

**HB**

**3003**

**HFIN**

**FILE**

# FISCAL NOTE

STATE OF ALASKA  
2006 LEGISLATIVE SESSION

Fiscal Note Number: \_\_\_\_\_  
Bill Version: HB3003-DNR-O&G-07-26-0  
( ) Publish Date: \_\_\_\_\_

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Natural Resources  
Title Oil and Gas Taxes/Adjustment/ELF RDU Resource Development  
Component Oil and Gas Development  
Sponsor Reps. Croft, Crawford, Gruenberg  
Requester Finance Component No. 439

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

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

| OPERATING EXPENDITURES | FY 2007    | FY 2008    | FY 2009    | FY 2010    | FY 2011    | FY 2012    |
|------------------------|------------|------------|------------|------------|------------|------------|
| Personal Services      |            |            |            |            |            |            |
| Travel                 |            |            |            |            |            |            |
| Contractual            |            |            |            |            |            |            |
| Supplies               |            |            |            |            |            |            |
| Equipment              |            |            |            |            |            |            |
| Land & Structures      |            |            |            |            |            |            |
| Grants & Claims        |            |            |            |            |            |            |
| Miscellaneous          |            |            |            |            |            |            |
| <b>TOTAL OPERATING</b> | <b>0.0</b> | <b>0.0</b> | <b>0.0</b> | <b>0.0</b> | <b>0.0</b> | <b>0.0</b> |

|                      |  |  |  |  |  |  |
|----------------------|--|--|--|--|--|--|
| CAPITAL EXPENDITURES |  |  |  |  |  |  |
|----------------------|--|--|--|--|--|--|

|                        |  |  |  |  |  |  |
|------------------------|--|--|--|--|--|--|
| CHANGE IN REVENUES ( ) |  |  |  |  |  |  |
|------------------------|--|--|--|--|--|--|

**FUND SOURCE** (Thousands of Dollars)

|   |            |            |            |            |            |            |
|---|------------|------------|------------|------------|------------|------------|
| 1002 Federal Receipts                   |            |            |            |            |            |            |
| 1003 GF Match                           |            |            |            |            |            |            |
| 1004 GF                                 |            |            |            |            |            |            |
| 1005 GF/Program Receipts                |            |            |            |            |            |            |
| 1037 GF/Mental Health                   |            |            |            |            |            |            |
| Other (Specify Type--Do not abbreviate) |            |            |            |            |            |            |
| <b>TOTAL</b>                            | <b>0.0</b> | <b>0.0</b> | <b>0.0</b> | <b>0.0</b> | <b>0.0</b> | <b>0.0</b> |

Estimate of any current year (FY2006) cost: 0.0

Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:

**POSITIONS**

|           |  |  |  |  |  |  |
|-----------|--|--|--|--|--|--|
| Full-time |  |  |  |  |  |  |
| Part-time |  |  |  |  |  |  |
| Temporary |  |  |  |  |  |  |

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

There is no anticipated fiscal impact to the Department of Natural Resources.

Prepared by: William Van Dyke, Acting Director  
Division: Oil and Gas  
Approved by: Michael Mongo, Commissioner  
Agency: Natural Resources

Phone: 269-8800  
Date/Time: 7/26/2006  
Date: 7/26/2006

# FISCAL NOTE

STATE OF ALASKA  
2006 LEGISLATIVE SESSION

Fiscal Note Number: \_\_\_\_\_  
Bill Version: HB 3003  
( ) Publish Date: \_\_\_\_\_

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Revenue  
Title An Act Relating to the Oil and Gas Properties RDU Tax and Treasury  
Production Tax Component Tax  
Sponsor Rep. Croft  
Requester \_\_\_\_\_ Component No. 2476

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

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

| OPERATING EXPENDITURES         | FY 2007      | FY 2008      | FY 2009      | FY 2010      | FY 2011      | FY 2012      |
|--------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Personal Services              | 98.4         | 98.4         | 98.4         | 98.4         | 98.4         | 98.4         |
| Travel                         | 7.2          | 7.2          | 7.2          | 7.2          | 7.2          | 7.2          |
| Contractual                    | 112.5        | 3.1          | 3.1          | 3.1          | 3.1          | 3.1          |
| Supplies                       | 5.3          | 0.3          | 0.3          | 0.3          | 0.3          | 0.3          |
| Equipment                      |              |              |              |              |              |              |
| Land & Structures              |              |              |              |              |              |              |
| Grants & Claims                |              |              |              |              |              |              |
| Miscellaneous (OH office, etc) |              |              |              |              |              |              |
| <b>TOTAL OPERATING</b>         | <b>223.4</b> | <b>109.0</b> | <b>109.0</b> | <b>109.0</b> | <b>109.0</b> | <b>109.0</b> |

|                             |  |  |  |  |  |  |
|-----------------------------|--|--|--|--|--|--|
| <b>CAPITAL EXPENDITURES</b> |  |  |  |  |  |  |
|-----------------------------|--|--|--|--|--|--|

|                               |                             |
|-------------------------------|-----------------------------|
| <b>CHANGE IN REVENUES ( )</b> | <i>See analysis section</i> |
|-------------------------------|-----------------------------|

**FUND SOURCE** (Thousands of Dollars)

|   |              |              |              |              |              |              |
|---|--------------|--------------|--------------|--------------|--------------|--------------|
| 1002 Federal Receipts                   |              |              |              |              |              |              |
| 1003 GF Match                           |              |              |              |              |              |              |
| 1004 GF                                 | 223.4        | 109.0        | 109.0        | 109.0        | 109.0        | 109.0        |
| 1005 GF/Program Receipts                |              |              |              |              |              |              |
| 1037 GF/Mental Health                   |              |              |              |              |              |              |
| Other (Specify Type--Do not abbreviate) |              |              |              |              |              |              |
| <b>TOTAL</b>                            | <b>223.4</b> | <b>109.0</b> | <b>109.0</b> | <b>109.0</b> | <b>109.0</b> | <b>109.0</b> |

Estimate of any current year (FY2006) cost: \_\_\_\_\_

Check this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:

**POSITIONS**

|           |   |   |   |   |   |   |
|-----------|---|---|---|---|---|---|
| Full-time | 1 | 1 | 1 | 1 | 1 | 1 |
| Part-time |   |   |   |   |   |   |
| Temporary |   |   |   |   |   |   |

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

This bill would amend the oil and gas production tax by establishing a minimum tax rate on most North Slope oil and gas production. With the exception of heavy oil, a base tax rate of 15% would apply to all North Slope oil production. From this tax base, each oil operating unit as defined by the Department of Natural Resources would be allowed an exemption of 10,000 barrels per day from taxation. A surcharge of 0.2% would be applied to every dollar or fraction of a dollar by which the gross value at point of production exceeds \$50, to a maximum of total tax rate (including surcharge) of 25%. Heavy oil production, defined as crude oil with an assay of 18 degrees or less using the American Petroleum Institute (API) scale) would be subject to a lower base tax rate, reduced by 5% for every 1 degree API gravity that the oil falls below the API gravity threshold of 18.

The bill would also amend the tax rate on natural gas production by establishing a base tax rate of 10%. Each gas operating unit would be allowed an exemption of 60,000 mcf per day from taxation. There is no surcharge on gas production under this proposal.

Prepared by: Robynn Wilson, Michael Williams, Roger Marks, and Cheryl Nienhuis  
Division: Tax Division

Phone 269-1019  
Date/Time 7/25/06 1:00 PM

Approved by: Jerry Burnett  
Agency: Department of Revenue

Date 7/25/2006

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2006 LEGISLATIVE SESSION

BILL NO. HB 3003

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### ANALYSIS CONTINUATION

The Department of Natural Resources currently defines 11 oil production operating units on the North Slope. These are the following units: Prudhoe Bay, Colville River, Kuparuk River, Milne Point, Duck Island, North Star, Badami, Point Thomson, Ooguruk, Nikaitchuq, and Tuvaq. Most of the fields in our oil production forecast fall into one of these units. Federal properties, however, including the Liberty field and parts of the NPR-A, have not yet been utilized. Fields that do not currently belong in a unit were considered single field units for the purposes of this analysis.

The 10,000 barrel per day exemption per unit translates to about 70,000 tax-free barrels per day in FY 2007, building to 120,000 barrels per day in FY 2012, with the startup of the Liberty, NPR-A, and offshore fields. At \$60 per barrel, 120,000 tax-free barrels per day in FY 2012 equal close to \$400 million of foregone revenue.

Problems associated with identifying, measuring, and monitoring heavy oil (as described below) make a realistic assessment of the tax treatment of heavy oil extremely difficult to complete. Due to these difficulties and to the relatively negligible tax impacts of the heavy oil tax calculation, we have chosen not to attempt to model heavy oil separately. This fiscal note also does not attempt to assess the impacts this tax would have on revenue from Cook Inlet oil and gas production.

There are four issues related to heavy oil in HB 3003 that need to be recognized as critical to the collection of production taxes. These items are the following:

- Definition of Heavy Oil
- Measurement
- Time and Changes Over Time
- Technology and Time

As currently proposed in HB 3003, the four items listed above would make the collection of taxes challenging and problematic. It is assumed that heavy oil is omitted from tax liability in HB 3003 due to the difficulty and high cost of developing it. As this discussion will show, just because a crude oil is classified as heavy [according to HB 3003] does not mean it will be difficult or expensive to develop and oil not classified as heavy may be very difficult and expensive to develop. What is now classified as expensive to develop, may not be in the future. Each topic is now reviewed.

#### Definition of Heavy Oil

HB 3003 defines heavy oil as that with an American Petroleum Institute [API] gravity of 18 degrees or less. While this appears to be a "clean" definition, it omits the fact that crude oils with an API of 18 degrees or less are not necessarily difficult to produce. Other factors may be more important. Some basics:

Heavy Oil is a type of crude oil which is very viscous and does not flow easily. The common characteristic properties are the following:

- High specific gravity
- Low hydrogen to carbon ratios
- High carbon residues, and
- High contents of asphaltenes, heavy metal, sulphur and nitrogen

It is not just the gravity that makes the heavy oil difficult to deal with – it is the presence of other factors. There is no one definition of heavy oil, but it refers to oil with a high density and low API gravity due to the presence of a high proportion of heavy hydrocarbon fractions. All these definitions refer to the crude oil at the surface. In terms of the ability of the oil to flow within the formation – the key issue in Alaska – is that heavy oils are generally those with a viscosity greater than 100 centi Poise [cP] at reservoir conditions (although on occasions the term heavy oil has been applied to in situ viscosity as low as 4 cP).

Viscosity is the measure of the internal friction of a fluid. This friction becomes apparent when a layer of fluid is made to move in relation to another layer. The greater the friction, the greater the amount of force required to cause this movement, which is called "shear." Shearing occurs whenever the fluid is physically moved or distributed, as in pouring, spreading, spraying, mixing, etc. Highly viscous fluids, therefore, require more force to move than less viscous materials.

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Temperature also plays a key role in viscosity. Higher temperatures imply lower viscosity with the fluid flowing more easily. In oil formations, the deeper in the ground the oil formation, the warmer the temperature, the lower the viscosity, the easier the flow. In Alaska, the viscous oils tend to be in shallower depths, which mean the oil is cooler, more viscous, and does not flow as easily. Also, the Alaska oil is found in less consolidated formations which produce a lot of sand as the oil is produced.

The combination of temperature, viscosity, and additional components in the oil [carbon residues, heavy metals, sulphur, nitrogen and sand] make for difficulty in developing of heavy oil – not necessarily API gravity.

### Measurement

To accurately interpret HB 3003, all oil coming from the North Slope would have to be examined and evaluated to determine if it is heavy. This would imply measuring all oil produced from each well. A well may be multi-lateral with different bores going to different levels. Oil produced at one level may be classified as heavy [less than 18 degrees API] while crude produced from a different formation [same well, same field, different depth] may not be classified as heavy. Measurement could be a nightmare.

### Time and Changes Over Time

The production would have to be measured and monitored on a monthly basis. Changes in field operations occur all the time. A well may be producing oil classified as heavy today, and that classification could change in a day, a week, a month, or a year as new bores are drilled into different layers. Thus, the measurement aspect would have to be an on-going monthly event.

### Technology and Time

What may be difficult and expensive to produce today, may well be commonplace and cheaper to produce in the future. The oil industry has shown tremendous ingenuity in developing techniques to find and develop oil. For example, in the case of deepwater offshore oil development, it was impossible to produce oil from depths greater than 600 meters in the early 1970s. By 2003, oil companies were regularly producing oil at depths below 1,500 meters. New systems and techniques were developed to access the oil deeper and deeper under the ocean.

In North America, similar results can be found in Canada where new techniques have been introduced to develop heavy oil. As the new techniques were developed, the per barrel costs of developing heavy oil decreased.

In summary, oil that is difficult and expensive to produce today may well be less expensive to produce in the future. Any legislation that assumes heavy oil will always be expensive to develop does not take into account the dynamic nature of the oil industry and its ability to develop new methods and techniques to produce hydrocarbons, and reduce costs in the process.

### Conclusions

Legislation that seeks to tax oil production using API gravity as a means to determine tax liability has a high likelihood of being difficult to administer while offering real challenges to measure and enforce. Changes in methods and technology over time will likely allow heavy oil to be recovered and often developed at a lower per barrel cost as time marches on. This means the very rationale for using heavy oil as a discriminating factor will lose its basis over time. It is recommended that another option be used for tax legislation purposes.

Costs associated with this bill fall into three categories: (1) A one-time information technology/database change estimated to be \$50,000; (2) A one-time expenditure of about \$60,000 for assistance with drafting regulations; and (3) two half-time equivalent individuals for additional engineering and audit work pertinent to the heavy oil designation and to North Slope fields that currently pay little or no tax.

The bill would be effective September 1, 2006.

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**ANALYSIS CONTINUATION (MILLIONS OF 2005 DOLLARS)**

The figures in the table below reflect the revenues that would be received from the bill relative to the status quo for FY 2007-2012 at the DOR forecast prices, a \$40 price and a \$60 price. (Note that the status quo numbers are slightly different from what is reflected in the Spring 2006 Revenue Sources Book because of volume adjustments from the oil spill, and because of some differences between what some taxpayers actually remit and what is ultimately expected to be collected.) The figures reflect North Slope activity; the impact on Cook Inlet is expected to be modest. The status quo tax figures assume the January 2005 ELF aggregation decision by the Department of Revenue for Prudhoe Bay continues.

| Fiscal Year | DOR Forecast | Status Quo Tax | Tax from Bill | Gain from Bill |
|-------------|--------------|----------------|---------------|----------------|
| 2007*       | \$53.60      | 989            | 1,525         | 537            |
| 2008        | \$46.90      | 759            | 1,361         | 602            |
| 2009        | \$25.50      | 355            | 647           | 292            |
| 2010        | \$25.50      | 315            | 610           | 294            |
| 2011        | \$25.50      | 281            | 582           | 301            |
| 2012        | \$25.50      | 271            | 569           | 298            |

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| Fiscal Year | Medium Price | Status Quo Tax | Tax from Bill | Gain from Bill |
|-------------|--------------|----------------|---------------|----------------|
| 2007*       | \$40.00      | 708            | 1,088         | 380            |
| 2008        | \$40.00      | 655            | 1,135         | 480            |
| 2009        | \$40.00      | 631            | 1,160         | 529            |
| 2010        | \$40.00      | 582            | 1,128         | 546            |
| 2011        | \$40.00      | 544            | 1,110         | 566            |
| 2012        | \$40.00      | 536            | 1,102         | 566            |

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| Fiscal Year | High Price | Status Quo Tax | Tax from Bill | Gain from Bill |
|-------------|------------|----------------|---------------|----------------|
| 2007*       | \$60.00    | 1,120          | 1,811         | 691            |
| 2008        | \$60.00    | 1,032          | 1,892         | 861            |
| 2009        | \$60.00    | 978            | 1,948         | 971            |
| 2010        | \$60.00    | 901            | 1,896         | 995            |
| 2011        | \$60.00    | 842            | 1,866         | 1,024          |
| 2012        | \$60.00    | 831            | 1,856         | 1,025          |

\*FY 2007 revenues were adjusted for September 1, 2006 start date

4-27-06

# **HB 3003**

## **The “True Value / Shelf the ELF” Bill**

**Representative Eric Croft  
House Finance Committee  
July 27, 2006**

**Yesterday's presentation did an excellent job of explaining the benefit of gross vs. net, and the need to reform the system this year.**

**This will be much more brief.**

# A Tax on the Gross is Better

- Simple and Understandable
- Easier to administer and audit
- Preferred by general public
- Can raise the same revenue as any PPT without the risk of manipulation
- Continues to raise revenue during gas field development without the problem of gas credits wiping out oil revenue

## **Oil production taxes are not like a “tax” on other kinds of business**

- Not a manufacturing process
- Not a service
- Oil companies are privatizing a publicly-owned resource. The portion received by the state is not a “tax,” it is the price we receive for selling our resources
- Selling our resources based on the “net” creates the possibility we can get nothing

# **Incentivizing new development is important. So is stopping the bleeding.**

Several factors why North Slope development expenditures are flat, that are beyond the scope of this bill:

1. New resources in unstable regimes in Central Asia and Africa must be developed quickly while there are still friendly governments
2. Other oil provinces enforce a much stronger “duty to develop”
3. Weak facility access works against new producers
4. High pipeline tariffs on TAPS system owned by the Big Three discourages new development

# What HB 3003 Does:

1. Raises same amount as 20/20 PPT at \$60 oil
2. Eliminates the complex and obsolete ELF language in AS 43.55.012-013
3. Base 15% tax on wellhead value
4. Progressivity of up to 25% at higher prices
5. Protects smaller fields and Cook Inlet with volume exclusion (“standard deduction”) of first 10,000 barrels per day per operating unit
6. Reduced rate for heavy oil
7. Broadens ability to challenge TAPS tariffs
8. Four pages long

# 1. Raises same amount as 20/20 PPT at \$60 oil

## Est. Revenue of Various Oil Tax Bills (\$ millions)

|                                       | \$40    | \$60    |
|---------------------------------------|---------|---------|
| Existing ELF                          | \$708   | \$1,120 |
| House Adopted SB 305 (21.5)           | \$926   | \$2,284 |
| House Adopted SB 2001 (23.5)          | \$1,171 | \$2,881 |
| Conf. Committee SB 2001 (22.8)        | \$1,141 | \$2,515 |
| Governor's HB 3001 (20)               | \$972   | \$1,994 |
| Rep. Gara's HB 3004                   | \$1,556 | \$2,938 |
| HB 3003 (begin progressivity at \$50) | \$1,188 | \$1,995 |
| HB 3003 (begin progressivity at \$35) | \$1,188 | \$2,366 |

**Is 20 / 20 Too Low?**

**Yes.**

## **2. Eliminates the complex and obsolete ELF language in AS 43.55.012-013**

- Pedro Van Meurs says he attempted to fix the ELF in 2001
- Any “gross” tax reform that preserves the ELF formula will continue to have major distortion and unfairness
- At projected oil prices we don’t need the extreme tax breaks some fields receive with ELF

### 3. Base 15% tax on wellhead value

- Only auditable item is transportation, just like at present
- Eliminates 12.25% rate for first five years and obsolete “cents per barrel” tax

## 4. Progressivity of up to 25% at higher prices

- Uses similar mechanism as many of the PPT versions
- Increases tax rate by 0.2% per dollar above \$50 / barrel at the wellhead
- (Tax rate is 17% at \$60, 19% at \$70, etc)
- Hits maximum 25% rate at \$50 above trigger point, \$100 at the wellhead
- Easy to adjust bill to desired revenue by changing the trigger point

**5. Protects smaller fields and Cook Inlet with volume exclusion (“standard deduction”) of first 10,000 barrels per day per operating unit**

- The lower a unit’s production, the greater the tax benefit
- Value of the exclusion would be pro-rated among unit participants based upon percentage of volume produced
- Operating Unit is defined by DNR approval in AS 38.05.180(p)
- Using the Unit Agreement aggregates any satellite fields with the main field

**5. Protects smaller fields and Cook Inlet with volume exclusion (“standard deduction”) of first 10,000 barrels per day per operating unit**

**Currently seven oil producing units on the North Slope**

| <b>Unit</b>             | <b>Jan. 2006 daily production</b> | <b>Base Tax Rate under HB 3003</b> | <b>Current Rate with ELF</b> |
|-------------------------|-----------------------------------|------------------------------------|------------------------------|
| Prudhoe Bay             | 473,700                           | 14.7%                              | 12.4%                        |
| Kuparuk                 | 159,400                           | 14.0%                              | 0.0%                         |
| Colville River (Alpine) | 122,700                           | 13.8%                              | 11.9%                        |
| Milne Point             | 42,100                            | 11.4%                              | 0.0%                         |
| Northstar               | 40,700                            | 11.3%                              | 6.1%                         |
| Duck Island (Endicott)  | 19,200                            | 7.2%                               | 0.0%                         |
| Badami                  | 1,570                             | 0.0%                               | 0.0%                         |

**5. Protects smaller fields and Cook Inlet with volume exclusion (“standard deduction”) of first 10,000 barrels per day per operating unit**

**Currently four oil producing units in Cook Inlet**

**All will pay zero production tax under HB 3003**

## 6. Reduced rate for heavy oil

- Oil with API gravity of 18 or more pays the full rate
- For each point below 18, the tax rate is decreased by 5%
- (Thus API 17 oil pays 95% the taxes of API 18 oil)

## 7. Broadens ability to challenge TAPS tariffs

- Tariff and transportation costs are the only “fudgeable” numbers in the gross tax system
- Currently, “gross value at the point of production” equals market price less reasonable transportation
- Existing law says that “reasonable” costs equals “actual” costs unless three conditions exist
  1. Producer and transporter are “affiliated”
  2. Not an “arms length transaction”
  3. Method of transportation is not reasonable
- Bill clarifies that only one of three needs to exist for DOR to intervene in determining reasonable costs

## 8. Four pages long

- Simple, readable, understandable bill
- No hidden surprises in the language
- No new powers or processes
- No hidden surprises in the language

## Similarities between HB 3003 and HB 3004

- Both based on gross wellhead value
- Both use a base 15% rate, with lower rates for certain oil fields
- Both have progressivity with maximum rates between 25% and 27.5% that are reached at about \$100 oil

# Differences between HB 3003 and HB 3004

- HB 3003 goes to a flat 15% rate  
HB 3004 keeps the ELF but substitutes a 5% alternative minimum “floor”
- HB3003 has the 15% rate for all prices up to the progressivity trigger point  
HB 3004 has “reverse progressivity” below \$16 and the ability to apply for tax relief
- HB 3003 addresses tariff issues  
HB 3004 addresses facility access issues
- Different revenue, but both bills can be adjusted to generate desired revenue

# Possible alternative approach: capital development credits

- 20% tax credit for well development and construction
- Broadens the existing 40% exploration tax credit
- May not reduce taxes by more than  $\frac{1}{2}$ , but can be carried forward
- Must be for well construction and related capital expenditures
- May not be used for administration, management, and other indirect costs

# Conclusion

## Legislative Wisdom

1. Law of Unintended Consequences  
*Minimum Action to Fix Known Problem*
2. If You Don't Understand It, Vote No  
*Get A Bill We Understand*
3. Politics Gets in the Way of Good Policy  
*We Can Do Great Things if We Don't Care  
Who Gets the Credit*

## HB 3003 Croft True Value "Shelf the ELF" Bill

### Bill Summary:

- Eliminates ELF multiplier, keeping base 15% tax rate on wellhead value. Royalty oil is excluded
- Progressivity of 0.2% per dollar over \$50 wellhead value, with a maximum tax rate of 25% reached at \$100 oil
- Standard deduction for oil of 10,000 barrels per day per operating unit. The net effect is, smaller units pay significantly less than Prudhoe Bay and Cook Inlet operators pay zero
- Standard deduction for gas of 60,000 Mcf per day per operating unit. This preserves our existing taxes for future North Slope production, and taxes less than 1/3 of Cook Inlet gas
- Tax rate reduced by 5% per degree for heavy oil below 18 degrees API
- Broadens the state's ability to challenge TAPS tariffs
- Estimated revenue is comparable to what the oil companies agreed to in the Governor's original 20 / 20 PPT bill
- Fair and simple bill easy to implement and regulate

|                             | Existing ELF                         | Governor's<br>PPT<br>HB-3001 | Conference<br>Committee PPT<br>SB 2001 | Croft's True<br>Value Plan<br>HB 3003           |
|-----------------------------|--------------------------------------|------------------------------|--|---|
| Base Oil Tax                | 15%                                  | 20%                          | 22.8%                                  | 15%   |
| Base Gas Tax                | 10%                                  | 6.67%                        | 20%                                    | 10%   |
| Tax Basis                   | Gross Value                          | Reported<br>Profits          | Reported Profits                       | Gross Value                                     |
| Heavy Oil<br>Benefit        | None if oil over<br>about \$10 / bbl | None                         | None                                   | 5% tax break for<br>each degree<br>below API 18 |
| Complexity                  | Moderate                             | High                         | Extreme                                | Low   |
| Verifiable?                 | Yes                                  | No                           | No                                     | Yes   |
| Playground for<br>Lawyers?  | Moderate                             | High                         | High                                   | Low   |
| 2007 Revenue<br>at \$40 Oil | \$708 million                        | \$972 million                | \$1,140 million                        | \$1,188 million                                 |
| 2007 Revenue<br>at \$60 Oil | \$1,120 million                      | \$1,994 million              | \$2,515 million                        | \$1,995 million                                 |

**HB 3003**  
**Croft True Value "Shelf the Elf" Bill**  
**Sectional Analysis**

**Section 1**

Eliminates tax rate reference to ELF multiplier and alternative cents-per-barrel tax on oil.

**Section 2**

Eliminates 12.25% tax rate for first five years of production, leaving only the base 15% rate. Adds a progressivity multiplier by which the tax rate increases by 0.2% per dollar above \$50 / barrel, calculated on gross value at the wellhead. Maximum rate is 25% is reached when oil value reaches \$100 / barrel.

**Section 3**

Adds exclusion from oil taxes for first 10,000 barrels per day per operating unit. Value of exclusion is pro-rated among unit participants. Creates multiplier for heavy oil; the tax is reduced by 5% of the total per point of API for each point below 18.

**Section 4**

Eliminates alternative cents-per-Mcf tax on gas.

**Section 5**

Clarifies base 10% tax rate on gas, adding the word "taxable" so as to enable exclusion described in Section 6.

**Section 6**

Adds exclusion from gas taxes for first 60,000 Mcf per day per operating unit. Value of exclusion is pro-rated among unit participants.

**Section 7**

Clarifies that "gross value at the point of production" is based on reasonable transportation costs, and broadens the circumstances under which "actual cost" is not the appropriate measure.

**Section 8**

When actual cost is inappropriate, generally when the producer and pipeline owner are affiliated entities, the state shall determine reasonable transportation costs.

**Section 9**

Creates a definition of "operating unit" for the purpose of the Section 3 and Section 6 exclusions.

**Section 10**

Repeals chapters related to the ELF multiplier calculation and related definitions.

**Section 11**

Effective date

7/27/06

## CPF Testimony before House Finance on HB3004

1. Before proceeding, I want to disclose to you that, immediately prior to serving on the AOGCC, I worked as an engineering consultant and, as such, I participated in preparing the "North Slope of Alaska Facility Sharing Study" performed by Petrotechnical Resources of Alaska for the Division of Oil and Gas of the Department of Natural Resources. I discussed this participation with the other AOGCC commissioners and they agreed that this did not represent a conflict of interest. However, I did want to disclose the information to you.
2. My comments will be limited to Section 1 of HB 3004 addressing facility access.
3. The AOGCC recognizes the need to enable new operators to acquire reasonable access to existing facility infrastructure.
4. If the Legislature adopts HB3004, the AOGCC will do our best to implement it.
5. That said, there are a few challenges to implementing this bill as it is currently written and, if you'll bear with some technical description from me, I'll explain what those are with some suggested ways around them.
6. The bill requires working interest owners to provide access to production or other facilities "only if the commission finds that the facility has excess capacity and that directing the working interest owner to provide access by or for the benefit of others would not materially interfere with the owner's paramount use of the facility." The AOGCC has two concerns with this wording.

- a. First, there will never be excess capacity in the oil production facilities that this bill is targeting. Let me explain why I say this.

#### Explain Facility Capacity

However, there is a way that new production can, and in fact already does, get access:

#### Explain Back Out

That's how it looks for the existing owners' new production. For a new player, this is how it would look:

Show how the DNR study suggests letting someone new in

- b. Even if we get past the "excess capacity" wording, there is a second complication. Since the owner's paramount use of the facility is to separate the associated gas and water from their oil, any back out for another operator would interfere with their "paramount use of the facility."
7. Supposing that we work our way past these two concerns, let's next take a look at the fiscal impact.
    - a. First, a primary role here is a rate-setting role, and the AOGCC has no staffing or experience in rate setting. Therefore, to take on this rate-setting role we would have to hire accountants and/or other financial expertise.

- b. Second, we would need someone on staff who understands and can oversee facility optimization; we currently have no one on staff to perform that function.
- 8. We have one final concern with placing this authority within the AOGCC. And that is the potential for conflict with the AOGCC's role implementing the Oil & Gas Conservation Act. The commission is charged with preventing waste, ensuring greater ultimate recovery, protecting correlative rights, and protecting ground waters. Decisions under this bill may be in conflict with the commission's responsibility to prevent waste of hydrocarbon resources and ensure greater ultimate recovery. For example, granting access to a production facility for one WIO's high-oil-rate well may result in the permanent loss of oil from the WIO whose marginal well is backed out of the facility.
- 9. Our recommendation would be to give this rate-setting responsibility to either a new or an existing agency that is intended as a rate-setting agency.
- 10. I want to conclude by reiterating what I said first: The AOGCC recognizes the need to enable new operators to acquire reasonable access to existing facility infrastructure, and if the Legislature adopts HB3004, the AOGCC will do our best to implement it.

Judy  
Brady

**Testimony of the  
Alaska Oil & Gas Association  
to the  
House Finance Committee  
July 27, 2006**

**HB 3003 and HB 3004**

Thank you for the opportunity to comment on the proposed production tax legislation you've been discussing – proposed legislation that increases oil production taxes substantially.

My name is Judy Brady. I am testifying today as executive director of the Alaska Oil & Gas Association (AOGA). With me is Michael Hurley, chairman of AOGA's Tax Committee. AOGA is a private non-profit trade association whose 18 member companies represent the majority of the oil and gas exploration, production, transportation, refining and marketing activities in Alaska.

HB 3003 and HB 3004 are tax bills introduced for the first time in this special session. Both proposed bills go back to the present production tax – and add some new twists, in order to increase taxes; HB 3004 adds complications to the present tax system, and raises policy issues that are arguably outside the call of this special session; both are strictly tax increases on the gross production at a level that fails to address the critical need for Alaska to attract new investment at the same time as the state's share in oil revenues increases.

You have heard us say many times that declining production is the eight hundred pound gorilla in Alaska's future. Tax legislation must be configured to attract the new investment necessary to increase production. Incentives for new investment and reasonable tax rates that keep Alaska competitive with like oil and gas regions must be part of the package. Any legislation that overreaches on tax rates or neglects real world incentives will simply be a black hole that leaves Alaska as a backwater in worldwide oil and gas regions.

There are now 14 days left in this special session – and four tax bills on the table. HB 3003 and HB 3004 you've just been hearing. HB 3005 was introduced two days ago. We understand two other bills are being drafted. Of the four tax bills presently on the table, only one has been the subject of long and intense review and scrutiny – and that is HB 3001, the Petroleum Production Tax legislation. The PPT legislation was the subject of hundreds of hours of hearings in the last legislative session and in the last special session. It has been reviewed and critiqued by consultants hired by the legislature, the administration and the oil and gas companies affected. The parameters of this legislation are well understood.

We ask you to consider focusing the remaining days in this special session on reviewing, finalizing and adopting HB 3001. The fact of the matter is that developing clear, fair tax legislation that both incentivizes investment and brings a larger share of revenue to the state...is rocket science. Those of you who have spent hundreds of hours trying to develop fair, equitable legislation, are well aware of this fact. Rocket science takes time. The legislature has spent that time on a new approach for oil production tax in Alaska - a tax that

reflects real production economics. A tax that substitutes real cost figures for the proxy Economic Limit Factor. The promise is that this tax will increase revenues to Alaska by over one billion dollars a year. The promise is that in addition to increased revenues, this tax will provide incentives for new investments for the new production so desperately needed.

#### AOGA Supports HB3001 – Governor's PPT

- Even Though many of our members remain concerned that the increased level of state take reflected in this bill will result in reduced investment in Alaska. This bill would raise taxes on the industry over \$1 billion a year at \$60/bbl.
- There continues to be a sense of astonishment in oil and gas financial circles about this agreement to a tax increase of this size.
- And would raise total government take to around 60%.
- "Government take" – royalty; production tax, corporate Income tax; property tax, federal taxes
- What do "costs" have to do with it– costs have to be counted-either directly or as a proxy to conserve oil in the ground in maturing fields
- PPT more accurately reflects true production economics
- The balance in the PPT is the higher tax rate counterbalanced by the reinvestment incentive.
- The balance is essential – throughout the hearings on PPT there have been references to countries with a "higher" government take than Alaska – as Pedro Van Muers and other consultants have pointed out, many of those countries either have government-owned oil companies or are using production sharing contracts. In both cases the governments take a bigger share of risk for a bigger share of profits.
- Some policy makers seem to be frozen between the concepts of "risk" and "profits". They want a lot more of the share of the profits; they don't want any share of the risk.
- This one-sided "two for me – one for you" won't work in the worldwide competitive market. Under those terms, Alaska's won't even place for new investment in any serious way.

Gross Versus Net tax – Criticisms of a Net system seem to be based on a misunderstanding of how the present system works and how the PPT would work.

- The ELF in the current system is a proxy for costs. So in that sense the current system is a form of "net" tax. The PPT simply substitutes real costs for the proxy.
- Some legislators have expressed the concern that the state does not have the capability to determine real costs. However the State currently audits the costs in the netback in a lot of detail.
- Operating and capital costs are in our state income tax return and Property tax renderings

#### AOGA Does Not Support either HB3003 or HB3004

- These bills are simply tax increases- with no counterbalance
- No re-investment incentives, do nothing to stem decline or encourage investment, there's no structural change in the risk sharing.
- With HB3003 ELF disappears so there's no recognition of costs at all.

FINAL

- HB3004 is a band-aid approach -- a higher rate, with much more complexity . It seemed puzzling that the sponsor spent so much of his time providing figures about the industries profits, yet was proposing a tax that has nothing to do with the profits.

#### Oil and Gas Tax Legislation Is Not a Game of Texas Hold 'Em

- Whether it is political one-ups-man-ship during an election year – or real belief that Alaska does not have to be competitive to attract new investment – the bidding up of how much the State of Alaska can "make" or "take" from oil production is going to lose the game for all of us.

The end game for Oil and Gas Tax Legislation can be About a Higher Return for the State of Alaska but must recognize the need for Incentives that foster additional Investment – Bottom Line – It is About Increasing Production and keeping Alaska competitive.

7/27/06  
Cathy Foerster

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