

**ALASKA STATE LEGISLATURE  
SENATE RESOURCES STANDING COMMITTEE**

October 26, 2007

1:45 p.m.

**MEMBERS PRESENT**

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

**MEMBERS ABSENT**

All members present

**OTHER LEGISLATORS PRESENT**

Senator Lyman Hoffman  
Senator Joe Thomas

**COMMITTEE CALENDAR**

SENATE BILL NO. 2001

"An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to the issuance of advisory bulletins and the disclosure of certain information relating to the production tax and the sharing between agencies of certain information relating to the production tax and to oil and gas or gas only leases; amending the State Personnel Act to place in the exempt service certain state oil and gas auditors and their immediate supervisors; establishing an oil and gas tax credit fund and authorizing payment from that fund; providing for retroactive application of certain statutory and regulatory provisions relating to the production tax on oil and gas and conservation surcharges on oil; making conforming amendments; and providing for an effective date."

HEARD AND HELD

**PREVIOUS COMMITTEE ACTION**

BILL: SB2001

SHORT TITLE: OIL & GAS TAX AMENDMENTS

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

10/18/07	(S)	READ THE FIRST TIME - REFERRALS
10/18/07	(S)	RES, JUD, FIN
10/19/07	(S)	RES AT 9:00 AM BUTROVICH 205
10/19/07	(S)	Heard & Held
10/19/07	(S)	MINUTE(RES)
10/20/07	(S)	RES AT 8:00 AM BUTROVICH 205
10/20/07	(S)	Heard & Held
10/20/07	(S)	MINUTE(RES)
10/21/07	(S)	RES AT 1:00 PM HOUSE FINANCE 519
10/21/07	(S)	Heard & Held
10/21/07	(S)	MINUTE(RES)
10/22/07	(S)	RES AT 11:30 AM BUTROVICH 205
10/22/07	(S)	Heard & Held
10/22/07	(S)	MINUTE(RES)
10/23/07	(S)	RES AT 9:00 AM BUTROVICH 205
10/23/07	(S)	Heard & Held
10/23/07	(S)	MINUTE(RES)
10/24/07	(S)	RES AT 10:00 AM BUTROVICH 205
10/24/07	(S)	Heard & Held
10/24/07	(S)	MINUTE(RES)
10/25/07	(S)	RES AT 10:00 AM BUTROVICH 205
10/25/07	(S)	Heard & Held
10/25/07	(S)	MINUTE(RES)
10/26/07	(S)	RES AT 1:30 PM BUTROVICH 205

**WITNESS REGISTER**

MR. RUGGIERO

Gaffney, Cline & Associates

Representing the Administration

**POSITION STATEMENT:** Commented on SB 2001

COMMISSIONER PATRICK GALVIN

Department of Revenue (DOR)

Juneau AK

**POSITION STATEMENT:** Commented on SB 2001

JOHN IVERSEN, Director

Tax Division

Department of Revenue (DOR)

Juneau AK

**POSITION STATEMENT:** Commented on SB 2001

## **ACTION NARRATIVE**

**CHAIR CHARLIE HUGGINS** called the Senate Resources Standing Committee meeting to order at [1:45:24 PM](#). Present at the call to order were Senators Green, Stevens, Stedman and Huggins.

### **SB2001-OIL & GAS TAX AMENDMENTS**

[1:46:24 PM](#)

CHAIR HUGGINS announced SB 2001 to be up for consideration. He said that his intent today is to "sort of close the loop" on any issues that are out there that the administration wanted to discuss or that committee members had on their minds. He started by asking Commissioner Galvin to comment on ConocoPhillips' concern about triggering the floor based on different scenarios.

COMMISSIONER PATRICK GALVIN, Department of Revenue (DOR), said he wanted Rick Ruggiero to provide his comments on how adjusting the floor one way or the other might change the outcome.

[1:47:22 PM](#)

SENATOR WIELECHOWSKI joined the committee. Senators Hoffman and Thomas were in attendance.

RICH RUGGIERO, Gaffney, Cline & Associates, representing the Administration, went to slide 5 entitled "Impact of the 10 Percent Legacy Floor" from the ConocoPhillips presentation dated 10/24/07. Under the second bullet it states that the minimum tax can be triggered by two events occurring. One is high investment and the other is that investment in a low price scenario. He said it's not impossible that that will occur, but it's unlikely that if there's a project with very low prices there would be very high investment. But it could happen.

[1:48:47 PM](#)

Slides 6 and 7 ConocoPhillips ran an example basically assuming a \$50/barrel price. Mr. Ruggiero said roughly they indicate a \$10 operating expense and then they run two different scenarios - one with a \$10 Capex (the equivalent to reinvesting about 25 percent of the otherwise profit) and then they run a case of a \$20 investment. They compared the two and showed that when they are reinvesting 25 percent of their profit in a low price scenario, that the tax they would pay under the ACES 25 percent net profit is greater than the floor at 10 percent applied to the gross revenue. But, he said, when you go to the very high investment case, under the net calculation with the credits

given, the tax would be \$1, but the minimum tax says they have to pay \$5 because of the otherwise minimum in the proposed legislation. He reiterated that they have stated a set of circumstances of low price with very high reinvestment as a situation under which this could occur.

1:50:37 PM

SENATOR MCGUIRE joined the committee.

1:50:50 PM

MR. RUGGIERO said ConocoPhillips also looked at this scenario on a more Kuparuk-wide valuation on slide 8. They ran through the same type of calculation, but using more of the volumes that one would expect in Kuparuk and applying, as they say in the footnote, the prices that are in the PPT Status Report. It indicates that in the potential high investment case, their tax bill under a straight net would have been \$228 million; it also shows their tax bill, because of the minimum, is \$280 million - a \$52 million difference.

He said that ACES offers the immediate write off of the capital. So in the calculation on the right-hand side they have taken immediate write off of the \$800 million.

CHAIR HUGGINS asked if "immediate" means over 24 months.

MR. RUGGIERO replied that the capital gets to be deducted in the year spent.

COMMISSIONER GALVIN clarified that under ACES you can deduct capital expenditures from income in the first year; however the credits in the second part of the proposal are spread out over the 24 months.

MR. RUGGIERO said that in the example they took their full \$800 million immediately, which other jurisdictions might have a 2 - 10 year process in which to write off that capital against production based taxes. He commented that both the PPT and ACES allow very generous write offs for investment.

Coming down through ConocoPhillips' calculation, he explained, that they also subtracted the credits and in the example they take the full 20 percent in that one year. He pointed out that if they have the right credits, they could create an example similar to this that would take them below the minimum line. If you add up the \$800 million and add up the full credits of \$160 million, that's \$960 million. They are actually able to deduct

(even if they go to their minimum number) \$908 million of the \$960 million - or 95 percent of the credit available to them. The other \$52 million would just carry forward to the next year. The loss in that example was their perception of the time value of being able to write that to the next year. Even this example using numbers representative of Kuparuk does not create much of a problem for the minimum, he said.

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SENATOR GREEN asked if he was referring to the same scenario under the current PPT or the rewrite.

MR. RUGGIERO replied that this was representative of the current PPT. He explained:

What they have done is they've mixed two things. The current PPT allows the immediate write off of the credit. But PPT doesn't have the 10 percent minimum floor.

SENATOR GREEN said that comparing this example to other jurisdictions of the world isn't as germane as a comparison of it to the original PPT.

[1:56:10 PM](#)

SENATOR WAGONER joined the committee.

COMMISSIONER PATRICK GALVIN, Department of Revenue (DOR), added the question of how realistic it is that the state will actually face this type of scenario when you look at the North Slope average of about \$14/barrel Opex plus Capex and that legacy fields are on the lower end of that average is low. The low level assumption on slide 7 starts higher than prices they are experiencing now by a significant amount and they wouldn't be affected by the floor. Costs would have to go up to \$30/barrel for the two, which is more than twice the current reported amounts at a \$50 price.

[1:58:50 PM](#)

SENATOR WIELECHOWSKI said the testimony he heard from the oil companies was very compelling - that the gross minimum really does have an impact on their decisions. The next few pages of the presentation show how the gross minimum makes a number of fields uneconomical. He wanted to hear Mr. Ruggiero's opinion on that.

MR. RUGGIERO clarified that they are referring to slides 12, 13 and 14 from ConocoPhillips' original presentation. He gave some background saying that from his experience, normally in the public forum three things come into play in presenting economics: one has to do with the size of the reserves as modified by the recovery factor as modified by the overall production profile, a market price and an expected Opex cost, as well as the Capex to develop it. Traditionally he would present conservative cases in each of those. ConocoPhillips didn't indicate what price they used. However, their previous examples ran a very conservative \$50 price and he supposed that flowed through to these examples.

Second, one of their fields is similar to field A, but with a different reserve figure, which could be the result of a different interpretation of the recovery factor. In slide 13, a spread of prices from \$40 to \$60 is presented with conservative volumes and costs and indicates that at this range they have some vulnerability. He deduced that a problem with the floor might happen closer to the \$40 figure.

[2:04:46 PM](#)

COMMISSIONER GALVIN said slide 14 shows that under PPT all the projects are economic other than projects 4 and 6. Slide 13 shows that projects 4 and 6 are the two that have data points of \$40, \$50 and \$60. He supposed that the projects that are above the black line at \$50 are considered economic and below \$50 marginal. He said the slides are all a reflection of ConocoPhillips's risk assessment in making investment decisions and they chose to characterize that assessment very subjectively.

[2:09:00 PM](#)

SENATOR STEDMAN asked if the new commissioners had an opportunity to look at the banded range that was discussed in the old PPT presentations. He said the legislature spent a lot of time trying to stay out of that range with progressivity, in particular, to not impact their capital budget process. He wanted to know if those numbers had now moved upwards substantially.

COMMISSIONER GALVIN replied they hadn't gone back and looked at those discussions. They have primarily looked at the question of how much investment is needed to bring the decline curve back up.

[2:10:30 PM](#)

CHAIR HUGGINS said his motivation in asking the original question is to close the loop and decide whether the scenarios are valid or not and if the state can live with those unintended consequences. He then said the committee would take up the questions that were asked by the Alaska Oil and Gas Association (AOGA).

[2:12:05 PM](#)

AOGA Question 1:

Clarify the department's ability to use joint interest billings (JIBs) as a starting point for audits.

COMMISSIONER GALVIN explained that the current statute dealing with lease expenditures has fairly detailed subsections that describe how the department should use JIBs in determining what lease expenditures are allowed and what shouldn't be. ACES changes the obligation for the Department of Revenue (DOR) to define the allowed expenditures.

From listening to his auditors and people who are writing the regulations to implement the PPT into the audit process, he found that although joint interest billings are a key component in finding what costs have accrued, they are a representation of agreements between the parties, not a representation of compliance with the statute and regulations. Current statutory language provides a requirement that JIBs are one of the primary drivers in establishing the appropriateness of a deduction and he wanted to reshape that section so it is properly identified as one of the components of making the determination. The question he had to answer is what specific authority exists in the bill that recognizes the roll of JIBs in that determination process.

He said the language he came up with was on page 42, line 11, of the bill. It lists the components and references an operator is allowed to bill a producer that is not an operator and it says how the department shall consider joint interest billings in determining lease expenditures. He said this language exists in current statute, but it is being moved to a different spot.

CHAIR HUGGINS asked if AOGA's concern was ill-founded.

COMMISSIONER GALVIN replied yes.

[2:16:31 PM](#)

AOGA Question 2:

Why is the specific authority given to the department for using JIBs being removed in ACES? JIBs appear to be an excellent starting point (given the fact that they've been audited by partners in a project) for audit purposes by DOR. If this authority is removed by ACES when it is specifically now authorized, on what basis does DOR believe it will be allowed to use them?

[2:16:44 PM](#)

JOHN IVERSEN, Director, Tax Division, Department of Revenue (DOR), explained that this question is posed to section 1 of the bill and the intent of this provision doesn't have anything to do with interest; it only affects the statute of limitations and expresses what is already in regulations regarding retroactive adjustments. Current regulations have an express reference to lease expenditures and that is in 15 AAC 55.820.

[2:18:53 PM](#)

Question 3:

Section 1 "confirmation by clarification of the long-standing interpretation of AS 43.05.260 by DOR relating to limitation of assessments for the production tax on oil and gas and conservation surcharges on oil". Why is it necessary to confirm this interpretation? Are there matters currently being adjudicated which would be impacted by this new "confirmation" and if so, what is the nature of those? Why isn't the regulatory language in 15 AAC 55.200 sufficient and what is the practical effect of AS 43.55.075(b) in the ACES legislation? Why does the department feel it's necessary to extend the statute of limitations from three years to six? Three years is used for all of tax structures in the state, so what is it about PPT that requires an additional three years?

COMMISSIONER GALVIN said this question is related to the timeline that is very complex in terms of the returns a company provides to the department, the interrelated returns that they are filing for the federal government as well as those that are connected to their partners. There is a lag in the time when those issues are resolved between the partners, the federal government and ultimately with the state - and there is likelihood of adjustments as a result of the resolutions. Recognizing that each one of these things could drag out some period of time, he wanted enough time to capture all the possible changes in the underlying discussions so that the state's statute of limitations would not force the department to take a premature position.

CHAIR HUGGINS asked what the current lag factor is in the current audit process.

MR. IVERSEN replied it depends on the taxpayer for one thing. He was doing one audit from as far back as 2003 and others from 2004 and 2005. He said that taxpayers sometimes cooperate by waiving time so they can get things done and so the department doesn't have to do a jeopardy assessment.

COMMISSIONER GALVIN followed up that the audits Mr. IVERSEN is referring to are under the previous tax system. They recognized the net tax would need the same number of auditors, but of a significantly higher level of expertise. The answer to the question of what lags the department has in the net tax-related audits is that there are none, because it has just started doing them.

[2:23:20 PM](#)

SENATOR WIELECHOWSKI said he has heard deep concerns about the auditing issue and he wanted assurance that the state could compete with the oil companies in auditing so it gets its fair share.

COMMISSIONER GALVIN assured him that with the ACES requirements and the rest of tools he is asking for, he has a high degree of confidence that the department will be able to insure maximum compliance. He will know within a couple of years if he needs additional help and this administration recognizes that challenge and will do everything it can to meet it.

[2:27:30 PM](#)

SENATOR WIELECHOWSKI said he keeps hearing about a 10 percent discount rate that the oil companies have and sees profit margins that are much higher than that and he is wondering if that needs to be tweaked. He said that was one of Dr. van Meurs recommendations.

COMMISSIONER GALVIN responded that was a legitimate area of inquiry and they are looking at how other places do to insure compliance and make sure the system doesn't inherently incentivize under reporting of income. He is on the right track by comparing what a company evaluates in terms of their cost of capital versus what they are going to have to pay.

He said if there is a good faith disagreement, you could end up in a situation where you are penalizing someone for exercising their right to disagree.

CHAIR HUGGINS asked MR. IVERSEN to describe the other mechanisms that would kick the interest rate up.

MR. IVERSEN replied under the general powers of the commissioner of Department of Revenue (DOR), in addition to the 11 percent rate on the annual payment that is due, there are penalty provisions for underpayments and those vary on the level of culpability. The first section of AS 43.05.220 sets a 5 percent penalty for every 30-day period up to 25 percent in the aggregate based on the amount of underpayment for under-filing or not filing. Section (b) adds another 5 percent of the unpaid amount for negligence or intentional disregard of a law or regulation without intent to defraud on top of that. A civil fraud, provision (c), has a 50 percent of due tax or \$500 whichever is greater. In addition there are some criminal penalties in AS 43.05.290 and go as high as a class C felony.

[2:30:47 PM](#)

SENATOR WAGONER said he heard from one company that its total capital investment in Prudhoe was \$19.5 billion which pencils out to about \$1.50/barrel of all the barrels that have been produced since they started producing oil out of that field. He asked if there is a rule of thumb to come up with its Opex.

MR. RUGGIERO replied that it would have to do with the type of field it was and the type of recovery it is under, location and environment et cetera. There are a lot of variables to come together to come with an average over the entire period. He said for a very long duration they were operating in a \$20 - \$25/barrel world and he thought the DOR could find that cost structure, which he could use as a surrogate to average out the Opex. He thought they could come up with a spread that could be split between the companies.

COMMISSIONER GALVIN reminded Mr. Ruggiero in that most other places the Department of Revenue could get that information, but not in Alaska because it wasn't part of the tax system.

[2:33:15 PM](#)

SENATOR WIELECHOWSKI said it will take a lot more investment to pull out the heavy oil and extract the significant resources that are left and he asked Mr. Ruggiero if he sees a lot of money made in Alaska staying here or going outside and if he is seeing it go outside, how could we capture more.

MR. RUGGIERO replied from outside looking in - money leaving - BP and ConocoPhillips reported \$2 billion net profit out of Alaska. You kind of know the working interest percentages of the different players in the fields and how they might related to those two companies and you would expect partners made similar profits. "It's easy to say that based on those 2006 numbers, although there was roughly \$1.9 billion invested, there was somewhere between \$6 billion to \$9 billion exported from the state as profit." He suspected similar figures for 2007.

CHAIR HUGGINS asked the commissioner to deduce that number for future reporting.

COMMISSIONER GALVIN said it would be a very rough estimate looking at ownership patterns, but he would do it until they get better information from the companies.

2:37:21 PM

SENATOR WIELECHOWSKI wanted to capture more of the money that is leaving the state.

MR. RUGGIERO answered that he didn't want to make fiscal policy. However, it's very important to figure out first what the drivers are and what the state is trying to accomplish; reinvesting in legacy fields would be one. There are a lot of moving parts that have to be considered.

SENATOR WIELECHOWSKI asked the department to explore that question a little bit more.

SENATOR STEDMAN said back when they were working PPT last year they had presentations by EconOne that took the gross revenue in a couple different years and broke it out into its component parts. He is not personally too excited about or interested in profit numbers from the ConocoPhillips, Exxon and BP.

What I'm interested in is where is the cash to the state and what's our cut. And when we get to looking at the federal government take, the state take and then the industry, I think we can get derailed very easily by going down rabbit trails worrying about one particular company's profit margins versus another one. It's irrelevant. We need to pay attention to the state take and make sure we get that balance correct. And as far as how do we keep the money in the state, we spent weeks and weeks on it and it's the credit. You make it a financial inducement for them to

reinvest the money versus send it back to the home office to be allocated around the world. So we have the mechanism in place.

And I think the other day the same subject came up and we can go back into our EconOne presentations and pull some of that data out and maybe update it for the last fiscal year. But there is no surprise that the Prudhoe Bay is a very profitable oil field. It's the biggest oil field in North America. It's 30 years old under different price regimes when it was put in and to the earlier question I asked you, Mr. Commissioner, I think, the number that was used on the upper band of their targeted investment modeling was \$40/barrel oil. And the reason I ask it is because now we seem to be - you know that doesn't seem to be the upper band and my concern is that the industry doesn't just move that number around to suit the particular presentation in front of them or bill in front of them - that we actually trying to get as accurate information as we can.

But again the fundamental issue in front of us is the state take and is it fair.

COMMISSIONER GALVIN said they would look at the numbers closely in the Finance Committee.

[2:42:16 PM](#)

CHAIR HUGGINS encouraged them to look at the ramifications of hauling diesel fuel, because DOTPF thinks upkeep of the road would cost \$2 million for 100 vehicles a day and a stoplight outside Wasilla was estimated to cost \$1.5 million. A greater concern is one crash - one fire - safety sorts of things or assuming one plant in Fairbanks goes down and they have to haul in from Kenai.

[2:43:58 PM](#)

SENATOR WAGONER said any diesel going to the Slope comes out of Kenai, but it would be piped to Anchorage and "taken off the rack there."

COMMISSIONER GALVIN said the issue is multi-faceted, because on one had if the state allows the deduction the cost of building the low sulphur diesel topping plant, the state is basically contributing \$115 million to \$150 million to that plant. It will take the ability of another competitor out of the competition to

create the same product and sell it to them. He agreed that the state had to consider all the costs associated with it - and the trucks driving up and down the road should be one of those.

2:46:38 PM

CHAIR HUGGINS said that the DOR is bound by some IRS requirements about what can be shared and he asked if DOR has those same bounds or does it get information that would cause it to be bound.

MR. IVERSEN replied the state has very strict confidential requirements to get access to any federal tax information.

COMMISSIONER GALVIN said those requirements would apply to any state agency.

MR. IVERSEN said they are very careful.

2:50:18 PM

SENATOR WIELECHOWSKI went to the Chevron risk/economic analysis indicating that taxing the upside can discourage investment and said it was a compelling argument; he asked him to comment on that theory in general.

MR. RUGGIERO responded that Chevron out of all the oil companies did the best job of showing how its decision making is done by lying out the five different pieces of information and then running them through the expected monetary valuation (EMV) calculation - in essence you're looking at how much a company risks if it has failure versus how much you can make if you have success. One of the things you consider with success is if you will have a low range of success, medium or very high very successful project. One thing they mentioned is that depending on what you do with the fiscal if you just treat one end of it which is at the high end, and you reduce that, it just becomes calculus at that time and it just flows through the numbers and spits out an answer at the other end.

But depending on what you do within your system, for example giving dry holes an immediate write off of investments and credits, especially on the low case, can actually raise the numbers. So, in that representation they chose to show both ends.

SENATOR WIELECHOWSKI asked if their analysis caused him to think there is enough protection in ACES.

MR. RUGGIERO said he hadn't done that type of the detailed comparison between A and B.

COMMISSIONER GALVIN reminded them that ACES is only at the beginning of this process and in the first committee. One of the things they need to keep in mind with regard to adjustments is if the upside is being affected or the downside - or if they are affecting both.

[2:54:45 PM](#)

SENATOR STEDMAN said Marianne Kah, Chief Economist, ConocoPhillips, last year did very good job of going over the capital budgeting process dealing with their banded targeted rates and what happens in their process if the state puts in some changes within the tax structure that kicks in substantially higher than their high rate. The bottom line is that it didn't come into the realm of price probability and it didn't affect their decision making very much.

COMMISSIONER GALVIN said he would be sure to go back and look at those materials.

There being no further business to come before the committee, CHAIR HUGGINS adjourned the meeting at [2:56:24 PM](#).