SENATE FINANCE COMMITTEE
January 27, 2012
9:04 a.m.

9:04:18 AM

CALL TO ORDER

Co-Chair Stedman Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:04 a.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

Senator Lesil McGuire, Vice-Chair

ALSO PRESENT

Darwin Peterson, Staff, Senator Bert Stedman; Bruce Tangeman, Deputy Commissioner, Tax Division, Department of Revenue; Dan Stickle, Petroleum Economist, Department of Revenue; Senator Hollis French; Senator Joe Paskvan; Senator Fred Dyson; Bryan Butcher, Commissioner, Department Of Revenue; Senator Cathy Giessel.

SUMMARY

CSSB 30(2d JUD)
RETURN OF SEIZED PROPERTY

CSSB 30(2d JUD) was REPORTED out of committee with a "do pass" recommendation and with a new zero fiscal note from the Department of Public Safety and a new indeterminate fiscal note from the Department of Law.

CSSSSB 51(L&C)
STATE VENDING LICENSES

CSSSSB 51(L&C) was REPORTED out of committee with a "do pass" recommendation and with a new zero fiscal note from the Department of Labor and Workforce Development.

CSSB 103(L&C)
WORKERS' COMPENSATION FOR FIREFIGHTERS

CSSB 103(L&C) was REPORTED out of committee with a "do pass" recommendation and with a new fiscal impact note from University of Alaska, a new fiscal impact note from the Department of Administration, and a new zero fiscal note from the Department of Labor and Workforce Development.

SB 167 SEPARATE OIL & GAS PROD. TAX/ DEDUCTIONS

SB 167 was HEARD and HELD in committee for further consideration.

#sb167
SENATE BILL NO. 167

"An Act providing that the tax rate applicable to the production of oil as the average production tax value of oil, gas produced in the Cook Inlet sedimentary basin, and gas produced outside of the Cook Inlet sedimentary basin and used in the state increases above $30 shall be 0.4 percent multiplied by the number that represents the difference between that average monthly production tax value and $30, or the sum of 25 percent and the product of 0.1 percent multiplied by the number that represents the difference between that average monthly production tax value and $92.50, except that the total rate determined in the calculation may not exceed 50 percent; providing for an increase in the rate of tax on the production of gas as the average production tax value on a BTU equivalent barrel basis of gas produced outside of the Cook Inlet sedimentary basin and not used in the state increases above $30; relating to payments of the oil and gas production tax; relating to the lease expenditures that may be deducted when determining production tax value; relating to availability of a portion of the money received from

the tax on oil and gas production for appropriation to the community revenue sharing fund; relating to the allocation of lease expenditures and adjustments to lease expenditures; and providing for an effective date."

9:05:44 AM

DARWIN PETERSON, STAFF, SENATOR BERT STEDMAN, introduced himself and presented SB 167. The legislation separated oil and natural gas for the purpose of calculating the progressivity portion of the production tax value under AS 43.55. He added that the effort had become commonly known as "decoupling." Under current law, the tax rate was based on the combined BTU (British Thermal Unit) value of oil and gas; however, oil and gas can have vastly different values on a BTU basis. Recently, North Slope crude had been trading at $110 dollars per barrel, while the price for natural gas had been hovering around $3 per million BTU. He furthered that currently oil was worth more than 40 times the value of natural gas on a BTU equivalency. When oil is priced significantly higher than gas, Alaska's coupled tax structure allowed lowered value gas to dilute the revenues generated by higher value oil. The net effect was lower tax liabilities for producers and reduced revenue for Alaska. Under forecasted production and pricing scenarios, the state could potentially see upwards of a $2 billion per year loss in revenue in the event of a major gas sale; Alaska would be getting no money for its gas and even less money for its oil. He continued that the current tax structure not only exposed the state to unnecessary financial risk, but it also created economic instability and financial uncertainty for partners looking to invest in a natural gas pipeline. Under the bill, there would be two distinct progressivity calculations, which would produce two different tax rates to be applied separately. First, progressivity would be calculated on all combined current activity including, oil, Cook Inlet gas, and other in-state gas. Second, the progressivity would be calculated separately for North Slope gas that is exported out of state. The exclusion of North Slope export gas and the progressivity calculation for oil meant the gas would not dilute the value of oil, and oil taxes would not be reduced as the result of a major gas sale. The progressivity calculation itself would be unchanged, based on 0.4 percent of the production value that exceeds $30 per barrel for oil, and $30 per BTU barrel of oil equivalent for gas. The

base tax rate is unchanged at 25 percent of production tax value. As in current law, this bill would give the Department of Revenue (DOR) the authority to adopt regulations to allocate costs between oil and gas. As the recipients of confidential cost data, DOR was in the best position to evaluate costs. He clarified some of the documents in the packet, including a letter from David Wood to Co-Chair Stedman from March, 2010.

Co-Chair Stedman clarified the identity of Dr. David Wood. Mr. Peterson continued to speak about the documents in the bill packet.

9:10:12 AM

BRYAN BUTCHER, COMMISSIONER, DEPARTMENT OF REVENUE, introduced himself and his staff. He gave a brief explanation of the overview and indicated that Bruce Tangeman and Dan Stickle would give the majority of the presentation.

BRUCE TANGEMAN, DEPUTY COMMISSIONER, TAX DIVISION, DEPARTMENT OF REVENUE, introduced himself. He indicated that the overview would include a high level summary on how the production tax worked in Alaska, a definition and detail on "decoupling," and a history of SB 305, which had passed in 2010.

Mr. Tangeman explained slide 3. The production tax was a company specific tax where the progressivity affects each tax payer slightly differently and was based on the production tax value (PTV). Market price minus transportation costs determined the gross value at the point of production (GVPP). The PTV was determined by GVPP minus lease expenditures.

9:13:03 AM

Co-Chair Stedman indicated that this was the first of many hearings on the bill and requested a simple overview for the people at home.

Mr. Tangeman discussed the tax rate on slide 3 as follows:

- Tax Rate
  - Base tax rate of 25% of “production tax value”

- Progressivity applies when PTV is over $30 / barrel of oil equivalent (BOE), and increases rate by 0.4% for each $1 of PTV over $30 /BOE
- Example: At $50 / BOE PTV, tax rate is 33% (25% + 0.4% * $20)
- At $92.50 / BOE progressivity changes to 0.1% per $1 of PTV

Mr. Tangeman explained slide 4 titled "FY 11 Production Tax Calculation." He indicated that it was commonly referred to as the income statement and was included each year at the back of the income revenue sources book. He furthered that the slide had been prepared at the behest of the Senate Finance Committee. It was meant to be a high level snap shot view of how the PTV was calculated and the bottom line revenue was reached. He mentioned that the tax was very complicated to calculate and detail, so the slide was meant to be a higher level view.

Mr. Tangeman discussed the first line titled "Avg ANS Oil Price ($/bbl) & Daily Production (bbls)." For FY 11, which ended June 30, the average annual oil price was $94.49. The average production was 602,723 barrels for a value of $56.9 million per day. The total annual production was 219,993,895 barrels of oil. The royalty and federal barrels were backed out of the tax, leaving the taxable barrels at 190,488,390. The downstream transportation costs like ANS marine transportation, the TAPS (Trans-Alaska Pipeline System) tariff, and other transportation costs were backed out for total transportation costs of $7.17 per barrel. The lease expenditures, which were the operating and capital expenses, averaged $21.74 per barrel. The production tax was then calculated based on the PTV, which was $12.496 million. Using the $94.49 price, the base rate of 25 percent was calculated on the first $30. The resulting figure was $3.123 billion. The remainder was calculated with the 0.4 percent incremental going up, and that 0.4 percent was applied to the entire tax base for an additional $1.788 billion. The total tax due before credits was $4.901 billion, but the credits applied of $400 million resulted in $4.501 billion total tax after credits.

9:18:12 AM

Co-Chair Stedman indicated that there was another $400 million in a separate category, bringing the total up to $800 million. Mr. Tangeman agreed. He explained that tax

credits taken by explorers, who did not have tax liability, was a separate category.

Mr. Tangeman discussed "What is "decoupling"" on slide 5:

•Under current law, gas production from major gas sales would be converted to “barrel of oil equivalent” and taxed in the same calculation as oil*

•“Decoupling” would calculate oil and gas tax for major gas sales separately.

*special provisions exist currently that extend special tax rates to Cook Inlet Gas, and gas for in-state use, until 2022. However these types of production are still included in the statewide “progressivity” calculation

Mr. Tangeman elaborated on slide 6 titled "Conceptually, decoupling is simple." He explained that the slide made it easier to conceptualize decoupling.

Mr. Tangeman discussed slide 7 titled "Why decouple?":

•Oil is different than gas (different uses, different resource endowments, different substitutes)

•Decoupling allows tax policy to be crafted specific to oil or gas production

•Oil is currently worth more than gas (per unit of energy)

•Gas value relative to oil varies greatly over time

Mr. Tangeman discussed slide 8. He explained that the thermal parity, or "BTU equivalency," was the big issue. The "BTU equivalency" was approximately 6 Million British thermal units (MMBtu) of gas to 1 barrel (bbl) of oil. He continued that currently the price of gas and oil was clearly not in a 6 to 1 parody. (The 6 to 1 parity was represented by the red dotted line and the actual oil price was represented by the blue line on slide 7.)

Co-Chair Stedman stated that if the current oil prices were plugged in at $112 dollars a barrel and gas at $2.70 a gallon, the parity was more like 40 to 1. He would work

with the department on a base price of oil standard for use in future presentations. He stated that the multiplier under equivalency was roughly 22 or 23 to on DOR's chart, but that under current market prices it was more like 40 to 1.

Mr. Tangeman explained slide 9 titled "Why decouple?":

- Including lower value gas in the same tax calculation as higher value oil reduces the average value per BOE and therefore reduces the progressive tax rate on oil

- By taxing oil and gas together, gas production reduces oil taxes even though oil operations are unaffected. He added that the state was not experiencing this at the moment, because it had not realized gas production on a commercial level

- This has been called the “flip the switch” problem… as soon as major gas sales begin, state tax revenue could drop significantly, under certain price scenarios (including current prices!)

Co-Chair Stedman recalled that during previous discussions on decoupling, the Nikiski gas plant was operating. As a result, the current impact on the state's treasury was more than $100 million. He continued that Nikiski had since been shut down, so he expected the current gas dilution effect was well under $100 million. He indicated that those calculations would be addressed in the future. He stressed that the calculations would not involve billions as with the "flip the switch problem," but that it was a hypothetical if the 4.5 billion cubic foot (BCF) gas pipeline was in operation.

Mr. Tangeman discussed slide 10 titled, "Numerical Examples: Assumptions.":

- One Year “Income Statement” model

- DOR 2012 Profiles
  - Oil: 450 Mbbl/d
  - Gas: 4.5 Bcf/d

- Conversion 6 Mcf = 1 boe

- Costs allocation

- Opex: $2,500,000,000
- Capex: $2,500,000,000
- Costs split on the basis of gross value at the Point of Production (PoP)

•Transportation

- Oil: $11.00/bbl
- Gas: $4.5/MMBtu

Mr. Tangeman explained that the slide indicated what assumptions the next several slides would operate on.

Co-Chair Stedman pointed out that slide 10 assumed that 450,000 barrels of oil a day would be produced, but that the FY 13 forecast assumed roughly 575 thousand barrels a day in production. Mr. Tangeman responded that Co-Chair Stedman was correct.

9:25:19 AM

Mr. Tangeman discussed slide 11 titled "At high parity, SB 167 > Status Quo." He explained the slide represented a 15 to 1 parity where oil was at $120 per bbl and gas was $8 per MMBtu. The slide assumed that production was at 450,000 barrels of oil per day and 4.5 BCF per day of gas. The left hand column showed oil and gas decoupled for a total of $5.9 million in state production taxes. Under the scenario, the status quo would only generate $4.1 million in taxes. He concluded that under SB 167, the state would generate another $1.8 billion in taxes.

Mr. Tangeman discussed slide 12 titled "At lower parity, SB 167 > Status Quo." Slide 12 assumed the same production as the previous slide, but it plugged a lower parity into the equation. He concluded that even at a lower parity, the state would generate $500 million more in taxes under the proposed legislation.

Mr. Tangeman discussed slide 13 and explained it showed that the calculation between coupled and uncoupled was fairly equal at the 6 to 1 parity, but furthered that a difference between the calculations occurred if the oil price rose and the gas price dropped.

9:27:49 AM

Mr. Tangeman pointed to slide 14 titled "At Today's prices." He remarked that the slide put the decoupling issue into the perspective of today's conditions. He declared that under current prices, the price of gas was less than the cost of transporting it. He expounded that the current gas price was approximately $3, while the transportation costs had been identified as $4.50. The gas tax would result in a net operating loss (NOL) and would generate NOL credits of $0.6 billion, which could be applied in the following year.

Co-Chair Stedman asked whether the slide communicated that SB 167 would generate $1.9 billion more in taxes than the status quo, given today's prices and a 37 to 1 parity. Mr. Tangeman responded in the affirmative.

DAN STICKLE, ASSISTANT CHIEF ECONOMIST, DEPARTMENT OF REVENUE, stated that the $1.9 billion showed on slide 14 did not include the $600 million NOL credit for the gas that could be taken in the following year.

Mr. Tangeman continued to slide 15 titled "Observations.":

- •SB167 provides for a state share similar to the status quo when gas prices are relatively high (less dilution of progressivity under status quo)
- •SB167 imposes a higher state share compared to the status quo when gas prices are relatively low
- •SB167 generates revenue equal to or greater than “oil stand alone” revenue in all cases
  - o But at very low gas prices NOL credits are generated which can be applied against oil tax liabilities in the following year

9:30:36 AM

Mr. Tangeman discussed slide 16 titled "Decoupling Issues: Cost Allocation":

- •How costs are allocated between oil and gas has a significant impact on overall taxes owed
- •Because oil and gas are generally produced together, it is not easy or straight forward to determine the costs “applicable to the gas [or oil] produced”

•The cost allocation method could result in uncertainty, disputes, and delays

•Cost allocation should be specified in the statute, and is a very important policy decision

Mr. Tangeman discussed slide 17 titled "Cost Allocation Examples." He explained that the slide assumed that production would be at $120 per barrel of oil and $8 per MMBtu for gas.

Mr. Stickle elaborated on slide 17 and stated that it showed three potential methods for allocating costs between oil and gas under a decoupled tax. He added that there were many allocation methods, but the slide showed three of the most commonly used methods. The top column indicated how many barrels of oil equivalent were produced in the year. Under the scenario, there were 164 million barrels of oil and 274 million barrels of oil equivalent of gas. On an energy basis, with 450 thousand barrels of production and 4.5 BCF of gas a day, there would actually be more gas than oil being produced. The gross value shown on line two was $17.9 billion for oil versus $5.7 billion for gas.

Mr. Stickle stated that the second set of numbers represented the cost allocation if costs were spilt based on the barrels of oil equivalent. Out of the total $5 billion cost, gas made up 63 percent, while oil only accounted for 38 percent. Under the split based on barrels of oil equivalent, the deduction of costs for the oil tax would be about $1.9 billion.

Mr. Stickle explained that the third set of numbers showed a split based on gross value at the point of production. Using the method would give the oil tax a higher share of the total value, and oil would be assigned 76 percent of the costs for a deduction of about $3.8 billion.

Mr. Stickle concluded that the fourth set of numbers detailed a spilt where individual companies assigned the costs oil and gas. He acknowledged there were many issues involving how the costs would be assigned; however, if the assumption was that 90 percent of the costs were associated with oil, $4.5 billion would be deducted against the oil tax. He stressed that choosing which cost allocation method to use was a multi-billion dollar decision for deductions.

9:34:44 AM

Mr. Stickle moved on to slide 18 titled "Impact of Allocation Methods on SB 176 Revenue." The slide detailed the financial impact of the three allocation methods used in the previous slide. An allocation based on BOE equivalency (where oil represented the lowest cost), would result in $7 billion in state revenue. If allocation was based on value at point of production, $5.9 billion in state revenue would be generated. Allocation based on a 90 percent/10 percent cost split resulted in $5.5 billion in total revenue; where most of the costs were assigned to oil. He stressed that determining which method would be used was a $1.5 billion a year decision.

Mr. Stickle discussed slide 19 titled "Impact of Allocation Methods on SB 167 Revenue":

- "Lock in" for gas committed at first open season

- Potential impact on current gas production
  - Cook Inlet gas
  - Gas used in state
  - Small quantities of other gas production (OCS)

- Complexity of administration for state, taxpayers
- Specify gas tax now or save for another session?
- Balance between desire for revenue and making a major gas project attractive
- Treatment of Net Operating Loss for gas

9:37:41 AM

Co-Chair Stedman wanted Mr. Stickle to move back to slide 14 for clarification. He queried whether the $1.9 billion in the far right column would go up or down if the $600 million NOL credit was applied the following year. Mr. Tangeman responded that the $1.9 billion figure would go down to $1.3 billion.

Mr. Stickle clarified that the intent of the slide was to show the revenue generated in the "snap shot" year they were looking at. He explained that under the decoupled tax and current conditions, the state would receive the $3.1 billion in revenue, but would also have incurred $600

million dollars in NOL credits that would be carried forward against future tax liability.

Mr. Stickle continued on slide 20 titled "History: SB 305 in 2010." He explained what SB 305 did as follows:

- Decoupled oil and gas for purposes of a major gas sale (solving the “flip the switch” problem)
- Held harmless most current gas production
- Provided one tax calculation for oil, Cook Inlet gas, and gas used in-state
- Provided a separate tax calculation for non-Cook Inlet gas that is exported out of state
- Specified GVPP cost allocation “to the extent possible”
- Extensive analysis by Legislature, administration, consultants
- Numerous technical issues raised and addressed
- Final bill is the basis of this year’s SB 167

9:41:06 AM

Commissioner Butcher continued to present the overview on slide 21 titled "History: SB 305 in 2010" as follows:

- Passed Senate and House, vetoed by Governor
- 3 reasons cited in veto message:
    1. Decoupling, on its own, represents an overall tax increase
    2. Changing the tax during the pipeline open seasons (AGIA, Denali) creates uncertainty
    3. Change not needed at this time because Legislature retains ability to make changes to tax laws… any tax locked in for firm commitments at the first AGIA open season only applies to gas, not oil.
- 2 years later…
    - The AGIA first open season is complete; the Denali project has been suspended

- Decoupling has now been “on the table” for two years
- Opportunity to reconsider decoupling in context of the broader discussion of increasing oil and gas production

Commissioner Butcher stated that the governor was still concerned with SB 167 being an overall tax increase, but he indicated that DOR felt it could work with the committee to establish something that was agreeable to both parties. He mentioned that the governor had set out an aggressive timeline for the three producers on taking a look at moving forward with a gas line. He concluded that if the timelines were strictly held, the legislature might be looking at working on the gas tax issue in the 2013 session.

Co-Chair Hoffman wondered if DOR could give the committee a comparative analysis of what DOR's assumptions were in FY 12 and how they would be impacted by actual numbers in FY 11. Commissioner Butcher agreed to provide the analysis.

9:43:42 AM

Senator Olson asked if the commissioner was saying that the governor would be unlikely to veto SB 167.

Commissioner Butcher responded that the governor did have concerns with SB 167; however, DOR believed it could work with the committee to achieve a result that would be acceptable to both parties.

Senator Olson inquired what other oil and gas producing states or nations did when dealing with coupling or decoupling a tax. Mr. Stickle responded that there were states and countries that did it both ways and indicated that DOR would be happy to provide that information.

9:44:48 AM

Co-Chair Stedman discussed the fiscal note from DOR in the amount of $330,000 in general funds to cover the cost of public workshops, contractual assistance, and drafting regulations.

SB 167 was HEARD and HELD in committee for further consideration.

Co-Chair Stedman stated the committee was looking forward to working with DOR and working through "these issues."

9:45:40 AM
AT EASE

9:45:43 AM
RECONVENED

#sb103
CS FOR SENATE BILL NO. 103(L&C)

"An Act amending the medical examination requirements for firefighters entitled to a presumption of compensability for a disability resulting from certain diseases."

9:47:39 AM

Co-Chair Hoffman MOVED to report CSSB 103(L&C) out of committee with individual recommendations and the accompanying fiscal notes. There being NO OBJECTION, it was so ordered.

CSSB 103(L&C) was REPORTED out of committee with a "do pass" recommendation and with a new fiscal impact note from the University of Alaska, a new fiscal impact note from the Department of Administration, and a new zero fiscal note from the Department of Labor and Workforce Development.

#sb51
CS FOR SPONSOR SUBSTITUTE FOR SENATE BILL NO. 51(L&C)

"An Act relating to the operation of vending facilities on public property."

9:49:03 AM

Co-Chair Hoffman MOVED to report CSSSSB 51(L&C) out of committee with individual recommendations and the accompanying fiscal note. There being NO OBJECTION, it was so ordered.

CSSSSB 51(L&C) was REPORTED out of committee with a "do pass" recommendation and with a new zero fiscal note from the Department of Labor and Workforce Development.

#sb30
CS FOR SENATE BILL NO. 30(2d JUD)

"An Act providing for the release of certain property in the custody of a law enforcement agency to a crime victim under certain conditions and relating to requests for that release by the office of victims' rights."

9:49:53 AM

Co-Chair Stedman mentioned a new zero fiscal note from the Department of Public Safety and a new intermediate fiscal note from the Department of Law.

9:50:08 AM

Co-Chair Hoffman MOVED to report CSSB 30(2d JUD) out of committee with individual recommendations and the accompanying fiscal notes. There being NO OBJECTION, it was so ordered.

CSSB 30(2d JUD) was REPORTED out of committee with a "do pass" recommendation and with a new zero fiscal note from the Department of Public Safety and a new indeterminate fiscal note from the Department of Law.

#
ADJOURNMENT

9:51:00 AM

The meeting was adjourned at 9:51 AM.