

**ALASKA STATE LEGISLATURE**  
**SENATE RESOURCES STANDING COMMITTEE**

February 11, 2013

3:31 p.m.

**MEMBERS PRESENT**

Senator Cathy Giessel, Chair  
Senator Fred Dyson, Vice Chair  
Senator Peter Micciche  
Senator Click Bishop  
Senator Anna Fairclough  
Senator Hollis French

**MEMBERS ABSENT**

Senator Lesil McGuire

**COMMITTEE CALENDAR**

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."

- HEARD AND HELD

**PREVIOUS COMMITTEE ACTION**

BILL: SB 21

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

|          |     |                                   |
|----------|-----|-----------------------------------|
| 01/16/13 | (S) | READ THE FIRST TIME - REFERRALS   |
| 01/16/13 | (S) | TTP, RES, FIN                     |
| 01/22/13 | (S) | TTP AT 3:30 PM BELTZ 105 (TSBldg) |

01/22/13 (S) Heard & Held  
 01/22/13 (S) MINUTE(TTP)  
 01/24/13 (S) TTP AT 3:30 PM BUTROVICH 205  
 01/24/13 (S) Heard & Held  
 01/24/13 (S) MINUTE(TTP)  
 01/29/13 (S) TTP AT 3:30 PM BELTZ 105 (TSBldg)  
 01/29/13 (S) Heard & Held  
 01/29/13 (S) MINUTE(TTP)  
 01/31/13 (S) TTP AT 1:00 PM BUTROVICH 205  
 01/31/13 (S) Heard & Held  
 01/31/13 (S) MINUTE(TTP)  
 02/05/13 (S) TTP AT 3:30 PM BUTROVICH 205  
 02/05/13 (S) Heard & Held  
 02/05/13 (S) MINUTE(TTP)  
 02/07/13 (S) TTP AT 3:30 PM BUTROVICH 205  
 02/07/13 (S) Moved SB 21 Out of Committee  
 02/07/13 (S) MINUTE(TTP)  
 02/08/13 (S) TTP RPT 1NR 4AM  
 02/08/13 (S) NR: DUNLEAVY  
 02/08/13 (S) AM: MICCICHE, GARDNER, FAIRCLOUGH,  
 MCGUIRE  
  
 02/08/13 (S) LETTER OF INTENT WITH TTP REPORT  
 02/09/13 (S) TTP AT 10:00 AM BUTROVICH 205  
 02/09/13 (S) -- MEETING CANCELED --  
 02/11/13 (S) RES AT 3:30 PM BUTROVICH 205

**WITNESS REGISTER**

BRYAN BUTCHER, Commissioner  
 Department of Revenue (DOR)  
 Juneau, Alaska

**POSITION STATEMENT:** Explained revenue implications of SB 21.

DAN SULLIVAN, Commissioner  
 Department of Natural Resources (DNR)  
 Juneau, Alaska

**POSITION STATEMENT:** Provided background and rationale for policies in SB 21.

MIKE PAWLOWSKI, Advisor  
 Petroleum and Fiscal Systems  
 Department of Revenue (DOR)  
 Juneau, Alaska

**POSITION STATEMENT:** Walked the committee through SB 21 so that they could understand the language and locations of the provisions in it.

JOE BALASH, Deputy Commissioner  
Department of Natural Resources (DNR)  
Juneau, Alaska

**POSITION STATEMENT:** Explained the Gross Revenue Exclusion (GRE) in SB 21.

**ACTION NARRATIVE**

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**CHAIR CATHY GIESSEL** called the Senate Resources Standing Committee meeting to order at 3:31 p.m. Present at the call to order were Senators Fairclough, French, Micciche and Chair Giessel.

**SB 21-OIL AND GAS PRODUCTION TAX**

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CHAIR GIESSEL announced SB 21 to be up for consideration.

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SENATOR BISHOP joined the committee.

BRYAN BUTCHER, Commissioner, Department of Revenue (DOR), Juneau, Alaska, introduced himself.

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DAN SULLIVAN, Commissioner, Department of Natural Resources (DNR), Juneau, Alaska, introduced himself.

COMMISSIONER SULLIVAN began the first part of the presentation saying that throughput decline is the most urgent issue facing the economic future of Alaska and his goal today was to provide a little bit of background on the Trans Alaska Pipeline System (TAPS) throughput and describe the challenge in the broader context of what is going on in the country and globally with energy developments and underscore the fact that the decline is not inevitable. There are many examples where the state can look at how other basins have turned around serious production declines and Alaska can do that, too!

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He said TAPS is a critical state and national energy asset and having the federal government as a partner is critical in turning the decline around, but he hadn't seen much interest from them. TAPS used to represent 25 percent of US domestic production and he said the administration sees the decline as

the "ultimate giveaway." Bloomberg reported about a month ago that it lost 40,000 barrels a day from December 2011 to December 2012; at \$100/barrel that is about \$1.5 billion that is not circulating through either state coffers or the Alaska economy. That revenue is gone and he stated that is the ultimate giveaway to future generations of Alaskans.

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COMMISSIONER SULLIVAN said the North Slope is a mature basin but the state as well as the United States Geological Survey (USGS) believe that it still has enormous opportunity, but there is some urgency he said recalling a TAPS shutdown that happened two years ago in 40 below zero weather. If you talk to Admiral Barrett or the folks at Alyeska, getting it back up and running was not a sure thing. The lower output TAPS has each year, the more risk there is of it shutting down. Companies will be required to spend more on maintaining existing infrastructure and that also has an impact with regard to how new explorers view the state and on the revenues the state will be getting. The best way to address these challenges is to turn the throughput around.

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COMMISSIONER SULLIVAN said many positive things are going on that are providing Alaska the wherewithal to address this challenge. A huge resource basin still exists on the North Slope and its next phase of development includes huge fields, smaller conventional fields, unconventional oil and the fact that much of its area is still relatively unexplored, enough to sustain Alaskans for decades.

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SENATOR DYSON joined the committee.

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COMMISSIONER SULLIVAN said the other positive development that has happened in the last couple of years is the very significant renaissance of energy production in the US and the Organization for Economic Co-operation and Development (OECD) countries; the International Energy Agency (IEA) has predicted the US will become the world's largest global oil and gas producer by 2020, overtaking Saudi Arabia and Russia. This monumental shift has all kinds of positive implications. The Financial Times reported an estimated \$600 billion was spent in 2012 in the US and OECD and that was projected to increase to \$650 billion in 2013; unfortunately he estimated that only about half of 1 percent of that \$600 billion went to Alaska in 2012. He said it was

important for this committee to realize that the US energy renaissance is happening and that Alaska should be leading it not dragging it down. The industry investment is out there for Alaska to get.

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COMMISSIONER SULLIVAN said most other basins had or were in the process of turning around their production declines; that Alaska clearly has better geology companies agree, but it still is not getting any of that investment. One Internet article said the UK was turning its North Sea production around with tax reform and reductions and that area is mature and in many other ways analogous to Alaska.

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COMMISSIONER SULLIVAN said Apache had also turned around a declining field by using technology here in Alaska. So, facilitating the next phases of North Slope development in terms of unconventionals or smaller pools of conventionals is not just about tax reform. He said the DNR went to Houston last week and set up a booth meeting with dozens of companies that talked about Alaska and its resource basin, but a continuing theme from those companies was that while they recognized the resource base they also recognized the costs around developing them; one was Alaska's high production taxes particularly at high prices.

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SENATOR FRENCH ask how Alaskans would know this bill is working if it passes. When throughput goes up?

COMMISSIONER SULLIVAN replied yes; they are focused on the throughput decline number, although it would not go up overnight. And they would start to see increased investment on the North Slope.

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COMMISSIONER BUTCHER said the governor's oil tax reform principles were under a base of getting Alaska more competitive. If you look at the investment and job increases going on in other jurisdictions you see that Alaska is lagging. Alaska has the highest oil taxes in North America in the current high price environment; in fact it is second to Norway among OECD states and countries and they don't have to go much higher to pass Norway. Taxes are not the only thing that companies base their decisions on, but it's a big piece. Combining that with how expensive it is to do business on the North Slope, it is not

surprising that Alaska is not seeing what is going on in almost every other oil producing jurisdiction.

He outlined the governor's four tax reform principles. It must:  
-be fair to Alaskans.

-encourage new production in new and legacy fields

-be simple so that it restores balance to the system

The state takes a disproportionately large chunk of revenue at high ends and at low ends we take a very minimal piece of it. In a way at low prices you would hope to have a higher percentage coming in and we have very little; at high prices when potentially we have enough coming in that we don't need to take a huge piece and we are taking a large piece. We have one of among the most complex tax systems in the world; companies struggle with understanding it.

-be durable for the long-term

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COMMISSIONER BUTCHER explained that companies view our tax system as being very complicated to explain to board members making the return on investment equation hard to calculate. It has to do with how progressivity works at any particular dollar amount, how the tax credit system works and with how it is calculated on a monthly basis rather than annually.

The tax reform must be durable for the long-term. Alaska's oil tax structure has changed too many times over the last few years and if you think of being a company and looking at some areas around the world that don't change very often, they know what they are going to get 10 years out. They look at Alaska and see it changing every couple of years and in the years it's not, change is seriously being talked about.

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He said that the DNR and DOR had been working closer than previously and had brought on a new consultant, Econ One Research with Barry Pulliam, who has worked for the administration and the legislature before.

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CHAIR GIESSEL asked what he meant by tax reform "being fair to Alaskans." Is there a particular way to divvy that up, 60/40?

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COMMISSIONER BUTCHER replied that is one issue that makes this topic so difficult. They started out looking at Jay Hammond's

one-third/one-third/one-third concept, but of course, it doesn't work out that way; the state government takes much larger than a third share and the federal government takes less. Ultimately, Alaskans can define what makes a lot of sense to the state, but if it's not getting any new development or new production, it needs to take a fresh view.

COMMISSIONER SULLIVAN commented that he thinks that fairness also goes to future generations of Alaskans and that the decline status quo approach is unfair now as well as into the future.

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COMMISSIONER BUTCHER said the tax reform team reviewed previous work by the legislature and the administration, work done during the past two years, work done during ACES, PPT, ELF and identified problems with the current tax system as follows:

- declining production of 6 percent per year
- competitive environment
- progressivity

It's difficult piece to compare to other areas that don't have it or have it in a very simple way such as North Dakota that has 8.5 percent up to \$50/barrel and 11 percent after that, which is very easy to calculate. Their tax department has one person doing its oil taxes as opposed to Alaska's Army.

- tax credits

(Which ones are working and which ones need tweaking to be a little more effective)

SENATOR FAIRCLOUGH asked for a better explanation of North Dakota progressivity.

COMMISSIONER BUTCHER explained that they use a gross tax, which is much simpler (although he wasn't suggesting going to that) and it's two-tiered; up to \$50 is taxed at a flat percent and over \$50 is taxed at a higher percentage. It doesn't go back and pick up the entire barrel like Alaska does. It is progressive in that they take a little bit higher percentage when the price of oil is higher, but it doesn't lead to the high marginal tax rates of 80 to 90 percent that Alaska's progressivity has for its government take.

SENATOR FAIRCLOUGH said she wanted it to be clear that it isn't really progressivity as the state of Alaska has defined it.

COMMISSIONER BUTCHER agreed and said he wasn't aware of any jurisdiction that had progressivity like Alaska's. Very few have it and the ones that do tend to do it bracketed.

SENATOR DYSON asked if he was inferring they should go to a gross tax as opposed to a net profit tax on new oil.

COMMISSIONER BUTCHER answered no, just the opposite. The benefit of net is that it takes into consideration a higher cost development compared to gross. But it is much more difficult to administer.

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SENATOR DYSON said they had heard testimony that our net profits tax removes the incentive for the producers to reduce their cost of drilling allowing a way to hide some of their resources from taxes and he hoped the commissioner would help them rethink that.

COMMISSIONER BUTCHER said they would in future discussion about taxes and credits.

SENATOR DYSON asked if he was suggesting that credits reduce the impediments to more efficient production.

COMMISSIONER BUTCHER answered yes; tax credits can be used to spend down one's tax liability under progressivity and all the credits in this bill were weighed separately on how effective they have been.

SENATOR DYSON said he would come back to that question at another time.

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COMMISSIONER BUTCHER said there was a coordinated effort to understand the impacts of production decline on not just revenues but on TAPS. Slide 15 compared the largest oil producing jurisdictions in North America of North Dakota, Texas, Alaska and Alberta after the 2003/04/05 price spike. They all started with very slow but steady production over many decades until the price of oil spiked. Then oil shale played a huge factor in North Dakota passing Alaska as a producer. New technology allowed this to happen, but the price of oil had to be at \$70 in order for that technology to become economic. So at \$40 or \$50 a barrel it wouldn't have happened. Alberta was faced with the same situation.

Most interesting, however, was the comparison between Texas and Alaska, because Texas had been producing oil a lot longer than Alaska. In the mid-70s they were in a decline when Alaska shot up with Prudhoe Bay. After Prudhoe Bay peaked in the mid-80s Texas and Alaska had the same decline curve until the price of oil spiked up. Then Texas turned around and Alaska stayed the same.

COMMISSIONER BUTCHER said everyone knows that shale oil is occurring in Texas just like it is in North Dakota, but the interesting things about Texas was told to him by the Texas Railroad Commission - that the Texas turn-around was done almost entirely on conventional oil and only the last two years was from shale oil.

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SENATOR MICCICHE asked if it was all conventional in 2006 and 2007 when Alaska and Texas started separating on the graph.

COMMISSIONER BUTCHER replied yes; for Texas it was a combination of going into new fields and going back to old fields that were more economical to produce at \$100/barrel than they were when they had stopped producing at \$30/barrel.

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Slide 16 compared Alaska to other opportunities using detailed models and analyzing a variety of metrics. It showed Alaska being more competitive at lower oil prices, but less competitive at higher prices. Unfortunately, companies lose money when the price goes low and it's at the high prices where they hope to recoup that loss. But in Alaska that is where the state takes a lot higher piece.

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SENATOR FAIRCLOUGH asked why he pulled a slide of West Coast ANS prices from the TTP Committee presentation.

MIKE PAWLOWSKI, Advisor, Petroleum and Fiscal Systems, Department of Revenue (DOR), Juneau, Alaska, explained that that slide evolves continually as the administration's consultant runs the numbers, which he does on a regular basis.

SENATOR FAIRCLOUGH again asked why they were not showing \$70/barrel that had some negative numbers.

MR. PAWLOWSKI replied that there was no specific reason, but it does go negative in certain circumstances for different jurisdictions.

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COMMISSIONER BUTCHER said progressivity is complicated and unpredictable both for the state and investors. Having to factor in the rate dollar by dollar makes forecasting where the price of oil is going and how it will affect a particular development more complicated. Having to calculate it monthly also makes it more difficult; and at high marginal tax rates, the government can take 80 percent plus on each increasing dollar.

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Slide 18 showed a graph on how production tax credits were applied against production tax liability as refunded tax credit certificates. The commissioner said they started with a five-year look back, but there was very little information on how tax credits were working and there wasn't a break down on what the spending was on even by the time he came into office two years ago. He explained that the DNR and the DOR had spent the previous years trying to implement and administer over 70 new regulations for ACES, which took the vast majority of their time. As a result they didn't have as good of a picture of what tax credits were doing on the North Slope as they would have liked. But 2013 will be the first year in which companies will provide a much more detailed breakdown and they expect at the close of calendar year 2013 to have a much more detailed view of what is going on up there.

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SENATOR DYSON asked if the Y axis represented billions.

COMMISSIONER BUTCHER answered that it represented millions. He said the state had paid out a little under \$6 billion in tax credits so far and an estimated \$800 million plus would be paid out in FY14. The state paid out almost \$1 billion in credits to companies that have no production yet - and at high oil prices with a lot of revenue coming in, that number doesn't jump out as much as it does when there are low oil prices and less revenue coming in. If the price of oil drops into the \$70s, \$80s or \$90s the state budget would be billions of dollars in deficit, he said and the state would still be on the hook for the credits. The current tax system really gets into difficulties if we were able to get the kind of investment we want, like \$20 billion over two or three years because we would also see the \$8 to \$12 billion going out in tax credits to pay for that investment. We

may not even have the reserves to get us to the point of that potential production, because we were too good at getting companies to come here. And that is a pretty upside down tax structure.

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COMMISSIONER SULLIVAN added that situation would happen particularly at low oil prices.

COMMISSIONER BUTCHER said the reason it was set up that way was because one company used to be able to sell its tax credits to another company, but it was discovered they would have to be sold at a discount. That was changed so that now companies can come to the state for a check.

SENATOR MICCICHE said he would like to know if the state is paying out more than it is bringing in and which were the right credits.

COMMISSIONER BUTCHER said they would get that information for him, but basically, the companies that are producing in Alaska are paying for all the tax credits. As the department analyzed what the state was getting for the \$5.85 billion, they didn't see a direct connection over these years to any production in the future. That isn't to say there isn't a connection, but the DOR couldn't see that with the information it has.

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COMMISSIONER SULLIVAN said one of the reform proposals is to significantly tighten up the nexus between credits and production.

SENATOR FAIRCLOUGH asked if they were establishing criterion in regulations for credentials of people applying to become wildcatters or explorers on the North Slope - or could Fairclough and Company come in and receive millions of dollars' worth of credit to try and dig a hole and then go back home.

COMMISSIONER BUTCHER answered if your company does the work and submits the information, you would qualify for the tax credit.

SENATOR FAIRCLOUGH said that was her point; Fairclough has no experience in oil exploration and she was asking if the department had considered criteria so they know a company actually has exploration ability and experience for getting those credits.

COMMISSIONER BUTCHER said they hadn't spent any time talking about it, but they could.

SENATOR FAIRCLOUGH asked if she would have any skin in the game if she was able to do that.

COMMISSIONER BUTCHER answered yes. The state would not be paying for 100 percent of what she was doing, but it would be a fairly high percentage depending on the credits she qualified for.

SENATOR FAIRCLOUGH asked an outside number for how much skin she would have in the game in order to qualify for Alaska's tax credits.

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COMMISSIONER BUTCHER replied that the department has generally considered that state participation is 40 to 60 percent.

He said there was growing concern that their revenue modeling didn't link throughput with tariff rates or capture any CAPEX or OPEX for low throughput mitigation measures and how those costs may affect the state of Alaska's bottom line. Low flow mitigation CAPEX and OPEX could increase tariffs by as much as \$1/barrel by 2019 and as much as \$2.50/barrel by 2022. If you assume the price of production and the tariff that was provided in the fall 2012 Revenue Sources Book, a \$1 increase in TAPS tariff would decrease state oil and gas revenue by an average of about \$110 million a year.

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COMMISSIONER SULLIVAN said it's hard to attract new investment with those kinds of TAPS tariff issues.

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COMMISSIONER BUTCHER said the proposal has the following pieces:

- eliminates progressivity and qualified capital expenditures (QCE) credits of 20 percent. Exploration tax credits would be kept the same
- reforms remaining credits to be carried forward to when there is production (up to 10 years) to subtract it from, eliminating checks going out from the State Treasury
- establish a Gross Revenue Exclusion (GRE) for newer units and new Participating Agreements (PAs) in existing units
- holds Cook Inlet and Middle Earth harmless

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SENATOR DYSON asked what "gross revenue exclusion" means and how it applies.

COMMISSIONER BUTCHER replied in this case it would mean a certain amount of barrels. If you were to start production from a new field - 100,000 barrels a day for instance - 20 percent of those would be excluded from the tax equation. So, 80,000 barrels would be taxed. It accomplishes what they were already working on - making the economics of a project better.

SENATOR DYSON asked why he was using gross instead of net on the revenue side.

COMMISSIONER BUTCHER explained that equation was done on the gross and the net would apply to the 80 percent not the entire 100,000 percent.

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SENATOR BISHOP asked if capital expenditures credits are going away.

COMMISSIONER BUTCHER replied yes, as of January 1, 2014.

SENATOR BISHOP said he was concerned that some new drilling technology that might advance and further enhance production from the existing fields wouldn't qualify and he wanted that to be a deduction. Is that eliminated in the proposal?

COMMISSIONER BUTCHER said he had a presentation that dug into that in detail that he would be happy to show him. He said no changes would be made to Cook Inlet and Middle Earth and that this change would only affect 68 degrees North latitude (the North Slope).

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Slide 21 compared the current tax rate with the proposal in SB 21. The 25 percent base rate would stay the same. Under the proposal, progressivity and the QCE tax credits would be eliminated and the proposal would add the GRE for new oil.

Under current law, they expect progressivity in FY14 to amount to approximately \$1.5 billion and the tax credits to amount to \$1 billion. So there is a much more modest number in the fiscal note as a result of that balance.

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SENATOR FRENCH asked if he would consider the bill a failure if it's adopted and production doesn't goes up.

COMMISSIONER BUTCHER replied that he would consider it a failure if it doesn't lead to new investment that leads to new production. If it goes from a 6 percent decline rate to flattening out and not turning around, he would consider that the first step.

COMMISSIONER SULLIVAN added the state is looking for levers it can pull, but it doesn't have all the levers. They might do everything right, but wished the federal government would be a little bit more motivated to help us and help the country put more oil in it.

COMMISSIONER BUTCHER said they could see when Econ One testifies if this bill passes how the state will become more competitive.

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SENATOR DYSON said he didn't want to appear negative, but he really wanted to see what the state's oil and gas people say will add another 400,000 barrels a day, because he didn't think that would happen until Shell oil comes in from the Beaufort Sea. None of the little fields coming on line are going to produce half of what one well did in the legacy field. He thought we would be lucky to just flatten the decline curve.

COMMISSIONER SULLIVAN said that was a good point and they realize the 1 million barrels a day goal in 10 years is very ambitious, but it's important to be able to lay out a vision that people can try to achieve. If they get to only 700,000 barrels a day within 10 years, he wouldn't consider that a failure. They are concentrating on a diversity of plays; there's Shell in the OCS and the shale play and that technology could take off here like it did in North Dakota and Texas. There are smaller pools that folks like Repsol are focused on. Maybe all of them will come together, but maybe only one or two. So, they have to focus on all of them and make the tax system attractive to them all.

[4:44:06 PM](#)

SENATOR MICCICHE said he thought flattening the decline curve would be an absolute victory, but reducing it to 3 percent would kick the sustainability foot out there quite a ways and give the state a chance to diversify the rest of the economy. Texas, a tired 100-year old producing economy, turned itself around and he wanted to capture some of those philosophies.

COMMISSIONER SULLIVAN explained that the spike in the price of oil made things become economic in Texas, but Alaska has progressivity which the others don't and companies can't get the same return on investment they can in Texas or elsewhere.

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SENATOR FRENCH said he had asked why there was a difference in the spring revenue forecast that had a 2 percent decline for Prudhoe Bay over the next 10 years whereas the fall Revenue Sources Book a much steeper decline and he wondered how that answer was coming along.

COMMISSIONER BUTCHER said he had just signed off on that and he should get it tomorrow.

CHAIR GIESSEL thanked them and said they would next get an overview of SB 21 from the Department of Revenue (DOR).

[4:47:24 PM](#)

MICHAEL PAWLOWSKI, Oil & Gas Project Manager, Department of Revenue, Anchorage, Alaska, stated that he would walk the committee through SB 21 so that they could understand the language and locations of the provisions in the bill. He said the principles in SB 21 were:

- Tax reform must be fair to Alaskans
- Encourage new production
- Simple so that it restores balance to the system
- Durable for the long term

He said when taken together, these guiding principles are intended to create a competitive environment that attracts new investment to the state and grows the economy.

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MR. PAWLOWSKI explained that the proposal is built around four core provisions:

- Eliminating progressivity and credits based on capital expenditures
- Reforming remaining credits to be carried forward to when there is production
- Establishing a "Gross Revenue Exclusion" for newer units and new participating areas in existing units
- Holding Cook Inlet and Middle Earth Harmless

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MR. PAWLOWSKI explained how the bill intends to eliminate progressivity starting with Section 26 on page 23, line 12, which repeals three sections of law: AS 43.55.011(g), the actual progressivity; AS 43.55.023(i), the transition investment expenditure credits that were done leading into PPT before ACES (that are no longer being used and this was an opportunity to take it off the books) and AS 43.55.160(c), the monthly production tax value that relates specifically to the progressivity going away (because it was repealed).

MR. PAWLOWSKI explained when progressivity is repealed it affects several different parts of statute. To understand those he went to the beginning of the bill, page 1, line 12.

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SENATOR MICCICHE asked what is retroactive to January 1, 2013 if this passes (page 23).

MR. PAWLOWSKI said to answer that he would have to walk through the different sections; section 3 is the Cook Inlet Middle Earth provision that was passed last year in SB 23 establishing a 4 percent gross tax for oil and gas produced from frontier basins essentially outside of Cook Inlet and not the North Slope for the first seven years immediately following the commencement of commercial production if it happens before January 1, 2012.

MR. PAWLOWSKI continued that section 7 on page 9, line 12, was the important one. He explained under current law when a qualified capital expenditure credit (QCE) is earned on the North Slope, that 20 percent credit is divided and taken over two years and is issued in two certificates, 10 percent one year and 10 percent the next year. Outside of the North Slope, credits are allowed to be taken in one year. So, because the bill is ending qualified capital expenditure credits for the North Slope after January 1, 2014, they need to go retroactive to 2013 and allow the credits to be taken in one certificate, cut the program off and end the obligation to the state.

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He explained that several years ago a fund for community revenue sharing was established and revenue from progressivity was dedicated to it. That revenue was limited to the amount of 20 percent of progressivity, intended to be \$60 million a year or up to the amount necessary to bring the balance of the fund to \$180 million, the thought being that if revenue sharing is \$60 million a year there would be three years of revenue sharing in the fund and then it could be refreshed. The proposal (section 1

on page 1, line 12, through page 2, line 7) eliminates the "20 percent of" language and rather relies strictly on the \$60 million and \$180 million criteria as the goal. But since progressivity is being eliminated, a different fund source (the Alaska net income tax which is corporate income tax payments to the state) is designated in AS 43.20.030(c) on pages 2, line 3. So under this proposal revenue sharing is not linked to one element of the oil tax system but rather the corporate income and earnings of the diversified base of businesses that pay corporate income taxes in the state of Alaska.

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MR. PAWLOWSKI said another adjustment was required due to the removal of progressivity from the bill. He said it is found in section 2 on page 2, lines 8 through 18. The language deleted is currently in AS 43.55.011(e), the primary tax section. Line 14 says that the annual production tax value of the oil or gas as it's calculated in AS 43.55.160(a) is multiplied by 25 percent. Then under the current system, that 25 percent plus progressivity is where the production tax is defined. In that progressivity is repealed, this deletes (2), the "sum of", language that is no longer necessary, because going forward the production tax will be a simple 25 percent of the net value of the oil or gas produced from the North Slope.

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SENATOR DYSON asked how \$30 figures into what he just said.

MR. PAWLOWSKI replied that the \$30 is the trigger that determines the progressivity feature each month that is being repealed. Repealing progressivity means going back into the statute and repealing every place that it is referenced in the monthly installment payments, because now it is 25 percent of your production tax value (not 25 plus 13 percent one month and 25 plus 6 month the next), which is all dependent on the price of oil, the production of the company and the costs associated with that production.

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Section 4, starting on page 2, line 25, is the installment payments for Cook Inlet and Middle Earth that will exist for one year before the progressivity is repealed to make the law work in the way it is referenced. Section 4 will exist for a year and then section 5 will be the law of the land going forward after January 1, 2014.

Section 5 eliminates the "sum of" language again (same as section 2). It is what the monthly installment payments will be after progressivity is repealed. And that is why it is considered a conforming section.

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CHAIR GIESSEL noted that there are still monthly payments.

MR. PAWLOWSKI said that was true; there are still monthly payments in an annual true up. What is different in the proposal is that the tax rate won't vary on a monthly basis.

SENATOR DYSON asked how "gross value at the point of production" on page 7, line 3, was used.

MR. PAWLOWSKI replied that a specific calculation determines the gross value at point of production.

SENATOR DYSON asked if production costs were deleted from that figure.

MR. PAWLOWSKI replied it's the market price minus the transportation costs.

SENATOR DYSON said he would be interested in knowing why they are doing that.

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MR. PAWLOWSKI said section 6, on page 8, line 25, through page 9, line 10, was another conforming section because progressivity goes away. He explained that several different tax treatments for specific types of oil and gas had been added into law over the years and after progressivity is repealed, section 22, on page 21, line 10, is the cleaner and clearer categorization of all of those tax treatments.

SENATOR BISHOP asked if they are "bundling" everything now.

MR. PAWLOWSKI answered no, but rather highlighting in statute how oil will be treated based on the existing law in an orderly list rather than leaving them scattered around the statute. The point would be that page 21, line 21, talks about oil or gas produced from leases or properties in the state that include land north of 68 degrees - the North Slope - the area the bill is attempting to really make changes to - other than gas produced before 2022 and used in state that gets treated differently.

SENATOR FRENCH asked what AS 43.55.011(p) referred to.

MR. PAWLOWSKI replied that is the provision that was included in SB 23 last year that was the specific tax treatment for oil or gas produced from areas south of 68 degrees North latitude and not in the Cook Inlet sedimentary basin (Middle Earth). To put a finer point on it he said page 22, lines 9-11, will read kind of like the oil or gas that essentially at this point in time does not exist in the State of Alaska. This is oil or gas produced from leases or properties that are not north of 68 degrees, not gas used in state, not oil produced from Cook Inlet, not gas produced from Cook Inlet, and not oil or gas produced from Middle Earth. There must be a catch-all statute that says after the limits that were put in other statutes expire after 2022 - the treatment has to go somewhere and it defaults back into essentially the flat 25 percent severance tax under this proposal.

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The North Slope qualified capital expenditure credits (QCE), section 8, on page 9, line 30 through page 10, line 18 has new language that a credit for QCE incurred for those areas north of 68 degrees may only be taken if the expenditures occurred before January 1, 2014. So, until January 1, 2014 the QCE credit on the North Slope will qualify for the 20 percent credit; after that it will not.

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SENATOR MICCICHE asked if that was adequate time for smaller investors to wean off of the old system.

MR. PAWLOWSKI said that is an important conversation to have, but he would have to defer to testimony from the companies. The administration's consultants have shown the improvement in the economics of the life cycle of the project should actually drive the ability to move past the credits and into the actual investment and taking too long could cause the problem the bill is attempting to address.

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Section 7 was another conforming section that talked about the retroactive appeals. That was followed up with section 11 on page 11, line 4, that talks about two credit certificates that are divided up. The conforming change on page 11, line 8, substitutes "certificate" for "certificates" because they are no longer two certificates but rather a single certificate. The

associated language on lines 21-28 that is deleted also relates to that division of certificates.

The important piece here is the conforming language later on the North Slope QCE credits that had to be divided into the two certificates. However, a separate provision - AS 43.55.023(m) - said a credit can be taken in a single year if it is not on the North Slope. The problem in trying to simplify the system is that AS 43.55.023(d) said credits had to be divided into two certificates and then AS 43.55.023(m) came along later and said "except for anywhere other than the North Slope"; an investor could read that and misinterpret it by not reading the other. This language is trying to be transparent by saying that these credits can be retained and already can be taken in one certificate.

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Section 12 on page 11, line 29 is conforming language that conforms "except for the tax credits incurred after December 31, 2013." It's just being clear that the issuance of transferable and redeemable tax credit certificates cannot be done for qualified capital expenditure credits that occur on the North Slope after that date.

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Section 9 changes the North Slope net operating loss credits. The current system has a 20 percent capital credit and a 25 percent credit of the losses that are incurred by a company that might have no production but is spending and has a loss on an annual basis on the North Slope. Twenty-five percent of that loss can be turned into the state for a credit certificate which is redeemable by a cash payment from the state or sold to another company. Under the governor's proposal that 25 percent loss credit would no longer be allowed for an area north of 68 degrees North latitude. Instead they are subject to language on page 10, line 24, the new (p)-(u) sections of AS 43.55.023. A loss carry forward credit on the North Slope will be subject to a host of new requirements in section 15, which begins on page 13, line 15.

SENATOR BISHOP asked for clarification.

MR. PAWLOWSKI replied (p) through (u) relates only to the loss-carry forward credit and in order to qualify for a loss-carry forward credit you have to have a loss. So it is hard functionally to see a situation where this would apply on legacy fields.

Subsection (p) on page 13, line 20, limits application of a North Slope carried-forward loss credit to tax liability two or more calendar years after the expenditures on which the credit is based were incurred. Since the credit isn't applied for until the second year after the loss is why there is the two-year issue. Then they can come to the state and get a certificate if they have complied with the filing law. The other limitation is on page 13, line 23, that says each one of the of these credit certificates expires after 10 years.

SENATOR BISHOP asked if the credit on line 23 shows as a liability in the state's annual budget.

MR. PAWLOWSKI responded that there are provisions in this section about coming to the state so it can recognize that liability. The importance of the other provisions was to have the certification, have reporting and have it tracked so that it can be included subsequently.

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SENATOR FRENCH asked if this is meant to say you can't lose money for 10 years on the North Slope or does it pick some arbitrary date.

MR. PAWLOWSKI replied that the function of 10 years is balanced by subsection (r) on page 14, lines 2-14. He explained that under current law these credits are given to a company as a cash payment from the state, and not getting that cash payment a company suffers essentially a loss of opportunity. So there is an opportunity cost to the company. The credit is increased at a rate of 15 percent a year beginning in the second year to compensate for that cost of capital. They decided on 15 percent, because it was comparable to what their consultant saw as a reasonable level of upstream oil and gas opportunity - and the point was to protect the state from that being carried forward.

Functionally, it is intended to allow a company to recover a lot of the cost that they put into the development when they get into the production tax payment stage. It's complicated, but the credit is based on 25 percent of your losses; 15 percent compounds that credit by doubling in five years. So you can write off 50 percent of the cost of your development prospect when you have production tax. This is intended to provide a balance between how long those costs and the obligation to the state are out there with really improving the economics of the life cycle, which is the goal of the bill.

SENATOR FRENCH provided a hypothetical example: if Fairclough Oil and the committee are shareholders and drill one well for \$10 million and it's a duster, then they leave Alaska and never come back, that 25 percent credit expires after 10 years and grows to a magnificent number, but since they had no profit to show, it just expires and goes away. They can't sell it or trade it.

SENATOR FAIRCLOUGH asked if that credit is also intended to increase production.

MR. PAWLOWSKI answered yes, because the value of the credit only exists if there is production and revenues.

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SENATOR FRENCH asked how mergers and acquisitions are handled.

MR. PAWLOWSKI said a provision will allow for the transfer of a credit to another company, but its only valuable in that the purchaser of the credit takes the property, creates production from it and then a proxy limits the value of the credit each year to 20 percent of the gross value X the operating percentage. The goal is to not let a company buy a property, produce a very little bit of oil and then use a massive amount of tax credits bought from someone else. It is meant to provide a ceiling on the use of the credit which will let market forces drive how that credit is actually affected.

SENATOR BISHOP asked if the end result was intended to limit the state's exposure.

MR. PAWLOWSKI answered yes. It enforces that point that there needs to be production and revenue before the credits are used.

SENATOR MICCICHE asked if there is other text saying if the remainder is negative it is considered to be equal to zero for purposes of this paragraph (page 15, line 13) to ensure there is no cash back.

MR. PAWLOWSKI replied yes in relation to this specific credit. One other credit is available under current law until 2016 that could be turned in for cash specifically limited to the exploration phase on the North Slope that have distance and sharing information with DNR requirements. There is a similar concept in the small producer tax credit that is extended as well in Section 16 of the bill.

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He said there are two more important things to say about the treatment of the 15 percent increase in value for these credits: page 13, line 25, is really the "first in/first out rule." Because expenditures are happening in several years before there is other production and the credits are increasing in value, the first credit earned should be the first credit used. The second credit earned the second credit used - as there is production value that comes on. That is intended to keep the person earning the credits from taking a credit and holding it for the 15 percent increase. In fact, to protect the state further, if a company has a tax liability and doesn't use a credit against it, they lose the increase for that year. The point is to not have a company have the opportunity of either paying their taxes with a credit or holding on to the credit and getting the 15 percent compounded. The credits are earned and should be used to take the tax liability to zero in any given year.

MR. PAWLOWSKI said that philosophy takes them to page 16, line 26, section 16, which is the small producer tax credit. Like the new version of the loss-carry forward credit, it is only usable to offset a tax liability. It may not be transferred or turned into the state for cash. This is a basic reduction for a small producer in the state of Alaska.

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He explained under current statute (page 16, line 29) a small producer had until 2016 to come into production and qualify for this credit and SB 21 extends that deadline to 2022.

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MR. PAWLOWSKI said that brought them to the Gross Revenue Exclusion (GRE) on page 23, line 1.

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SENATOR MICCICHE asked why 15 percent was used and not some indexed figure.

MR. PAWLOWSKI replied that the point was to provide predictability to an investor and also that you are creating almost a proxy for the cost to be recovered. An existing producer could write these expenditures off against taxes; a person without production can't. So the 25 percent is giving them credit for that expenditure. The increase in value of that expenditure carry forward is essentially a way to allow for a company to write the costs of their investment off against their

taxes in the early years if they have a tax liability. In working the life-cycle economics, 15 percent was the one that provided transparency and worked. It's important to know the 15 percent isn't occurring for 10 years but for the 8 years because of the two calendar years issue.

5:30:17 PM

JOE BALASH, Deputy Commissioner, Department of Natural Resources (DNR), Juneau, Alaska, explained that another section, section 24, is a key component of the bill; it is the incentive that has been targeted at new production. There is very little disagreement about a willingness to extend some incentive or share some portion of the pie with those companies that are going to bring in new oil to TAPS. This particular provision emerged in the waning days of last session. It is a mechanism that takes the gross value at the point of production and reduces it by 20 percent before a company starts to apply its costs to arrive at the production tax value (PTV). The mechanism itself fits well for investors who are incumbents and have legacy production that happen to qualify for the gross revenue exclusion on any new production.

One can qualify for the gross revenue exclusion (GRE) one of two ways: you can produce barrels from a unit formed after January 1, 2003 or you can produce oil or gas from a participating area (PA) approved by the DNR after December 31, 2011. Those two types of lease management units are important and have different dates for different reasons. The date January 1, 2003 goes back to the only two units that are producing today, Oooguruk and Nikaitchuq, that experienced a tax change while they were in the middle of having their fields developed. Oooguruk Unit was formed in 2003; a sanctioned decision was made for the field in 2006 and while they were doing that, changes were circulating around ELF and PPT. By the time they got through construction and first production, PPT was modified in 2007 by ACES and their first oil flowed in 2008. The Nikaitchuq field was unitized in 2005/6 and a similar royalty modification was granted in 2008, sanctioned and construction began, and their first oil was produced in 2010.

SENATOR FRENCH asked if both fields would qualify for the 20 percent GRE.

MR. BALASH replied yes; these are the only two units producing today that would qualify under this unit threshold.

He said the second way in which a company could qualify for the GRE is through the formation of a new PA approved by the department after December 31, 2011. No PAs have been approved since that point in time, so they are really talking about those that would be approved prospectively.

He explained that PAs are a management tool used by the DNR. PAs are a third dimension to leases and units, two dimensional measures of property. In other words, within a unit area you have a large column of earth that has multiple pockets of oil and gas within it. When they are produced they are reported as belonging to a PA. Those reservoirs that contribute to production are included in the PA.

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If at another horizon in a different formation in a different reservoir another pocket or pool of oil is found and developed, a new PA is formed. You can have multiple PAs within the same unit at varying horizons so that they may be overlying or underlying one another. The important point here is that a new PA is new oil. That is how the GRE would apply to oil produced in the legacy fields in terms of satisfying the "command" from the public and the legislature that they are going to reward new oil.

CHAIR GIESSEL asked what if there is a provision for new technology finding more oil in an existing PA that is producing.

MR. BALASH answered no, but that isn't to say they couldn't account for it. He said expanding that provision could be done, but it wouldn't be easy and some policy calls would have to be made.

SENATOR FRENCH asked where Pt. Thomson falls in this scheme.

MR. BALASH replied that Pt. Thomson doesn't have a PA. If they are successful in meeting their obligations under the settlement, a PA would be formed once they achieve production in 2016, and they would qualify for the GRE. But with other changes being made, certain incentives and benefits that the leaseholders at Pt. Thomson would receive under the current system would no longer be available to them, particularly the QCE credit and the benefits of deducting their expenditures as they proceed to production.

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SENATOR FRENCH said new fields had been produced from Kuparuk, for example Tarn and Tabasco, and asked if those are new PAs.

MR. BALASH replied yes, both are separate PAs.

SENATOR FRENCH said that enhanced oil recovery (EOR) was not envisioned here.

MR. BALASH said that was right.

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MR. PAWLOWSKI said one policy call had to be made to preserve the Cook Inlet and Middle Earth sections that had separate tax treatments for oil and gas. It was reflected on page 2, lines 19-24. He explained that prior to the passage of SB 23 last year gas produced in state and used in state was subject to the equivalent of the "Cook Inlet treatment." With passage of SB 23, gas produced in the Middle Earth and used in state was left unclear and subject to a 4 percent. So they went with the most recent action by the legislature around the tax treatment of that gas or oil produced from that area. That was really done largely because of the complexity of trying to do separate accounting for the potential producers within the Middle Earth for one stream of oil and one stream of gas under a different tax system while they are both coming out of the ground in the same well. So, they went with the most recent action by the legislature, which means gas produced in Middle Earth and used in state would be subject to (up to) the 4 percent cap for the first seven years.

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MR. PAWLOWSKI explained that section 4 on page 2, line 25, was a conforming section so that now instead of having to divvy out all the different sections for a calendar year in which a producer is subject to tax under AS 43.55.011(e)-(i) or (p) it just says AS 43.55.011.

Section 13 on page 12, line 19, was the provision dealing with the credit split (AS 43.55.123(m)); it now says a credit issued under (d) (which was the former (m) that was deleted). This is about the two-year to one-year certificates and being able to turn them into the state for a transferable tax certificate. There is no reason to have duplicative sections, which is what you see through sections 13, 14, and 17. Section 18, on page 17, inserts "former" to recognize that there was a time period before where credits were issued under (m) and (d). This is related to the purchase of certificates by the state in AS

43.55.028(g) and recognizes if a tax credit was issued under (m) at one point and someone waited a few years to turn it in to the state, that at one point (m) was an actual statute that a credit was validly issued under.

Section 21 on page 19, line 5, talks about the way the production tax (AS 43.55.160) value is calculated. This is clean up language related to all the different types of production that are in statute and is for the period of one year while there still is progressivity. This inserts a reference to AS 43.55.011(p) that was missed in the passage of SB 23 last year so there isn't a mistake in the calculation of production tax value. After next year this section will be repealed and replaced with the clean section that lists each type of production and tax treatment.

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Finally, he said Section 25 on page 23, line 11, repeals AS 43.55.023(m), which he reminded them was for areas outside of the North Slope where a credit doesn't have to be divided between two certificates and can be issued as one certificate.

MR. PAWLOWSKI wrapped up his presentation saying that his intent today was to make it easier for people to find the relevant sections.

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SENATOR DYSON said under ACES discussions, Governor Palin had reluctantly said that companies should be allowed to deduct their expenses under a net profits tax, because they needed to incentivize development. Pedro van Meurs and at least one of the producers in the last two weeks said that incentive was gone. If that was true, was there any way to help? His other point was that they should be careful about raising folks' expectations that they were going to get 1 million barrels of throughput a day in the TAPS, because that sets them up for looking like failure. He agreed with Senator Micciche flattening the decline by half that would be a victory. The million barrels is probably subject to the unconventional and heavy oil production and probably Shell bringing their oil on shore.

CHAIR GIESSEL thanked Mr. Pawlowski for his presentation and held SB 21 in committee.

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There being no further business to come before the committee, Chair Giessel adjourned the Senate Resources Committee meeting at 5:53 p.m.