

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 21, 2011

1:05 p.m.

MEMBERS PRESENT

Representative Eric Feige, Co-Chair
Representative Paul Seaton, Co-Chair
Representative Peggy Wilson, Vice Chair
Representative Alan Dick
Representative Neal Foster
Representative Bob Herron
Representative Cathy Engstrom Munoz
Representative Berta Gardner
Representative Scott Kawasaki

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Representative Mia Costello
Representative Mike Hawker

COMMITTEE CALENDAR

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."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 110

SHORT TITLE: PRODUCTION TAX ON OIL AND GAS

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

01/18/11	(H)	READ THE FIRST TIME - REFERRALS
01/18/11	(H)	RES, FIN
02/07/11	(H)	RES AT 1:00 PM BARNES 124
02/07/11	(H)	Heard & Held
02/07/11	(H)	MINUTE(RES)
02/21/11	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

BRYAN BUTCHER, Acting Commissioner
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: On behalf of the governor, discussed the ramifications of the oil tax changes proposed by HB 110.

BRUCE TANGEMAN, Deputy Commissioner
Office of the Commissioner
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: Provided a sectional analysis of HB 110.

LENNIE DEES, Audit Master
Production Audit Group
Tax Division
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: During the hearing on HB 110, answered questions.

CHERYL NIENHUIS, Petroleum Economics Policy Analyst
Anchorage Office
Tax Division
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: During the hearing on HB 110, answered questions.

ACTION NARRATIVE

1:05:32 PM

CO-CHAIR ERIC FEIGE called the House Resources Standing Committee meeting to order at 1:05 p.m. Representatives Feige, Seaton, Gardner, Foster, and Munoz were present at the call to

order. Representatives P. Wilson, Herron, Dick, and Kawasaki arrived as the meeting was in progress. Representatives Costello and Hawker were also present.

HB 110-PRODUCTION TAX ON OIL AND GAS

[1:05:45 PM](#)

CO-CHAIR FEIGE announced that the only order of business is 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."

[1:06:46 PM](#)

BRYAN BUTCHER, Acting Commissioner, Department of Revenue (DOR), provided a PowerPoint discussion on the ramifications of the oil tax changes proposed by HB 110. He began by noting that three of the bill's goals are: to make Alaska more competitive both nationally and globally, to produce more jobs for Alaskans, and to increase oil production for Alaska (slides 1-3). He reminded members that North Dakota is expected to surpass Alaska in oil production within the next five years. Two more goals of HB 110 are: to develop currently unexplored fields and to get more production out of the legacy fields, which currently provide 80-90 percent of Alaska's oil production. The challenge is that the bulk of the easiest to produce fuel has been produced and Alaska is now looking at viscous and heavy oil. This is coupled with looking at areas that have very little to no infrastructure, which makes the high cost of doing business in Alaska even higher than it has been in the past.

ACTING COMMISSIONER BUTCHER noted that HB 110 is the largest part of a bigger effort by Governor Parnell to increase Alaska's oil production. For example, the Department of Transportation & Public Facilities (DOT&PF) is building infrastructure to open areas for exploration, such as the road to the Gubik field. The Department of Natural Resources (DNR) is looking at how to

expedite permitting. The Department of Law (DOL) is actively engaged in the federal issues that have been roadblocks to the development of oil and other natural resources in the state. The Department of Labor & Workforce Development (DLWD) is actively engaged in training Alaskans for the jobs the state sees coming in the future. The Department of Environmental Conservation (DEC) is continuing work to ensure that all development is done in an environmentally responsible manner.

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ACTING COMMISSIONER BUTCHER reviewed the decline in Alaska's oil production, explaining that a naturally maturing field has a decline similar to that depicted on slide 4. The question is what can be done about it. Texas has produced oil longer than has Alaska, yet has successfully ramped up its oil production to a zero or minimal decline. This can also be done in Alaska, he said, and HB 110 will play a large role in accomplishing that. He addressed the issue that investment is needed in both old and new fields (slide 5). He said the Department of Revenue's fall [2010] forecast projects that by the year 2020 about 50 percent of the oil is expected to come from currently producing fields and approximately 50 percent is expected to come from new fields.

ACTING COMMISSIONER BUTCHER allowed there has been a question that the Department of Revenue does not have all the information that it could. However, he continued, when the information that is on hand indicates something is not working, then that is weighed to decide what needs to be done to move forward. For example, at the time the petroleum production profits tax (PPT) was being considered the department had next to no information, but given the amount of production and the amount of taxes coming in it was clear something needed to be done and the PPT was passed. Eighteen months later Alaska's Clear and Equitable Share (ACES) was taken up. The department now has much more information than it has ever had, and while this information is not enough to answer every single question it is enough information to know that the state is not getting the exploration and development that should be happening given what is out there. This is highlighted by the projection that only one exploration well will be drilled in Alaska in 2011 (slide 6).

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ACTING COMMISSIONER BUTCHER maintained that a lot of oil is left in Alaska (slide 7). Cumulative production through 2010 is estimated at about 16 billion barrels, he said. The department believes there is 5-7 billion barrels remaining in North Slope reserves. Most of the remaining reserves are more challenged than the previous barrels. An example of this is the estimated 20 billion barrels of heavy oil in the giant Ugnu field. This oil is not included in the department's forecast of remaining reserves because recovery is not economically viable at this time. However, he pointed out, six years ago all of the shale gas deposits in the Lower 48 were considered uneconomic, and that has now completely turned around to being highly economic. He noted that the department's projected reserves also do not include offshore volumes from the Chukchi or Beaufort seas. While those offshore volumes would be federal barrels, that oil would go through the Trans-Alaska Pipeline System (TAPS) and would create jobs for Alaskans and allow the pipeline to continue operating for many years to come.

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ACTING COMMISSIONER BUTCHER reviewed the six primary goals of HB 110 (slide 9). Goal 1 is to encourage development of new leases or properties, he said. This would be accomplished by lowering the base tax rate [from 25 percent to 15 percent] on leases and properties that have not been produced prior to 2011. Goal 2 is to encourage investment in exploration, development, and production. This would be accomplished by using a different calculation for [progressivity] that does not take such an extreme percent of the high end. Goal 3 is to strengthen the minimum tax. This would be accomplished by lowering the threshold value. Thus, while the state gives up a little bit at the high end, it picks up a little bit at the low end. Goal 4 is to extend to the North Slope (north of 68 degrees north latitude) the 40 percent tax credit for well lease expenditures and allow producers to apply tax credits in one year rather than over two years. Changing application of the tax credit to one year is minor to the state, but gives more value to the companies. Goal 5 is to limit the time for assessment of additional production taxes. Four years will now be adequate for completing audits, as opposed to the six years currently allowed under ACES. Goal 6 is to reduce the interest rate on delinquent taxes and refunds. Currently the interest rate is 11 percent or the federal rate plus 5 percent, whichever is [higher]. With the low interest rate environment of the past few years, 11 percent seems higher than needed for adjustments on overpayment or underpayment of taxes. The interest rate cuts

both ways because the state must pay interest on any overpayments.

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ACTING COMMISSIONER BUTCHER said that ultimately HB 110 is about balance between current revenue and the future health of Alaska's economy (slide 10). Under HB 110 the state would continue receiving its fair share of revenue. Additionally, HB 110 would establish a secure investment climate for industry. While there would be a revenue reduction over the near term if HB 110 is enacted, it is projected that the state would still have plenty of surplus revenues 10 years from now. After that the surplus is expected to increase as the state experiences more exploration and development.

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CO-CHAIR SEATON requested an explanation of what is meant by strengthening the minimum tax under Goal 3.

ACTING COMMISSIONER BUTCHER reminded members that producers testified they were not thrilled with this particular provision of the bill. However, [the administration] believes that if the state gives up something at the high end, it is reasonable for the state to pick up something at the low end.

CO-CHAIR SEATON asserted that this provision would weaken, not strengthen, the state's position because it appears to him that the state would get less revenue.

ACTING COMMISSIONER BUTCHER responded that the 4 percent [of gross] would apply at a lower cost of oil. So, under HB 110, the 4 percent [of gross] would kick in at \$20 instead of the current \$25. The 3 percent of gross that currently kicks in at \$20-\$25 would kick in at \$17.50-\$20. The 2 percent of gross that currently kicks in at \$17.50-\$20 would kick in at \$15-\$17.50. The 1 percent of gross that currently kicks in at \$15-\$17.50 would kick in at \$12.50-\$15.

CO-CHAIR SEATON described a scenario of declining oil prices under current law in which a price of \$25 is reached, at which the floor would kick in and the state would be guaranteed at least 4 percent; but under HB 110 the 4 percent floor would not kick in until the price goes down to \$20.

ACTING COMMISSIONER BUTCHER said the 4 percent would kick in at \$20 and would also be there for \$25. The difference is that right now at a price of \$21 the floor would not be 4 percent; it would have to get to \$25. Under HB 110, the 4 percent floor would hit at \$21.

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ACTING COMMISSIONER BUTCHER returned to his presentation and compared the current nominal tax rate on production tax value to the two rates proposed by HB 110 (slide 12). For presently operating fields the proposed nominal tax rate [would remain at the current starting rate of 25 percent] and would follow the same curve as under ACES, but it would be bracketed and would be capped at a peak of 50 percent. For new fields the proposed nominal tax rate would start at 15 percent, would be bracketed, and would be capped at 40 percent.

ACTING COMMISSIONER BUTCHER next compared the current marginal tax rate on production tax value to the two marginal rates proposed by HB 110 (slide 13). He explained that the marginal tax rate is what the tax is on each additional dollar above the production tax value and what percent goes to the state. The proposed incremental progressivity eliminates the current 87 percent marginal tax rate effect. He pointed out that the 87 percent is strictly for the state production tax percent; it is actually 93 percent when all state and federal taxes are included. Under HB 110, the marginal tax rate would increase at a more gradual rate and would not have as large a take at the high end of production tax value than under current law.

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ACTING COMMISSIONER BUTCHER moved to a comparison of the current effective tax rate based on gross value at point of production with the two effective rates proposed by HB 110 (slide 14). Under current and proposed rates, the percentage of state take increases as the [Alaska North Slope West Coast price per barrel increases]. However, under HB 110 the slope of the tax increase is less than that of current law.

ACTING COMMISSIONER BUTCHER, in response to Co-Chair Seaton, confirmed that the effective tax rate is the real money that is paid and is the percent of total dollars earned per barrel that would go to the state. He said the effective tax rate is applied after tax credits and after deduction of transportation and other costs.

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CO-CHAIR SEATON said industry has reported that the other countries it is investing in have effective tax rates in the range of 60 percent or so. For example, the government take in Norway is 78 percent on the gross and in Indonesia it is 85 percent. He asked why, when compared to other jurisdictions around the world, Alaska's effective tax rate of 35 percent is perceived as onerous.

ACTING COMMISSIONER BUTCHER responded that the effective tax rate shown [on slide 14] is lower because of the credits that Alaska has, which are something that many other states and countries do not have. The credits apply to some but not all dollars produced. He said he believes California and one other state are the only states with a higher tax rate than Alaska. Therefore, on a North American basis Alaska does not stack up when companies are deciding where to invest their dollars. On a world basis there are other countries that have vast resources like what Alaska used to have and, infrastructure-wise and exploration-wise, those countries are not nearly as challenging as is Alaska.

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CO-CHAIR SEATON requested the Department of Revenue to provide the committee with a comparison of where companies are investing, rather than a comparison of where they are not investing. In regard to the argument that investment in Alaska does not compare to others, he maintained that some of the countries in which industry is investing, such as Russia, do not have any more infrastructure than does Alaska.

CO-CHAIR FEIGE observed that at an Alaska North Slope West Coast price of \$100 per barrel, the effective tax rate is 28 percent (slide 14). He asked whether this includes the percent of federal taxes and property taxes.

ACTING COMMISSIONER BUTCHER replied that this is just the production tax. In further response, he confirmed that the percentages depicted on slide 14 do not include the entire government take.

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ACTING COMMISSIONER BUTCHER resumed his presentation and discussed the cash flow split at different oil prices under ACES for the years 2013-2040 as projected under the Department of Revenue's fall 2010 production forecast (slide 15). He recounted that when oil first started flowing through the Trans-Alaska Pipeline System (TAPS), then-Governor Hammond and the legislature emphasized that an approximately even split between the producers' take and the state's take was considered reasonable. He said he is not saying that [the administration] is shooting for this; rather, it is a historical observation that he is relating. At Alaska North Slope West Coast oil prices of \$50-\$90 per barrel, Alaska's take under ACES would be 50 percent or less of the cash flow for the years 2013-2040. At \$100 per barrel, Alaska's take would be 53 percent of the cash flow, the producers' take would be 29 percent, and the federal government take would be 18 percent. At a price of \$150, Alaska's take would be 62 percent.

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REPRESENTATIVE GARDNER described a scenario in which the price of oil rises, thereby increasing the marginal tax rate. She surmised that since Alaska has a net profit tax, a producer could reduce its tax rate in the aforementioned scenario by reinvesting the extra dollar which would reduce the profit.

ACTING COMMISSIONER BUTCHER agreed.

REPRESENTATIVE GARDNER further surmised that a producer can control its tax rate by drilling a new well and deducting it, which is exactly what the state is trying to do. She understood that about one-third of every dollar less in state take would go to the federal government. Thus, she presumed, the graph on slide 15 is based on certain assumptions that can be changed by any producer.

ACTING COMMISSIONER BUTCHER answered yes. He directed attention to slide 16 which illustrates what the total cash flow split would be under the proposed provisions of HB 110 at different oil prices for the years 2013-2040 as projected under the department's [fall 2010] production forecast. He said the graph shows that the state's take would be reduced, while the federal government's and producers' takes would increase.

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REPRESENTATIVE GARDNER surmised it is being assumed that passage of HB 110 would result in a certain amount of investment, but it is unknown how much that investment might be because there is no way to calculate it.

ACTING COMMISSIONER BUTCHER agreed. He related that the governor has made it clear there is no way [the administration] can promise what will happen in the future. The governor has pointed out that industry needs to step up and discuss where it sees things going, which it did last week. He acknowledged that the Department of Revenue's numbers in the fiscal note are estimates based on the best information available at the time.

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REPRESENTATIVE GARDNER understood that predicting the future price of oil is an informed guess. However, she said predicting how investment may or may not change as a result of HB 110 is crucial. She asked whether there is any data and noted that the producers testified that the passage of HB 110 "may" change investment or that it is "a start." There was no commitment that reducing taxes would necessarily increase the producers' investments.

ACTING COMMISSIONER BUTCHER referenced the [2/11/11] testimony of the department's consultant [Rich Ruggiero] from Gaffney, Cline & Associates. In this testimony the consultant provided general projections about what the state would be giving up in the short term and what the state would potentially have in the long term. However, he continued, the department does not have a dollar to dollar breakdown of those projections. He offered to provide members with more detail in this regard.

REPRESENTATIVE GARDNER said she is very interested in knowing what goes into calculating what the investments will be.

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ACTING COMMISSIONER BUTCHER returned to his presentation and outlined the estimated total cash flow spilt that would occur at different oil prices under HB 110 for the years 2013-2040 based on the department's [fall 2010] production forecast (slide 16). At an Alaska North Slope West Coast oil price of \$100 per barrel, the cash flow split would be 44 percent to the state, 35 percent to the producers, and 21 percent to the federal government, as compared to 53 percent, 29 percent, and 18 percent, respectively, under current ACES law. At increased

prices, the producers' percentage of take would still be reduced and the state's take would still increase, but not as steeply as under current law. He said [the administration] believes the state would still be getting its fair share at 50 percent of the cash flow when oil prices are high [\$150].

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CO-CHAIR SEATON inquired where the incentive comes in for the investment. He calculated that at a price of \$120, less \$30 in cost, the production tax value would be \$90, at which industry would receive 29 percent of the cash flow under HB 110 as compared to 25 percent under ACES, as well as industry getting the investment in the field. Under HB 110, all of that investment would only yield industry a 1 percent change in the retention of tax. He inquired whether HB 110 would therefore eliminate the tax incentive that was trying to be built in for stimulating infield production.

ACTING COMMISSIONER BUTCHER said he believes industry has testified quite strongly behind HB 110. He presumed that, if asked, industry would suggest lower numbers than what are proposed in the bill. The purpose of slide 16 is to show that from the department's perspective the state would still be protected under HB 110 and would get its fair share; not to point out why the industry should be happy that this change is being made.

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CO-CHAIR SEATON directed attention to the marginal tax rates depicted on slide 13. He calculated that if the amount of investment reduced the production tax value from \$90 to \$70, the marginal basis would drop by 15 percent under current law, but under HB 110 the marginal basis would drop by only 5 percent. He said this is two-thirds less reward for the investment and he therefore questions how HB 110 provides incentive for investment.

ACTING COMMISSIONER BUTCHER responded that any time the tax rate is reduced and there is deduction, theoretically there would be a reduction in what industry would be able to take from the taxes. The producers and explorers have testified that this is not viewed as detrimental to their business, just as [the administration] does not view it as detrimental to the state.

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CO-CHAIR SEATON said that in his aforementioned example the tax liability is reduced by 15 percent [under current law], but that same investment under HB 110 would only reduce the tax liability by 5 percent. He asked how that is an incentive for reinvesting, other than just saying that industry might do something if it has more money.

ACTING COMMISSIONER BUTCHER replied that producers have told the department and have testified that when making investment decisions about where to explore and where to invest funds, the long term is looked at and it is more than just what is reinvestment and tax credits. It is what the high end is, what effective is, and what marginal is, and taking a higher marginal tax rate down a higher percentage to what is still a higher number is going to be less of an incentive than would occur under HB 110, which would take it down a smaller percentage but would be at a lower percentage of taxes looking long term.

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CO-CHAIR FEIGE asked whether the commissioner and the department believe that the current ACES structure has encouraged exploration.

ACTING COMMISSIONER BUTCHER answered that, based upon there being virtually no new exploration over the past few years and based upon anecdotal information that explorers that have found oil have been unable to find partners to develop, the department believes the current tax structure has been a deterrent to investment. The state has not received the kind of investment that seems to be going on in the rest of the U.S. and the world, which is spurred in particular by the high price of oil.

CO-CHAIR FEIGE inquired whether the commissioner believes that altering the tax rate as proposed by HB 110 would increase exploration and subsequent production if the exploration is successful.

ACTING COMMISSIONER BUTCHER said he would. The department believes the changes in HB 110 will spur exploration and increase production while still allowing the state to keep its fair share and not do more than it needs to do.

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REPRESENTATIVE P. WILSON observed that the decrease in exploration started a few years before PPT or ACES went into effect. Therefore, she asked, how is it known that the decreased exploration would not have happened anyway.

ACTING COMMISSIONER BUTCHER responded that during the pre-PPT years the price of oil was fairly low. When Governor Frank Murkowski took office in 2003, the state was looking at a budget deficit of about \$500-\$600 million. While much of that was due to the ELF needing to be reformed, it was also due to the low oil price. Many factors affect whether there is exploration, he continued, but he believes that tax rates are the biggest piece that the State of Alaska can do something about. He said it is his opinion that the lack of exploration in Alaska is even more alarming given what is going in other states and countries at this high price.

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REPRESENTATIVE GARDNER observed that industry must currently spend money in Alaska to reduce its taxes, but if HB 110 is passed industry will not have to spend anything to reduce its tax rate. She inquired whether HB 110 is not the opposite of what the state would want to do.

ACTING COMMISSIONER BUTCHER replied that under HB 110 spending and increased investment would reduce industry's tax load. He allowed that on a percentage basis a lower tax rate would result in a lower amount of taxes being reduced by spending, but said that producers take many things into consideration when making their decisions, and for the out years they look at the tax to see where the high take can be to offset when prices are low; for example, "Shell" has spent nearly \$4 billion in developing the outer continental shelf (OCS). When making decisions, industry looks at the upside as well as everything. Department discussions indicate that looking at the tax rate, in particular the high marginal tax rate, plays a greater role than do the other pieces, although that is not to say the other pieces are unimportant. The department is trying to do what it has heard will spur investment and spending and would create more jobs in the state.

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REPRESENTATIVE GARDNER said she still does not understand how reducing taxes will increase industry investment.

ACTING COMMISSIONER BUTCHER responded that if he was running a company he would not increase spending on exploration just to reduce his taxes if it was cost prohibitive in the long run to develop and produce the area that he was exploring. It would ultimately cost hundreds of millions of dollars to do so, he said. He suggested that industry be asked this question.

REPRESENTATIVE GARDNER remarked that this would be true under either system.

1:56:40 PM

BRUCE TANGEMAN, Deputy Commissioner, Office of the Commissioner, Department of Revenue (DOR), provided a sectional analysis of HB 110. He explained that Sections 1-5 of the bill would amend AS 43.05.225 to address the interest rate clauses (slide 18). Sections 1 and 2 are conforming amendments. Section 3 proposes a new interest rate of 11 percent or the federal rate plus 3 percent, whichever is lower. Currently, the interest rate is 11 percent or the federal rate plus 5 percent, whichever is higher. Sections 4 and 5 are conforming amendments.

MR. TANGEMAN related that Section 6 addresses the 25 percent tax rate for existing oil producing fields and proposes to incorporate a 15 percent tax rate for state land that is not currently producing or not unitized (slide 19). Section 6 also proposes that progressivity be levied on an annual, rather than a monthly, basis. This would annualize the revenue side of the equation to what is currently annualized under the credits and expenditures side. The state would still receive a monthly payment, but how that payment is calculated would be changed.

1:58:46 PM

MR. TANGEMAN said Section 7 proposes lower threshold prices for application of the minimum tax (slide 20). Currently, the minimum tax is 4 percent of gross when the Alaska North Slope West Coast price is over \$25 per barrel; Section 7 would lower the price to \$20. Currently, three percent of gross is calculated between \$20 and \$25; under the new language it would be between \$17.50 and \$20. Two percent of gross currently is calculated between \$17.50 and \$20; under the new language it would be between \$15 and \$17.50. Minimum tax of one percent of gross currently is between \$15 and \$17.50; under the new language it would be between \$12.50 and \$15.

MR. TANGEMAN explained that Section 8 proposes an income-tax-type bracketing of progressivity (slide 20). He directed attention to page 4 of the bill where Section 8 lays out the brackets for both the 25 percent oil production and the 15 percent oil production.

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MR. TANGEMAN said Section 9 accounts for the technical changes of going from a monthly to an annual calculation (slide 21). Section 10 is a conforming amendment for the proposed interest rate change. Section 11 proposes to remove the requirement that tax credits for qualified capital expenditures be taken over two years; thus, the credit could be taken in one year. Section 12 is a cleanup section to allow the proposed change in Section 11 to take place.

MR. TANGEMAN related that Sections 13 and 14 are amendments to reflect the proposed interest rate change and relate to the proposed change in issuance of well lease expenditure credits. Sections 15 and 16 propose to expand the 40 percent well lease expenditure credit to include qualified expenditures on the North Slope; currently the 40 percent credit applies only to wells below 68 degrees north latitude. Sections 17 and 18 are the conforming amendments to implement Sections 15 and 16. Section 19 proposes that the statute of limitations for production tax be reduced from six years to four years beginning with the 2014 tax liability. It is believed that this would not be onerous on the department, he said.

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MR. TANGEMAN explained that Section 20 would amend AS 43.55.160 to account for production subject to the proposed 15 percent tax rate and the proposed progressivity changes (slide 23). Sections 21, 22, and 23 are conforming amendments for the proposed interest rate change. Section 24 would repeal AS 43.55.023(m) since all capital credit certificates would be issued as one certificate and relates to the proposed change that the credits do not have to be taken over two years.

MR. TANGEMAN said the rest of the sections are mostly clarification and conforming amendments (slide 25). Section 26 would provide the Department of Revenue (DOR) with the authority to adopt regulations to implement HB 110, which is standard for any proposed tax change. Sections 27-30 provide the effective dates: July 1, 2011, is the proposed effective date for the

proposed reduction in interest rate for overpayment and underpayment of taxes; January 1, 2012, is the proposed effective date for the proposal to allow credits for expenditures made after this date to be used in one year instead of having to be spread over two years; January 1, 2012, is also the proposed effective date for the proposed extension to the North Slope of the 40 percent well lease expenditure credit; January 1, 2013, is the proposed effective date for the proposed change to annual and bracketed progressivity along with a proposed 50 percent maximum rate; January 1, 2013, is also the proposed effective date for the proposed lower tax rate of 15 percent for new leases or properties as well as for the proposed change to the minimum tax thresholds; and January 1, 2014, is the proposed effective date for the proposed change from six years to four years in the statute of limitations for production tax.

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CO-CHAIR FEIGE pointed out that all of the producers testified the effective dates should be sooner. He asked why the department chose these effective dates.

ACTING COMMISSIONER BUTCHER responded that the Tax Division is a bit behind in auditing because of the PPT and ACES changes. Additionally, new regulations would need to be written. An effective date for the tax changes of January 1, 2013, therefore seemed much more realistic than 2012. The effective dates for the interest rate and credit changes are earlier because those would not take a tremendous amount of work by the department to implement. The additional year for the statute of limitations change is to make absolutely sure the department is as caught up on its audits. In further response, he confirmed that the spacing of the proposed effective dates is to give the department the time to write the new rules.

[2:08:15 PM](#)

REPRESENTATIVE GARDNER referenced Section 8 and inquired who is doing exploration work right now.

ACTING COMMISSIONER BUTCHER replied that according to the Department of Natural Resources (DNR) and the Alaska Oil and Gas Conservation Commission (AOGCC), Brooks Range Petroleum is drilling the one oil exploration well expected in Alaska this year, and it is on the North Slope.

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REPRESENTATIVE GARDNER asked what is the total amount paid out in capital tax credits under ACES and how much of that was for exploration wells.

MR. TANGEMAN deferred to Mr. Lennie Dees.

LENNIE DEES, Audit Master, Production Audit Group, Tax Division, Department of Revenue (DOR), answered that he does not have in front of him a number for just ACES. However, from the beginning of PPT to date, the total is \$3 billion in the amount withheld from tax liability plus what the state has paid through the appropriations fund. Of that, about \$450 million was paid out for exploration credits.

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REPRESENTATIVE GARDNER calculated that about one-sixth of the tax credits paid out were for exploration. She asked what, in broad terms, the rest of the tax credits were for.

MR. DEES responded that capital expenditure credits are for drilling development wells and building facilities in both old and new fields and these credits were about \$2.4 billion of that amount. Net operating loss carried forward credits are for companies that are not currently tax payers but are incurring net operating loss and these credits were \$475 million. The remainder was the small producer credits applied against taxes.

REPRESENTATIVE GARDNER cited the Kuparuk field as an example of basically \$0 in production tax under the old ELF system and inquired whether there was any evidence of exploration or drilling of new wells.

MR. DEES said he believes the exploration credit came into being in 2003 and that about \$48 million in exploration credits was applied for prior to PPT.

2:13:43 PM

REPRESENTATIVE GARDNER asked whether the state has historical data indicating that the lowering of taxes fosters job growth or new wells.

MR. DEES said he does not have any data that he could positively associate with that.

ACTING COMMISSIONER BUTCHER interjected that a few years ago Alberta raised its royalty to a level seen as prohibitive by industry and the amount of exploration subsequently dropped. About a year ago the province lowered its royalty and the anecdotal information is that there is now more development; the department is still looking into finding black-and-white information to show that. In further response, he said the department has no data for Alaska since the last two oil tax increases, other than it appears that there is less exploration.

[2:15:15 PM](#)

CO-CHAIR FEIGE inquired whether there has been an increase or decrease in capital credits for exploration since the 2007 enactment of ACES.

MR. DEES answered that when PPT was in effect prior to Fiscal Year (FY) 2007, the exploration credits claimed were about \$48 million in addition to what was withheld from the tax liabilities and what was claimed via the applications. In fiscal years 2007, 2008, 2009, and 2010, that amount was about \$92 million, \$93 million, \$84 million, and \$133 million, respectively. The projection for FY 2011 is \$22 million. He cautioned against looking at that trend as being when those activities actually occurred because there is a time lag between when the activities occur and when the companies actually apply for those particular credits.

[2:18:33 PM](#)

CO-CHAIR FEIGE understood that these credits do not necessarily reflect activity that took place in those particular years.

MR. DEES replied correct. He explained that the drilling season on the North Slope is typically between October of one year and March and April of the next year. Under the statute, companies must file for the credit within 6 months after completion of the project. Some projects may take two drilling periods. So, by the time the department receives and processes an application there could be a lag time of one to one and a half years since the actual expenditure was incurred. In further response, he confirmed that the figure of \$133 million in FY 2010 could have happened as far back as 2008. He further clarified that many of the applications for FY 2010 would have begun July 1, 2009, through June 30, 2010, so the department probably received a lot of those applications in September of 2009.

[2:20:15 PM](#)

REPRESENTATIVE MUNOZ asked how much of the \$2.4 billion in capital expenditure credits since PPT was for maintenance of facilities.

MR. DEES responded he does not have that breakdown.

REPRESENTATIVE GARDNER inquired whether that data is available to the state or whether Mr. Dees does not have it right now.

MR. DEES said he does not have the data in front of him, but of the \$2.4 billion nearly \$1 billion was credits claimed by companies not currently producing. In the application process a company must provide a listing of the expenditures for which it is claiming credits. The companies applying for transferable tax credit certificates are primarily in either an exploration or development stage, so at least \$1 billion of that would have been for construction of facilities or drilling of development wells, not maintenance. The remaining \$1.5 billion came from the more mature fields, which means currently-producing companies, and the department does not have a breakdown of those particular costs until it actually audits those tax filings. The department has completed its audits for the year 2006, which is the first year on the PPT, and is now in the process of auditing 2007. Under the current requirements for tax filings, the amount of capital expenditures must be provided for the amount of credits being claimed, but a detailed breakdown of what those capital expenditures are for is not required.

[2:24:29 PM](#)

ACTING COMMISSIONER BUTCHER added that the Department of Law (DOL) has concluded that a regulatory change requiring a breakdown of capital expenditures can be done by the Department of Revenue. When the regulations were written, the department did not include that as a requirement; thus, it is not a matter of industry not giving this information to the department.

CO-CHAIR FEIGE said the committee probably expects the department to add something to those regulations.

ACTING COMMISSIONER BUTCHER replied, "Duly noted."

[2:25:29 PM](#)

CO-CHAIR SEATON recalled that the monthly basis of progressivity was put in place for the purpose of windfall profits, such that the state rather than the federal government would receive something if there was a big spike in oil prices. He asked why Section 6 proposes to change the progressivity to an annual basis that would miss capturing any windfall profit tax.

ACTING COMMISSIONER BUTCHER conveyed that it has been more difficult than expected to line up monthly oil prices with expenditures, which are done on a yearly basis. This provision is not a key aspect of the bill, it is just one of many tweaks the department looked at to simplify things for both the department and the industry.

[2:27:56 PM](#)

CO-CHAIR SEATON commented that he does not see how the state would benefit from giving up the windfall profit tax angle by going from a monthly to an annual basis for progressivity.

ACTING COMMISSIONER BUTCHER responded that it would be a rolling average through the course of the year. He said the department believes the true-up in March would be easier if it was based on a rolling average that adjusted as the year went on than it would be with the spike and drop of monthly oil prices. He allowed that Co-Chair Seaton is correct because when the department reviewed the last six years to determine the difference between monthly and annually, it varied from a difference of about \$150 million to about \$450 million.

ACTING COMMISSIONER BUTCHER, in response to Co-Chair Feige, confirmed that this difference was in relation to billions of dollars per year over this time period. In further response, he confirmed that a rolling average would not only smooth over the spikes, it would fill in the sharp troughs in the price as well. However, he allowed, a rolling average would have an effect.

CO-CHAIR SEATON noted that the intended effect was to catch those windfall profit spikes that occur when an accident or worldwide event happens and that are not at all tied directly to investment. He inquired whether the fiscal note reflects the loss of \$100-\$400 million from this issue.

ACTING COMMISSIONER BUTCHER replied yes.

[2:30:38 PM](#)

REPRESENTATIVE KAWASAKI said he does not see this loss reflected in the fiscal note. He asked what price per barrel the fiscal note is modeled on.

ACTING COMMISSIONER BUTCHER answered that it is modeled on the Department of Revenue's fall 2010 forecast for both production and price.

REPRESENTATIVE KAWASAKI inquired how the calculations for price spikes are done, such as for the current spike that is happening as a result of the turmoil in Egypt and Libya.

ACTING COMMISSIONER BUTCHER responded that it would be just a very rough estimate, given that no one can predict the ups and downs throughout a year.

REPRESENTATIVE KAWASAKI asked whether the department has considered calculating the deductions monthly as opposed to the way they are done annually.

ACTING COMMISSIONER BUTCHER replied that he believes it would be much more difficult for the industry. He deferred to Mr. Dees.

MR. DEES said he does not believe the Department of Revenue has looked at deducting actuals on a monthly basis. He predicted that industry would tell the committee that this would be difficult to do. There would be a greater need for industry to do adjustments if this was required, he continued. It would depend on each company's monthly accounting cycles and when a company finalizes its books as to how difficult it would be to match up the actual expenditures for the month; so it would be possible for some companies and more difficult for others. He said he believes that most companies currently have an annual estimate for projected lease expenses for the year; as that changes throughout the year the company makes adjustments to its monthly installments and must also adjust prior months if those are affected.

[2:34:18 PM](#)

REPRESENTATIVE HERRON requested the department to prepare a slide showing a scenario where the overall tax rate remains the same as current law, but with the progressivity bracketed.

ACTING COMMISSIONER BUTCHER agreed to do so.

[2:35:07 PM](#)

CO-CHAIR SEATON inquired where the \$100-\$400 million loss from the proposed annualizing of progressivity is shown.

ACTING COMMISSIONER BUTCHER deferred to Ms. Nienhuis.

CHERYL NIENHUIS, Petroleum Economics Policy Analyst, Anchorage Office, Tax Division, Department of Revenue (DOR), said the tax rate change is addressed in Section 3 of [Fiscal Note #1, dated 1/13/11, page 2]. Because the tax rate change would take effect on January 1, 2013, it is unknown what the monthly oil prices will be in FY 2013 and therefore unknown what the monthly variation in tax rate will be. So, as far as being built into the fiscal note, the department did not hazard a guess; for FY 2013 just one price for the year is projected. Under ACES there was a pretty significant monthly to annual tax rate change, so calculating monthly versus annually would have a fairly sizeable difference, especially if there is volatility in that year. Under the proposed bracketed progressivity of HB 110, there would be much less of a change between monthly and annual; the percentages are significantly less. That is because under ACES the progressivity is formulaic, which means that every dollar of profit actually increases the tax rate; whereas under HB 110 there would be \$12.50 worth of profit under the same tax rate, so the monthly to annual calculation would result in less of a tax rate change.

[2:37:27 PM](#)

CO-CHAIR SEATON reiterated that eliminating the windfall portion of the monthly progressivity would result in an average annual decrease of \$100-\$400 million. He asked whether this revenue loss is shown somewhere in the fiscal note or is off the books.

MS. NIENHUIS responded that the \$100-\$400 million referenced by Acting Commissioner Butcher was calculated under ACES. The department is calculating much lower changes under HB 110 and without knowing the volatility it is unknown how much that would be. With the current year prices it could be very little because there has been little month-to-month volatility; therefore, that was not automatically built into the fiscal note. Department fiscal notes are normally done on the most recent forecasted prices and production, so there was not any volatility to model this under. She offered to provide the ranges of differences in production tax with monthly and annual calculations.

2:39:11 PM

CO-CHAIR FEIGE accepted Ms. Nienhuis's offer. Regarding the difference between these two methods of calculating the tax, he surmised that if the price is less volatile the difference is less, and if the price is more volatile the difference is more.

MS. NIENHUIS replied correct. She noted that FY 2009 had very volatile oil prices and that was where the biggest difference was seen. This would be calculated on a calendar year basis, so it would not necessarily correspond to fiscal years. However, whatever measure of volatility there is for month-to-month is going to make the difference in the production tax rate between monthly and annual.

2:40:16 PM

CO-CHAIR SEATON expressed his concern that the revenue projections for HB 110 do not reflect this loss of \$100-\$400 million per year. He inquired whether there are any other aspects of HB 110 that reduce revenue that are not shown on the fiscal note for the same type of reasoning.

ACTING COMMISSIONER BUTCHER apologized for this misinformation on the fiscal note. He said he and Ms. Nienhuis had not spoken in detail about this and her view that the amount of change based on the switch from the higher spikes of ACES to the brackets would result in a much smaller number. He added that he thinks it will be much less than \$100-\$400 million.

2:41:29 PM

REPRESENTATIVE KAWASAKI referenced [Chart 8, page 11] of the commissioner's [January 18, 2011, Oil and Gas Production Tax Status Report] which depicts employment in Alaska's oil and gas industry during the years of a gross profits tax and during the years of a net profits tax. He asked for an explanation of what these numbers would mean in terms of Representative Gardner's question about whether the state has historical data indicating that the lowering of taxes fosters job growth.

ACTING COMMISSIONER BUTCHER answered that the department does not have a good breakdown of where that employment has been going. The producers have told the department that a tremendous amount of maintenance work is being done on mature fields and in trying to keep production levels from declining further, but very little is going into exploration. That is backed up when

exploration wells are looked at, but DOR does not have the hard data that says specifically what those positions are going for.

[2:43:19 PM](#)

REPRESENTATIVE KAWASAKI inquired whether DOR has any data that connects jobs with what has happened with tax rates historically.

ACTING COMMISSIONER BUTCHER responded that the department does not have any breakdown that would say definitively one way or another, but there is anecdotal information. The department has discovered that through regulation it can get more information than it currently has, but he is unaware why that was not pursued by the department previously.

MR. TANGEMAN added that specifically tying the effects of the tax one-to-one on job growth would be very difficult without taking into account the other variables, such as oil price.

[2:44:47 PM](#)

CO-CHAIR FEIGE pointed out that the number of exploration wells depicted on slide 6 shows a definite downward trend and this could be tied to price or jobs. He asked whether Representative Kawasaki wants more information.

REPRESENTATIVE KAWASAKI replied he does want more information because HB 110 has multi-billion-dollar implications and it does not seem like the Department of Revenue has the data to back up any of the proposed changes. He requested information that shows the number of exploration wells drilled prior to 2005.

ACTING COMMISSIONER BUTCHER said DOR will get what it can.

[2:46:03 PM](#)

REPRESENTATIVE GARDNER recalled that House Bill 280, the Cook Inlet gas storage bill by Representative Hawker, was passed last year. That bill replaced the 20 percent credit for general capital activity with a new 40 percent credit for well drilling activity. Under Section 15 of HB 110, she noted, the state would pick up the 40 percent credit statewide. She surmised that because it is a net profits tax the cost for the well would bring down the taxes; so, at a price of \$85 per barrel the tax rate would be about 35 percent. Therefore, the state would be

participating in the well at about 75 percent of the cost, she calculated. She asked whether that is the intent of HB 110.

MR. TANGEMAN answered that it is not that simple because some tax credits are stackable and some are not. He said 75 percent is not a number he has heard.

[2:47:55 PM](#)

REPRESENTATIVE GARDNER reiterated that there would be a 40 percent credit at the top. The tax would also be reduced by 35 percent of that amount because Alaska has a net profits tax. For example, if a company is being taxed on \$100 that would be reduced to \$50 by the 40 percent tax credit; the company would then pay taxes on only 60 percent. Thus, roughly 35 percent of that \$40 is also a tax savings to the taxpayer.

MR. TANGEMAN asked whether that \$100 is the price per barrel of oil or \$100 of investment in a well.

CO-CHAIR FEIGE interjected that the tax credit is not received unless the company invests the money.

REPRESENTATIVE GARDNER said there is the 40 percent tax credit as well as a deductible expense at about 35 percent tax rate.

MR. TANGEMAN deferred to Mr. Dees.

MR. DEES explained that the 40 percent well lease expenditure credit did not replace the 20 percent credit; rather, it allowed an additional credit on certain well lease expenditures that met certain criteria. The criteria for meeting that are what are called intangible drilling costs associated with drilling a well. So, it is not that the entire cost of a well received 40 percent; the intangible drilling costs received the additional 20 percent. Intangible drilling costs are those costs for items associated with a well that are deemed to not have a salvage value. As a rule of thumb, intangible drilling costs constitute about 75-85 percent of the cost of drilling a well. Theoretically, what Representative Gardner is saying is true: if the well received the regular 20 percent credit plus the other additional 20 percent credit on those certain items, and the cost was deductible for production tax purposes, the company would benefit to the extent of whatever the production tax rate is for that particular month or year.

[2:52:10 PM](#)

REPRESENTATIVE DICK inquired how the federal government take is determined and why the federal government is not participating in the effort to stimulate development.

ACTING COMMISSIONER BUTCHER explained that federal taxes are based on what Congress passes. Some parts of the state tax are deductible from the federal tax, so when Alaska's tax goes up the federal tax drops. He offered to provide more information in this regard if it is requested.

REPRESENTATIVE DICK said he will pursue that.

[2:53:08 PM](#)

CO-CHAIR FEIGE said he believes the original intent of the 40 percent credit for Cook Inlet was to encourage more exploratory drilling in the Cook Inlet to increase the supply of gas for the Anchorage Bowl. He asked whether there has been effect from that credit.

ACTING COMMISSIONER BUTCHER deferred to the Department of Natural Resources for details, but said it appears that the credit is working because a couple of companies are currently trying to bring jack-up rigs to the Cook Inlet.

CO-CHAIR SEATON asked whether the intangible drilling cost of 40 percent is what is stimulating that instead of the 100 percent of the cost of the first well and 90 percent of the second.

ACTING COMMISSIONER BUTCHER replied he is sure that is playing a major role as well. A few changes were made and as a result there has been activity.

[2:54:27 PM](#)

CO-CHAIR SEATON observed that Item 3 of Fiscal Note 1 [page 2 of 2] projects a decrease in revenue to the state of \$1,423 million in FY 2017. He further observed that Item 6 projects a revenue decrease of \$200-\$400 million, which he does not believe is included in Item 3. Additionally, \$100-\$400 million in revenue would be lost from changing the windfall profits tax from a monthly to an annual basis. He calculated that the real impact of HB 110 would therefore be a revenue loss of \$1.723-\$2.223 million in FY 2017.

ACTING COMMISSIONER BUTCHER pointed out that DOR's estimates of reduced revenue are only half of the picture. The fiscal note does not show the increased revenue the department believes will result from passage of HB 110. He deferred to Ms. Nienhuis to answer the question.

MS. NIENHUIS agreed that Co-Chair Seaton's numbers are in the ballpark, although \$100-\$400 million might be a little high for the change to annual progressivity. The fiscal impact of each provision was stated separately and the impacts would be added together if HB 110 passed as currently written. As far as the 40 percent well lease expenditure credits, the department had very limited data on which to project because DOR does not receive its expenditure estimates by type of expenditure. It is hoped there would be additional production if passage of HB 110 results in the additional development that is foreseen by the department. If there is additional drilling, the well lease expenditure credits could go up. In its fiscal notes, the department tries as much as possible to follow its last forecast information, so anything on this fiscal note uses that forecast alone.

[2:58:46 PM](#)

CO-CHAIR SEATON said an average revenue reduction of \$2 billion per year is more significant than has been the general feeling. There is talk about increased drilling, yet there are no commitments from anyone for new projects. The major companies testified that they are giving up exploration leases and will not be in the position to do exploratory work. There is no forecast of potential new units beyond Liberty and the other fields scheduled to come on line soon, and no forecast that is above the current level of well workover and production wells within existing units. He therefore surmised that the projected revenue reduction will not change unless the bill does cause stimulation.

ACTING COMMISSIONER BUTCHER agreed, but explained that Ms. Nienhuis's task on compiling the fiscal note was to look at the current forecast and extrapolate the numbers from that, she was not tasked with estimating the positive effects that HB 110 would have on exploration and production. Industry and the explorers have testified about what they are looking for; it is unlikely there will be any promise of investments, particularly from the larger corporations, because they must work through their boards of directors. However, industry should be able to give members the information that is needed about whether HB 110

would be a material change to their companies' views on where their investment dollar will go forward in regard to Alaska.

3:01:39 PM

CO-CHAIR FEIGE announced that all proposed amendments must be prepared by Legislative Legal and Research Services and be submitted to the co-chairs 24 hours prior to the next hearing. He further announced that Admiral Barrett of Alyeska Pipeline Service Company will give a presentation on low-flow issues when HB 110 is before the House Finance Committee.

CO-CHAIR SEATON inquired whether the Department of Revenue will have the requested analyses of projections for oil and the impact on state revenue by the next hearing on 2/23/11.

ACTING COMMISSIONER BUTCHER said DOR should have answers to the questions that have been asked.

3:03:28 PM

REPRESENTATIVE P. WILSON noted that she was expecting to receive an answer from the department regarding how the statutes could be changed so the state could receive more of the needed information.

ACTING COMMISSIONER BUTCHER answered that DOR believes it can do this through regulation. He said he will provide the co-chairs with the information that he has from the Department of Law.

REPRESENTATIVE P. WILSON pointed out that when this question was asked the other day, the answer was that more information could not be received by the department than now because of current state statute.

ACTING COMMISSIONER BUTCHER said his response at the time of the question was that he believed it was statutory but it could be regulatory. The Department of Law (DOL) looked into it and determined that this can be done by regulation. He reiterated that he would provide the DOL opinion.

REPRESENTATIVE GARDNER observed that Section 20 of HB 110 references existing legislation about small producer credits. She asked whether expansion of the small producer credits around the state could result in a doubling up on the credit and, if so, whether this is the intention or the effect.

ACTING COMMISSIONER BUTCHER replied he will get that information to the committee.

3:05:30 PM

The meeting was recessed at 3:05 p.m. until 5:15 p.m. that evening.

5:21:53 PM

CO-CHAIR ERIC FEIGE called the House Resources Standing Committee meeting back to order at 5:21 p.m. Present at the call back to order were Representatives Feige, Seaton, Kawasaki, P. Wilson, Herron, Munoz, Foster, and Gardner.

[HB 110 was held over.]

5:22:08 PM

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 5:22 p.m.