

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

February 25, 2011

3:34 p.m.

MEMBERS PRESENT

Senator Joe Paskvan, Co-Chair
Senator Thomas Wagoner, Co-Chair
Senator Bill Wielechowski, Vice Chair
Senator Bert Stedman
Senator Hollis French

MEMBERS ABSENT

Senator Lesil McGuire
Senator Gary Stevens

COMMITTEE CALENDAR

SENATE BILL NO. 91

"An Act amending the termination date of the licensing of sport fishing operators and sport fishing guides; and providing for an effective date."

- HEARD AND HELD

SENATE BILL NO. 85

"An Act providing for a tax credit applicable to the oil and gas production tax based on the cost of developing new oil and gas production; and providing for an effective date."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 91

SHORT TITLE: SPORT FISHING GUIDING SERVICES

SPONSOR(s): SENATOR(s) MCGUIRE

02/16/11	(S)	READ THE FIRST TIME - REFERRALS
02/16/11	(S)	RES, FIN
02/25/11	(S)	RES AT 3:30 PM BUTROVICH 205

BILL: SB 85

SHORT TITLE: TAX CREDIT FOR NEW OIL & GAS DEVELOPMENT

SPONSOR(s): SENATOR(s) WAGONER

02/07/11 (S) READ THE FIRST TIME - REFERRALS
02/07/11 (S) RES, FIN
02/25/11 (S) RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

MIKE PAWLOWSKI
Staff to Senator McGuire
Alaska State Legislature
Juneau, AK

POSITION STATEMENT: Presented SB 91 for the sponsor.

MARY JACKSON
Staff to Senator Wagoner
Alaska State Legislature
Juneau, AK

POSITION STATEMENT: Presented SB 85 for the sponsor.

DON BULLOCK, Attorney
Legislative Legal Services
Legislative Affairs Agency
Alaska State Legislature
Juneau, AK

POSITION STATEMENT: Commented on SB 85 as the drafting attorney.

ACTION NARRATIVE

3:34:49 PM

CO-CHAIR TOM WAGONER called the Senate Resources Standing Committee meeting to order at 3:34 p.m. Present at the call to order Senators Stedman, Wielechowski, French, Wagoner, and Paskvan.

3:35:44 PM

SB 91-SPORT FISHING GUIDING SERVICES

CO-CHAIR WAGONER announced SB 91 to be up for consideration.

MIKE PAWLOWSKI, staff to Senator McGuire, sponsor of SB 91, explained that SB 91 extends the existing program for the licensing of sportfish guides in the state of Alaska for another year. On page 1, line 8, of [SB 91] 27-LS0550\A the only change is made from the year 2012 to 2013. This extends the program for the current year to give the committee time to do work on the overall systems for fish licensing and most importantly the log book program, which allows Alaska Department of Fish and Game

(ADF&G) to collect data from the sport guide industry on catch that goes on in different areas of the state.

SENATOR WIELECHOWSKI asked if this is similar to the bill the legislature has had before it for the last couple of years.

MR. PAWLOWSKI answered yes.

CO-CHAIR WAGONER said they would have a public hearing on Monday and held action on SB 91 until that time.

[3:37:11 PM](#)

SB 85-TAX CREDIT FOR NEW OIL & GAS DEVELOPMENT

CO-CHAIR WAGONER announced SB 85 to be up for consideration. He asked for a motion to bring the bill before the committee.

SENATOR PASKVAN moved to bring SB 85, labeled 27-LS0484\M, before the committee. There were no objections.

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MARY JACKSON, staff to Senator Wagoner, sponsor of SB 85, explained that the genesis for this bill came from an Alberta royalty tax holiday provision. She said Senator Wagoner intends to use it here as a production tax holiday and is intended to encourage new conventional and unconventional oil and gas development. The Department of Revenue fiscal note is indeterminate. She said the target is to simply increase the throughput in the Trans Alaska Pipeline System (TAPS) because of the reported decline. The result of increased throughput is economic activity, jobs and after five years, assuming this bill passes, continued production taxes.

MS. JACKSON said the bill sets a very high bar by being for new developments only. It applies to all areas and the credit must be taken within five years. The credit is not transferable and it may not be used to reduce the tax liability to below zero. In other words, the new development gets a five-year holiday from production taxes or 100 percent of the development costs, whichever is first.

She explained when a producer explores currently they get exploration credits. In SB 85, when they hit a field, they find a play that is developable and then the Alaska Oil and Gas Conservation Commission (AOGCC) certifies that it is developable. From then on all development costs associated with it up to the point of production are counted as part of this 100

percent. The bill then says that the Department of Natural Resources (DNR) certifies that production is done and the company is producing. All the costs between the AOGCC certification and DNR certification are attributable to the costs for this credit.

MS. JACKSON said the best way to explain the five-year holiday is with an example. So, she described a \$25 million development that had \$5 million worth of production, so their tax liability would be a wash. Conversely, a \$50 million project with a \$5 million production tax liability would only be eligible for \$25 million - because of the cap. She explained this feature was to deal with the "gold plating" risk. The policy question is if the production tax value that the state gives away is worth adding throughput to the TAPS.

MS. JACKSON next invited Don Bullock, Attorney, Legislative Legal Services, to help her go over the sectional analysis.

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DON BULLOCK, Attorney, Legislative Legal Services, Legislative Affairs Agency, joined Ms. Jackson.

MS. JACKSON said sections 1, 2 and 3 are new and are added to AS 43.55.026. Section 3 actually sets out the new credits; subsection (a) directs that the new credit applies to qualified expenditures that were incurred prior to the production of oil and gas in paying quantities for a lease or a property that is not and has not been within any unit or produced oil and gas. She explained that this language targets the new development.

SENATOR FRENCH asked what "within a unit" means.

MR. BULLOCK answered that unitization is authorized through the oil and gas leasing statute, AS 38.05.180 (b). Generally it will occur whether a common pool may actually be under several leases. It protects one person's milkshake straw from sucking all the oil out from underneath somebody else's property. The production and costs of producing it are allocated among the operators, "So, once the unit is formed, it's a group of leases to develop a particular area."

SENATOR FRENCH said one widely covered new development is ConocoPhillips' efforts to get across the Colville River into an area known as CD5. If oil starts to flow out of CD5, as he hoped it would, he asked if their expenditures would qualify for credit under this bill or not.

MR. BULLOCK replied that he wasn't familiar with the facts relating to that field, but the key date in SB 85 is December 31, 2010 and whether or not the project had previously not been within a unit or produced oil and gas.

SENATOR FRENCH remarked that they had not produced oil and gas yet in paying quantities, but they had probably found some.

MR. BULLOCK said the Alaska Oil and Gas Conservation Commission (AOGCC) could probably answer that.

CO-CHAIR WAGONER added that AOGCC people will be here next week.

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SENATOR WIELECHOWSKI asked if this credit would apply to activities on federal lands - NPRA and ANWR - and OCS. He guessed it doesn't apply past the 6-mile limit, but within the 3-6 mile limit.

MR. BULLOCK answered the production tax is a tax on the activity of producing oil and gas; it's not on the oil and gas itself. So, if there is activity on federal land that produces oil and gas, that activity would be taxable. The oil that is produced that is not taxable (for example, the federal royalty share) would not be subject to tax because of the exclusion in AS 43.55.011 that limits the tax to taxable production - and defines it.

SENATOR WIELECHOWSKI said then that it would apply in NPRA, ANWR and within 3 miles off the coast, but how about within 3-6 miles?

MR. BULLOCK answered that it applies in any area that is subject to the state's tax jurisdiction.

CO-CHAIR WAGONER added, "But only to that share of the oil that belongs to the State of Alaska."

MR. BULLOCK stated that both state and federal royalty oil are not taxed.

MS. JACKSON pointed out that some people are interested who are in that range Senator French just spoke to; so there may be some public comment about expanding it beyond "new." But that is obviously a policy call.

SENATOR WIELECHOWSKI asked if this credit applies only north of the 68th parallel. Would it apply to Cook Inlet?

CO-CHAIR WAGONER responded that discussion had happened in his office, but it was decided to leave it out for the time being. He didn't think it would apply to many areas in Cook Inlet.

MS. JACKSON added that most of Cook Inlet is already unitized and therefore wouldn't be eligible for this credit. She said that Senator Wagoner want a high bar - like new development - to have discussions on and then go from there.

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SENATOR STEDMAN said that's a point they could work on as they work with the bill, because the tax structure in Cook Inlet is quite a bit different than the rest of the state.

MS. JACKSON said that subsection (b) defines the amount of the credit, which is 100 percent of the qualified costs - subject to the AOGCC and DNR certifications of starting and stopping production. She said that AOGCC prefers to certify both start and stop since the production is under their purview.

SENATOR PASKVAN asked if the "Department of Natural Resources" in (b)(2) on page 2, line 30, would be changed to "AOGCC".

MS. JACKSON answered yes, and that was DNR's suggestion. She didn't have a chance to talk it over with Mr. Bullock. She said the credit is for 100 percent of the costs or a five-year tax holiday, whichever comes first.

SENATOR WIELECHOWSKI asked if this credit would cover dry holes.

MS. JACKSON answered no; AOGCC has to certify that the pool is developable.

SENATOR WIELECHOWSKI asked what the standard is for that.

MR. BULLOCK answered that language in subsection (h) on page 3, line 31, says "meets an expenditure other than an expenditure for exploring for new oil or gas reserves." This would all be subject to how AOGCC categorizes the wells.

CO-CHAIR WAGONER remarked that other credits would apply to it, but not under this bill.

SENATOR WIELECHOWSKI said a well in a new unit would get a 40 percent tax credit right now, plus other net operating cost deductions and asked how this credit interplays with those.

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MR. BULLOCK replied subsection (d) on page 3 explains the fact that 100 percent credit can be taken and that's a lot. They may not double dip and take a credit for the same expenditure under another credit provision.

SENATOR WIELECHOWSKI asked if a company drills in a new area and is eligible for the 40 percent tax credit, the net operating loss deduction and maybe some other things, do they get it immediately.

MR. BULLOCK answered they would continue to get their exploration credits for those costs. Whether they have net operating losses that are carried forward depends on what the value of their production is and whether their lease expenditures exceed that value.

SENATOR WIELECHOWSKI asked if a company found oil and started producing it in recoverable amounts, say if they got a tax credit of 60 percent of their exploration costs, are they proposing giving them an additional 40 percent?

MR. BULLOCK nodded no. He said the first thing this bill does is set up the period in which the credit may be earned and that period starts on a lease or property in which they discovered a pool that is capable of production. From that point until they produce oil in sufficient quantities to go into the pipeline, all those costs to get that field in operation - additional drilling for wells and the equipment needed for that - to produce the oil in a pipeline quality, then those costs are development costs. And they get 100 percent credit for those costs during that time period.

CO-CHAIR WAGONER said maybe a different way to say it is, generally speaking, an exploratory well does not become the producing well. So, existing credits go towards an exploratory well and then once they know they have a pool and it is producible, that's when these credits kick in.

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MS. JACKSON said the drafter was charged with saying "only costs that lead to production" excluding any exploration from the day AOGCC says this well is developable.

MS. JACKSON said the credit is not transferable and can't reduce a tax liability to "under zero." She said subsection (f) authorizes the department to promulgate regulations.

SENATOR STEDMAN went back to the exclusion on AS 43.55.011(e) [page 3, line 15] and asked if that referred to the 25 percent base tax.

MS. JACKSON answered yes.

SENATOR STEDMAN asked if the progressivity part of the tax would still trigger in.

MR. BULLOCK answered (e) says the tax is 25 percent plus the amount determined under (g).

SENATOR STEDMAN said he was trying to fit these parts together. He said AS 43.20.043 in (d) deals with gas, which some believe is already a negative. He asked the impact of this credit on the gas tax.

MR. BULLOCK answered this particular credit is not limited to oil; AS 43.20.043(d) combines oil and gas.

SENATOR STEDMAN said he understands there is no gas market other than the small one which costs the state treasury around \$150 million a year, but he thought the gas issue should be explored so people could be clear about how this credit stacks into what some people think is already a negative impact.

MR. BULLOCK added that part of the issue is that reinjected gas may not be considered produced and therefore is not taxable at that time.

MS. JACKSON added that his question might be perhaps to just separate oil and gas.

SENATOR STEDMAN said he would like to do that, but for the discussion on this bill, he wanted to know how this credit flows into what is already a negative impact on the treasury concerning gas. If someone had several sources of gas to reinject, would it be beneficial for them to use some of this gas to go after the credit if they didn't hit oil and just hit gas reserves. It might make it better to hit a dry hole than a gas well.

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MR. BULLOCK said there may never be production for one reason or another and the state won't get anything unless there is production that is taxable.

SENATOR WIELECHOWSKI said he thought he had it figured out. So, if he is an explorer and goes out and does seismic studies, there is no tax credit under this bill. But the moment he identifies a field he wants to explore, he puts his well in the ground. Then AOGCC determines potential development, then the credit would kick in at that point. Ms. Jackson indicated that was correct. He went on and supposed he was a new entrant - Great Bear for instance - then he is not eligible because he can't transfer his tax credit because he doesn't have an income stream now. He doesn't start getting the credits until he actually produces.

MS. JACKSON said that is correct.

SENATOR WIELECHOWSKI said if he were BP or ConocoPhillips, then the moment he starts drilling he can actually start taking that credit off of his production taxes.

MS. JACKSON answered for that unit.

CO-CHAIR WAGONER added not until you are in production.

MS. JACKSON added it's per well and not transferable.

SENATOR WIELECHOWSKI asked what "quantities sufficient to recover the cost of operating and marketing" means and why it would cover marketing expenses.

MR. BULLOCK replied if a company is producing oil above the breakeven point it must get sold and part of that is going to involve a certain amount of developing the market and getting the product there.

SENATOR WIELECHOWSKI queried that companies typically start producing in very small quantities, maybe a few thousand barrels a day and that is not the breaking point, right?

MR. BULLOCK replied that would be a question of fact, but at some point they would produce enough oil to cover the cost of production.

SENATOR WIELECHOWSKI said that is the point at which they would start taking the tax credit, but lines 29 and 30 say "although the quantity may be insufficient to recover the cost of drilling."

MR. BULLOCK replied right, but drilling costs are not recoverable; operating costs are. He said this is a standard definition for production in paying quantities which he thought came from "Williams and Myer."

MS. JACKSON said AOGCC also wants to know what that is, particularly if they are the ones who are going to be certifying that a well is producing. The sponsor's intent is to keep the bar very high she repeated.

CO-CHAIR PASKVAN said subsection (d) says whatever is taken as a credit may not be used as an expenditure and his assumption is that means a company is not taking expenditures as deductions on their taxes in that five-year period.

MR. BULLOCK replied right; the bill intends to "compartmentalize" all the costs that are incurred during this development period.

CO-CHAIR PASKVAN asked if operation expenses are currently deducted at Prudhoe Bay.

MR. BULLOCK said he didn't know for sure, but the Department of Revenue would know.

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MS. JACKSON went on to subsection (g) [on page 3] which has to do with the credits being applied only toward leases and then on to the definitions section, subsection (h). One company asked what if they didn't want to take this credit but take the other credit instead. But she hadn't had the opportunity to see whether or not that choice was available to them.

SENATOR STEDMAN said that is a good question and maybe later on they could have some calculations and comparisons back and forth on it.

SENATOR WIELECHOWSKI asked how this credit would play out with shale oil, because the oil is trapped in sands not in a pool.

CO-CHAIR WAGONER answered that wells wouldn't get drilled that fast and this is meant to stimulate development in the area. It

wouldn't be in effect long enough to develop the total area. He thought this committee should discuss a five or seven year sunset date for that reason. He added that this credit also allows companies that are looking to develop these new "non-traditional plays" on the North Slope to have others become involved with them and share the risk of the development phase.

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MS. JACKSON went to section 4 on page 4 that amends existing law to include this new section of tax credits. Section 5 is the effective date, which is immediate.

CO-CHAIR PASKVAN said the original thought pattern for this credit came from tax changes done in Alberta and asked what was included compared to what wasn't included from their tax pattern, so they can determine which expenditures might be working or not compared to Alberta.

CO-CHAIR WAGONER answered that Alberta reduced their royalty to a 2 percent level and stays at the level until the company pays itself back from coming into production. The credit in SB 85 was designed to do that, but with a different design. This is done using the reduction of the production tax. Alberta's royalty is about 50 percent.

MS. JACKSON said it is interesting to see Alberta go through what they are going through now.

SENATOR WIELECHOWSKI said they might want to consider a provision about shortening the credit time period for a company that finds a major well and asked if that was done in Alberta.

CO-CHAIR WAGONER answered Alberta didn't do that, but companies did come back and asked for more royalty reductions. That's why he wanted to look at a sunset date that is not too soon and not too late.

SENATOR WIELECHOWSKI said if their goal is to incent oil fields, hypothetically Congress could decide to open up ANWR and then Alaska would be subsidizing its development. What about excluding some production that doesn't need incentives?

CO-CHAIR WAGONER answered they could "ringfence this thing" and put lines where they want them - north of the Brooks Range over to but not to exceed the boundary of such and such.

MS. JACKSON said a lot of those questions would go away with sunset language.

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SENATOR STEDMAN went back to Senator Wielechowski's point of a big find in a big field - maybe they could have some hypotheticals run under the current tax structure with different dollar amounts and different size pools versus the scenario under this bill. They might get a better feel for which type of credit enhancement would be most desirable from the industry's perspective.

MR. BULLOCK said there are two factors relating to the value of the production: the quantity of the production and the costs that are incurred to develop the field. So, if the field is very rich, the credit would be used up quickly. On the other hand, if the development costs are very high and the production is not of sufficient value, the full amount of credit might never get used because of the five-year limitation.

SENATOR WIELECHOWSKI asked if the credit applies only to the production tax.

MR. BULLOCK answered yes, only to the production tax in AS 43.55.011.

SENATOR WIELECHOWSKI asked if a company paying its 12.5 percent royalty can't lower its burden there at all.

MR. BULLOCK said the royalty continues, as well as the 1 and 4 cent surcharges and income tax.

SENATOR WIELECHOWSKI asked what percentage of a field is typically developed in the first five years and whether or not companies could extract enough in that time to damage the fields.

MS. JACKSON replied that the AOGCC would have to allow them to do that because of that very issue.

SENATOR STEDMAN went to a hypothetical larger find that is actually profitable where the credit is used up in three years and asked if they would then automatically trigger existing credits for ongoing work and development.

MR. BULLOCK replied that is his understanding. They are allowed to take credits until the production tax is offset by those

credits; then this credit is not an issue any more. The credits they earn for ongoing capital and lease expenditures will apply from that point on.

SENATOR STEDMAN stated there is no look-back provision so they would have to have a date certain where one stops and the other one activates.

MR. BULLOCK said the department would have to consider when the transition occurs when they adopt their regulations. He remarked that payments are made on a monthly basis.

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CO-CHAIR PASKVAN asked since the bill indicates that the credit doesn't apply to work that was done in an area that is currently in a unit or had previously been in a unit, if it applies to heavy oil in the known fields.

CO-CHAIR WAGONER remarked that heavy oil is already in unitized areas but lying in a different level than what is being produced right now.

SENATOR WIELECHOWSKI said he would be interested in finding out what the typical costs of developing a field are, maybe various sized fields. Then he said that the issue of gold plating is a potential concern, particularly in a very profitable field.

MR. BULLOCK agreed with him and added also if someone is sharing the risk with you, perhaps the standard for deciding whether to make that investment may be different because you are backstopped.

SENATOR STEDMAN asked, "How could we be gamed?"

MS. JACKSON said they were hoping during the discourse in the next week someone would slip and tell them.

SENATOR STEDMAN said the concept of allowing immediate credits is very common all over with little different twists.

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SENATOR WIELECHOWSKI agreed and said they hear all the time about other countries that have much higher tax rates than Alaska and maybe they are doing things like this where they keep the high tax rate, but front load the payback. He said it would be great if the administration could "chime in" on what other countries do.

MS. JACKSON said she had talked briefly with the Department of Revenue about modeling that very issue. Senator Wagoner's goal was to stay removed from production taxes and see what they could do in terms of credits.

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CO-CHAIR WAGONER stated his long term goal is "more oil in the pipe." With that he thanked everyone for coming and adjourned the meeting at 4:24 p.m.