

SENATE FINANCE COMMITTEE  
March 13, 2013  
1:42 p.m.

1:42:21 PM

CALL TO ORDER

Co-Chair Meyer called the Senate Finance Committee meeting to order at 1:42 p.m.

MEMBERS PRESENT

Senator Pete Kelly, Co-Chair  
Senator Kevin Meyer, Co-Chair  
Senator Anna Fairclough, Vice-Chair  
Senator Click Bishop  
Senator Mike Dunleavy  
Senator Lyman Hoffman  
Senator Donny Olson

MEMBERS ABSENT

None

ALSO PRESENT

Senator Cathy Giessel; Senator Burt Stedman; Roger Marks, Legislative Consultant, Legislative Budget and Audit Committee; Barry Pulliam, Managing Director, Econ One Research, Inc.; Michael Pawlowski, Advisor, Petroleum Fiscal Systems, Department of Revenue; Bruce Tangeman, Deputy Commissioner, Tax Division, Department of Revenue

SUMMARY

SB 21 OIL AND GAS PRODUCTION TAX

SB 21 was HEARD and HELD in committee for further consideration.

#sb21

SENATE BILL NO. 21

"An Act relating to appropriations from taxes paid under the Alaska Net Income Tax Act; relating to the oil and gas production tax rate; relating to gas used

in the state; relating to monthly installment payments of the oil and gas production tax; relating to oil and gas production tax credits for certain losses and expenditures; relating to oil and gas production tax credit certificates; relating to nontransferable tax credits based on production; relating to the oil and gas tax credit fund; relating to annual statements by producers and explorers; relating to the determination of annual oil and gas production tax values including adjustments based on a percentage of gross value at the point of production from certain leases or properties; making conforming amendments; and providing for an effective date."

[1:43:43 PM](#)

ROGER MARKS, LEGISLATIVE CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE, presented the PowerPoint presentation, "SB 21: Long-Run Revenue Scenarios" (copy on file). He examined the fiscal implications of adjusting oil and gas taxes in order to create a more competitive investment climate for Alaskan oil. He voiced that in 2007 the state instituted a production tax increase. He shared that during the same time period, Alberta, Canada increased oil tax royalties. The oil drillers moved their operations to nearby provinces in Canada and oil production in Alberta declined. Subsequently, Alberta reduced its royalties and production increased. He furthered that the infrastructure on the North Slope was worth \$60 billion and could not be relocated. He characterized the present situation as "captive investment." The producers kept producing oil and paid increased taxes to the state.

Mr. Marks discussed Slide 2, "Alaska North Slope (ANS) Production under Status Quo Current Decline Rate Extended Out 20 Years." The slide graphed the decline curve by barrels per day from 2006 through 2023. He stated that the "predictable" consequence of the increased tax structure caused a shift in investment from Alaska to worldwide upstream capital investment, which increased 50 percent. Conversely, investment in Alaska's oil industry remained at 2007 levels. Alaskan North Slope oil production dropped 300,000 barrels per day (bbl./d) to 550,000 bbl./d currently. Within the next twenty years ANS production was predicted to decrease to 200,000 bbl./d. He cautioned that the Department of Revenue's (DOR) production forecasts were historically high.

Mr. Marks pointed to two important elements when instituting changes in the tax structure in order to create a more competitive environment: (1) Revenue comparisons could not use the same production number of barrels when examining the difference between a non-competitive tax system and a competitive one. A competitive tax system needed more investment in production. (2) In the short term, changes in the production tax needed "lead time" for the investment in production response to work itself out. Reductions in revenue were expected.

Mr. Marks turned to Slide 3, "ACES Total Petroleum Revenues over 20 Years, ACES at Trended Current Production Forecast vs. CSSB 21 (FIN) with Various Potential Production Increases \$110/bbl. ANS Market Price (\$billions)." He predicted that a competitive tax system would increase investment and production. He commented that ANS recoverable oil was estimated at 10 billion barrels. The amount of increased investment and production was impossible to predict but estimation was possible. He explained that under ACES (Alaska's Clear and Equitable Share) and the current production decline rate the state was estimated to receive \$87 billion in total petroleum revenues (production tax, royalties, property tax, and state corporate income tax). He hypothesized a scenario that incorporated the predicted base production and added increments of 10,000 bbl./d taxed under the provisions of CS SB 21 (FIN) and calculated that over a 20 year period the state would generate increase revenue above ACES at 70,000 additional bbl./d. He noted that 70,000 bbl./d was not that large of an increase when compared to the fact that oil production declined 300,000 barrels per day within the last six years. North Slope proven oil reserves stood at 4 billion barrels. He reiterated that recoverable oil reserves were estimated at 10 billion barrels.

Mr. Marks displayed Slide 4, "Total Petroleum Revenues over 20 Years, ACES at Trended Current Production Forecast vs. CSSB 21 (FIN) with Various Potential Reserve Growth \$110/bbl. ANS Market Price (\$billions)." He explained that 70,000 bbl./d was only a small fraction of the potential reserve base; one half billion barrels per day out of a 10 billion barrel potential reserve was only 5 percent of the potential reserve base. He concluded that the tradeoff of modifying the tax system was lost ACES revenue in the short term with the potential for more or less new tax revenue in the future.

[1:52:27 PM](#)

Senator Hoffman referred to his support of tax credits in previous years. Mr. Marks replied that "there were pro and cons to credits." He discerned that the expenditure credits were not increasing production. He related that credits incentivize production and when utilized in the investment period of the project they positively affect the net present value.

Senator Hoffman wondered whether the credits under ACES were expected to produce new oil over the next 10 years. Mr. Marks responded that any increased production was included in the long term production forecast.

Co-Chair Meyer cited a slide from a previous presentation and asked for clarification on extending the time period of the GRE (Gross Revenue Exclusion).

BARRY PULLIAM, MANAGING DIRECTOR, ECON ONE RESEARCH, INC., reviewed Slide 6, "Relationship Between Length of GRE and Percent of NPV of Drilling Cost Initial 1,500 BPD, 12% Decline Rate" of "Comments on Senate Finance CSSB 21" (March 12, 2013) (copy on file) from the previous presentation. He explained that the analysis translated the value of the GRE into an equivalent capital credit value. The longer the GRE applied and the higher percentage of the GRE the greater monetary value it produced. He delineated that at a 20 percent GRE the tax rate was reduced each year. Within five years half of the oil from the well would be produced and was the equivalent of a 30 percent capital credit up front. He added that the GRE at 15 percent would yield the same results when applied over a longer time period. He recommended the lower GRE, citing benefits for the producers and the state. Consequently, each year the revenue loss to the state would be reduced with the same level of benefit to the producer extended over a longer period of time. The scenario avoided increasing the tax during the production period of the well, therefore extending the life of the well.

[1:59:37 PM](#)

Vice-Chair Fairclough asked about "price distortions" at various prices per barrel. Mr. Pulliam explained that percent fluctuations would happen concurrently with price fluctuations. He examined the GRE after 5 years at \$80 per

barrel as opposed to \$100 per barrel. The NPV (net present value) of GRE as a percent of drilling costs would drop to 20 percent instead of 30 percent. If the prices were \$120 per barrel the percentage would rise to 40 percent of drilling costs. The fluctuations could be avoided by eliminating the GRE and instituting an additional \$4 per barrel allowance. The benefit would be "invariant" to price.

Co-Chair Meyer asked for clarification on the later point.

Vice-Chair Fairclough asked whether he was referring to the proposed 30 to 5 ratio [30 percent tax rate and \$5 production allowance per barrel and raising the \$5 to \$9. Mr. Pulliam answered, "Yes." He explained that eliminating the GRE for new production and adding an additional \$4 per barrel for a total of \$9 per barrel production allowance coupled with the 30 percent tax rate for new production eliminated the need for a GRE. The additional \$4 per barrel took the place of the GRE.

Vice-Chair Fairclough asked whether the change eliminated the need for additional accounting and acted as a bonus for new oil production. Mr. Pulliam responded in the affirmative. He offered that the method was an additional way to reduce the tax rate without a GRE.

Mr. Pulliam turned to Slide 7, "Example of Tax Calculation With and Without GRE." He explained that the GRE was based on the wellhead value. He pointed out that at \$100 per barrel the GRE translated to a \$15 reduction in taxable value. He furthered that if the wellhead value was \$120 per barrel the value of GRE would be greater than \$15; worth more at a higher price. Conversely, the GRE was worth less at a lower price; a well head value of \$80 per barrel was worth \$12. He concluded that the GRE fluctuated with oil price fluctuations. The fixed per barrel allowance did not change as prices changes. He summarized that the GRE equivalent of a fixed price allowance meant that with lower prices the allowance as a percentage was higher and at higher prices the percentage was lower.

Mr. Pulliam discussed Slide 3, "Summary of Investment Measures Incumbent Investment in 50 MMBO Field \$20/Bbl. Development Capex, 12.5% Royalty Rate." The slide demonstrated that a \$5 allowance was the equivalent of a 20 percent GRE percentage at \$80 per barrel and at \$150 per

barrel the allowance was equivalent to a GRE of 10 percent and at \$60 per barrel the percentage equated to a 30 percent GRE. With a fixed barrel allowance the value was greater at lower prices and lower at higher prices where the incentive wasn't as necessary. He recommended a higher fixed per barrel allowance for new oil instead of a GRE.

Vice-Chair Fairclough wondered what the administration thought of eliminating the GRE and adopting a fixed price allowance.

[2:07:29 PM](#)

MICHAEL PAWLOWSKI, ADVISOR, PETROLEUM FISCAL SYSTEMS, DEPARTMENT OF REVENUE, shared that the administration considered striking a balance with utilization of the GRE. The fixed price allowance created a higher value at lower prices and the GRE offered higher benefit at higher oil prices. The administration wanted to balance protection for the state at lower oil prices and how much was offset at increased per barrel allowance. Both methods produced a curve. The administration decided that "smaller per barrel allowances and more comparable GRE's was a healthy balance."

Senator Dunleavy asked how confident Mr. Pulliam was that increased production would occur if the production tax rate was reduced. He asked what his direct experience with the situation was. He thought that the tax reduction could be viewed as either an investment or a giveaway. Mr. Pulliam shared that he had 25 years' experience in the petroleum industry as an economist. He exemplified a situation where only two gas stations existed in a small town and the gas station with lower prices did more business. The higher priced gas station will lower its price of gas. He believed that in markets with "rational economic actors" price and volume were "inversely related." He expected that the state would attract more investment but was uncertain whether production would compensate the state sufficiently for the revenue lost due to the reduction in taxes. The results were difficult to predict with a "high degree of accuracy."

Mr. Pulliam shared that an academic research study examined a change in Wyoming's tax rate by 5 percent (to 10 percent) and concluded that the change resulted in a 20 percent impact on drilling and a 6 percent impact on production. He noted that 5 percentage points equaled 3 percent in

government take. The Alaskan proposal supported a change of government take by 10 percent, which "would suggest a pretty large response in drilling and production." Predictions from the various methods of analysis determined that the state should expect a "pretty good response." He judged that the state had a reputation for instability in tax systems. He pointed to the ELF (Economic Limit Factor) system at one "extreme" and ACES at the other. He thought a stable tax system, if not perfect, was more beneficial than continued adjustments to the tax structure.

[2:15:33 PM](#)

Senator Dunleavy wondered what other model worldwide comes the closest to mirroring Alaska's situation of high taxes, declining production, and other related variables. Mr. Pulliam remembered that a similar situation occurred in the United Kingdom. The government increased government take as oil fields matured. The government subsequently embarked on a program of field allowances in 2012. The production response was too early to determine but the amount of applications for development was substantial. The government held a high expectation for increased production.

Senator Dunleavy reiterated his question about how confident Mr. Pulliam was that the tax reduction would increase production in Alaska. Mr. Pulliam stated that the current tax structure was in need of "meaningful change." The state had the ability to analyze and change the tax system if the proposed changes did not work. The state was currently engaged in the same process with ACES. As production in the state declined, the state needed to create a competitive environment to attract new investment. He determined that the first successful sign would be in increased investment. He stated that "production will follow investment." He discerned that the various versions of SB 21 all contained significant enough changes to spur significant responses.

Co-Chair Kelly announced that the state wanted to choose the accurate tax structure now and avoid changing it again in the future. He furthered that the state had a history of incentivizing exploration and spending and it worked. The state currently wanted to incentivize production. He believed that production would increase with the passage of the legislation. Mr. Pulliam agreed that "getting it right"

was important and furthered that "stability" was the main element. He commented that if the system wasn't working it would be appropriate to re-examine it for further changes.

Co-Chair Kelly stated that from personal experience in retail that if reducing prices didn't work the first time more reduction was necessary.

[2:23:42 PM](#)

Senator Bishop referred to Mr. Pulliman's experience and queried what a reasonable amount of time that Alaska should expect increased activity was. Mr. Pulliam replied that increased investment should begin within a "couple years."

Senator Bishop stated that from personal experience with collective bargaining that once something was given up it was difficult to get it back. He believed it was important to get the right tax system for future natural gas investment opportunities on the North Slope. He was encouraged by industries pledge to create more jobs for Alaskans and grow the state's economy.

Vice-Chair Fairclough referred to prior testimony related to incomplete audits. She asked whether incomplete audits under ACES should be finished before changing the tax system and if the information from the completed audits could effectuate "more informed" decisions regarding SB 21. Mr. Pawlowski answered in the negative.

BRUCE TANGEMAN, DEPUTY COMMISSIONER, TAX DIVISION, DEPARTMENT OF REVENUE, replied that the department received monthly information from tax payers. He detailed that an audit was a compilation of information from the past twelve months. The department was currently auditing taxes from 2007 on ACES and PPT (Petroleum Production Tax). The department did possess accurate tax information from subsequent years from the monthly tax filings paid by the taxpayers. He recapped that an audit was a reconciliation of large quantities of information already received. He added that DOR was operating within the statutory timeframe for completing audits.

Vice-Chair Fairclough surmised that DOR had not received information from audits that would affect the information the department was utilizing as the basis for changing the tax regime. Mr. Tangeman concurred.

Vice-Chair Fairclough shared that she heard previous testimony in a DOR subcommittee that audit completions were slowed down due to various changes in federal regulation. She confirmed that DOR was within the regulatory timeframe for completing the audits. Mr. Tangeman added that each time an audit was re-opened the six year period for completion began again.

Vice-Chair Fairclough asked whether a legislator could sign a confidentiality agreement and examine tax records. Mr. Tangeman answered, "Yes."

Vice-Chair Fairclough shared that in the interest of transparency, individual legislators had access to the unaudited oil tax records.

SB 21 was HEARD and HELD in committee for further consideration.

#

ADJOURNMENT

[2:33:19 PM](#)

The meeting was adjourned at 2:33 p.m.