

HOUSE FINANCE COMMITTEE
March 17, 2011
8:05 a.m.

8:05:30 AM

CALL TO ORDER

Co-Chair Stoltze called the House Finance Committee meeting to order at 8:05 a.m.

MEMBERS PRESENT

Representative Bill Stoltze, Co-Chair
Representative Bill Thomas Jr., Co-Chair
Representative Anna Fairclough, Vice-Chair
Representative Mia Costello
Representative Mike Doogan
Representative Bryce Edgmon
Representative Les Gara
Representative David Guttenberg
Representative Reggie Joule
Representative Mark Neuman
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Representative Alan Austerman; Representative Eric Feige; Senator Cathy Giessel; Bryan Butcher, Commissioner, Department of Revenue; Lennie Dees, Audit Master, Tax Division, Department of Revenue; Bruce Tangeman, Deputy Commissioner, Department of Revenue; Roger Marks, Legislative Consultant, Legislative Budget and Audit Committee.

SUMMARY

HB 110 PRODUCTION TAX ON OIL AND GAS

HB 110 was HEARD and HELD in committee for further consideration.

#hb110

HOUSE BILL NO. 110

"An Act relating to the interest rate applicable to certain amounts due for fees, taxes, and payments made and property delivered to the Department of Revenue; relating to the oil and gas production tax rate; relating to monthly installment payments of estimated oil and gas production tax; relating to oil and gas production tax credits for certain expenditures, including qualified capital credits for exploration, development, and production; relating to the limitation on assessment of oil and gas production taxes; relating to the determination of oil and gas production tax values; making conforming amendments; and providing for an effective date."

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BRYAN BUTCHER, COMMISSIONER, DEPARTMENT OF REVENUE, explained that the presentation would be about tax credits as related to HB 110. He stated that tax credits were a substantial part of the legislation.

Co-Chair Stoltze appreciated the prompt communications the committee had been receiving from the department.

LENNIE DEES, AUDIT MASTER, TAX DIVISION, DEPARTMENT OF REVENUE, provided an overview of his credentials and work experience, including a degree in accounting and twenty-four years of experience in the oil and gas industry, both in the natural gas pipeline sector and upstream oil and gas. He noted that he had been with the Department of Revenue (DOR) since 2008, right after Alaska Clear and Equal Share (ACES) came into effect.

Mr. Dees offered a PowerPoint presentation, "Production Tax Credits, March 17, 2011" (copy on file). He began with a list of the seven different types of tax credits allowable under the Alaska oil and gas production tax statute (AS 43.55) on "Types of Production Tax Credits" (Slide 3):

Credits which may taken against oil and production taxes include:

- Capital Expenditure Credits

- Alternative Tax Credits for Oil and Gas Exploration
- Net Operating Loss ("NOL") Carry Forward Credits
- Transitional Investment Expenditure ("TIE") Credit
- Additional Nontransferable Tax Credits
- Well Lease Expenditures Credit
- Cook Inlet Jack-up Rig Credit

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Mr. Dees noted that the next slide provided a history of when the various tax credits were created, illustrated with comparative timelines on Slide 4, "Timelines for Production Tax Credits." [NOTE: only the types of credits are listed below, not the timelines, which can be found on the slide.]

- 43.55.023(a) QCE and (b) CFAL credits
- 43.55.023(l) 40% Well Lease Exp (CI)
- 43.55.023(i) TIE credits (PPT)
- 43.55.023(i) TIE credits (ACES)
- 43.55.024(a) New Area Development credit
- 43.55.024(c) small producer credit
- 43.55.025(20%/40%) credit for exploration
- 43.55.025(30%/40%) credit for exploration
- 43.55.025(l) Cook Inlet Jack-up Rig credit

Mr. Dees highlighted that the earliest credit enacted under AS 43.55 was the alternative credit for oil and gas exploration; the credit was enacted in 2003. Most of the other credits came into being with the passage of the petroleum production tax (PPT), starting with AS 43.55.023(a), the qualified capital expenditure credits (QCE) and AS 43.55.023(b), the carried-forward annual loss (CFAL) credits; the two came into effect April 1, 2006. Initially the credits were 20 percent each; during PPT, credits taken under the particular statute could be taken by a taxpayer in their entirety in the year they were earned. The provision was changed by ACES so that a taxpayer could only take 50 percent of the credit in the year it was earned; the other 50 percent had to be taken in later years.

Mr. Dees continued that the next credit enacted under PPT was the transitional investment [expenditure] (TIE) credits. Initially, the credit was for expenditures that

companies had made in the five-year period between April 1, 2001 through March 31, 2006; if the particular expenditures would have been QCEs after April 1, 2006, the company would have been able to get 20 percent of the particular expenditures as a credit. However, each year the credit was going to be limited by the amount of the company's expenditures during that particular year. The credit changed under ACES and was only available to companies that did not have production prior to January 1, 2008, or companies that were already producing before 2006 and 2007.

Mr. Dees turned to the next credit that came into effect under PPT, the AS 43.55.024 non-transferrable tax credits. There were two credits under the section. One was the new-area development credit, a \$6 million credit for those companies producing oil and gas outside of Cook Inlet and the North Slope above 68 degrees north latitude. The credit could only be taken against a tax liability and was not transferrable or useable in a succeeding year. The credit was available to a company each year and had a sunset date of 2016.

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Mr. Dees described the next credit available under AS 43.55.024(c), the small producer credit, with a \$12 million credit for companies producing less than 50,000 barrels per day of oil and gas (BTU equivalent). The credit was prorated down to zero at 100,000 barrels per day, could only be used against a tax liability, could not be converted into cash, transferred to another taxpayer or carried forward, and the expiration date was 2016.

Mr. Dees informed the committee that the AS 43.55.025 credit came into being prior to PPT and was revised under ACES for activities after June 30, 2008; the credit became a 30 or 40 percent tax credit (it initially had been 20 or 40 percent). The credit amount was dependant on where the activity took place; the activity had to be at least 25 miles outside the boundary of a unit on the North Slope or 10 miles outside the boundary of a unit in Cook Inlet. A well drilled under the credit had to be three miles away from an existing well.

Mr. Dees directed attention to the two tax credits passed by the legislature in the prior year: the 40 percent well-lease expenditure credit under AS 43.55.023(1) and the Cook

Inlet Jack-up Rig Credit under AS 43.55.025(1). The well-lease expenditure credit was 40 percent for well-lease expenditures (well-lease costs considered intangible drilling and development costs, as defined by the Internal Revenue Code). He noted that in the drilling of a well, between 75 and 85 percent of the drilling costs were typically considered to be intangible; intangible costs were costs of items without a salvage value. The credit was currently only available in areas south of 68 degrees north latitude and became effective for expenditures after July 1, 2010.

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Mr. Dees provided details about the last credit, the Cook Inlet Jack-up Rig Credit; the credit was for 100, 90, or 80 percent of the first \$25 million for companies using the same jack-up rig that targeted a particular zone within Cook Inlet, the pre-tertiary zone. He noted that to date, there was not a jack-up rig in Cook Inlet, but the department anticipated that there would soon be one.

Representative Gara referred to prior discussion that the credits were too liberal and concerns that the state was giving away so many credits that companies were "gold-plating." Some had talked about limiting credits to things like exploration wells and development wells. He pointed to the 20 and 40 percent credits listed for exploration (20 percent inside a field and 30 and 40 percent for further away). He asked whether the credits covered every sort of tangible capital expenditure besides development and exploration wells. He wondered whether there were some limitations.

Mr. Dees responded that exploration credits under AS 43.55.023(a)(2) and under AS 43.55.025 had a very limited scope as to the activity that would qualify. The credits could only be used for activities associated with the drilling of an exploration well or a geological or geophysical (G&G) activity such as a seismic shoot. The scope was very limited and the purchase of vehicles would not be allowed. The credit that would include all tangible purchases (like the truck) would be the AS 43.55.023(a)(1) credit, the qualified capital expenditure credit; the expenditures that qualified for that credit were a broad definition of what a capital expenditure was under Internal Revenue Code 26 U.S.C. The credit would apply to the

purchase of equipment, vehicles, and the improvement of buildings, in addition to the drilling of wells and the construction of facilities.

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Representative Gara referred to the 20 to 40 percent capital exploration credit (limited to more exploration-related activities). He thought there was also the broader AS 43.55.023(a) credit. He asked why the 20 percent capital exploration credit was needed if a broad array of credits was available under the first one.

Mr. Dees answered that the capital exploration credit under AS 43.55.023(a)(2) was typically for those particular exploration well or G&G activities that occurred within a unit, so they would not qualify for the 30 to 40 percent AS 43.55.025 credit for outside the unit; it would be within the 20-mile limit or within the 3-mile distance from an existing well. The purpose was to allow for those companies currently producing and conducting exploration activities in the vicinity of their unit. He noted that another reason for the separation was that there was a requirement for the company to submit information to the Department of Natural Resources (DNR) for the types of activities related to the credits, in addition to the exploration wells.

Representative Doogan requested that the common names of the tax credits be used in the discussion rather than the numerical statute designations in order to better understand the references.

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Vice-chair Fairclough queried the reporting mechanisms for credits in totality. She referred to grids that the committee had seen, with companies that were drilling and permitting in various years (provided by Roger Marks in a prior presentation). She asked whether there was a summary of what credits were being accessed, the amounts of the credits, and the companies using the credits.

Mr. Dees answered that the reporting mechanism for the companies taking the credits off the top of tax liabilities was the annual true-up based on the projected forecasted capital expenditures. He noted that throughout the year, the companies made installment payments based on the

projected forecasts and took credits against their tax liability based on the projections. At the end of the year when the companies did the true-up (on March 31), they submitted information to DOR about the capital expenditures amounts that led to the credits taken against their liability. At that point, the department did not get the detail; the invoice-level details on the expenditures would not be acquired until the audit. The companies that were not producers and did not have a tax liability and were simply coming to the department to apply for transferrable tax credit certificates had to submit (along with the application) sufficient detail to support the amount of expenditures for the credits claimed. For the AS 43.55.023 QCE credits and for the annual loss credits, the department did a due-diligence review of the detail. He noted that there had been occasions when claims were disallowed. After issuing the certificate, the department maintained audit rights to go back later and do a more thorough review of the expenditures. When companies applied for the exploration credits under Section AS 43.55.025 (alternative credit for oil and gas exploration), they had to submit sufficient detail, and DOR conducted a full audit of the claims prior to issuance of a certificate.

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Mr. Dees continued that for the transferable tax credit certificates, DOR would have either done a full audit or a review of the information, so there would be more detail about what types of expenditures there were and where they were incurred. He added that the credits taken against the tax liabilities would follow when the company's tax return was audited.

Vice-chair Fairclough agreed that the procedures described met government and general accounting standards. For the credits just listed, she wanted a break-out per year of how much money had been given away or invested in Alaska by the entity asking for the credit. She wanted the committee to be able to see whether the recommendations from the administration matched with what the legislature wanted to accomplish. She wanted to know who had accessed the credits. She understood there was a six-year auditing backlog. She wanted to know who the "winners and losers" were in order to understand who the state was backing.

Commissioner Butcher responded that DOR would be happy to put the information together for the committee. He warned that there were confidentiality issues related to the tax returns of individual companies; the department was limited regarding a breakdown by company.

Vice-chair Fairclough stated that she did not want to break confidentiality. She felt the legislature should still be able to see how many dollars were applied per category in order to analyze which credits were working. She commented that the information should be available to the tax division through an accounting system query. She asked how the department would access the information requested.

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Commissioner Butcher replied that DOR would provide as much detail as possible. He noted that the department was somewhat hampered by its current accounting system; a new data-base would be able to produce the information more quickly. He pointed out that DOR was currently working with the Department of Administration (DOA) on a more comprehensive review of what was needed related to software.

Vice-chair Fairclough clarified that to get the information the department had to look through actual paperwork. Commissioner Butcher answered "pretty much yes."

Co-Chair Stoltze asked that the report of the information requested use the common names of the tax credits.

Representative Hawker addressed a "mischaracterization" made of Mr. Marks's presentation about credits and gold-plating. He stated that gold-plating was the result of high tax rates and not of the existence of credits.

Co-Chair Stoltze noted that there would be a presentation by Mr. Marks.

Representative Wilson understood that credits could be detailed until full audits had been done. She asked what was happening to credits if full audits had not been done since 2006.

Mr. Dees answered that the credits had been taken off the top of the tax liabilities. As long as the audits were

completed within the assessment periods, adjustments made through the audits would be assessed to the taxpayer with interest. The credits would not be in a holding pattern because the statute allowed the taxpayer to take the credit off the top of the liability.

Representative Wilson referred to the information requested by Vice-chair Fairclough. She asked how the committee could know which one of the companies could come back and say which credit was not allowed without the information.

Mr. Dees agreed.

Representative Wilson asked whether a model could be produced that would show what most companies would do (tax liability and types of credits normally used for a new operation) to compare the numbers of new producers and longer-term ones.

Mr. Dees thought the model could be done.

[8:34:26 AM](#)

Commissioner Butcher offered to work with DNR to provide the information for the committee.

Representative Wilson wanted to know the bottom line.

Co-Chair Stoltze referred to a Seinfeld episode reference to "write-offs."

Co-Chair Thomas asked whether work-over wells were available for credits.

Mr. Dees replied that it depended; not all workovers were "capital" in nature. He did know that a portion of the allowable credit under the 40 percent well-lease expenditure credit referred to work-overs as being part of the activity allowable. However, the costs had to be intangible drilling and development costs. A work-over to increase the efficiency or through-put of a well could be a capital activity; a repair job to get a well back to its normal production would not apply. He noted that the issue would be a challenge for auditors.

Co-Chair Thomas pointed out that there had been over 500 work-over wells the previous year alone. He thought that

giving tax credits where they were not due without audits would mean the state was operating "blind." He questioned whether tax credits would be allowed for exploratory drilling and development of oil too far from infrastructure to deliver the oil.

Mr. Dees replied that activity on state land meeting the distance requirements from units and wells would be allowed.

Co-Chair Thomas thought the activity would only be allowed if the oil was put into the pipe.

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Commissioner Butcher believed the incentive of including all possibilities was meant to encourage companies to explore in new areas and not be penalized twice if nothing was found (no oil and no credits).

Vice-chair Fairclough asked whether taxpayers historically tended to over- or under-report credits if the result meant there would be penalties.

Mr. Dees opined that taxpayers did not over- or under-report intentionally; he believed companies reported expenditures they believed they were eligible for. He stated that he had not come across a situation in which a company had intentionally over- or under-reported. The department had had disagreements with interpretations of how types of expenditures fit a particular credit, but he did not think the claims were deliberate.

Vice-chair Fairclough asked whether audits historically resulted in more taxpayers receiving additional credits or penalties.

Mr. Dees replied that typically, audits had resulted in the state trying to get money back from taxpayers.

Vice-chair Fairclough asked whether the taxpayers received a penalty and were charged interest.

Mr. Dees replied that as long as the filings were timely, the taxpayer did not get a penalty. He added that there was interest attached to an assessment.

Representative Doogan queried the status of the completed audits.

Mr. Dees answered that the 2006 PPT audits had substantially been completed and the work on the 2007 audits had been started. He added that the 2006 audits were still under the three-year statute; the assessment period for those audits expired March 31, 2010.

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Mr. Dees continued that the assessment period for the 2007 audits would expire March 31, 2014.

Representative Doogan asked whether the audits were under the current tax system and not the proposed one. He wondered what would happen if the system were "backed up."

Mr. Dees replied that the timeline would be two years sooner. He believed the department would be able to accomplish the task. The 2007 audits would be completed sometime in the current calendar year.

Representative Doogan asked how the proposed new deadline would affect the situation.

Mr. Dees replied that under the four-year statute of limitation, the 2007 tax filings were filed March 31, 2008; the statute of limitation would be March 31, 2012. The particular section of the bill was scheduled to start in 2014, which he thought would provide the opportunity to get more current on the audits.

Commissioner Butcher added that the most difficult transition for the auditors was from the net tax to the gross tax, which took place in the 2006 audits just done; until then, DOR was working off the gross and not looking at everything that could be taken off what was potentially paid in taxes. He pointed out that the particular provision was taken out in the House Resources Committee; the current version of the bill was back to the six years.

Representative Doogan questioned forwarding a bill that would cause a lot more paperwork just because it would mean a lot more money for the industry.

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Mr. Dees spoke to the ways credits could be redeemed. He directed attention to Slide 6, "Credits Applied Against Production Tax Liability":

Credits may be redeemed in two ways:

(1) All Credits may be applied against production tax liability

- Capital Expenditure and Capital Exploration Credits split over two years (except south of 68 degree North latitude - eff. July 1, 2010)
- NOL, TIE, Small Producer and Alternative Tax Credits for Oil and Gas Exploration may all be applied against tax liability in total in a single year

(2) Some Credits may be converted into a transferable Tax Credit Certificate

- Capital Expenditure, Capital Exploration, NOL, and Alternative Tax Credits for Oil and Gas Exploration are convertible to tax certificates
- Capital Expenditure, Capital Exploration and NOL Tax Credit Certificates must be applied over two years (except south of 68 degrees North latitude - passed 2010)
- Alternative Tax Credits for Oil and Gas Exploration Certificates can be used in single year

Mr. Dees detailed that the credits converted to a transferable tax credit certificate could be either sold to another taxpayer or sold back to the state for cash.

Mr. Dees turned to a chart on Slide 7, "Production Tax Credits Applied Against Tax Liability (Fiscal Year)" with historical and projected information related to tax credits applied against tax liabilities since 2006. He noted that the credit most used by taxpayers was the capital expenditure credit. He pointed to the TIE credit, which went away for most taxpayers effective at the end of 2007; the 2008 number represented data for the last six months of 2007 (part of fiscal year 2008). There had been use of the small producer credits; there were some taxpayers producing less than the 100,000 barrels per day required for the use

of the credit. The exploration credits have also been applied in some situations.

Representative Doogan thought the current law stipulated that some of the credits had to be applied in two-year segments. He wondered how a person could tell when the credits were applied as opposed to when they were earned.

Mr. Dees responded that the information would be mostly on the capital credit expenditure line; the major producers use the credit the most and it was limited to the 50 percent split. Under PPT, 100 percent of the credits were used in the year they were earned, but beginning in 2008 to 2010, there was a lag; 50 percent of one year's credit and 50 percent of the previous year's credit were used. He did not think the numbers would provide the answer, because there were variant levels of capital expenditure. He stated that the numbers on the chart would suggest that as the amount of the credits went up, the underlying capital expenditures giving rise to the credits increased for those years.

Representative Doogan thought that the number was increasing because of the popularity of the credits; on the other side, the state's liability was increasing in terms of having to pay the credits.

[8:49:40 AM](#)

Mr. Dees clarified that the question related to the state's liability referred to the actual credits the state was paying out in cash. He stated that the two had to be separated. The credits were not the ones the state was paying out in cash, but were the credits resulting from a company spending an amount in capital expenditures in a given year and taking 20 percent against the liability; the amount would never come to the state treasury. For example, there would be a check for \$280 million to the state on a tax liability of \$300 million. He was trying to account for the fact that although the amounts did not come to the state's treasury, the amounts represented the benefit to the companies from making the capital expenditures. He added that an upcoming slide would show the state's payout, which was related to a different group of taxpayers.

Representative Doogan apologized for using the word "liability" with an accountant. He surmised that overall,

the credits seemed to be costing the state increasingly more each year. He asked whether the increase would continue.

Mr. Dees replied that the ascending curve on the credits (especially the capital expenditure credit line) had to be directly tied to the amount of capital expenditures made by companies. He said the numbers would increase corresponding to the increase of capital expenditures by the companies. He noted that a later slide would show what capital expenditures had done over the last few years. He stated that there was a direct correlation to the capital expenditures made by a company. The numbers would continue to rise if the capital expenditures continued to rise because the numbers would be 20 percent of a higher number (unless the credit laws changed).

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Co-Chair Thomas asked whether there had been an increase in oil production with the tax credits. He suggested the credits should be abolished if there had not been an increase.

Representative Edgmon referred to a slide from a past presentation by Mr. Seamount that had depicted the precipitous drop in exploration activity in 2010 and the years before that. He asked why the capital expenditure credit number seemed to be going up and how that related to the information from the previous presentation.

Mr. Dees answered that exploration activity would not be reflected in the numbers listed in the credits. He noted that there would be a slide further on in the presentation that was more in line with Mr. Seamount's numbers and the drop. He stressed that there was always a lag between activities that were occurring and the request for credits; the two did not necessarily happen in the same year.

Representative Edgmon recalled earlier information that there were basically three types of wells: exploration, development, and service wells. He was having difficulty making a connection between earlier presentations and the numbers Mr. Dees was presenting, particularly the numbers under capital expenditure credits. He had read in the press that the state had issued \$3 billion worth of credits over the past few years.

Mr. Dees pointed out that the \$3 billion referred to was inclusive of the numbers on Slide 7, plus numbers on another slide. He added that most of the exploration activity was being conducted by companies that did not have a production tax liability. The numbers on the slide were from companies that were paying a production tax liability. The credits that had been claimed against the liabilities were depicted. He explained there would be another slide showing information from companies that did not have a production tax liability.

Representative Edgmon asked whether the credits were working for smaller companies and not working for larger companies.

Mr. Dees responded that he could not say that; all companies were taking advantage of the credits available to them. Companies were incurring expenditures and doing the activities that generated the credits. He did not know if the companies would be doing the work if they were not getting some benefit.

[8:58:29 AM](#)

Representative Gara apologized for an earlier misunderstanding about Mr. Marks's statements about gold-plating. He explained that he had not intended to change anything said before. He stated that "your words on gold-plating would be your words on gold-plating." He thought if the gold-plating argument was that the combination of deductions and credits put together were lucrative, then it sounded more like what it was than what he had said.

Representative Gara recalled previous discussion about a four-year statute of limitations. He thought the PPT audits from 2006 were done "just in the nick of time" if there were a four-year statute of limitations. He thought there were currently a lot more taxpayers and people claiming tax credits, and a greater need for audits. The department had gone from a time when it could barely do the audits in four years (with fewer companies) to a proposal to do them in four years for more companies. He asked how many additional companies were filing credit and tax returns.

Mr. Dees responded that the 2006 audits had been completed in 2010, one year before the four years would have been up;

the 2006 audits would have been due in 2011 had they been on the four-year statute of limitations. The audits were completed a year earlier than the statute stipulated. As far as the credits were concerned, the credits applied for with the department received a due-diligence review (like a "light audit") prior to issuance of the credits. A full audit was done for the exploration credits up-front, so there was no danger of running out of the statute of limitations for the exploration credits. For most of the companies for which the department did the due-diligence review, there would be a determination about the need for a full audit; there had not been a need to-date. He stated that the department was current with most of the tax credits, except for the ones that were taken on tax liabilities. He stated that the number of taxpayers had not substantially increased.

Representative Gara asked for the number of taxpayers that would have to be audited, compared to 2006. Mr. Dees offered to get the information to him at a later time.

Representative Gara asked whether the presentation would cover operation expenses.

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Mr. Dees replied that most of the credits were issued as a result of capital expenditures. He noted that the only time operation expenditures came into the credit picture was when they were part of the expenditures that led to a net operating loss credit. He added that he did not plan to go into operating expenditures.

Representative Gara referred to a November 30, 2010 Juneau Empire article in which the commissioner of DOR had estimated that operation-only capital expenditures had been \$4.7 billion the prior year. The numbers for the current year were expected to be \$5.1 billion, and the projection for the following year was \$5.5 billion. He estimated the number represented an increase of about 8 percent per year. He asked whether the numbers cited were correct.

Commissioner Butcher responded that he did not have the information referred to but acknowledged there had been a slow increase in spending in operating and capital expenditures, which was one of the issues DOR had begun researching. The industry had communicated that the

expenses replaced things in a mature field and were not exploration related. He stated that DOR did not have that kind of information, although it had since learned that asking for more detail was allowed in the statutes through regulations. He noted that the department had not requested the information previously but it intended to include the legislature as the information was developed. He offered to get information about the capital and operating expenses by year.

Representative Guttenberg referred to testimony that the taxpayers were taking advantage of all the tax credits available to them. He asked whether any of the tax credits qualified as gold-plating. He wondered whether the companies were spending additional money because it was available to them.

Mr. Dees replied that he did not know whether companies were gold-plating.

Representative Guttenberg pointed to the top line (for capital expenditure credits) on Slide 7 ("Production Tax Credits Applied Against Tax Liability"), and asked how the increase from 2006 to 2011 related to oil production. He wondered whether there was a correlation.

Mr. Dees responded that at the present time, DOR did not have information to correlate the two, as the department did not get information about how companies were spending the money. He noted that the department was going to request the categories of expenditures.

[9:06:15 AM](#)

Mr. Dees directed attention to "Transferable Tax Credit Certificates" (Slide 9):

Companies may also claim tax credits by applying for a Transferable Tax Credit Certificate (TTCC)

- Available to companies (explorers) with no tax liability to which credits can be applied
- Tax Credit Certificates under 43.55.023(a) and (b) must be split or applied over two years (except credits issued for expenditures incurred south of 68 degrees North latitude effective July 1, 2010)

- May be transferred to another taxpayer or cashed with the state

Mr. Dees detailed that the certificates were available to all companies, even those with production tax liability. However, most companies preferred to take the credit off the top of their tax bill. He emphasized that transferable tax credit certificates were especially important to those companies or explorers with no tax liability to which the credit could be applied (for various reasons), as the certificates could be sold to other companies or could be sold back to the state.

Mr. Dees continued that tax credit certificates were split in two when issued, because they had to be applied or split over two years. He added that the prior year's legislation made it so that effective July 1, expenditures incurred south of 68 degrees north latitude could be issued in one certificate.

Mr. Dees next discussed "Production Tax Credits Under AS 43.55 Claimed by FY (\$M)" (Slide 10). He noted that the previous slide had shown the tax credits that were directly applied against tax liabilities; Slide 10 represented all the requests for tax credit certificates received over the years by DOR from various explorers or companies without tax credit certificates. He pointed out that an earlier version of the slide had a different amount in 2008 for exploration AS 43.55.025 credits, but the net amount of credits issued would not be changed.

Mr. Dees continued that Slide 10 represented what had been requested by tax payers or explorers. He noted there had been a trend related to exploration activity; the AS 43.55.025 numbers increased in FY 2008, came down a little in FY 2009, and then had a big increase in FY 2010. He emphasized that fiscal years were depicted; he stressed that the period for drilling a well (the drilling season) on the North Slope was typically between October of one year through March of the next year. Accordingly, the \$99.5 (million) number in 2010 did not mean that there was that much activity in the state; it just reflected when the particular applications were submitted to DOR for credit. Most of the activity that was related to the \$99.9 million occurred during the exploration season from October of 2008 through March of 2009; in the fall of 2008, exploration activity was high and there had been a large increase in

oil prices. Six months after the exploration activity was over, the companies were required to submit their applications for the AS 43.55.025 claims. The \$99.5 million figure represented claims that were submitted in September of 2009 (which was part of FY 2010).

9:11:02 AM

Representative Guttenberg surmised that the AS 43.55.025 credits in 2010 reflected expenditures that had been made because of the increased price of oil.

Mr. Dees responded that the number reflected activities that had occurred during the drilling season beginning in October 2008 and completed in March 2009; after the drilling season was over, the companies had to apply for the AS 43.55.025 credit within six months for the completed exploration activities. Generally, around September every year (when there was a lot of activity), DOR would get inundated with a lot of applications for wells that were drilled the previous season. He had hoped to illustrate that even though the chart indicated the year 2010, it did not mean that the activity had occurred in 2010. The chart showed when the applications were received for activity that occurred in a previous drilling season.

Representative Guttenberg asked whether DOR was finished processing companies that had applied for credits in 2011.

Mr. Dees replied that the department had not finished processing the applications, as FY 2011 went through June 30 of 2011. He provided an example related to dates between October 2010 and March 2011; there was only one application for \$2.4 million, which indicated that there had not been much exploration activity at the end of 2009. He believed the numbers would correspond to a chart that had been presented by Mr. Seamount. He underlined that there was a lag between the exploration activity and the application for the credit.

Representative Doogan opined that the chart was confusing. He thought the chart seemed to say that up until 2011 (for which there were no numbers) things were going well in terms of exploration, and that it would not be known what would happen in FY 2011 until the process was complete. He thought the explanation of the chart just provided had communicated something very different. He asked Mr. Dees to

rework Slide 10, because it did not match what was being reported by the testifier.

Mr. Dees clarified that there was a lag between when the activities occurred and when DOR got the application for the credit. For example, for a drilling season that began at the end of 2009 and went through the spring of 2010, under the statute, the company had six months after the exploration activity was completed to file for a tax credit certificate. In September of 2009, DOR had only received one application for exploration activity totaling \$2.4 million; his interpretation of that was that there had been very little exploration activity going on in the drilling season that preceded the application.

Representative Doogan asked when Mr. Dees would know how accurate the \$2.4 million number was.

[9:16:47 AM](#)

Mr. Dees replied that the numbers (on Slide 10) represented applications received through January 4, 2011; the number was accurate through the listed date only. The department had not received additional AS 43.55.025 applications.

Representative Doogan wondered when DOR would have the final number. Mr. Dees replied that at the end of FY 2011 (June 30, 2011), he would update the chart to include all the applications received through that date.

Representative Wilson wondered whether there had been applications received between January 4 and the current date (March 17).

Mr. Dees responded that typically the department was inundated with year-end applications during the period that it received the annual true-up. He noted that there was a statutory requirement that everyone doing business in the state that was incurring lease expenditures or expenditures for which they would apply for credit had to submit the information to DOR by March 31. He expected that applications would be coming in; he thought most would be received by March 31.

Representative Wilson suggested using the same deadline for each year to be able see a comparable true-up over the years. She wondered whether the information was available.

Commissioner Butcher replied that DOR would try to get the information to the committee. He noted that the presentation showed all tax credits that had come in up to the date it was prepared.

Representative Wilson did not believe that the presentation reflected the information stated. She wanted to see the numbers based on the same date every year.

[9:20:25 AM](#)

Mr. Dees pointed out that the slide did reflect the same date each year, June 30 of each year. Since it was not June 30 yet in the current year, he had provided the fiscal year numbers to-date.

Representative Wilson wanted the numbers to reflect the calendar year, since the decision would be made before the end of the current fiscal year. She wanted to see the numbers yearly to see whether the numbers had decreased during the current year.

Mr. Dees clarified that DOR typically received the exploration claims in September, within six months after the October through March drilling season. Most of the \$99.5 (million) number reflected claims that were received in September of 2009 (for FY 2010). In FY 2011, the \$2.4 (million) was all that was received in September of 2010. The same period was somewhat reflected. He emphasized that the numbers illustrated that there had been a lot less exploration activity in the drilling period.

Representative Wilson asked what DOR expected to receive by March 31. Mr. Dees responded that he did not expect to get many exploration claims, if any.

Vice-chair Fairclough thought DOR had given the committee what was needed from an accounting perspective, but observed that the committee was trying to get to a policy perspective.

[9:24:00 AM](#)

Co-Chair Stoltze believed Commissioner Butcher would provide the policy perspective.

Representative Gara hoped to draw conclusions from the numbers on Slide 10. He summarized that the years represented were ACES years. In 2010, the state paid almost \$100 million in exploration credits and in 2011, the number was significantly smaller. He wondered whether the fluctuations reflected the change in oil prices. For example, in 2008, the price reached \$140 per barrel and then went down to \$30 per barrel in 2009. He asked whether there was a correlation between different prices and different results for the different years.

Mr. Dees did not know whether there was a correlation. He suspected that companies would tend to explore more during the period of higher prices.

Co-Chair Stoltze asked whether the subject of the question asked reflected Mr. Dees' area of expertise.

Mr. Dees replied that it did not.

Commissioner Butcher replied that the answer could be obtained from companies that made the decisions. He added that he could reply to questions about price and other issues, but ultimately the companies made the decisions about whether or not to explore and the criteria they used when making the decisions.

Representative Gara pointed to the small 2011 number (\$2.4 million). From a policy perspective, he wanted as much input as possible from the government proposing the oil tax and not from the companies that wanted the change.

Co-Chair Stoltze emphasized that there was a separation between the two, and that was the problem.

Representative Gara referred to testimony that reflected an expectation of one real exploration well in 2011. He noted that the current presentation had helped him understand that there was a lag between the numbers and the years the exploration wells were done. He wanted to know whether there was only one well for 2011 or whether that could change between the current date and June. He wondered whether the \$2.4 million figure was from 2010 and not 2011.

Commissioner Butcher replied that DOR got the information about the one well in 2011 from DNR and not DOR data. He

had asked DNR whether there was an expectation of more than one well and DNR had replied no.

[9:27:54 AM](#)

Representative Neuman referred to the statutes. He queried how the numbers for new exploration should be understood, related to AS 43.55.023(b) providing for exploration credits for new well exploration.

Mr. Dees replied that AS 43.55.023(b) was not for exploration wells, but was the net operating loss carry-forward.

Mr. Dees believed there was confusion being expressed about dates. He stated that the year 2011 did not mean the calendar year 2011, but the fiscal year beginning on July 1, 2010. In each of the years discussed, the dates were between July 1 of one year and June 30 of the following year. He was trying to reflect what had been received by DOR in terms of claims for incurred expenditures, not in terms of credits that had actually been issued.

Mr. Dees turned to the next chart, "Transferable Tax Credit Certificate Activity by Fiscal Year (\$M)" (Slide 11). He emphasized that the chart showed the transferable tax credit certificates that were issued each fiscal year, how much the department had refunded to the taxpayers, how much the taxpayers had either transferred or applied to tax liabilities, and the balance as of a given date.

Mr. Dees directed attention to "Cash Refunds History" (Slide 13):

Cash Refunds Governed by AS 43.55.028:

- To cash must be usable against tax liability
- Must show subsequent (24 months) QCEs or lease bids equal to cash sought (repealed in 2010)
- Have a zero tax owed in current and past years
- Have no more than 50,000 BOE/d

Mr. Dees reviewed the attributes of cash refunds in Slide 13, "Cash Refunds History":

Cash Refunds Governed by AS 43.55.028:

- To cash must be usable against tax liability

- Must show subsequent (24 months) QCEs or lease bids equal to cash sought (repealed in 2010)
- Have a zero tax owed in current and past years
- Have no more than 50,000 BOE/d

Mr. Dees spoke to Slide 14 ("Oil and Gas Tax Credit Fund"), a history of the fund that had been appropriated in order to pay the transferable tax credit certificates:

Oil & Gas Tax Credit Fund

Appropriations	\$ 904 M
Tax Credit Purchases (TC Fund)	(772) M
Tax Credit Purchases (GF)	(79) M
Interest Earned	22 M
<hr/> Balance	<hr/> \$ 75 M

[9:32:10 AM](#)

Mr. Dees concluded with Slide 15 ("Impact of Production Tax Credits Total State Stimulus") with a bar graph depicting a combination of the credits taken against tax liabilities and the actual cash paid out by fiscal year. He noted that 2011 and 2012 were estimated numbers for what was expected to occur by the end of the fiscal year.

Vice-chair Fairclough acknowledged that the administration was providing data for a body that was trying to make a policy decision. She voiced concerns about a statement made related to legacy fields or large producers receiving tax credits. She felt the committee was being told that there was no different benefit in the tax-credit structure for legacy fields versus for the explorers that the state was trying to incentivize through ACES.

Mr. Dees replied that there was no difference other than the 40 percent well-lease expenditures for well-lease expenditures north of 68 degrees north latitude and the Cook Inlet Jack-up Rig Credit. Otherwise, the same benefits would accrue to the legacy fields; they would get an oil credit if they happened to get into a net-operating loss situation. They would get the same 20 percent capital-expenditure credit and the exploration credits if they were doing the appropriate types of activities.

Vice-chair Fairclough thought Mr. Dees was providing a technical response; from a policy perspective, she wanted

to differentiate that the legislature was trying to incentivize smaller exploration and smaller drilling through ACES. She did not think that everyone had equal access related to tax credits. The slide made it look like that was not happening.

Vice-chair Fairclough spoke to concerns about jobs for Alaskans. She thought jobs were being decreased on the North Slope, specifically in the legacy fields. She wondered whether there was additional information related to tax credits that she had not yet heard.

[9:36:37 AM](#)

BRUCE TANGEMAN, DEPUTY COMMISSIONER, DEPARTMENT OF REVENUE, explained that Mr. Dees was describing the technical way the tax credits were being used. The credits were available and in statute, and companies were taking advantage of them. He pointed to testimony from companies that were enthusiastic about the tax-credit system already in place, like Great Bear Petroleum. He emphasized that those companies were not yet close to production. The other side of the equation was the progressivity on the tax when the companies started producing. He noted previous testimony in the House Resources Committee by a company that was close to production; up until that point, they had taken advantage of the tax system, but progressivity was a disincentive once they were looking at production. He stated that all of the provisions in ACES were not being thrown out, just the progressivity component, which the department viewed as a serious problem on the production side of the equation.

Representative Doogan referred to Slide 15. He asked whether the graph meant to communicate that in 2012, approximately half of the tax credits were going to the big three companies and the other half to the smaller oil companies.

Mr. Dees responded that he was correct; a little over half was projected as going to companies applying tax credits to their tax liability. He clarified that the companies represented were more than just the "big three."

Representative Doogan asked whether the representatives from DOR at the testifier's table had written the bill.

Commissioner Butcher responded "yes, we did; the three of us primarily, as well as Joe Balash from the Department of Natural Resources." [Commissioner Butcher, Deputy Commissioner Tangeman, and Mr. Dees were at the testifier's table.]

Representative Doogan asked whether the ideas behind the bill and the approach to it were theirs.

Commissioner Butcher answered "yes." He noted that there had been many conversations with the industry discussing what individual companies would see as incentives and "game-changers," as DOR did not operate in a vacuum. He did not think there would be a point to coming up with legislation that would not work. He acknowledged that there had been "a lot of conversations" [with industry] but ultimately, when the bill came out in January, they did not see it before anyone else.

Representative Doogan asked whether "conversations" meant meetings.

Commissioner Butcher responded that there were meetings with members of the industry.

Representative Doogan asked whether the meetings were about the bill.

Commissioner Butcher replied that the meetings were to get input from the industry on what industry felt could be a "game changer." He reported that industry was not happy with all parts of the bill, as had been heard in testimony; those were not things that had been discussed.

[9:40:54 AM](#)

Representative Edgmon referred to the subject of gold-plating brought up in the detailed presentation by Roger Marks, who had 25 years with the department as well as extensive experience on the subject. He stated that he could not tell from comments by the DOR senior officials and the auditor whether there was gold-plating by companies. He was troubled by the discrepancy and wanted assurance that someone had a better idea of what was going on with tax credits.

Mr. Tangeman replied that the department had stated that it had gone from gross to net just in 2006 and had done the audit for 2006. He believed Mr. Dees had stated that he had not seen gold-plating taking place in the audit that was substantially completed. He noted that DOR was in the midst of auditing 2007 and that new information going from gross to net would be available.

Commissioner Butcher pointed out that the department would never have the staff to address the kinds of questions raised during the presentation by Mr. Marks (related, for example, to the decisions to buy different kinds of trucks because of possible incentives). He added that the department was looking for signs of gold-plating insofar as the existing audit staff could.

[9:44:14 AM](#)

Representative Edgmon thought there was still a big gap between what the committee was being told and how the information was being substantiated by the department through the auditing process. He stressed that the legislature would have to make a major policy decision based on information from audits, which were lagging behind the real-time activity. He expressed confusion about how to substantiate his decision.

Co-Chair Stoltze interjected that there was a "great deal of subjectivity" in the whole area of gold-plating. He asked for further comment by the department.

Commissioner Butcher agreed that the subject was tremendously subjective. He thought the group could spend an hour debating whether there could be a need by a company for a nicer truck; he thought it all depended on how the issue was being looked at. He argued that whether there was overreaching by a company was very difficult to sort out, other than through an audit.

Co-Chair Thomas referred to a television "reality" show in which someone shot seven times at a caribou; he thought the legislature was at shot three on the discussed subject. He pointed to people who thought the state had gone back and forth from taking too much to giving away too much. He wondered whether the administration had a goal or a cap related to how much it wanted to give back to the industry,

so that the legislature could get the bill right and shoot the caribou once and for all.

Commissioner Butcher responded that the administration had considered what it called the "zone of reasonableness." He argued that when dealing with progressivity and tax credits, the numbers changed; there would never be an "exact sweet spot." Regarding progressivity, for example, when the department considered the difference between changing progressivity from a 0.4 to a 0.3 or 0.2 [percent], or considered brackets as a different approach, it would run the numbers through a model to try and see where it evened out at different prices. He stressed that the department was trying to find where the state was continuing to get its fair share while still allowing an oil company (particularly when oil prices were higher) to get a little more to incentivize exploration and production. He believed a tax bill would always be an inexact science.

Co-Chair Thomas agreed; he pointed out that with ACES, no one had imagined oil could reach the high prices it did. He wanted to assure the public that functioning programs would continue to receive state funding.

Co-Chair Stoltze recommended not spending so much time arguing over how the profits would be split that the job never got started.

[9:49:12 AM](#)

Representative Gara stated that he was disturbed by the lack of information on the bill. He referred to DOR information published in the Juneau Empire that investment spending on the North Slope was increasing about 8 percent each year over the past four years. He pointed to another statement by DOR in the Juneau Empire in December 2010 that had the answer to a question the testifiers from DOR were now saying they did not have an answer to; the quote was that the increase in capital spending was not driven by an increase in maintenance costs but primarily driven by new projects coming on line. He asked whether the prior commissioner was able to answer the question [in the Juneau Empire] because he had information Commission Butcher did not have.

Commissioner Butcher replied that he had not been in the room with the prior commissioner [when the statement was made] and he did not know what information he was looking at and what evaluation he was making from the information. He reported that in the few months prior, his administration had considered what the decline curve looked like, the lack of exploration wells, and had tried to make connections about where the credits were. He added that there was not a lot of activity expected in the near future; he did not see much exploration or fields that were ready to go.

Representative Gara asked why there was not a proposal directing the state to enhance exploration and development credits if the state was trying to get more exploration. He thought testimony by Mr. Marks had led the committee to the conclusion that the state was spending money (about \$1 billion each year) on things it perhaps should not be spending money on. He asked whether the administration would consider starting over with the legislation and focusing on things that were wanted, such as a credit for processing facilities so that companies could develop the smaller fields, or a credit that would be better for exploration, or for development wells.

Commissioner Butcher responded that they had spoken to many independent companies that had come to Alaska in response to tax credits passed in ACES. He noted the companies would be testifying about the issue. He believed the credits had made the companies interested in Alaska, but there had been challenges with negotiations related to the production. The department believed more than incentivizing credits was needed, because ultimately the tax paid over many years on a producing field did not add up to much more than the credits on the front end. Credits might bring companies in, but the measure would only be half-effective if it did not result in production through TAPS.

[9:53:57 AM](#)

Representative Gara referred to questions by Representative Doogan about who the administration had worked with in writing the bill. He asked which companies were involved in the meetings. He asked whether Exxon, BP, and ConocoPhillips were involved in the meetings.

Commissioner Butcher responded that the administration had had meetings with ConocoPhillips, BP, Exxon, Chevron, Armstrong, Pioneer, and with virtually every company operating in the state. Everyone on the state team was not in each meeting, but between them, the administration had touched base with as many companies as possible to get as much input as possible. He did not think there was a point to creating a bill to incentivize private-sector decision making without input about what potentially might work.

Co-Chair Stoltze interjected that there had recently been a statement in a newsletter that industry had written the bill.

Representative Gara was not concerned about who wrote the bill but about who had influenced it. He asked whether members of the companies had requested the major provisions in the bill, including reducing progressivity and going from monthly to annual taxation.

Commissioner Butcher replied that the discussions had covered many topics, not specific requests. From the beginning, conversations with members of the companies were about doing something with progressivity, as the governor had raised the issue months earlier; the governor thought progressivity was inhibiting exploration and development production on the North Slope.

Representative Costello noted that she considered the constitution when thinking about the state's resources, and quoted that it was the "policy of the state to encourage the settlement of its land and the development of its resources by making them available for the maximum use consistent with the public interest." She questioned whether it was in the interest of the public to develop and produce the state's oil.

Commissioner Butcher responded that he believed it was in the best interest of the state to develop its resources in an environmentally safe manner.

[9:57:05 AM](#)

Representative Costello pointed out that production was declining. She queried the purpose of tax incentives in statute.

Mr. Dees replied that although it was not explicitly stated in statute, the credits were intended to provide incentives for companies to spend money in a way that would lead to more oil and gas production. He noted that no outcome was explicitly tied to whether or not a credit was given, but he thought it was implied that if someone spent capital dollars to drill wells, the result would be to either maintain or increase the amount of oil and gas production.

Representative Costello continued that exploration and development were two separate processes and that the state was willing to take a significant amount of the risk. She recalled information given that a low percentage of wells drilled resulted in oil. She argued that the state should be willing to take the risk at the beginning of the exploration process for the long-term benefit of the public. However, it seemed that the result had not been production. She asked what the state was incentivizing and whether it was incentivizing the right things.

Mr. Tangeman replied that Mr. Dees was very knowledgeable about tax credits and how they were implemented, but the question related to setting policy. He agreed that the credits had gotten the state to a certain point; new companies were exploring. However, there was a distinct break between exploration on the one hand, and production and throughput on the other, which had raised the concerns. At high oil prices, people were interested in looking for oil, but there was still not an increase in production comparable to other areas in the world (such as North Dakota).

Representative Costello asked whether the bill would change the base tax rate.

Mr. Tangeman replied in the negative.

Representative Costello likened the situation to two different things on either end of a balancing toy called a seesaw. On one side, there were the tax credits or incentives; on the other side was progressivity. She wanted to achieve a balance, so that too much activity would not be incentivized on one side. She queried the balance the state was trying to achieve between incentives offered and the tax rates the companies would pay.

Mr. Tangeman answered that the bill would only make one change to the tax credit side, because the administration believed that the tax credits already in place were being used and were effective. The proposal was to go from 20 percent to 40 percent. He noted that the bulk of the bill would address the progressivity side; everything else was working.

10:03:01 AM

Representative Costello queried the value of the resource in the ground that the state wanted to incentivize enough to get to production.

Mr. Tangeman referred to earlier "optimistic" testimony by the Alaska Oil and Gas Conservation Commission (AOGCC) regarding the amount of oil present in the state. He noted that the state was assisting industry with short-term expenses through the tax credits in order to get the long-term value of the oil. He did not think the department was the expert on the amount of the resource, but AOGCC was; he did believe there was enough oil for the pipeline for decades to come.

Commissioner Butcher added that the value was certainly in the hundreds of billions of dollars.

Representative Doogan stated that he wanted a list of the meetings that were held related to the bill by Commissioner Butcher, any of the people at the table, any of their predecessors, and anybody in the governor's office. He wanted to know when they met and who was at the meetings. He understood that somebody might offer a privileged defense regarding the contents of the meetings; he was not asking for that. He wanted to know who the administration had spoken to and when.

Commissioner Butcher replied that he would relay the request to the governor's office. He asked whether Representative Doogan also wanted a list of Native Corporations. He stated that the group involved was broad and not limited to just a handful of folks that they were eliciting opinions from.

Representative Doogan stated that he wanted a list of everybody involved. He wanted to know who was talked to and when they were talked to.

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Representative Doogan wondered whether the committee would receive something in writing based on the presentation.

ROGER MARKS, LEGISLATIVE CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE, provided a brief summary of his background experience. He had been a petroleum economist with the Tax Division at DOR before retiring in 2008. He had spent a lot of time analyzing the production tax and had some role in designing both the statutes and the regulations.

Mr. Marks presented an overview on the intent and design of PPT and ACES, particularly the relationship between the credit rates and tax rates and how it was all intended to fit together.

Mr. Marks reported that PPT was designed in 2006 to do two main things. The first was to increase taxes; most people realized that the economic limit factor (ELF) had not been working properly. The second goal of PPT was to incentivize new investment. A two-pronged system was designed to reach the goals. Exploration and new development would get the credits, and production would pay the tax. The cycle was supposed to work with a credit system; an entity could convert losses to a credit. For example, under ACES, \$100 million in exploration costs would convert into a \$25 million carry-forward loss and a 20 percent credit, totaling \$45 million in credit.

Mr. Marks explained that the credit system was important because in exploration economics, the main thing driving the outcome was the probability of success and the cost of drilling the well. He emphasized that the failure leg carried more weight if there were a 90 percent chance of coming up with a dry hole. He noted that a 90 percent chance of failure was not an unreasonable number. Part of the goal in designing the credit structure was for the state to assume a share of the failure risk as a way of incentivizing exploration.

Mr. Marks continued that new field-development costs were mostly on the front end. The goal was "backend-loading the tax," which meant reducing the cost to the developer on the front end of the project to increase the value of the project on the net present-value basis. He pointed out that the described structure was used all over the world and that accelerated appreciation was one example. The state had a credit system that would give the producers more money on the front end and get it back on the tail end.

10:19:18 AM

Mr. Marks explained that the system contained was a balance between the tax rate and the credit rate to make sure things worked right. He stated that his judgment was that ACES had created a distortion in the balance. Currently, he felt the state had a great system for incentivizing exploration. For example, the government assumed 45 percent of the dry-hole risk. In addition, costs for state and federal corporate income tax could be deducted, which added up to the government assuming 70 percent of the dry-hole risk, a great incentive. However, exploration economics (given a 90 percent chance of failure and a 10 percent chance of success) meant that taxes were not relevant for an entity in the exploration phase. Costs and probability of success were the drivers.

Mr. Marks used the analogy of a scene in the movie "Butch Cassidy and the Sundance Kid." The characters were being chased by the law and came to the edge of a cliff; they had to jump into a river. Sundance said to Butch, "I don't know how to swim." Butch answered, "Don't worry, the fall will probably kill you." During exploration, the taxes do not matter that much, because when coming up dry, there would be no taxes to pay.

Mr. Marks believed the current credit system worked well for exploration. The tax was designed so that taxes would be paid if a company found oil. However, currently, the exploration incentives were so good the companies found oil, began to produce, and then looked at the tax rate and things slowed down as the impact of paying the taxes became real. He believed the current disconnect between exploration and production was a problem that was built into the structure of ACES.

Mr. Marks emphasized that the credit system was strong, with taxes that were not too high or too low; the problem was the high taxes.

Mr. Marks addressed Representative Edgmon's question about gold-plating. He did not believe that even a very strong audit could tell that a company had purchased a better truck than it needed to. He thought the solution to the gold-plating problem was to have a tax structure that did not incentivize such spending. He noted the main element contributing to gold-plating was high marginal tax rates, under which the tax rate and net value dropped with additional costs. He estimated the credits contributed perhaps 20 to 25 percent to the problem, but the main driver for gold-plating was high marginal tax rates at oil high prices.

HB 110 was HEARD and HELD in committee for further consideration.

Co-Chair Stoltze reviewed upcoming presentations.

[10:24:25 AM](#)

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ADJOURNMENT

The meeting was adjourned at 10:24 AM.