

SENATE FINANCE COMMITTEE  
February 17, 2010  
9:00 a.m.

9:00:28 AM

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:00 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

Marcia Davis, Deputy Commissioner, Office of the Commissioner, Department of Revenue; John Larson, Master Auditor, Department of Revenue.

PRESENT VIA TELECONFERENCE

None

SUMMARY

Oil and Gas Overviews:

PRODUCTION TAX LEASE EXPENDITURE REGULATIONS

OPERATING and CAPITAL EXPENDITURES

Oil Industry Employment and Resident Hire

Scheduled but not Heard

9:00:53 AM

^PRODUCTION TAX LEASE EXPENDITURE REGULATION

9:01:53 AM

AT EASE

9:07:04 AM

RECONVENED

MARCIA DAVIS, DEPUTY COMMISSIONER, OFFICE OF THE COMMISSIONER, DEPARTMENT OF REVENUE, explained the production tax lease expenditure regulations and the process whereby the department arrived at them. She reviewed the PowerPoint presentation "Production Tax Lease Expenditure Regulations" (Copy on File).

Ms. Davis began with Slide 2: "Overview"

- Alaska Clear and Equitable Share (ACES) passed 12/20/2007
- Regulatory Process governed by AS 44.62-APA
- The Department of Revenue (DOR) worked with the Department of Law (DOL) in order to ensure the legality, constitutionality, and consistency with other regulations
- All of our regulations are reviewed by DOL as required (AS 44.62.060)

9:12:01 AM

Ms. Davis discussed Slide 3: "Public Workshops"

- DOR shared outline of approach and then held "public workshops" to gain public input at early regulation design stage.
- Significant changes were made as a result of comments received during workshops. If big changes on important issues, then additional workshops held.
- Workshops were teleconferenced.

Ms. Davis detailed Slide 4: "APA- 30-Day Formal Notice"

After Workshops, proposed regulation is put out for a minimum 30 day public comment under AS 44.62.190.

1. Published in a newspaper
2. Furnished to every person who has filed for a request of proposed action ("Interested Parties")
3. Furnished to Department of Law
4. Provided to all incumbent State of Alaska legislators, committee chairs, and to the Legislative Affairs Agency.

Ms. Davis explained Slide 5: "APA-Notice of Proposed Action"

- The agency shall give each interested person an opportunity to present statements, arguments, or contention in writing, with or without opportunity to present them orally (AS 44.62.210(a))
- Agency "shall consider all factual, substantive, and other relevant matter presented to it before adopting, amending, or repealing a regulation. (AS 44.62.210(b))

Ms. Davis detailed Slide 6: "APA-Final Step"

After considering public comment, regulation is either adopted, or put out for another public notice. Once regulation has been adopted:

- Regulation is put in final form
- Final review by Department of Law
- Submitted to Lt. Governor for review and signature
- Regulation effective 30 days after filing by Lt. Governor

[9:13:44 AM](#)

Ms. Davis reviewed the Alaska's Clear and Equitable Share (ACES) regulations as listed on Slides 7-18. She noted that the regulations were listed on the Department of Revenue (DOR) website. The department first provided a format for

the taxpayer to report taxes under the new law. Each taxpayer must file a monthly estimate of their taxes necessitating a monthly form. She informed of the advisory bulletin, which helped interpret particular tax laws. Regulations also addressed facility sharing arrangements and the interpretation of the issues.

[9:16:41 AM](#)

Ms. Davis continued with Slide 19: "What Remains?"

Forty six of the approximately seventy production tax regulations have been adopted and signed into law by the Lt. Governor. Of those remaining, seventeen relate to transportation and AGIA issues, four relate to facility sharing and the British Thermal Unit (BTU) heating value.

Public Hearing for facility sharing and BTU heating value has been held and the written comment period has also been closed. The department is currently evaluating comments received.

Transportation and AGIA related Regulations distributed for public comment February 9, 2010.

Unplanned Production Interruption Regulations--Second workshop to be scheduled this spring.

Co-Chair Stedman asked about the last sentence of the first paragraph.

Ms. Davis responded that "seventeen relates to transportation" refers to sections of the regulations that require revision. Approximately 17 provisions govern the way transportation costs are deducted from the gross revenue to arrive at the production tax value. With respect to "facility sharing and BTU heating value," those provisions that relate to AS 43 55 170 created a barrier to facility sharing on the North Slope. Because the producers read the statute in a defensive manner, there was a significant tax impact. Therefore, to protect themselves in a facility sharing arrangement, the producers took all of the payments received from a new entrant requesting a share of the facility. The cost to share facilities was therefore unnecessarily high because of the uncertainty around the interpretation of the statute. She spoke of great learning

about the industry's challenges and ensuring that the tax law is not a barrier.

Co-Chair Stedman asked about the fundamental issue of opening the basin and accessing the facilities. Ms. Davis explained that policy is at stake when a tax law requires a facility owner to provide any payment received. The department was able to break through the elements of facility sharing, which included a facility owner requiring a sharing party to pay its proportionate share of operating expense associated with the other party's production. Generally, in a facility sharing arrangement, the operator of the facility should strive for optimum efficiency.

[9:24:07 AM](#)

Co-Chair Stedman noted that the cost of the facilities create difficulty for a firm like Pioneer to come in and build their own facility. He mentioned the third paragraph and the Alaska Gasline Inducement Act (AGIA) regulations. He asked if the "in kind" and "in value" regulations would be in place by May 1st. He requested definitions for "in kind" and "in value" regulations.

Ms. Davis explained that there were two pieces of AGIA and the related inducements in terms of the open season. Under AS 43.90.300 there is opportunity to come forward and make a commitment to ship during the initial open season. If they do so in a manner that satisfies both the commissioner of natural resources and the commissioner of revenue, then Department of Natural Resources (DNR) will issue regulations to govern the royalty inducement.

[9:28:45 AM](#)

Co-Chair Stedman asked if the exemption applies to oil. Ms. Davis replied that the exemption only applies to gas.

Co-Chair Stedman asked for a definition of "get worse." Ms. Davis answered that from an industry perspective, the tax will not be greater on May 1st for the volume of gas that is committed to the pipeline.

Senator Thomas clarified that the tax would prove worse for the new shipper versus one with the tax already in effect.

Co-Chair Stedman requested definitions for open season. Ms. Davis responded that the initial open season begins on the firm date of May 1st, 2010 and is held open for 90 days. During the three month time period, a substantial amount of communication between pipeline companies and potential shippers occurs and a negotiation for shipping is arrived at. Because the regulations have been released for public comment, too much description is prohibited. Each company strikes its own deal during the time period.

Co-Chair Stedman asked if the second open season was not applicable. Ms. Davis concurred and explained that a second open season is necessary when commitments about the previous open season are no longer applicable and the party does not qualify under the existing AGIA law for the inducements.

[9:32:13 AM](#)

Co-Chair Stedman asked about the firm's certificate transfer ability. Ms. Davis explained the important AGIA provision stating that every shipper does not own gas on the North Slope. Large cooperatives of utilities are willing to make the commitment to acquire gas on the North Slope, but they would not pay taxes because they are not producing oil and gas. There is provision in AGIA that enables the transfer of the benefit of that tax or royalty inducement to the producer from whom they buy the gas in an effort to broaden the potential shippers and create a successful open season.

Co-Chair Stedman queried the potential subscription to the entire volume of the pipe by one entity followed by a division among members. Would the certificate be transferable? Ms. Davis assumed that the certificate would be transferable.

Co-Chair Hoffman referred to a newspaper article stating that the administration is open for business and China is invited. He asked about provisions included in the regulations that allow the arrangement. Ms. Davies responded that the situation would be similar to a large utility group in the lower 48. She provided an example where the arrangement proved appropriate.

Co-Chair Stedman pointed out that the value exists only if the tax is lower. Ms. Davis clarified that the value exists when the tax is subsequently increased.

Co-Chair Hoffman asked about the federal level's effect on the above mentioned scenario with China. Ms. Davis explained that the federal constraints required an American partner.

[9:37:42 AM](#)

Senator Huggins asked about similarities between in-state gas and AGIA regarding tax provisions and the demand for a large volume of gas. Ms. Davis answered that an instate gas line would be similar to an industrial anchor user. She added that the AGIA inducements would not be available. The current law stated that the gas used to fuel the plant would have the lower tax rate of 17 cents. The ethane would be taxed at the normal tax rate. She pointed out that HB 217 purports to give ethane gas the favored tax rate.

[9:40:09 AM](#)

Co-Chair Stedman requested information about operating and capital expenditures at corporate level.

Ms. Davis Slide 20: "Statutory Directions on Allowable Costs"

AS 43.55.165(a)(1)(B) provides that, "[a] producer's lease expenditures for a calendar year are costs that meet the following three requirements:

(i)The costs must be incurred upstream of the point of production of oil and gas

(ii)The costs must be ordinary and necessary costs of exploring for, developing, or producing, as applicable, oil or gas deposits; and

(iii)The costs must be direct costs of exploring for, developing, or producing, as applicable, oil or gas deposits"

[9:43:40 AM](#)

Co-Chair Stedman asked why some people were uncomfortable with the statute. Ms. Davis answered that the concern was

that the standard could be manipulated by industry. She highlighted the new recognition that the economy exists on a global scale in the modern world, which eased some of the discomfort with the statute.

Co-Chair Stedman asked about risk of an overzealous department tightening the regulations and excluding some expenditures better left included. Ms. Davis responded that the admonition was protective of industry.

[9:47:12 AM](#)

Ms. Davies reviewed Slide 22: "Statutory Directions on Allowable Costs"

AS 43.55.165(b) further delineates lease expenditures as including:

- (i) Direct cost of an asset even if it is capitalized for accounting or IRS purposes
- (ii) Payments of property, sales, use, motor fuel, and excise taxes
- (iii) Activity where the costs incurred do not are not on or near the oil and gas lease

Ms. Davis discussed Slide 23: "How Clear Are the Lease Expenditure Regulations"

15 AAC 55.250 -provides standards for the types of activities and purposes for which costs will be allowed, other than overhead.

15 AAC 55.260 -defines the direct charges that will be allowed as lease expenditures for the activities and purposes described in 15 AAC 55.250.

JOHN LARSON, MASTER AUDITOR, DEPARTMENT OF REVENUE, addressed the question about off-lease charges. He explained that historically, charges must be incurred on-sight to be considered "direct." With the development of electronic communications, the boundaries of the lease were expanded efficiently. He believed that industry's concern was valid. He claimed that the department sought a fair and balanced approach to the exploration, development, and production of oil and gas. The department agreed that those costs were reasonable.

Mr. Larson addressed the transportation workshops. He stated that regulations were released on February 9, 2010 with the aid of 12 workshops addressing the various types of proposed regulations. He noted four separate workshops addressing transportation issues.

Mr. Larson addressed Slide 23: "How Clear Are the Lease expenditure Regulations?"

Types of activities and purposes allowed under 15 AAC 55.250:

Exploration costs, including mobilization of a drilling rig, crew costs, drilling, processing & interpreting data, and completion, abandonment, or suspension costs

Development & production costs, including designing, constructing, operating, or maintaining an oil or gas production facility or equipment

Support activities, such as camps, roads, bridges and similar transportation, communications systems, medical, security, and emergency facilities.

[9:53:59 AM](#)

Mr. Larson moved on to Slide 24: "How Clear Are the Lease Expenditure Regulations?"

Direct costs under 15 AAC 55.260 for activities described in 15 AAC 55.250:

On-site labor

Technical labor whether on-site or remote location

Third-party contractor costs

Stand-by costs for a drilling rig

Property taxes and payments in lieu-of

Regulatory and permitting costs

Transportation costs of fluids used for reservoir maintenance and recovery.

9:55:59 AM

Co-Chair Hoffman sought the location of property tax and payment in lieu of property tax information in the presented handout. Mr. Larson answered Pages 10 and 11, Paragraphs 15 and 16.

Mr. Larson described Slide 25: "State Regulations vs. IRS Rules"

We align with the Internal Revenue Service (IRS) Code in several instances:

- The Department uses IRS Code 263(c) to determine whether a cost is a qualified capital expenditure under AS 43.55.023(1).
- "Ordinary and necessary" costs defined by IRS code 162
- Incorporation of concepts, regulations and guidance issued under IRS Code 482 for income and deduction allocation among taxpayers. We are directed to disregard the IRS code rules in some instances:
- We allow the deduction of a direct cost of an asset even if it is capitalized for IRS purposes.

9:58:37 AM

Co-Chair Stedman asked why the committee should be interested in the topic. Mr. Larson explained that ACES allowed deduction of the cost of the facility. Co-Chair Stedman asked if he referred to the production tax. Mr. Larson replied yes. Co-Chair Stedman asked about depreciation of corporate income tax. Mr. Larson replied that deduction of costs or amortization is required for IRS purposes.

Senator Egan asked about the capitalized cost and the difference between the IRS and the state. Mr. Larson responded that deduction of costs for IRS require capitalization of an asset and then depreciate the costs over a period of time. The department then uses the IRS rules to capitalize on an entity's books to base the capital credits on the cost. In addition to gaining the capital credits, the department allows the cost of the asset to be deducted as the costs are incurred.

10:01:40 AM

Co-Chair Stedman asked about capital investment depreciation. He inquired about the operating expense and the treatment of the corporate income tax. He noted that the deduction is accelerated and cash flow timing is switched.

Ms. Davis commented that the provision is unusual in regard to global practices in net tax calculation. Other countries spread the deduction over two years. Alaska allows 100 percent of the deduction in the year incurred, which is an element of ACES.

Co-Chair Stedman commented that the practice provides a big stimulus.

Ms. Davis noted Slide 27: "Comments from Industry"

"Without clear regulatory guidance from the Department, AS43.55.170 may be interpreted in a manner which artificially inflates the costs associated with facility sharing in the state; and acts as a disincentive to future third-party facility access agreements.

Thanks to this collaborative effort and the Department's hard work, the proposed regulation largely addresses the concerns Pioneer has expressed over the past year, and in doing so, removes barriers to future facility sharing opportunities in the state."

Patrick Foley, Manager, Pioneer Natural Resources  
Alaska November 19, 2009

10:05:39 AM

Ms. Davis finished with Slide 29: "Conclusion".

Tax Division's Regulations Process has ensured maximum meaningful input from industry and public. When final public comment period begins, involved parties have had opportunity to critique proposed regulations and Division has had opportunity to fully understand how the regulations will impact industry and been able to address ambiguity and problems.

Industry input and dialogue with the Department has never been greater than in the implementation of the AS 43.55 regulations.

[10:07:44 AM](#)

Co-Chair Stedman questioned the April 2010 date listed on the presented regulations. Mr. Larson explained that the date specified the register that the regulations will be published. Ms. Davis added that the date was a publication date, but the regulations were already signed and issued by the lieutenant governor.

Co-Chair Stedman commented on the processing of disputes with the industry where the settlement travels to the Constitutional Budget Reserve (CBR) fund. He inquired about an expectation of differing opinions with the industry regarding regulations. Ms. Davis did not expect to see much change in the returns filed, as the regulation aligns with the different operating agreements. Co-Chair Stedman questioned whether there would be litigation. Ms. Davis did not think so.

[10:10:02 AM](#) AT-EASE

[10:17:37 AM](#) RECONVENED

^OPERATING and CAPITAL EXPENDITURES

[10:18:46 AM](#)

Ms. Davis stated that prior to ACES, the department received an inquiry regarding the crude oil topping plant. The North Slope producers require diesel fuel for operations support. The diesel fuel is manufactured in a plant in Kenai. A crude oil topping plant is a small scale refinery where diverted oil is refined for the diesel component. High sulfur diesel production has since been outlawed. The department viewed the cost of the plant as a "downstream cost" and therefore not deductible. She referenced a handout titled "Oil Company Upstream Capital Spending" by Gaffney, Cline and Associates Inc. (Copy on file). The issue of cost deduction was put to the legislature. Ultimately, the legislature included in the exclusions from lease expenditures, costs associated with the crude oil topping plant. The regulations reflect the exclusion; the cost of acquiring diesel is legitimate lease expenditure and may be deductible.

[10:24:10 AM](#)

Ms. Davis referred to Page 11, Item 20 of the legislation describing the means of calculating the cost of the product.

Co-Chair Stedman asked about the deduction. Ms. Davis responded that industry is allowed to deduct the fair market value of the acquired product. Certain provisions address fair and appropriate charge when a producer owns a facility and creates a product for other producers.

Co-Chair Stedman expressed concerns about fair market value and diesel fuel. He asked how fair market value was derived with only one topping plant. Ms. Davis referred to Subsection 20 and explained that the department subtracted the fair market value of the product from the prevailing value.

[10:28:26 AM](#)

Senator Egan asked for a review of the fair market value. Ms. Davis responded that the diesel that is trucked and sold to the North Slope encompasses benchmarks for products delivered in the vicinity. Diesel fuel is then sold by the crude oil topping plants to other owners and operators on slope allowing the factoring in of Kenai prices.

Senator Egan asked if value is determined only from Alaska. Ms. Davies responded yes unless a competitive market for the product does not exist.

Co-Chair Stedman noted termination of the orders in Seattle.

[10:30:17 AM](#)

Ms. Davis mentioned the department's presentation request regarding Alaska's global investments relative to investments by companies. What makes Alaska an attractive place for investment? The legislative body wants to make the state as attractive as possible. She referred to the report generated by Gaffney, Cline, and Associates, Inc. in 2007, which was updated to comprise upstream capital spending. The report viewed the largest investors in Alaska to find out where they are investing their dollars. Oil

companies are for-profit companies and several factors affect investment. If resource potential and other variables are similar, government take can swing. Investment tends to happen in places where government take is the lowest. The likelihood and size of the discovery also affect the decision about where to invest. She noted that large oil companies are spending money in places where approximately 70 percent of the capital spent is not in the United States. Comparisons among United States provide a small piece of the puzzle. Increased information can be gathered by comparing Alaska to the international market.

[10:33:54 AM](#)

Ms. Davis informed about upcoming presentations involving global regions. The Gulf region of the United States has one of the lowest tax regimes in the world.

Co-Chair Stedman requested comment regarding the differences and similarities between the Gulf region and Alaska. Ms. Davis replied that business in the Gulf of Mexico experienced a downturn due to a lack of deep water development. The shallow water around the Gulf was exhausted, but the offshore water is identified as federal land, which is governed by the federal royalty rules. Historically, the federal government has a low royalty take, which is attractive to big oil industry. She noted that the oil industry has shareholders and obligations as reserves are used to replace them. The Gulf of Mexico is not large enough to allow all of the big oil companies to replace their reserves. For the reasons listed, a diversified portfolio is necessary. The outer continental shelf is an important piece of the puzzle, although small. Alaska has a substantial resource offshore in the outer continental shelf. She mentioned heavy oil and its appeal. Offshore Alaska provides another large target. A tariff charge is altered by lowering the cost and increasing the throughput.

[10:39:28 AM](#)

Ms. Davis addressed the chart on Page 2 of the handout titled "Oil Company Upstream Capital Spending," which compares the capital spending of Exxon-Mobil, British Petroleum (BP), Chevron and Conoco-Phillips. Only Conoco-Phillips had a reported Alaska share. Exxon had the

smallest investment in the United States, while BP had the highest percentage spent.

10:41:18 AM

Senator Olson asked about the demarcation point and the United States/Canadian division. Ms. Davis did not know but assumed that international treaties were very specific about the use of country boundaries.

Ms. Davis concluded that the report gave information regarding an analysis of ACES and what can or cannot be done to improve Alaska as an investment location. The advice from Gaffney, Cline & Associates was to accept that a large share of the money is directed internationally. Alaska must therefore position itself accordingly. Alaska did not have the highest government take when compared to the global market. The international monies were invested in jurisdictions with high government takes, meaning that a company's decision to invest is not driven by the government take analysis. Factors might include potential prizes that add large stakes to the reserve portfolios. She recommended a thoughtful approach when attracting investment.

Co-Chair Stedman commented on the historic presentations that have occurred in committee in the past few years and he offered to provide copies to members if necessary.

^Oil Industry Employment and Resident Hire

Scheduled but not Heard

#

ADJOURNMENT

The meeting was adjourned at 10:45 AM.