

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

April 1, 2011

3:32 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Senator Joe Thomas
Representative Les Gara

COMMITTEE CALENDAR

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."

- REMOVED FROM AGENDA

SENATE BILL NO. 49

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

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 49

SHORT TITLE: PRODUCTION TAX ON OIL AND GAS

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

01/19/11	(S)	READ THE FIRST TIME - REFERRALS
01/19/11	(S)	RES, FIN
03/09/11	(S)	RES AT 3:30 PM BUTROVICH 205
03/09/11	(S)	Heard & Held
03/09/11	(S)	MINUTE(RES)
03/11/11	(S)	RES AT 3:30 PM BUTROVICH 205
03/11/11	(S)	Heard & Held
03/11/11	(S)	MINUTE(RES)
03/14/11	(S)	RES AT 3:30 PM BUTROVICH 205
03/14/11	(S)	Heard & Held
03/14/11	(S)	MINUTE(RES)
03/16/11	(S)	RES AT 3:30 PM BUTROVICH 205
03/16/11	(S)	Heard & Held
03/16/11	(S)	MINUTE(RES)
03/18/11	(S)	RES AT 3:30 PM BUTROVICH 205
03/18/11	(S)	Heard & Held
03/18/11	(S)	MINUTE(RES)
03/30/11	(S)	RES AT 3:30 PM BUTROVICH 205
03/30/11	(S)	<Above Item Removed from Agenda>
03/30/11	(S)	MINUTE(RES)
04/01/11	(S)	RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

BRIAN BUTCHER, Commissioner Designee
Department of Revenue
Anchorage, AK

POSITION STATEMENT: Discussed the Oil and Gas Production Tax Status Report as it related to SB 49.

BRUCE TANGEMAN, Deputy Commissioner
Department of Revenue
Anchorage, AK

POSITION STATEMENT: Offered information related to the Oil and Gas Production Tax Status Report as it related to SB 49.

KEVIN BANKS, Director
Division of Oil and Gas
Department of Natural Resources
Anchorage, AK

POSITION STATEMENT: Discussed North Slope leasing and the state's royalty modification program as it related to SB 49.

ACTION NARRATIVE

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CO-CHAIR JOE PASKVAN called the Senate Resources Standing Committee meeting to order at 3:32 p.m. Present at the call to order were Senators French, Stevens, Stedman, Wielechowski, Wagoner, and Paskvan.

SB 49-PRODUCTION TAX ON OIL AND GAS

[3:33:20 PM](#)

CO-CHAIR PASKVAN announced the consideration of SB 49, and informed the committee that Bryan Butcher would discuss the Oil and Gas Production Tax Status Report and Kevin Banks would discuss North Slope leasing and the state's royalty modification program. He asked Mr. Butcher to begin with an overview of the Alaska's Clear and Equitable Share (ACES) Status Report, and then walk through the executive summary, focusing on each key finding. Before transitioning to Mr. Banks, he said he'd like to know if DOR performed an economic analysis when it contemplated a production tax reduction, similar to the one DNR conducted for royalty modification. He asked for an explanation of the decision, and if it would be in the best interest of the state to do that sort of analysis considering the potential impact of SB 49.

BRIAN BUTCHER, Commissioner Designee, Department of Revenue, stated that the Oil and Gas Production Tax Status Report to the Legislature is required under AS 43.55.180 as part of the 2006 Petroleum Profits Tax (PPT) legislation.

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SENATOR MCGUIRE joined the committee.

COMMISSIONER BUTCHER provided the following overview of the ACES status report, which evaluates six elements of the state's production tax system.

1. Revenue Generation/Tax Rate - Revenues under PPT and ACES exceeded the amount that the state would have received under the Economic Limit Factor (ELF) each of the four fiscal years since a net profits tax was implemented. He

noted the PowerPoint includes a chart that compares the three tax systems.

CO-CHAIR PASKVAN noted that the explanation also includes the statement that the production tax rate under ACES may be as high as 75 percent. He asked if that is a nominal, marginal, or effective tax rate.

COMMISSIONER BUTCHER answered it's a nominal tax rate.

CO-CHAIR PASKVAN asked what the price is for crude oil at that rate.

COMMISSIONER BUTCHER said he would follow up with specifics, but that is the cap under the original ACES legislation.

2. Industry Investment - Capital expenditures have increased each of the four fiscal years since the net profits tax was implemented. However, it is not clear how much of those capital expenditures were drilling or well-related and how much were maintenance or facilities-related. He noted that the committee previously discussed that DOR will need to implement regulations to gather additional information so as to definitively know what that breakdown is. He acknowledged that it's an area that needs improvement.

CO-CHAIR PASKVAN asked if he knew whether or not the major oil companies were rebuilding infrastructure at Prudhoe Bay.

COMMISSIONER BUTCHER replied he didn't have specifics, but he's sure that considerable work is being done to keep that mature infrastructure going and safe.

CO-CHAIR PASKVAN asked if it's fair to assume that if capital expenditures are not going into well-related activities, then they are likely going into infrastructure rejuvenation at Prudhoe Bay.

COMMISSIONER BUTCHER replied that is one area where that is probably taking place.

BRUCE TANGEMAN, Deputy Commissioner, Department of Revenue (DOR), referenced the earlier question about the 75 percent nominal production tax rate, and explained that is the top rate in a production tax value (PTV) of \$342.50.

SENATOR WIELECHOWSKI asked what the nominal and effective tax rates would be when oil is \$100/barrel.

MR. TANGEMAN offered to follow up with precise numbers, but generally it's about \$30 in transportation costs.

COMMISSIONER BUTCHER continued to review the elements of the state's production tax system.

3. Impact on Exploration, Development, and Production - Exploration generally increased after 2003, when the Exploration Incentive Credit (EIC) was implemented, but dropped off in 2010 and 2011. Although development continues in three relatively new North Slope projects, production continues to decline.

4. Industry Employment and New Entrants - Industry employment rose steadily between 2006 and 2009, but dipped slightly in 2010.

CO-CHAIR PASKVAN asked what that signifies.

COMMISSIONER BUTCHER replied that's simply the information that DOR received.

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SENATOR WIELECHOWSKI asked if in 2004 and 2005, roughly 8,000 people were working in the oilfields.

COMMISSIONER BUTCHER answered yes.

SENATOR WIELECHOWSKI asked if the tax rate at that time was zero percent on at least 15 of 19 fields.

COMMISSIONER BUTCHER answered yes.

SENATOR WIELECHOWSKI recapped that there were 8,000 jobs when the tax rate was zero, and he understands that last year there were 12,800 jobs on the North Slope.

COMMISSIONER BUTCHER agreed, and added that the largest spike in jobs occurred in 2006 when corrosion became a big issue on the North Slope. Job numbers increased by 1,400 that year and continued the next couple of years.

MR. TANGEMAN pointed out that the price of oil in 2003/2004 was between \$30 and \$40 per barrel. In 2008 the price spiked to well over \$100 per barrel.

SENATOR WIELECHOWSKI said his understanding is that as the production tax rate on the North Slope was declining towards zero from 2001 to 2003, job numbers on the North Slope were also declining. He asked if that was his understanding as well.

COMMISSIONER BUTCHER replied job numbers bounced up and down, but definitely trended down.

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CO-CHAIR PASKVAN said a lot of people that were previously employed in the oilfields are questioning why so many Alaskans aren't working when total numbers in the oil industry are up.

COMMISSIONER BUTCHER agreed it's a contradiction, but DOR has not received detailed information from the Department of Labor and Workforce Development (DOLWD) as to why this is occurring.

CO-CHAIR PASKVAN asked if there was a potential correlation between the numbers of resident versus nonresident hires.

COMMISSIONER BUTCHER replied the breakdown on unemployment claimants indicates that both residents and non-residents are affected. He didn't have the breakdown of the North Slope employment numbers for residents and nonresidents.

CO-CHAIR PASKVAN asked if people from the Interior who previously worked in the oil industry have a valid concern about nonresident hires in light of the fact that their employment numbers are down when overall employment numbers are up.

COMMISSIONER BUTCHER replied he, too, has that concern, but until DOR gets a breakdown from the Department of Labor and Workforce Development (DOLWD), he can't dig in and figure out what is really going on.

SENATOR FRENCH said at some point he'd like to hear from Mr. Fried.

CO-CHAIR PASKVAN noted for the record that Neal Fried with DOLWD, Kevin Banks with DNR, and Lennie Dees, Cheryl Nienhuis and John Larsen with DOR were online to answer questions.

SENATOR FRENCH asked Mr. Fried if he had an explanation for the apparent contradiction between DOLWD's most recent numbers indicating record high employment on the North Slope, and the volume of individual testimony about layoffs and force reductions.

MR. NEAL FRIED, Economist, Department of Labor and Workforce Development (DOLWD), said part of the difficulty comes from looking at the annual averages instead of the monthly data. In 2008, 2009, and 2010, annual average employment was relatively stable, but the monthly data shows a lot more volatility.

In 2009, employment for oil and gas peaked at about 13,500, but by November that number had dropped to 11,988. Employment drifted down over the course of the year, and at the same time the number of unemployment claims increased between 2008 and 2009. In 2010, employment stabilized in the first quarter then grew through the third quarter, while unemployment claims in the oil industry drifted down. Between 2008 and 2009, the number of unemployment claimants in the oil and gas industry went from about 1,400 to about 2,700 and then dropped to about 2,500 the following year. There's a lot more volatility month-to-month, quarter-to-quarter than on the average annual basis, he said.

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CO-CHAIR PASKVAN asked him to explain the context of his statement that "The oil industry has been able to perform more work using fewer workers."

MR. FRIED said he wasn't sure.

CO-CHAIR PASKVAN asked if he generally believes the statement to be accurate.

MR. FRIED reiterated that he would need to see the context within which he made that statement.

SENATOR WIELECHOWSKI asked if the BP corrosion work ended in 2008.

MR. FRIED replied he couldn't pinpoint the time.

SENATOR WIELECHOWSKI asked if he had a breakdown of the number of residents versus nonresidents filing for unemployment.

MR. FRIED said in 2008, the number of residents receiving unemployment that were tied to the oil and gas industry was about 1,200, and increased to about 2,200 in 2009. In that same data set, nonresident numbers increased from 154 in 2008 to almost 500 in 2009. Resident numbers doubled and nonresident numbers almost tripled. In 2010, resident numbers dropped to about 2,100 and nonresident numbers stayed about the same. He

added that there is a certain amount of churning in the oilfields as contracts come and go, even if overall employment doesn't change much.

MR. FRIED summarized that the large increase in unemployment numbers between 2008 and 2009 was due to the job losses that took place during the latter part of 2009. Those numbers began to recover in 2010 and unemployment claims began to drop.

SENATOR WIELECHOWSKI asked if the 2,200 residents that filed for unemployment in 2009 are new people filing or if the 1,200 residents that filed in 2008 are included.

MR. FRIED replied it's hard to tell, but he would guess that there was both overlap and new claimants.

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SENATOR MCGUIRE asked if DOLWD had ever collected oil and gas industry data that more clearly defined work categories like drilling, transportation, catering and other companies that are directly involved in the oil industry.

MR. FRIED replied the definitions are specific to the oil industry, which means they exclude people that are involved in transportation or catering, despite the fact that those players also directly work in the oilfield. He explained that a number of years ago, DOLWD looked at Prudhoe Bay and found that about 25 percent of the employment that was generated in the oilfields was from non-oilfield employers. They weren't drilling companies like Schlumberger, ConocoPhillips, CH₂MHill, or Doyon Drilling. He said it's difficult for DOLWD to separate those non-oil industry employers because a lot of those players (the catering, transportation and construction companies) are also involved in activity elsewhere in the state and in other sectors of the economy.

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SENATOR MCGUIRE asked if DOLWD data delineates the categories of activities to maintain existing infrastructure as opposed to activities that are specifically related to oil and gas extraction.

MR. FRIED answered no. DOLWD does break out oil producers from oilfield service companies, but not the activity of exploration versus maintenance. Most of the North Slope employers work both sides so there is no way of knowing if they are involved in maintenance activity or exploration activity.

CO-CHAIR PASKVAN asked if the definition had changed in last 6-10 years.

MR. FRIED answered no; there had been no change in the definition of the oil industry and the oil industry employers that fall within that category.

SENATOR WIELECHOWSKI said the jobs issue is critical, and at some point he'd like a deeper analysis to figure out why employment on the North Slope is at a record high, yet Alaskans are saying they've lost their jobs. Between 2008 and 2009 the Alaskan unemployment rate nearly doubled so this is a good discussion to have, he stated.

CO-CHAIR PASKVAN reiterated the committee's extreme concern about the apparent conflict between overall employment versus resident employment numbers on the North Slope.

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COMMISSIONER BUTCHER continued the presentation.

5. Use and Expansion of Tax Credits - The amount of credits used has increased annually since 2006 and that trend is expected to continue, because new credit programs were added during the 2010 legislative session. He noted that DOR continues to look at how effective those tax credits are.

CO-CHAIR PASKVAN observed that the "Conclusions and Recommendations" section of status reports includes the statement that "it is untenable to blame a tax system for the lack of industry investment." He asked Commissioner Butcher to comment.

COMMISSIONER BUTCHER replied that sentence continues to state that, "it is equally untenable to claim that the tax system is the reason increased activity or investment occurs." He explained that the point is that industry investment is dependent on many factors, and changing just one element won't solve all the problems.

CO-CHAIR PASKVAN said he was trying to square that qualifying statement with Commissioner Galvin's January 14, 2010 ACES status report that indicated that ACES was performing as it was expected to perform when it passed in 2007. The economic provisions resulted in the anticipated revenue levels, and the

investment incentives appeared to distribute the increased tax burden in a manner that continued to encourage investment.

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COMMISSIONER BUTCHER responded the current status report looks at information that is one year beyond where Commissioner Galvin was looking. At the beginning of 2010 his team might not have been aware that only four exploration wells would be drilled (two of which would be delineation wells), and that just one exploration well would be drilled in 2011. He also didn't know that the result would be a spike in the price of oil.

SENATOR WIELECHOWSKI said DOR's conclusion just one year ago was that the investment incentive provisions in ACES were contributing to increased levels of expenditure. He asked Commissioner Butcher if he was saying that he had evidence to the contrary.

COMMISSIONER BUTCHER confirmed that there had been increased spending since ACES passed, and added that there was already increased spending before both ACES and PPT passed. He opined that since the slope was already increasing, it would be difficult to say that the increase was due to passage of either tax legislation.

SENATOR WIELECHOWSKI asked if he believes that the \$3 billion in tax credits led to any increased investment or exploration, or that it should be scrapped.

COMMISSIONER BUTCHER answered the changes made in ACES resulted in a lot of new companies and smaller independents coming to Alaska. There are many positive aspects to ACES and it definitely should not be scrapped. However, the new companies have indicated ongoing difficulty getting the larger companies to move from exploration to production as a result of the progressivity tax. That is the focus of the governor's legislation.

SENATOR WIELECHOWSKI said he finds it implausible that exploration companies would come to Alaska and spend huge amounts of money to buy leases and explore before analyzing the potential costs, profits and taxes under ACES.

COMMISSIONER BUTCHER suggested he ask the companies specifically what they look at in those situations. He noted that Savant, for example, last year testified that they loved the credits, but had difficulty getting partners to move on to production.

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SENATOR WIELECHOWSKI asked if the administration believes that it is helping the investment climate when it says that Alaska is closed for business; the tax rates are too high and the state is uncompetitive.

COMMISSIONER BUTCHER responded the administration is not saying that Alaska is closed for business. There are many tax credits that make investment in Alaska attractive, but the administration believes the tax needs to be adjusted. In part, this belief is based on conversations the administration has had with the companies that have come to Alaska or those that would like to come.

CO-CHAIR PASKVAN asked Commissioner Butcher to address point 6.

COMMISSIONER BUTCHER continued.

6. Tax Administration and Compliance - DOR continues to write regulations for the new tax system. The last audits under PPT have been completed and the first audits under ACES are underway. DOR believes that most of the work that needed to be done to change from a gross tax to a net tax has been done, and the expectation is that the audits will be accelerated thereafter. However, DOR has been hampered in its tax reporting and compliance efforts by the lack of a centralized database in which to house and manage the large volumes of oil and gas data. This slows the process and limits output.

CO-CHAIR PASKVAN summarized that the state is slow in processing the data it receives and, in part, that is the reason that DOR is unable to provide answers as to whether or not the tax credits are working to promote investment.

COMMISSIONER BUTCHER responded that doesn't help, but it's also a matter of not having passed regulations that would help to get more definitive numbers from the industry. He reiterated that he wasn't aware of that prior to becoming commissioner, but getting that information is a focus going forward.

CO-CHAIR PASKVAN noted that Senator Joe Thomas had joined the meeting.

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SENATOR WIELECHOWSKI noted that the legislative audit report found significant issues related to the auditing of ACES, and asked if he still supported reducing the timeframe to perform those audits from six years to four years.

COMMISSIONER BUTCHER replied the administration is very comfortable that the audits could be done in the shorter timeframe, but leaving it at six years is also acceptable. The provision addresses the difficulty associated with hiring and keeping good auditors and, while the situation is better now than a year ago, it is still an issue.

SENATOR STEVENS asked if it was possible to contract with independent firms to do the auditing.

COMMISSIONER BUTCHER offered to follow up with specific details about the times in the last few years that DOR has relied on contracts.

CO-CHAIR PASKVAN asked what type of industry information was missing from the DOR database and if those significant holes should be addressed in statute or regulation.

COMMISSIONER BUTCHER replied DOR doesn't get a detailed breakdown from industry on capital and operating expenses so as to know what is going into exploratory versus maintenance work. However, DOR has the regulatory authority to get more detailed information, and will probably pursue it after the end of the legislative session. He noted that the extensive regulation process that occurred during ACES focused on an open workshop process that encouraged participation from producers, legislators and any other interested parties. That same invitation will go out for the upcoming process, he stated.

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MR. TANGEMAN added that there are two issues. First is what information DOR is getting and how they get it. Second is how to handle the information. The change from gross tax to net tax resulted in a huge amount of additional information coming in, and the existing standalone systems have difficulty keeping up with the influx. He said it's often necessary to page through documents by hand to respond to legislative requests for information.

SENATOR WIELECHOWSKI asked for the timeline for when the legislature could expect to see the regulations. He reminded the commissioner that it was more than three years ago that Gaffney,

Cline & Associates highlighted that Alaska didn't have anywhere near the information that other sovereign jurisdictions had, and reinforced that point again this year. Their testimony was that Alaska is handicapped in making decisions about its economic future because it doesn't have the data necessary to manage its resource like a landowner.

COMMISSIONER BUTCHER responded that it was a personal priority and he would like to start the process this summer.

MR. TANGEMAN added that DOR was substantially caught up on the regulatory work it had done the last several years and was ready to look at what was needed and getting those additional regulations in place.

SENATOR MCGUIRE suggested that this was an opportunity to develop a robust and detailed database that could last for institutional generations. She opined that Alaska should be the number one oil and gas jurisdiction in the U.S., and its fiscal system should be able to move on a dime to respond to needs as they arise. Data should be readily available to show when and why adjustments should be made, she stated.

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CO-CHAIR PASKVAN asked who authored the January 18, 2011 report.

COMMISSIONER BUTCHER replied it was a joint process that included work from Bruce Tangeman, Cheryl Nienhuis, most of the economics team, and himself.

MR. TANGEMAN added that they relied heavily on the DOR petroleum economists and then put the report together.

CO-CHAIR PASKVAN asked Commissioner Butcher if the report was put together after he became commissioner designee.

COMMISSIONER BUTCHER replied he had an impact on the report, but it was already in a preliminary form as it was due 14 days after he started.

SENATOR STEDMAN commented that the single point audit and the marked deficiencies caught a lot of attention at the Legislative Budget and Audit meeting, and that information has since been released to the public so there are no surprises. He then highlighted that the FY12 budget did not include a request from the governor to put the database in place, despite the fact that legislators are being asked this winter to come to a decision

about the tax system and they need more data points to come to a proper conclusion. He reported that rather than waiting for the next budget cycle, the legislature was stepping forward to address this situation by including about \$34.7 million in the capital budget for the purchase and implementation of that system. He said there have already been discussions with the commissioner to identify that amount, so the department won't be taken by surprise. He emphasized that the legislature will do everything possible from a policy-making standpoint to ensure that DOR has the funds available to protect the state's interest. He stated that he and other policy makers are not comfortable that the most recent audit was conducted in 2006, and opined that the administration also would be more comfortable with a more timely audit.

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CO-CHAIR PASKVAN segued to the royalty modification issue, and asked if DOR performed an economic analysis when it contemplated a production tax reduction similar to what DNR performs when it does a royalty reduction.

COMMISSIONER BUTCHER replied he couldn't speak to the DNR program, but he could say that DOR's process was underway with both DNR and the governor's office in January when he started as commissioner. In that process, DOR looked at numbers, talked to companies and gathered as much information as possible in order to make the decision to move forward.

CO-CHAIR PASKVAN pointed out that the report on the DNR model indicates that it describes project cash flows; incorporates fiscal system attributes including state/federal taxes, state production tax, and royalty obligations; includes the metrics of annual and cumulative discounted and undiscounted cash flows; years to payout net present value, expected monetary value and internal rate of return on investment as well as state revenues. He asked if DOR intended to provide any comparable information to the legislature with respect to a production tax reduction.

COMMISSIONER BUTCHER replied DOR worked with DNR and spent a great deal of time "tweaking with brackets, with no brackets, taking a look at what ... the shifts in share would be." He offered to follow up and show DOR's various models that can be manipulated to show different scenarios. He reiterated that he would need to become more familiar with the DNR model before he could specify both similarities and dissimilarities.

CO-CHAIR PASKVAN asked if the overall debate would be enhanced if DOR were to perform a similar process to find things like internal rates of return, expected cash values and years to pay out.

COMMISSIONER BUTCHER opined that more information is always beneficial, but there will always be more information that one could have.

MR. TANGEMAN pointed out that the royalty modification analysis is done on a field-by-field basis, whereas DOR is looking at a production tax modification for the state as a whole.

SENATOR STEDMAN asked if DOR would conduct a field-by-field analysis to set up a fiscal system for a new basin or if the analysis would cover the entire basin.

MR. TANGEMAN responded the information such as internal rates of return would be of value, but his understanding was that DOR doesn't have those details. A lot of the information that companies base their decisions on is proprietary and limited with regard to what is shared with the department.

SENATOR STEDMAN observed that rate of return style calculations are done all over the world, and asked if DOR had ever looked at those when it considered things like modifying a base tax or changing progressivity.

COMMISSIONER BUTCHER responded DOR has looked at that sort of information, but it was very much an estimate and there were so many differences that it was difficult to make any specific comparison between Alberta or Nigeria or Alaska, for example.

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SENATOR STEDMAN asked if DOR runs calculations to determine rates of return, present values, and expected monetary values when it suggests changing the state's fiscal system from 25 percent to 15 percent base tax, for example.

COMMISSIONER BUTCHER responded DOR used all the information it had when it ran the different analyses, but that kind of detailed information was limited. He offered his belief that DNR receives much more detailed information in the royalty program because companies have to prove whether or not the area would be economic based on the royalty.

SENATOR STEDMAN pointed out that the state has the ability to grant royalty relief, and questioned why there wasn't a flood of royalty relief questions when the royalty ranges from 12.5 percent to 16.5 percent. He explained for the listening audience that the royalty comes off the gross value coming out of the ground, so changing it has a huge impact.

COMMISSIONER BUTCHER suggested that Kevin Banks could provide a more complete answer, but his understanding was that just four developments considered that the economics of the field hinged on the royalty. Two of those were turned down and two were worked out with the department.

SENATOR WIELECHOWSKI stated agreement with the notion that more information is better, and observed that a problem with the bill was that it had virtually no information that would cause anyone to believe that it would lead to extra production or more jobs. He said we know there was a six percent decline when the tax rate was zero percent on 75 percent of the fields; that jobs are at all-time highs, that capital expenditures are at all-time highs, that operating expenditures are at all-time highs, and that the North Slope now has twice as many producers. But we don't know why jobs are being lost; how the incentives are working; which fields are marginal; which fields will be incentivized if SB 49 passes; how much more exploration will be incentivized; which fields meet hurdle rates; if this bill will cause a single drop of oil to be put into the pipeline; if any Alaskans will be hired if the bill passes; if a single well will be drilled if the bill is passed; what the company hurdle rates are; what their net present value rates are for certain fields; what the internal rates of return are for certain fields; or how much profit Exxon makes in this state. He emphasized that the legislature needs a lot more information in order to make a decision on what will cost the state from \$7-10 billion over the next five years.

COMMISSIONER BUTCHER responded that oil continues to decline more than the department's annual revenue forecast, and there seems to be almost no exploration when oil prices are at historic highs and boons are going on all over the world. Companies have come forward and testified that SB 49 will make a material difference and while there have been no promises DOR believes that to be the case. He pointed out that there was next to no information with PPT changing from a gross tax, and then a year later PPT was changed to ACES. DOR gathers and analyzes the information it gets and then makes a decision, he stated.

SENATOR STEDMAN highlighted that the FY12 fall forecast had about \$5.5 billion going to the state and \$2.4 billion of that was royalties. He pointed out that it's not necessary to run through the math model to see that changing the royalty rate will result in a huge material difference. Obviously, they are very significant.

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COMMISSIONER BUTCHER responded that he didn't intend to convey that the issue wasn't important. He added that DNR has said that it is a piece that is more difficult to prove as to whether a field is economic or not economic.

SENATOR STEDMAN observed that one of the questions is why industry isn't coming forward and asking for relief, because requests were made and granted in the past.

MR. TANGEMAN suggested he ask Mr. Banks when DNR can enter a royalty relief negotiation. He offered his understanding that it is before a field comes on line, not necessarily after production starts.

CO-CHAIR WAGONER asked if anyone looked at a carry-forward credit tied to an increase in production, and the amount of deduction the governor wants to provide to the legacy field producers.

COMMISSIONER BUTCHER responded that DOR would be happy to talk about any issue that would facilitate the governor's goal of more production. He assured the committee that the governor would be willing to discuss any beneficial ideas.

CO-CHAIR WAGONER asked if he had information on the number of well workovers that had been done and the result.

COMMISSIONER BUTCHER replied AOGCC delivered that information to House Finance several weeks ago and will probably include that information in their presentation to this committee next week, but DOR can also provide it.

CO-CHAIR PASKVAN thanked Commissioner Butcher and Mr. Tangeman and again emphasized the importance of modeling and a detailed analysis to determine if modifying the lease terms for an applicant would or would not result in the state giving up revenue for no reason.

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KEVIN BANKS, Director, Division of Oil and Gas, Department of Natural Resources (DNR), stated that the issue is royalty modification, and that is governed by AS 38.05.180(j).

He explained that the DNR commissioner has always had the statutory authority for royalty modification, but until about 1996 it could only be used for fields that fell into two categories: 1) to prolong the economic life of a field that was about to be shut in because the operating costs had exceeded the operating revenues, or 2) to allow lessees to reestablish production from a shut-in field. In both cases, royalty could be reduced to as little as three percent.

A third category was added in 1996 to the authority of the commissioner to relieve royalty for fields that were not yet in production. To qualify, the field had to be sufficiently delineated to satisfy the commissioner, it had to be a field that would not otherwise be economically feasible, and the royalty rate could not be reduced below five percent.

MR. BANKS said the important discussion that took place in those days was that tinkering with the royalty modification statute meant the legislature was tinkering with contracts that had been let competitively. In tinkering with the statute, the state arguably was pushing up against the doctrine of material change to a competitively let contract. The legislature was also concerned that the royalty modification be both efficient and effective. Effective means that it actually changes the behavior of the applicant, and they go into production when they otherwise would not. Efficient means the state would not give away anymore royalty relief than was necessary.

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MR. BANKS said the legislation stipulated that the information provided to the commissioner would make a clear and convincing showing that relief was in the best interest of the state. Because of the complexity of the analysis, DNR has the ability to expedite the process by selecting a contractor to do the work and the lessee pays for it.

He explained that DNR offers a relief mechanism on a sliding scale based on price, but there is some latitude to tailor it to the situation at hand. In addition to price, the relief can be conditioned on production rates, ultimate recovery, capital expenditures or operating expenditures. Finally, the legislature can review the analysis through the Legislative Budget and Audit Committee.

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MR. BANKS highlighted the following:

- BP applied for royalty relief for Milne Point in 1995.
- UNOCAL in 1997 applied for royalty relief for ten platforms in Cook Inlet, which didn't fit any of the three categories. The legislature eventually amended the statute to allow a decrease in royalty from platform production. Depending on the rate of production, it could be as low as five percent.
- Phillips in 1999 applied for royalty relief for the Tyonek platform to develop the Tyonek Deep under the sufficiently delineated new field category, but the application was withdrawn when the company merged with Conoco.
- Pioneer in 2005 applied for and received royalty relief for the Oooguruk unit.
- E&I in 2007 applied for and received royalty relief for the Nakiachuk unit. An earlier application by Kerr McGee for that same unit was denied, in part because the cost structure showed that royalty relief wasn't necessary. The E&I application had much better information about the costs and the royalty relief was structured around a minimum price protection, rather than an outright five percent royalty relief. The Nakiachuk sliding scale royalty doesn't kick in until the price falls below \$42.64.
- Chevron applied for royalty relief at the Ivan River and Stump Lake units in Cook Inlet, but the application was withdrawn before a full analysis was done.

MR. BANKS mentioned an earlier comment about the huge amount of royalty that is collected as part of the state's revenue, and submitted that unless some of that production is in the category of "about to be shut in," there isn't a royalty relief mechanism in statute that can have any effect on that production.

SENATOR STEDMAN clarified that his point was more broadly directed. He then asked if a company could still ask for royalty relief given the opportunity for a 40 percent exploratory credit.

MR. BANKS answered yes. He explained that DNR applied the tax credits under ACES when evaluating the Nakiachuk royalty relief application, and ended up awarding royalty relief, but Nakiachuk was different than Oooguruk in that the behavioral mechanism for

the Nakiachuk application was to provide some insurance for low price situations.

SENATOR STEDMAN asked if he should conclude that if the situation was in front of DNR today and the price of oil was \$100/barrel, royalty relief would not be granted because the company's returns would be fairly attractive.

MR. BANKS replied they probably wouldn't qualify for royalty relief if costs and production rates were the same, and the only difference was the \$100 price of oil.

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SENATOR WIELECHOWSKI asked about the merit of having a provision in law to provide production tax relief, much the same as with royalty relief. DNR would look at the company's books to evaluate the economics in terms of meeting hurdle rates, net present value and internal rates of return.

MR. BANKS reiterated that royalty relief is a rather difficult process simply because of the lengthy analysis that DNR does. Second, he said, the applicant has to be sitting on a prospect that is sufficiently delineated to provide a clear and convincing showing that relief is needed, and it takes a fair amount of investment to get to that point. Third, it's something of a deterrent in terms of new exploration and new activities, in part because nobody is betting on failure and the need to request royalty relief. Finally, there was the concern about how different lessees would be treated under the rules of royalty relief. The definition of royalty relief was tightly woven into the legislation so there would never be a situation where a commissioner could grant relief to one applicant and deny it to another similarly situated applicant.

CO-CHAIR PASKVAN thanked Mr. Banks and commented that production tax reduction was an interesting concept, and might be a process that defines best interests in a way that gets positive results for both the state and the company. [SB 49 was held in committee.]

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There being no further business to come before the committee, Co-Chair Paskvan adjourned the meeting at 5:03 p.m.