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STATE OF ALASKA  
OFFICE OF THE GOVERNOR  
JUNEAU

January 20, 1999

The Honorable Drue Pearce  
Senate President  
Alaska State Legislature  
State Capitol  
Juneau, AK 99801-1182

*Drue*  
Dear President Pearce:

In the interest of improving efficiency within our state government, as well as between government and industry, I am transmitting this bill to transfer oil and gas royalty audit functions from the Department of Revenue (DOR) to the Department of Natural Resources (DNR). It makes sense to put the audit duties in the same department that administers, enforces, and is therefore most knowledgeable with, the oil and gas leasing program.

Ironically, the audit functions used to rest with DNR, but were switched to DOR in 1980 based on a legislative audit report. The recommendation stated cost savings would be achieved by having one staff of auditors review both tax and royalty compliance information. Since 1980, however, the state has entered into royalty settlements with the major North Slope producers and has made changes to its tax regulations. As a result, there is no longer as much overlap between royalty and tax audits. In addition, separating DNR's duty to administer and enforce oil and gas contracts, agreements, and leases from the department's ability to conduct audits leading to possible enforcement actions, has resulted in inefficiencies and other problems.

The bill specifically authorizes DNR to audit reports and costs relating to exploration incentive credits and oil and gas licenses. It also grants DNR audit powers commensurate to those of DOR currently, including the right to subpoena information for audit purposes. The two departments would be allowed to exchange confidential information obtained in the course of their respective audits; a breach of confidentiality by any agency employee would be a felony offense.

This bill takes a sensible step in how the state does business with the oil and gas industry.

Sincerely,

*Tony Knowles*  
Tony Knowles  
Governor

# FISCAL NOTE

**STATE OF ALASKA**  
**2000 LEGISLATIVE SESSION**

**BILL NO. SB 38**

Revision Date/Time (Note if correction) March 24, 2000 - Noon Dept. Affected Revenue  
 Title Oil & Gas Audits BRU Revenue Operations  
 Component Tax Division  
 Sponsor Senate Rules  
 Requester Senate Resources Component No. 115

**Expenditures/Revenues** (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Personal Services	(230.9)	(230.9)	(230.9)	(230.9)	(230.9)	(230.9)
Travel	(2.5)	(2.5)	(2.5)	(2.5)	(2.5)	(2.5)
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
<b>TOTAL OPERATING</b>	<b>(233.4)</b>	<b>(233.4)</b>	<b>(233.4)</b>	<b>(233.4)</b>	<b>(233.4)</b>	<b>(233.4)</b>

<b>CAPITAL EXPENDITURES</b>						
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<b>CHANGE IN REVENUES ( )</b>						
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**FUND SOURCE** (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Permanent Fund receipts)	(233.4)	(233.4)	(233.4)	(233.4)	(233.4)	(233.4)
<b>TOTAL</b>	<b>(233.4)</b>	<b>(233.4)</b>	<b>(233.4)</b>	<b>(233.4)</b>	<b>(233.4)</b>	<b>(233.4)</b>

Estimate of any current year (FY2000) cost: \_\_\_\_\_

**POSITIONS**

Full-time	-3	-3	-3	-3	-3	-3
Part-time						
Temporary						

**ANALYSIS:** (Attach a separate page if necessary)

This bill transfers from DOR to DNR the responsibilities and authority for auditing reports and payments relating to revenue under oil and gas contracts, agreements and leases. This function is performed by three DOR positions that would be transferred from DOR to DNR.

The DOR positions had been funded with General Fund money but the Legislature in 1999 changed the funding source starting with the FY 2000 budget to Permanent Fund Receipts.

Prepared by: Dan Dickinson, Director Phone 269-1033  
 Division Tax Division Date/Time 3/24/00 12:00 AM  
 Approved by: Commissioner Wilson Condon Date 03/24/2000  
 Agency Department of Revenue

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### DNR Analysis of SB 38

#### "An Act relating to certain audits regarding oil and gas royalty and net profits..."

SB 38 will transfer the authority to audit royalty revenues from the Department of Revenue (DOR) to the Department of Natural Resources (DNR). This legislation will create administrative efficiencies and provide DNR with the tools to successfully pursue the state's interests in its relationship with the oil industry.

#### Background

Most of state government petroleum revenues come from two sources: production taxes levied by DOR and royalty payments administered by DNR.<sup>1</sup> The calculation of production tax and royalty payments involves very similar arithmetic. In both cases, a percentage of oil and gas production is multiplied by a "netback" value. The netback value is the difference of the price of the oil or gas at the market destination minus marine transportation costs and pipeline tariffs.

DNR and DOR used to conduct audits of their respective revenues independently. In 1980 the legislature consolidated auditing functions under DOR. The legislature felt then that a single audit authority made sense because most of the oil and gas production that was subject to royalty payments was also subject to production taxes. Given the similarity in the calculation of production taxes and royalty payments, the legislature believed a single audit was all that was needed.

Since 1980, circumstances have changed and it now makes sense for the audit authority for royalty to be transferred back to DNR. The impact of the economic

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<sup>1</sup> "Royalty payments" in this context refers to both royalty payments and net profit share payments. It is the audit of these revenue streams that are the subject of HB 58.

limit factor (ELF) means that more oil and gas production is exempt from taxes while royalty payments are still required. For example, oil producers in the Cook Inlet pay no production taxes because of the ELF but they still must pay royalties. The netback calculations required by each department also have become more dissimilar over time. Production taxes are imposed on the oil and gas producer by statute and regulations and each taxpayer calculates the netback value for taxes following identical rules. DNR calculates the netback value on the basis of leases and royalty settlement agreements that have evolved over time and are different for each lessee.

### Efficiency

The state will benefit from the specialization of a DNR in-house audit staff and by the elimination of duplication between the departments.

- Specialization. Auditors within DNR participate in the development of royalty valuation methods used in the leases and royalty settlements and are familiar with the logic and history of each lessee's unique requirements. SB 38 will grant DNR better access to audit information and DNR will be able to more efficiently guide audits while they are underway to investigate issues important to the department.<sup>2</sup>
- Reduced Duplication. DNR currently requests a royalty audit after DOR has completed the production tax audit. DOR will start a new audit separate from the original tax audit and will include tax audit information only when possible under the law. In addition to DOR staff assigned to the audit, DNR staff must be involved in the process as much possible. DNR needs to be familiar with the information acquired in the audit and DNR needs to

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<sup>2</sup> DOR recognizes the value of specialization and usually assigns the same staff to work on royalty auditor when possible. However, DOR's auditors do not work exclusively on DNR royalty audits.

provide direction and oversight while the audit is conducted. When the audit is completed and delivered to DNR, DOR must keep its own records as well as transmitting copies to DNR. If DNR conducted its own audits, fewer audit staff will be required and there will be no need for inter-department reporting. The paperwork burden for each department will be reduced.

Because the potential for overlapping responsibilities between the departments has decreased over time, a single audit of both taxes and royalty payments is not really possible. SB 38 should not create an additional burden on the taxpayer. In fact, in no other state are the tax and royalty audit functions shared by departments.

#### What does SB 38 do?

The data provided from these audits are invaluable to DNR when evaluating whether or not its royalty settlement agreements are achieving the correct royalty netback value. As the DNR crafts new valuation methods and sets new lease terms, the audits will reveal what issues need to be considered. It makes sense that DNR acquire audit information first-hand rather than via summary reports and worksheets provided by DOR.

The language in Sections 1, 2, 3, and 5 of SB 38 cleaves the royalty audit role from DOR and transfers the audit authority to DNR. When the legislature granted to DOR the sole authority to audit royalty payments, DOR already had in AS 43 a toolbox to conduct audits. The original AS 38.05.036 was fairly straightforward. SB 38 provides DNR with not only the authority conduct royalty audits but also provides DNR with some tools it will need to conduct audits. These sections also retain for each department the existing authority to acquire data from the other in order to successfully conduct its own audits.

Section 1 also adds a provision to explicitly provide DNR the authority to audit exploration incentive credits awarded under AS 41.09. This remedies an oversight in the original statute where neither DOR nor DNR had such authority.

Parts of Section 4 were added after discussions with industry. Under current law, information collected in a DOR audit is held confidential under threat of criminal penalty. The penalties of divulging information given to DNR and considered confidential under current AS 38.05.035 are not so explicit. Section 4 imposes the same criminal penalty protection on royalty audits conducted by DNR. Section 6 provides reciprocal protection when DOR acquires DNR royalty audit data.

Section 4 also extends subpoena powers to DNR. When DOR performs an audit, whether for production tax or royalty, it has the authority under AS 43 to subpoena books and records. SB 38 does not expand the state's power it only transfers existing subpoena powers to DNR. Without this change, the power of the state to audit royalty payments will be diminished. As a practical matter, subpoena powers are rarely exercised.

#### Fiscal Impact

As noted in the Fiscal Note that accompanies SB 38, three staff are transferred from DOR to DNR at no additional cost to the state. With improved efficiencies, more royalty audits can be completed in the course of a year and the backlog of audits eliminated.

SB 38 achieves an important and simple goal. In the performance of its duties to maximize the value of the state's oil and gas royalty revenues, DNR should conduct its own audits.

**SENATE COMMITTEE REPORT  
First Committee of Referral**

DATE: 1/21/99

FURTHER: Finance

Date of 5-Day Notice: 3/23/00  
(in accordance with Uniform Rule 23)

DATE TURNED  
IN TO OFFICE: 3/29/00

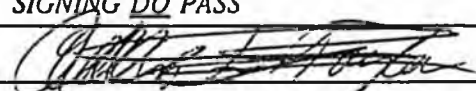
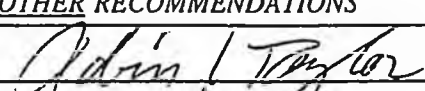
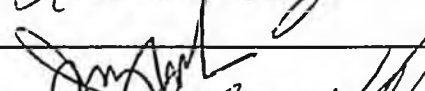
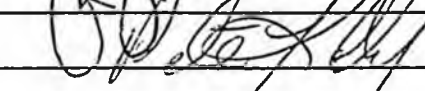
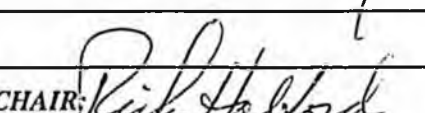
Resources Committee considered      SENATE BILL NO. 38

"An Act relating to certain audits regarding oil and gas royalty and net profits and to audits regarding costs relating to exploration incentive credits and oil and gas exploration licenses; and providing for an effective date."

and recommends:

- be replaced with \_\_\_\_\_ CS \_\_\_\_\_ (\_\_\_\_\_)
- adopt previous \_\_\_\_\_ CS \_\_\_\_\_ (\_\_\_\_\_)
- attached amendment(s)
- adopt Letter of Intent by \_\_\_\_\_ Committee
- further referral to the \_\_\_\_\_ Committee

- Senate Bill:**
- same title
  - new title
- House Bill:**
- same title
  - technical title
  - new: SCR# \_\_\_\_\_

<u>SIGNING DO PASS</u>	<u>DP</u>	<u>OTHER RECOMMENDATIONS</u>	<u>NR</u>	<u>DNP</u>	<u>AM</u>
			✓		
			✓		
			✓		
<b>CHAIR:</b>		<b>CHAIR:</b> 	✓		

**NEW FISCAL NOTE(S):**

Department	Date	Zero	Fiscal
<del>DNR</del> Revenue	3/24/00		✓
DNR	3/24/00		✓

**PREVIOUS FISCAL NOTE(S):\***

Department	Date	Zero	Fiscal
Revenue	1/21/99		✓
DNR	1/21/99		✓

APPROPRIATION -- no fiscal note

\*include fiscal notes accompanying Governor's bill