

ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE

February 15, 2010

1:05 p.m.

MEMBERS PRESENT

Representative Mark Neuman, Co-Chair
Representative Craig Johnson, Co-Chair (via teleconference)
Representative Bryce Edgmon
Representative Kurt Olson
Representative Paul Seaton
Representative Peggy Wilson
Representative David Guttenberg
Representative Scott Kawasaki
Representative Chris Tuck

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

HOUSE BILL NO. 308

"An Act relating to the tax rate applicable to the production of oil and gas; relating to credits against the oil and gas production tax; and relating to the period in which oil and gas production taxes may be assessed."

- HEARD & HELD

HOUSE BILL NO. 217

"An Act relating to the tax applicable to the production of natural gas used in the state as fuel or feedstock in producing a manufactured end product."

- SCHEDULED BUT NOT HEARD

PREVIOUS COMMITTEE ACTION

BILL: HB 308

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(s): REPRESENTATIVE(s) JOHNSON

01/19/10	(H)	READ THE FIRST TIME - REFERRALS
01/19/10	(H)	RES, FIN
02/08/10	(H)	RES AT 1:00 PM BARNES 124

02/08/10 (H) Heard & Held
02/08/10 (H) MINUTE(RES)
02/10/10 (H) RES AT 1:00 PM BARNES 124
02/10/10 (H) Heard & Held
02/10/10 (H) MINUTE(RES)
02/15/10 (H) RES AT 1:00 PM BARNES 124

WITNESS REGISTER

DAN DICKINSON, CPA, Consultant
to the Legislative Budget and Audit Committee
Anchorage, Alaska

POSITION STATEMENT: During the hearing on HB 308, provided a PowerPoint presentation and answered questions.

ACTION NARRATIVE

[1:05:50 PM](#)

CO-CHAIR MARK NEUMAN called the House Resources Standing Committee meeting to order at 1:05 p.m. Present at the call to order were Representatives P. Wilson, Guttenberg, Edgmon, Olson, Tuck, Johnson (via teleconference), and Neuman. Representatives Seaton and Kawasaki arrived as the meeting was in progress.

HB 308-OIL AND GAS PRODUCTION TAX

[Contains discussion of HB 337]

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CO-CHAIR NEUMAN announced that the only order of business is HOUSE BILL NO. 308, "An Act relating to the tax rate applicable to the production of oil and gas; relating to credits against the oil and gas production tax; and relating to the period in which oil and gas production taxes may be assessed." [Before the committee was the proposed committee substitute for HB 308, labeled 26-LS1328\E, Bullock, 2/5/10 ("Version E").]

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DAN DICKINSON, CPA, Consultant to the Legislative Budget and Audit Committee, noted that his presentation today is a follow-up to his 2/8/10 presentation in which he discussed two of the six changes to current statute that are proposed by Version E of HB 308. He said he will be discussing the other four proposed

changes as well as some of the issues raised by the Department of Revenue (DOR) in testimony before the committee on 2/10/10.

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CO-CHAIR NEUMAN recalled Co-Chair Johnson's 2/10/10 statement to the Department of Revenue in which he advised that his intent as sponsor of HB 308 is to create more jobs and investment in Alaska, and that he will continue moving the bill forward while agreeing with the administration on some things that are similar between HB 308 and the governor's bill [HB 337] and disagreeing on other things.

MR. DICKINSON responded that he will address the issues as he comes to them in his presentation. He drew attention to slide 3 and noted that it depicts where the proposed changes can be found in Version E. He said many of the changes are technical; however, six are substantive and those are the changes he will address.

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MR. DICKINSON began his presentation with discussion about the proposed change that interest would not be due on retroactive regulation changes prior to those regulations being implemented [slide 5]. He pointed out that both production tax and royalty tax are due on the last day of the month following the month of production [AS 43.55.020(a)], and this is the cash flow that keeps the state going.

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MR. DICKINSON, in response to Co-Chair Neuman, further explained that every 30 days the state can change whether a royalty is in-kind or in-value, but that change is forward-looking by, he believes, 120 days. In response to Representative Guttenberg, he said the state has changed from royalty in-value to royalty in-kind about 20 times on the North Slope over about 33 years, but he is unsure about Cook Inlet. In response to Representative Seaton, he said the royalty is exempt from taxation regardless of whether it is in-kind or in-value.

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MR. DICKINSON returned to his presentation and noted that the amount of tax that is due for a particular month can change at a later date because of a number of things, such as a retroactive

revision of tariff. If additional tax is due because the value of the oil changed, the taxpayer must pay that tax plus interest from the time that original tax payment was due. It is explicit in law that in settlement the Department of Revenue can compromise on the tax amount without having to take the settlement before a judge. The department can also settle in regard to whether there will be a penalty for tax underpayment. However, current law does not mention interest and therefore the department cannot change the amount of the interest due.

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MR. DICKINSON explained that the 2007 act, Alaska's Clear and Equitable Share (ACES), made several major changes and very explicit directions were given to the Department of Revenue to write regulations [slide 6]. One major change related to oil transportation - the cost of shipping oil through the Trans-Alaska Pipeline System (TAPS) and on tankers. Under ACES, the transportation cost is the lower of actual cost or what the Department of Revenue determines as reasonable cost [AS 43.55.150]. However, the department has not yet said how it will calculate those reasonable costs. Therefore, a taxpayer that is currently deducting what it pays for TAPS might owe more money once the department publishes its new regulations for the transportation standard.

MR. DICKINSON, in response to Co-Chair Neuman, expounded further. Under the change proposed by both HB 308, Version E, and the governor's bill, a taxpayer would not owe interest on additional tax due as a result of the new transportation regulations. However, if this change is not made, a taxpayer will be required to pay interest when those regulations are finally implemented.

MR. DICKINSON continued his presentation, stating that there is a similar dynamic in regard to the upstream or lease costs; transportation being the downstream cost after leaving the lease. Under ACES, a lease expenditure is not deductible unless it is specifically allowed by Department of Revenue regulation [AS 43.55.165(a)]. The regulations affecting 2007 were just adopted this last quarter, and taxpayers must now look back over the past two years to see if they owe additional tax as a consequence of these new regulations.

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REPRESENTATIVE SEATON inquired whether that was limited by the standard deduction methodology so that those regulations are really only going to be currently applicable because the lease expenditures were limited by the percentage increase; thus, the regulations were not really necessary at that time.

MR. DICKINSON replied that for the limitations under [AS 43.55.165](j) and (k), a taxpayer would clearly not be affected by the definition for 2007, 2008, and 2009 because this requirement that the department define it by regulation was not there under the rules for 2006, the year that laid the base and which increases by 3 percent a year.

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MR. DICKINSON returned to his presentation and explained that the production tax is a yearly tax. Twelve estimated payments are made and these are trued up in March. Many of the ACES reforms were affective in the middle of the year, which required that two half years be melded into a single year. It took the Department of Revenue several years to write the regulations on that. There were also new report requirements [AS 43.55.030 and AS 43.55.040] and there were new rules for exploration credits [AS 43.55.025].

MR. DICKINSON noted that slide 7 summarizes the Department of Revenue's status for each of these projects. The reporting requirements were published in May 2008, effective June 2008. The next project was the changing of 35 sections of the regulations which included the mid-year regulations; those were adopted in September 2009 and became effective in October 2009. The regulations for exploration credits were adopted in November 2009, effective December 2009. Regulations regarding deductible lease expenditures were adopted in January 2010, effective February 2010. Regulations regarding reasonable cost of transportation have not yet been adopted, but the public draft was released in February 2010. There are also a number of other projects, some which will have retroactive effects, and some which will not; of these major projects, a period of nearly two years has gone by in which the taxpayers have not necessarily known what their obligations are.

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MR. DICKINSON said Governor Parnell's proposal would require that interest be waived by amending AS 43.55.020(i) [slide 8]. Two things make the governor's proposal more explicit than HB

308, Version E, and committee members may want to consider the governor's language to ameliorate the language of Version E. The first is the recognition that just because there are no regulations does not mean there are no rules; a taxpayer still needs to consider what tax would be owed under existing rules. The second is that Governor Parnell's proposal is explicitly retroactive.

REPRESENTATIVE P. WILSON understood Mr. Dickinson to be saying the tax goes back retroactively, but the interest does not.

MR. DICKINSON answered correct. Under both of these approaches, the tax is always going to be retroactive and the amount of money owed is not going to change; it is just who is bearing the interest for it.

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MR. DICKINSON continued his presentation and advised that if the governor's approach was adopted by HB 308, Version E, the restructuring [of AS 43.05.225] would not be required and half the sections in the bill would disappear because all of references would no longer need to be changed [slide 8]. He pointed out that currently under Section 6 of Version E, page 3, line [4], all the changes would be to subsection (a), but when AS 43.05.225 itself was changed, the (a) was not introduced, which may cause confusion in how that all ties together.

MR. DICKINSON, in response to Representative Seaton, stated that the governor's bill just deals with the issue of production taxes, but HB 308, Version E, would affect all taxes. In response to Co-Chair Neuman, he explained that the governor's provision would be in AS 43.55 which deals just with production taxes, and HB 308, Version E, deals with AS 43.05 which deals with interest on all taxes.

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MR. DICKINSON, in response to Representative Tuck, clarified that the governor's bill alleviates only the interest due, not the tax that is due. In further response, he said HB 308, Version E, does not waive the other non-production taxes that are due and both HB 308, Version E, and HB 337 deal only with the interest issue.

REPRESENTATIVE TUCK understood that Section 6 of Version E, page 3, line 4, should read "Sec. 43.05.225(a)."

MR. DICKINSON responded correct.

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REPRESENTATIVE SEATON inquired whether both bills would affect the interest that would be due on settlement amounts that have been negotiated for the amount of tax that is due. He further understood that under the governor's bill a waiver of interest on settlements would not be discretionary.

MR. DICKINSON, in regard to the first part of Representative Seaton's question, replied that he thinks this affects settlements and non-settlements the same way. Currently, when there is a settlement of an issue, agreement is reached on the amount due and interest is added on top of that. Mr. Dickinson said that during the seven years when he was the director of the Division of Tax settlements were typically more by the issue than by the dollar amount, and one of the first things that was done in settlement discussion was the identification of the amount of each issue and everyone was aware of the interest that was tagged with it. In a settlement under current law, neither the attorney general nor the Department of Revenue can compromise the amount of the interest, but the amount of penalty and amount of tax due can be compromised.

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MR. DICKINSON, in regard to the second part of Representative Seaton's question, stated that waiver of the interest is not discretionary in both HB 337 and HB 308, Version E. However, there is an important distinction and one thing he would like to talk about is possible upgrades to the governor's language in Version E. Under the governor's proposal the Department of Revenue would be required to make a determination that "the producer made a good faith estimate of its tax obligation in light of the regulations then in effect when the payment was due" [slide 9]. Therefore, the department must first make a determination that the taxes were paid in good faith and then the interest waiver automatically follows. Mr. Dickinson suggested that members consider an improvement to the governor's language such that the department would not be required to make a determination of good faith and the interest would just be automatically waived. However, interest would be charged in those cases where the department makes a determination that a taxpayer acted in bad faith [slide 10].

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REPRESENTATIVE SEATON posed a scenario in which a dispute is settled and the producer agrees that it owes the state \$100 million from two years ago, but no interest is due on that settlement amount. He asked whether that would be the discretionary or non-discretionary point that is being talked about by Mr. Dickinson. For example, there would be no reason to pay the full taxes because the producer would know that waiver of the interest in the settlement is mandatory.

MR. DICKINSON responded that there are two parts to the answer. The first part is that this does not change the law as it affects settlements. The attorney general and the commissioner must still approve the settlement of the principal amount and the penalty if they are different than what was assessed. The only case in which the waiver of interest would be required is when the amount in dispute arises as a consequence of there not being a regulation in place and the regulation comes in after the fact; thus, a carte blanche waiver of interest would not be the case. Additionally, a timeline is being talked about here. The statutory requirement came in 2007, the regulatory fulfillment came in 2009, and under the current six-year statute of limitations it may be 2012-2013 before an assessment is issued. The interest between 2010 and 2013 is not changed at all by these rules. All that is changed is the application of the interest before the rules were in place up until they came into place. From then on, once the rules are official and known by the taxpayers, it is as if the rule had always been there.

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REPRESENTATIVE SEATON surmised the aforementioned would not apply to Prudhoe Bay or Kuparuk production.

MR. DICKINSON replied that the fixing of costs at 2006 levels will only apply to the lease expenditure issue. The downstream transportation was not affected by that; neither was how the 22.5 percent and 25 percent rates are meshed, nor how the reporting requirements are dealt with.

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REPRESENTATIVE P. WILSON understood the governor's bill would deal only with the production tax, but that HB 308, Version E, would deal with all of the taxes. She asked whether that would

apply only to the timeline between when it started and when the regulations are in place.

MR. DICKINSON answered yes. He said he believes the intent in both bills is only to deal with the issue of when a taxpayer has to file a return and does not know what the rules are. Then there is the question of whether that happens in the cigarette tax or the alcohol tax as opposed to the production tax; so when he used the term "all" he meant the other 20 tax types of the state's 21 tax types.

[1:37:05 PM](#)

REPRESENTATIVE KAWASAKI commented that it seems the committee is taking up a bill that has not yet been calendared. He said he thinks it may be out of order to talk about the governor's bill until the provisions of HB 308, Version E, are addressed and it is known how those provisions would impact the state. He would therefore prefer to stay away from HB 337 until it is before the committee.

CO-CHAIR NEUMAN responded that the Department of Revenue talked to the committee about the governor's bill on 2/10/10. Additionally, members should have HB 337 in their offices because it has been read across the House floor. The point is to look at where there is agreement between the two bills and develop the best legislation to move forward; therefore, Mr. Dickinson looked at the department's presentation and at HB 308, Version E, and is presenting those likenesses and differences.

REPRESENTATIVE KAWASAKI reiterated his discomfort with drawing another bill into the discussion unless it is officially planned to do that.

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REPRESENTATIVE GUTTENBERG, in regard to the good faith estimate language on slide 9, (1)(B), inquired how good faith is defined.

MR. DICKINSON replied that he does not know and an attorney would need to be asked. He said that in some ways he was speaking to this same point when he suggested the improvement to the governor's language [slide 10, second bullet]. He noted that four versions of transportation regulations have come out so far [slide 7] and that the department is considering two very different approaches for these regulations. So, while the taxpayers are familiar with the four versions that have come

out, they are still left with having to figure out which version will be the most likely. The point is that until the department really defines something, there is not really a rule out there.

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REPRESENTATIVE GUTTENBERG stated he was unaware that there were regulations in the past regarding facility sharing [slide 7]. He asked whether there will be impacts on taxes from these regulations.

MR. DICKINSON said that is the exact point. There is currently a rule, but the rule has never mentioned facility sharing. Until that rule is adopted, taxpayers are going to act as if there is not a special rule for facility sharing and that it is just like any other cost. When a law is passed that says the department shall now define by regulation, there is no rule in place until the department actually does so.

CO-CHAIR NEUMAN stated that a taxpayer is acting in good faith when adhering to the rules that are currently in place and a change in the rules that increases the taxpayer's taxes does not negate this; therefore the taxpayer should not have to pay interest.

MR. DICKINSON agreed that that is the intent of the bill.

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REPRESENTATIVE SEATON, in regard to Mr. Dickinson's suggested change to HB 308, inquired whether it would it make sense to say that if a taxpayer has paid its full tax obligation under the rules that existed at the time, then the interest is waived.

MR. DICKINSON responded that that would cover many situations. However, in a situation where a cost is a cost as defined by the department by regulation, there is technically no rule that applies. A lot of time could be spent trying to figure out what rule should have applied. For example, should a taxpayer have looked by analogy to some other section of the regulations, or applied the statute directly, or known the regulations were coming.

CO-CHAIR NEUMAN interjected that under ACES it is up to the Department of Revenue to make the determination that a taxpayer acted in good faith.

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REPRESENTATIVE SEATON stated that there were regulations in place [when ACES passed], so if a company paid its taxes consistent with the regulations existing at the time, then that could be the bar to qualify as acting in good faith.

MR. DICKINSON reiterated that that might make sense in a lot of situations. However, he is asterisking that when the law changed in July 2007, the regulations had been written under prior laws, so it must be determined what pieces apply and how well they apply. For example, Alaska had separate accounting income tax from 1978-1981, but the regulations for that were not written until 1980. In a large hearing on this case in the 1990s one of the things being fought was what rules were in place if the regulations were not there. Conflicts occur because there are two ways to think about something.

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REPRESENTATIVE TUCK posed a scenario in which there are no regulations in place, but a company still pays what it estimates its taxes would possibly be. In this case the interest could be waived under all tax schemes when regulations are implemented at a later date. He asked whether under HB 308 a company that did not make any tax payments would be considered to not have acted in good faith and would therefore owe interest.

MR. DICKINSON said he hesitates to answer because that is getting into attorney areas. However, in general he does not think there is an obligation to follow regulations that have not been properly adopted. This is because not all regulations that get proposed get adopted.

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MR. DICKINSON returned to his presentation and addressed the proposed tax rate tied to resident hire under Section 15 of HB 308, Version E [slide 12]. He explained that this section applies to taxpayers that are subject to the base tax rate of 25 percent under AS 43.55.011(e)(1). Any direct labor that is a lease expenditure would have to be accounted for as being either resident or nonresident by a set of definitions. At the end of the year, the taxpayer could get a tax rebate if its resident hire rate is at least 80 percent. The new effective tax rate would then be somewhere between 20 percent and 25 percent. If an 80 percent resident hire rate is not achieved, the taxpayer's

tax rate would remain at 25 percent. He recommended this provision become effective at the beginning of a year because a change in mid-year would require lots of regulation writing.

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REPRESENTATIVE KAWASAKI, in regard to the third bullet on slide 12, inquired how the accounting of direct labor as resident or nonresident would work in a practical manner. For example, there are many nonresident subcontractors working on what would be considered a lease expenditure deduction.

MR. DICKINSON said he will be addressing this in future slides and that this question is a good point because the production taxpayers comprise less than one-fourth of the actual employees in the oil patch.

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REPRESENTATIVE SEATON understood that the Department of Revenue currently limits what is an allowed expenditure. He asked whether the third bullet on slide 12 would mean establishing a new category and that the state would mandate what the companies put into lease expenditures as well as limit what is put into lease expenditures

MR. DICKINSON replied no, there is no mandating. The rules about what constitutes a lease expenditure have been established by the Department of Revenue. A separate test would then say that the labor in that is classified as either resident or nonresident and the ratio would subsequently be determined. He said he will be dealing with how the labor is defined and how it all fits together later in his presentation.

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MR. DICKINSON returned to his presentation, noting that slide 13 depicts how the resident hire ratio translates into an effective tax rate after the rebate. He said he started at a 70 percent resident hire ratio because that is currently the average rate in the oil patch according to Department of Labor & Workforce Development figures. He explained that the tax rebate would be 0 percent for resident hire ratios between 70 percent and 80 percent. Starting with 80 percent, there would be a 2 percent rebate for every 2.5 percent incremental increase in the resident hire ratio. From a 97.5 percent resident hire ratio to 100 percent, the tax rebate would increase by 4 percent. The

effective tax rate would be calculated by multiplying the rebate amount by the 25 percent nominal [base] tax rate. Thus, for 70-80 percent local hire ratios, the effective tax rate would remain at 25 percent. At an 80 percent ratio the effective tax rate would drop to 24.5 percent and at 100 percent local hire the effective tax rate would drop to 20 percent.

[2:01:18 PM](#)

REPRESENTATIVE KAWASAKI cited the issue brought up by Marcia Davis, Deputy Commissioner of the Department of Revenue, where a company might choose to fire a non-Alaskan to reach a 2.5 percent increment rather than hire an Alaskan as a new employee. He asked why a step approach was used rather than a linear approach.

MR. DICKINSON answered that later in his presentation he will explain why a linear slope would work better.

[2:02:33 PM](#)

MR. DICKINSON moved to slide 14, a depiction of oil industry nonresident workers from a Department of Labor & Workforce Development publication. He said that in 2008, 29.8 percent of the 17,000 workers in the oil industry were out-of-state, which translates to 5,043 out-of-state workers and about 12,000 Alaska resident workers.

MR. DICKINSON provided an example [slide 15] of the impact of the tax rebate derived from the Department of Revenue's [2/10/10] presentation. He pointed out that when a company's resident worker ratio is right next to the line between tiers, an increase in the ratio of just 0.5 percent would have a huge [per employee] tax effect. However, when the ratio is not near a tier line, an increase in the ratio would have a small [per employee] tax effect. This tiered, or step, method makes it difficult to determine what the tax effect will be for a change in the number of resident employees. He said the extreme example put forth in a [2/11/10 Anchorage Daily News] article correctly depicted that the hiring of just one Alaskan would result in a \$30 million tax savings [slide 16].

[2:05:02 PM](#)

MR. DICKINSON provided another example of the impact of the tax rebate. He posed a scenario in which Company C, the hypothetical company used in the Department of Revenue's 2/10/10

example, has 4,500 resident workers for a ratio of 70 percent [slide 18]. The addition of 650 resident workers would bring the ratio to 79.98 percent. This increase would be at no cost to the state because the ratio must be at least 80 percent to receive a rebate. He offered his understanding that the sponsor of HB 308 purposely chose 80 percent because it is significantly higher than the state's current average of 70 percent. He pointed out that his example is expressed as number of workers while HB 308, Version E, is written in terms of hours. Therefore, he has provided an example on slide 19 that uses 2000 hours a year per worker.

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MR. DICKINSON said his purpose in providing these two different examples is to illustrate that a small increase in the worker ratio, even as little as one hour, could result in a large tax rebate, and the opposite could also occur whereby a large increase in the ratio results in no tax rebate. Therefore, Representative Kawasaki was therefore correct in his identification of this problem.

MR. DICKINSON moved to another example [slide 20] in which a large company has 5,200 resident workers [out of 6,500 total workers] for an 80 percent ratio and a 24.5 percent tax rate. If that company increased its ratio to 82.49 percent by adding 162 resident workers there would be no change in its tax rate. He suggested a formula as an answer to this problem. [The formula depicted on slide 21 would be a continuous function with rounding. The rebate would be equal to the tax base (production tax value) times the higher of resident hours divided by total hours or 0.8, less 0.8. That would transform resident hire rates between 80 percent and 100 percent into a series from 0 percent to 20 percent.] He said he has attached "the bottom pieces" in his suggested formula, but that a formula could be run that hits the "tops" or the "middles". Regardless of which piece is used, the point of using the formula is that any extra hour or extra worker will move a company by the same amount.

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REPRESENTATIVE TUCK noted that even if the linear formula is used there would be no tax rebate for increasing the number of resident workers when the ratio still remains below 80 percent. He therefore surmised that it is possible a company converting from nonresident workers to resident might not receive a tax rebate for some time.

MR. DICKINSON responded correct, the 80 percent is a choice that has been made and getting up to that 80 percent would get a company no additional tax breaks.

[2:09:20 PM](#)

REPRESENTATIVE KAWASAKI commented that a carrot is being given to those employers who hire Alaskans but a stick is not being used on those that refuse to hire Alaskans. Could this baseline be lowered, he asked.

MR. DICKINSON replied that a decision must be made on where the baseline is and whether there is a penalty below that or a benefit above. He added that a better way to answer this question is to look at what is really happening in the oil patch and to look at another problem. For example, at a previous meeting the question was raised about whether a company could simply not report its nonresident workers and not apply for a deduction, thereby letting its taxes rise as a result of not taking that deduction but still coming out ahead because of the rebate. The answer to that question is yes.

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MR. DICKINSON provided an example of how this would work for the year 2009 for the entire North Slope using the assumption of a \$10 billion tax base/production tax value (PTV) [slide 23]. Under AS 43.55.011(e)(1), that \$10 billion is taxed at a rate of 25 percent, thus the total tax burden is \$2.5 billion. The maximum possible resident hire rebate on that tax burden would be 20 percent or \$500 million. In 2008 there were 5,000 nonresident workers in the industry at an assumed average wage of \$100,000, for a total of \$500 million in nonresident wages. Not claiming the nonresident wages as lease expense would result in the wages not being deductible, and the tax base would go from \$10 billion to \$10.5 billion, which would increase the tax burden by \$125 million. However, the rebate would drop the tax rate from 25 percent to 20 percent, which would decrease the tax burden by \$500 million. The taxpayer would therefore come out ahead by \$375 million. Thus, setting up a situation where this can occur does not drive companies to hire more Alaskans, which is the point of HB 308, Version E.

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CO-CHAIR NEUMAN pointed out that a large corporation will often form several corporations within itself so that A buys from B, and C buys from D, and D buys from A, and therefore who reports labor costs can get pushed down the line. He said this needs to be kept in mind when looking at the next set of Mr. Dickinson's slides so that the state does not get gamed in this regard.

MR. DICKINSON reviewed four possible solutions that he has discussed with the sponsor to prevent the no reporting of nonresident wages [slide 24]. One solution would be to shift the scale so that resident hire would only swing the tax rate between 24 percent and 25 percent rather than 20 percent and 25 percent. This way, the swing would only be \$100 million, rather than \$500 million, and therefore it would not be worth not reporting nonresident workers in the deduction.

CO-CHAIR NEUMAN interjected that slide 28 lists the largest employers in the oil and gas industry.

[2:16:40 PM](#)

MR. DICKINSON continued his review of solutions, saying that a second solution would be to put out rules that require that any time any labor is included as a lease expense, all the labor from that company must be included. This would address the issue of pass through that was raised by Co-Chair Neuman. However, the problem with putting down more rules is that it results in ever more complex rules to get there, which is not Co-Chair Johnson's intent. A third solution would be to focus on new hires only and provide a specific dollar rebate for every new Alaskan. The problem with this solution is that it does not recognize a company that already has a good Alaska hire rate above a company that does not; so, part of the issue is whether the intent is to focus on new hires versus the overall experience. A fourth solution, given the structure of the industry, would be to have the Department of Revenue commissioner publish the amount of the tax rate each year. This tax rate would be based upon the resident hire ratios of the 10-20 largest employers in the industry that are generating the lease expenditures.

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MR. DICKINSON said his reason for stating "given the structure of the industry" is that he wants to focus on what is really happening on the North Slope, which is that the producers are the taxpayers, but employees are working for the operators and

not necessarily the producers [slide 25]. This is because producers hire an operator to operate the field for them and it is the operator that hires the employees that actually work in the field. Typically, however, much of the field work is done by contractors. According to Department of Labor & Workforce Development numbers, direct employment in the oil and gas industry is [4,055] while indirect employment in oilfield services is [12,875].

[2:19:54 PM](#)

MR. DICKINSON, in response to Co-Chair Neuman, noted that the Department of Revenue's annual summary shows there are 15 entities that file production tax [slide 26]. Twelve of those are filing a zero return or a return for \$10 or \$15 that is based upon the requirement to pay a conservation surcharge of 5 cents for every oil barrel produced. There are really only three large taxpayers and two small taxpayers.

MR. DICKINSON further explained that the structure on the North Slope is in units. On the Prudhoe Bay unit, "ConocoPhillips" produces about 130,000 barrels a day, "BP" produces about 96,000, "ExxonMobil" about 130,000, "Chevron" about 4,000, and some other taxpayers are down in much smaller ranges; "BP" is the operator and passes on the costs proportionately to how much oil each producer is being assigned. The Kuparuk unit is operated by "ConocoPhillips" and "BP" gets about 50,000 of the 80,000 barrels that are produced there each day. "ConocoPhillips, BP, and ExxonMobil" own most of the production from each of the fields. These three majors are not a part of the "Pioneer and ENI" group. "Anadarko" has a piece of the Alpine field. "Chevron" has very small pieces in several fields. Thus, while there are quite a few different fields, the underlying ownership is by three large corporations and those corporations depend upon the operator. The Oooguruk field is operated by "Pioneer" and all the rest are operated by either "BP or ConocoPhillips."

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MR. DICKINSON related that production is about 700,000 barrels per day or about 250 million barrels a year, according to 2009 fiscal data. Cook Inlet produces about 10 percent of that, most of which is in gas. However, Cook Inlet pays less than one-half of one percent of the taxes because under the current production tax law the economic limit factor (ELF) was frozen in place for the Cook Inlet until 2022. Thus, the tax for Cook Inlet oil is

zero and the tax for Cook Inlet gas is about 17.5 cents per thousand cubic feet (Mcf).

CO-CHAIR NEUMAN interjected that at one-half of one percent of the taxes, Cook Inlet production is minimal compared to Prudhoe Bay.

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MR. DICKINSON pointed out that AS 43.55.024 provides a \$1 million per month credit for production that is less than 50,000 barrels per day [slide 27]. Thus, most of the taxpayers in Cook Inlet, as well as the smaller taxpayers on the North Slope, have no production tax obligation other than the AS 43.55.011(i) conservation charge, which is only in the tens of dollars. This leaves the state with three major producers covering 95-98 percent of the taxes and two others picking up the remainder.

MR. DICKINSON, in response to Representative Tuck, said "NS" stands for North Slope and the fields listed on the top half of slides 26 and 27 are North Slope fields. He further pointed out that his statements about who is paying tax and who is not are based purely upon his own estimates because he has not seen the tax returns for any of the companies as that is confidential information. He said he is certain about his conclusions, however.

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MR. DICKINSON directed attention to a list of the state's largest oil and gas industry employers [slide 28]. He said "BP, Conoco, and Chevron" are field operators and are probably the employers of the 4,000 direct employees. All the rest of the employers on the list are oil field service companies. He further noted that this list shows only those employers under the categories of oil and gas extraction and oil field services. There are additional North Slope oil and gas industry employers under the categories called catering and security, engineering, communications, and construction. "ConocoPhillips and BP" will make decisions on which contractors to hire and he therefore surmises that the sponsor's goal with HB 308, Version E, is to make the number of residents in a contractor's workforce an important bid variable. This would be accomplished through the [fourth suggested solution on slide 24], which sets the tax rate by looking at the industry as a whole.

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MR. DICKINSON noted that "Exxon" is the operator of Point Thomson, but is not on the list of the top 100 employers because that field is not yet producing and that corporation is not the operator of any other fields. He turned to slide 39 and pointed out that the Prudhoe Bay field constitutes most of the oil production in Alaska and all of the work being done on Prudhoe Bay goes through to the three largest taxpayers. Kuparuk is the next largest oil producer and all of the work on that field will also go through these three largest taxpayers. He said his point in reviewing this is that the industry-wide work may be best reflected by looking at an industry-wide employment number as opposed to parceling it out between each taxpayer.

CO-CHAIR NEUMAN commented that Mr. Dickinson is talking about a structure that offers a beneficial bid variable to a lot of the support companies.

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MR. DICKINSON, in response to Representative Kawasaki, explained that the Department of Labor & Workforce Development reports employment numbers in ranges. Thus, on slide 28 the two numbers depicted under the column for total employees represent that range; where there are no numbers depicted in that column, the numbers immediately above the blank space are applicable. He added that this information is available in the department's document entitled, Nonresidents Working in Alaska, 2008, that was released in [January 2010].

REPRESENTATIVE EDGMON stated he would like to see a breakdown in the nonresident column [of slide 28] as to how many of those positions could actually be filled by Alaska residents. He surmised that some of those are skilled positions that Alaska's workforce cannot support. For example, a commercial fisherman from Alaska could work as a laborer but not as a chemical engineer. This type of breakdown would help show the potential for converting these jobs from nonresidents to residents.

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REPRESENTATIVE GUTTENBERG said he has worked on the North Slope most of his life and he does not at all read HB 308, Version E, as a jobs bill. The bill is based on total work hours and has nothing to do with wages. It would use state revenue to buy jobs for Alaskans plus give the companies hundreds of millions of dollars, all without knowing whether that money will be used

to put more oil into the line or provide legacy jobs. There is nothing that says those jobs will be high-paying, high-skilled, generational legacy jobs. While he recognizes that the bill will come back with major changes, there is nothing that says jobs are needed on the North Slope. Giving money to the industry to hire Alaskans is not the right track because it would be a subsidy for existing jobs, he opined. The bill would not create new jobs or new investment. Industry says Alaskans are too expensive to hire, therefore if industry receives anything it should be the difference in cost between hiring a resident versus a nonresident. He cited examples for why he believes the bill would create inefficiencies rather than efficiencies, and said he thinks the bill could be written in a whole different way that would better reflect the real economic situation.

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REPRESENTATIVE SEATON said it seems there would not be any impetus for 12 of the 15 companies to hire Alaskans given that they have no production tax liability. He surmised that this provision is therefore targeted only at the three payers of production tax.

MR. DICKINSON agreed the provision is targeted at the production tax. The operators are the critical link between the taxpayers and the contractors and that three-step removal is important.

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REPRESENTATIVE TUCK, in regard to resident versus nonresident hire, presumed that this would be for workers that have to do with particular leases.

MR. DICKINSON answered that generally to be qualified the labor must be a lease expenditure.

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REPRESENTATIVE TUCK inquired whether catering and security, engineering, transportation, communications, and construction are positions that are typically held with lease expenditures [slide 28].

MR. DICKINSON responded yes. Such positions in the oil patch are deductible lease expenditures. While these services can

happen in different industries, in Alaska they tend to happen predominantly in the oil industry.

REPRESENTATIVE TUCK surmised that there is potential for this provision to reach into other industries that are not included on slide 28.

MR. DICKINSON replied yes, this would make them part of that total equation.

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CO-CHAIR NEUMAN requested the help of the Department of Labor & Workforce Development in answering both Representative Edgmon's question and Representative Guttenberg's concerns. Given the economic multiplier effect, he presumed that the impact of the local hire provision could be widespread.

[2:44:07 PM](#)

REPRESENTATIVE TUCK asked whether a company that uses a lot of subcontractors would be able to come out ahead by not reporting the subcontractors' nonresident workers.

MR. DICKINSON replied that all the taxpayers do lots of contracting. Non-reporting of nonresident workers would mean the penalty of no tax deduction for that cost. However, as he discussed earlier, the problem could arise that the rebate benefit outweighs the penalty, which would incentivize a company to not report the nonresident workers that it employs directly as well as all the way through to the subcontractors. It therefore does not make sense to create a system, as Version E might, where this could happen.

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REPRESENTATIVE TUCK stated he does see where there are any checks and balances in regard to a company with direct employees that are predominantly residents but has subcontractors that are predominantly nonresident. What is to keep that company from not reporting its subcontractors' nonresident workers, he asked. He further understood that the Department of Revenue can see who a company's direct employees are. He inquired whether this is also true for the company's subcontractors.

MR. DICKINSON answered yes. One of the things that will happen, this bill aside, is that most of the time and effort will be

spent looking at contracting because that is how most of the work is done. Under current labor figures, one-fourth of the labor is done by employees and three-fourths is done by contractors. The work done by contractors is the vast majority of deductible lease expense. The effect on a taxpayer of not reporting the dollar spent to hire a nonresident to do lease work is the same whether it is paid directly as a wage or is bounced down through a contractor or a subcontractor.

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REPRESENTATIVE GUTTENBERG asked how Mr. Dickinson sees the first three bullets on slide 29 being addressed. He further asked whether there would be a reason for leaving out overhead labor, contractor labor, or professional service labor from the resident hire calculation.

MR. DICKINSON responded no, but posed a scenario to outline the problem. A taxpayer gets a bill from the operator. The operator gets a bill from a contractor. The contractor built some things with materials and labor. A bill is presented at each point. Someone goes to a hardware store and buys a unit that has already been built. Someone built that unit from manufactured parts. So, how far down does this go? These are issues that he therefore thinks should be figured out in statute rather than regulation because they could be very problematic.

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REPRESENTATIVE SEATON pointed out that right now the state has a limitation on allowable expenses. However, under Version E there would be both allowable and required expenses which would result in mandating a company to declare something as a lease expenditure or mandating what a company can deduct. He inquired whether that gives the state a lot of additional problems.

MR. DICKINSON returned to slide 24 which provides four options for solving that particular problem and said that option two fits Representative Seaton's description. He said this option would require a bunch of new rules and he does not think that is the most appropriate way of solving the incentive problem that he identified earlier. However, he continued, he does not think that option four would be a mandate. In further response, he explained that the notion behind option four is that there are only three taxpayers responsible for 97 percent of the tax and all three are basically in the same sets of units and hiring the same kind of contractors. Therefore, the overall ratios of

those contractors could be looked at and used to set the tax rate for all three major taxpayers. This way there would be no major winners and no major losers. These three taxpayers would then be driving towards the hiring of more residents.

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REPRESENTATIVE SEATON said he thinks option four gets to not having a company-specific profit tax rate. He asked whether his understanding is correct.

MR. DICKINSON explained that the structure of the net tax would not be changed. The profits determine the base. The tax would be a rate times the base, and the rate would be determined by the taxpayer's local hire. For example, there are several sets of rates for federal income tax - individual, married, and so forth - and each of these rates is applied to the same base.

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MR. DICKINSON provided a quick overview of the next 10 slides in his presentation. He said [slides 32-35] address the proposed 30 percent credit for well work. Slide 34 outlines the differences of putting this provision under AS 43.55.023 or under AS 43.55.025. Slide 35 compares the definitions of well work between HB 308, Version E, and the governor's bill. Slide 37 addresses the proposed change in the statute of limitations. The Department of Revenue used to have three years to set the amount of tax due, but typically that three-year statute was not met and this resulted in extensions. In 2007, the statute of limitations was extended to six years for production taxes. Under HB 308, Version E, the statute of limitations would be returned to three years. He pointed out that the statute of limitations does not apply in cases of fraudulent returns or when it can be shown there was an intent to evade taxes. The statute of limitations only applies for a disagreement and subsequent audit. Tax avoidance, not tax evasion, is where the statute of limitations comes in.

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MR. DICKINSON concluded by drawing attention to slide 39 which depicts the decline of Alaska oil production. He said that 20 years ago Alaska was producing 2 million barrels a day and today it is only producing 600,000 barrels a day.

CO-CHAIR NEUMAN noted that the governor's bill was read across the House and Senate floors on 2/10/2010. He urged members to address further questions to staff at the Department of Revenue and Department of Labor & Workforce Development.

[HB 308 was held over.]

[2:59:43 PM](#)

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 3:00 p.m.