA testimony given by Judy Brady last week about the overlap between existing terms in the PPT and the new standard of improper maintenance under the bill. I will not repeat that testimony now. But the issue of improper maintenance only governs when the provisions of SB 80 would be triggered.

What I'd like to focus on now is what happens under SB 80 after the trigger is pulled. In other words, imagine a hypothetical future situation that by definition arises from improper maintenance. If you look at page 3 of the CS, beginning on line 24, you'll see subparagraphs....

If you look at beginning at line 24, you'll see three subparagraphs in paragraph (19) that are designated (A), (B) and (C). It's these subparagraphs that specify what happens once the improper maintenance trigger is pulled. For the moment I'd like to skip over subparagraph (A) in order to talk about (B) and (C) because they raise similar questions about sound tax policy. Then I'll come back to (19)(A), which presents an entirely different kind of issue.

Subparagraph (19)(B) disallows any cost determined by the commissioner of revenue to again 'incurred to maintain the operational capability of facilities or

equipment shut down because of lack of or improper maintenance of property or equipment;'

The first thing to note is that the disallowance is not limited to standby costs for keeping up the operational capability of improperly maintained property or equipment. Let me say that line again, because that was an awkward sentence. The stuff that wasn't properly maintained is not just the subject here. What is disallowed is the costs of maintaining shut down facilities or equipment, but the trigger is the improper maintenance of property or equipment – not the same term. To the extent they use equipment, they could overlap, but the different language means clearly that they are not congruent.

CHAIR HUGGINS asked him for an example.

MR. WILLIAMS responded:

Let's say there's an O-ring that was improperly maintained and it bursts a leak. In order to be safe, you have to shut down a whole processing center - a gathering center. It was the O-ring that was improperly maintained. This would disallow the costs of shut down facilities, so it would be the whole gathering center. And that's the point – is (19)(B) would permit disallowance of all costs of standing by and staying ready to resume production, even the portion for facilities and equipment that were properly maintained. I don't think that's what you meant. Certainly, from my point of view, it doesn't make sense. It penalizes spending money....

SENATOR WAGONER said that was not his intent and that is not what it says, but he asked him to go on.

MR. WILLIAMS continued:

If I may, through the Chairman, I'd just like to say that these comments are intended to help.

CHAIR HUGGINS said this is being constructive and they understand that.

MR. WILLIAMS continued:

All I can say is it says you can't get a deduction if spend money to maintain operational capability. If it were up to me, as a former revenue commissioner, I would want to feel to get back up and running as soon as possible after a shut down. But, it doesn't seem to do that.

Subparagraph 19(C) now, similarly disallows costs determined by the commissioner of revenue to be 'incremental operating expenses incurred as a result of operating facilities or equipment at diminished capacity when that diminished capacity is caused by the lack of or improper maintenance of property or equipment.'

Here, again, the disallowance is not limited to this diminished capacity of the property or equipment that was improperly maintained, but includes diminished capacity of any operating facilities and equipment. Again, does this make sense from a tax policy point of view? I don't think so. (19)(C) is effectively saying that if it costs more to run a field with diminished capacity, the state will deter a producer from doing so by disallowing these costs.

I should think that having a part of the field in production, even at higher than normal operating costs is better than having it completely shut down – especially in light of state royalties and income taxes which are both enhanced by keeping the field in production. If anything, (19)(C) should be reducing the PPT as an incentive for keeping as much of the field in production as possible, but it does precisely the opposite instead. Thus, I submit neither (19)(B) nor (19)(C) is sound tax policy for the state and both of them should be taken out of the bill.

This gets me back to paragraph (19)(A) on page 3, lines 24 and 25. Under this subparagraph, any costs determined by the commissioner of revenue to be 'related to the repair or replacement' of the improperly maintained property or equipment are disallowed.

The problem with this new disallowance, from my point of view, is that it double dips on the flat rate 30 cents a barrel disallowance under paragraph (18). Last

week, Judy Brady explained how this 30 cent disallowance proposed by Pedro van Meurs was directed at exactly the same issue that (19)(A) addresses and how the Senate Special Committee on Natural Gas Development then rejected a proposal like (19)(A) twice in favor of the van Meurs' flat-rate disallowance in paragraph (18). I'll not repeat those details now.

Even paragraph (18) went too far, in BP's opinion, and was ill-advised. Other provisions in the PPT law already address and deal with the questions about adequate maintenance and they do so in a fair and reasonable way. If the objective is to make the PPT a better law for the future, then SB 80 should repeal paragraph (18). Instead the CS proposes to compound the error, not only by keeping paragraph (18), but by adding paragraph (19)(A) to double-dip on the same costs. This concludes, Mr. Chairman, our testimony on SB 80 and the committee substitute and I thank you again for this opportunity to be before you.

SENATOR WIELECHOWSKI asked how much more Alaska would make at $50/barrel if it charged the world average for its oil.

MR. WILLIAMS replied that he didn't know what the world average is.

SENATOR WIELECHOWSKI asked if other fees and royalties were paid to private landowners in Texas and Oklahoma.

MR. WILLIAMS said those are included in his figures.

SENATOR STEDMAN asked if the Gulf of Mexico is on his chart.

MR. WILLIAMS replied yes.

SENATOR MCGUIRE said she understands the ELF was a hybrid and that Mr. Williams had studied tax systems all over the world that BP and other companies have entered into agreements on or been subject to as a result of them existing by dictatorship or on the statutes in democracies. Her question related to a statement she made earlier about the ease of taxing the gross amount and figuring out what deductions the state would like to give in a more controlled legislative way to offer incentives. Her concern is that she wants to encourage the companies to

maintain their facilities and operate. She saw good lawyering going on with his arguments on (B) and (C). She said:

> The overall goal is to have safe, good, well-maintained operations in Alaska. So, if you were king for the day, what type of a tax system works the best? And we know we've never seen anything like this. I mean, that testimony is on the record – and Pedro and others have said they've never seen anything like this PPT. Can you answer it?

MR. WILLIAMS answered it's not so much what fits the rest of the world, but how Alaska wants to manage its resources. He related:

> When I was commissioner, the costs of getting the oil and gas out of the ground were immaterial relative to the value of the oil and gas and a gross tax made sense. The reason we put an ELF in was to take advantage of while it was a very small percentage to have a very high rate on that oil and gas. But over time, what's really available in an economic sense is the margin, you know, after you've got the costs taken out of getting it out of the ground. That's really what's available. You can still say, 'Well, we'll tax on the gross,' but if you do, it threatens to end up leaving oil and gas production in the ground.
>
> And you can look at the 1977 study that I co-authored. It's too long to read; it's a couple hundred pages. It talks about this issue - about a gross tax and its affect on investment and its affect ultimately on production and when you push a field across the break-even point prematurely. And the ELF was the response of the Department of Revenue then. It's very clear. I'm not making this up now with 25 years of hind sight - or 30 years. Heavens! But that system was how it was designed then.
>
> Obviously, since then there were problems that crept in with the ELF. Now, which is the worse set of problems? One of the things that Bernard didn't mention is that when I was director of the Petroleum Revenue Division, I got to administer the separate accounting tax where all these types of deductions entered into the situation. It was the super tax on the net and we made it work. I mean it can be done. And I'm not a rocket scientist. So, I think that there

> are rockets scientists now who are working for the state and advising the state and the administration. And so I have every confidence that they can look and see how we made separate accounting work back then; look and see what the tools are the legislature gave them in the PPT and make this one work, too. And structurally for the future where costs are not immaterial as we look at what are the opportunities – heavy oil, fields are in decline. Those are challenges and this is a better suited structure for that type of future than if you were talking about a brand new province where you just discovered Prudhoe Bay.

5:00:58 PM
SENATOR MCGUIRE asked if he believed the existing statute that gives the standard for fraud and gross negligence covers the hypothetical situation, and the alleged situation of no maintenance or improper maintenance, that has been described without adding more clarifying language.

MR. WILLIAMS said he couldn't form an opinion because he didn't know enough of the facts. Nothing now indicates it was gross negligence; so BP thinks it is entitled to take a deduction. It doesn't rise to the level of willful misconduct.

CHAIR HUGGINS asked him to think about SB 80's retroactive date back to April 2006 and how it relates to ex post facto and federal laws.

5:03:13 PM
SENATOR WAGONER stated that it looks like they are letting themselves be dragged back into a debate on PPT and not just this amendment to it. He reminded them that PPT, boiled down to its lowest concept, was credits for exploration and new production.

> We never intended - through PPT - there was never discussion on the PPT legislation – and I sat through most of it and I know Senator Stedman did. You sat through a lot of it – never anything discussed or brought to the committee about a maintenance item of this size and of this expense. Just to add one other thing. We've all got a letter from Don Bullock addressing your question and I've already read that.

SENATOR STEDMAN mentioned that at some point he wanted to talk about Pedro van Meurs' consultation with the administration and

the legislature in dealing with this aging field and the potential costs of up to $2 billion in infrastructure improvements and the effect the PPT would have on that as far as potentially putting the state at a disadvantage if PPT wasn't modified to disallow the 30 cents.

CHAIR HUGGINS said he understood that and they would have that discussion on another day.

MR. WILLIAMS replied that ex post facto laws are prohibited under the federal constitution, as well as the state constitution. An ex post facto law is a law that changes the legal effect of an action or an omission. Sometimes in a criminal context, it means the sentence or fine is changed after the act. Usually it means a specific fact, act, omission or person is in mind. The closer to the action, the easier it is for an ex post facto law to be found.

The question of due process is raised in making an act retroactive. If a law is made retroactive to an earlier date in the same year, that doesn't offend due process. If it's a general law, like the PPT that didn't have any specific person or event in mind – that's when due process principles would apply. The farther back in time you go with legislation, the higher the risk can become of having a due process issue. He summarized that an ex post facto law is about specifying who or what you are trying to change the rule on.

5:07:58 PM
CHAIR HUGGINS asked if SB 80 is a violation of ex post facto law.

MR. WILLIAMS replied that he thought there was a serious risk that it is an ex post facto law.

CHAIR HUGGINS asked Mr. Mintz's opinion.

ROBERT MINTZ, attorney with K&L Gates, said he is working with the Department of Law and the Department of Revenue on production tax matters. His understanding of the constitutional prohibition of ex post facto laws is that they are limited to criminal penalties and don't apply to civil law. He agreed with Mr. Williams that due process is a civil law issue.

He stated no law absolutely prohibits retroactive changes. Retroactive changes to taxes, in particular, have generally been upheld in court. Courts have said as long as you don't go too

far in the past that there is no due process problem, but he didn't know how far back you could go. He thought it more likely that the change discussed in SB 80, if enacted now, would be upheld. However, he said:

> Mr. Williams, I think, was also kind of focusing on a slightly different issue, but – which might also have due process ramifications. And that is when the legislature makes such a change, are you really focusing on a particular event, a particular individual entity, and that could be somewhat problematic.
>
> I wouldn't view it that way. Firstly, what I think it was Senator Stedman a few minutes ago explained that when the legislature was looking at issues such as gross negligence, what costs would be deductible under the new law. It hadn't necessarily focused on the question of the major cause of an event that might be due to some sort of failure to observe industry practices. So, I think that the legislature should be cautious about making changes in the law, particularly retroactive changes that are targeted at a particular entity or a particular event, but I wouldn't view it that way here. To me it seems that basically the legislature has become more educated about some of the issues and some of the factual situations that might arise under the law and there may be a gap in the way that the current law deals with some situations – or there may be policy questions that were not clearly before the legislature's – that the legislature hadn't focused on when it was originally considering the legislation. And from that standpoint, it's perfectly legitimate to become informed based on more recent events and for the legislature to consider what the appropriate policy is based on the additional information.

5:12:49 PM
SENATOR WAGNER read a memo from Don Bullock, legislative counsel, dated February 26, 2007, into the record as follows:

> 'You asked whether enactment of SB 80 would violate the prohibition against ex post facto laws in the United State and Alaska Constitutions because of the disallowance of certain deductions applied

retrospectively to April 1, 2006, the effective date of the PPT.' And then he said, 'The answer is no.'

5:13:31 PM
SENATOR MCGUIRE added for clarification that the committee is discussing the specific case of BP only because it has been described or alleged in the news. But what the committee is generally discussing is what would happen to any company that failed to maintain, properly or at all, any line.

So, to be clear, I don't regard this bill as a specific response to a specific situation, but rather a recognition that an allegation, if true, could occur in the future - might have occurred - and we should address it.

5:14:36 PM
CHAIR HUGGINS said:

I do not want to allow the people of Alaska to be exploited. My take is much different than yours. I've got to say that in all candor. I mean I think this is event-driven. My good friend, Meryl, there – we were talking about it today – about BP – and, you know, taking the citizens of Alaska based on the event that happened. So I just had to say that in all candor. That's my take on it. It's different and that's just the way it is.

SENATOR MCGUIRE responded that it certainly got the conversation going.

There being no further business to come before the committee, the chair adjourned the meeting at 5:15:15 PM.