

SENATE FINANCE COMMITTEE
February 19, 2010
9:02 a.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:02 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Johnny Ellis
Senator Dennis Egan
Senator Joe Thomas

MEMBERS ABSENT

Senator Charlie Huggins, Vice-Chair
Senator Donny Olson

ALSO PRESENT

Pat Galvin, Commissioner, Department of Revenue; Susan Pollard, Attorney, Department of Law; Senator John Coghill; Senator Joe Paskvan.

PRESENT VIA TELECONFERENCE

None

SUMMARY

WEEK IN REVIEW-PRODUCTION TAX ELEMENTS
TAX CREDIT-FOLLOW-UP TO COMMITTEE QUESTIONS
REVENUE FORECASTING & SHARING
TAX PAYMENT PENALTIES

^Week in Review-Production Tax Elements

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PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE, presented the PowerPoint "Summary of the Production Tax Review" expanded format of information requested earlier." (Copy on File) He explained that the information was in response to earlier requests. The information regarding the revenue forecasting includes a separate discussion involving comparison with the Economic Limit Factor (ELF) system.

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Commissioner Galvin began with Slide 2: "Production Tax Calculation--FY2009." The presentation consolidated the information provided in the week prior. He discussed Slide 4 and "Oil Price and Production Outlook," which addresses the various components of the calculation sheet. He informed that costs are crucial to calculation when using the production forecast method. Previous committee discussions captured the "income statement" approach.

Commissioner Galvin turned to Slide 5-6 and "Transportation Costs." He pointed out the deduction for marine transportation, the tariff on the Trans-Alaska pipeline, and information on the history of the tariff including issues regarding the calculation methodology. The currently producing fields constituted the majority of capital expenditures. The underdevelopment expenditures have experienced the greatest expansion in the capital expenditure projection.

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Commissioner Galvin discussed Slide 7 and "Lease Expenditures." The process used to draft regulations defines qualified lease expenditures by providing a clear and predictable method of discerning which costs can be deductible. Projections relating to spending levels across the North Slope in an aggregated fashion are shown on Slide 7. The slide exhibits growing capital expenditure levels collectively. The currently producing fields comprised a majority of the capital expenditures. Once the lease expenditures were deducted from the point of production value, the production tax value (PTV) was computed. The PTV is the per barrel value that derives the progressivity rate. Progressivity rate is the tax rate applied to production for an individual tax payer. The base tax is 25 percent along with the progressive tax, which increased at

a rate of .4 percent per dollar. He explained the example provided on the slide. If the expenditures had been greater per barrel by one dollar, reducing the production tax value by one dollar, the progressive tax rate would have been reduced by .4 percent. He pointed out the dynamic of an altered progressive tax value and progressivity charge with an increase in the price of oil.

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Commissioner Galvin continued with "Tax Credits" on Slides 10 and 11. The general capital expenditure credits equal 20 percent of all capital expenditures. Exploration credits fall into different categories. Operating losses where the company has more expenditures than production values results in a credit.

Commissioner Galvin discussed Slide 12 "The Updated Credits Applied Against Tax Liability." He noted that the graph is presented in calendar years as opposed to fiscal years. For 2006, 2007 and 2008 the department has annual tax returns to derive the credits from. For 2009, 2010, and 2011, the department is basing the number on the expected level of capital expenditure.

Co-Chair Hoffman asked about the capital expenditure credits under the governor's proposed legislation. Commissioner Galvin responded that the bill will contain the requested information including a breakdown of capital costs.

Co-Chair Stedman asked about effects of the large capital expenditure credit. He asked if the presentation will break down Prudhoe Kuparuk data and compare it to that of Point Thompson. Commissioner Galvin responded yes, that a full break down of the different fields will be presented later in the morning.

Co-Chair Stedman noted that the presentations are fast paced and he appreciated the department providing up to date information.

Commissioner Galvin explained Slide 13: "How Credits are Used" The use of credits depends upon the tax payers own situation.

Two Examples

New Entrant

\$200 million exploration project

No Current Production

Incumbent Producer

\$200 million new development project

Commissioner Galvin addressed Slide 14 and the "Credit Example 1: New Entrant"

A new entrant with no current production pursues an exploration project requiring \$200 million in investment

Company receives a 20% -40% investment credit (depending on location), worth \$40 -\$80 million

Company also receives an additional 25% credit for its "tax loss" or "net operating loss (NOL)", worth up to \$50 million

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Commissioner Galvin discussed Slide 15 and the "Credit Example 1: New Entrant (cont.)"

The total credits of \$90 -\$130 million, can be:

Directly recouped (cash) from the state

Transferred to a person that does pays tax, so that the Transferee pays \$90 -\$130 million less in tax

Either way, State pays \$90 -\$130 million for the exploration; company pays \$70 -\$110 million.

If the exploration effort fails, the state never recoups this money.

The state bears the risk for failure as does the new entrant

Commissioner Galvin addressed Slide 16 and the "Exploration Dry Hole- New Entrant." He explained that the state share

was 65 percent and the state could expense the 12 percent of the federal income tax.

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Commissioner Galvin continued with Slide 17, "Credit Example 2: Incumbent Producer"

Incumbent with current production pursues a development requiring \$200 million investment

Company receives a 20% capital investment credit, worth \$40 million

By reducing their Production Tax Value (PTV), the company reduces their taxes due by the total capital expense multiplied by the tax rate:
\$200 million * 25%, worth \$50 million; plus
\$200 million * progressivity surcharge rate (which is reduced due to the drop in PTV)

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Co-Chair Stedman pointed out the statement that progressivity applies to all barrels produced, once triggered. Commissioner Galvin agreed with Co-Chair Stedman.

Commissioner Galvin addressed Slide 18: and the "Credit Example 2: Incumbent Producer (cont.)"

Deductions and credits total more than 45% of the \$200 million, greater than \$90 million

State pays more than \$90 million of the new development's capital cost; true investment cost for the incumbent is less than \$110 million

If the development fails, the state never recoups this money

The state bears the risk for failure as does the incumbent investor

Commissioner Galvin referenced an exploration project on Slide 19: "Unsuccessful Development Project-Existing Producer" He explained that the state share is greater than

under the experience of the new entrant because of the progressivity impact. Assuming that the state had a \$70 well head value, the result was a 9 percent progressivity rate, which results in 76 percent as the state's share of the investment cost.

Co-Chair Stedman asked about an estimate in the event that the exploration incentive credit was unavailable. Commissioner Galvin responded that the exploration incentive credit would be dropped from 40 percent to 20 percent reducing the state share to 56 percent. The federal share would then increase to 15 percent resulting in a company share of approximately 28 percent.

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Co-Chair Hoffman referred to Slide 12 and commented that the increase in values from 2006 to 2011 is a result of the state's financial responsibility for the vast majority of exploration. Commissioner Galvin agreed that the state revenue is increasing and the tax burden on the industry is increasing and the state has distributed the impact so that those investing in the new exploration and development in Alaska receive a tax benefit. The department is endeavoring to bring in additional revenue while incentivizing production and employment opportunities.

Co-Chair Hoffman asked about the top line of capital expenditures rising in 2009 to 2011 with an additional \$130 million in state expenses. He opined that the incentive was working as there is a dramatic \$200 million increase from 2006.

Co-Chair Stedman requested clarification regarding Prudhoe and Kuparuk and the exploration and development expenditure definitions. Commissioner Galvin replied that Prudhoe and Kuparuk were considered development expenditures.

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Senator Thomas referred to Slide 12 and the reference to calendar years. He asked if the information presented on Slide 12 was historical or estimated. Commissioner Galvin explained that the shaded areas are estimated and refer to monthly reports, which are not as detailed as the annual report. He noted that a different format was employed with the projections of spending levels to anticipate credit use

and application. He recalled a past presentation discussing the difference between credit earning and application. He clarified that Slide 12 represents the taxes applied by producers.

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Commissioner Galvin discussed "Overall Sharing of Oil Revenue and Profit" on Slide 20. He commented on Slide 21 "Allocation of Revenue and Profit on \$76 Barrel of Alaska North Slope Oil" which represents the allocation of revenue generated from a barrel of oil at a \$76 price. He explained the graph and its various components. He determined production and transit costs to be \$24. State royalty was approximately 12.5 percent calculated with the point of production value. The production tax, state income tax, state property tax, the federal income tax and the after tax value for the company are also exhibited on Slide 21. The graph is broken down by dollars and after cost profit.

Co-Chair Stedman asked about the production tax and whether it includes a progressivity calculation. Commissioner Galvin replied yes, the production tax includes both the base tax rate and the progressivity.

Co-Chair Hoffman questioned the use of 34.4 percent on Slide 2.

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Commissioner Galvin responded that a deduction of the tax and the royalty allows for the production tax value. The production tax equals the progressivity component as mentioned earlier. He pointed out that Slide 21 shows an after credit portion exhibited in the green band of the graphic image. The percent of the profit is therefore less than the tax rate multiplied by remaining \$43. The combination of 25 percent plus the progressivity subtracting the credits results in 23.8 percent of the profit.

Co-Chair Stedman pointed out that the net of the credit is not taken into account with high level calculations of the tax structure. Commissioner Galvin agreed and noted that the provided example uses \$76 per barrel as a generalization across the North Slope. The example

represents the state's share of the profit as 47 percent. The royalty drives the state share higher at the lower end. The upper end with the progressivity element of the production tax drives the state share higher.

Commissioner Galvin moved on to Slide 22: and the "Shares of North Slope Oil Profit at Different Prices." He explained that the slide does not account for the costs paid to arrive at the profit. The share of the revenue generated from the oil did not reveal the fact that the producers will recover costs first. The percent allocated to the producer to cover costs provided a different picture of the distribution of the revenue.

Commissioner Galvin addressed the Slide 23: "Split of Total Oil Revenue."

Reviewing only "Take" does not reveal the fact that the Producer recovers all costs before taxes are assessed.

Whereas State share of profit is high at low prices, the Producer retains the majority of the revenue.

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Senator Thomas requested a chart similar to Slide 23 illustrating the investment made by the parties in relationship to the dispersion of revenue. Commissioner Galvin responded that he had such a slide and would present it to the committee. He mentioned earlier charts exhibiting the marginal tax rate or the marginal government take, which represent the share of the dollar of investment born by the state and federal government versus the producer. When the price approaches \$92.50, the state and federal government share is approaching 90 percent of the investment dollar. Senator Thomas appreciated the information.

Commissioner Galvin addressed Slides 24 and 25, "Estimated FY 2010 Tax-Prudhoe Bay and Kuparuk" and the various categories. The North Slope fields are separated into three categories. The initial category is Prudhoe Bay and Kuparuk. The second category includes all producing fields other than Prudhoe and Kuparuk. The third category includes non producing fields. The numbers seen here were deduced as rounded estimates for 2010, and were not intended to be specific dollar amounts. These aggregate the production tax

by field. Each player has a different category of interest. This exercise provides the committee with a sense of a proportionate share between the different components of the field.

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Commissioner Galvin continued that current production price estimates for Prudhoe Bay and Kuparuk was 488 thousand barrels per day, which equaled \$32 million per day, equivalent of \$11 billion annually in value. Subtracting royalty barrels results in taxable barrels with a value of approximately \$10.5 billion. Rounded transportation costs reduce the estimate by approximately \$1 billion. Lease expenditures are valued at approximately \$10 per barrel, operating expenditures are valued at \$6 per barrel, and capital expenditures result in a production tax value of \$7 billion resulting in a progressivity rate of 6.2 percent. The total derived taxes before credits were \$2.2 billion. The credits include 20 percent of the amount expended. The after-tax revenue generated from Prudhoe and Kuparuk resulted in an estimated \$2 billion.

Commissioner Galvin moved on to "Estimated FY 2010 Tax for Producing North Slope units excluding Prudhoe and Kuparuk," Slides 27 and 28. He explained that the methodology was similar to that discussed in Slides 25 and 26, but with less production resulting in taxable barrels on an annual basis of \$3.5 billion. The transportation deduction equals approximately \$300 million. Lease expenditures are similar to Prudhoe at \$9, but capital expenditures are greater. The production tax value for these fields was lower due to the additional capital expenditure resulting in a lower progressivity rate and after-credit tax of approximately \$528 million.

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Commissioner Galvin addressed Slide 29: "Estimated FY 2010 Tax for Developing Units." These units provide zero production and therefore zero costs on a per barrel basis. He explained that expenditures would result in a negative production tax value similar to a new entrant. Some fields will take the loss and apply it against the revenue generated by other fields resulting in a 25% reduction in the state's tax bill or a credit of \$243 million.

Commissioner Galvin detailed Slide 31: "Summary of Tax Calculation for Different Fields." He commented that the majority of production and tax revenue was generated from the two largest fields. The operating expenditures were similar on a per barrel basis.

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Co-Chair Stedman assumed that Prudhoe and Kuparuk had lower operating costs. Commissioner Galvin responded that the operating expenditure level for a field reaches the lowest level during the peak of production. Prudhoe and Kuparuk are no longer in peak production. He summarized that the other North Slope producing units were nearing peak production allowing for the similarity in operating expenditures.

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Co-Chair Stedman commented on the amount of investment required to stem decline in production thereby doubling the capital expenditures. He asked if the capital expenditures targeted those included in the original Petroleum Production Tax (PPT). Commissioner Galvin indicated that additional investment was necessary. The data reflects that the level of investment was not evenly spread throughout the fields.

Commissioner Galvin continued that Slide 31 provides an interesting comparison regarding the different fields. The committee views the line item in the budget representing a reduction of \$400 million, which nearly equates to the amount of tax generated by the non-producing units.

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Commissioner Galvin summarized with the information on Slide 32: "At the Close of the Week"

Covered Information on Production Tax Components,
their Function, and Relationship

Provided a Broad Understanding of How Oil Production
Tax is Calculated

Upcoming Topics

How Alaska's Fiscal System stacks up to Global Comparables

How the Production Tax performs in an Oil and Gas production basin

Co-Chair Stedman commented on the helpful nature of presentation.

[10:11:08 AM](#) AT-EASE

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TAX PAYMENT PENALTIES

SUSAN POLLARD, ATTORNEY, DEPARTMENT OF LAW, referred to an overview entitled, "Tax Payment Penalties" (copy on file). She began with Slide 2: "Presentation Overview"

Tax penalty provisions with general application

Compromise and settlement

Provisions that apply to production tax

She turned to Slide 3: "Overview-Tax Penalties and Interest"

Alaska Statutes 43.05

General application to Title 43 except as provided in specific tax chapters

Covers returns, agreements on liability, compromise of tax or penalty, assessment, interest on underpayments and refunds

Production tax has some specific provisions on interest and penalties, discussed below

Disputes over tax assessments, including penalties, are first heard through informal conference at DOR

Appeal is to Office of Administrative Hearings - confidential until final administrative decision AS 43.05.470 (may be subject to protective order)

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Ms. Pollard explained Slide 4: "Penalties"

AS 43.05.220: civil penalties

Failure to file or pay: 5% for each 30 days up to 25%

-Penalties won't be imposed if taxpayer shows that failure to file or pay is due to reasonable cause and not willful neglect.

-Regulations apply administrative and judicial interpretations of IRC 6651 15

AAC 05.200 (reasonable cause for delay)

Negligence or intentional disregard: 5% of deficiency

-Includes substantial deviation from statutes in reporting income or claiming deductions, exaggerated deductions, failure to keep adequate records, or failure to justify understatement of income. 15 AAC 05.220

Fraud: greater of 50% of deficiency or \$500

-Requires clear and convincing evidence that tax liability was understated as attempt to evade tax. 15 AAC 05.230

Penalties are cumulative

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Ms. Pollard discussed Slide 5: "Penalties-Criminal"

AS 43.05.290: criminal penalties

Willful attempted tax evasion, failure to collect, or truthfully account for and pay tax: class C felony

Willful failure to pay, make return, keep records: class A misdemeanor

Willfully making and subscribing, or assisting in making, a false return (perjury): felonies, up to \$25k and 3 years imprisonment

Willfully delivery or disclosure of a false return: class A misdemeanor

Willful failure to obtain a required license: misdemeanor, up to \$2000 fine, 6 months imprisonment

Ms. Pollard discussed Slide 6: "Compromise and Settlement"

AS 43.05.070 - If in opinion of DOR there is doubt over liability or collectability of tax or penalty, DOR, with approval of Attorney General, may compromise tax or penalty

Agreements are final absent fraud, malfeasance or misrepresentation of material fact

Confidential under AS 43.05.230

Senator Egan asked, since the penalties involve corporations, who would go to jail. Ms. Pollard did not know. Commissioner Galvin relied on knowledge of other situations where corporations were liable. Jail time would only be relevant in an instance where an individual breaks the law, but a corporation can be subject to other criminal penalties such as probation and fines.

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Ms. Pollard continued with Slide 7: "Production tax penalties: failure to provide information"

AS 43.55.030-Filing of statements 43.55.030

Annual report due March 31 whether or not tax payment due

Statement: description of lease or property, producer name, gross amount of oil or gas production, gross value at point of production, purchaser and price information, qualified capital expenditures, lease expenditures and payments or credits from facility sharing

Department adopted standards in regulation for delinquent reports

Penalty maximum \$1,000 a day

Regulation 15 AAC 55.840 covers notice and penalty amount

In addition to other penalties

Ms. Pollard included the regulation in Slide 8: "15 AAC 55.840 (b)-Penalties AS 43.55.030"

(b) If, 30 days after a report required to be filed under AS43.55.030 is due, the department has not notified the person required to file the report ... the department will not assess ...a penalty that begins earlier than a date specified in a written notice to the person, except in case of the person's fraud or willful concealment. ... [T]he department will specify a date that is at least 10 days after the date of the department's delivery of the notice ... Nothing in this subsection affects the person's obligation to file a complete and accurate report.

Commissioner Galvin stressed that the importance of the reports cannot be underestimated. The function of the production tax is noted through the reports. The additional penalty addresses those who choose not to provide the reports.

Ms. Pollard summarized that the reports provide a useful tool for all concerned.

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Ms. Pollard detailed Slide 9: "Production tax penalties: failure to provide information"

AS 43.55.040:

DOR may require person engaged in production, purchaser or royalty owner to provide information necessary to compute the tax

If person fails to provide information, DOR may assess a penalty, under standards determined by DOR of not more than \$1,000 a day for each day the person

fails to file *after notice by the department*. 15 AAC 55.840

In addition to any penalties under AS 43.05.220 or 43.05.290

Ms. Pollard discussed Slide 10: "15 AAC 55.840(c)-Penalties 43.55.040"

(c) If a person fails to file a report, statement, or other document required to be filed under AS 43.55.040, the department will provide written notice of the failure to the person and will specify in the notice a date beginning on which the person will be liable for a penalty under AS 43.55.040(7) if the person does not remedy the failure before that date... If, 30 days after the date specified, the department has not assessed a penalty or otherwise notified the person in writing that the person has failed to remedy the failure before the date specified, the department will not assess a penalty under AS 43.55.040 (7) for the failure, except in case of the person's fraud or willful concealment.

Nothing in this subsection limits the department's right to require the additional or more complete and accurate filing of a report, statement, or other document.

Ms. Pollard spoke about Slide 11: "Penalties 43.55.030 and .040"

To determine amount of penalty, DOR will consider:

Willful or knowing nature of act or omission

Importance of required information and effect on ability of DOR to proceed in absence of information

Benefits to person in failure to file

History of noncompliance by person

Need to deter future noncompliance by that person and others

Effort made by person to correct noncompliance

15 AAC 55.840(d)

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Ms. Pollard reviewed Slide 12: "Summary"

Penalties are imposed for failure to comply with reporting provisions of production tax

In addition to penalties under 43.05.220 and .290

DOR has implemented clear and balanced regulations for taxpayers

Co-Chair Stedman recalled a case necessitating payment of tens of millions of dollars in interest. He recalled concern that the system lacked flexibility. He commented on the inflexible rate of interest. He observed that he was unsure where to direct his question.

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Commissioner Galvin apologized that interest rates were not included in the packet. He agreed that a discussion about interest rates was important and he suggested a separate presentation. Co-Chair Stedman concurred.

Senator Thomas recalled a comment that for every dollar spent in a lawsuit, the state recovered ten dollars. He asked about the statistic. Ms. Pollard offered to provide an answer following consultation with her supervisor.

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ADJOURNMENT

The meeting was adjourned at 10:41 AM.