

3/4/06

**PRESENT-  
ATION ON  
OIL & GAS  
PRODUC-  
TION TAX**

**SFIN**

**FILE**

SENATE BILL NO. 305

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - SECOND SESSION

BY THE SENATE RULES COMMITTEE BY REQUEST OF THE GOVERNOR

Introduced: 2/21/06

Referred: Resources, Finance

A BILL

FOR AN ACT ENTITLED

1 "An Act repealing the oil production tax and gas production tax and providing for a  
2 production tax on the net value of oil and gas; relating to the relationship of the  
3 production tax to other taxes; relating to the dates tax payments and surcharges are due  
4 under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the  
5 treatment of oil and gas production tax in a producer's settlement with the royalty  
6 owner; relating to flared gas, and to oil and gas used in the operation of a lease or  
7 property, under AS 43.55; relating to the prevailing value of oil or gas under AS 43.55;  
8 providing for tax credits against the tax due under AS 43.55 for certain expenditures,  
9 losses, and surcharges; relating to statements or other information required to be filed  
10 with or furnished to the Department of Revenue, and relating to the penalty for failure  
11 to file certain reports, under AS 43.55; relating to the powers of the Department of  
12 Revenue, and to the disclosure of certain information required to be furnished to the

1 Department of Revenue, under AS 43.55; relating to criminal penalties for violating  
 2 conditions governing access to and use of confidential information relating to the oil and  
 3 gas production tax; relating to the deposit of money collected by the Department of  
 4 Revenue under AS 43.55; relating to the calculation of the gross value at the point of  
 5 production of oil or gas; relating to the determination of the net value of taxable oil and  
 6 gas for purposes of a production tax on the net value of oil and gas; relating to the  
 7 definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making  
 8 conforming amendments; and providing for an effective date."

9 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

10 \* Section 1. The uncodified law of the State of Alaska is amended by adding a new section  
 11 to read:

12 INTENT OF SEC. 11 OF THIS ACT. It is the intent of the legislature through sec. 11  
 13 of this Act to confirm by clarification the long-standing interpretation of AS 43.55.020(f) by  
 14 the Department of Revenue.

15 \* Sec. 2. AS 43.20.031(c) is amended to read:

16 (c) In computing the tax under this chapter, the taxpayer is not entitled to  
 17 deduct any taxes based on or measured by net income. The taxpayer may deduct the  
 18 tax levied and paid under AS 43.55.

19 \* Sec. 3. AS 43.20.072(b) is amended to read:

20 (b) A taxpayer's business income to be apportioned under this section to the  
 21 state shall be the federal taxable income of the taxpayer's consolidated business for the  
 22 tax period, except that

23 (1) taxes based on or measured by net income that are deducted in the  
 24 determination of the federal taxable income shall be added back; the tax levied and  
 25 paid under AS 43.55 may not be added back;

26 (2) intangible drilling and development costs that are deducted as  
 27 expenses under 26 U.S.C. 263(c) (Internal Revenue Code) in the determination of the  
 28 federal taxable income shall be capitalized and depreciated as if the option to treat

1 them as expenses under 26 U.S.C. 263(c) (Internal Revenue Code) had not been  
2 exercised;

3 (3) depletion deducted on the percentage depletion basis under 26  
4 U.S.C. 613 (Internal Revenue Code) in the determination of the federal taxable income  
5 shall be recomputed and deducted on the cost depletion basis under 26 U.S.C. 612  
6 (Internal Revenue Code); and

7 (4) depreciation shall be computed on the basis of 26 U.S.C. 167  
8 (Internal Revenue Code) as that section read on June 30, 1981.

9 \* Sec. 4. AS 43.05.230(f) is amended to read:

10 (f) A wilful violation of the provisions of this section or of a condition  
11 imposed under AS 43.55.040(1)(B) is punishable by a fine of not more than \$5,000,  
12 or by imprisonment for not more than two years, or by both.

13 \* Sec. 5. AS 43.55.011(a) is repealed and reenacted to read:

14 (a) There is levied upon the producer of oil or gas a tax for all oil and gas  
15 produced each month from each lease or property in the state, less any oil and gas the  
16 ownership or right to which is exempt from taxation. The tax is equal to 20 percent of  
17 the net value of the taxable oil and gas as calculated under AS 43.55.160.

18 \* Sec. 6. AS 43.55.017(a) is amended to read:

19 (a) Except as provided in this chapter, the taxes imposed by this chapter are in  
20 place of all taxes now imposed by the state or any of its municipalities, and neither the  
21 state nor a municipality may impose a tax upon

22 (1) producing oil or gas leases;

23 (2) oil or gas produced or extracted in the state;

24 (3) the value of intangible drilling and development costs, as defined  
25 in 26 U.S.C. 263(c) (Internal Revenue Code), as amended through January 1,  
26 1974 [EXPLORATION EXPENSES].

27 \* Sec. 7. AS 43.55.020(a) is repealed and reenacted to read:

28 (a) The production tax on oil and gas shall be paid as set out in this subsection.  
29 Ninety percent of the tax levied under AS 43.55.011, net of any credits applied under  
30 this chapter, is due on the last day of each calendar month on oil and gas produced  
31 from each lease or property during the preceding month. The remaining portion of the

1 tax levied under AS 43.55.011, net of any credits applied under this chapter, is due on  
 2 March 31 of the year following the calendar year during which the oil and gas were  
 3 produced. An unpaid amount of tax that is not paid when due in accordance with this  
 4 subsection becomes delinquent. An overpayment of tax with respect to a month may  
 5 be applied against the tax due for any later month. Notwithstanding any contrary  
 6 provision of AS 43.05.280, interest on an overpayment is allowed only from a date  
 7 that is 90 days after the later of (1) the March 31 described in this subsection; or (2)  
 8 the date that the statement required under AS 43.55.030(a) and 43.55.030(e) to be filed  
 9 on or before that March 31 is filed. However, interest is not allowed if the  
 10 overpayment was refunded within the 90-day period.

11 \* Sec. 8. AS 43.55.020(b) is amended to read:

12 (b) The production tax on oil and [OR] gas shall be paid by or on behalf of the  
 13 producer.

14 \* Sec. 9. AS 43.55.020(d) is amended to read:

15 (d) In making settlement with the royalty owner with respect to oil or gas  
 16 that is taxable under AS 43.55.011, the producer may deduct the amount of the tax  
 17 paid on taxable royalty oil and [OR] gas, or may deduct taxal royalty oil or gas  
 18 equivalent in value at the time the tax becomes due to the amount of the tax paid.  
 19 Unless otherwise agreed between the producer and the royalty owner, the  
 20 amount of the tax paid on taxable royalty oil and gas for a month is deemed to be  
 21 the product of the quantity of that taxable royalty oil and gas produced during  
 22 the month times the quotient of the producer's total tax liability for the month of  
 23 production under AS 43.55.011 divided by the producer's total quantity of  
 24 taxable oil and gas, other than royalty oil and gas, produced from all leases and  
 25 properties in the state during the month. For purposes of the product calculated  
 26 under this subsection, 6,000 cubic feet of gas are considered to be equivalent in  
 27 amount to one barrel of oil.

28 \* Sec. 10. AS 43.55.020(e) is repealed and reenacted to read:

29 (e) Gas flared, released, or allowed to escape in excess of the amount  
 30 authorized by the Alaska Oil and Gas Conservation Commission is considered, for the  
 31 purpose of AS 43.55.011 - 43.55.160, as gas produced from a lease or property. Oil or

1 gas used in the operation of a lease or property in the state in drilling for or producing  
2 oil or gas, or for repressuring, except to the extent determined by the Alaska Oil and  
3 Gas Conservation Commission to be waste, is not considered, for the purpose of  
4 AS 43.55.011 - 43.55.160, as oil or gas produced from a lease or property.

5 \* Sec. 11. AS 43.55.020(f) is amended to read:

6 (f) If oil or gas is not sold, or if oil or gas is sold under circumstances where  
7 the sale price does not represent the prevailing value for oil or gas of like kind,  
8 character, or quality in the field or area from which the product is produced, the  
9 department may require the tax to be paid upon the basis of the value of oil or gas of  
10 the same kind, quality, and character prevailing during the calendar month of  
11 production for that field or area.

12 \* Sec. 12. AS 43.55 is amended by adding a new section to read:

13 **Sec. 43.55.024. Tax credits for certain losses and expenditures.** (a)  
14 Notwithstanding that a qualified capital expenditure may be a deductible lease  
15 expenditure for purposes of calculating the net value of oil and gas under  
16 AS 43.55.160(a), a producer or explorer that incurs a qualified capital expenditure  
17 may also elect to take a tax credit in the amount of 20 percent of that expenditure,  
18 unless a credit for that expenditure is taken under AS 43.55.025. A credit under this  
19 subsection may be applied only against a tax due under AS 43.55.011 - 43.55.160.  
20 Only for a calendar year for which the producer makes an election under  
21 AS 43.55.160(f), a producer that incurs a qualified capital expenditure during that year  
22 and that wishes to apply a credit based on that expenditure against a tax due under  
23 AS 43.55.011 - 43.55.160 shall calculate and apply every month an annualized tax  
24 credit in an amount equal to one and two-thirds percent of the total qualified capital  
25 expenditures incurred during that year and for which the tax credit is taken for that  
26 year, instead of taking a tax credit of 20 percent of each separate qualified capital  
27 expenditure after it has been incurred.

28 (b) A producer may elect to take a tax credit in the amount of 20 percent of a  
29 carried-forward annual loss. A credit under this subsection may be applied only  
30 against a tax due under AS 43.55.011 - 43.55.160. For purposes of this subsection, a  
31 carried-forward annual loss is the amount of a producer's adjusted lease expenditures

1 under AS 43.55.160 for a previous calendar year that was not deductible in any month  
2 under AS 43.55.160(a) and (b).

3 (c) A credit under this section may not be used to reduce a person's tax  
4 liability under AS 43.55.011- 43.55.160 for any month below zero; any portion of a  
5 credit not used for that reason may be applied in a later month.

6 (d) A person entitled to take a tax credit under this section that wishes to  
7 transfer the unused credit to another person may apply to the department for a  
8 transferable tax credit certificate. An application under this subsection must be on a  
9 form prescribed by the department and must include supporting information and  
10 documentation that the department reasonably requires. The department shall either  
11 grant or deny an application, or grant it as to a lesser amount than that claimed and  
12 deny it as to the excess, no later than 60 days after the latest of (1) March 31 of the  
13 year following the calendar year in which the qualified capital expenditure or carried-  
14 forward annual loss for which the credit is claimed was incurred; (2) if the applicant is  
15 required under AS 43.55.030(a) and 43.55.030(e) to file a statement on or before the  
16 March 31 described in (1) of this subsection, the date the statement was filed; or (3)  
17 the date the application was received by the department. If, based on the information  
18 then available to it, the department is reasonably satisfied that the applicant is entitled  
19 to a tax credit, the department shall issue the applicant a transferable tax credit  
20 certificate for the amount of the credit. A certificate issued under this subsection does  
21 not expire.

22 (e) A person to which a transferable tax credit certificate is issued under (d) of  
23 this section may transfer the certificate to another person, and a transferee may further  
24 transfer the certificate. Subject to the limitations set out in (a) - (c) of this section, and  
25 notwithstanding any action the department may take with respect to the applicant  
26 under (f) of this section, the owner of a certificate may apply the credit or a portion of  
27 the credit shown on the certificate only against a tax due under AS 43.55.011 -  
28 43.55.160. However, credits shown on transferable tax credit certificates may not be  
29 applied so as to reduce a producer's total tax due under AS 43.55.011 - 43.55.160 on  
30 oil and gas produced during a calendar year to less than 80 percent of the tax that  
31 would otherwise be due without applying those credits. Any portion of a credit not

1 used for that reason may be applied in a later period.

2 (f) The issuance of a transferable tax credit certificate under (d) of this section  
 3 does not limit the department's ability to later investigate or audit a tax credit claim to  
 4 which the certificate relates or to adjust or deny the claim if the department determines  
 5 that the applicant was not entitled to the amount of the credit for which the certificate  
 6 was issued. The tax liability of the applicant under AS 43.55.011 - 43.55.160 is  
 7 increased by the amount of the credit that is in excess of that to which the applicant  
 8 was entitled. That amount bears interest under AS 43.05.225 from the date the  
 9 transferable tax credit certificate was issued. For purposes of this subsection, an  
 10 applicant that is an explorer is considered a producer subject to the tax levied under  
 11 AS 43.55.011.

12 (g) The department may adopt regulations to carry out the purposes of this  
 13 section, including prescribing reporting, record-keeping, and certification procedures  
 14 and requirements for purposes of verifying the accuracy of credits claimed and  
 15 ensuring that a credit is not used more than once, and otherwise implementing this  
 16 section.

17 (h) For purposes of this section,

18 (1) "explorer" has the meaning given in AS 43.55.025(k);

19 (2) "qualified capital expenditure"

20 (A) means, except as otherwise provided under (B) of this  
 21 paragraph, an expenditure that is a lease expenditure under AS 43.55.160 and  
 22 is

23 (i) incurred for geological or geophysical exploration;

24 or

25 (ii) treated as a capitalized expenditure under 26 U.S.C.  
 26 (Internal Revenue Code), as amended, regardless of elections made  
 27 under 26 U.S.C. 263(e) (Internal Revenue Code), as amended, and  
 28 either is treated as a capitalized expenditure by the person incurring the  
 29 expenditure or is eligible to be deducted as an expense under 26 U.S.C.  
 30 263(e) (Internal Revenue Code), as amended;

31 (B) does not include an expenditure to acquire an asset (i) the

1 cost of previously acquiring which was a lease expenditure under  
 2 AS 43.55.160(c) or would have been a lease expenditure under  
 3 AS 43.55.160(c) if it had been incurred on or after July 1, 2006; or (ii) that has  
 4 previously been placed in service in the state; an expenditure to acquire an  
 5 asset is not excluded under this subparagraph if no more than an immaterial  
 6 portion of the asset meets a description under (i) or (ii) of this subparagraph;  
 7 for purposes of this subparagraph, "asset" includes geological, geophysical,  
 8 and well data and interpretations.

9 \* Sec. 13. AS 43.55.030(a) is amended to read:

10 (a) The tax shall be paid to the department and the person paying the tax shall  
 11 file with the department at the time the tax or a portion of the tax is required to be  
 12 paid a statement, under oath, on forms prescribed by or acceptable to the department,  
 13 giving with other information required, the following:

14 (1) a description of each [THE] lease or property from which the oil  
 15 and [OR] gas were [WAS] produced, by name, legal description, lease number, or  
 16 [BY] accounting codes [CODE NUMBERS] assigned by the department;

17 (2) the names of the producer and the person paying the tax;

18 (3) the gross amount of oil and the gross amount of [OR] gas  
 19 produced from each [THE] lease or property, and the percentage of the gross amount  
 20 of oil and of gas owned by each producer for whom the tax is paid;

21 (4) the gross [TOTAL] value at the point of production of the oil  
 22 and of the [OR] gas produced from each [THE] lease or property owned by each  
 23 producer for whom the tax is paid; [AND]

24 (5) the name of the first purchaser and the price received for the oil  
 25 and for the [OR] gas, unless relieved from this requirement in whole or in part by  
 26 the department; and

27 (6) the producer's lease expenditures and adjustments as  
 28 calculated under AS 43.55.160 [IF SOLD IN THE STATE].

29 \* Sec. 14. AS 43.55.030(d) is amended to read:

30 (d) Reports by or on behalf of the producer are delinquent the first day  
 31 following the day the tax is due. [EACH PRODUCER IS SUBJECT TO A PENALTY

1 OF \$25 A DAY FOR EACH LEASE OR PROPERTY UPON WHICH THE  
 2 REPORT IS NOT FILED. THE PENALTY FOR FAILURE TO FILE A REPORT IS  
 3 IN ADDITION TO THE PENALTY FOR DELINQUENT TAXES, AND IS A LIEN  
 4 AGAINST THE ASSETS OF THE PRODUCER.]

5 \* Sec. 15. AS 43.55.030 is amended by adding a new subsection to read:

6 (e) In addition to other required information, the statement required to be filed  
 7 on or before March 31 of a year must show any adjustments or corrections to the  
 8 statements that were required under (a) of this section to be filed for the months of the  
 9 preceding calendar year during which the oil or gas was produced.

10 \* Sec. 16. AS 43.55.040 is amended to read:

11 Sec. 43.55.040. Powers of Department of Revenue. Except as provided in  
 12 AS 43.05.405 - 43.05.499, the department may

13 (1) require a person engaged in production and the agent or employee  
 14 of the person, and the purchaser of oil or gas, or the owner of a royalty interest in oil  
 15 or gas to furnish, whether by the filing of regular statements or reports or  
 16 otherwise, additional information that is considered by the department as necessary to  
 17 compute the amount of the tax; notwithstanding any contrary provision of law, the  
 18 disclosure of additional information under this paragraph to the producer  
 19 obligated to pay the tax does not violate AS 40.25.100(a) or AS 43.05.230(a);  
 20 before disclosing information under this paragraph that is otherwise required to  
 21 be held confidential under AS 40.25.100(a) or AS 43.05.230(a), the department  
 22 shall

23 (A) provide the person that furnished the information a  
 24 reasonable opportunity to be heard regarding the proposed disclosure and  
 25 the conditions to be imposed under (B) of this paragraph; and

26 (B) impose appropriate conditions limiting

27 (i) access to the information to those legal counsel,  
 28 consultants, employees, officers, and agents of the producer who  
 29 have a need to know that information for the purpose of  
 30 determining or contesting the producer's tax obligation; and

31 (ii) the use of the information to use for that

1                    purpose:

2                    (2) examine the books, records, and files of [SUCH] a person  
3                    described in (1) of this section;

4                    (3) conduct hearings and compel the attendance of witnesses and the  
5                    production of books, records, and papers of any person; and

6                    (4) make an investigation or hold an inquiry that is considered  
7                    necessary to a disclosure of the facts as to

8                                (A) the amount of production from any oil or gas location, or of  
9                                a company or other producer of oil or gas; and

10                               (B) the rendition of the oil and gas for taxing purposes.

11 \* Sec. 17. AS 43.55.080 is amended to read:

12                    Sec. 43.55.080. Collection and deposit of revenue. Except as otherwise  
13                    provided under art. IX, sec. 17, Constitution of the State of Alaska, the [THE]  
14                    department shall deposit in the general fund the money collected by it under  
15                    AS 43.55.011 - 43.55.160 [AS 43.55.011 - 43.55.150].

16 \* Sec. 18. AS 43.55.135 is amended to read:

17                    Sec. 43.55.135. Measurement. For the purposes of AS 43.55.011 - 43.55.160  
18                    [AS 43.55.011 - 43.55.150], oil is [SHALL BE] measured in terms of a "barrel of oil"  
19                    and gas is [SHALL BE] measured in terms of a "cubic foot of gas."

20 \* Sec. 19. AS 43.55.150(a) is amended to read:

21                    (a) For the purposes of AS 43.55.011 - 43.55.160 [AS 43.55.011 - 43.55.150],  
22                    the gross value at the point of production is [SHALL BE] calculated using the  
23                    reasonable costs of transportation of the oil or gas. The reasonable costs of  
24                    transportation are [SHALL BE] the actual costs, except when the

25                                (1) [WHEN THE] parties to the transportation of oil or gas are  
26                                affiliated;

27                                (2) [WHEN THE] contract for the transportation of oil or gas is not an  
28                                arm's length transaction or is not representative of the market value of that  
29                                transportation;

30                                (3) [WHEN THE] method of transportation of oil or gas is not  
31                                reasonable in view of existing alternative methods of transportation.

1 \* **Sec. 20.** AS 43.55.150 is amended by adding a new subsection to read:

2 (d) Under regulations adopted by the department, the department may allow a  
3 producer, subject to limitations prescribed by the department as to the frequency of  
4 making elections, to elect prospectively to calculate the gross value at the point of  
5 production of oil or gas based in whole or part upon

6 (1) a royalty value determined under a royalty settlement agreement  
7 between the producer and the state, with adjustments if appropriate;

8 (2) a formula prescribed by the department that uses, with adjustments  
9 if appropriate, a royalty value or valuation methodology accepted by the

10 (A) Department of Natural Resources under AS 38.05, in the  
11 case of oil and gas produced from a lease issued by the Department of Natural  
12 Resources or produced from a lease or property that is part of a unit approved  
13 by the Department of Natural Resources; or

14 (B) United States Department of the Interior under applicable  
15 federal oil and gas leasing statutes, in the case of oil and gas produced from a  
16 lease issued by the United States Department of the Interior that is not part of a  
17 unit approved by the Department of Natural Resources, or produced from a  
18 lease or property that is part of a unit approved by the United States  
19 Department of the Interior but not approved by the Department of Natural  
20 Resources; or

21 (3) another formula prescribed by the Department of Revenue that  
22 reasonably estimates a value for the oil or gas at a specific geographical location such  
23 as the point of tender or delivery into a common carrier pipeline; the formula may use  
24 such factors as published price indices for oil or gas in or outside the state, quality  
25 differentials for oil or gas, transportation costs between markets, and inflation  
26 adjustments.

27 \* **Sec. 21.** AS 43.55 is amended by adding a new section to article 1 to read:

28 **Sec. 43.55.160. Determination of net value of oil and gas.** (a) Except as  
29 provided in (f) and (i) of this section, for purposes of AS 43.55.011, the net value of  
30 the taxable oil and gas produced during a month is the total of the gross value at the  
31 point of production of the oil and gas taxable under AS 43.55.011 and produced by the

1 producer from all leases or properties in the state, less (1) first, the producer's lease  
2 expenditures for the month as adjusted under (e) of this section, and (2) second, to the  
3 extent allowed under (g) of this section and until the total amount of the producer's  
4 transitional investment expenditures has been deducted, an amount equal to 1/72 of the  
5 producer's transitional investment expenditures. However, the net value calculated  
6 under this subsection may not be less than zero.

7 (b) Any adjusted lease expenditures that would otherwise be deductible in a  
8 month but whose deduction would cause the net value calculated under (a) of this  
9 section of the taxable oil and gas produced during the month to be less than zero may  
10 be added to the producer's adjusted lease expenditures for one or more other months in  
11 the same calendar year. The total of any adjusted lease expenditures that are not  
12 deductible in any month during a calendar year because their deduction would cause  
13 the net value calculated under (a) of this section of the taxable oil and gas produced  
14 during one or more months to be less than zero may be used to establish a carried-  
15 forward annual loss under AS 43.55.024(b). An amount of transitional investment  
16 expenditures that would otherwise be deductible in a month but whose deduction  
17 would cause the net value calculated under (a) of this section of the taxable oil and gas  
18 produced during the month to be less than zero

19 (1) may be deducted in a later month during any calendar year to the  
20 extent allowed under (g) of this section, but no more than 1/72 of a producer's  
21 transitional investment expenditures may be deducted in any month;

22 (2) may not be used to establish a carried-forward annual loss under  
23 AS 43.55.024(b).

24 (c) For purposes of this section, a producer's lease expenditures for a period  
25 are the total costs upstream of the point of production of oil and gas that are incurred  
26 on or after July 1, 2006, by the producer during the period and that are direct,  
27 ordinary, and necessary costs of exploring for, developing, or producing oil or gas  
28 deposits located within the producer's leases or properties in the state or, in the case of  
29 land in which the producer owns no working interest, direct, ordinary, and necessary  
30 costs of exploring for oil or gas deposits located within other land in the state.  
31 However, lease expenditures do not include the costs incurred to satisfy a work

1 commitment under an exploration license under AS 38.05.132. In determining whether  
 2 costs are direct, ordinary, and necessary costs of exploring for, developing, or  
 3 producing an oil or gas deposit located within a lease or property or other land in the  
 4 state, the department shall give substantial weight to (1) the typical industry practices  
 5 and standards in the state and in the United States as to costs that an operator is  
 6 allowed to bill a working interest owner that is not the operator, under unit operating  
 7 agreements or similar operating agreements that were in effect on or before  
 8 December 1, 2005, and were subject to negotiation with working interest owners, not  
 9 the operator, with substantial bargaining power; and (2) the standards adopted by the  
 10 Department of Natural Resources as to the costs, other than interest, that a lessee is  
 11 allowed to deduct from revenue in calculating net profits under a lease issued under  
 12 AS 38.05.180(f)(3)(B), (D), or (E). The Department of Revenue may authorize a  
 13 producer to treat as its lease expenditures under this section the costs paid by the  
 14 producer that are billed to the producer by an operator in accordance with the terms of  
 15 a unit operating agreement or similar operating agreement, if the Department of  
 16 Revenue finds that the pertinent provisions of the operating agreement are  
 17 substantially consistent with the Department of Revenue's determinations and  
 18 standards otherwise applicable under this subsection and that at least one working  
 19 interest owner party to the agreement, other than the operator, has substantial incentive  
 20 and ability to effectively audit billings under the agreement.

21 (d) For purposes of (c) of this section, direct costs

22 (1) include

23 (A) outlays for capital assets;

24 (B) payments in lieu of property taxes;

25 (C) a reasonable allowance, as determined under regulations  
 26 adopted by the department, for overhead expenses directly related to exploring  
 27 for, developing, and producing oil or gas deposits located within leases or  
 28 properties or other land in the state;

29 (2) do not include

30 (A) depreciation or amortization of capital assets;

31 (B) royalty payments;

- 1 (C) taxes based on or measured by net income;
- 2 (D) interest or other financing charges or costs of raising equity
- 3 or debt capital;
- 4 (E) acquisition costs for a lease or property or exploration
- 5 license;
- 6 (F) costs arising from fraud, wilful misconduct, or negligence;
- 7 (G) fines or penalties imposed by law;
- 8 (H) costs of arbitration, litigation, or other dispute resolution
- 9 activities that involve the state or concern the rights or obligations among
- 10 owners of interests in, or rights to production from, one or more leases or
- 11 properties or a unit;
- 12 (I) donations;
- 13 (J) costs incurred in organizing a partnership, joint venture, or
- 14 other business entity or arrangement;
- 15 (K) amounts paid for purposes of indemnification.
- 16 (e) A producer's lease expenditures must be adjusted by subtracting any
- 17 payment or credit the producer receives
- 18 (1) for the use by another person of a production facility in which the
- 19 producer has an ownership interest;
- 20 (2) for a reimbursement or similar payment that offsets the producer's
- 21 lease expenditures, including any payment from the state or federal government for
- 22 reimbursement of the producer's upstream costs, including any costs for gathering,
- 23 separating, cleaning, dehydration, compressing, or other field handling costs
- 24 associated with the production of oil or gas upstream of the point of production;
- 25 (3) for the sale or other transfer of
- 26 (A) an asset, including geological, geophysical, or well data or
- 27 interpretations, acquired by the producer as a result of a lease expenditure or an
- 28 expenditure that would be a lease expenditure if it were incurred on or after
- 29 July 1, 2006; and
- 30 (B) oil or gas
- 31 (i) that is not considered produced from a lease or

1 property under AS 43.55.020(e); and

2 (ii) the cost of acquiring which is a lease expenditure  
3 incurred by the person that acquires the oil or gas.

4 (f) In place of the adjusted lease expenditures for a month under (a) of this  
5 section, a producer may at any time elect to substitute for every month of a calendar  
6 year one-twelfth of the producer's adjusted lease expenditures for the calendar year.

7 (g) For the purposes of this section, a producer's transitional investment  
8 expenditures are (1) the sum of the expenditures the producer incurred on or after  
9 July 1, 2001, and before July 1, 2006, that would be qualified capital expenditures, as  
10 defined in AS 43.55.024(h), if they were incurred on or after July 1, 2006, less (2) the  
11 sum of the payments or credits the producer received before July 1, 2006, for the sale  
12 or other transfer of assets, including geological, geophysical, or well data or  
13 interpretations, acquired by the producer as a result of expenditures the producer  
14 incurred on or after July 1, 2001, and before July 1, 2006, that would be qualified  
15 capital expenditures, as defined in AS 43.55.024(h), if they were incurred on or after  
16 July 1, 2006. An amount of transitional investment expenditures may not be deducted  
17 under (a) of this section for a month for which the average price of Alaska North  
18 Slope oil delivered on the United States West Coast, as determined under (h) of this  
19 section, is equal to or less than \$40 per barrel, as adjusted for inflation under (h) of this  
20 section.

21 (h) The average price described in (g) of this section shall be an average, as  
22 calculated using a formula prescribed by the department by regulation, of published  
23 daily spot price assessments during the month for Alaska North Slope oil delivered on  
24 the United States West Coast. However, if the department determines that such daily  
25 assessments cease or appear likely to soon cease to be published throughout the  
26 calendar year or that they cease or appear likely to soon cease to be reliable evidence  
27 of market conditions, the department shall by regulation provide that the average price  
28 described in (g) of this section is the prevailing value of Alaska North Slope oil  
29 delivered on the United States West Coast as determined under regulations of the  
30 department implementing AS 43.55.020(f). For each year after 2006, the reference  
31 price of \$40 per barrel set out in (g) of this section shall be adjusted for inflation using

1 an appropriate consumer price index published by the United States Bureau of Labor  
2 Statistics, as prescribed by the department by regulation.

3 (i) For a month for which the net value of the taxable oil and gas produced  
4 during the month calculated under (a) of this section exceeds zero, a producer that is  
5 qualified under (j) of this section may reduce the net value by deducting an allowance  
6 in an amount calculated such that (1) the net value for the month is not reduced below  
7 zero; and (2) the total of the allowances deducted for all months during the calendar  
8 year does not exceed \$73,000,000. An unused allowance or portion of an allowance  
9 under this subsection may not be carried forward to a later calendar year or used to  
10 establish a carried-forward annual loss under AS 43.55.024(b).

11 (j) Upon written application by a producer, including any information the  
12 department may require, the department shall determine whether the producer  
13 qualifies under this subsection for a calendar year. To qualify under this subsection, a  
14 producer must demonstrate that its operation in the state or its ownership of an interest  
15 in a lease or property in the state as a distinct producer entity would not result in the  
16 division among multiple producer entities of any net value of taxable oil and gas, as  
17 defined under (a) of this section, that would be reasonably expected to be attributed to  
18 a single producer entity if the allowance provision of (i) of this section did not exist.

19 (k) If a cost that would otherwise constitute a lease expenditure under (c) of  
20 this section is incurred to explore for, develop, or produce (1) both an oil or gas  
21 deposit located within land outside the state and an oil or gas deposit located within a  
22 lease or property, or other land, in the state, or (2) an oil or gas deposit located partly  
23 within land outside the state and partly within a lease or property, or other land, in the  
24 state, the department shall specify or approve a reasonable allocation method for  
25 determining the portion of the cost that is appropriately treated as a lease expenditure  
26 under (c) of this section.

27 (l) The department may adopt regulations that establish additional standards  
28 necessary to carrying out the purposes of this section.

29 (m) For purposes of AS 43.55.024(a) and (b) and only as to expenditures  
30 incurred to explore for an oil or gas deposit located within land in which an explorer,  
31 as defined in AS 43.55.025(k), owns no working interest, the term "producer" in (c)

1 and (e) of this section includes "explorer."

2 (n) For purposes of this section,

3 (1) "explore" includes to conduct geological or geophysical  
4 exploration;

5 (2) the drilling of a stratigraphic test well is considered geological  
6 exploration for an oil or gas deposit located within land in the state only if the well's  
7 target zones are located in the state; for purposes of this paragraph, a stratigraphic test  
8 well is a well drilled for the sole purpose of obtaining geological information to aid in  
9 exploring for an oil or gas deposit.

10 \* Sec. 22. AS 43.55.201(b) is amended to read:

11 (b) The surcharge imposed by (a) of this section is in addition to and shall be  
12 paid in the same manner as the tax imposed by AS 43.55.011, except that  
13 notwithstanding anything to the contrary in AS 43.55.020(a), the full amount of  
14 the surcharge is due on the last day of each calendar month on oil produced from  
15 each lease or property during the preceding month. The surcharge [AS 43.55.011  
16 - 43.55.150; AND] is in addition to the surcharge imposed by AS 43.55.300 -  
17 43.55.310.

18 \* Sec. 23. AS 43.55.201(c) is amended to read:

19 (c) A producer of oil shall make reports of production in the same manner and  
20 under the same penalties as required under AS 43.55.011 - 43.55.160 [AS 43.55.011 -  
21 43.55.150].

22 \* Sec. 24. AS 43.55.201 is amended by adding a new subsection to read:

23 (d) Oil not considered under AS 43.55.020(e) to be produced from a lease or  
24 property is not considered to be produced from a lease or property for purposes of this  
25 section.

26 \* Sec. 25. AS 43.55 is amended by adding a new section to read:

27 **Sec. 43.55.205. Tax credit for surcharge payment.** The amount of a  
28 surcharge paid by a producer under AS 43.55.201 may be applied as a credit against  
29 the producer's taxes due under AS 43.55.011 - 43.55.160. A credit under this section  
30 may not be used to reduce a person's tax liability under AS 43.55.011 - 43.55.160 for  
31 any month below zero; any portion of a credit not used for that reason may be applied

1 in a later month.

2 \* Sec. 26. AS 43.55.300(b) is amended to read:

3 (b) The surcharge imposed by (a) of this section is in addition to and shall be  
4 paid in the same manner as the tax imposed by AS 43.55.011, except that  
5 notwithstanding anything to the contrary in AS 43.55.020(a), the full amount of  
6 the surcharge is due on the last day of each calendar month on oil produced from  
7 each lease or property during the preceding month. The surcharge [AS 43.55.011  
8 - 43.55.150; AND] is in addition to the surcharge imposed by AS 43.55.201 -  
9 43.55.231.

10 \* Sec. 27. AS 43.55.300(c) is amended to read:

11 (c) A producer of oil shall make reports of production in the same manner and  
12 under the same penalties as required under AS 43.55.011 - 43.55.160 [AS 43.55.011 -  
13 43.55.150].

14 \* Sec. 28. AS 43.55.300 is amended by adding a new subsection to read:

15 (d) Oil not considered under AS 43.55.020(e) to be produced from a lease or  
16 property is not considered to be produced from a lease or property for purposes of this  
17 section.

18 \* Sec. 29. AS 43.55 is amended by adding a new section to read:

19 **Sec. 43.55.305. Tax credit for surcharge payment.** The amount of a  
20 surcharge paid by a producer under AS 43.55.300 may be applied as a credit against  
21 the producer's taxes due under AS 43.55.011 - 43.55.160. A credit under this section  
22 may not be used to reduce a person's tax liability under AS 43.55.011 - 43.55.160 for  
23 any month below zero; any portion of a credit not used for that reason may be applied  
24 in a later month.

25 \* Sec. 30. AS 43.55.900(b) is repealed and reenacted to read:

26 (b) "gas" means

27 (A) all natural, associated, or casinghead gas;

28 (B) all hydrocarbons that

29 (i) are recovered by mechanical separation of well  
30 fluids or by gas processing; and

31 (ii) exist in a gaseous phase at the completion of

1                   mechanical separation and any gas processing; and

2                   (C) all other hydrocarbons produced from a well not defined as

3                   oil;

4       \* Sec. 31, AS 43.55.900(7) is repealed and reenacted to read:

5                   (7) "gross value at the point of production" means

6                   (A) for oil, the value of the oil at the automatic custody transfer  
7                   meter or device through which the oil enters into the facilities of a carrier  
8                   pipeline or other transportation carrier in a condition of pipeline quality; in the  
9                   absence of an automatic custody transfer meter or device, "gross value at the  
10                  point of production" means the value of the oil at the mechanism or device to  
11                  measure the quantity of oil that has been approved by the department for that  
12                  purpose, through which the oil is tendered and accepted in a condition of  
13                  pipeline quality into the facilities of a carrier pipeline or other transportation  
14                  carrier or into a field topping plant;

15                  (B) for gas, other than gas described in (C) of this paragraph,  
16                  that is

17                   (i) not subjected to or recovered by mechanical  
18                   separation or gas processing, the value of the gas at the first point  
19                   where the gas is accurately metered,

20                   (ii) subjected to or recovered by mechanical separation  
21                   but not gas processing, the value of the gas at the first point where the  
22                   gas is accurately metered after completion of mechanical separation;

23                   (iii) subjected to or recovered by gas processing, the  
24                   value of the gas at the first point where the gas is accurately metered  
25                   after completion of gas processing;

26                  (C) for gas run through an integrated gas processing and gas  
27                  treatment facility that does not accurately meter the gas after the gas  
28                  processing and before the gas treatment, the value of the gas at the first point  
29                  where gas processing is completed or where gas treatment begins, whichever is  
30                  further upstream;

31       \* Sec. 32, AS 43.55.900(10) is repealed and reenacted to read

- 1 (10) "oil" means  
 2 (A) crude petroleum oil; and  
 3 (B) all liquid hydrocarbons that are recovered by mechanical  
 4 separation of well fluids or by gas processing;

5 \* Sec. 33. AS 43.55.900 is amended by adding new paragraphs to read:

- 6 (17) "gas processing"  
 7 (A) means processing a gaseous mixture of hydrocarbons  
 8 (i) by means of absorption, adsorption, externally  
 9 applied refrigeration, artificial compression followed by adiabatic  
 10 expansion using the Joule-Thomson effect, or another physical process  
 11 that is not mechanical separation;  
 12 (ii) for the purpose of extracting and recovering liquid  
 13 hydrocarbons; and  
 14 (iii) upstream of any gas treatment and upstream of the  
 15 inlet of any gas pipeline system transporting gas to a market;  
 16 (B) does not include gas treatment;

- 17 (18) "gas treatment"  
 18 (A) means conditioning gas and removing from gas non-  
 19 hydrocarbon substances, for the purpose of rendering the gas acceptable for  
 20 tender and acceptance into a gas pipeline system; and  
 21 (B) may include incidentally removing liquid hydrocarbons  
 22 from the gas.

23 \* Sec. 34. AS 43.55.011(b), 43.55.011(c), 43.55.012(b), 43.55.013(b), 43.55.013(c),  
 24 43.55.013(d), 43.55.013(g), 43.55.013(h), 43.55.013(i), 43.55.013(j), 43.55.013(k),  
 25 43.55.016, 43.55.900(1), 43.55.900(8), 43.55.900(11), 43.55.900(12), and 43.55.900(16) are  
 26 repealed.

27 \* Sec. 35. The uncodified law of the State of Alaska is amended by adding a new section to  
 28 read:

- 29 APPLICABILITY. (a) Sections 5, 7 - 10, 12, 13, 15, and 19 - 34 of this Act apply to  
 30 oil and gas produced on or after July 1, 2006.  
 31 (b) Section 11 of this Act applies to oil and gas produced before, on, or after the

1 effective date of sec. 11 of this Act.

2 \* Sec. 36. The uncodified law of the State of Alaska is amended by adding a new section to  
3 read:

4       TRANSITION PROVISIONS. (a) Notwithstanding any contrary provision of  
5 AS 43.55.024(a), enacted by sec. 12 of this Act, for oil and gas produced on or after July 1,  
6 2006, and before January 1, 2007, the phrase "every month an annualized tax credit in an  
7 amount equal to one and two-thirds percent" in AS 43.55.024(a), enacted by sec. 12 of this  
8 Act, shall be replaced by the phrase "every month during the period July 1, 2006, through  
9 December 31, 2006, an annualized tax credit in an amount equal to three and one-third  
10 percent."

11       (b) Notwithstanding any contrary provision of AS 43.55.024(e), enacted by sec. 12 of  
12 this Act, for oil and gas produced on or after July 1, 2006, and before January 1, 2007 the  
13 phrase "a calendar year" in AS 43.55.024(e), enacted by sec. 12 of this Act, shall be replaced  
14 by the phrase "the last six months of the calendar year."

15       (c) Notwithstanding any contrary provision of AS 43.55.160(f), enacted by sec. 21 of  
16 this Act, for oil and gas produced on or after July 1, 2006, and before January 1, 2007, the  
17 phrase "for every month of a calendar year one-twelfth of the producer's adjusted lease  
18 expenditures for the calendar year" in AS 43.55.160(f), enacted by sec. 21 of this Act, shall be  
19 replaced by the phrase "for each of the last six months of 2006, one-sixth of the producer's  
20 adjusted lease expenditures for that six-month period."

21       (d) Notwithstanding any contrary provision of AS 43.55.160(i), enacted by sec. 21 of  
22 this Act, for oil and gas produced on or after July 1, 2006, and before January 1, 2007, the  
23 number "\$73,000,000" in AS 43.55.160(i), enacted by sec. 21 of this Act, shall be replaced by  
24 the number "\$36,500,000."

25       (e) For oil and gas produced before July 1, 2006, the provisions of AS 43.55, and  
26 regulations adopted under AS 43.55, that were in effect before July 1, 2006, and that were  
27 applicable to the oil and gas continue to apply to that oil and gas.

28 \* Sec. 37. The uncodified law of the State of Alaska is amended by adding a new section to  
29 read:

30       TRANSITION REGULATIONS. The Department of Revenue may proceed to adopt  
31 regulations to implement the changes made by this Act. The regulations take effect under

1 AS 44.62 (Administrative Procedure Act), but not before the effective date of the law  
2 implemented by the regulation.

3 \* Sec. 38. The uncodified law of the State of Alaska is amended by adding a new section to  
4 read:

5 REVISOR'S INSTRUCTION. The revisor of statutes is instructed to change the  
6 heading of

7 (1) AS 43.55 from "Oil and Gas Production Taxes and Oil Surcharge" to "Oil  
8 and Gas Production Tax and Oil Surcharge";

9 (2) article 1 of AS 43.55 from "Oil and Gas Properties Production Taxes" to  
10 "Oil and Gas Production Tax";

11 (3) AS 43.55.011 from "Oil production tax" to "Oil and gas production tax";

12 (4) AS 43.55.025 from "Tax credit for oil and gas exploration or gas only  
13 exploration" to "Alternative tax credit for oil and gas exploration or gas only exploration";

14 (5) AS 43.55.150 from "Determination of gross value" to "Determination of  
15 gross value at the point of production."

16 \* Sec. 39. Sections 1 - 4, 6, 11, 14, 16, and 37 of this Act take effect immediately under  
17 AS 01.10.070(c).

18 \* Sec. 40. Except as provided in sec. 39 of this Act, this Act takes effect July 1, 2006.

# Presentation by Jim Eason

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SB 305/HB 488--Oil & Gas Production Tax

March 4, 2006

- Consultant to Legislative Budget and Audit Committee
- My Background

# WHO SAID IT ... and when?

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\*\* “Since discovery of oil in commercial quantities on the Kenai Peninsula in 1957, two great interrelated responsibilities face the Legislature. One will be that of encouraging further exploration and greater production. Greater cost factors such as those incurred in reaching and developing inaccessible fields may affect Alaska’s competitive position in world markets. We will wish to consider how far to go in creating a favorable investment climate toward attracting new payrolls and realizing rental and royalty income for the state.”

# The Challenge

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- ✘ Your responsibility is not unique – but you are relatively better situated because you have the benefit of historical perspective.
  - ✘ Among your considerations, there is only one certainty – your numbers are wrong, but not necessarily bad.
  - ✘ Why are your numbers wrong?
    - ◆ Geological uncertainty
    - ◆ Production volume forecasts
    - ◆ Price forecasts
    - ◆ Failing to identify and quantify the range and magnitude of credits and deductions
  - ✘ Not much control of these uncertainties – best judgment.
  - ✘ Your choice of words, however, can reduce fiscal risk and provide greater certainty.

# The Past

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- ✘✘ Cook Inlet example – “wells” versus “completions”
  - ✘✘ North Slope example – the disaggregation and aggregation issue.
  - ✘✘ ANS Litigation History – the past can be the key to the future.
  - ✘✘ The most costly words – the ANS royalty litigation.
  - ✘✘ Where and how – “at the well” and in a multitude of ways.

# The Lessons

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- ✦ Milestones in the ANS Litigation.
    - ◆ ANS field cost allowance settlement (1980)
    - ◆ TAPS Agreement – “just and reasonable rates” (1985)
    - ◆ Royalty Settlement Agreements (early 1990’s)
  - ✦ One common lesson learned – reasonable opportunity to revisit fiscal provisions critical to long term satisfaction
    - ◆ ANS field cost allowance history and magnitude
    - ◆ TAPS Settlement
    - ◆ Royalty Settlement Agreements

# Examples of Concerns

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- ✧ Point of Production
- ✧ Definition of Gas Processing Facilities
- ✧ Definition of Gas Treatment Facilities
- ✧ The unknown relationship of terms to a stranded gas contract
- ✧ The unquantified but major deduction and/or credit exposure – “abandonment”
- ✧ Pending Questions

# Recurring Historic Themes

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- ✧ The use of the unit operating agreements
  - ◆ Substantial weight (see Sec. 21, pg. 12)
- ✧ The adoption of royalty settlement methodologies (see Sec. 20, pg. 10)
- ✧ Arbitration

# Recommendations

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- ✘ Take the time to confirm the lessees' AND the DOR's intent where there is an ambiguity
- ✘ Expect linkages and try to understand how they may affect or be affected by future events
- ✘ Take advantage of your "extra eyes"