

ALASKA STATE LEGISLATURE
SENATE SPECIAL COMMITTEE ON TAPS THROUGHPUT

January 22, 2013

3:30 p.m.

MEMBERS PRESENT

Senator Mike Dunleavy, Co-Chair
Senator Peter Micciche, Co-Chair
Senator Anna Fairclough
Senator Lesil McGuire
Senator Berta Gardner

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Senator Cathy Giessel
Senator Click Bishop
Senator Charlie Huggins

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)

WITNESS REGISTER

DAN SULLIVAN, Commissioner
Department of Natural Resources
Anchorage, Alaska

POSITION STATEMENT: Presented information on SB 21.

BRYAN BUTCHER, Commissioner
Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Presented information on SB 21.

MICHAEL PAWLOWSKI, Oil & Gas Project Manager
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: Presented information on the location of provisions in SB 21.

ACTION NARRATIVE

3:30:21 PM

CO-CHAIR PETER MICCICHE called the Senate Special Committee on TAPS Throughput meeting to order at 3:30 p.m. Present at the call to order were Senators Gardner, Fairclough, McGuire, Co-Chair Dunleavy, and Co-Chair Micciche.

SB 21-OIL AND GAS PRODUCTION TAX

3:30:35 PM

CO-CHAIR MICCICHE stated that the first order of business to come before the committee was SB 21. He noted the presence of Senator Giessel.

CO-CHAIR MICCICHE related that the Senate Special Committee on TAPS Throughput is "looking through challenges to decreasing the decline of North Slope oil production." He pointed out that the committee is not an oil tax committee, but rather it is designed to arrest throughput decline.

CO-CHAIR MICCICHE said that the purpose of the meeting was to begin the discussion of SB 21, the Governor's oil and gas

production tax bill. He introduced the presenters: Commissioner Butcher, Commissioner Sullivan, Joe Balash, and Michael Pawlowski.

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DAN SULLIVAN, Commissioner, Department of Natural Resources, began by thanking the Senate for the public service of establishing a special committee to work on the goal of decreasing throughput decline. He emphasized that the Department of Natural Resources (DNR) believes that the issue of TAPS throughput decline is the most urgent problem facing the economic future of Alaska. He maintained that the more people understand the problems and the solutions of oil production decline, the more likely the issue will be addressed for the benefit of all Alaskans. He said that DNR and the Department of Revenue (DOR) have been working together as a team on this goal at the request of the Governor.

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COMMISSIONER SULLIVAN stated the goals of the presentation: provide the background of TAPS; show some of the challenges of hydrocarbon production and investment in Alaska, the U.S. and the world; and provide examples to support the idea that oil production decline in Alaska is not inevitable.

COMMISSIONER SULLIVAN drew attention to a handout entitled, "Arresting TAPS Throughput Decline & Oil Tax Reform." He depicted TAPS as a critical state and national energy asset. He reminded the committee that Congress was instrumental in the approval and rapid development of TAPS and continues to have an important role. The throughput issue has federal elements, such as the energy security of the country and access to federal lands.

He highlighted the staggering number of barrels produced since June of 1977. Production peaked at 2.2 million barrels per day in the late 1980s, representing 25 percent of U.S. domestic production. He noted how impressive that amount was. Today, at a little less than 600,000 barrels per day, there is excess capacity and the decline threatens America's economic future. He said there was currently a reconfiguration of TAPS capacity.

COMMISSIONER SULLIVAN stated that the ultimate giveaway is the year-after-year decline of throughput. He spoke of a Bloomberg report from December 2011, which showed production of 620,000 barrels of oil a day compared to December 2012 with 582,000 barrels a day, a loss of 40,000 barrels per day for a year. The

value of 40,000 barrels of oil a day in a year is 4.7 million barrels; at \$100 per barrel, \$1.5 billion was lost. He emphasized the goal to arrest and turn around that giveaway.

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COMMISSIONER SULLIVAN showed a graph of Alaska North Slope (ANS) production history, pointing out the dominance of Prudhoe Bay. He distinguished mature fields from mature basins. He maintained that the state does not have a mature basin, it has some mature fields.

He highlighted the urgency of the throughput decline issue and stressed that it was not a scare tactic. He gave a personal example of his experience with the January 2011 TAPS shutdown in minus-40 weather. He concluded that the lesson from that near disaster was that the lower the output, the higher the risk of shutdown and the more chance for technical challenges. He discussed the consequence of higher tariffs due to companies' costs from efforts to address such problems.

CO-CHAIR MICCICHE emphasized the increase in operational costs due to lower flow rates.

COMMISSIONER SULLIVAN agreed. He did not think that there was any dispute that lower flow rates create a higher risk of complication.

CO-CHAIR DUNLEAVY asked if the state can flatten out or decrease the decline.

COMMISSIONER SULLIVAN said absolutely. He related that there is a large resource base and several basins have already begun to decrease the decline.

SENATOR GARDNER asked if the future looks larger with the majors or with new smaller investors.

COMMISSIONER SULLIVAN replied that he believes that all players will contribute; all investors and the entire diversity of plays. He spoke of the opportunities that lie in all plays. He pointed out that Alaska is unique in that conventional and shale plays can exist in the same field or basin. The goal of increasing competition in the North Slope is very important.

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SENATOR FAIRCLOUGH referred to the TAPS shutdown in 2011 and the anxiety over that situation. She emphasized that it was not an

easy start up and it was fortunate that the pipeline had great employees and attorneys to interpret TAPS language and prevent outside entities from stopping the flow of oil.

COMMISSIONER SULLIVAN agreed with Senator Fairclough's depiction.

CO-CHAIR DUNLEAVY requested information on a possible timeline for stemming the decline and increasing production in existing wells and for the onset of new oil, given the right climate.

COMMISSIONER SULLIVAN said it was a good question, but hard to predict the answer. He agreed that infield drilling would be an obvious place to begin a turnaround. He pointed out that there has been exploration outside of the big units which could turn into capable production within a few years. He used Point Thomson as an example of a field that ExxonMobil is starting to build this winter with a target three years away. He recalled a commitment by Exxon a year earlier that ran into delays due to federal permitting problems.

CO-CHAIR MICCICHE suggested that the committee was formed to streamline legislation related to the timeframe between discovery and production. He noted Senator Bishop's arrival.

CO-CHAIR DUNLEAVY thought it was a huge issue.

COMMISSIONER SULLIVAN suggested that the best way to address technical issues from a shutdown is to get more oil through the pipeline.

He turned to positive solutions to address the decline. He pointed out the most important factor; the huge, world-class basin on the North Slope. The United States Geological Survey (USGS) estimates that Alaska's North Slope has more oil than any other Arctic nation. It has about 40 billion barrels of conventional oil (federal, state, and OCS), and over 200 trillion cubic feet of conventional natural gas. Alaska also has world-class unconventional resources, including tens of billions of barrels of heavy oil, shale oil, and viscous oil, and hundreds of trillions of cubic feet of shale gas, tight gas, and gas hydrates. He added that the North Slope remains relatively unexplored relative to other hydrocarbon basins in the U.S., another positive factor.

He spoke of efforts to market oil prospects in an attempt to bring more investors to the state. One of the most common themes

heard from potential companies is that though the hydrocarbon structure is great, the cost of doing business is too high.

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CO-CHAIR MICCICHE thought an important piece of educating the public is if people believe there are adequate supplies on the North Slope to increase throughput. He suggested DNR and industry geologists provide further information on that topic.

COMMISSIONER SULLIVAN said there were geologists available to do so.

CO-CHAIR DUNLEAVY asked if the "majors" share the state's optimism about the potential to stem throughput decline because of the large amount of resources.

COMMISSIONER SULLIVAN opined that the majors see infield, unconventional, and federal land potential. He spoke of the efforts to get companies to invest and lease in shale play. He used North Dakota as an example of large shale production increases within a period of five years. He predicted that source rock in Prudhoe Bay would have huge potential.

SENATOR GARDNER understood that shale development involves more drilling and more wells. She inquired if shale oil comes on line more quickly than conventional oil.

COMMISSIONER SULLIVAN related that a task force made up of DNR, other agencies, and counterparts from North Dakota has been set up in order to deal with shale development. He said he would find the answer to that question.

He showed a map of Alaska's North Slope oil and gas potential. He said he was optimistic about the resource; however, he said it would cost billions to bring it to production.

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COMMISSIONER SULLIVAN discussed the U.S. energy renaissance. The International Energy Agency (IEA) predicted in their "2012 World Energy Outlook" that the U.S. would overtake Saudi Arabia and Russia to become the world's largest global oil and gas producer by the second half of this decade. This would include an enormous capital spending boom by the oil industry. In 2012 about \$600 billion was spent on exploration and production globally, and it is projected that in 2013, \$650 billion will be spent. He opined that Alaska needs to be on the leading edge of the American energy renaissance, rather than an anchor.

Currently, a lot of the spending is going to Organisation for Economic Co-operation and Development (OECD) countries. He stated that Alaska should strive for more of that global spending.

SENATOR GARDNER asked how Alaska's position as an exporter compares to the rest of the nation.

COMMISSIONER SULLIVAN said he did not think Alaska would become a major exporter of oil; however, he did think it would become a larger exporter of gas.

He provided examples of how other basins have turned their decline around, such as in Texas, Alberta, and North Dakota. A lot of those basins involved shale plays. The North Sea basins and Apache Corporation's Forties field acquisitions have turned declines around as a result of tax reform. He described Apache's tax reform, which had an impact on production, new jobs, and investment.

COMMISSIONER SULLIVAN related that the TAPS Throughput Committee has a much broader mandate than just tax reform. He said the state has been focused on a comprehensive plan that covers many areas beyond tax reform. For the last couple years, the state has examined permitting reform, the next phase of North Slope development, and promoting the state's resources by targeting certain companies that would be a good fit in Alaska. He agreed with a statement from Governor Parnell's 2013 State of the State address that said the state's problem with attracting investment is not below ground, but above ground.

COMMISSIONER SULLIVAN discussed the North Slope's recent and proposed activity for oil and gas. Recent lease sales demonstrated positive results. He shared that DNR has actively sought out new investment and has seen positive results. He stressed that this is only the beginning and Alaska has the ability to attract new investment by all types of players.

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SENATOR GARDNER asked about the role of Congress in developing a gas pipeline.

COMMISSIONER SULLIVAN offered to provide that information.

CO-CHAIR MICCICHE noted the presence of Senator Huggins.

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BRYAN BUTCHER, Commissioner, Department of Revenue, began the presentation on oil tax reform. He listed the four principles of oil tax reform which the Governor recently reiterated: the tax reform must be fair to Alaskans, it must encourage new production, both short-term and long-term, it should be simple so that it restores balance to the system, and it should be durable for the long term. He gave an example of the complexity of Alaska's current tax system.

CO-CHAIR MICCICHE inquired what the administration means by "it must be fair to Alaskans."

COMMISSIONER BUTCHER shared the idea proposed by former-Governor Hammond of 1/3 of profits each going to the state, the federal government, and the companies. He said that, in reality, it never works out quite that way. The state's take is much larger than the federal government's take.

COMMISSIONER SULLIVAN added that it must be fair to future generations of Alaskans.

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COMMISSIONER BUTCHER defined "durable for the long term" as a system that is competitive into the future. He pointed out that the proposed tax change is the third one in the past six or seven years. He said that the administration has a goal of making the tax a "long-term answer."

COMMISSIONER BUTCHER spoke of the integrated team made up of DOR and DNR, as well as the consulting firm Econ One Research, Inc.

COMMISSIONER BUTCHER described the process used to develop SB 21. The team reviewed previous work by both the legislature and the administration. It identified problems with the current tax system: declining production, lack of a competitive environment, problems with progressivity, and tax credits.

CO-CHAIR MICCICHE agreed that lack of competitiveness due to high government take was a problem. He asked whose role it is to determine the distribution of government take for oil and gas production and severance taxes, the legislature or the administration, or both. He suggested setting a number first.

COMMISSIONER BUTCHER said it comes down to the legislature and the Governor to determine what number is competitive and makes the most sense in moving forward.

CO-CHAIR MICCICHE asked if there was a place in global average government take where "we can see excitement beginning to occur, versus a level where there is not much happening because the take is too high."

COMMISSIONER BUTCHER did not know. He suggested Barry Pulliam with Econ One might have an answer.

CO-CHAIR MICCICHE noted that the committee would be commissioning PFC for independent consulting work.

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COMMISSIONER BUTCHER continued to identify problems with the current tax system. He discussed progressivity and tax credits. He said DOR and DNR coordinated efforts to understand the impacts of production decline on TAPS revenues.

He showed a graph that shows how the competition fared when oil prices spiked. He maintained that other basins have turned the decline around. He compared Texas, North Dakota, and Alberta with Alaska. He said the biggest takeaway compares Texas with Alaska to show that Texas flattens out and turns around, while Alaska shows no production increase at higher oil prices. He noted that unconventional oil, not shale oil, turned production around. He maintained that these examples are proof that decline is not inevitable.

COMMISSIONER SULLIVAN commented that "everybody is turning it around" except for Alaska.

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SENATOR GARDNER questioned Texas's government take during the time when production was low.

COMMISSIONER BUTCHER answered that Texas's tax rate was also low during that time. He did not know what royalties were paid to primarily private land owners. He speculated that government take was not much higher than Alaska's. He offered to find out.

CO-CHAIR MICCICHE suggested a theoretical scenario that contained two product lines; shale oil play during a high price environment and conventional oil at a low price environment. He talked about decoupling types of oil and encouraging additional production at lower prices, if shale does play out.

COMMISSIONER BUTCHER agreed that it could be done and has been considered. He spoke of heavy oil as an example and suggested that it might be incentivized.

COMMISSIONER BUTCHER explained a table with detailed models and a variety of metrics that shows how Alaska compares to other oil opportunities. The table shows an example for a 50 million barrel development in Alaska and comparable developments in the Lower 48, Canada, Norway, and the United Kingdom's North Sea. In PFC Energy's analysis last year, Alaska rated second to Norway when comparing OECD sites. At \$140 per barrel, Alaska would surpass Norway. He stated he could provide comparisons in a variety of ways.

CO-CHAIR MICCICHE said he has seen very different numbers published in tables that look like the one Commissioner Butcher presented. He questioned why there are so many versions and how to know the right numbers on which to base decisions.

COMMISSIONER BUTCHER explained that it was a very complicated issue. Progressivity, price, and credits, all have to be taken into account. He stated that DNR and DOR have presented Econ One with the most up-to-date information on how Alaska's tax system works.

CO-CHAIR MICCICHE wished to bring all the groups together and arrive at the real numbers for Alaskans. He added that if the departments have spent the time to arrive at the real numbers that should be made clear.

COMMISSIONER BUTCHER said that, generally, all the consultants get together to make sure the input to the models produce the same numbers.

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COMMISSIONER BUTCHER spoke of the difficulty of defining progressivity. He noted it was complicated and unpredictable, both for the state and investors. He described how the progressivity rate is achieved. He compared Alaska's system to North Dakota's simple tax system.

SENATOR GARDNER thought the difficulty was in calculating production tax value, but that changing progressivity and adding different values is just a formula to put into a spreadsheet. She opined that it might be complicated to explain and to set up a spreadsheet, but it's not hard after that.

COMMISSIONER BUTCHER related that companies have complained that they have to run endless numbers based on the changing price of oil. He described the difficulty of the tax system due to its not being a straight percentage.

SENATOR GARDNER did not accept that progressivity is hard to calculate.

COMMISSIONER BUTCHER added that Alaska's tax calculations must be done monthly instead of annually.

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COMMISSIONER BUTCHER explained a graph that shows the number of tax credit certificates refunded and the credits applied against production tax liability. In FY 13, of \$800 million in production tax credits, \$360 million credits were refunded and \$440 million were credits applied against production tax liability. He predicted that the total would be about \$1 billion in FY 14. He questioned what the state was getting for \$1 billion. He said it was difficult to see what the state is getting for its investment. He noted that the tax credit system is incentivizing spending, but that it has not been connected with increases in production. As a result, the administration has approached the bill cautiously.

He posed a hypothetical situation where the price of oil would drop to \$80 - \$90 per barrel over the course of a year and Alaska would have a deficit in "the billions of dollars." He spoke of the type of investment being sought.

CO-CHAIR MICCICHE requested clarification about pre-2009 through 2014 when the state averaged paying out \$375 million for credit certificates that did not produce any oil.

COMMISSIONER BUTCHER said it was speculation on the companies' parts as to what may have been produced that wouldn't have been produced as a result of production tax credits. He said that DOR was never able, in their five-year look back, to make any direct connections. He added that the total of \$5.85 billion is the amount the state either took off the tax liabilities of companies or paid out in cash over the last 5-7 years.

CO-CHAIR MICCICHE asked what conditions in 2011 made the refunds higher than the credits applied against production.

COMMISSIONER BUTCHER explained that the department relies on company expense reports. That year, more companies spent more

money. The department checks to see that the work is done and that the company qualifies for the refund before it pays.

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CO-CHAIR DUNLEAVY understood that there is no evidence that production tax credits increase production.

COMMISSIONER BUTCHER said DOR does not have that information.

COMMISSIONER SULLIVAN stressed the point that the system should be balanced and Alaska's treasury should be solid.

CO-CHAIR DUNLEAVY asked if tax credits are spending credits not tied to production.

COMMISSIONER BUTCHER said yes. The company only has to show that an expense qualifies under law.

He discussed a growing concern of DOR and DNR that TAPS tariffs in revenue modeling did not dynamically link throughput with tariff rates or capture any added capex or opex spending for low throughput mitigation measures. He said that assuming price, production and tariff provided in the "Fall 2012 Revenue Sources Book," a \$1 increase in the TAPS tariff will decrease state oil and gas revenue by an average of \$110 million.

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SENATOR GARDNER questioned the statement, "Current work not designed to find the optimal low flow mitigation option or forecast specific operational outcomes and exact tariffs." She wondered whose current work the phrase refers to.

COMMISSIONER BUTCHER explained that it means the department is running models to determine the effect an increased or lowered tariff will have, not to determine when oil will run out and TAPS would shut down.

SENATOR GARDNER asked who is doing that work. She assumed it was the operators and owners, not the department whose job it is to evaluate the impact on state revenues.

COMMISSIONER BUTCHER agreed. He added that the state is not getting involved in predicting operational outcomes.

CO-CHAIR MICCICHE said that Admiral Barrett [President, Alyeska Pipeline Services] would be covering those issues.

COMMISSIONER BUTCHER highlighted the oil tax reform proposal which would eliminate progressivity and credits based on capital expenditures - a 20 percent capital expenditure credit on the North Slope and reform remaining credits to be carried forward to when there is production - tax credits can be taken where there is a tax liability and the state would no longer be paying cash out on a yearly basis. It would also establish a "Gross Revenue Exclusion" for newer units and new participating areas in existing units targeting new oil and challenged areas, such as a new area that is far from infrastructure with higher costs, or a heavy viscous oil area. The bill also holds Cook Inlet and Middle Earth harmless.

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MICHAEL PAWLOWSKI, Oil & Gas Project Manager, Department of Revenue, began an overview of SB 21 - the oil and gas production tax. He reviewed the highlights of the bill and locations where that information can be found within the bill. The information regarding eliminating progressivity can be found in Sections 1 and 26. Conforming sections can be found in Sections 2, 5, 6, and 22. Information on North Slope credits based on capital expenditures is located in Section 8. Conforming sections are 7, 11, and 12.

CO-CHAIR DUNLEAVY questioned the contents of Section 2.

MR. PAWLOWSKI provided clarification. He said that Section 2 was also a conforming section.

SENATOR GARDNER asked for the rationale behind the "hold harmless" provision in Cook Inlet, but not for other smaller developers.

MR. PAWLOWSKI explained that the provision applies mainly to the tax ceiling. The legislature has provided for limited taxes in areas south of 68 degrees. Middle Earth has a 4 percent tax based on legislative work last year.

He discussed the sections in SB 21 related to reforming remaining credits to be carried forward until there is production. He related that the North Slope net operating loss credits are found in Sections 9 and 15, with conforming sections 10, 19 and 20. Information about small producer tax credits is found in Section 16. The forth provision, Gross Revenue Exclusion (GRE), is found in Section 24, and in the conforming section 5.

MR. PAWLOWSKI stressed that relatively few sections of the bill relate to the basic proposals for the North Slope system.

He provided locations for the provisions dealing with Cook Inlet and Middle Earth. The hold harmless provisions are found in Sections 3 and 22, with conforming sections 4, 13, 14, 17, 18, 21, and 25.

He said he hoped this guidepost would be helpful to the committee.

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CO-CHAIR MICCICHE suggested extending the meeting on Thursday to 6:00 p.m. in order to finish the presentation on SB 21.

CO-CHAIR MICCICHE held SB 21 in committee.

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There being no further business to come before the committee, Co-Chair Micciche adjourned the Senate Special Committee on TAPS Throughput at 5:01 p.m.