

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

February 22, 2013

3:35 p.m.

**MEMBERS PRESENT**

Senator Cathy Giessel, Chair  
Senator Fred Dyson, Vice Chair  
Senator Peter Micciche  
Senator Click Bishop  
Senator Lesil McGuire  
Senator Anna Fairclough

**MEMBERS ABSENT**

Senator Hollis French

**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 & 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  
 02/11/13 (S) Heard & Held  
 02/11/13 (S) MINUTE(RES)  
 02/13/13 (S) RES AT 3:30 PM BUTROVICH 205  
 02/13/13 (S) Heard & Held  
 02/13/13 (S) MINUTE(RES)  
 02/15/13 (S) RES AT 3:30 PM BUTROVICH 205  
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 02/20/13 (S) Heard & Held  
 02/20/13 (S) MINUTE(RES)  
 02/22/13 (S) RES AT 3:30 PM BUTROVICH 205

**WITNESS REGISTER**

SHARON LONG, staff to Senator Giessel  
 Alaska State Legislature  
 Juneau, AK

**POSITION STATEMENT:** Explained provisions in CSSB 21( ), labeled 28-GS1647\U.

JANEK MAYER, Project Manager  
Upstream Practice  
PFC Energy  
Washington, D.C.

**POSITION STATEMENT:** Modeled provisions in CSSB 21( ), labeled 28-GS1647\U, on behalf of the legislature.

MIKE PAWLOWSKI, Advisor for Petroleum Fiscal Systems  
Office of the Commissioner  
Department of Revenue (DOR)  
Juneau, AK

**POSITION STATEMENT:** Commented government take issues related to CSSB 21( ), labeled 28-GS1647\U.

BARRY PULLIAM, Managing Director  
Econ One Research, Inc.  
Los Angeles, CA

**POSITION STATEMENT:** Modeled provisions in CSSB 21( ), labeled 28-GS1647\U, on behalf of the administration.

JOE BALASH, Deputy Commissioner  
Department of Revenue (DOR)  
Juneau, AK

**POSITION STATEMENT:** Explained that gross revenue exclusion in CSSB 21( ), labeled 28-GS1647\U.

MARGARET DOWLING, staff to Senator Giessel  
Alaska State Legislature  
Juneau, AK

**POSITION STATEMENT:** Explained the exploration incentive credit (EIC) in CSSB 21( ), labeled 28-GS1647\U.

BRUCE TANGEMAN, Deputy Commissioner  
Department of Revenue (DOR)  
Juneau, AK

**POSITION STATEMENT:** Explained how the manufacturing credit in CSSB 21( ), labeled 28-GS1647\U, would impact the state treasury.

#### **ACTION NARRATIVE**

[3:35:24 PM](#)

**CHAIR CATHY GIESSEL** called the Senate Resources Standing Committee meeting to order at 3:34 p.m. Present at the call to

order were Senators Dyson, Fairclough, Bishop, Micciche, McGuire and Chair Giessel.

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

CHAIR GIESSEL announced SB 21 to be up for consideration.

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SENATOR DYSON moved to adopt CSSB 21( ), labeled 28-GS1647\U, as the working document.

CHAIR GIESSEL objected for discussion purposes and invited her staff, Sharon Long, to explain the committee substitute (CS), starting with a concept that addresses the government take at high and low prices that was labeled the "35/5 element."

SHARON LONG, staff to Senator Giessel, Alaska State Legislature, Juneau, AK, explained the provision that flattens the government take starts on page 4, line 1, and changes the base tax rate from 25 to 35 percent and adds a \$5 per taxable barrel credit for North Slope production. That credit is not transferrable and cannot be carried forward; it must be used against the tax liability for the year in which the barrel was produced and it cannot be used to reduce the tax below zero in any given year.

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MS. LONG said the chair asked this to be modeled by their consultant, PFC Energy and Mr. Mayer was here to present it.

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CHAIR GIESSEL noted the language saying a producer may apply a tax credit of \$5 for each barrel of taxable oil produced during a calendar year was inserted throughout the bill for uniformity and was a concept brought forward by Senator Micciche.

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JANEK MAYER, Project Manager, Upstream Practice, PFC Energy, Washington, D.C., explained that a significant impetus for this CS came from concerns that the bill, while it is a tax decrease at high oil prices, has a crossover point below which (because of removing the capital credit) represents a tax increase rather than a decrease. The point at which that occurs depends a lot on one's assumptions about levels of capital spending. So a producer with low levels of capital spending might see that crossover occur only at the \$70-80 price range (looking at the large mature producing fields and nothing else). But if you also incorporate new spending and use a higher CAPEX number, the

price level at which this tax increase steadily rises to is more like \$110/bbl.

In the context of overall regime competitiveness, while it starts off being reasonably competitive at \$60/bbl, by \$100 or so it's already up at the average of other regimes and up at the average of production-sharing contract regimes, which tend to be some of the highest government take contracts around versus the average for royalty regimes which is down at \$60 and the high \$50s for Organization of Economic Co-operation and Development (OECD) countries.

MR. MAYER said the CS, based purely on base production assumptions (not the higher capital costs that come from new development), by contrast has that crossover at \$75 or \$80/bbl and from that point on down represents a steady reduction in government take, but below that point it is in fact a tax increase.

CHAIR GIESSEL for clarification said that SB 21 as currently written has a downward slope and then levels off (above the yellow line).

MR. MAYER said that was correct, the yellow line being the average for royalty regimes around the world.

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MR. MAYER said there are two fundamental issues here; one being concerns about the regressive nature of SB 21 in that the government take steadily falls, particularly earlier in the price deck and then flattens off, and then the question of the crossover and how to address that by introducing a different form of tax credit that is tied to production rather than one tied to spending and capital development (which has its own strengths and weaknesses).

His charts compared a number of other possible regime interventions, but using both discounted and undiscounted rates for base production an incumbent producer would have rising rates under ACES and falling government take under SB 21 (from 66 percent at \$70/bbl down to 62 percent at \$150/bbl).

Raising the base rate to 35 percent and introducing a \$5/bbl production credit per taxable barrel produced only claimable in that year [in the CS] had a much flatter overall level of [undiscounted] government take around the 65 percent mark in the for a base producer (of a mature field at Prudhoe Bay) and the

crossover point there went from about \$75/bbl down to \$70/bbl. He also looked at discounted cash flows of government take and found those to be fairly comparable.

But, he said, that changes when looking at a new development on a standalone basis (outside an existing producing area including the gross revenue exclusion (GRE)). In his model of the CS one saw a slightly higher level of government take with the 35/5 element, but the impact is less evident because one is looking at a new development rather than base production. Ultimately what is lowering government take in this case is not any of the fundamentals of either the base rate or the production credit, but overwhelming it is the impact of the GRE.

MR. MAYER noted that one looks at any of these regimes on a discounted basis, there is a crossover, ultimately, because of the capital credits (which account for quite a lot in ACES). He added that when evaluating government take cash flows and not treating all time periods identically the near term is more valuable than the future and any one of the options (for a new development) looks substantially better than ACES from \$90/bbl onwards. That is because the credit helps with the early negative cash flows that reduces and improves the project economics.

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In raising the cost of a (standalone) new development [in the CS] from \$16/bbl to \$25/bbl, the undiscounted government take, because of the GRE, is lower than ACES, but the crossover point moves up to \$75/bbl. However, overall it is a higher level of government take than one sees under SB 21 because of the higher base rate that is compensated at least in part by the production credit.

MR. MAYER advised that with any high cost development there comes a point at which government take no longer becomes a meaningful metric, because there is no divisible income to go around (at around the \$100/bbl mark on the slide) and that crossover is relatively higher for ACES than it is for the CS.

Looking at incremental analysis for an incumbent producer that has a new development and subtracting one from the other resulted in the crossover level being substantially lower for a \$16/bbl development in the CS. But modeling it on a discounted basis, one sees it's only at very high levels that you get levels of government take that are lower than they are under ACES. That is exacerbated further by looking at the \$25/bbl

field where the crossover comes at about \$85/bbl, but a it is a relatively lesser tax increase below that point than was the case under SB 21(before the CS).

MR. MAYER reminded folks that they were looking at 60-65 percent government take as being in the area of competitiveness. And for base production the net present value (NPV) at a 12 percent discount rate per barrel of reserves is significantly improved in SB 21 with or without the CS (using both a discounted and undiscounted basis).

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A new development on a standalone basis including the GRE has a crossover point where at a low price level economics look better under ACES, but for anything above that they look substantially better under SB 21. However, that crossover point rises with the CS from \$75/bbl to \$85-90/bbl for a \$16/bbl new development. At \$25/bbl none of these things have positive NPV above about the \$90/bbl mark. The crossover between ACES and the CS rises from being about that \$90/bbl mark to being more like \$100-105/bbl. That is from the impact of a higher base rate that is being only partially compensated for by the \$5 per taxable barrel production credit.

MR. MAYER said when you look at base production, the 35/5 element looks like the perfect regime - very flat, very neutral and right where a lot of people want to go in terms of overall levels of government take. But when drilling down into the details of new developments, one can find further sources of concern over improving the way the overall picture works.

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He said the crossover point is highest on an incremental basis and that is because of some of the things he had discussed in terms of the impacts of buy down and to the extent that one thinks the incremental rather than standalone economics is the way to analyze these things. He elaborated that ultimately one sees a crossover in the low \$100s under SB 21 for a \$16/bbl/day new development that has a higher NPV on an incremental basis, but that moves marginally higher under the CS. Both are substantially higher in terms of the crossover point when one looks at it for an expensive \$25/bbl new development.

In summary, he said some strong points in terms of overall level of government take, particularly when looking at the base portfolio, but more sources of concern in terms of looking at some of the other economic metrics for a new development both on

a standalone basis (where that is assisted by the GRE for a completely new producing project), but particularly when the GRE doesn't apply (when potential sources of concern arise).

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MR. MAYER said similarly when it comes to rates of return (IRR) the crossover under SB 21 becomes higher rather than lower versus ACES; with the CS that crossover point is relatively higher (both for the \$16/bbl development and the \$25/bbl development). All of them look worse on an incremental basis, if one thinks that is a good way to look at this.

He explained that the very high levels of IRR a new producer can get under ACES for on an incremental basis are really the work of progressivity; and one has the counterintuitive result that the higher the progressivity the higher the IRR you can get on an incremental basis for a project that says nothing about the quality of the project or the economic value that it creates. It's simply a quirk of the buy-down phenomenon, which he explained by providing this example: imagine having a 100 percent tax rate where you could receive nothing, but with each dollar of spending could buy down your rate. That first dollar of spending that brings you down from 100 to 99 percent would have infinite rate of return. So, it seemed to him that the question of high rates of return under ACES looking solely at incremental analysis is a phenomenon of the problems of using incremental analysis not a fundamental benefit of ACES as a regime.

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CHAIR GIESSEL said the goal had been to levelize the government take a bit more and asked for comments.

SENATOR MICCICHE said they heard complaints that the take was too high of a tax increase at the low end and people, including many senators, didn't like the slightly regressive nature of the original SB 21.

CHAIR GIESSEL asked the administration if they had any thoughts on this.

SENATOR MICCICHE added that they also looked at smoothing out the curve, but that had its own problems. Their concept was to create a slightly progressive system without using progressivity, but to preserve the simplicity of the governor's proposal. This CS achieves that by raising the base rate and offsetting it with a per barrel credit. Since the tax rate was

raised they also had to fix the GRE with corresponding changes by increasing it to 30 percent and increasing the loss carry forward to 35 percent. They like the curve, the slightly progressive nature of it and the fact that it's a smaller fiscal note while still retaining the competitive level with other OECD producing areas where Alaska wants to be.

CHAIR GIESSEL said that they didn't want to create a runaway schedule of credits that would incent spending and not production the administration's consultant had modeled this also and emphasized.

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SENATOR FAIRCLOUGH asked if the fiscal note was in process.

[4:05:12 PM](#)

MIKE PAWLOWSKI, Advisor for Petroleum Fiscal Systems, Office of the Commissioner, Department of Revenue (DOR), Juneau, AK, said the fiscal impact of the proposed CS is being evaluated, but the impact of the bill is readily apparent in the government take numbers, the inference being that at the current range of prices the government take under the CS is higher than what the governor asked for.

CHAIR GIESSEL asked if he had any comment on this portion of the CS.

MR. PAWLOWSKI said they asked their consultant, Mr. Pulliam with Econ One, to run it through his models.

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BARRY PULLIAM, Managing Director, Econ One Research, Inc., Los Angeles, CA, said he revised the government take line from a slide he presented last week with the 35 percent flat rate and the \$5/bbl "production allowance." Over the period in a fiscal note of 2015-2019, it will somewhat increase government take for all existing producers on the North Slope from the low 60 percent range to a range that approaches 65 percent at prices above \$80 or \$90/bbl and reduces government take at prices below \$80/bbl closer to where it was under ACES.

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The way it accomplishes this is by modifying the GRE to give an allowance that is a percent of the production value; in SB 21 it was 20 percent. That allowance, in terms of a dollar per barrel amount, would rise with higher prices and fall with lower prices. Allowing a per barrel allowance is putting in a GRE that

as a percentage increases with lower prices - therefore helping out more than a standard percentage-based GRE - and declines with higher prices. So it bends the curve a little bit and accomplishes the goals of providing some lower taxes at lower levels (closer to what ACES does) and a little bit higher take at higher levels (closer to what one sees on average throughout the world).

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SENATOR FAIRCLOUGH said she wanted the fiscal note to reflect the \$5 credit.

MR. PAWLOWSKI said they will put it into the same table format as was used in SB 21.

MR. PULLIAM proceeded to another revised slide showing how the system would work with this allowance at different prices (\$60-\$160/bbl) with total lease expenditures of \$30/bbl. At \$60/bbl (West Coast) the taxable barrel value would be \$20 and the production tax value would be \$1 million. A 35 percent rate would be an obligation of \$350 million. Then you would take your per barrel allowance of \$5 against that (assuming a producer of 50 million barrels) which would be \$250 million. That reduces the tax to \$100 million and the effective rate goes to 10 percent (in his model). That allowance, while it stays the same at \$5/bbl and going up in price, its value declines on a percentage basis. So the effective tax rate rises from 10 percent all the way up to 30 percent at \$160/bbl; and that is about where it would cap out.

SENATOR MICCICHE said they heard through testimony that this helps companies in analyzing projects.

MR. PULLIAM answered that it does and without the messiness of a progressive net tax, which is important. One of the things he liked about it was that the credit was tied to production and the value of it increases at the lower prices and fades away at higher prices where it isn't really needed. It achieves a flat take over most ranges and gets progressive at the lower prices.

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He also looked at the impacts on new projects at \$16/bbl and \$25/bbl incorporating the 35/5 element with the 30 percent GRE and compared it with SB 21 (with the GRE). That indicated that NPV at all price levels was enhanced by the CS as were all of the other investment metrics; and government take would be about 60 percent for new investment. While the present value of the

project isn't as attractive at the \$25/bbl level, it's more attractive under the CS than SB 21. In summary it accomplishes a lot of what they want to do in a meaningful way.

SENATOR MICCICHE commented that he looked forward to hearing from the stakeholders. It accomplishes what he want to accomplish - improving economics on the low end at the price where they hear companies evaluate projects; he also liked the fact that it's slightly progressive without using progressivity and has a little more take for Alaskans, but doesn't put us out of the ballpark on being competitive. He thanked the administration and Mr. Pawlowski for their work.

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SENATOR MCGUIRE remarked that Senator Bishop had worked hard on this as well.

SENATOR BISHOP said the modeling showed it as being as close to hitting the sweet spot as possible.

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CHAIR GIESSEL asked Ms. Long to explain the expansion of the gross revenue exclusion (GRE) to include legacy fields and enlarging the PAs.

MS. LONG explained that section 28 on page 26, line 26, through page 27, lines 3 - 11 had language that allows expanded PAs in existing units. Another change on line 3 changed January 1 to December 31, 2011,

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She said Mr. Bullock suggested including a definition of "participating area" on line 10.

CHAIR GIESSEL highlighted that the GRE was altered from 20 to 30 percent on page 26, line 29.

MS. LONG added that was triggered by the 35/5 element. Line 30 had another small adjustment changing "land" to "lease".

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JOE BALASH, Deputy Commissioner, Department of Revenue (DOR), Juneau, AK, said that language was on page 27, lines 3-8 and it makes an addition to the two ways in which you can qualify for the GRE relative to the governor's original bill. This was to include expansions of a participating area, because as the committee has heard in testimony from various operators, new

technology is allowing companies to reach certain parts of the reservoir that weren't available previously. As that kind of work unfolds, it seems expansions of those original PAs will be needed and it seems reasonable to apply the same logic and policy there as in new participating areas as long as they are able to track and count the barrels.

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CHAIR GIESSEL said Bill Barron had explained about how new technology had affected industry and Senator McGuire was concerned about broadening PAs. ConocoPhillips said the GRE was not broad enough and that the legacy fields need to be part of the GRE and that is what this change was intended to capture.

SENATOR MICCICHE thanked the chair for going through the process and embracing the concepts talked about in TAPS Throughput Committee.

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MR. BALASH returned to page 26, line 30, the first test for qualifying for the GRE that the oil and gas is produced from a lease or property that does not contain a lease that was within a unit as on January 1, 2003. He said the original language read "did not contain land" within a unit, and Brooks Range testified on Monday that some of the leases they hold today that are part of the Mustang unit on that date were actually part one of the legacy units and didn't qualify. So they had to be specific as to the lease not the land, because in the intervening time the land was contracted out of the Kuparuk River Unit and re-leased to Brooks Range for development. This fix should correct that problem.

SENATOR BISHOP asked him to elaborate on tracking and counting barrels.

MR. BALASH said page 27, line 6, referred to the expanded PA, saying "and the producer demonstrates to the department that the volume of oil and gas produced is from an area added to an existing participating area." And that is where the taxpayer has the burden to demonstrate to the Department of Revenue that those barrels are being counted.

SENATOR FAIRCLOUGH asked him to explain how new production would be quantified in this instance for department analysis.

MR. BALASH explained the department manages oil and gas leases through leases, units, and then participating areas (PA). Leases

and units are measured in two dimensions; a unit is a way of managing multiple leases that contain an oil or gas reservoir. That reservoir rests in a third dimension and as those deposits are shaped across the different leases within that unit, certain parts of that reservoir when penetrated with a well actually contribute to the production in that well; reservoir engineering and analytics is used to determine which parts of the reservoir are actually contributing to that production in the well bore. It is through that analysis that PAs are then defined in the unit. By identifying specifically new participating areas they are talking about parts of the unit that today are not contributing to production and so, by definition, would be new production. Expansion of an existing PA is land that previously was not determined to have been contributing to production - rather new parts of the reservoir that will in the future to be contributing new barrels that will help sustain TAPS.

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SENATOR FAIRCLOUGH asked if other jurisdictions sell royalties based on that third dimension.

MR. BALASH answered that they had at times talked about segregating the state's leases vertically, but hadn't done it yet. But even in Alaska, they will sell the oil and gas rights in the subsurface but not necessarily the coal rights or the gold rights. To a degree there is a distinction, but the participating area concept is common to the industry.

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MS. LONG said Chair Giessel had requested language about not rewarding the industry for what it would produce anyway and this amendment [on page 27, lines 6-8] puts the burden on industry to prove that it is new oil.

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MS. LONG went over details of the Competitiveness Review Board that had been talked about over a couple of legislatures on page 27, line 12, through page 29, down to the membership, how they are appointed, the information that will be provided by it, and a sunset provision for it.

CHAIR GIESSEL invited Senator McGuire to speak to this.

SENATOR MCGUIRE thanked the chair, Mr. Pawlowski and Mr. Balash, and complimented Senator Giessel, the best first time chairperson she had experienced for driving this bill through the process in the allotted time while respecting that the

public's wisdom and experience would warrant at least 30 minutes to speak and then for getting all of their ideas incorporated into this document.

She said the idea for this board would have not been right without the proper rollback of ACES. She said the state's budget is 90 percent dependent on this particular revenue and if we don't get our act together quickly we're in a whole heap of trouble. It struck her that the discussions in her 13 years here have been so politicized when it comes to oil and gas taxes and she has thought that putting together a board, in this case it would be nine members - the commissioners of DNR DOR DEC, the chairperson of the Alaska Oil and Gas Conservation Commission(AOGCC) and five members of public to be selected by the governor including a petroleum engineer, a geologist and an economist all with at least three years' experience in the field, a person from the Alaska Oil and Gas Association (AOGA) and the Support Industry Alliance - to serve without compensation and be eligible for per diem and travel expenses. This board would meet at least four times annually and report its recommendations to the legislature about how to keep Alaska competitive - without a political agenda.

They would look around the globe and at the Lower 48 to see what the emerging trends are, how other places are staying competitive, and at what kinds of things Alaska could do in its fiscal regime and regulatory process; they would review historical, current and potential levels of investment, rig counts, factors that affect investment in oil and gas across the world and make recommendations to the legislature to increase Alaska's competitiveness. She said the legislature makes the ultimate decisions about how to change the fiscal system, so they would not be delegating anything about that ultimate control.

SENATOR MCGUIRE wrapped up by relating a personal story about how this idea came to her. When she was president of the Pacific Northwest Economic Region, her friend, Mel Knight, the Minister of Energy for the Province of Alberta, said they went through a very similar situation. They had high oil prices and the public wanted to capture more of it and so they adopted a windfall profits tax much like ACES. The backlash was immediate with oil companies "voting with their feet" and moving their rigs and operations to Saskatchewan and British Columbia.

Alberta suffered immensely, because it is their bread and butter and having a parliamentary system, many were voted out of

office. So they put together a competitiveness review panel that came back with a series of recommendations, which the parliament put into place and now Alberta is back on track and extremely competitive. It was her hope that this will be a part of Alaska's governance for the future much like the Permanent Fund Board that sits in perpetuity outside of the legislative structure.

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CHAIR GIESSEL asked Ms. Long to discuss "cleanups."

MS. LONG said they start on page 10 that combines sections 7 and 8 from the previous bill; that was suggested by Legislative Legal. On page 15, they also suggested better phraseology on lines 9 and 10, 17 and 18. The other cleanup was having the definition of participating area to be included within the GRE amendment, which had already been talked about.

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CHAIR GIESSEL went on to the exploration incentive credit (EIC), an element advocated by the AOGA and Brooks Range.

MARGARET DOWLING, staff to Senator Giessel, Alaska State Legislature, Juneau, AK, explained that the EIC was discussed by the committee; in response a change was made on page 18. They took the current law which allows an EIC that is set to expire in 2016 and extended it to 2022. In addition, on page 20, lines 18-20, the three-mile restriction was eliminated because Brooks Range said the distance around the well was too tight for them to qualify for an additional credit.

CHAIR GIESSEL noted AOGA's recommendation for extending the EIC and reminded the committee that Brooks Range showed them a slide of the very tight three-mile boundary around a well. She invited DNR to speak to this portion.

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MR. BALASH explained that language on page 20, line 8, creates a gate for getting this .025 exploration credit. It requires that the commissioner of DNR must make an affirmative determination as to the geological objective of the well. So this credit mechanism has a gate; you have to come in and demonstrate to the technical guys in the Division of Oil and Gas (DOG) that in fact something new is being looked at or looked for in order to qualify as an exploration credit. Assuming that threshold is met, that is a front end gate, then the well is drill and the costs accounted for; the information from that well needs to be

shared with DNR again in order to qualify for the credit and receive it. So, there is a check on the front end and one on the back end that makes sure the state gets something for a generous credit, as the state is taking risk with a company on what is the riskiest part of oil and gas development, the exploration side.

MR. BALASH explained that in years past, limits have been tied to unit boundaries and distance from other wells. This eliminates all of those. So even if they are talking about an exploration well within a unit, as long as it is targeting something new, you have the potential to qualify. That should help in taking on some of the opportunities that are close to the nearer the existing producing units that they believe are out there and quite prevalent.

SENATOR FAIRCLOUGH asked the potential liability to the state of the exploration credit on a percentage basis and a dollar amount.

MR. BALASH answered that this credit is set at 40 percent and typically the cheapest winter exploration well drilled on the North Slope costs around \$15 million. That cost goes up depending on how far away it is, building ice roads and maybe setting up a temporary man-camp. So 40 percent of that is in the range of \$6 million.

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SENATOR MICCICHE asked if this credit has to be taken against production; so the state is not exposed.

MR. BALASH answered that these particular credits fall in the category of those which are available for a transfer or refunding on the front end.

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SENATOR FAIRCLOUGH, using the example of Fairclough and Co., asked if there are any qualifying criteria for these companies we hope will be part of our renaissance to be able to apply for the credits. So that people with prospects who can actually follow through on production are the ones being incentivized.

MR. BALASH answered that that still needs to be spelled out somewhere.

SENATOR MICCICHE said that could be added to the existing letter of intent. He also said that while this definitely helps some of

the smaller companies for initial exploration, the folks that know best all say the most new oil likely to arrest the decline will likely come from infield areas and this makes access to those credits available to the legacy companies as well.

MR. BALASH said that was correct and he emphasized that the role for credits to play is to incentivize those activities to find the oil and then allow the value of the oil itself to drive the economic decisions makings and ultimately the development as opposed to the credit cycle.

CHAIR GIESSEL asked Mr. Mayer to comment on the generosity of this credit.

MR. MAYER said that, in general, exploration risk is by far the largest risk in upstream oil and gas development and the part that governments around the world usually seek desperately to avoid. Alaska is unusual in the degree to which it happily takes it exploration risk, particular as it stands as a 40 percent exploration credit and the 25 percent net operating loss credit if there is no production. So if Fairclough and Co. decides to drill up some random moose pasture, they are drilling with \$.65 on the dollar paid for by the state of Alaska. If Fairclough and Co. is an existing producer using the buy down it could get even higher support than that.

SENATOR FAIRCLOUGH disclaimed owning an oil exploration company.

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SENATOR BISHOP said Mr. Mayer was a little bit cautious and he felt that the credits were a skosh generous, but they had heard for the last several weeks how much it costs to do business in Alaska, and he felt confident in taking a little risk in getting the new production going.

SENATOR FAIRCLOUGH thanked Mr. Mayer for commuting back and forth from Washington D.C. to testify before the committee.

CHAIR GIESSEL said the last element included in this bill is innovative came from the TAPS Throughput Committee's letter of intent that talked about Alaska hire and Alaska purchase. She invited Ms. Long to explain that section.

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MS. LONG explained that language on page 2, line 10, called the corporate income tax break, was for Alaska manufacturing. A primary concern in the legislature and all over the state was to

have jobs for Alaskans and to encourage manufacturing here. The Department of Law (DOL) and the courts don't agree with a lot of ideas, but they came up with this one that they think will pass muster. It's a corporate income tax break for oil and gas sector goods made or modified in the state. It is transferable and is capped at \$10 million per year. If a company does not have a tax liability that credit can be carried up to seven years.

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BRUCE TANGEMAN, Deputy Commissioner, Department of Revenue (DOR), Juneau, AK, added that this is for expenditures directly attributable to instate manufacturing or instate modification of tangible personal property in exploration, development and production of oil and gas. It's a very targeted tax credit aimed specifically at the manufacturer and building of items that are related to the oil and gas industry.

CHAIR GIESSEL asked if Fairclough and Co. was a manufacturing company located in Fairbanks and produced something for the North Slope, how this would play out for that company.

MR. TANGEMAN replied that expenditures attributable to an oil and gas depreciable item that the company would make would be allowed a 10 percent tax credit against the expenditures that go into that item.

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SENATOR DYSON said he suspected that the 10 percent credit would then allow that company to bid on a product or services at a lower rate than a competitor who may also be bidding on it from somewhere else.

MR. TANGEMAN answered yes; that's the intent.

CHAIR GIESSEL asked if a company that is actually based in North Dakota and producing a tangible item that is being used on the North Slope get this credit.

MR. TANGEMAN answered no; they would need to have a corporate income tax or be an entity within the state of Alaska.

CHAIR GIESSEL asked if they built a manufacturing facility in Fairbanks and actually were producing that product in Alaska would they qualify.

MR. TANGEMAN answered yes and it would go the opposite way.

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CHAIR GIESSEL said this piece is aimed at incentivizing or helping our companies that are here on the ground in Alaska employing Alaskans and helps bolster diversification of our economy.

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SENATOR FAIRCLOUGH asked how this will affect Alaska's bottom line. Is it stackable on other benefits someone might receive? Could a company accumulate up to \$60 million worth of credits because of the carry forward and those would enter a market at a discounted rate possibly for a larger company that is paying taxes, because they are transferable?

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MR. TANGEMAN explained the intent is that the tax liability is less than the credit they would receive and it is transferable, but that should also go into the economics of the pricing involved in manufacturing of whatever they are producing in the state.

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SENATOR DYSON said he was startled that an Alaskan company could get this credit for products going to the Outside.

MR. TANGEMAN replied that it's for the sale of a product that was built in Alaska but sold to North Dakota, for instance.

SENATOR DYSON said we want jobs, but he was questioning about they would pick out this particular industry to subsidize above others like the fish boat manufacturer. He said it might also have title problems because this whole thing has to do with oil and gas in the state and all of a sudden a section was slipped in talking about subsidizing an industry that is selling products outside of the state that has nothing to do with our oil and gas.

SENATOR FAIRCLOUGH said the tax credits have to stay within Alaska, but there are still some dynamics at play in terms of incentivizing an industry. She was thinking about the fabrication of pipe. At one time there was a conversation about rounding pipe here and that kind of company would qualify for this credit. She wanted to think the concept through.

MR. PAWLOWSKI supplemented that saying one of the things they had heard consistently is the impact of the high cost of doing business in Alaska on the oil industry in that we have a net tax

system, and there is a relationship between a vibrant service industry and support industry to a healthy oil industry. One of the attempts here is to increase the health of that sector and hopefully drive down costs.

He said it was focused towards oil and gas specific property considering the relationship of the ultimate revenues the state gets from the more profitable projects. The state has a profits based tax, the less expensive the property that goes into the cost equation actually does have a feedback loop to the revenues of the state.

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SENATOR FAIRCLOUGH said she thought "manufacturing" was probably defined somewhere in code, but it wasn't having a product and adding a bolt to it and that should be clarified for the general public.

MR. TANGEMAN pointed to page 3, line 10, where "manufacturing" was defined as "needs to perform substantial industrial operations in the state to transform raw material into tangible personal property with a useful life of three years or more for use in the exploration and development and production of oil and gas regardless of whether the oil or gas is located in the state."

Line 14 defined "modification" as "an adjustment, equipping or other alteration to existing tangible personal property that has a useful life of three years or more and is for use in the exploration, development and production of oil and gas reserves."

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MR. PAWLOWSKI said the important caveat in that section was on page 3, line 17, that said, "modification does not include minor product alterations or inventory activities." He said they would continue to work with the committee and the legislature on this going forward.

SENATOR FAIRCLOUGH asked if they had consulted the oil industry or someone manufacturing somewhere about what that product might be and if there was an example. And why choose \$10 million?

MR. TANGEMAN said he had some initial conversations, but looked forward to hearing more from the service sector. It seemed they thought it would be beneficial to their business in promoting business growth in Alaska. The \$10 million cap is a threshold;

they are hoping it will be a boom, but they have to see how it works through the process.

MR. PAWLOWSKI said the sincere intent in the bill overall was to protect the state treasury in any ongoing obligations. They heard testimony from PFC that when there are credits, that offering transferability of credits to be used against a tax liability is a viable mechanism to provide some protection.

SENATOR BISHOP commented said this is another way to make Alaska competitive and the more you do here the cheaper it is to do it.

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CHAIR GIESSEL said that summarized the committee's ideas in addition to those of the TAPS Throughput Committee. She said some amendments were not included in the CS and those would be heard on Monday.

[5:18:08 PM](#)

CHAIR GIESSEL removed her objection and CSSB 21( ), labeled 28-GS1647\U, was adopted and held in committee.

[5:18:23 PM](#)

Finding no further business to come before the committee Chair Giessel adjourned the Senate Resources Standing Committee at 5:18 p.m.