

SENATE FINANCE COMMITTEE
March 9, 2010
9:03 a.m.

9:03:00 AM

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

Senator Joe Paskvan, Senator John Coghill, Charles Logsdon, Logsdon and Associates, Consultant Legislative Budget and Audit; Roger Marks, Petroleum Economist, Economic Research Section, Tax Division, Department of Revenue.

PRESENT VIA TELECONFERENCE

SUMMARY

SB 305-SEPARATE OIL & GAS PRODUCTION TAX

#sb305

SENATE BILL NO. 305

"An Act relating to the tax on oil and gas production; and providing for an effective date."

SB 305 was HEARD and HELD in Committee for further consideration.

9:03:05 AM

Co-Chair Stedman explained that SB 305 concerns the separation of oil and gas production tax. Preliminary

questions will be answered today by legislative consultants. Public testimony is scheduled for Thursday, March 11. He stated that SB 306 will not be addressed today.

CHARLES LOGSDON, LOGSDON AND ASSOCIATES, CONSULTANT LEGISLATIVE BUDGET AND AUDIT, stated that he was the Chief petroleum economist for the state from 1979 through 2004 and he became familiar with the oil and gas production tax. He negotiated a fiscal regime which involved changing from the Economic Limit Factor (ELF) system to the net value production system, which eventually became Alaska's Clear and Equitable Share (ACES). He also works with Legislative Budget and Audit (LB&A) which is a non partisan joint committee. Co-Chair Stedman informed that LB&A is the body who hires consultant for technical help in the oil and gas arena.

ROGER MARKS, PETROLEUM ECONOMIST, ECONOMIC RESEARCH SECTION, TAX DIVISION, DEPARTMENT OF REVENUE, explained that works with Logsdon and associates under the arrangement with LB&A to assist in analyzing gas taxation. He worked previously as a petroleum economist with the tax division of the Department of Revenue for 25 years. He explained that he continually analyzed North Slope gas commerciality. He retired approximately one year ago and started his own private practice.

Co-Chair Stedman requested a brief high level overview regarding the oil and gas tax regime.

Mr. Marks reviewed the PowerPoint presentation "SB 305: The Separation of Oil from Gas for the Oil and Gas Production Tax."

[9:09:36 AM](#)

Mr. Marks addressed Slide 2: "Premise of the Bill"

- Under current law oil and gas are taxed together
- oil is worth much more than gas
- The combining mechanism materially reduces oil taxes even though oil operations are unaffected

Mr. Marks addressed Slide 3: "Oil is Different than Gas"

- Oil more geographically concentrated (fewer sellers: OPEC)
- Oil supplies more depleted
- Gas is more plentiful
- Oil has fewer substitutes
- Gas has more substitutes

Mr. Marks detailed Slide 4: "BTU 10:1"

West Coast ANS

- Market Price \$80/bbl
- Less:
 - Shipping \$2.07
 - TAPS \$4.18
- Gross Value \$73.75

North Slope Gas

- Market Price \$6/mmbtu
- Less:
 - Tariff AK to AB \$3.54
 - AB Hub \$.24
 - Tariff AB to L48 \$0.85
- Gross Value \$1.37/mmbtu
- BOE Basis (X 5.5)= \$7.54
- On a straight BTU to BTU basis oil is worth nearly 10 X as much as gas

[9:13:26 AM](#)

Mr. Marks detailed Slide 5: "Some Things that have BTUs"

- Oil
- Gas
- Coal
- Wood
- Asphalt
- Shoe Leather
- Rubber
- Coffee grounds
- Citrus rinds
- Corn cobs
- Dung

Mr. Marks explained that if a suggestion were made to combine oil and shoe leather for taxation, you might wish to decline the opportunity. He pointed out that gas and oil are so different in value and net worth.

Mr. Marks described Slide 6: "Mechanics of Current Tax"

- Oil gross value (market price less transport cost)
- Gas gross value (market price less transport cost)
- Oil + gas gross value gas=Combined gross value
- Combined gross value--lease capital and operating costs=Combined oil and gas net value
- Combined oil and gas net value/total oil and gas BOEs=p/BOE net value (see Slide #7)

- Progressivity factor (based on per BOE net value) plus 25% base rate=tax rate
- Single tax rate applied to combined oil and gas net value

Co-Chair Stedman referred to the Senate Finance Committee presentations during the last couple of weeks. He noted those presentations from the Department of Revenue (DOR) and various consultants.

Mr. Marks continued with Slide 7: "Barrel of Oil Equivalents (BOEs): Putting Oil and Gas on an Apples/Apples Basis

- 4.5 billion cubic feet per day (bcf/d) of natural gas
- A cubic foot of North Slope gas will have about 1,100 BTUs
- Natural gas is measured in millions of BTUs (mmbtu)
- 4.5 billion cubic feet per day will have 4.95 million mmbtu's (4.5 X 1,100)
- A barrel of oil has about 5,500 BTUs
- 4.5 billion cubic feet per day will have the BTU equivalence of 900,000 barrels of oil (BOEs) (4,950,000/5.5)
- If there are 500,000 barrels of oil, total BOEs will total 500,000+900,000=1,400,000

Co-Chair Stedman asked if the 4.5 billion cubic feet per day indicates in estimated capacity that TransCanada is proceeding with their binding open season. He pointed out that the capacity was important with the large diameter of gasline moving down into Alberta.

Mr. Marks stated that the plan for TransCanada is to ship 4.5 billion cubic feet a day of natural gas from the North Slope to Alberta. North Slope gas is enriched with natural gas liquids such as ethane, butane, propane, and other heavier hydrocarbons that enhance the British Thermal Unit (BTU) content. Dry gas content without natural gas liquids has approximately 1000 BTUs to the cubic foot. North Slope gas is expected to have approximately 1100 BTUs to the cubic foot.

Mr. Marks explained that the per Barrel of Oil Equivalent (BOE) net value is the combined oil and gas net value divided by the total amount of oil and gas BOEs. Based on the per BOE net value, a progressivity factor is derived. The progressivity factor kicks in when the net value is \$30 a BOE or greater. Below 30 dollars there is no progressivity factor. The progressivity factor is added to the 25 percent base rate. The single tax rate for the oil and gas is applied to the combined oil and gas net value to arrive at the tax.

[9:21:43 AM](#)

Mr. Marks addressed Slide 8: "Progressivity Mechanics"

- "Trigger"=\$30 net/BOE value
- "Slope"=0.4%*
- Progressivity surcharge=(Net per BOE value-\$30) X.004
- Example: if net value=\$50
 - o Base tax rate=25%
 - o Progressivity=(\$50-\$30)X.004=8%
 - o Total tax of 33% on net value
 - *Slope changes to 0.1% after \$92.50 net per BOE value.

Co-Chair Stedman explained that the operating cost is subtracted along with capital expenditures and shipping charges from Valdez to the market.

Mr. Marks stated that the starting point is the per barrel of oil equivalent net value, which includes the shipping and pipeline tariffs and the operating and capital lease development costs.

[9:24:06 AM](#)

Mr. Marks remarked on Slide 9: "How Gas impacts oil taxes"

	<u>Oil</u> Alone (p/bbl)	Gas (p/mmbtu)
Market Price	\$80.00	\$6.00
Transportation	\$5.00	\$4.50
Gross Value		
Costs	\$20.00	\$0.50
Net (p/barrel or p/mmbtu)	\$55.00	\$1.00
Base rate	25.00%	
Progressivity	10.00%	
Total tax rate	35.00%	
Daily bbls (oil) or mmbtu (gas)	500,000	4,950,000
Daily BOEs	500,000	900,000
Annual BOEs(millions)	183	329

Combined Oil and Gas

Oil	\$55.00
p/bbl net value	183

mmbtu's (millions)	\$10,038
Gas	
p/mmbtu net value	\$1.00
mmbtu's (millions)	1,807
Total gas net value (\$mm)	\$1,807
Total oil and gas net value	\$11,844
Total BOEs	511
Net value/BOE	\$23.18
No Progressivity!	

[9:26:41 AM](#) AT EASE
[9:26:56 AM](#) RECONVENED

Mr. Marks detailed Slide 10: "Department of Revenue Examples from February 24, 2010 Presentation to Senate Finance." He discussed the magnitude of the combination of oil and gas. The more oil and gas values differ, the greater the net value is diminished. The progressivity and tax also drop.

[9:32:40 AM](#)

Mr. Marks detailed Slide 11: "How the Bill Works"

- Under the current law there is a base tax rate of 25%
 - o Plus progressivity based on the combined oil and gas net value/BOE
- The bill removes progressivity on gas
- Progressivity on oil continues to be calculated just on oil net value/barrel
- Exclusion of gas in the progressivity calculation does not reduce oil taxes.

Co-Chair Stedman stated that the committee does not have an intention of bringing SB 306 to the committee.

[9:34:58 AM](#) AT EASE
[9:35:33 AM](#) RECONVENED

Dr. Logsdon noted that the bill's intention is to separate oil and gas for the purpose of production tax. The legislation is designed to correct the method that the progressive element in the current tax is calculated in respect to oil and gas. He referred to Section 1 and the specific language that identifies the production of oil for progressivity rate purposes, which includes Section (g) of AS 43.55.011. He noted that (g) shows a number of changes designed to take out the language per BTU equivalent. The two words define the combination of gas with oil to calculate the progressivity tax schedule outlined through (g) one and two. He noted that when the price of oil is greater than \$30 per barrel then progressivity kicks in at the rate of 4/10 of a percent for every dollar that the net

value per barrel is above \$30 to a maximum trigger point of \$92.50. Gas has been removed from the calculation of the progressivity element of the tax rate.

[9:38:21 AM](#)

Dr. Logsdon referred to Section 3, where elements of the production tax addresses taxation outside of the North Slope. He mentioned that taxes on the Cook Inlet are limited to the lesser of the net tax. Section 3 addresses taxable oil if sold at the average price as calculated under the Economic Limit Factor (ELF) law. The current law includes a cross reference to the base rate. Any reference to progressivity in the statute does not affect gas.

Dr. Logsdon referred to Section 4, which is an exception for the application of the net tax to property outside of the Cook Inlet. He noted that the base rate is another way to clarify that gas will not be subject to the progressive rate. Section 5 repeats the sentiment.

[9:43:15 AM](#)

Dr. Logsdon continued that a key concept is that each reference to the use of a progressivity factor is only indicated for oil, never for gas. Section 6 covers AS 43.55.160(a)(2) to the tax base and the calculation of the net production value. There are no references to a progressive tax rate affected by the calculation. The annual production tax value in Section 1 references (e), but Section 6 references AS 43.55.011(g), which is the section that describes the progressivity rates. All references to gas are parsed out. The next change is in Section 7 where the language controlling the taxable net value and any reference to gas is eliminated. Section 8 states that the bill takes effect after the governor's signature or the day after the expiration period on gubernatorial action. This bill separates oil from gas in calculating the progressivity factor, which is a function of calculating the net value at the point of production and focuses on the progressivity calculated on the basis of the value of oil and how it compares to \$30 per barrel.

[9:48:38 AM](#)

Senator Olson asked about the advantages for eliminating progressivity for the natural gas production tax.

Dr. Logsdon responded that the task was to separate oil and gas because of the dilution affect on the tax rate. One tax theory states that matching up the tax on substances matches the ability to pay, which would suggest that a lower value commodity should be taxed at a lower rate. Setting tax policy is more complicated than speculating. He noted that

taxes can have positive effects on state revenue and negative effects on the revenue source. He did not offer an opinion on Senator Olson's question. Senator Olson imagined that there were no advantages to encouraging exploration or investment. Dr. Logsdon responded that SB 305 does not change the basic incentive structure that is already in statute.

[9:51:17 AM](#)

Senator Thomas asked if there was gas currently sold at Prudhoe Bay. He asked about the effect of SB 305 on the gas sales. Mr. Marks answered that the gas sold in-state is subject to the ELF provisions and is not affected by progressivity.

Co-Chair Stedman stated that public hearing is scheduled for March 11, 2010 with input from the administration.

[9:52:52 AM](#)

SB 305 was HEARD and HELD in Committee for further consideration.

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ADJOURNMENT

The meeting was adjourned at 9:53 AM.