

**ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE**

February 4, 2010

3:36 p.m.

MEMBERS PRESENT

Senator Lesil McGuire, Co-Chair
Senator Bill Wielechowski, Co-Chair
Senator Hollis French
Senator Bert Stedman
Senator Gary Stevens
Senator Thomas Wagoner

MEMBERS ABSENT

Senator Charlie Huggins, Vice Chair

COMMITTEE CALENDAR

Update by the Administration - ACES and its Effect on Oil and Gas Investment

PREVIOUS COMMITTEE ACTION

No previous action to record.

WITNESS REGISTER

PATRICK S. GALVIN, Commissioner
Alaska State Department of Revenue (DOR)
POSITION STATEMENT: Presented an overview of ACES.

MARCIA DAVIS, Deputy Commissioner
Alaska State Department of Revenue (DOR)
POSITION STATEMENT: Discussed the ACES Status Report.

ACTION NARRATIVE

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CO-CHAIR LESIL MCGUIRE called the Senate Resources Standing Committee meeting to order at 3:36 p.m. Present at the call to order were Senators French, Stedman, Stevens, Wagoner and McGuire.

Update by the Administration - ACES and its Effect on Oil and Gas Investment

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PATRICK S. GALVIN, Commissioner, Department of Revenue (DOR), Anchorage, Alaska, introduced Deputy Commissioner Marcia Davis and outlined his presentation. He said he would give a brief review of Alaska's Clear and Equitable Share (ACES) for the people at home and then turn it over to Deputy Commissioner Davis to talk in more detail about the ACES status report and some of the data that was generated to look at the question of ACES impact on the investment climate.

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COMMISSIONER GALVIN began with a high-level overview to remind everyone of what the structure of ACES is intended to accomplish and how that may play into its impact on the investment climate. He explained that the term production tax value (PTV) is at the heart of the calculation of what will actually be due; it is the sales price of Alaska's oil at market minus the cost of the tankers and pipeline to get the oil to market; and then, because this is a net-based tax, minus the cost to produce the oil. It is the capital and operating expenditures associated with producing the oil, which companies deduct from their revenue in order to generate the production tax value. So, he said, two moving parts are going to drive PTV - the price and the expenditures. (Slide 3)

SENATOR FRENCH interjected that the equation on slide 3 should include the word "minus" on the top line.

COMMISSIONER GALVIN agreed. He continued saying that the other two terms they need to look at are the base tax rate on production, 25 percent under ACES, and the progressive surcharge rate, which is the additional tax rate that is added to the 25 percent based upon that extra production tax value. When the profit on a barrel of oil goes above \$30, then the tax rate increases. Between \$30 and \$92.50 profit, the rate goes up 4 percent per dollar of additional production tax value. Once the profit gets above \$92.50, which is the break-point of a 50 percent total tax rate between the base tax and the progressive surcharge, it increases at 1 percent per dollar up to \$342.50 of profit, which is at a 75-percent total tax rate.

SENATOR FRENCH asked Commissioner Galvin to remind him where the PTV kicks in on the price per barrel of oil.

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COMMISSIONER GALVIN replied that it is different for each taxpayer, because each will have a different cost (both operating and capital) associated with producing their oil. A company that has a new development project under way may be expending a significant amount of money during those years and gets to deduct that immediately from its production tax value. On average, across the North Slope a ballpark figure of \$25 to \$27 is used to represent the per-barrel aggregate of transportation and lease expenditures. That means that the market price (West Coast Alaska North Slope [ANS] price) needs to be approximately \$56 to \$57 before progressivity kicks in.

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SENATOR FRENCH said he thought the first \$25 to \$27 per barrel escaped production tax and between \$25 and \$50 the tax is 25 percent, and that progressivity kicks in after \$50.

COMMISSIONER GALVIN added that a minimum tax acts as a floor.

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COMMISSIONER GALVIN commented that for those who want more detail on this type of calculation, they go through a much more rigorous analysis of the different components in Senate Finance.

He reviewed the big picture tax calculation, which was shown on slide 4 as follows: multiply PTV times the base tax rate to get the base tax, multiply PTV times the progressive surcharge rate to get the progressive surcharge, combine the base tax and the progressive surcharge to get the pre-credit tax bill. He said credits are in multiple forms and come right off the tax bill, dollar-for-dollar. If the amount after subtracting the credits is negative and credits remain that can't be applied against the tax bill, then those can be transferred to another tax bill or submitted to the state for full payment.

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SENATOR HUGGINS and CO-CHAIR WIELECHOWSKI joined the meeting.

COMMISSIONER GALVIN explained that small producers, those with production levels less than 50,000 barrels per year, get a \$12-million off-the-top credit and an across-the-board 20-percent credit on all capital expenditures. The exploration incentive credit is 30 to 40 percent for certain expenditures that are outside the current operating areas, and if a producer has no production and is incurring operating and capital costs that

result in a negative PTV, the 25 percent tax rate results in a loss carry-forward that can be used as a credit in future years.

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COMMISSIONER GALVIN provided two examples to demonstrate the way the state participates in these investment factors. The first assumed a new entrant, a company that has no production in the state at this time but is pursuing an exploration project that requires a \$200 million investment (slides 6 and 7). Depending on the location of that exploration activity, they would receive a capital credit of 20 to 40 percent on those expenditures; so their investment is worth \$40 to 80 million in terms of what they would get back from the state. They would also likely incur a tax loss which, at a base tax rate of 25 percent, would result in an additional credit, bringing credits to \$50 million. Between the two, they would qualify for credits on that \$200 million investment of between \$90 and \$130 million. They could either submit the credit to the state for cash back or find a taxpayer who is willing to buy the tax credit from them.

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SENATOR FRENCH said it looks as if a new entrant is going to get back almost half of his money; it is like a 50-percent-off sale through the state.

COMMISSIONER GALVIN confirmed that under the right circumstances a new entrant would get 45 to 65 percent of their investment costs. He added that although they probably will not get to it today, in future discussions this session they will talk about some of the provisions that may hinder that transaction.

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COMMISSIONER GALVIN continued that either way, whether they try to get the cash back or transfer the credit to another taxpayer, the state pays for that \$200 million exploration activity. Recognizing that exploration itself is risky, the state bears the risk associated with failure as well as a large part of the cost of the exploration project.

He moved on to the second example, which assumed an incumbent with current production (slide 8). If this producer pursues a \$200-million development project within the existing field that is not eligible for the exploration incentive program, the capital credit associated with that investment will earn a 20 percent credit - so \$40 million comes off the top. Reducing their production tax value by the amount of their capital expenditure reduces their taxes in the amount of their PTV

reduction - \$200 million times 25 percent - a \$50-million reduction in their taxes.

The second part to note, Commissioner Galvin said, is that the PTV establishes their progressivity surcharge - the higher their PTV, the higher they slide up that scale. By making a \$200 million investment and having it immediately reduce their PTV, they slide back down the scale, so the tax rate that will apply to all of their production is reduced as well. In addition, the \$200 million gets multiplied by the reduced progressivity surcharge, so both of those components add value, and the state will provide an immediate tax benefit of at least 45 percent of the cost of that development investment.

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SENATOR FRENCH asked if that assumes oil prices are over \$25 and they are paying a production tax.

COMMISSIONER GALVIN answered that even if they were not paying a production tax, they would get the credit and be able to reduce their PTV. If that brought them down below \$27, it would still provide them with a similar economic benefit.

SENATOR FRENCH said he thought they had established that they aren't paying any production tax with oil below \$25 to \$27 a barrel and he didn't think the investment shouldn't get them any benefit but the credit.

COMMISSIONER GALVIN said the \$25 to \$27 he mentioned before was an average. If an individual taxpayer was otherwise at the average and then added a \$200-million expenditure, the deductions would amount to more than \$25 per barrel and become a loss carry-forward for a subsequent credit.

SENATOR FRENCH ventured that for an existing producer with a new development expenditure, the state would pay at least \$90 million and probably more at today's oil prices.

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COMMISSIONER GALVIN confirmed that the state will pay a total of at least \$90 million for an existing producer with a new development expenditure and bears the risk if that development fails.

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COMMISSIONER GALVIN recapped the key points in the two previous examples (slide 10). He said there is no difference in the cash

flow to the state, whether the investment is made by an existing producer or a new entrant; either way, the state is going to be out the money in the form of reduced initial revenue, or in the payment of a credit certificate. But by taking on some of the risk and reducing the initial investment hurdle for these companies, the state is making the investment more attractive than it would otherwise be. Recognizing that, the state is generally providing more than 50 percent of the cost of all new investment and becomes the largest investor in exploration and development in the state under this system.

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COMMISSIONER GALVIN pointed to a graph of ACES nominal, marginal, and effective tax rates (slide 11), which illustrated some of the confusion that occurs in public discussions associated with ACES, because the tax rate can be described in many different ways. He explained that when he says at certain price-points the marginal tax rate associated with the ACES system goes up to almost 90 percent, it sounds like an incredibly high number, but that doesn't convey the whole picture. What most people think of with regard to the tax rate is the number in statute, which starts at 25 percent, and climbs through progressivity, and slides out potentially to 75 percent; that is what is referred to as the nominal tax rate. The percentage of revenue that a producer pays in taxes at a given market rate is referred to as the effective tax rate, and is one that most people are familiar with.

He explained that the term "marginal tax rate" is a much different calculation and determines how much of the additional revenue represented by a \$1 increase in the price of oil is going to be paid in taxes. Because of progressivity, that number goes up fairly steeply. On the other hand, as that number goes up, every dollar a company spends reduces its taxes by the same percentage. When the PTV is in the \$92.50 range at an average of \$120 per barrel market price, the rate hits that 90 percent level and then drops off immediately. At that point in time, every dollar spent by a company reduces their taxes by about \$.90. So the tax rate the company is paying is not really 90 percent. At that point, as the chart shows, they are paying less than a 40-percent actual tax rate, so their incentive to invest is greater. They can't control the price, but if they spend money it has a significant impact on their tax bill. At these rates, the state is participating at upwards of 90 percent.

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SENATOR FRENCH asked Commissioner Galvin to go back one slide to confirm his understanding of the tax rate. He said it appears that at a market price of \$100 per barrel the effective tax rate is 28 or 29 percent; that rate represents the company's total revenue divided by the total tax paid.

COMMISSIONER GALVIN said that is correct.

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SENATOR STEDMAN asked what impact these different tax rates may or may not have on a company's decision to continue an investment. He said some people have expressed concern that the marginal rate puts them at a disadvantage when competing against other locations in the company for capital.

CO-CHAIR MCGUIRE said she has also heard those concerns expressed - that for some producers the ability to profit at the high end becomes the driving force behind decisions regarding new investment.

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COMMISSIONER GALVIN responded that they have to recognize that a lag time exists between the decision to invest and when the expenditures are actually made. If a company knew the price would be in the \$110 range when they actually spend the money, they could count on the fact that the state would be paying the bulk of the expenditure. The worst-case scenario is that prices will be low when they make the investment and high when the production comes in.

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CO-CHAIR WIELECHOWSKI said he recalls that the administration and the legislature made a conscious decision to structure ACES this way to encourage reinvestment in Alaska. The state was seeing oil companies making billions of dollars in profit and not reinvesting any of that money in Alaska, even though the state had fairly low tax rates. Under the Economic Limit Factor (ELF), many fields had 0 percent severance tax rates and yet the state did not see any investment.

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COMMISSIONER GALVIN said that is an accurate depiction of how this system is intended to work. It is intended to tax the money that is taken out of state at a higher rate than money that is invested back in Alaska.

CO-CHAIR WIELECHOWSKI asked if that was a good policy call.

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COMMISSIONER GALVIN replied that he would like to let Ms. Davis go through her presentation before addressing that issue, so they have all of the information in front of them.

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MARCIA DAVIS, Deputy Commissioner, Department of Revenue (DOR), said she would be covering the information that was developed by the Department of Revenue's Economic Research Group, including the revenue comparisons under the various production tax systems the state has had: ELF, Petroleum Production Tax (PPT) and ACES. She would also look at lease expenditures, standard deduction experiences, the oil and gas employment figures, and drilling activity levels.

She said the ACES Status Report was released on January 14, 2010 (slides 13-14). The department began preparing it in late summer to determine whether ACES is working the way it should. While they were working on it, they began receiving inquiries from various legislators asking the same questions Commissioner Galvin was asking, so they rolled the answers to as many of those questions as they could into the report. They looked at confidential taxpayer data consisting of monthly and annual tax returns that had a level of detail that enabled them to look at what types of expenditures were being made. The department was given the right to request information from operators on what they were seeing ahead in the one to four years, so they could get an idea of where those companies thought they were going in terms of expenditures. They requested employment statistics from the Department of Labor and Workforce Development (DOLWD); they inquired of the Alaska Oil and Gas Conservation Commission (AOGCC), which is the agency that issues well permits and tracks completion reports throughout the state; they also obtained information from the Department of Natural Resources (DNR).

MS. DAVIS said the question they were asked most often was how revenue to the state compares under ACES versus PPT versus ELF, so slide 15 shows a bar graph comparing those figures for fiscal years 2007 through 2010. She noted that the revenue projections for 2010 are based on the oil price forecast issued in fall of 2009 at \$66.93 per barrel. In each of the years shown on the graph, ACES did generate a larger amount of state revenue under the production tax structure. She pointed out that ACES outperforms the prior system, ELF, at about \$51 per barrel West Coast price, but the corollary is also true, that ELF outperforms ACES at under \$51 per barrel West Coast price.

She explained that, because ACES is a net tax, one has to ask what lease expenditures are being deducted. Lease expenditures are made up of two categories of expenses: capital expenses, which are hard costs that have a life and can be depreciated, and operating expenditures, which tend to be upkeep, services, labor and other things that have to be done over and over again.

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SENATOR FRENCH asked if she had any data prior to 2007.

MS. DAVIS replied that she had some data for CAPEX and some data for OPEX on the next two slides. The capital expenditures trend shown on slide 16 was increasing from 2007. She added that the operating expenditures shown were real reported costs, not the standard deduction for those earlier years.

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CO-CHAIR MCGUIRE asked Ms. Davis if the data differentiates between capital expenditures for repairs to existing infrastructure and for new infrastructure.

MS. DAVIS answered that they did try to separate the details of those expenditures using the data they had by identifying in a conservative manner those things that were clearly tied to wells, drilling, workovers, coiled tube drilling, and costs that were directly associated with anything related to production. They considered everything else "other," which would be maintenance and things companies would do anyway. They found that both production-related and maintenance-related capital and operating expenditures were going up.

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CO-CHAIR WIELECHOWSKI said that is helpful to know and asked if she had that broken down somewhere.

MS. DAVIS answered that they had not represented the break-down, in part because that is confidential taxpayer information. It can be aggregated, but it varies by unit. Unit information for at least three owners can be displayed, but not for fewer than three owners. So that would provide an incomplete portrait.

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CO-CHAIR WIELECHOWSKI asked if the bar graph representing CAPEX and OPEX included maintenance costs or not.

MS. DAVIS answered that it included maintenance and production.

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At ease due to technical difficulties.

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CO-CHAIR MCGUIRE called the meeting back to order.

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CO-CHAIR WIELECHOWSKI asked Ms. Davis to confirm that maintenance is included in the figures represented on the bar chart.

MS. DAVIS said it is.

CO-CHAIR WIELECHOWSKI asked if she could give them a rough estimate of how much is maintenance.

MS. DAVIS replied that one of the department's challenges is that it has data from the tax returns only. So, they have partial data for 2007, all of 2008, and monthly returns for 2009; they wouldn't have final returns for 2009 until March of 2010. They did the calculation to see trends, she said, but hadn't done a chart for that yet. She said she expected to have better data as they get a few more years under their belts.

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SENATOR FRENCH opined that what many people are referring to when they say "maintenance costs" is really the costs that BP incurred as the result of their failure to maintain their flow lines for so long.

MS. DAVIS responded that while that was certainly the start of it, under ACES any costs that are related to gross negligence or associated with a spill cannot be deducted. That kind of experience, however, teaches operators what needs to be done; so one would expect to see more maintenance costs after an incident like that.

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SENATOR HUGGINS asked if Pt. Thomson is a significant part of these numbers.

MS. DAVIS answered that part of the forecast of North Slope expenditures from fiscal year 2009 into fiscal year 2011 includes some large expenditures for new development in Pt. Thomson, Oooguruk, and Nikaitchuq.

SENATOR HUGGINS said he recalled Exxon talking about how expensive the up-front costs of their investments were. He wondered how large a chunk of the listed numbers it was.

MS. DAVIS responded that confidentiality provisions prevent her from speaking with reference to Pt. Thomson individually. However their revenue source book identified Pt. Thomson, Nikaitchuq, and Oooguruk as a significant chunk of the capital expenses they expect to see going forward.

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COMMISSIONER GALVIN said with reference to Senator Wielechowski's request for historical information, although they cannot reveal taxpayer information, perhaps the committee could get a cost estimate from Exxon as an operator, then they could compare it to the overall figures to get a sense for how it stacks up on an annual basis.

SENATOR HUGGINS said he just wants to be sure they aren't drawing conclusions from an incomplete picture.

MS. DAVIS agreed.

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SENATOR HUGGINS said he would be interested to hear if she saw some picture emerging from this activity.

MS. DAVIS said that is precisely why they were trying to look at which of the expenditures were associated with "production adds" and which were actually increasing production.

SENATOR HUGGINS asked if that information was somewhere in the slides.

MS. DAVIS answered that that was the back side of the question regarding what was and was not maintenance. The growth in expenditures was not all about maintenance; it was about production adds, which are also increasing.

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CO-CHAIR MCGUIRE said she would be interested in seeing a better breakdown in terms of where the investments are for Pt. Thomson, Nikaitchuq, and Oooguruk are, because two of those fields have royalty reductions in place. If capital investment were being made in those fields, then it was certainly not indicative of any kind of an ACES pattern, but rather of what the state had done to incentivize development.

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COMMISSIONER GALVIN commented that the incentives offered through royalty relief and the production tax are significantly different in terms of scale. Because royalty is a smaller percentage of the overall take, it would provide a much smaller incentive than what the state provides through the production tax.

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CO-CHAIR MCGUIRE conceded the distinction between severance tax relief and royalty relief, but said they can push and pull a number of different levers and buttons to encourage exploration, and they are trying to figure out how best to do that while maintaining a healthy balance between the state's take and industry's take.

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COMMISSIONER GALVIN responded to Senator Huggins' question regarding Pt. Thomson that it was less than a quarter of the overall capital expenditure.

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MS. DAVIS stated that DOR can provide operating costs on a historical basis only for Prudhoe Bay; the prior tax systems were not net tax, so they didn't really gather data related to OPEX or CAPEX, and the state was privy to some historical costs associated with Prudhoe Bay only because of discussions that took place relative to the Stranded Gas Development Act.

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She continued to say that the graph on slide 17 tracked those operating expenses from 2003 through 2009 and showed they were increasing. The next question would be whether that represents an increase in costs per unit or if it actually represents an increase in activity; the answer is a combination of both. She stated that while unit costs have increased, activity had increased as well.

CO-CHAIR MCGUIRE noted that the first meaningful drop on that chart was between 2009 and 2010.

MS. DAVIS agreed. She said the reason for that drop was that they are seeing the global indexes for operating expenditures coming down; their data on per-unit costs was also showing a downward trend. This was essentially because oil prices came down from the peak at the end of 2008 and unit costs of goods

tend to trail oil price by about a year to a year and a half; so the costs of goods and services were just catching up to the decrease in oil price.

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CO-CHAIR WIELECHOWSKI asked if this chart indicated a good thing or a bad thing - if all costs had gone down or if materials and labor had gone down and, therefore, the operating costs.

MS. DAVIS said on the surface it was hard to tell whether it was good or bad. They looked deeply enough to know this was not simply an increase in the cost of goods and services, but rather reflected an increase in activity - a good thing.

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COMMISSIONER GALVIN clarified for Ms. Davis that Senator Wielechowski's question went to the 2010 trend.

CO-CHAIR WIELECHOWSKI confirmed that his question was whether the projected reduction in costs was a positive thing. He said if the costs totaled \$11.80 per barrel in 2009 and now total \$9 per barrel, that should be a good thing for the producers.

MS. DAVIS agreed that it was a good indicator that the industry had been able to get the service industry to respond by lowering their costs as revenues went down.

CO-CHAIR MCGUIRE pointed out that Ms. Davis indicated a combination of factors in play here and that there is a direct correlation between both the unit costs and activity. If prices go down, the reduction in costs would mean a reduction in activity.

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MS. DAVIS answered yes, they have gathered publicly available data about what some of the major companies are doing, and they all are cutting back on expenditures because of the global recession. The only question is how much and where. DOR is finding that some of that may be a reflection of some ratcheting back of expenditures at a corporate center level, plus the lower expenditure of unit costs.

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COMMISSIONER GALVIN said, in general, the escalation of per-unit costs was not a good thing for the state or for the producers. The question Ms. Davis answered initially was whether the increase indicated that something had happened with regard the

incentive that ACES created back in 2007 with regard to operating expenses in particular. And this didn't seem to be driven by an investment-incentive, decision-making methodology. As she indicated, he said, most of this was driven by a steep escalation in across-the-board oil and gas sector costs, followed by a drop-off across the oil and gas sector worldwide after the peak in 2009. It wasn't reflective of ACES either way.

SENATOR HUGGINS recalled previous discussions of "lifting cost" and asked if that was synonymous with operating expenditure.

COMMISSIONER GALVIN answered that they were pretty interchangeable; lifting costs are a component of operating costs.

SENATOR HUGGINS noted that these numbers were less than half of what they were talking about in relation to lifting costs.

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COMMISSIONER GALVIN cautioned that lifting costs associated with the whole North Slope were different from those isolated for Prudhoe Bay, which is more efficient due to its size and scale. Also, under ACES a provision now allows the department to show the legislature some information on Prudhoe Bay that they could not previously share.

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SENATOR HUGGINS commented that they need to know how Prudhoe Bay numbers compare to the rest of the North Slope.

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MS. DAVIS responded that the department would provide a range of what they considered to be the OPEX and the CAPEX charges on a per-barrel basis. She said she worked in the industry for nine years and had heard "lifting costs" used in various ways and she would hesitate to opine how it was used historically with this body.

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She moved on to slides 19 and 20 that showed the historical trends associated with capital expenditures. She said they acquired this information from the TIE credit data that was presented to the department.

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COMMISSIONER GALVIN added that when the PPT was passed, TIE was also referred to as a "claw back" and allowed companies to earn

credits for the capital expenditures they had made for five years in the past. That gave the forward-producing companies a reason to provide the department with numbers for their previous five years of capital expenditures.

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MS. DAVIS said the figures reflected on the slides were not restricted to Prudhoe Bay and that the chart showed a dip in capital expenditures during the period when ELF was in place, from about 2001 to 2005. They started to build coming out of 2005 and continued to increase through 2009. She highlighted that this chart didn't indicate a decrease in capital expenditures after the passage of PPT and ACES.

She said the forecast was for about \$2.5 billion in capital expenditures for fiscal year 2010, and about \$2.9 billion for 2011. Unfortunately, the chart was in calendar years and the forecast was in fiscal years, so it only roughly illustrated the trend.

CO-CHAIR MCGUIRE asked if the projection in expenditures was based on answers provided by the companies to questions on Department of Revenue forms.

MS. DAVIS answered yes; they ask operators at all of the fields in development or exploration what they are doing over the next five years.

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CO-CHAIR MCGUIRE said the committee needed to explore why companies like ConocoPhillips have for the first time in 44 years said they won't drill an exploration well.

MS. DAVIS reminded Senator McGuire that they reported a rolled-up number for capital expenditures on the whole North Slope.

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CO-CHAIR MCGUIRE reiterated that she would like Ms. Davis to come back to the committee with as much information as she was able to provide on where those expenditures were being made. She pointed out that the Resources Committee had a history of looking at the individual resources in each part of the state to determine how to incentivize each particular field.

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CO-CHAIR WIELECHOWSKI said he wanted to be sure he understood the chart correctly. Under ELF, the state had quite a number of

fields that paid little or nothing in severance tax from 2001 to 2005 and it saw a pretty steady decline in capital expenditures on the North Slope during that time. PPT became effective April 1, 2006 and there was a pretty significant increase; that upward trend continued after ACES became law in 2007. He asked if that was correct.

MS. DAVIS replied that it was. She expanded that part of the department's forecasting involved looking at what was happening worldwide and they had confirmation that capital costs were coming down globally. That told them that if they were seeing an increase in the overall capital costs incurred on the North Slope, it was due to activity as opposed to increased costs per unit.

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CO-CHAIR WIELECHOWSKI asked if she was using "capital costs" and "capital expenditures" interchangeably.

MS. DAVIS answered yes.

CO-CHAIR WIELECHOWSKI said the chart indicates that the rest of the world experienced a steady increase in investment from 2001 through 2005, but Alaska showed a steady decline. However, 2009 saw a pretty significant decline in capital expenditures worldwide, but Alaska had an increase. He asked if he was reading that correctly.

MS. DAVIS answered that was correct.

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SENATOR HUGGINS said the debate in the legislature when they were going through the tax structure was gross versus net. He asked if Ms. Davis would say they made a good decision on ACES, based on the data that was now available.

COMMISSIONER GALVIN responded that net had proven to be very valuable to this state.

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MS. DAVIS said one of things they wanted to address in the ACES report is the unique feature of "ACES past," the standard deduction provision. This provision said a field that had produced a cumulative 1 billion barrels of oil up to the effective date of ACES could deduct the operating expenses associated with their 2006 level of operating expenditures. Although it was grossed up slightly, it was indexed off the 2006

operating expense rates. The reason for this was that the state had little experience with what the costs coming out of those large fields would be. Since the large fields were the dog, not the tail, there was concern about what the revenue hit would be to the state because of the leap from a gross tax structure to a net tax structure. This provision was to be in place for only two and a half years and expired on December 31, 2009. She said that slide 22 illustrated the amount of additional tax paid by taxpayers who had interests in Prudhoe and Kuparuk during the half year of 2007, all of 2008, and all of 2009 because of the difference between the standard deduction allowed and their actual reported operating expenses. Presuming the reported operating expenses were correct, she said, this was the increase in the state's production tax. Even though in FY 2008 the operating expense was approximately \$2.6 billion and in 2009 it was \$2.7 billion, there was a big difference in the revenue impact because the overall tax rate was higher due to the much higher oil prices in 2008.

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SENATOR HUGGINS recalled that the standard deduction was introduced on the floor of the House with very little debate. He asked if the administration supported the standard deduction.

COMMISSIONER GALVIN replied that the administration did not propose a standard deduction, but the governor at that time was not opposed.

[4:54:38 PM](#)

MS. DAVIS said another indication of activity level was oil and gas industry employment and that the department had obtained statistics from the Alaska Department of Labor and Workforce Development (DOLWD), which were shown on the graph on slide 23. She noted that this graph was different from the one in the published ACES Status Report, because they had not received all of the data for 2009 at the time it was developed. The information on slide 23 was adjusted to reflect more complete information. In 2008 the oil and gas employment numbers were 12,900. In 2009, when the report was published, the number was 13,500; that was revised to 13,000 on this slide, so there was an increase of 100 between 2008 and 2009. The forecast from the Department of Labor and Workforce Development for 2010 was 12,700, a decrease of about 300 jobs. According to the graph, 2007 through 2010 are the highest oil and gas industry employment numbers since the beginning of field development.

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SENATOR FRENCH said he worked in the oil industry until 1992 and did not remember anything that would account for a major drop in employment, but the chart indicates that between 1991 and 1992 the industry lost about 2000 jobs. He asked if such large fluctuations are common in the industry.

[4:57:13 PM](#)

MS. DAVIS said according to the Department of Labor and Workforce Development, oil and gas employment is very project-dependant and when workers are let go it takes some time for them to be reabsorbed into other projects. They would probably have to look at what major project might have been concluded in 1991 to explain the drop.

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CO-CHAIR MCGUIRE stated that both investment and employment are focal points for the legislature. She said she was interested in knowing whether jobs had shifted away from those related to maintaining infrastructure and toward building new infrastructure. She also wanted to know whether Ms. Davis had looked at unemployment insurance filings for people in oil and gas sector jobs.

MS. DAVIS responded that DOR has access to reporting related to some state taxes and state programs under the jurisdiction of the Department of Labor and Workforce Development, but none of that reporting was specific to the oil and gas industry. They based their unemployment statistics primarily on payroll records that tend to be the most complete, because employers are required to report their payroll for purposes of paying the unemployment ESC tax. She was advised that the current rate of unemployment filings is no higher than it was in 2003.

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CO-CHAIR MCGUIRE said she wanted to understand as a policy-maker what impacts the legislature's efforts are having on oil and gas employment regarding the data for 2008, 2009 and 2010.

[5:01:40 PM](#)

COMMISSIONER GALVIN said in response to Senator McGuire's first question regarding a breakdown between maintenance and production jobs that the Department of Revenue does not have that information. He said he did ask the Department of Labor and Workforce Development about it and was told by Commissioner Bishop's statistical economist that the department does not get the reports in a form that allows them to discern that.

[5:03:21 PM](#)

COMMISSIONER GALVIN said they can see that the trend in employment seemed to track expenditures pretty closely.

[5:03:59 PM](#)

SENATOR HUGGINS remarked that slide 23 was interesting because it showed that employment was actually lower in 2001 than it was when prices were so low in the late 80s and early 90s.

[5:05:08 PM](#)

MS. DAVIS pointed out that the dip in employment from 2001 to 2003 mirrored the dip in capital expenditures on slide 19; so labor seemed to track the CAPEX, which could be reflective of projects that were going on in that time period.

SENATOR HUGGINS said the chart made it appear that things were going pretty well in Alaska around 1991, but that sure wasn't the case where he lived.

[5:06:17 PM](#)

CO-CHAIR WIELECHOWSKI said it would be helpful to him to see a worldwide oil and gas industry employment comparison. He asked if Ms. Davis had any sense of what employment had been doing worldwide.

MS. DAVIS replied that they hadn't looked at employment numbers globally, but said she would try to find them. She continued that they also obtained information from the Alaska Oil and Gas Conservation Commission (AOGCC) that tracks drilling rigs and completions. Slide 24 showed a graph of active drilling rigs in Alaska from 2005 through 2009 using the West Coast spot price of oil. The Commission concluded that there was relatively flat rig usage through this time period with a drop-off in the last three quarters of 2009; they were not sure what that drop-off represented, but it lagged PPT and ACES enactment.

CO-CHAIR MCGUIRE asked when that chart was completed.

MS. DAVIS answered that they got the final data from AOGCC at the end of December 2009.

[5:08:39 PM](#)

CO-CHAIR WIELECHOWSKI asked why Alaska has historically had fewer wells drilled than other oil-producing states like Wyoming, Oklahoma, and Texas.

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COMMISSIONER GALVIN responded that it was due to a combination of things; number one is probably cost. The per-well cost in Alaska is significantly higher than in those other states. The logistics of drilling a well, particularly an exploration well, in Alaska are much more challenging; access to land is an issue in that a significant part of Alaska's oil and gas land is locked up in existing leases.

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CO-CHAIR WIELECHOWSKI suggested that Alaska think bigger. He stressed that the state needs to find a way to encourage smaller companies to get out there and drill not five or six more wells per year, but hundreds.

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MS. DAVIS related that many new entrants comment that it is costly to do work in Alaska, so a job has to be big enough to justify the expense. Things those companies take for granted when they are drilling in Wyoming, like the ability to move a rig across 20 miles fairly easily, are a big deal on the North Slope. From their perspective, the state could help them most by improving the infrastructure to open up access.

[5:12:02 PM](#)

COMMISSIONER GALVIN asserted that a starting point in trying to address these barriers was a system like the one Alaska now has in ACES where the state participates significantly in the up-front costs. The fact that the state will pay upwards of half the cost is a significant incentive that was not there previously. Dealing with access and permitting issues will also be in the interests of the both the state and the producers.

[5:14:47 PM](#)

MS. DAVIS pointed out that the increase in rig activity shown on slide 24 lags behind West Coast price fluctuations by about three quarters. They looked deeper to see how high the correlation is between oil prices and these types of expenditures and found that development expenditures seem to have a very high correlation (slide 25).

[5:15:41 PM](#)

Moving on to slide 26 and wells completed, Ms. Davis said the AOGCC did not see much of a correlation between numbers of wells completed and the enactment of PPT or ACES.

Finally, she said the Department of Revenue was asked what companies were actually drilling in Alaska during the calendar

year 2009, so they provided a list of those companies on slide 27.

[5:16:26 PM](#)

SENATOR HUGGINS referred to the graph on slide 24 showing drilling activity and asked if the trend shown there indicated that the state should see an increase in drilling activity based on the cost per barrel of oil.

MS. DAVIS said the Department of Revenue is forecasting a relatively flat oil price for the coming year, so she would expect activity to be fairly level as well.

SENATOR HUGGINS said he keeps hearing reports from oil service companies that they aren't drilling, so he would expect to see a downturn.

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MS. DAVIS said their information is not definitive; it will be interesting to see how it turns out.

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SENATOR FRENCH said he thought Exxon was drilling in 2009, but they were not listed on slide 27.

MS. DAVIS said she got the list from AOGCC and the data may not be complete.

SENATOR FRENCH asked if the committee would hear from members of the oil industry today.

CO-CHAIR MCGUIRE replied that they are not scheduled to speak at this meeting.

[5:18:42 PM](#)

MS. DAVIS summarized that the information the Department of Revenue was able to gather from various state agencies and the tax system does not reveal a direct negative impact due to the state's tax changes.

[5:19:46 PM](#)

SENATOR HUGGINS said one of Senator Stedman's concerns going into the open season for the gas pipeline is whether the state will suffer a serious loss of revenue due to the association between oil and gas.

COMMISSIONER GALVIN said he agreed that all of the members need to be aware of the relationship between oil and gas production. They need to discuss the price parity issue and what its impact could be, look at ways to address the problems it may create, and decide whether they need to something about it before the end of this session.

[5:21:42 PM](#)

CO-CHAIR MCGUIRE thanked everyone for their comments and adjourned the meeting at 5:21 p.m.