

SENATE FINANCE COMMITTEE

April 6, 2012

9:06 a.m.

9:06:07 AM

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:06 a.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

None

ALSO PRESENT

Darwin Peterson, Staff, Senator Bert Stedman; Brian Butcher, Commissioner, Department of Revenue; Bruce Tangeman, Deputy Commissioner, Department of Revenue; Kara Moriarty, Executive Director, Alaska Oil and Gas Association; Senator Gary Stevens; Senator Cathy Giessel; Senator Joe Paskvan; Senator Thomas Wagoner; Senator Bill Wielechowski; Representative Les Gara.

SUMMARY

SB 192 OIL AND GAS PRODUCTION TAX RATES

SB 192 was HEARD and HELD in committee for further consideration.

PRESENTATION:

DEPARTMENT OF REVENUE

ALASKA OIL AND GAS ASSOCIATION

#sb192

SENATE BILL NO. 192

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

9:07:10 AM

Co-Chair Hoffman MOVED to ADOPT the proposed committee substitute for SB 192, Work Draft 27-LS1305\U (Bullock, 4/5/12).

Co-Chair Stedman OBJECTED for discussion.

DARWIN PETERSON, STAFF, SENATOR BERT STEDMAN, outlined the three changes in the new CS. He explained that there had been concern that the prior draft of Alaska Statute 43.55.0119(g), which included tax rates for the three different types of production, would have allowed producers to access the intermediate tax level if any production in a field was above the target volume decline curve; as a result the language had been redrafted to clarify that all existing production below the target volume would be taxed at the high progressivity rate (page 4, lines 19 through 25). He pointed to page 5, lines 8 through 13 that defined what production was incremental above the target volume decline rate; the language had been redrafted to make it clear that any production above the target volume would be taxed at the intermediate progressivity rate, but that all remaining production below the target rate would still be taxed at the higher rate.

Mr. Peterson addressed the third change that began on page 6, line 31. New language had been inserted to specify that a company involved in a merger or acquisition of another company could not use the other company's production to increase its production above the target volume decline rate.

Co-Chair Stedman REMOVED his OBJECTION. There being NO further OBJECTION, Work Draft 27-LS1305\U was ADOPTED. He apologized for any confusion that had resulted from language included in the prior bill version.

^DEPARTMENT OF REVENUE

9:10:39 AM

BRIAN BUTCHER, COMMISSIONER, DEPARTMENT OF REVENUE (DOR), thanked committee consultant PFC Energy for a positive working relationship. He provided a PowerPoint presentation titled "Comments on CSSB 192(FIN) Work Draft 27-LS1305\O" and noted that the majority of the presentation was not impacted by the CS introduced that morning (copy on file). He relayed the department's intent to touch on the impact that each piece of the legislation would have.

Co-Chair Stedman explained that an email had been sent out the prior day to DOR and other presenters when the drafting glitch had been identified. Commissioner Butcher responded that DOR had taken the email into account; the only update that was not reflected in the presentation was related to language that would not allow an acquisition to be beneficial [to a producer].

Commissioner Butcher addressed questions DOR had considered related to its version of an oil tax bill (slide 3):

- Does this bill make Alaska more competitive?
- Does this bill make Alaska more appealing to potential investors?
- Does this bill make our tax structure less complicated & more understandable to investors?
- Are these changes meaningful enough to compete for investment capital?

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Commissioner Butcher relayed that the presentation focused on items listed on slide 4 titled "CSSB 192(FIN) Changes from Current Law":

- Change to progressivity calculation
 - For currently producing fields
 - For production from currently producing fields exceeding a production target

- o For new fields
- Change to minimum tax
- Change to lease expenditure allocation
- Petroleum information management system

Commissioner Butcher moved to slide 5: "Impact of Change to Progressivity on Production Tax Liability." The tax was company specific particularly in relation to lease expenditures. In general the system was kept neutral at \$100 per barrel and taxes were increased at lower prices due to the gross minimum tax floor provisions in the legislation; however, there were companies that would see tax increases at \$100 per barrel and under. The tax was a small reduction for many companies above \$100 per barrel. He reiterated that tax changes would impact all companies differently.

Commissioner Butcher pointed to slide 6: "Comments on Change to Progressivity." Currently companies were allowed to use their lease expenditures to reduce their production tax value, which reduced their progressive tax rate. The bill did not factor lease expenditures into the progressivity calculation. He explained that companies with higher lease expenditures could find the bill less attractive because they would no longer be able to use the expenditures to reduce their progressive tax; however, companies with lower lease expenditures could find the bill more attractive because they would benefit from lower progressive tax. He would provide detail later in the presentation on the difference between a company spending a significant amount on development versus a company spending a smaller amount.

Commissioner Butcher informed the committee that the gross progressive tax could reduce the incentive to invest and reward companies in a harvest mode with low lease expenditures; however, certain progressivity aspects related to production on new fields and new production from existing fields could help balance things out.

[9:15:50 AM](#)

Co-Chair Stedman inquired whether DOR planned to provide more detail on information in the presentation. Commissioner Butcher responded in the affirmative.

Commissioner Butcher addressed slide 7: "Comments on the Minimum Tax." The bill would create a substantial tax increase at lower prices, generally at \$60 per barrel and below. The minimum tax would impact companies when prices were below their current amount. He elaborated that state revenues from oil would be less than half their current level if oil prices dropped to \$60 per barrel or lower; a tax increase would only have a minimal benefit to the state and substantial budget decisions would be necessary as a result of the low oil price.

Co-Chair Stedman requested that Commissioner Butcher go into depth on the items included in the presentation. Commissioner Butcher explained that the presentation would provide more substantive detail on following slides.

Co-Chair Stedman asked Commissioner Butcher to continue with the presentation, but reiterated the need to discuss the items in further detail.

[9:17:31 AM](#)

Commissioner Butcher directed attention to slide 8 titled "Petroleum Information Management System (PIMS)":

- Requires the Department to have the information management system in place by January 1, 2014
- Competes with core mission of the Tax Division, which is to assess and collect taxes
- Competes with daily staff goals of interacting with taxpayers, forecasting revenues, and auditing tax returns
- Will likely delay the completion of those core duties and result in slower responses to legislative policy questions

Commissioner Butcher noted that DOR had been criticized for not providing the legislature information quickly enough without catching up on its audits; the bill would task the department with rewriting regulations, implementing a new

tax, implementing a new Public Information Management System that would likely cost millions of dollars, and adding a number of positions at the same time that DOR was working to put a \$35 million tax database system in place to improve the prior system. He discussed that much of the requested information in the management system was already gathered by the Department of Natural Resources (DNR), the Alaska Oil and Gas Conservation Commission (AOGCC), Department of Labor and Workforce Development (DLWD), and DOR. He elaborated that most of the DOR information was confidential and the bill would require it to gather all of the information from other departments. He opined that the process would be much more difficult for the Tax Division given all of its other responsibilities and challenges.

Commissioner Butcher read additional points related to PIMS on slide 9:

- Millions of data elements would have to be manually uploaded to the system, in various formats including electronic copies of Excel spreadsheets, PDFs, Word documents, and in hard copy format
- Determination would have to be made as to the confidentiality of each item for uploading to the system, which would take thousands of employee hours
- Department currently has only begun long-awaited Tax Revenue Management System (TRMS) project, which is expected to take 3 - 5 years to complete
- PIMS would likely delay the implementation of that important tax-specific project
- Would require significant funding and additional staff resources for the Department

Commissioner Butcher stated that from the department's perspective, spending millions of dollars to compile information that was already available to various departments did not seem to be a wise use of state resources.

[9:20:05 AM](#)

BRUCE TANGEMAN, DEPUTY COMMISSIONER, DEPARTMENT OF REVENUE, pointed out that some of the graphs in the printed version of the presentation included too many lines; DOR would provide corrected copies after the meeting.

Commissioner Butcher looked at slide 10 titled "Effective Tax Rates" that included a line chart showing the effective Production Tax Rate (post-credits). The current law, Alaska's Clear and Equitable Share (ACES) was shown in black ranging from \$40 and \$200; the governor's proposed bill CSHB 110(FIN) was included for a frame of reference in red; and CSSB 192(FIN) was depicted in blue. The chart showed that from \$60 per barrel and below the bill would result in a significant tax increase (shown in blue); from the \$60 to \$110 tax would be the same as current law; a tax decrease was seen at increased prices that had not been reached historically.

Co-Chair Stedman asked for verification that the presentation dealt with effective tax rates. Commissioner Butcher replied in the affirmative.

Co-Chair Stedman queried why detail on marginal tax rates had not been included in the presentation. He pointed out that the legislation made a substantial shift away from the marginal tax concern and potential exposure the state would have associated with any federal financial help related to capital expenditures (up to and over 100 percent) that could incentivize behavior that was not in Alaska's interest.

Mr. Tangeman responded that the related graphs DOR had seen showed a slight improvement on the marginal side, but not to the extent that would have resulted from the bracketing system under CSHB 110(FIN).

[9:23:10 AM](#)

Co-Chair Stedman asked whether DOR believed that going from a 90 percent marginal tax rate to a 45 percent marginal tax rate was barely measurable. Mr. Tangeman replied that DOR would be happy to share the graphs with the committee, but he was not prepared to go into detail on the issue at the time.

Co-Chair Stedman reminded DOR that the [oil tax] subject was not new and that it should be careful with its

testimony. Members did not find it "humorous" to be told that such a significant change [in the marginal tax rate] was inconsequential. He asked for accuracy in the discussion.

Commissioner Butcher responded that DOR was not saying the difference was inconsequential. The department was happy to provide the data to the committee, but had not had time to gather the information for the meeting, given that the CS had come out the prior afternoon. The presentation used effective tax rates because DOR had been told that the rate provided a more well-rounded view.

Co-Chair Stedman clarified that the effective rate was the primary issue; at high prices the marginal rate was a challenge within the current system. He asked the department to choose its words carefully because he did not agree with the inference that reducing the marginal tax rate from 90 percent down to 45 percent was inconsequential.

Commissioner Butcher answered that DOR had misspoken if it had described the reduction as insignificant.

[9:25:09 AM](#)

Co-Chair Stedman discussed that the committee had heard a substantial amount of testimony that the current fiscal system was good for a harvest mode environment and that the problem existed when oil prices were above \$100. He pointed to the effective tax rate proposed in CSSB 192(FIN) that included a floor at the \$40 per barrel price (represented by the blue line on slide 10). He stated that the legislation had roughly a \$50 million impact on the state-take at the \$100 per barrel price; whereas, CSHB 110(FIN) had a \$1.1 billion impact on the state. He wondered what data was available that would assure the committee that the impact to the state should be changed from \$50 million to \$1.1 billion at the \$100 per barrel price when consultants had expressed that the change was not needed.

Commissioner Butcher responded that he disagreed with the consultants. He stressed that Alaska had the nation's highest tax rate and one of the highest in any OECD [Organization for Economic Co-operation and Development] country; DOR believed it was a disincentive that was seen in the lack of production, development, and investment in

Alaska. He opined that the difference was more than a dollar amount; it impacted how companies evaluated Alaska and how it changed their investment decisions.

[9:28:08 AM](#)

Co-Chair Stedman believed that the companies would speak for themselves, but recalled that their concern was related to oil prices above \$100 per barrel. The concern had been one of the reasons the committee had spent a substantial amount of time on the issue of prices over \$100 and how to fix the state's increasing share that became exaggerated at around \$200 per barrel.

Co-Chair Hoffman believed that it would be more helpful if the chart's Y axis (slide 10) used dollars instead of percentages. The chart showed the tax rate going up 100 percent [at the \$40 level], but when the number was looked at in dollars the graph would not be as drastic. He offered that under the scenario cash to the companies at \$40 would be a reduction of \$194 million and at \$100 the amount was negligible; however, at \$150 per barrel cash to companies represented approximately two-thirds of one billion dollars; at \$170 per barrel companies would receive over \$1 billion; at \$200 companies would receive \$1.75 billion. He believed companies would be looking at the numbers when developing investment models. The committee believed that the state should have protection at the low price end if substantial changes were made at the high end of the tax formula. When \$194 million was compared to the potential of another \$1 billion at the \$170 price per barrel it was significant. He addressed that the probability of \$170 per barrel oil was low, but consultants had also said that the probability of \$40 per barrel oil was very low as well. He opined that the finance committees would be "scrambling" anyway if the price of oil dropped to \$40. He reiterated that if the state gave on the high price end that it should have some protections on the low price end.

[9:31:57 AM](#)

Co-Chair Stedman noted that at the \$140 per barrel (indicated by a green line on slide 10) the difference between ACES and CSSB 192(FIN) was \$765 million [ACES was \$765 million higher]; the difference between ACES and CSHB 110(FIN) was \$2.784 billion [ACES was \$2.784 billion higher]; the difference between CSSB 192(FIN) and CSHB

110(FIN) was \$2 billion [CSSB 192(FIN) was \$2 billion higher]. He emphasized that the amounts were significant.

Commissioner Butcher replied to Co-Chair Hoffman's earlier question. He explained that looking at the dollar amount was worthwhile; however, the reason the chart used percentages was that keeping the transportation operating and capital expenditures constant the percentages would apply for any year and in any scenario. The chart provided more of a snapshot into the future than it would if current dollars were used.

Co-Chair Hoffman surmised that the presentation appeared to be geared towards providing shock value.

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Co-Chair Stedman pointed to the bend in the CSSB 192(FIN) line (blue) where the goal was to keep the percentage of profit evenly split and staying constant at prices above approximately \$120 per barrel (\$130 shown on the chart). He asked DOR to explain why the CSSB 192(FIN) line flattened out; it flattened out intentionally to hold the split constant and to get away from the marginal tax impact the state was facing at high rates; he believed the chart looked accurate related to that point. He opined that the chart looked dramatic, but the number was somewhere around \$300 million more to the state than under current law at \$40 per barrel. He observed that there was an increase to the state at a \$40 per barrel price of approximately \$300 million, but at prices of \$120 the state was giving up approximately \$277 million. He speculated that the probability of hitting \$40 per barrel and remaining there without significant state and industry involvement would be minimal. He could not imagine running at \$40 oil without a substantial modification to the current structure in order to keep the industry alive and vibrant and the state functioning.

[9:36:12 AM](#)

Mr. Tangeman commented that in the recent past, \$40 per barrel to \$140 per barrel swings had occurred in a short amount of time. He noted that the occurrence was not unheard of; DOR was projecting relatively flat prices into the near future, but price swings had happened and they would have a serious impact on the budget.

Co-Chair Stedman agreed, but the swings had not been at sustained levels for quite some time. He referred to a "price shock upward" at \$145 per barrel that had occurred in the past.

Co-Chair Hoffman agreed that [major price fluctuations] had occurred in the past. He reiterated an earlier statement that consultants believed the occurrence would be a low probability.

Senator Thomas thanked DOR for its presentation. He read from a proposal by consultant PFC Energy:

"Consistent with DOR methodology these revenue numbers do not include payments for tax credits which are not claimed against current production as these are accounted for separately in the budget. In 3013 DOR forecasts a potential liability of \$400 million for these credits."

Senator Thomas understood that PFC Energy's proposal used credits that had been claimed, but not anticipated claims. He asked for clarification on whether the DOR chart on slide 10 included anticipated credits.

Commissioner Butcher answered that DOR excluded the \$400 million in credits that did not result in a tax liability for the companies; the credits were accounted for but were not included in how the effective tax rates would work on companies currently paying taxes because there were companies that currently had no production and were not paying taxes.

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Senator Thomas commented that at one time there had been predictions of oil prices at \$150 per barrel, which had seemed hard to imagine when oil was at \$30 or \$40 per barrel. He reflected that oil prices had been at \$30 per barrel in the relatively recent past and currently Alaska North Slope (ANS) prices were at \$120 per barrel. He noted that it was always good to be prepared for the future, which was hard to predict.

Commissioner Butcher replied that DOR had wanted to show a per-barrel price range from approximately \$40 to \$200. He

acknowledged that it was not likely oil prices would reach the end of the spectrum in either direction, but the goal had been to keep the numbers in a realm that was reasonable for the future.

Senator Thomas surmised that a 10 percent to 15 percent increase in the price of oil over the next few years would be reasonable. Commissioner Butcher agreed that the increase would be reasonable, but noted that the price of oil had never coincided with a normal inflation rate. He referred to a time when oil had gone from \$30 per barrel to \$15 per barrel over an extended period.

[9:40:47 AM](#)

Commissioner Butcher moved to slide 11 titled "Effective Tax Rates - Impact of Producing 25% Over Target (i.e. 1/5 of Production at Lower Rate." The slide showed how a currently producing company's effective tax rate would be impacted if it were to increase its production to 25 percent over the target. Current law (ACES) was represented in black; CSSB 192(FIN) was shown in blue; and the dotted blue line showed what a company would pay under CSSB 192(FIN) if it produced 25 percent over target.

Co-Chair Stedman discussed that production was currently about 600,000 barrels per day and that an increase of 25 percent would bring the total to 750,000. There had not been a significant amount of time spent looking at the capital costs to get to 750,000 barrels per day; there had been discussion that it would take \$3 billion to \$5 billion per year (the equivalent to the Ooguruk and Nikaitchuq oil fields) to level out. He did not know how much it would take to get to the 750,000 amount, but he supposed they could inquire and try to determine an answer.

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Co-Chair Stedman referred to comments in the press that it would be nice to reach production of 1 million barrels per day. He surmised that everyone would like to see that level

of production, but maintaining production at 600,000 would surprise many people and reaching 750,000 barrels per day would be monumental.

Commissioner Butcher answered that slide 11 showed a conceptual percentage; it did not show that production was currently at 600,000 barrels per day and what would occur at 750,000. The slide showed what it would look like for any company (regardless of production levels) to increase production and how the lower tax rate would factor into the entire amount of tax the company would pay.

Co-Chair Stedman remarked that BP accounted for roughly half of the production in Prudhoe Bay.

Mr. Tangeman thought it would be interesting to hear the perspectives of the companies when they presented to the committee. The department agreed that significant investment would need to take place in order to extract the resource and it felt that the net system under ACES was an incentive (tax credits were a separate issue that effected the tax), but DOR believed shifting to gross on the progressivity portion of the tax was likely a disincentive to investment at a time when the state would need significant investment to extract the harder to access hydrocarbons. The oil would not be easy to reach and included heavy, viscous, shale oils that would be more capital intensive.

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Co-Chair Stedman relayed that the topic would be discussed later, given that there were varying views related to simplifying the tax code to incentivize heavy, viscous, and shale oils, and cost allocation issues. He remarked that it was nice to see the impact of the 25 percent increase (shown on slide 11), but the committee had focused on the cash flows and net present value over the incremental production of a 10,000 barrel field; how to move the tax code to enhance the rate of return and cash flows to enable companies to reach or get closer to their hurdle rates so they would begin new projects. He observed that the slide did not address the same focus. He believed that the slide addressed a piece of the equation, but to get to the core of the issue it was necessary to measure companies' cash flows and rates of return. He noted the committee

would ask the industry the questions. He appreciated that the slide referenced the effect of full credits.

Commissioner Butcher discussed that slides 12 and 13 showed how the legislation and gross [tax] issue would impact high-cost and low-cost producers in relation to economically challenged projects that would have higher costs such as, heavy or shale oil, and developments located farther from infrastructure. Slide 12 titled "Effective Tax Rates - High-Cost Producer" included an estimate of \$20 per barrel for operating expenses and \$25 per barrel for capital expenditures. Slide 13 titled "Effective Tax Rates - Low-Cost Producer" included data related to companies in harvest mode that would be doing what they needed to continue producing at their current rate. He explained that there would be a considerable tax increase under the bill for high-cost companies dealing with more challenged and expensive fields (slide 12).

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Co-Chair Stedman replied that the committee had seen an analysis showing that present value numbers would increase under the legislation in a high-cost scenario. He expounded that the high-cost producers' economics had improved over the lifecycle of their investments in other projections the committee had seen. He furthered that the committee had seen numerous presentations with varying degrees of progressivity and its impact on rate of return and net present values in order to determine what to include in the bill. He asked to see how the lifecycle economics worked according to DOR; if the numbers were not improved over ACES, the system would not be improved. He wanted to work with DOR on the issues because he believed that its data conceptually did not fit with other data presented to the committee.

Commissioner Butcher responded that DOR would be happy to provide the data. He noted that the presentation took into account far fewer variables than looking at the lifecycle of a field.

Mr. Tangeman pointed out that the black line (current ACES system) took the deduction of all qualified capital and operating expenditures into account; the blue line (CSSB 192(FIN)) that reflected a net system for the base and a gross system for the progressivity, did not allow companies

to take as many capital and operating lease expenditures against their taxes.

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Co-Chair Stedman observed that in certain circumstances progressivity on the gross tax in a high-cost environment was somewhat of a disadvantage; however, it put downward pressure on the expenditure side from the producer. He referred to concerns with the current ACES tax system related to the high-cost expenditure side including, exposure to the state for all of the credits and the mechanics of the high tax structure and how it worked. The goal was to fix the problem.

Mr. Tangeman agreed that the tax credits used to construct the ACES line (shown in black on slide 12) could be adjusted in any tax regime. He noted that working with the tax credit system within the existing infrastructure the black line could be adjusted however a person wanted.

Commissioner Butcher discussed that slide 13 "Effective Tax Rates - Low-Cost Producer" showed the effective production tax rate (post credits) using per barrel operating expenses of \$10 and capital expenses of \$3 for a low-cost producer or a producer in harvest mode. He pointed out that there was a substantial tax reduction for the producers.

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Co-Chair Stedman remarked that one of the goals was to bring the tax rate down at prices above \$100 per barrel. He relayed that one of the fundamental points the committee had heard repeatedly was that there was a lack of a need for incentive at prices below \$100 per barrel in the legacy fields. He queried how DOR justified moving approximately \$1.1 billion to the industry when consultants had told the committee that it was not justified.

Commissioner Butcher respectfully disagreed with the opinions of the consultants. He stressed that Alaska had one of the highest tax rates of any OECD country. Companies that did not do business in the state had talked about Alaska's high tax rate. He stated that even under the proposed CSHB 110(FIN) Alaska would have the highest tax rate in North America. He emphasized that billions of dollars in increased investment was needed to increase

production. He asserted that maybe there was a "sweet spot" between ACES and CSHB 110(FIN) where taxes were reduced and investment was increased. He relayed that the governor had said he was willing to work on whatever scenario was feasible. The department had not heard from companies subsequent to the release of the most recent version of CSSB 192(FIN); therefore, it did not know what they would say. The department's quick snapshot of the bill was that it discouraged investment of higher-cost, more challenged projects and encouraged harvest mode, which was the opposite direction the administration had been going with the governor's bill.

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Co-Chair Stedman believed that according to testimony it was more accurate to say that current tax regime was affected if a producer was operating under harvest mode. He did not think there had been any testimony from the committee's consultants that CSSB 192(FIN) encouraged harvest mode.

Commissioner Butcher explained that under harvest mode the bill was better than current law.

Co-Chair Stedman agreed. He added that there were significant differences between Alaska that was "subsurface owned and commons" and any other area in North America. Alaska had different cost environments and other; therefore, it was not possible to compare Alaska's tax structure directly with those of other states. He remarked that Prudhoe Bay was one of the most prolific oil basins in the world; there had been testimony that the field was among the world's top 10 oil fields. He opined that the comparison was too narrow. He did not believe that the state had ever limited its comparisons to North America and he did not think it was appropriate.

Commissioner Butcher clarified he had not been referring to the issue addressed by Co-Chair Stedman; however, he did believe there was value in North America comparisons because most the companies doing business in Alaska had a North American focus. He noted that PFC Energy had discussed that Norway was the only other OECD location above Alaska and at \$140 per barrel it dropped below the state. He expressed that [the tax rate] was a disincentive to business in the state and that it was important to focus

on the current system rather than on high oil prices that may never be seen; the high costs of doing business in the state were another component that played into the state's competitiveness with other areas.

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Co-Chair Stedman noted that ACES and PPT (Petroleum Production Tax) had been intentionally modeled against Norway's fiscal regime. He added that it was not by happenstance that the state tracked the Norway system so closely.

Co-Chair Hoffman wondered whether Commissioner Butcher had been referring to the administration when he stated that "we" have not discussed the current bill version with the oil companies. Commissioner Butcher responded that he had only been referring to himself and Mr. Tangeman; DOR had only worked on the current version internally.

Co-Chair Stedman surmised that based on the chart on slide 13 the current bill enhanced the economics for low-cost producers. Commissioner Butcher answered in the affirmative.

Co-Chair Stedman thought there was a peak spread around \$130 per barrel (slide 13) and that the economics improved and got closer together above and below \$130 per barrel relative to the ununitized fields in CSHB 110(FIN). Commissioner Butcher responded in the affirmative.

Co-Chair Stedman that CSSB 192(FIN) did not address the ununitized fields included in CSHB 110(FIN). He believed that CSSB 192(FIN) incentives would get close to the unitized fields and what the existing producers in the basin would pay under CSHB 110(FIN). He restated that the CSSB 192(FIN) incentives came close to where CSHB 110(FIN) was without incentives.

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Commissioner Butcher concluded with slide 14: "Summary of DOR Comments on CSSB 192 (FIN)." The department believed that the changes in CSSB 192(FIN) moved in the wrong direction by discouraging higher investment on more challenged projects and encouraging harvest mode; and made the state's complicated tax structure more complex with the

change to part net, part gross. He emphasized his concern about the additional burdens of a multi-million dollar database that DOR would have to compile. The department had been working desperately to catch up with the 70-plus regulations, audits, and other that had come up within the past 6 years. He relayed that the department was doing the best it could and everything it needed to do, but it was opposed to the idea of a new database.

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Co-Chair Stedman asked if DOR believed the bill would be worse than ACES. Commissioner Butcher replied that the bill was more complicated than ACES because of items that would need administering and new regulations would need to be put in place. Additionally, the bill appeared to be worse for high-cost projects due to the taxes a company would have to pay.

Co-Chair Stedman asked DOR to follow up with the committee on the full cycle economics of CSSB 192(FIN), given that DOR's data was different. He recalled that petroleum consultant Pedro van Meurs had pointed out the dysfunctionality of CSHB 110(FIN) related to its cost allocation issues between different hydrocarbon streams. Mr. van Meurs had discussed that it was cleaner to stay away from the cost allocation concept by moving the progressivity on the gross. He stated that the DOR data showed a 180-degree difference from at least two consultants that had reviewed the bill. There had been no discussion on the decoupling of oil and gas, which would substantially increase the size of the bill. Under the current structure the state would lose approximately \$2 billion per year if it ran a 4.5 billion cubic feet line. He asked for the department's opinion on the delinking of oil and gas. He asked if the items should be linked, which would mean the state would face a \$2 billion loss.

Commissioner Butcher replied in the negative. He had no doubt that if the price of oil dropped to \$40 per barrel for an extended time period there would be changes and difficult decisions to be made. Additionally, he believed that oil and gas would be delinked before a major gas sale. He relayed that DOR was willing to work on the issue with the committee, but he felt that CSSB 192(FIN) was not the only way to decouple oil and gas.

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Co-Chair Stedman felt that the state had some risk exposure with the linkage of oil and gas in the first open season associated with the Alaska Gasline Inducement Act (AGIA). The committee was working to get a definitive answer from the administration on the issue and until told otherwise the committee would operate under the assumption that the state had significant financial exposure.

Commissioner Butcher replied that the Department of Law had relayed that the particular door had been closed. He would provide the information to the committee.

Senator McGuire wondered how much had centered on the ability to write-off costs associated with gas from companies that had been moving toward a gasline under AGIA. She felt that the linking of oil and gas had provided a significant advantage for the companies. She opined that the negotiation of a rate through decoupling was one issue, but another issue was how cost had factored into companies' willingness in Pt. Thompson and other areas to explore a gasline. She requested to hear from DOR, Exxon, BP, and Conoco Philips on the issues. She discussed that she and Senator Tom Wagoner had introduced SB 309 in the past to incentivize drilling in Cook Inlet, which had been done. She believed that the players with the ability to write-off their costs in Cook Inlet were more prone to invest in the area. She expressed concern about impacts that would disincentivize investment in Cook Inlet and areas that led to the gasline.

Commissioner Butcher replied that he was aware of the issue, but did not have insight on the role the issue would play. He noted that there would be a significant amount of work done on gas fiscals between present day and a major gas sale in the future. He noted that Governor Parnell hoped that the FY 13 legislative session could focus on gas fiscals.

Mr. Tangeman added that Senator McGuire was correct about the interplay between Cook Inlet, the North Slope, and the companies involved associated with the various tax structures (i.e. net versus gross, versus a net and gross combination). He remarked that an issue was how the change would impact DOR and the state. He referred to a belief that the state was "out-gunned"; the private sector could

pay more, gear up more quickly, and had more resources to throw at problems. The state had been under the same tax system for 4.5 to 5 years; state employees (auditors and other) dealing with the ACES tax structure on a daily basis understood it. He relayed that Repsol had recently contacted DOR for an explanation of ACES. The state was currently on equal footing and understood the system as well or better than the private sector. He opined that an overhaul of the system may be a step backwards because the department would have to start over after it had implemented over 70 regulations; all of the regulations would have to be analyzed to determine how they would interplay with each other. He explained that the point of CSHB 110(FIN) was to work within the current system. He furthered that there were a multitude of moving parts and there were various ways to deal with tax credits to achieve different results. He believed that it was better to deal with the tax system that was currently in place.

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Senator McGuire surmised that the creation of a dual tax system using gross for progressivity and net for other would require state employees to assess two different structures. Mr. Tangeman replied in the affirmative. He expounded that DOR would figure out and work with a change to the tax system if a new structure passed the legislature; however, DOR understood the current system in greater detail than most companies coming into the state.

Co-Chair Stedman opined that there was a substantial difference between going from a tax and royalty system to a concession system (i.e. from PPT to ACES). He believed the difference was much greater than moving progressivity from the net and switching it to the gross; the main calculation was multiplying the amount of oil produced and the portion of the oil allocated to royalties. He did not agree with DOR's testimony, excluding the concerns related to the proposed implementation of a new database; he recognized that the database represented a piece of complexity.

Co-Chair Hoffman wondered whether a portion of the burden related to the proposed database or portions of the legislation could be lifted if effective dates were postponed.

Commissioner Butcher responded that it would be a benefit; however, the database was still a significant lift for the department that had a minimal amount of involvement in the information.

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Mr. Tangeman added DOR had previously provided a schematic that included the 35 pieces of information required under CSSB 192 (FIN); DOR, DNR, and AOGCC already collected much of the information. He expounded that the Tax Revenue Management System (TRMS) DOR was working to implement would replace the current antiquated system. He furthered that PIMS would work with the same dataset. Work on TRMS would feed into other types of things that would be beneficial to the public and would get at the same dataset as PIMS, but with a different output. He felt that DOR could accomplish the objective of PIMS with TRMS in the future.

Senator Thomas conveyed that the committee had not intended to create a "huge worthless system"; most of the committee's concern had originated from a lack of accurate or conflicting information from different departments. The goal of the proposed system was to provide a coordination of activity between departments. He detailed that most state departments had antiquated systems, which was the reason money for a system had been appropriated the prior year. He expounded that it was discouraging to get different answers from different departments. He hoped that requiring departments to provide information to DOR for it to coordinate would automate processes and provide efficiency that would lead to a better tax understanding and better auditing performance.

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Commissioner Butcher replied that DOR was working to come up with a cost estimate for the committee. One estimate from Kathy Forester of AOGCC was approximately \$36 million and 10 to 12 positions. The department did not know whether that would be the price, but the cost would be substantial; the more different systems, databases, and forms were involved the more complex it became.

Mr. Tangeman elaborated that DOR had been coordinating with AOGCC and the Division of Oil and Gas because it had spent the past year working on TRMS. The department recognized

that the system in place required companies to provide information to several different departments in diverse formats. Ultimately DOR wanted to see all of the information being sent to one location and divvied out based on confidentiality, non-confidentiality, and other.

Senator Olson referred to proposed gasline legislation (HB 9) that included a first open season in January 2013. He was concerned that companies would not bid on an open season if they did not have a good idea of what the tax rate would be; especially if the possibility of an LNG plant used for export was considered for Kenai or other.

Commissioner Butcher answered that two pipelines had previously had open seasons. There needed to be work done by the state and companies related to gas fiscals beyond a coupling. He hoped that the work required would be done sooner rather than later.

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Co-Chair Stedman requested calculations that showed the deterioration of the economics with the lower tax rate based on DOR's belief that changes under CSSB 192(FIN) moved in the wrong direction (slide 14). He was interested in the full-cycle economics and FY 13 numbers relative to the current system. He would agree with DOR that the state would be going in the wrong direction if the numbers showed that the tax rates were higher than those under ACES; however, if the calculations showed lower figures he thought DOR should reevaluate its remarks. He discussed the goal of encouraging industry to move away from harvest mode and he wanted specific detail on how the bill encouraged it.

Commissioner Butcher replied that DOR did not have the specific details related to the full scale economics, but it was happy to work with committee aide Darwin Peterson to accomplish the committee's request. The point on slide 14 was based on the fact that high-cost developments would benefit less when the tax system moved from net to a net/gross combination.

Commissioner Butcher noted that Department of Law (DOL) had brought up potential constitutional issue related to equal taxing of different companies. The department of Law would follow up with Legislative Legal Services and Mr. Peterson

on the issue. He mentioned that there were several technical tweaks related to new field definitions that DOR would talk to the committee about.

Co-Chair Stedman had not heard the concern about a potential constitutional issue and requested that the departments get the information to his office.

Co-Chair Hoffman pointed to slide 3 and queried whether the bill made Alaska more appealing to potential investors if the price of oil was \$170 per barrel. Commissioner Butcher responded in the affirmative, but noted that the price of oil had never reached \$170 per barrel. The price could get that high at some point, but he did not believe decisions should be focused on the possibility.

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Co-Chair Hoffman answered that world history had not predicted \$145 per barrel four years earlier. Commissioner Butcher responded in the affirmative. He recalled that the price had dropped to \$37 per barrel following the price spike.

Co-Chair Hoffman asked at what price level the bill became appealing.

Commissioner Butcher replied that it was up to the oil companies to provide the answer. He expounded that because the information was proprietary, companies would not provide what specifically in their economic model they based decisions on. According to information provided to the department the number had been more conservative (\$70, \$80, or \$90 per barrel). Companies were aware of what would happen if oil reached \$170 per barrel, but he did not believe that they made investment decisions based on the figure as opposed to a price around \$70, which according to history was more likely to be seen.

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Co-Chair Hoffman believed that it was all relative and it was hard to know what the price of oil would be. He asked whether DOR believed that overall the current bill version would not make Alaska more appealing to investors. Commissioner Butcher deferred the answer to the oil companies.

Co-Chair Hoffman pointed out that DOR had included the remark in its presentation. He observed that DOR had voiced that CSHB 110(FIN) would be an improvement, but it did not want to say yes or no to the current bill.

Commissioner Butcher responded that the questions on slide 3 had been considered by the department and the administration as it worked on a bill. The department believed that oil companies had agreed with CSHB 110(FIN) because they had come up with commitments based on a material change that would positively affect investment decisions and a discussion of dollar amounts. He did not know how oil companies felt about CSSB 192(FIN).

Co-Chair Stedman remarked that oil companies had expressed interest, but he did not believe that they had made commitments. He understood that it took all three major oil companies to agree; it was not much of a commitment until the companies signed a letter of agreement. He requested that a commitment should be delivered to his office if one existed.

Mr. Tangeman responded that not all investments on the North Slope would require the agreement from all three major oil companies. He believed that there were some areas that only required that two companies provide approval.

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Co-Chair Stedman noted that prior testimony had indicated that it would take \$3 billion to \$5 billion per year and not \$5 billion over seven to ten years. He stressed that that \$5 billion could barely be seen in the analysis, unless there were multiple consecutive years driving the production curve up.

Commissioner Butcher agreed. There had been \$5 billion, \$9 billion, and other figures discussed, but he did believe the state would know until a bill passed. He continued that the question related to whether the legislature passed a bill that was viewed positively by the industry or not. He stated that a tax reduction bill that resulted in no new investment or development did not achieve the desired goal.

Co-Chair Hoffman queried whether DOR could answer whether the bill made Alaska more competitive (item 1, slide 3).

Commissioner Butcher replied that he could see the problems a potential investor would have with the bill because of the initial complexity. He could not speak for the industry related to the specific economics of the legislation.

Co-Chair Stedman pointed out that at \$100 per barrel the bill moved approximately \$277 million across the table [to the industry] in FY 13 figures; whereas, CSHB 110(FIN) moved \$2 billion. He elaborated that there was more money to the industry in the tax change than in the incremental drilling; he wanted to see economics that showed that it was not true. He believed the drive was more for a tax change than the benefit of the incremental drilling in the bottom line dollars. He requested an analysis showing that the initial review of the numbers was incorrect. He concluded that it would take a substantial amount of enhanced oil recovery to make a \$2 billion per year net swing to the state's treasury; oil companies would receive \$8 billion to \$10 billion before they started turning the oil.

[10:30:43 AM](#)

AT EASE

[10:38:25 AM](#)

RECONVENED

^ALASKA OIL AND GAS ASSOCIATION

[10:38:44 AM](#)

KARA MORIARTY, EXECUTIVE DIRECTOR, ALASKA OIL AND GAS ASSOCIATION (AOGA), spoke from a prepared statement (copy on file):

On behalf of the member companies of the Alaska Oil and Gas Association, who account for the majority of oil and gas exploration, production, transportation, refining and marketing in this state, I would like to offer the following comments regarding work-draft "0" of a Senate Finance CS for Senate Bill 192. Despite the diversity of our membership, my comments reflect a 100% consensus among them.

On March 16 we testified to you about the Senate Resources version of the Bill. At that time we told you that, unless one is satisfied to see North Slope

oil production continue to decline at about 6% a year or more, meaningful changes need to be made to the present ACES tax. We pointed out a number of measures that the Resources CS could have taken but didn't, as well as a number of things that it proposed to do that would be counterproductive.

Despite all the time and effort that have gone into work-draft "0", we have to say that this new CS also falls short of the meaningful tax change that is called for in order to meet the challenge of stopping decline, much less the even harder goal of getting back to a million barrels a day flowing through the TAPS oil pipeline.

The CS does indeed provide a slightly less onerous tax treatment for new fields and increases in production. But we would remind you that two very new fields - Oooguruk and Nikaitchuq -are each expected to peak at around 20,000 barrels a day. This year the North Slope at a 6% decline will decline by roughly 40,000 barrels a day, as much as these two new fields combined. In other words, to offset the decline, two new fields like Oooguruk and Nikaitchuq would need to come into production each year. These slight improvements are not likely to generate even this level of development.

The producers of the existing non-legacy fields on the Slope, and the developers of any new fields that may be discovered, need as much production as possible flowing from the legacy fields through the TAPS oil pipeline in order to keep the costs affordable to ship their oil from the Slope to its refinery destinations. Unaffordably high transportation costs could cripple the economics of any new fields that might be found, as well as the economics of non-legacy fields currently in production.

In other words, the North Slope oil province is like a tree, with the two great legacy fields being its trunk, and with the other fields being branches rising out of the trunk. If one peels the bark off all the way around the trunk and make it unhealthy, all the other branches will become unhealthy too, no matter how robust they might have been if the trunk had stayed strong.

It has been openly acknowledged during the Committee's hearings that the intent is to keep the tax essentially the same as the present tax for the legacy fields at \$100 oil, and workdraft "0" reflects that intent. But that intent is just the opposite of what we urged you to do in our March 16th testimony on the Resources CS, and it is the opposite of what we urge you to do now.

Throughout the Twenty-seventh Legislature, AOGA and others have been testifying about what is happening with their businesses on the North Slope, about the interrelationship between the level of new investment each year and the rate of decline in ANS production, and about the effects taxes have on investment decisions. These explanations are not threats, but they are not bluffs either. They have been candid attempts to describe to you how those companies evaluate their investment opportunities here against their opportunities elsewhere, and how Alaska's tax regime can influence the decisions about which opportunities to take.

Those decisions reflect the expectations of the companies' respective shareholders that each company will choose the opportunities that it perceives to be best, all things considered including taxes. If an Alaskan opportunity is better than one elsewhere and there is enough budgeted money only for one of them, the shareholders expect, and in a very real sense demand, that the Alaska opportunity be taken. The reductions in the level of companies' investments in Alaska since the enactment of ACES are not any kind of retaliation for ACES' enactment, nor does a company cut back here to spite its face. The investments are nothing more, and nothing less, than the result of the competition of the Alaskan opportunities against opportunities elsewhere.

Anyone is free to believe that the declining investments and declining production on the North Slope are due to something other than these reasons ... but they will be mistaken. Unfortunately, by the time they are proven to be mistaken, the opportunity for Alaska to have addressed the situation will have passed. And there aren't any "do overs."

Without meaningful tax relief for the legacy fields as well as the other production, the bark will continue to be peeled off the tree trunk, harming the entire tree. Work-draft "0" threatens harm for every member in AOGA.

Thank you, Mr. Chairman and Members of the Senate Finance Committee, for this opportunity to share our deep and grave concerns with you about work-draft "0" of the Finance CS. We respectfully ask you to take another look at what it would do, and to replace it with a CS that would provide meaningful tax change to enable the additional investments the state and its future need.

In closing, let me repeat that these comments have the unanimous support of AOGA's members: Apache, BP, Chevron, Eni petroleum, ExxonMobil, Flint Hills, Hilcorp, Marathon, Petro Star, Pioneer, Repsol, Shell, Statoil, Tesoro, XTO Energy, and Alyeska Pipeline Service Company. Thank you for this opportunity to share them with you.

[10:46:12 AM](#)

Co-Chair Stedman believed that it was challenge to come up with a universal definition of the words "meaningful" and "significant." He believed that at \$120 per barrel moving \$277 million to the industry was meaningful and significant; another person's interpretation could be the \$2 billion under CSHB 110(FIN). He asked for help with a definition.

Ms. Moriarty responded that AOGA represented a diverse group of oil companies and the term meaningful had a different implication for each of the companies. She explained that after AOGA's evaluation none of its members believed that the bill would improve Alaska's competitiveness compared to other projects in their portfolios. The association thought that bracketing progressivity (included in CSHB 110(FIN)) would bring Alaska to a more competitive playing field.

Co-Chair Stedman clarified that bracketing was only a mechanism to shift cash from one side to the other side of the table.

Ms. Moriarty replied that AOGA viewed bracketing as a more substantial change in progressivity versus the proposed structure under CSSB 192(FIN).

Co-Chair Stedman agreed that bracketing did represent a more substantial change related to the shifting of cash at a price of \$100 to \$120 per barrel. The current bill would shift \$2.6 billion at \$200 per barrel versus \$4.4 billion under CSHB 110(FIN); there was more shifting of cash to the industry above \$60 per barrel under CSHB 110(FIN). He noted that CSSB 192(FIN) also included a floor.

[10:48:21 AM](#)

Senator Thomas thanked Ms. Moriarty for her presentation. He believed that the commitment portion of the equation was very important. He opined that a tax structure could probably be structured depending on commitments where more of a business relationship existed and one could expect that if "y" happened that "x" would take place. He pointed to discussions related to a number of projects that had been in place prior to ACES that could have been done going forward; he surmised the state would probably be in a very different situation of understanding the terms meaningful and commitments. He thought it would have been possible to implement a tax rate that would take effect once a company committed to expend money on production. He observed that "it was simply language to put things in place" and believed that the legislature and other players had "all fallen short of trying to get a better understanding of what would take place in the future," which was not helpful to the process.

Co-Chair Stedman relayed that the scheduled BP presentation would be heard during the afternoon meeting that day.

SB 192 was HEARD and HELD in committee for further consideration.

ADJOURNMENT

[10:51:02 AM](#)

The meeting was adjourned at 10:51 AM.