

SENATE FINANCE COMMITTEE  
January 26, 2010  
9:03 a.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:03 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Charlie Huggins, Vice-Chair  
Senator Johnny Ellis  
Senator Dennis Egan  
Senator Donny Olson  
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Pat Galvin, Commissioner, Department of Revenue; Dan Stickel, Economist, Tax Division, Department of Revenue

PRESENT VIA TELECONFERENCE

Dona Keppers, Audit Master, Tax Division, Department of Revenue; Frank Molli, Production Forecasting Consultant, Department of Revenue; Cheryl L. Nienhuis, Acting Chief Economist, Department of Revenue

SUMMARY

^PRESENTATION: DEPARTMENT OF REVENUE OIL PRODUCTION & REVENUE FORECAST; STATE REVENUE FORECAST - FY 2011

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Co-Chair Stedman made introductory comments. He introduced Senator Dennis Egan, who is new to the Senate Finance Committee, as well as members of the secretarial staff.

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Co-Chair Stedman shared protocols for conducting Senate Finance meetings.

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Co-Chair Stedman encouraged members to review the Revenue Sources Book.

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PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE, introduced the presenters from the Department of Revenue (DOR). He referenced a handout entitled, "Overview of Fall 2009 Revenue Forecast", which accompanied his presentation. He began by sharing the outline of the presentation, as shown on slide 2.

Co-Chair Stedman pointed out that the presentation has been updated since it was presented to the House Finance Committee.

Commissioner Galvin shared that how the production tax is calculated will be contained in the presentation. Also included will be information about forecasts for oil production, oil price, and lease expenditures.

Commissioner Galvin turned to the "Fall 2009 Revenue Forecast - FY 10 and FY 11 Total Revenue". He explained that the primary distinction DOR makes is between unrestricted and restricted revenue - slide 4. Restricted revenue are those funds that are generally set aside by constitutional requirement or by general practice within the legislature and are not part of the general fund. General fund is referred to as unrestricted revenue and is broken down into oil revenue, other revenue, and investment earnings.

Commissioner Galvin reported that the Department of Revenue is projecting an increase in unrestricted revenue between FY 10 and FY 11. The total revenue will also increase between the two years.

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Commissioner Galvin turned to slide 5 to discuss general fund unrestricted revenue and the breakdown between oil revenue and non-oil revenue. Oil revenue continues to dominate the unrestricted revenue, making up between 87 and 88 percent of the total. He pointed out that the production tax is the dominant portion of the oil revenue, whereas royalties used to dominate.

Co-Chair Stedman noted that the subtotal for oil revenue would be \$4,647.7 billion in FY 11. Non-oil revenue will total \$589 million. He stressed the importance of the difference in magnitude of the two numbers. He commented that a reduction in non-oil revenue of 20 percent would not be significant; however, a reduction by 20 percent in oil revenue would be a challenge.

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Co-Chair Hoffman questioned the reason behind oil revenues increasing by about a billion dollars. Commissioner Galvin explained that it was as a result of higher oil prices. A decline in production is predicted between FY 10 and FY 11.

Commissioner Galvin turned to non-oil revenue detail on slide 6. The corporate income tax is tax from non-oil based companies such as mining and fishing.

Co-Chair Stedman wondered which month brought in the highest amount from oil revenue. Commissioner Galvin reported that in FY 09 the largest monthly amount was almost a billion dollars. For comparison, Co-Chair Stedman inquired what that amount was last month. Commissioner Galvin thought it was roughly \$300 million. Co-Chair Stedman stated that monthly revenue from oil currently equals what will be earned in one year from non-oil revenue taxes. Commissioner Galvin said that was correct.

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Senator Olson asked why the revenue from mining taxes is projected to decrease by a million dollars. Commissioner Galvin deferred to Mr. Stickel to answer.

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DAN STICKEL, ECONOMIST, TAX DIVISION, DEPARTMENT OF REVENUE, thought the tax decline in FY 11 was a result of lower mineral price projection.

Commissioner Galvin directed attention to the ten-year revenue/spending projection as depicted on slide 8. The information is a comparison of current revenue projections and an extrapolation of current spending at a very modest level of increase on an annual basis. It is a 3 percent budget escalation from FY 11 forward. He concluded that at the end of the projection period, the balance in the Constitutional Budget Reserve (CBR) would be almost \$24 billion.

Co-Chair Stedman requested an explanation of the CBR. Commissioner Galvin described the CBR as a fund set up by the state constitution to designate funds to be used for future budgetary purposes. It was designed to hold surplus dollars until they were needed. Accessing the CBR requires a three-quarters vote by the legislature and it is intended to be used to smooth the state's fiscal picture. Co-Chair Stedman noted that the CBR is the state's savings account. The PFD account is not used to finance shortfalls, but the budget reserve accounts are - the statutory budget reserve and the constitutional budget reserve. Commissioner Galvin agreed.

Co-Chair Stedman observed that the total reserve balances would be \$10 billion by the end of FY 10. Commissioner Galvin agreed.

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Co-Chair Stedman questioned if the total reserve balances would be \$20 billion in 2017. Commissioner Galvin said that was correct given the assumptions that went into the projection model.

Co-Chair Hoffman asked if Commissioner Galvin anticipated any draws from the CBR through FY 20. Commissioner Galvin reported that, given the very modest spending increases, draws would not be needed.

Co-Chair Stedman pointed out the projected 3 percent budget escalation. He recalled previous zero percent projections. Currently, the formula-driven side of the operating account

is substantially higher than 3 percent, while the portion of the operating budget the legislature manages is lower. The sum of the two is projected to be 5.8 percent, resulting in the need to substantially lower the legislature's portion. He predicted challenges ahead.

Senator Olson questioned the numbers in the FY 11 revenue vs. spending column. He thought the total should be \$4,094 million, rather than \$94 million. Commissioner Galvin referred to a footnote which explained that \$400 million was set aside for the governor's scholarship program.

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Co-Chair Stedman emphasized that the scenarios were hypothetical forecasts at 3 percent, which accounts for inflation. Commissioner Galvin agreed that the model, a reflection of a scenario that was unlikely to occur for a variety of reasons, was used in order to show revenue and spending projections.

Co-Chair Stedman requested capital budget projections. Commissioner Galvin explained that the capital assumptions were extremely modest, using last year's historically low capital budget and extrapolating it forward. Co-Chair Stedman recalled the Senate Finance Committee's extraordinary actions last year in reducing capital outlays due to the implosion in financial markets and the decline in oil prices.

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Commissioner Galvin explained how FY 09 production tax was calculated - slide 10. The intent of this calculation is to show the component parts of the production tax and how they relate to each other and how the total was derived. Not included in the production tax calculations are royalty and federal barrels. Royalty barrels are those owned by the state as part of the lease contract. Federal barrels are those that are offshore.

Co-Chair Stedman stated that the first thing "off the top" is 12.5 percent for royalties. Commissioner Galvin agreed. He explained that a quarter of that amount goes into the permanent fund, and the remainder goes into unrestricted revenue. Co-Chair Stedman stressed the importance of that order.

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Commissioner Galvin directed attention to the taxable barrels worth \$15 billion, after the royalty and federal barrels are subtracted out. That amount constitutes the value of the oil at its ultimate market - the refinery. In order to determine taxable value, deductions have to be made, such as downstream transportation costs. Those are costs incurred to get the product to market downstream of the production point. The marine transport costs, TAPS tariff, and other costs are deductible. This results in a "truing up" of the value of the oil. The \$6.50 is the transportation cost deduction, which amounts to about \$4 billion total. He defined "the value at the point of production" as the taxable barrels minus the total transportation costs.

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Commissioner Galvin explained deductible upstream costs as deductions associated with the cost of producing the oil. Those are broken into operating and capital expenditures. Generally, operating costs are day-to-day expenses, whereas capital costs involve buying new equipment or drilling new wells.

Co-Chair Stedman asked for more information on deductible operating expenditures, such as net and gross barrels and how they relate to royalty. Commissioner Galvin explained that in slide 10, the \$2 billion figure is the total operating expenditures figure which was deducted for oil that resulted in property tax. That was divided by 218 million taxable barrels. The operating costs include the cost of producing royalty barrels and are deductible. For purposes of the slide, the amount was divided by the taxable barrels to provide a per barrel cost. The number \$9.39 may not be the same if a company was showing its operating costs, because operating costs would be spread among all barrels, including royalty barrels.

Co-Chair Stedman noted the importance of taking into consideration the standardization of per-barrel costs for presentation purposes.

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Commissioner Galvin reported that the same principle would apply to capital expenditures. He clarified that the number on the right-hand side of the slide is the total capital expenditures for capital costs that were deducted from the taxes that were paid. The end total for lease expenditures is \$3.8 billion and approximately \$17.40 per barrel. The annual price per barrel, \$68.34, is the average across the entire year, minus transportation costs and the total lease expenditures, to get at the production tax value of \$44.46 per barrel, which equates to \$9.7 billion total taxable value. That value is used as the basis for calculating what the tax bill is.

Co-Chair Stedman asked if that was called the "total production cost." Commissioner Galvin agreed that it could be called that. He pointed out that the term "lease expenditure" was used to designate what is qualified as deductible for calculating the production tax. Co-Chair Stedman hope to standardized terms.

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Commissioner Galvin discussed the calculation used for the production tax. The \$9.7 billion production tax value is multiplied by the base tax rate of 25 percent and the result is \$2.4 billion in base tax. Next, the progressivity of the tax is figured resulting in the total tax due before credits, just under \$3 billion. Co-Chair Stedman commented on the calculations. Commissioner Galvin clarified that the total average tax rate in this model is 30.8 percent. The last piece allows for the deduction of the credits and yields a total calculation. In 2009 the total credits deducted were about \$350 million, which results in a total calculation of \$2.6 billion for production tax purposes.

Co-Chair Stedman requested an explanation of the credit. He noted that the model was very stripped down. Commissioner Galvin cleared up a misconception about capital credits. He stated that capital credits that are designated through this line item are predominantly "023 credits", a reference to the tax code. They result in 20 percent credit and are divided into two calendar years. In addition, companies may earn credits under "025" or the "exploration incentive credit program", which are either 30 percent or 40 percent of capital expenditures, depending on location and drilling and seismic costs.

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Co-Chair Stedman commented that the previous information references tax codes, which change from year to year. Commissioner Galvin explained about exclusions regarding costs of general maintenance.

Commissioner Galvin related that credits purchased by a taxpayer are also included in credits applied against taxes. He gave an example of how that works. He noted that credits can also be transferred.

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Senator Huggins asked for Commissioner Galvin's opinion as to how the production tax is working. Commissioner Galvin explained that the department is not privy to actual negotiations, but has heard a preference from companies that earn the credits for a cash-payment system, rather than going to an existing taxpayer, where there is a value loss and a time delay when converting credit into cash. Senator Huggins asked if this was a part of the governor's modified Alaska's Clear and Equitable Share (ACES) proposal. Commissioner Galvin said it was. A couple components would eliminate several barriers regarding explorers being able to get cash from the state for credits.

Co-Chair Stedman requested an explanation of how the 20 percent capital credit mechanism works. Commissioner Galvin explained that a current producer would deduct it off the top. The slide shows credits applied against taxes. The majority of producers would deduct it from their tax bill and the state would not receive any money. Others will have to apply to the state for a credit certificate because they do not owe production tax. The certificate allows the producer to sell credits to an existing producer or to be reimbursed by the state.

Co-Chair Stedman noted the importance of the 20 percent capital credit to large production companies like Exxon, BP, and ConocoPhillips and to the state. It is difficult for the state to see in the summary documents whether the capital deduction has been taken or not. Capital credit is the credit that impacts the state's cash flow. Smaller companies that do not have positive cash flow consume the credits themselves. There is need for clarification

regarding where the capital credit is being generated and its impact on TAPS. Capital credit has a huge impact on forecasting models.

Commissioner Galvin agreed that it was an important point. The \$350 million in credits applied against taxes is usually lost in the revenue projection. It is usually taken off because of credits earned. An amount for \$193 million would also be seen for credits for which the state paid cash, but which had to be paid through an appropriation. There was a total of \$540 million in credits that reduced the state's revenue.

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Commissioner Galvin summarized that the total annual production tax, after credits, was \$2.6 billion. The actual amount of production tax collected in FY 09 was \$3.1 billion. He clarified that this happened because the department calculates production tax on a monthly basis, not on an annual basis. The monthly oil price volatility matters - slides 12 and 13. The average price of oil in July was \$132.87; in December it was \$37.70. The progressive tax rate comes into play each month.

Co-Chair Stedman commented that such a large swing in oil prices was not considered during the discussions about progressivity under PPT and ACES. He hoped the extreme volatility was an aberration in time. Commissioner Galvin said the numbers also reflect the way in which the tax system responds to oil prices.

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Senator Huggins asked about the total government take, including federal take and royalties, in July versus January. Commissioner Galvin guessed that in a "\$37 world" it would be around 60 percent. At \$132 it is closer to over 80 percent. Senator Huggins stressed the importance of recognizing the large swing in prices. Co-Chair Stedman offered to provide a history of government take calculations. Commissioner Galvin emphasized that the government take for FY 09 would be significantly different if a yearly average of \$68 per barrel were done.

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Co-Chair Stedman requested a definition of "government take". Commissioner Galvin defined it as a number used to reflect the net value distributed between the government and the company. It reflects the percent of the profit that is acquired by the state or federal government. It can be used as a comparison between different jurisdictions.

Commissioner Galvin discussed the chart on slide 14, which reflects the production tax projected for FY 10. He described the adjustment to reflect monthly differentials. The information contains actual assumptions and projections.

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Commissioner Galvin detailed slide 15, production tax projections for FY 11 using quarterly oil price projections.

Co-Chair Stedman requested information about the capital credits in the various projections. Commissioner Galvin responded that the progression between FY 09, FY 10, and FY 11 shows an increasing level of credits applied against the taxes. That reflects an increase in spending.

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Senator Huggins asked about the "carry forward" from the previous year as it applies to capital deductions. Commissioner Galvin responded that the impact of projected increasing levels of spending is lagged by the capital credits being taken over two years.

Senator Huggins expressed concern regarding the capital piece's accuracy, if it was looked at separately. Commissioner Galvin explained that the impact of the expenditure is delayed, although the capital expenditures projection is reflected in the actual expenditures of the appropriate year. During the reporting process for lease expenditures there is no lag.

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Co-Chair Stedman commented on the need to examine the capital credit issue further in the future. He asked about the "less adjustment" line on slide 15, which did not appear in FY 09. Commissioner Galvin responded that it was

the reflection of the difference between an annualized calculation and the monthly variations. In order to reconcile the two for the actual revenue forecast, an adjustment has to be made.

Senator Egan inquired about the reason for the increase in capital expenditures between FY 09 and FY 11. Commissioner Galvin responded that capital expenditures, including new development projects, seismic programs, and capital replacements are increasing. There has been discussion about the amount of maintenance dollars expended; however, the department has not seen an increase in spending projections as a result of higher maintenance costs.

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Commissioner Galvin observed that the model is an amalgam of all the companies. Each individual taxpayer is affected differently due to various levels of costs and progressivity. As a company ramps into production, there is a period of time when the credits eliminate the tax obligations as a function of oil prices. He explained that it was a multiple variable tax structure.

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Senator Huggins wondered when Exxon was planning to go from explorer to producer at Point Thomson. Commissioner Galvin stated that in 2014 Exxon would begin to move toward production of liquids.

Senator Huggins asked what liquids includes. Commissioner Galvin defined it as "barrels of oil".

Senator Thomas voiced concern about the impact to the state's revenue due to oil spills and the need to shut the pipeline down. Commissioner Galvin replied that, under ACES, maintenance costs that are associated with interrupted service cannot be deducted. That provision is being examined; however, it is expected to prevail. Currently, there is a lawsuit regarding the impact of lost production from a shutdown.

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Commissioner Galvin discussed the components of production tax calculations and price forecasting. He introduced the specialists available for the presentation.

FRANK MOLLI, PRODUCTION FORECASTING CONSULTANT, DEPARTMENT OF REVENUE, testified via teleconference. He characterized the graph as showing North Slope production by field from 1978 through 2030. It shows both historical and forecast data. To generate the forecast, production data was gathered from each well from the Alaska Oil and Gas Conservation Commission (AOGCC) and then a trend analysis on the recent history for each well was applied in order to generate a per-well forecast. Then, a discussion with the operators about development plans for future wells was considered, along with public and private information.

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Mr. Molli described the FY 09 fall forecast as more conservative than previous forecasts. There were several areas not included in this forecast such as ANWAR, NPRA, and some heavy oil deposits. Also not included was a recent public statement by Renaissance Alaska, LLC, about the Umiat Field with about 1 billion barrels of oil in place and a probable recovery of about 200 million barrels.

Mr. Molli described slide 19 - forecasted ANS production FY 10 - FY 30. He explained that the gray portion is oil from currently-producing wells. The department's confidence in the forecast is high, within plus or minus 3 percent of the actual numbers in the forecast one or two years out. The rainbow colors show production projected from projects that are either under development or under evaluation. The department's confidence in these numbers is not quite as good - within plus or minus 10-15 percent for the next one to two years. The years 2022-3 show the projection for Point Thomson, contingent upon a gas line.

Co-Chair Stedman requested an explanation of the inclusion of the National Petroleum Reserve - Alaska (NPR-A) in the forecast. Mr. Molli explained that NPR-A is under evaluation.

Mr. Molli shared statistics about recent production decline - slide 20. Since peak production in 1988, there has been a 66 percent decline. The decline rates, on average, have

been around 5 percent. He noted that the near term shows a 4.5-5 percent decline.

Co-Chair Stedman asked if Alaska's production scheme over the last 20 years was normal. Mr. Molli answered that there is usually a steep decline at first and then it flattens out. He concluded that it was a typical oil basin.

Co-Chair Stedman noted that Mr. Molli's information disproves comments made in the press about dysfunctional policies in the state leading to a decline in production. Mr. Molli agreed that the decline in production was typical of a natural decline in an oil basin.

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Mr. Molli stressed that no amount of money could change the natural decline. Co-Chair Stedman thought that was important for the legislature to remember when attempting to slow down the decline.

Senator Huggins requested information on how to attack production decline.

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DONA KEPPERS, AUDIT MASTER, TAX DIVISION, DEPARTMENT OF REVENUE, testified via teleconference. She reported on slide 22, an overview of price forecast methodology. The information came from a recent price forecasting session attended by numerous experts in the field. Factors that influence price were studied: supply, demand, world economy, geopolitics, financial markets, and others. Due to economic uncertainty, analysts in the session focused on near-term prices.

Ms. Keppers explained slide 23 - price forecasts as of October 2009. It is a graph that shows West Texas Intermediate (WTI) price forecast. She explained that WTI is known as Texas light sweet crude oil and is used as a benchmark in oil pricing. The underlying commodity of the New York Mercantile Exchange (NYMEX) is oil future contracts. The chart shows forecasts from the Alaska Department of Revenue (AK - DOR) and Energy Information Administration (EIA), one of the industry's experts, as well as from NYMEX and the analysts.

Ms. Keppers turned to slide 24. She reported that for FY 10 and FY 11, the AK-DOR forecast came out at \$68.71 and \$78.85, respectively, very similar to predictions by NY-MEX, EIA, and the analysts.

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Commissioner Galvin defined EIA as the federal government's forecasting group from the Department of Energy. He pointed out that EIA, the green line, is extremely bullish regarding expectations of oil prices. He explained that the red line represents the futures market and involves people looking to make money; therefore, the forecast is on the lower end. The blue line is the synthesis of industry forecasts and it falls into the middle. The black line represents the state's official revenue forecast and is slightly more conservative than the average.

Co-Chair Stedman added that the production forecast is normally much tighter than the price forecast. The price sensitivity in the budgets overwhelms the volumes sensitivity. It is hoped that the price forecast is as accurate as the "barrels" forecast.

Ms. Keppers turned to slide 24, the fall 2009 DOR oil price forecast for WTI and ANS. Co-Chair Stedman requested information on the drifting off of West Texas Intermediate as a benchmark.

Commissioner Galvin said WTI is a standard benchmark and a published index of the West Coast oil price for delivery at a refinery. The differential between Alaska North Slope (ANS) and WTI will fluctuate. The state uses for forecasting purposes a \$2.50 discount from WTI to get to ANS projections. In reality, ANS has had more premium sales over WTI recently.

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Senator Egan asked if heavy oil is being considered. Commissioner Galvin answered that it is sometimes considered. He explained that on the upstream side, heavy oil costs more per barrel to produce. A "quality bank" adjustment is incorporated into future projections to account for heavy oil.

CHERYL L. NIENHUIS, ACTING CHIEF ECONOMIST, DEPARTMENT OF REVENUE, testified via teleconference. She agreed that there are additional costs to produce heavy oil. Heavy oil is discounted when it is marketed because it is not worth as much as light, sweet crude. A quality bank is something that occurs in Alaska when oil is sold to refineries which extract the most valuable oil components in order to refine it. Whatever is put back into the pipeline generally decreases the quality of the oil.

Co-Chair Stedman noted that the 20 percent credit embedded in ACES and PPT is targeted to deal with the extra cost of heavy oil.

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Commissioner Galvin commented that the department is gaining a window into the profiles of the companies that wasn't available previously. Company tax reports have provided data related to lease expenditures; however, this information is just beginning to provide data which can be analyzed.

Co-Chair Stedman noted pointed out that legislative consultants have been surprised by the lack of information from the oil companies. Commissioner Galvin stated that there are restrictions as to how much taxpayer information can be provided. The lease expenditure information must be presented in an aggregated form, rather than on a taxpayer-specific basis.

Mr. Stickel related that the department has historical data on lease expenditures based on annual tax returns and monthly information forms from 2007-2009. There is also data on capital expenditures from PPT information. Under ACES the department also requests forecasts from the producers for estimates of expenditures. The producers provide forecasts of expenditures as well as plans of development for projects. Companies typically provide a five-year window. The department's lease expenditure forecast is based on this information from the companies.

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Mr. Stickel explained slide 27 - Lease Expenditures (Costs). He related that the report contains three-year historical lease expenditure data. The graph shows

operating expenditures for the North Slope at about \$2 billion a year, which have been steady from FY 07 to FY 09 and should remain so for FY 10 and FY 11. Capital expenditures show an increase over the last two years and continuing to do so. Some companies are reducing capital expenditures; however, new companies are not.

Co-Chair Stedman suggested that information about revenue sources would be forthcoming.

Mr. Stickel related information on slide 28 - lease expenditures per barrel. Operating expenditures have been relatively steady, but are increasing on a per barrel basis. Capital expenditures on a per barrel basis have more than doubled.

Co-Chair Stedman recalled that when the legislature was looking at PPT, capital expenditures were expected to increase by \$1 billion in the Basin. He thought it would be interesting to revisit the expectations under the net profit tax versus under ELF, as well as projections on capital expenditure trends.

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Co-Chair Stedman requested that committee members make requests regarding more information on the revenue forecast model.

#  
ADJOURNMENT

The meeting was adjourned at 10:57 AM.