ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE
March 31, 2010
1:17 p.m.

MEMBERS PRESENT

Representative Craig Johnson, Co-Chair
Representative Kurt Olson
Representative Paul Seaton
Representative Peggy Wilson
Representative David Guttenberg
Representative Scott Kawasaki
Representative Chris Tuck

MEMBERS ABSENT

Representative Mark Neuman, Co-Chair
Representative Bryce Edgmon

COMMITTEE CALENDAR

HOUSE BILL NO. 267
"An Act relating to travel by snow machine within five miles of the right-of-way of the James Dalton Highway."

- HEARD & HELD

HOUSE BILL NO. 365
"An Act relating to sharing records regarding fish purchased by fish processors with certain federal agencies, to requirements to obtain and maintain a fisheries business license, and to payment of industry fees required of fish processors; and providing for an effective date."

- HEARD & HELD

HOUSE BILL NO. 414
"An Act relating to the tax on oil and gas production; and providing for an effective date."

- HEARD & HELD

HOUSE BILL NO. 337
"An Act relating to interest on certain underpayments or overpayments for the oil and gas production tax, to certificates for certain oil and gas production tax credits for qualified

capital expenditures, and to alternative tax credits for expenditures for certain oil and gas development and exploration activities for the oil and gas production tax; relating to the use of the oil and gas tax credit fund to purchase certain tax credit certificates; and providing for an effective date."

- BILL HEARING CANCELED

PREVIOUS COMMITTEE ACTION

BILL: HB 267
SHORT TITLE: SNOW MACHINE USE IN DALTON HWY CORRIDOR
SPONSOR(s): REPRESENTATIVE(s) KELLY, NEUMAN

01/19/10	(H)	PREFILE RELEASED 1/8/10
01/19/10	(H)	READ THE FIRST TIME - REFERRALS
01/19/10	(H)	TRA, RES
03/11/10	(H)	TRA AT 1:00 PM CAPITOL 17
03/11/10	(H)	Heard & Held
03/11/10	(H)	MINUTE(TRA)
03/16/10	(H)	TRA AT 1:00 PM CAPITOL 17
03/16/10	(H)	Heard & Held; Assigned to Subcommittee
03/16/10	(H)	MINUTE(TRA)
03/17/10	(H)	TRA AT 11:30 AM CAPITOL 17
03/17/10	(H)	-- Public Testimony --
03/22/10	(H)	TRA AT 5:30 PM CAPITOL 17
03/22/10	(H)	-- No Public Testimony --
03/25/10	(H)	TRA AT 1:00 PM CAPITOL 17
03/25/10	(H)	Moved CSHB 267(TRA) Out of Committee
03/25/10	(H)	MINUTE(TRA)
03/26/10	(H)	TRA RPT CS(TRA) NT 2DP 2DNP 1AM
03/26/10	(H)	DP: T.WILSON, JOHNSON
03/26/10	(H)	DNP: MUNOZ, P.WILSON
03/26/10	(H)	AM: PETERSEN
03/31/10	(H)	RES AT 1:00 PM BARNES 124

BILL: HB 365
SHORT TITLE: FISH PROCESSOR FEES, LICENSES, RECORDS
SPONSOR(s): REPRESENTATIVE(s) MILLETT

02/23/10	(H)	READ THE FIRST TIME - REFERRALS
02/23/10	(H)	FSH, RES
03/09/10	(H)	FSH AT 10:15 AM BARNES 124
03/09/10	(H)	Heard & Held
03/09/10	(H)	MINUTE(FSH)
03/16/10	(H)	FSH AT 10:15 AM BARNES 124
03/16/10	(H)	Moved Out of Committee

03/16/10	(H)	MINUTE(FSH)
03/17/10	(H)	FSH RPT 3DP 3NR
03/17/10	(H)	DP: MILLETT, BUCH, EDGMON
03/17/10	(H)	NR: KAWASAKI, KELLER, MUNOZ
03/31/10	(H)	RES AT 1:00 PM BARNES 124

BILL: HB 414
SHORT TITLE: SEPARATE OIL & GAS PRODUCTION TAX
SPONSOR(s): RESOURCES

03/10/10	(H)	READ THE FIRST TIME - REFERRALS
03/10/10	(H)	RES, FIN
03/22/10	(H)	RES AT 1:00 PM BARNES 124
03/22/10	(H)	Heard & Held
03/22/10	(H)	MINUTE(RES)
03/31/10	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

DEREK MILLER, Staff
Representative Mike Kelly
Alaska State Legislature
Juneau, Alaska
POSITION STATEMENT: Introduced HB 267 on behalf of joint prime sponsor, Representative Mike Kelly.

GENEVIEVE WOJTUSIK, Staff
Representative Charisse Millett
Alaska State Legislature
Juneau, Alaska
POSITION STATEMENT: Introduced HB 365 on behalf of the sponsor, Representative Millett.

CHUCK LOGSDON, Ph.D.
Energy Economist, Logsdon and Associates
Consultant to the Legislative Budget and Audit Committee
Palmer, Alaska
POSITION STATEMENT: Along with Mr. Roger Marks, provided a PowerPoint presentation on HB 414, Version E.

ROGER MARKS, Economist
Consultant to the Legislative Budget and Audit Committee
Anchorage, Alaska
POSITION STATEMENT: Along with Mr. Chuck Logsdon, provided a PowerPoint presentation on HB 414, Version E.

ACTION NARRATIVE

1:17:24 PM

CO-CHAIR CRAIG JOHNSON called the House Resources Standing Committee meeting to order at 1:17 p.m. Present at the call to order were Representatives Guttenberg, Kawasaki, Olson, Seaton, and Johnson. Representatives Tuck and P. Wilson arrived as the meeting was in progress.

HB 267-SNOW MACHINE USE IN DALTON HWY CORRIDOR

1:17:49 PM

CO-CHAIR JOHNSON announced that the first order of business is HOUSE BILL NO. 267, "An Act relating to travel by snow machine within five miles of the right-of-way of the James Dalton Highway." [Before the committee was CSHB 267(TRA).]

1:18:20 PM

CO-CHAIR JOHNSON, in response to Representative Seaton, confirmed that no public testimony will be taken on HB 267 at this time. He said he knows the bill is contentious, so public testimony will be allowed the next time it is brought before the committee. In response to Representative Kawasaki, he said no people are online to testify and the bill is being put forward today so that it can be heard later.

1:19:06 PM

DEREK MILLER, Staff, Representative Mike Kelly, Alaska State Legislature, introduced HB 267 on behalf of Representative Kelly, joint prime sponsor. He said that since 1980 state law has prohibited virtually all off-road vehicle use along the Dalton Highway. The bill would lift only the ban on snow machine use between the months of October 1 and April 30 when the tundra is frozen. The House Transportation Standing Committee amended the bill in three ways in response to the concerns that were heard: the prohibition for snowmachine use would be lifted, but only to south of Coldfoot [milepost 176]; the existing snowmachine prohibition would take effect again after two years so data on the use can be utilized in future discussions; and users would be required to obtain a permit so usage can be tracked. He added that the bill is supported by the Alaska Outdoor Council and the Alaska Outdoor Alliance.

CO-CHAIR JOHNSON stated that HB 267 will be a policy call because it is equally contentious pro and con. He held over the bill.

HB 365-FISH PROCESSOR FEES, LICENSES, RECORDS

1:20:55 PM

CO-CHAIR JOHNSON announced that the next order of business is HOUSE BILL NO. 365, "An Act relating to sharing records regarding fish purchased by fish processors with certain federal agencies, to requirements to obtain and maintain a fisheries business license, and to payment of industry fees required of fish processors; and providing for an effective date."

1:21:07 PM

GENEVIEVE WOJTUSIK, Staff, Representative Charisse Millett, Alaska State Legislature, introduced HB 365 on behalf of Representative Millett, sponsor. She said the bill pertains to the fishing capacity reduction programs, known as buybacks. Buybacks reduce the number of permits within a fishery by permanently retiring limited entry permits. The concept is to provide for long-term stability within a fishery and prevent over-capitalization, which occurs when too many boats are fishing for small numbers of fish, or when economic factors are such that no fisherman can make a reasonable income from the fishery. Most of the legal framework for the buybacks exist in Alaska statute and HB 365 would add the last few administrative pieces that enable fisheries to pursue such an option if they so choose.

CO-CHAIR JOHNSON said HB 365 is priority legislation for some people, and the intent is to put the bill forward today so it can be acted upon quickly in the future. He held over the bill.

HB 414-SEPARATE OIL & GAS PRODUCTION TAX

[Contains discussion of SB 305]

1:22:18 PM

CO-CHAIR JOHNSON announced that the next order of business is HOUSE BILL NO. 414, "An Act relating to the tax on oil and gas production; and providing for an effective date." He noted that a committee substitute (CS) had been drafted that is identical

to the bill version recently passed by the Senate Finance Committee.

REPRESENTATIVE OLSON moved to adopt the proposed committee substitute for HB 414, labeled 26-LS1592\E, Bullock, 3/31/10 ("Version E"), as a working document. There being no objection, Version E was before the committee.

CO-CHAIR JOHNSON, in response to Representative Seaton, confirmed the forthcoming presentation is on Version E.

1:24:15 PM

CHUCK LOGSDON, Ph.D., Energy Economist, Logsdon and Associates, Consultant to the Legislative Budget and Audit Committee, introduced himself and deferred to Mr. Roger Marks to begin their presentation on HB 414, Version E.

ROGER MARKS, Economist, Consultant to the Legislative Budget and Audit Committee, began the presentation by reviewing the rationale for HB 414 [slide 2]. He said oil and gas are taxed together under current law. Oil is presently worth much more than gas and, while that could change, the values of oil and gas can diverge quite a bit. Because of the way oil and gas are currently priced, the combining mechanism in the tax has the potential to materially reduce oil taxes and undermine the state's interests with a major gas sale, even though oil operations are unaffected by a major gas sale. The premise of HB 414 is to address that problem.

1:26:50 PM

MR. MARKS explained that while oil and gas are produced together, their values are quite different due to issues on both the supply side and the demand side [slide 3]. On the supply side, oil is more geographically concentrated than gas, which means fewer sellers, which makes the value higher. Oil has been used for a much longer time so oil supplies are more depleted. Relatively more lower-cost gas is available in the world than oil. On the demand side, oil has fewer substitutes. In the foreseeable future, most automobiles will run on gasoline which can only come from crude oil, which will make its price higher. Gas is mainly used for powering power plants or providing space heat and there are many substitutes for that. The result is that oil is worth more than gas. While the future is unknown, there are reasons to believe that this will continue being the case.

1:28:01 PM

MR. MARKS compared North Slope oil and North Slope gas to provide an example of how the values are different [slide 4]. Alaska North Slope (ANS) oil delivered to the West Coast has a current market price of $80 per barrel. After subtracting shipping costs of $2.07 and the Trans-Alaska Pipeline System tariff of $4.18, the gross value at the point of production for this oil is $73.75. Each barrel represents about 6 million British Thermal Units (MMBTU), making the oil worth $12.29 per MMBTU. For North Slope gas, Mr. Marks provided an example using a Lower 48 value of $6 per MMBTU. He noted, however, that the current value is about half that. In response to Co-Chair Johnson, he said today's Lower 48 gas price is just under $4 [per MMBTU], so if [North Slope] gas was being sold today it would lose money because its gross value would be negative.

1:29:53 PM

REPRESENTATIVE GUTTENBERG commented that historically the gaps in the equivalents change quite a bit. He asked whether the presentation will include a history of prices and the equivalents and/or the coupling effect.

MR. MARKS responded no. He added that there have been periods where the prices were closer than they are now and periods where they were farther apart than now. He said the presentation is not representing that this relationship or prices will be going on forever. Rather, the point is that since there is the potential for divergence of value, it creates additional risk for both the state and producers.

1:31:36 PM

REPRESENTATIVE GUTTENBERG inquired as to what the sweet spot is or the relationship that the state is trying to be in.

DR. LOGSDON replied he has that material, but did not bring it with him for today. He said it takes about 8 MMBTU of gas to give the same energy as one barrel of oil, so that is a little bigger than energy equivalence which is about 6 million. Since 1994, the highest monthly price for gas over that same 16 year period was $12 per MMBTU, the highest price for oil was about $120. The point is not so much about the averaging, but the variability, and there is a great deal of variability. The presentation will not focus on particular prices, but the risk

the state faces that prices can vary a lot and when they vary in certain ways they can have adverse effects on state revenues.

MR. MARKS added that he and Dr. Logsdon would characterize future prices as unknowable. The reason to be concerned about this issue is because of potential given that future prices are unknowable.

CO-CHAIR JOHNSON asked that the information requested by Representative Guttenberg be provided to members.

1:34:37 PM

MR. MARKS continued his comparison of North Slope oil and gas values [slide 4]. He assumed a Lower 48 price for North Slope gas of $6 per MMBTU, an estimated tariff from Alaska to Alberta of $3.54 per MMBTU, a cost of 24 cents per MMBTU to move the gas into and out of the Alberta Hub, and a tariff of 85 cents per MMBTU to move the gas from the hub to the Lower 48. Subtracting the transportation costs results in a gross value at the wellhead of $1.37 per MMBTU. Thus, on a straight BTU:BTU comparison, $12.29:$1.37, oil is worth 9 times as much as gas, which demonstrates that the two values can diverge by a fairly large amount.

MR. MARKS pointed out that many things have BTUs: oil, gas, coal, wood, asphalt, shoe leather, rubber, coffee grounds, citrus rinds, corn cobs, and dung [slide 5]. The point being that just because some things have BTUs does not mean they should be coupled together for taxation, and coupling oil and gas together for taxation is a very similar thing.

1:36:44 PM

REPRESENTATIVE SEATON inquired whether the presentation will address what the carbon tax currently being considered [by Congress] would do to the comparison values between oil and gas.

MR. MARKS answered this was not done because there is much uncertainty as to whether there will be a carbon tax, what form it would take, and how it would affect these relative values.

1:37:45 PM

MR. MARKS reviewed the mechanics of how the current production tax works [slide 6]: first, the oil gross value is determined (market price less transport cost), as is the gas gross value

(market price less transport cost); the two are added together to arrive at the combined gross value; the upstream costs of [lease] capital and operating costs are then subtracted from the combined gross value to arrive at the combined oil and gas net value, which in the tax code is called the production tax value; the combined oil and gas net value is then divided by the total oil and gas barrel of oil equivalents (BOEs) to arrive at the per barrel of oil equivalent net value.

1:39:14 PM

MR. MARKS described how to put oil and gas on an apples-to-apples basis by using barrel of oil equivalents [slide 7]. To provide an example of how to do this, he assumed a production of 4.5 billion cubic feet per day (BCF/D) of North Slope gas. Because North Slope gas is rich with natural gas liquids, such as butane, propane, ethane, and other heavier hydrocarbons, it has an elevated BTU content of about 1,100 BTUs per MCF [thousand cubic feet], as compared to 1,000 BTUs per MCF for Cook Inlet gas. Natural gas is measured and sold in millions of BTUs (MMBTUs). The 4.5 billion cubic feet per day of gas would have 4.95 million MMBTUs (4.5 times 1,100). A barrel of oil has about 6 MMBTUs. When converting gas to BOEs, Alaska statute specifies the use of 6 MMBTUs of gas to a barrel of oil. Thus, 4.5 BCF/D of North Slope gas would have 825,000 barrel of oil equivalents (BOEs) (4,950,000 divided by 6). If 500,000 barrels of oil was produced along with the 4.5 BCF/D of gas, the total BOEs would be 1,325,000 (500,000 plus 825,000).

1:41:40 PM

MR. MARKS returned to slide 6 and reiterated that the combined oil and gas net value divided by the total oil and gas BOEs equals the per BOE net value. The progressivity factor is determined by subtracting $30 from the per BOE net value and paying 0.4 percent per dollar on the amount remaining. The progressivity factor is then added to the 25 percent base rate to arrive at the single tax rate. That single tax rate is then applied to the combined oil and gas net value.

1:42:45 PM

MR. MARKS, in response to Representative Seaton, said slide 7 illustrates how to get oil and gas on a common denominator so the per BOE net value amount can be determined. In further response, he returned to slide 6 and reiterated that the combined oil and gas net value is determined by subtracting the

lease capital and operating costs from the combined gross value. The combined oil and gas net value is then divided by the total oil and gas BOEs to arrive at the per BOE net value.

1:45:04 PM

MR. MARKS reviewed the mechanics of how the progressivity calculation works [slide 8]. The "trigger" equals $30 net divided by BOE value. The "slope" is how much the progressivity goes up as the net value goes up [the 0.4 percent slope changes to 0.1 percent after $92.50 net per BOE value]. The progressivity surcharge is determined by subtracting $30 from the net per BOE value and this figure is then multiplied by .004. For example, if the combined oil and gas net value is $50 the progressivity is determined by subtracting $30 from $50, and the resulting $20 is multiplied by .004 to arrive at 8 percent. The 8 percent progressivity is then added to the 25 percent base tax rate for a total tax of 33 percent on the combined oil and gas net value.

1:46:01 PM

REPRESENTATIVE SEATON presumed that all of the lease costs have been subtracted before getting to the trigger.

MR. MARKS replied correct. In further response, he said three different values can be thought about: the market price in the Lower 48; the gross value at the point of production, which is where the oil or gas leaves the lease and before any operating and capital costs are subtracted; and the net value or production tax value, which is where all the capital and operating costs have been subtracted out.

1:47:15 PM

MR. MARKS discussed how gas could impact oil under Alaska's current tax system [slide 9]. To provide an example, he first assumed a West Coast market price of $80 per barrel for Alaska North Slope (ANS) oil with shipping and tariff costs of $5, for a gross value at the point of production of $75. Assuming upstream operating and capital costs of $20, the net value [per barrel or per MMBTU] is $55. Progressivity is determined by subtracting $30 from the $55, which equals $25. The $25 is multiplied by .4 percent to arrive at a 10 percent progressivity surcharge. The 10 percent progressivity is added to the 25 percent base rate for a total tax rate of 35 percent. He then assumed 500,000 barrels of daily oil production [slide 10],

which is 500,000 barrels of oil equivalent (BOE), since 1 barrel of oil is 1 BOE. Multiplying [500,000 barrels] times 365 days results in an annual production of 183 million barrels of oil or 183 million BOEs of oil.

MR. MARKS next assumed a Lower 48 market price of $6 for gas with a transportation cost of $4.50, for a gross value of $1.50. Assuming an upstream cost for gas of $.50 per MMBTU, the net value of the gas is $1 [per barrel or per MMBTU]. At an assumed daily gas production of 4.5 BCF, the MMBTUS per day equals 4.95 million; dividing that by 6 equals 825,000 BOEs of gas per day. Multiplying 825,000 BOEs times 365 equals 301 million BOEs of gas per year.

1:49:54 PM

MR. MARKS next combined the oil and gas [slide 11]. For oil, he noted that multiplying the net value of $55 times 183 million BOES per year yields a total annual net value of $10.038 billion. For gas, a $1 net value times 1.807 million MMBTUs results in a total annual net value of $1.807 billion. Adding together the $10.038 billion for oil and the $1.807 billion for gas equals a total annual oil and gas net value of $11.844 billion. Adding together 183 million annual BOEs for oil and 301 million for gas, the combined annual total is 484 million BOEs. Dividing the total oil and gas net value of $11.844 billion by the 484 million BOEs equals a net value of $24.49. Thus, combining the oil and gas results in the net value decreasing from $55 for oil alone to $24.49 for oil and gas combined [slide 12]. The progressivity goes from 10 percent for oil alone to 0, because progressivity starts at $30. Bringing in gas with oil dilutes the net value and dilutes the progressivity, and this dilution effect is critical to understanding the rational for HB 414.

1:51:37 PM

MR. MARKS outlined the magnitude of this dilution in terms of taxation [slide 13]. In general, the greater the divergence between oil and gas, the greater their net values will diverge, the greater the progressivity rate will drop when gas is added to oil, the greater the reduction in tax. He related that several weeks ago, the Senate Finance Committee brought in several folks to explain this issue, and all came up with much the same conclusion and numbers given the same assumptions. He said he will use the same numbers as did the Department of Revenue in its presentation to that committee: three scenarios

of oil prices at $75, $100, and $120, with all scenarios at a gas price of $8. For each scenario the department assumed an oil production of 500,000 barrels per day, a transportation cost deduction of $6.50 per barrel, upstream capital costs of $2 billion [per year], and upstream operating costs of $2 billion [per year].

1:52:51 PM

CO-CHAIR JOHNSON inquired whether it is a reasonable assumption that if oil went to $120, gas would stay at $8. He understood there used to be some correlation between the ups and downs.

MR. MARKS answered there is probably some correlation, but there is also some independence for the reasons mentioned earlier.

1:53:19 PM

CO-CHAIR JOHNSON, for purposes of discussion, asked whether it is reasonable to use in a formula consistent gas price when oil has nearly doubled.

MR. MARKS responded this is for illustration. Oil is currently priced at $80 and gas at $4, and it is not being said that any one of those scenarios is the norm because any one of them could be the norm. In general, there are reasons to believe that prices move together, but no one can say which one of those is the norm.

CO-CHAIR JOHNSON said he wants to ensure that when making assumptions and plugging in numbers, members are getting a realistic look at the back end, because what is really being dealt with is that progressivity factor at the end and it is an algebraic equation.

DR. LOGSDON advised the presentation will get to the examination of progressivity, as well. The current exercise is specifically designed to examine downside risk. There is upside risk and that gets towards how to deal with progressivity.

1:54:47 PM

MR. MARKS returned to outlining the magnitude of this dilution in terms of taxation [slide 13]. For its gas assumptions, the Department of Revenue assumed a gas production of 4.5 BCF/D, a transportation cost to the Lower 48 of $4.50 per MMBTU, upstream capital costs of $200 million per year, and upstream operating

costs of $200 million per year. In response to Representative Seaton, he said the Department of Revenue used about the same transportation costs as did Logsdon and Associates. [As shown on slide 4], Logsdon and Associates used a transportation tariff to Alberta of $3.54, plus the Alberta Hub cost [of $0.24], and the [tariff] from Alberta to the Lower 48 [of $0.85], which adds up to [$4.63] as compared to the department's transportation cost of $4.50 to the Lower 48.

1:55:57 PM

MR. MARKS reviewed what happens to the progressivity factor under each of these three scenarios [slide 13]. At a price of $75, the progressivity factor for oil by itself is 5.38 percent and at a price of $120 the progressivity factor is 23.38 percent. When oil and gas are combined, the progressivity factor at an oil price of $75 is 0 percent; at an oil price of $120 the progressivity factor is 6.79 percent, for a drop in the progressivity factor of 5.38 percent and 16.59 percent, respectively. Taxing oil alone, the production tax at an oil price of $75 would be $1.7 billion per year; at a price of $120 the production tax would be $6.4 billion per year. Taxing gas alone, the production tax at a price of $8 would be $1.1 billion per year. If oil and gas were taxed separately, the total tax at an oil price of $75 and a gas price of $8 would be $2.8 billion; at $120 for oil and $8 for gas the total tax would be $7.5 billion. If oil and gas tax is combined, the tax at a $75 oil price and $8 gas price would be $2.5 billion; at $120 for oil and $8 for gas that tax would be $5.5 billion. Thus, the annual tax reduction from combining oil and gas would be $0.3 billion and $2.0 billion, respectively. The context for dealing with this issue now is the Alaska Gasline Inducement Act (AGIA). If the AGIA provisions that lock in taxes are manifested and this issue presents itself, there could be a loss of $2 billion per year in production tax for 10 years, which would be a total of $20 billion. The AGIA provisions begin May 1 when the open season begins, so the rationale for dealing with this issue now is to avoid this possible outcome, in-so-far as the provisions are airtight. In response to Co-Chair Johnson, Mr. Marks clarified he said "in-so-far" as the provisions are airtight because there are questions about whether they are.

1:59:03 PM

MR. MARKS continued, saying there is no way to be sure about future prices [slide 14]. Different price relationships would produce different outcomes. If gas prices went very high

relative to oil, the inverse dilution effect would occur, and the dilution effect of combining oil and gas would drag the oil progressivity up rather than down. In that situation, the producer/taxpayer would lose money under the current tax statutes. Since the potential for these outcomes exist, the current tax structure adds another level of risk to an already large amount of uncertainty. Not only is there the worry about the price risk itself, there is the worry about the relationship between prices. If the current price relationship endures, there is the risk of undermining the state's finances.

2:00:22 PM

REPRESENTATIVE SEATON recalled conversations at the time [AGIA was being considered] about trying to build a robust system that would self-correct as prices changed and that some risk would be absorbed so the state would get a project to go forward. As he sees these numbers, what is really being talked about is that if gas is taxed alone it would not be taxed at the current rates because a pipeline would not be built due to too much risk on the downside. If oil and gas remain combined, there is a risk of this dilution effect if the gas price is relatively low, but that absorbs some of the risk of the development of a gas field. He asked whether the presentation will look at what would happen if there is not a large-diameter pipeline and the exploration for gas, along with the additional oil that would come with new gas fields. He maintained that if a tax system is put in place that does not absorb some of the downside or low-price risk, the state would be pulling the plug on North Slope development.

2:03:20 PM

REPRESENTATIVE SEATON, to clarify his question for Mr. Marks, said he is asking whether the current system of combined tax does not mitigate the risk of building a pipeline for low-price gas. He offered his opinion that if there is not something to mitigate that risk, the state would have to negotiate a much lower tax rate on the gas because otherwise it would be difficult to finance and build the project.

MR. MARKS surmised the question is whether the tax system should provide some cushion for low-price gas.

REPRESENTATIVE SEATON said yes, and further asked whether Mr. Marks does not believe that the current system is self-correcting and robust so that it works at a variety of prices.

2:05:23 PM

MR. MARKS responded that, first, he thinks having taxation based on net is one way to address the low cost issue; there will be no tax if the company is not making money. Second, one advantage of separating oil and gas is that down the road the state can deal with gas by itself and determine the taxation for gas without having oil affect things. Third, at face value it is easy to say that a taxpayer could save $2 billion in oil taxes by undertaking this gas project if oil is priced at $120 and gas at $8. However, there are other considerations, one of which is uncertainty and investors dislike uncertainty more than anything else. Taxpayers understand that a tax system has to work for both sides. An outcome of the legislature's rejection of the stranded gas development contract advanced by the Murkowski Administration is that it displayed the state has a bar it is setting for what it is expecting.

2:07:59 PM

MR. MARKS said these conversations and this bill are occurring because, as he has shown, it is crystal clear that there is what he would call a big crack in the tax system, which is the $2 billion revenue loss. Notwithstanding any provisions for fiscal certainty in AGIA, which may or may not be airtight, he cautioned that taxpayers will look at this crack as an issue of much volatility, given it is unknown who will be governor or who will be in the legislature in 10 years. While solving this problem now would not reduce all fiscal uncertainty, he said his personal opinion is that it would take a big piece out of it.

2:09:34 PM

REPRESENTATIVE GUTTENBERG understood Mr. Marks to be saying that the $2 billion less in tax revenue that would be collected under the current combined tax system, as compared with a separated tax system, creates volatility for the state which creates uncertainty for industry so that industry does not know what to do. He said many people believe that if there are fiscal terms on a gasline, industry will come back to the state to address fiscal certainty. In his opinion, to "decouple" now is to put the state's hand on the table, so it would be better for the state to wait for industry to put its proposals forward first.

2:11:31 PM

MR. MARKS responded he thinks there is a general expectation that there will be some discussion down the road between the state and the producers about fiscal terms. If fiscal certainty is essential, it is unclear whether the constitution would have to be changed to achieve that, so it is unclear what the outcome of a negotiation would be. This bill would not preclude future discussions; rather, it is a measure to protect the state from the scenario where the current tax system is locked in place for the first 10 years of production under the AGIA provisions. Even if the fiscal certainty proves not to be airtight, a future legislature may feel committed to upholding the terms that were in place on May 1, 2010. However, the question is what should be upheld and whether today's legislators would want the current tax system upheld knowing what would happen to the state's finances if those prices materialized.

2:14:14 PM

REPRESENTATIVE GUTTENBERG proffered that the producers may come back to the state with fiscal terms that are considerably different than those in HB 414. He said that since this issue is not new and is something being dealt with around the world, the state has the obligation to find out whether there are other possible scenarios, even though the scenario being presented is very legitimate and appreciated. He recognized producers may not come to the table at all with fiscal terms and right now the state is risking whether producers may even want any changes.

MR. MARKS replied there are millions of scenarios out there. He said the issue is not what will happen, but what has the potential to happen, and that is what needs to be thought about.

2:16:24 PM

REPRESENTATIVE P. WILSON understood Mr. Marks to have said that producers do not like uncertainty and the more things can be locked in, the better. She asked whether Mr. Marks is saying that if taxes were separated there would be more participation in an open season because producers would have more certainty, even though they would be paying more in tax.

MR. MARKS answered he believes the producers would love to proceed on a gasline under the current system and have their oil tax bill reduced by $2 billion. However, when producers think about committing gas at an open season, there are numerous considerations, one of which is the tax side. Under AGIA provisions the current tax system would be locked in, but there

are a lot of reasons to think those provisions are not airtight. If people are concerned now about what will be happening in 10 years, they will be even more concerned on that first shipping day. Additionally, it is unknown what the state's finances will be then. Even if HB 414 passes, a tax system is not being nailed down, but having a problem will make producers nervous and having that problem fixed means the range of outcomes narrows, which could make them feel more comfortable. He said this same kind of effect can be seen when a corporation is sued. Even when a large judgment is handed down, the corporation's share price will generally go up after the judgment because now investors know the result and the uncertainty has been removed.

2:20:07 PM

REPRESENTATIVE OLSON inquired whether any models were run that showed the current system appears to be working and looks more favorable than what is being seen right now.

MR. MARKS responded that Department of Revenue modeling showed that if the oil and gas are flip-flopped so that the gas value is very high relative to oil, a reverse dilution effect would happen with a major gas sale that would drag the oil progressivity factor up rather than down. In further response, he said the past three years have had relationships where the BTU value of oil has been much higher than the BTU value of gas.

DR. LOGSDON added that the highest monthly average price for oil over the last 16 years has been a shade over $120 per barrel, and the highest monthly average price of gas has been just over $12 per MMBTU. On the low side over this same 16-year period, gas has been as low as $2 per MMBTU and oil has been as low as about $30 per barrel. The average oil price over that 16 years is about $40 per barrel and gas is about $5-$6 per MMBTU. The statistical analysis shows the one thing that is consistent is the volatility in oil prices. In 2004, oil was about $30 per barrel and recently it was as high as $145 per barrel on a daily basis. If looked at statistically there will be an average, but the standard deviation, or the measure of average volatility, is extremely high.

2:23:35 PM

DR. LOGSDON continued, saying that from his and Mr. Rogers' perspective what can be done now before the lock-in period is to put into effect a kind of insurance policy against this type of thing happening in the future. He agreed it is unknown how this

would be viewed by industry and how it would affect negotiations. He said he and Mr. Marks chose these particular numbers to show some of the down side the state may be facing as the open season approaches. A $120 oil price and $8 gas price are plausible scenarios, he stressed, although he is not saying there is a 100 percent chance this would be the scenario for 10 years. However, it is one reason why he and Mr. Marks think that separating oil and gas might be something that would ensure safe financial stability for the state in the future.

2:25:18 PM

REPRESENTATIVE OLSON asked whether over the past three years the ratio of oil to gas numbers has stayed relatively close.

DR. LOGSDON replied the average ratio has been 8.8. Right now, at prices of $4 and $80, it is a catastrophic ratio of 20. Over the last 16 years, it has been below 6 in a couple of months, but not very often. It actually averaged close to 6 in 2005 or 2006. He said Senator Paskvan distributed a graph in this regard and most of the time the ratio has been above 6 over a fairly long period of time. Generally speaking, 6 is the amount of energy it takes to equal the BTUs in a barrel of oil.

2:26:52 PM

REPRESENTATIVE TUCK inquired what ratio is the point of the reverse dilution effect.

DR. LOGSDON answered the ratio is important, but what is really important is the taxable value of the gas. At a fairly low net taxable value for gas and oil prices somewhat higher than that, there will be dilution because a low-value substance is being added together with a high-value substance.

2:28:09 PM

REPRESENTATIVE TUCK asked what the ratio would be to trigger the reverse dilution effect, based on all things being equal and the tax structure of today.

DR. LOGSDON responded he will have to get back to members in this regard. However, once the net taxable value of gas gets into the teens, the pipeline would begin spinning off a lot of gas revenue.

[CO-CHAIR JOHNSON passed the gavel to Representative Olson.]

REPRESENTATIVE TUCK surmised that at gas prices of $4-$5 per MMBTU there would be more than a $2 billion giveaway.

MR. MARKS nodded yes.

2:29:59 PM

REPRESENTATIVE TUCK proffered that the tax incentive/giveaway might be needed to get the pipeline built if gas drops to $4 because at that price it may not be worthwhile for any company.

DR. LOGSDON replied that once a gas pipeline is built, the investment is fixed. He said the scenario Mr. Marks was laying out is that a company or investor wants fiscal certainty so it knows that once $40 billion has been spent on building a pipeline the state will not come back and demand the $2-$4 billion it is losing by changing the fiscal system.

2:31:53 PM

REPRESENTATIVE TUCK argued that would be true of any scenario, not just this one. Given that oil and gas are produced together on the North Slope, he said he does not have a problem with allowing industry to take advantage of the combined tax system as a way to incentivize getting the gas to market. He asked whether gas is always valued in BTUs compared to oil.

[Representative Olson returned the gavel to Co-Chair Johnson.]

MR. MARKS answered not that he is aware of; gas is universally valued on a BTU basis.

2:32:45 PM

DR. LOGSDON explained that gas is valued and bought and sold in BTUs throughout the world market. If, going forward, members want to focus on how to make the gas pipeline robust, looking at gas separately is one way to seriously have a policy discussion about how to do that. He recognized that Representative Seaton considers the combined system to be robust and said that is a decision committee members will have to make. He said any scenario presumes there is a pipeline, and he and Mr. Marks are trying to show this potential downside that could happen in the future that could be avoided by splitting apart gas and oil.

REPRESENTATIVE TUCK commented that the dilution effect is to the benefit of industry, but the reverse dilution effect would be of concern to industry and that is why he wants to know where that ratio is going to be under the current structure. He would like to know what the possibility is of that happening and how often it might happen.

2:36:17 PM

REPRESENTATIVE P. WILSON proffered that gas prices are currently low because of the current oversupply, but this oversupply could change if hydraulic fracturing is disallowed. Therefore, her opinion is that gas is also volatile, which makes it hard to decide what to do.

MR. MARKS agreed there is uncertainty now over gas, but said there will always be uncertainty over gas and oil. He added there is another consideration besides the market. Returning to slide [4] he pointed out that the transportation cost for getting oil to market is about $6, or about $1 per MMBTU as compared to about $4.50 per MMBTU for gas. The reason for this difference is physics. The BTUs in crude oil are very dense and lots of BTUs can be wrapped in a little bit of metal. The BTUs in gas are dispersed and less dense, so it takes a lot more metal to wrap around the same number of BTUs. Therefore, no matter the ratio or market price, the transportation cost for gas will always unequivocally be much higher on a BTU basis than the transportation for oil, which will exacerbate this issue of the difference between oil and gas even if the market price of gas comes up relative to oil.

DR. LOGSDON interjected that it is the cost overrun risk.

2:40:08 PM

REPRESENTATIVE GUTTENBERG understood the [5/1/10] lock-in to be for gas only, not oil.

MR. MARKS responded correct, it is the gas tax that gets locked in.

2:40:22 PM

REPRESENTATIVE TUCK asked whether there is some part of transportation that needs to be considered that is not being shown in slide 4.

MR. MARKS replied the [$6.25] shown for oil transportation includes the current Trans-Alaska Pipeline System and shipping infrastructure. To line up the transportation cost on an apples-to-apples basis, this cost would be divided by 6 to come up with a cost of $1 per MMBTU for oil; the MMBTU cost for gas is about $4. In further response, he confirmed that this is a 9:1 ratio, all considered.

CO-CHAIR JOHNSON pointed out that the tariff for the Trans-Alaska Pipeline System (TAPS) is known, but the gas tariff is an estimate and could be more if there are cost overruns.

2:42:07 PM

REPRESENTATIVE SEATON said he is certain that if gas was taxed alone using the calculations shown in the presentation, the gasline would never be built because there needs to be some absorbing of the downside risk with the oil tax. According to what he has heard, gas taxes structured under the current base rate and progressivity would be a non-starter. He surmised Mr. Marks and Dr. Logsdon are talking about an inflexible, gross tax rate on gas and said he thinks those would have to be at a pretty low rate to get agreement for taxing gas separately. He inquired whether Mr. Marks thinks a gasline would be built if gas was taxed separately.

2:45:49 PM

MR. MARKS answered that regardless of whether HB 414 passes, most people think there needs to be a deliberative discussion on gas taxes down the road. This bill will not and should not supersede that. This bill is being proposed as a backstop measure in case of a lock-in of AGIA tax provisions. Members need to decide whether the current system creates incentive for the industry and so HB 414 should not pass, or that the current system undermines the state's financial picture and the bill should pass. He and Dr. Logsdon are laying out the options and it is the legislature's decision. He said even if HB 414 passes, the state will be far from a perfect tax system on gas, which is why further deliberation in this regard is needed. The intent of HB 414 is to guard against what the sponsor saw as an unfavorable outcome under a certain scenario, and it is up to other members to decide whether that is unfavorable or not.

2:47:51 PM

CO-CHAIR JOHNSON said he does not want anyone to leave the room thinking that if HB 414 does not pass the state is going to lose $2 billion in revenue; although that could be the case, it is an unknown at this point. This scenario may or may not happen, he continued, and different consultants may come up with different outcomes. There are a lot of scenarios out there that would not fit this. In response to Representative Seaton, he clarified that this possible scenario would not be until there is a pipeline and gas is flowing down it. He added the committee needs to look at whether there is a risk and, if there is a risk, whether separating the taxes is the solution to that risk. He urged members to focus on that rather than the numbers in the charts that are being presented as facts, because he does not think they are facts. He understood Representative Seaton's point that keeping the current tax system may be incentivizing.

2:50:26 PM

REPRESENTATIVE GUTTENBERG appreciated Co-Chair Johnson's comment because he thinks in many ways it boils down to what is in front of the members in the bill and the bill plays out in these charts. Regardless of what the legislature does now, there are other things that will be happening, such as elections and what producers put on the table.

CO-CHAIR JOHNSON said that is his point. He does not want to get wrapped around the numbers or lock in the next generations of legislators; rather, he wants to look at whether this road should even be taken.

2:52:24 PM

REPRESENTATIVE P. WILSON, should HB 414 be passed, asked whether the only thing that would be provided between April 30 and May 1 is certainty for the gas producers.

MR. MARKS responded that a section in AGIA provides upstream resource inducements. On the royalty side, the section spells out how the royalty oil is to be valued, along with some provisions for switching between in-kind and in-value. On the tax side, the section provides that anyone committing gas in the first binding open season, which is May 1, 2010, will be entitled to a tax exemption for the first 10 years of commercial production. That tax exemption is equal to the difference between what the actual tax would be for that first 10 years and the tax that is on the books at the time of the open season. For example, if the AGIA project started flowing on 1/1/20 and

taxes had been increased between now and then, anyone committing gas at this summer's first open season would be entitled to a tax exemption of the difference between what the tax code is on 1/1/20 and what it was on 5/1/10. He reiterated there are numerous issues as to how airtight the AGIA inducement provision is.

2:55:04 PM

REPRESENTATIVE P. WILSON asked whether a producer might sue if the state takes the position that the provision is not airtight.

MR. MARKS replied that while he is not a lawyer, he can explain two of the several issues that have surfaced regarding whether that provision is airtight. First, the state constitution prohibits one legislature from binding a future legislature; the power to tax cannot be contracted away. Second, the early versions of AGIA stated the royalty and tax resource inducement provisions are contractual. However, some legislators were concerned about the constitutionality of that, so the term "contractual" was removed from AGIA. Thus, there is the stark difference of one inducement saying it is contractual and one that does not. According to lawyers he has talked to, this leaves open the door that this inducement is not airtight. He allowed, however, that it may be a moral commitment that future legislatures are reluctant to change. He said he cannot say whether producers would argue that the provisions are airtight and sue.

2:57:46 PM

REPRESENTATIVE P. WILSON understood Mr. Marks to be saying that the gas of any company signing up for the AGIA open season will be tax free for 10 years, regardless of whether the state raises the tax during that 10-year period.

MR. MARKS answered that if taxes are raised during the first 10 years, those companies would pay the lower of the tax on May 1, 2010, or the tax at the end of those 10 years. If that lower of includes a $2 billion reduction because of this effect, that is what would be in there.

CO-CHAIR JOHNSON interjected that that scenario would be accurate if everyone bid the 4.5 BCF/D on day one. However, this AGIA provision applies only to those that bid in the first open season; the provision does not apply to anyone coming in at

a later time. This would therefore reduce the loss number that is being presented.

2:59:38 PM

REPRESENTATIVE GUTTENBERG inquired how long the first binding open season is, how definitive the length of that season is, and whether the length is defined in statute or determined by TransCanada's negotiation with the Federal Energy Regulatory Commission (FERC). For example, could someone claim the binding open season is not actually closed until all conditions are met for the firm transportation (FT) commitments.

DR. LOGSDON responded that according to TransCanada documents, the open season runs from May 1, 2010, to July 31, 2010. However, he said he does not know if that could be amended.

CO-CHAIR JOHNSON offered his belief that FERC can drive that timeline somewhat.

REPRESENTATIVE GUTTENBERG said that was part of his point - many of these hard and fast lines are not hard and fast.

3:02:24 PM

MR. MARKS, in response to Representative Guttenberg, confirmed that [the original version of] HB 414 would remove progressivity on gas, but the Senate committee substitute (CS) [SB 305] would not [slide 15]. In response to Representative Seaton, he explained that while the presentation addresses the original version of the bill, he will be talking about Version E. He said that the Senate CS and Version E would separate out the progressivity calculation for oil and gas and would include progressivity on both oil and gas.

3:04:07 PM

MR. MARKS related that as the bill evolved in the Senate, two issues presented themselves: [cost allocation and tax neutrality on current activity]. Regarding the cost allocation issue, he said oil and gas are currently combined and the costs are subtracted to determine the net value [slide 16]. To separate them, costs would need to be allocated between oil and gas. Right now, Prudhoe Bay produces about 275,000 barrels of oil a day, and this oil comes up with gas. The gas is separated and re-injected into the ground. By 2020, when a gas pipeline starts, Prudhoe Bay may be producing about 200,000 barrels of

oil a day, and out of 4.5 BCF/D of gas, about 3.0 BCF/D would come out of Prudhoe Bay. Thus, Prudhoe Bay would truly be an oil and gas field, as would most other fields, and the costs to produce oil and gas are truly joint costs.

3:06:04 PM

MR. MARKS pointed out that industry separates these costs all the time and there are many methods for doing so. The state's current tax code has certain situations where costs must be allocated between oil and gas - in Cook Inlet and in leases producing gas that is sold in-state. Alaska Statute 43.55.165(h) gives the Department of Revenue the authority to adopt regulations for allocating costs between oil and gas, and the Senate Finance Committee determined it should stay this way. He explained that the allocation method adopted by the Department of Revenue uses the barrel of oil equivalent (BOE) approach. The rational for using this approach is that the same costs that produce oil produce gas and, since produced together, the costs are allocated based on the amounts produced. The BOE method puts oil and gas on an apples-to-apples basis in terms of relative produced volumes, which he and Dr. Logsdon agree is the most reasonable approach.

3:08:18 PM

MR. MARKS related it was the Senate Finance Committee's feeling that some instruction should be given to the department on allocating costs. Thus, the committee's CS provides authority to the Department of Revenue to develop regulations to allocate costs and the CS states that, at a minimum, the department should consider the same BOE approach, but that the department is free to look at other methods as time goes on. This same language is included in HB 414, Version E.

3:09:01 PM

CO-CHAIR JOHNSON noted oil is more valuable than gas, but a well is a well. Someone exploring for gas would have a lower profit margin than someone exploring for oil, yet the two are being compared. He inquired whether this would be a disincentive to someone exploring just for gas.

MR. MARKS replied that when allocating the costs, the costs are independent of the value. The BOE approach looks at the costs of producing the substances and the costs are allocated based on the relative amounts produced. The problem with allocating

costs based on value is that world events could cause the value of oil to skyrocket even though the costs to produce the oil did not change. This is why he and Dr. Logsdon do not believe that value is the way to allocate costs, and that the reasonable way to allocate is by BTU content independent of the value. He reiterated that the proposed statute would give the Department of Revenue the authority to consider the BTU approach, but would not require that approach to be adopted.

CO-CHAIR JOHNSON repeated he does not want to create a disincentive.

3:11:38 PM

REPRESENTATIVE SEATON observed that no gas would be produced during the 10 years of constructing the gas pipeline. He presumed that if gas is now segregated and taxed at base and progressivity rates different than oil, everything for gas would be written off against oil and oil progressivity until the start of gas flow because gas would not be considered produced until it is flowing down the pipeline, given that the provision in Version E is for produced oil and produced gas.

MR. MARKS agreed that that is how it would work. One of the cornerstones of the petroleum production profits tax (PPT) and Alaska's Clear and Equitable Share (ACES) was that instead of depreciating costs or deferring the recovery of costs, the producer receives instantaneous deduction, and the whole credit rate and tax rate were designed around that instantaneous deduction.

3:14:13 PM

REPRESENTATIVE SEATON understood the current instantaneous write-off is a write-off of costs at oil and oil progressivity instead of gas tax rate and gas progressivity because the gas is not yet flowing.

MR. MARKS agreed that is how it would work.

3:14:55 PM

MR. MARKS discussed the second issue that presented itself during Senate deliberations [slide 17]. Some producers are currently producing both oil and gas. If the oil and gas were separated for calculating progressivity, the oil progressivity would be undiluted by gas so the oil progressivity would go up

and taxes would increase for these producers. While the progressivity would go up by a fairly small amount, the tax increase would be notable when applied to the large volumes produced at today's relatively high prices. However, it was not the intent of this bill to raise the taxes on current activity; it was to deal with what would happen with a major gas sale. So, the proposed progressivity structure in the Senate CS was designed to not increase taxes on current activity. This is done by providing one progressivity on oil, Cook Inlet gas, and other in-state gas, like what is currently going on in the state. A second progressivity would be applied to export gas. This would replicate the current situation so there would be no increase in taxes on current activity, while at the same time preventing the major gas sale gas from diluting the oil progressivity.

3:17:53 PM

REPRESENTATIVE SEATON commented it seems the proposal is to protect the state now by splitting apart oil and gas so one does not dilute the other; but, in 10 years, the effect of separating oil and gas taxes to protect the state would be cancelled out.

MR. MARKS responded a mini-dilution effect is going on right now. Some producers have North Slope oil and Cook Inlet gas, and if oil and gas progressivity was separated, the oil would not be diluted and taxes would go up for those producers. It was the sense of the Senate Finance Committee in developing this CS that the intent of this bill was not to increase taxes on current activity, but to protect the state on the long-term scenario what would happen with a major gas sale, and that is why this is structured the way it is.

CO-CHAIR JOHNSON said he thinks Representative Seaton is right.

3:19:33 PM

REPRESENTATIVE GUTTENBERG understood the bill's intent is not to raise taxes on current activity, or lower gas taxes; the bill would separate oil from gas and would have progressivity and a tax rate; and would lock-in gas, but not oil. He asked what is changed if after May 1, 2010, something happens.

MR. MARKS replied that if there is a major gas sale, the progressivity on export gas would be calculated by itself and would not dilute the progressivity of the oil.

REPRESENTATIVE GUTTENBERG surmised that separating oil and gas changes the economics, but said he must be missing something.

3:21:31 PM

REPRESENTATIVE SEATON referenced charts previously shown to the committee that depicted progressivity and the marginal tax rate. He said he thinks what is being said is that the effect of the current system of combined oil and gas taxes is that gas moves the progressivity down for certain companies. The objective of HB 414 is to make it so gas will not lower the progressivity of oil. However, the Senate CS proposes keeping oil and gas progressivity together for those companies already doing this, so that an oil company can lower progressivity with its current gas production.

MR. MARKS confirmed that that is basically correct and suggested this may become clearer once Dr. Logsdon explains the bill.

3:23:01 PM

DR. LOGSDON noted that in the CS for SB 305, Version T, the title has been tightened to focus the bill's scope [slide 23]. He explained that, under ACES, Cook Inlet gas and non-Cook Inlet gas used in-state are subject to the economic limit factor (ELF) tax that was in effect in March 2006 [slide 24]. These two elements of the tax system result in the current mini-dilution. The notion behind HB 414 is to separate the gas that is exported out of state, which would primarily be the gas feeding the gasline off the North Slope, and it is this separation that would get rid of the big dilution.

3:25:45 PM

REPRESENTATIVE SEATON inquired whether Dr. Logsdon has confidence in Alaska being able to maintain a differential tax rate on producers between the gas that is used in-state and the gas that is shipped to another state under the commerce clause.

DR. LOGSDON said he does not know the answer to that question.

REPRESENTATIVE SEATON suggested that if the commerce clause is ruled by the courts to prevail and the tax rate is going to be the Cook Inlet Sedimentary Basin and the in-state tax rate, then perhaps the thing to do right now is to remove the in-state tax rate as being the same as the Cook Inlet rate because then all

the North Slope sales would be at the same rate whether in-state or out of state.

3:27:48 PM

CO-CHAIR JOHNSON noted that another option would be to do away with the North Slope rate and use the Cook Inlet rate.

REPRESENTATIVE SEATON agreed.

DR. LOGSDON said the mini-dilution he has described is what is in statute right now and was established by ACES. Cook Inlet gas and any non-Cook Inlet gas, or oil, that is sold for use in-state, would pay the combined oil/gas progressivity rate because that is how it works today. By separating out just the export gas from the North Slope, as proposed by the Senate CS, the state would preserve the combined oil and gas rate for progressivity for Cook Inlet and in-state gas use. The separate gas progressivity rate would only be applied to North Slope exports.

3:29:26 PM

MR. MARKS added that right now every producer computes a statewide progressivity factor with all its activity. Cook Inlet gas activity goes into computing a producer's statewide progressivity factor, but the tax that Cook Inlet oil and gas pay is based on ELF and not the progressivity factor. The progressivity factor that is derived from the Cook Inlet oil, Cook Inlet gas, North Slope oil, and North Slope gas is the producer's statewide progressivity factor for when the producer pays tax on progressivity. So, the "bucket" with oil, Cook Inlet gas, and other in-state gas, is the activity the state currently has. Under HB 414, that bucket would still operate the way it operates now - that activity will go into computing a producer's progressivity for where progressivity applies, and the tax paid on Cook Inlet oil and gas will be based on ELF.

3:31:43 PM

REPRESENTATIVE GUTTENBERG recollected there was a case that went to court regarding tariffs for oil used in-state versus tariffs for oil going all the way to the West Coast.

MR. MARKS replied that that was a tariff issue.

MR. MARKS, in response to Representative P. Wilson, further explained that the tax paid on Cook Inlet oil and gas is the lower of the ELF tax or the ACES tax. The ELF tax is so low that the producer almost always pays on ELF; however, the producer must still go through the exercise of calculating what its tax would be using the ACES progressivity and what its tax would be using ELF.

DR. LOGSDON added that a producer may not pay tax based on the taxable value of oil and taxable value of gas because of the ELF limit. However, there is still some dilution of the North Slope oil tax because the progressive rate is calculated using the taxable gas from the Cook Inlet along with the taxable oil from the North Slope.

3:35:01 PM

DR. LOGSDON explained that under HB 414 there would be two "buckets" for progressivity. In the first bucket, the payment of taxes would be the same as it is now in that one progressivity is calculated on oil, Cook Inlet gas, and other in-state gas, so there would be no increase in taxes [slide 25]. The second bucket is for a major gas sale, and would specifically carve out export gas for separate tax treatment. He noted that a pipeline moving gas for in-state use would result in a bigger dilution effect than there is right now, which may be a good thing.

DR. LOGSDON pointed out there is upside risk as well as downside risk [slide 26]. If gas prices went high under the flat rate, the state would leave money on the table, which is why HB 414 includes progressivity on exported gas. The bill would establish the rates exactly like they are currently calculated for the combined substance: every dollar above $30 per barrel net taxable value would increase the tax rate by 0.4 percent and anything over $92.50 would increase it by 0.1 percent.

3:37:15 PM

DR. LOGSDON said the other element of HB 414 is the requirement that BTU equivalent barrels be considered as a method for allocating lease costs between oil and gas [slide 27]. The Department of Revenue already has regulations that use this method for allocating joint production. This method is straightforward, knowable, and relatively stable, and is based on production activity. However, the bill recognizes it is the Department of Revenue that has the resources, time, procedures,

public processes, and confidential information, and the department may ultimately determine that another method is preferable.

3:38:37 PM

REPRESENTATIVE SEATON asked whether Dr. Logsdon is confident the state will be allowed to have different tax rates for gas that is used in-state and gas that is exported to the Lower 48.

DR. LOGSDON responded his answer as an economist is that the value of the substance being taxed is not a pass forward. The market will determine the price, and the costs of getting it to market and of producing it will determine the tax base. The state's taxes have no influence on the price that someone in the Lower 48 is going to pay. He allowed there is another aspect, however, which is whether this is a violation of equal treatment among taxpayers and he does not have an answer to that.

CO-CHAIR JOHNSON said it is an answer that the committee needs to get.

3:40:48 PM

REPRESENTATIVE P. WILSON observed that HB 414 would require the Department of Revenue to consider the BTU equivalent method. She inquired whether the department could jump back and forth between methods.

DR. LOGSDON replied the language is what it says. The department is being seeded the ability to determine what the appropriate method is, but it is a recommendation that the BTU equivalent method be considered.

MR. MARKS, in response to a further question from Representative P. Wilson, said this language is in Section 8, page 11, of Version E.

3:42:31 PM

REPRESENTATIVE P. WILSON surmised from reading the language that the bill really does not tell the Department of Revenue which method to use.

DR. LOGSDON clarified that the specific language is on page 12, lines 1-2. In further response, he confirmed the language does

not say the department has to use the BTU equivalent method, just that it must consider it.

REPRESENTATIVE P. WILSON asked whether the department must decide on one method or another and then stick to that.

MR. MARKS answered the current statute says the Department of Revenue shall adopt regulations on how to allocate costs. All the amendment in HB 414 says is that when doing that, the department should consider this BTU/BOE equivalent method; it does not compel the department to use it. Whatever the department does, it must go through the regulatory process and if over time the department decides that it does not like how a method is performing, it would have the freedom to alter it.

3:44:26 PM

REPRESENTATIVE GUTTENBERG said the provision seems ambiguous as far as which method to use and that the method used could be changed.

MR. MARKS responded the Department of Revenue is not compelled to use the BOE method, which is the method the department came up with when it had the authority to adopt regulations to address pretty much the same question. It was simply the sense of the Senate Finance Committee that it would be useful to give the department some guidance as to how to address this issue.

3:45:58 PM

REPRESENTATIVE SEATON said he is a bit stuck because it seems the purpose of HB 414 is the worry about the May 1, 2010, date and that the binding open season might be something that is problematic for the state. He said it seems to him that a far greater liability than separating oil and gas is that the in-state usage and ELF system could become the required tax system should the state be sued for commerce clause reasons, and this tax is essentially near zero.

MR. MARKS replied those are two different problems that are not related; solving one does not solve the other. The belief that the current tax structure for Cook Inlet gas is defective is an independent issue of what HB 414 is addressing and could be rectified by other means.

3:48:12 PM

REPRESENTATIVE SEATON said he would agree if it was Cook Inlet Sedimentary Basin that was being talked about. However, that tax framework has been expanded to North Slope gas that is used in-state; so, it really is the state's current tax rate for the North Slope. He said it seems an argument could be made in a court of law that that was the tax structure in place on May 1, 2010. While he also worries about progressivity, he sees this as a greater concern.

3:49:32 PM

CO-CHAIR JOHNSON, in reference to the title, asked whether the bill would change the way revenue sharing is done [page 1, lines 5-6, Version E].

MR. MARKS answered that when the progressivity provisions were adopted this community revenue sharing fund was established and funded by a proportion of the progressivity revenues. The "bucket one" progressivity would be under AS 43.55.011(g) and the "bucket two" progressivity would be under AS 43.55.011(p). Section 1 of Version E would provide that a share of the new progressivity go into the community revenue sharing fund as well. That fund is up and running and has been receiving a share of the progressivity revenue since 2006. In further response, he said the only amendment is that which is on page 1, line 12.

CO-CHAIR JOHNSON said he wants to make sure that revenue sharing is not being codified.

3:51:30 PM

CO-CHAIR JOHNSON stated that HB 414 is a policy call and it is incumbent upon committee members to exercise due diligence by going through the bill with a fine-tooth comb.

[HB 414 was held over.]

3:53:43 PM

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 3:53 p.m.