

**SB**

**80**

**HFIN**

**FILE**

# FISCAL NOTE

STATE OF ALASKA  
2007 LEGISLATIVE SESSION

Fiscal Note Number: 2  
Bill Version: CSSB 80(RES)  
(S) Publish Date: 5/2/07

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Dept of Environmental Conservation  
Title: OIL & GAS PRODUCTION TAX: EXPENDITURES RDU: Spill Prevention and Response  
Component: Director's Office  
Sponsor: Wagoner et al  
Requester: Senale Resources Component No.: 1392

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

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

OPERATING EXPENDITURES	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
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>

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

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (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 2008 budget proposal:

**POSITIONS**

Full-time						
Part-time						
Temporary						

**ANALYSIS:** *(Attach a separate page if necessary)*  
No additional costs are expected with this legislation.

Prepared by: Larry Dietrick Phone: 465-5250  
Division: Spill Prevention and Response Date/Time: 2/20/07 4:00 PM  
Approved by: Larry Hartig Date: 2/20/2007  
Agency: Department of Environmental Conservation

# FISCAL NOTE

STATE OF ALASKA  
2007 LEGISLATIVE SESSION

Fiscal Note Number: 3  
Bill Version: CSSB 80(RES)  
(S) Publish Date: 5/2/07

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Revenue 04  
Title Oil & Gas Production Tax: Expenditures RDU Taxation and Treasury  
Component Tax Division  
Sponsor Senator Wagoner  
Requester (S) Resources Component No. 2476

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

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

OPERATING EXPENDITURES	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
Personal Services						
Travel						
Contractual	124.9	124.9	124.9	124.9	124.9	124.9
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
<b>TOTAL OPERATING</b>	<b>124.9</b>	<b>124.9</b>	<b>124.9</b>	<b>124.9</b>	<b>124.9</b>	<b>124.9</b>

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

1002 Federal Receipts						
1003 GF Match						
1004 GF	124.9	124.9	124.9	124.9	124.9	124.9
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
<b>TOTAL</b>	<b>124.9</b>	<b>124.9</b>	<b>124.9</b>	<b>124.9</b>	<b>124.9</b>	<b>124.9</b>

Estimate of any current year (FY2007) cost: 31.2

Check this box (X) if funding for this bill is included in the Governor's FY 2008 budget proposal:

**POSITIONS**

Full-time						
Part-time						
Temporary						

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

\*This bill would add certain costs relating to improperly maintained property or equipment to the list of costs that do not qualify as lease expenditures under AS 43.55.165, the petroleum profits production tax system. Under the bill, the commissioner of revenue, in consultation with the commissioner of environmental conservation and the chair of the Alaska Oil and Gas Conservation Commission, would determine whether costs are specifically disallowed under this provision. The provision would disallow any costs incurred to (1) repair or replace improperly maintained property or equipment; and/or (2) maintain the operational capability of facilities or equipment that are either shut down or are diminished in capacity. The bill effective date is retroactive to April 1, 2006 - the effective date of the petroleum profits tax (PPT).

Prepared by: Jon Iversen and Cherie Nienhuis  
Division: Tax  
Approved by: Jerry Burnett  
Agency: Department of Revenue

Phone: 269-1033  
Date/Time: 2/20/07 2:00 PM  
Date: 2/20/2007

FISCAL NOTE # 3

STATE OF ALASKA  
2007 LEGISLATIVE SESSION

BILL NO. CSSB 80(RES)

ANALYSIS CONTINUATION

The impact this bill would have on petroleum tax revenues is indeterminate. Costs identified as disallowed under this bill could be categorized as either operating costs or capital costs. The PPT authorizes eligible operating costs to be deducted from the petroleum profits tax at a rate of 22.5%; the PPT authorizes capital costs to be both deducted at a rate of 22.5% and credited at a rate of 20%, for a combined production tax savings of 42.5%. Any set of disallowed costs is likely to be split between these two categories in a way that is distinct from that of another set of costs.

Administering this legislation would require one full-time equivalent (FTE) with expertise in oil and gas industry practices on the level of a petroleum engineer. The department currently contracts with a petroleum engineer for five years at a cost of \$624,650, or \$124,930 per year, for technical support related to petroleum production. It is anticipated that the department would be required to carry a second contract of this magnitude or greater in order to fulfill the requirements of this legislation.

# FISCAL NOTE

STATE OF ALASKA  
2007 LEGISLATIVE SESSION

Fiscal Note Number: 4  
Bill Version: CSSB 80(FIN)  
(S) Publish Date: 5/8/07

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Natural Resources  
Title Oil & Gas Production Tax: Expenditures RDU Resource Development  
Component Petroleum Systems Integrity Office  
Sponsor Sen. Wagoner  
Requester Senate Finance Component No. 2847

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

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

OPERATING EXPENDITURES	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
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>

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

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (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 (FY2007) cost: 0.0

Mark this box (X) if funding for this bill is included in the Governor's FY 2008 budget proposal:

**POSITIONS**

Full-time						
Part-time						
Temporary						

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

SB 80 would prohibit oil and gas producers from deducting costs related to the repair and replacement of property or equipment, that was either not maintained or improperly maintained, when determining the taxable value of oil and gas production. In making the determinations as to which costs were related to improperly maintained property or equipment, the commissioner of Revenue would consult with the commissioners of Environmental Conservation and Natural Resources, and the coordinator of the Petroleum Systems Integrity Office (PSIO).

There is no fiscal impact associated with the implementation of this bill.

Prepared by: Kevin Banks, Acting Director Phone 269-8800  
Division: Oil and Gas Date/Time 5/8/2007  
Approved by: Thomas Irwin, Commissioner Date 5/8/2007  
Agency: Natural Resources

# REVISED FISCAL NOTE

STATE OF ALASKA  
2007 LEGISLATIVE SESSION

Fiscal Note Number: 1  
Bill Version: CSSB 80(RES)  
(S) Publish Date: 5/2/07

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Administration  
Title: Oil and Gas Production Tax RDU: AOGCC  
Component: AOGCC  
Sponsor: Senators Wagoner, Therriault, Dyson, et al.  
Requester: Senate Resource Component No.: 2010

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

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

OPERATING EXPENDITURES	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
Personal Services	0.0	0.0	0.0	0.0	0.0	0.0
Travel	0.0	0.0	0.0	0.0	0.0	0.0
Contractual	0.0	0.0	0.0	0.0	0.0	0.0
Supplies	0.0	0.0	0.0	0.0	0.0	0.0
Equipment	0.0	0.0	0.0	0.0	0.0	0.0
Land & Structures	0.0	0.0	0.0	0.0	0.0	0.0
Grants & Claims	0.0	0.0	0.0	0.0	0.0	0.0
Miscellaneous	0.0	0.0	0.0	0.0	0.0	0.0
<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>

<b>CAPITAL EXPENDITURES</b>	0.0	0.0	0.0	0.0	0.0	0.0
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<b>CHANGE IN REVENUES ( )</b>	0.0	0.0	0.0	0.0	0.0	0.0
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**FUND SOURCE (Thousands of Dollars)**

1002 Federal Receipts	0.0	0.0	0.0	0.0	0.0	0.0
1003 GF Match	0.0	0.0	0.0	0.0	0.0	0.0
1004 GF	0.0	0.0	0.0	0.0	0.0	0.0
1005 GF/Program Receipts	0.0	0.0	0.0	0.0	0.0	0.0
1037 GF/Mental Health	0.0	0.0	0.0	0.0	0.0	0.0
1162 AOGCC Receipts	0.0	0.0	0.0	0.0	0.0	0.0
<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 (FY2007) cost: 0.0

Mark this box (X) if funding for this bill is included in the Governor's FY 2008 budget proposal:

**POSITIONS**

Full-time						
Part-time						
Temporary						

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

Any consultation we provide as part of the Petroleum Systems Integrity Office (PSIO) working group will be part of our ongoing responsibilities at the Alaska Oil and Gas Conservation Commission (AOGCC). Therefore there will be no additional fiscal impact on the agency with the passing of this bill.

Prepared by: Jody J. Colombo, Special Assistant I  
Division: Alaska Oil and Gas Conservation Commission  
Approved by: Rachael Petro, Deputy Commissioner  
Agency: Department of Administration

Phone: 793-1221  
Date/Time: 4/26/07 3pm  
Date: 4/26/07



Official Business

# ALASKA STATE LEGISLATURE

## SENATOR THOMAS H. WAGONER

- Member, Resources
- Member, Community & Regional Affairs
- Member, World Trade

Session: January – May  
State Capitol, #423  
Juneau, AK 99801  
Phone: 907-465-2828 Fax: 907-465-4779

Interim: May – December  
145 Main Street Loop; Suite 226  
Kenai, AK 99611  
Phone: 907-283-7996 Fax 907--283-8127

## Sponsor Statement

### SB 80 – Oil and Gas Production Tax: Expenditures

The language in this bill was offered as an amendment to HB 3001, the Petroleum Production Tax (PPT) on August 9, 2006 before the Senate Special Committee on Natural Gas Development.

The issue which prompted that proposed amendment last August remains, and perhaps is even expanded, given the problems associated with the ongoing BP corrosion crisis.

Simply put, this bill protects the State of Alaska by encouraging proper maintenance efforts; which costs would then be allowed as deductions or credits against the PPT.

However, if a company failed to conduct proper maintenance on a pipeline, they would not be allowed to utilize the deductions or credits authorized by the PPT for their costs to repair that improperly maintained pipeline.

The authority to make a determination on costs related to improperly maintained facilities rests with the Commissioner of the Department of Revenue, in consultation with the Commissioner of the Department of Environmental Conservation and the newly formed Petroleum Safety Integrity Office and relying on good oilfield practice.

The bill is structured to be applicable on the same date as was the PPT tax – April 1, 2006.



Official Business

# ALASKA STATE LEGISLATURE

## SENATOR THOMAS H. WAGONER

- Member, Resources
- Member, Community & Regional Affairs
- Member, Work Trade

Session: January – May  
State Capitol, #423  
Juneau, AK 99801  
Phone: 907-465-2828 Fax: 907-465-4779

Interim: May – December  
145 Main Street Loop; Suite 226  
Kenai, AK 99611  
Phone: 907-283-7996 Fax 907-283-8127

## Sectional Analysis

### SB 80 – Oil and Gas Production Tax: Expenditures

**Section 1:** amends AS 43.55.165(e), which establishes criteria that are not included as lease expenditures, therefore are not eligible for a deduction, by establishing new language in subsection (19), regarding costs related to the repair and replacement of property or equipment that was not maintained or was improperly maintained.

The costs, or portion of costs, are to be determined by the Commissioner of the Department of Revenue, in consultation with the Commissioner of Environmental Conservation and Department of Natural Resources, and the newly formed Petroleum Safety Integrity Office and relying on good oilfield practice

Subsections (19)(a),(b) and (c) set forth which costs are not eligible.

**Section 2:** provides for applicability to oil and gas produced after March 31, 2006 (same as petroleum production tax time frame).

**Section 3:** provides for transitional language for payment of added taxes or installment payments due as a result of disallowing any expenditure set out in Section 1.

**Section 4:** provides for retroactive date to same period as the petroleum production tax.

**Section 5:** provides for the effective date of the bill.



Official Business

# ALASKA STATE LEGISLATURE

## SENATOR THOMAS H. WAGONER

- Member, Resources
- Member, Community, & Regional Affairs
- Member, World Trade

Session: January – May  
State Capitol, #423  
Juneau, AK 99801  
Phone: 907-465-2828 Fax: 907-465-4779

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145 Main Street Loop; Suite 226  
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Phone: 907-283-7996 Fax 907--283-8127

### Senate Resources

1. Page 3 (lines 21-23): Revised consultation group to include commissioner of department of natural resources and exchanged "AOGCC" for "PSIO" lead person.
2. Page 3 (line 24): Deleted "relying on the standard practices of the industry", inserted "taking into consideration good oil field practice"
3. Page 3 (line 26): Inserted "was not maintained"
4. Page 3 (line 27) Deleted previous subsection (B)
5. Page 4 – Section 3: "Transitional Provisions" – technical corrections to clarify costs that are not deductible. Also adds subsection explaining when interest would apply to an under-payment of a tax.

### Senate Finance

1. Page 3, line 27: Reinserted previous subsection (B) – reversing Senate Resources deletion.



## 25<sup>th</sup> ALASKA STATE LEGISLATURE

### SENATE REPUBLICAN CAUCUS

SENATOR GENE THERRIAULT, MINORITY LEADER  
STATE CAPITOL, ROOM 427, 465-4797 (FAX 465-3884)

[www.aksenateminority.com](http://www.aksenateminority.com)

SENATOR CON BUNDE  
SENATOR FRED DYSON  
SENATOR TOM WAGONER  
SENATOR GARY WILKEN

**Fact Sheet for: Senate Bill 80**

**Contact: Mary Jackson, 465-2828**

**Bill Version: CSSB 80 (FIN)**

**Sponsor: Senator Thomas Wagoner**

**Short Title: OIL & GAS PRODUCTION TAX: EXPENDITURES**

#### Summary:

- For determining the taxable value of oil and gas, empowers the commissioner of the Department of Revenue, in consultation with the commissioners of Environmental Conservation and Natural Resources, and the lead maintenance oversight person with the Petroleum Systems Integrity Office, relying on good oilfield practice, to disallow costs or portion of costs determined to be:
  - related to repair and replacement of property or equipment that was not maintained or improperly maintained;
  - incurred to maintain the operational capability of facilities or equipment shut down because of improper maintenance;
  - operating expenses resulting from diminished capacity caused by the lack of or improper maintenance of property or equipment.

#### Benefits:

- Gives state agencies the necessary tools to prevent oil producers from deducting expenses resulting from improper maintenance of property or equipment.
- Prevents the state from shouldering the costs of repairing or replacing equipment that was improperly or was not maintained.
- Encourages companies to properly maintain equipment by penalizing poor maintenance practices.
- Increases state revenue.

#### Background:

- The issue of tax credits for repairs became a concern in August 2006, when BP announced a partial shutdown of Prudhoe Bay in the wake of a corrosion-related spill that sent an estimated 200,000 gallons of crude over about 2 acres of tundra in March. This raised the question of how repairs would be handled under the new petroleum production tax enacted through HB 3001, passed by the 24th Legislature during a special session on August 10, 2006. For determining the value subject to tax, the new tax structure allows producers to deduct costs associated with the production of oil and gas from the gross value at the point of production. This bill prevents oil companies from deducting expenses resulting from improper maintenance. Similar language was offered as an amendment when HB 3001 was under debate in the Special Committee on Natural Gas Development in August, but failed by a vote of 5 to 7.

SKILLED

RESPONSIBLE

CONSERVATIVE

## Alaska Oil and Gas Association

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121 W. Fireweed Lane, Suite 207  
Anchorage, Alaska 99503-2035  
Phone: (907) 272-1481 Fax: (907) 279-8114

TESTIMONY  
OF  
THE ALASKA OIL AND GAS ASSOCIATION  
BEFORE THE HOUSE FINANCE COMMITTEE  
REGARDING  
SENATE BILL 80  
MAY 12, 2007

Mr. Chairman and Members of the Committee.

My name is Judith Brady and I am the Executive Director of the Alaska Oil and Gas Association, or AOGA. AOGA is the trade association for the oil and gas industry in Alaska. Our 16 members account for the majority of oil and gas exploration, development, production, transportation, refining and marketing activities in the state. The testimony I am presenting today reflects the consensus of the members of the AOGA Tax Committee, with no dissent. On behalf of each of them I thank you for this opportunity to testify about Senate Bill 80.

We are well aware that the stimulus for this legislation is corrosion discovered in oil transit lines at Prudhoe Bay and the resulting partial shutdown of that field last year. However, the existing law is more than adequate to address and deal with any culpable misconduct or non-conduct that may have given rise to this incident. The State's first line of defense is section 165(a) of the PPT, which defines deductible costs to be "ordinary and necessary costs ... that are direct costs of exploring for, developing, or producing oil or gas[.]" The principles of the Internal Revenue Code apply in determining whether costs are "ordinary and necessary". See AS 43.55.165(j)(2). Moreover, even when costs are ordinary and necessary, if they "aris[e] from fraud, wilful misconduct, or gross negligence" they are excluded from deductible costs under section 165(e)(6) of the PPT. In addition, all costs "incurred for containment, control, cleanup, or removal in connection with any unpermitted release of oil or a hazardous substance" are disallowed even if there is no negligence at all. See AS 43.55.165(e)(16) (emphasis added).

The State has already accessed \$8.75 million from the spill-response "470 Fund" to enable the Attorney General and the Department of Environmental Conservation to begin an investigation into the State's potential claims for "recovery of all state costs and lost revenues including fines and penalties" resulting from corrosion at Prudhoe Bay. See ADEC Division of Spill Prevention & Response, *120 Hour Notification of Fund Access* (20 Nov. 2006) (attached). If this ongoing legal investigation shows that the State does have claims for "lost revenues" due to the corrosion, it will be able to assert those claims at that time and sue, if necessary, to recover on them.

SB 80 also doubles up the disallowance for "improper" maintenance that already exists in paragraph (18) of section 165(e) of the PPT, which appears on lines 13-18 on page 2 of CSSB 80(FIN). Paragraph (18) excludes from otherwise deductible costs an amount equal to 30¢ per "BTU equivalent barrel[.]" That paragraph was added to the PPT legislation at the suggestion of Dr. Pedro van Meurs, who presented that suggestion on the last page of his memo of 5 August 2006 to Senator Wagoner (copy attached), who in turn shared the memo with the Senate Special Committee on Natural Gas Development as it considered CSHB 3001(FIN), the PPT Bill. Dr. van Meurs wrote:

Another concern that is regularly expressed is that the State should not permit the deduction of costs related to replacing equipment that is becoming defective or gathering lines that need to be replaced because of corrosion or other problems. The argument is that these assets should have been better maintained in the first place. [emphasis added]

Dr. van Meurs calculated that, at 900,000 "BTU equivalent barrels" a day, the 30¢ exclusion would mean "the companies will pay \$ 42.5 million more tax per year" (emphasis added).

SB 80 is also seriously flawed in several ways on technical grounds. First, cost disallowances under the bill would be triggered by a finding of "improper maintenance". This is not a standard or conventional term used in the petroleum industry. SB 80 now requires that cost decisions "take into consideration good oil field practice" but the amendment does not solve the problems of ambiguous standards. Both taxpayers and state auditors would be forced in the first instance to interpret and apply "improper maintenance" as best they can. This is all but guaranteed to generate disputes and litigation over what is or is not "improper". Eventually court decisions might result in a body of precedent that defines it. But taxpayers, including oil companies, deserve to know what is expected of them when they report and pay their taxes, and SB 80's reliance on such an undefined term undercuts this basic principle.

Second, in addition to disallowing costs of replacing and repairing "property or equipment" that was "improperly" maintained, CSSB 80(FIN) would, in paragraph (19)(B), disallow "costs of maintaining facilities or equipment shut down because of improper maintenance of property or equipment[.]" We draw your attention to two aspects of this. One is that the shut-down "facilities or equipment" whose costs would be disallowed are not limited to the "property or equipment" that was "improperly" maintained. The two phrases being used in (19)(B) are not the same: it is "facilities and equipment" whose costs are disallowed, while it is "property and equipment" whose maintenance is "improper". Therefore the two phrases will be interpreted as meaning two different things even though both include "equipment".

The third technical problem with the Finance CS is paragraph (19)(C), which again runs against the State's best interests. It would disallow "incremental operating expenses incurred as a result of operating facilities or equipment at diminished capacity" due to "improper" maintenance of "property or equipment." As with (19)(B), (C) does not limit its disallowance to costs for just the "improperly" maintained "property or equipment", but goes beyond to disallows costs for operating "facilities and equipment" at diminished capacity. It is in the State's economic interest to encourage a partially shut-down field to continue producing as much as it can. Just within the context of PPT by itself, the value of the extra taxable production will be greater than the additional deduction from the increased operating costs, and so the State should get more PPT, not less.

Another concern is the potential impact SB 80 could have on existing facilities everywhere in the state. Corrosion is not a problem unique to fields on the North Slope. It is a challenge everywhere there are structures and facilities made of iron or steel. Moreover, corrosion is something that, at most, you can only slow down. Sometimes you can slow it down a great deal, but you cannot stop it completely.

This means that the older an iron or steel structure or facility is, the greater the cumulative effects of corrosion are.

Prudhoe Bay will mark the 30<sup>th</sup> anniversary of the start of its production in June of this year. But in the Cook Inlet a number of fields will have their 40<sup>th</sup> anniversaries this year, and a few are closing in on their fiftieth. Our members with Cook Inlet interests are concerned that this legislation, which seems aimed at a particular situation that arose on the North Slope, may have unexpected implications and repercussions for them in Cook Inlet.

There are or will be facilities and structures in the Inlet area that will need to be replaced or significantly repaired because of their corrosion issues in order to remain in operation. When those facilities and structures are eventually replaced, there is nothing in SB 80 to protect them from claims that they were "improperly" maintained and thus the costs of repairing or replacing them are limited or disallowed altogether. This uncertainty over whether the costs will be fully recognized as deductions, and whether the tax credits the "capital" portion of those costs will be fully allowed, will impair the economics for incurring those expenditures and could well lead to fields or facilities being permanently shut-in instead of remaining in production even longer.

One final problem with SB 80 as a whole — and this might someday prove to be an important problem — is the way it will deter new companies from coming to Alaska and buying used production property or equipment for their own use, instead of installing or buying brand-new ones at much greater expense. This deterrence will arise because such a purchaser could find a significant amount of its costs associated with its purchased assets being disallowed after the purchase, if the Department of Revenue later claims that the purchased property or equipment had been “improperly maintained” by the seller. The disallowances under SB 80 are mandatory once “improper” maintenance is found to have occurred, regardless of who was responsible for it; and there is nothing in SB 80 as it is currently drafted that would protect a bona fide purchaser from those disallowances in such a situation.

For all these reasons, we believe SB 80 is unnecessary and inappropriate legislation. We thank you again for your time and attention.

## Alaska Oil and Gas Association

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Anchorage, Alaska 99503-2035  
Phone: (907)272-1481 Fax: (907)279-8114  
Email: brady@aoga.org  
*Judith Brady, Executive Director*

Date: May 12, 2007

To: House Finance Committee

From: Judith M. Brady

Thank you for taking the time to read this letter. As you know, the Alaska Oil & Gas Association (AOGA) is a private, non-profit trade association representing the majority of the oil and gas companies who operate in Alaska.

In addition to the formal testimony we will provide on SB 80, this letter details our concerns. While we understand the concerns that generated the interest in this bill, we truly believe those concerns are already resolved in the current PPT statutes. Moreover, after listening to agency managers discussing, in legislative hearings, the troublesome ambiguities and difficulties of implementing this bill and its companion, HB 128, we also believe that, if passed, SB 80 will inevitably lead to years of delay in the tax audit process and almost certainly result in prolonged litigation. We hope that those of you who have listened to the hearings in House Oil & Gas, House Resources and House Finance have reached the same conclusions.

Because we believe the State's interest are already protected and because of our concern of the unintended consequences of SB 80, we respectfully request you vote "no" on this legislation.

Following is a short summary of why we believe the State's interest is protected under the current PPT statute.

### **Current law fully protects the State of Alaska interest in cost sharing.**

- The current PPT reflects zero tolerance for spills and explicitly states that there will be no state cost sharing for "costs incurred for containment, control cleanup, or removal in connection with any unpermitted release of oil or a hazardous substance."  
(AS.43.55.165(e) (16).
- The PPT explicitly disallows "costs arising from fraud, willful misconduct, or gross negligence" (AS 43.55.(e)(6).

- The PPT explicitly states... “a producer’s lease expenditures for a calendar year are the ordinary and necessary costs...that are the direct costs of exploring for , developing, or producing oil or gas deposits located within the producer’s leases or properties in the state...”
- The PPT explicitly imposes an annual multi-million dollar repair/replacement proxy. From the beginning of the legislative hearings on the PPT last year, lawmakers made it clear that while they might be willing to consider sharing some of the oil and gas capital and maintenance costs to make Alaska more competitive for additional investment in exchange for a higher tax rate, they would not tolerate sharing in costs that were not appropriate. Dozens of hours of hearings were held on what deductions should or should not be allowed in determining a company's PPT obligation. The partial shutdown of Prudhoe Bay prior to the passage of the PPT brought the question of cost sharing into sharp focus. Twice a proposed amendment to the PPT with the exact language as that contained in the original SB 80 was introduced to the Senate Special Committee on Natural Gas Development, and twice it was voted down because of concerns with definitions and implementation – the same concerns raised by agency managers in hearings this year.. Instead, on the recommendation of the State's consultant, Dr. Pedro van Meurs, the Committee adopted an amendment adding a \$.30 cent a barrel “proxy” for maintenance-related issues that added millions of dollars to the PPT tax and answered, according to its author, Dr. van Meurs, both the “fairness” and the “practical” concerns related to the need for investment in continued maintenance of aging fields.

In an August 8, 2006 memo from Pedro van Meurs, to the administration, and which has been discussed in hearings on SB 80 and HB 128 this year, he discusses both the fairness issue (“*Should oil companies receive a tax deduction and tax credit ...for replacing a pipeline that was defective and not properly maintained*” ...and the broader issue “*It is likely that over time more defective equipment will be identified that needs repair or replacements. The Prudhoe Bay oil field is now 30 years old...*”) Dr. van Meurs recommended the Legislature disallow 30 cents per BTU equivalent barrel – costs a company would otherwise be able to deduct - in order to provide a maintenance proxy for the State. Dr. van Meurs described the choice of 30 cents as follows: “The US \$.30 per BTU is based on reasonable capital maintenance costs of fields for which I have (confidential) information.” This 30 cents a barrel is disallowed regardless of the circumstances and adds approximately \$47 million in taxes annually for the oil companies. The amendment was adopted and became part of the PPT legislation that passed August 10, 2006.

- The State is additionally protecting its interests directly related to the North Slope GC-2/FS 2 oil spills and shutdowns – which some legislators have identified as the catalyst for SB 80 - through an investigation currently underway. The State has already accessed \$8.75 million from the spill-response “470 Fund” to allow the Attorney General and the Department of Environmental Conservation to begin an investigation into the State’s potential claims for “recovery of all state costs and lost revenues including fines and

penalties" resulting from corrosion at Prudhoe Bay. *See* ADEC Division of Spill Prevention & Response, *120 Hour Notification of Fund Access* (20 Nov. 2006) (attached). If this ongoing legal investigation shows that the State does have claims for "lost revenues" due to the corrosion, it will be able to assert those claims at that time and sue, if necessary, to recover on them.

**There are three serious problems with the proposed legislation.**

*The language is ambiguous and will inevitably result in confusion, delay and a backlog of tax litigation.* The difficulty of interpreting and applying the ambiguous language in SB 80 has been commented on either in writing or in testimony by managers of Department of Environmental Conservation (DEC); Department of Natural Resources (DNR) and the Alaska Oil & Gas Conservation Commission (AOGCC). We are attaching these letters for your review. AOGA has also outlined our concerns on this bill in testimony to the House Oil and Gas, House Resources and House Finance Committees.

There were efforts in the Senate and House Committees to respond to some of these concerns but even with these changes, problems identified in hearings still remain embedded in the proposed legislation – and particularly in SB 80. Cost disallowances under SB 80 would be triggered by a finding of "improper maintenance". This is not a standard or conventional term used in the petroleum industry. As a result, both taxpayers and state auditors would have to, in the first instance, interpret and apply as best they could. While SB 80 does say the commissioner of DOR, in determining whether maintenance was "improper" must take "good oil field practice" into account, SB 80 does not make "good oil field practices" the new standard. It is simply a standard the commissioner "must take into consideration". Importantly the amendments adopted in House Resources to HB 128 defining "good oil field practices"; defining "improper maintenance" as "maintenance that is not consistent with good oil field practices"; and language tying decisions to regulations adopted by the Petroleum Systems Integrity Office, were not adopted in SB 80. Another issue, as letters from the resource agencies have pointed out, is that the standards referred to are normally used as "guidance". They are not intended as a check list, because maintenance activities are facility specific.

*Auditors must examine all costs, whether or not an incident has occurred.* SB 80's general application to *all* costs, regardless of whether or not there has been an incident, will require state auditors to determine whether each capital cost proposed for deductions is or is not the result of "improper maintenance" and therefore challengeable. This is a huge issue. The proposed language does not identify what "red flag" would alert a tax auditor to an engineering or maintenance problem. The suggestions ventured by DOR managers in hearings regarding what might trigger an audit ranged from "newspaper articles" to "large expenditures". The fact is that most newspaper articles would be related to an incident, which is already covered in the existing law and many expenditures in maturing fields are "large". The auditor's responsibility to review all costs in light of a possible determination of "improper maintenance" will almost certainly result in audit backlogs.

May 12, 2007

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No final decision can be made before consultation among three agency commissioners and a "person" from the Petroleum Systems Integrity Office. Before any final decision is made as to whether an expenditure flagged by an auditor can be deducted, the Commissioner of DOR must consult with the Commissioner of DEC and DNR and the newly formed Petroleum Systems Integrity Office "person". (It is noted that this legislation gives this "person" the same consultation authority as commissioners.) There is no guidance about a way forward if there is disagreement – as historically there has been among these three agencies.

The ambiguity of terms, the required application of the "improper maintenance" test to all expenditures, and the resulting consultation process will inevitably tangle the production tax audit process to a standstill. Alaska risks finding itself once again with years of back tax audit delays and litigation over interpretations.

For all these reasons, we believe SB 80 is unnecessary and inappropriate legislation. We hope you will consider these objections before you vote.

## ENHANCEMENT OF THE "GROSS" CHARACTER OF THE PPT BILL

August 5, 2006

Pedro van Meurs

This memo has been written at the request of Senator Wagoner. The request was to provide ideas as to how the "gross" character of the PPT bill can be enhanced.

This memo does not reflect the views of the Administration and is solely meant to provide Senator Wagoner with my professional advice on these ideas.

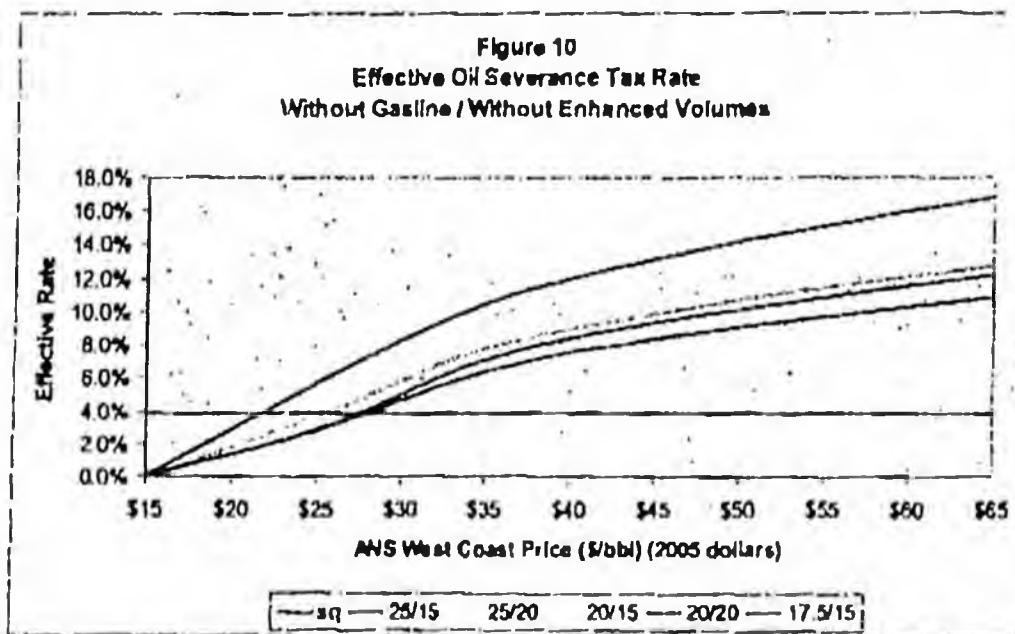
### FLOOR

Considerable concern has been expressed about the fact that under some circumstances of low prices and high levels of investment, the PPT may result in less severance tax than we would have received otherwise under the current severance tax.

This can be prevented with the introduction of a "floor", very similar as was introduced in House Bill 3004.

The floor would be based on the gross value at the point of production of the taxable oil and gas.

Roger Marks presented to the Legislature in February this year a direct comparison between the various proposed PPT systems and the 4% average on gross that would be otherwise applicable to the year 2006.



These graphs prove that at about \$ 25 per barrel the current ELF produces about the same amount as a 22.5/20 PPT.

If we assume the adoption of a 22.5/20 PPT than one could take the position that the PPT should not be less than 4% of gross when the ANS West Coast price exceeds \$ 25 per barrel.

HB 3004 introduced the concept that at lower prices the North Slope oil becomes obviously less economic and it would be counter productive to continue to tax the oil industry. Therefore HB 3004 proposes a scale with a lower floor at lower prices.

This overall concept could be combined with the results of the analysis of Roger Marks as follows:

Over an ANS price of \$ 25 per barrel	--	4%
When ANS is between \$ 20 and \$ 25 per barrel	--	3%
When ANS is between \$ 17.50 and \$ 20 per barrel	--	2%
When ANS is between \$ 15 and \$ 17.50 per barrel	--	1%
Below \$ 15 per barrel	--	0%

Each year the floor would be compared with the tax payable under the PPT and if the floor is higher, the higher amount would be paid.

Following is an example how the floor would work based on a PPT tax rate of 20% and a floor of 4%:

Gross Revenues	100	100	100
Cost deductions	40	90	120
Net Revenues	60	10	- 20
PPT Tax	12	2	-4
Floor	4	4	4
Tax payable	12	4	4

If the Gross Revenue based PPT is higher than the Net Revenue based PPT this extra payment can not be recovered in following years as a deduction. In other words this excess cannot be carried forward in order to be recovered in future years.

Of course, the payment of the differential between the Gross and Net Revenue based PPT cannot be taken as a deduction for the Net Revenue based PPT.

However, any carry forward credits as a result of a tax loss based on the Net Revenue based PPT remain unaltered.

Also under this scheme companies would not lose their capital investment credits of 20%.

It is also suggested that the additional non-transferable tax credits under Sec. 43.55.024 of the proposed House Bill 3001 (FIN) will still be creditable against the Gross Revenue Based PPT if this is higher than the Net Revenue Based PPT. These additional non-transferable tax credits were meant to protect small companies and encourage companies outside Cook Inlet and the North Slope. The Gross Revenue based PPT should not harm such companies.

**INCREASE THE NON DEDUCTABLE ITEMS**

The more costs are being excluded from the Net Revenue calculation the more the overall calculation becomes more similar to a Gross Revenue calculation. Therefore, the Gross Revenue character of the tax can be enhanced by simply adding to the list of items that are not considered lease expenditures.

There are two important cost components that could be excluded from lease expenditures:

- Costs related to gas development under a stranded gas contract, and
- Capital maintenance expenditures.

*Gas development costs under a stranded gas contract.*

Much concern has been expressed about the fact that with a net revenue based system there could be a joint cost problem in Point Thomson and other similar fields if the stranded gas contract would be implemented.

It is argued that all Point Thomson development and operating costs would be deductible under the PPT. At the same time under the stranded gas contract, companies would provide a 7.25% share to the State on gross and not pay the 20% or 22.5% PPT on gas. It is perceived that Point Thomson is being cross subsidized from what otherwise would be tax on oil under the PPT.

My view is that this is not a fair comparison, since reasonably all costs can be absorbed by the condensates. Nevertheless, this issue remains a concern of the Legislators.

It would be possible to add a further item on the list of non deductible costs under proposed AS. 43.55.165 (e) of House Bill 3001 (FIN) written as follows (*non legal language*):

- "(19) 75% of the capital and operating costs associated with the Point Thomson Unit and other gas fields that are being developed under a contract under AS.43.82, with respect to working interest owners which have concluded such a contract."

The 75% is based on the energy equivalent value considering that Point Thomson may have 400 million barrels of condensates and 7 - 8 Tcf of gas. In other words, the capital and operating costs would be allocated on an energy equivalent basis between condensates and gas. It is believed that many potential gas fields on the North Slope will have condensates and that these percentages may vary. For purposes of the bill, this percentage would be simply fixed.

The 25% allocated to condensates would be deductible for PPT purposes and would receive the related tax credits.

The 75% allocated to gas would not be deductible for PPT purposes and would not receive the related tax credits.

It can be assumed that the PTU would require a \$ 2.5 billion capital expenditure. Based on a 100% working interest, this arrangement would not receive a PPT tax reduction of \$ 750 million during development of the field. Assuming a \$ 1 billion operating expenditure over the life time of the field, it would mean that over time companies would pay \$ 150 million more tax during the operation of the field.

This is a significant tax increase, but in the total scheme of PPT taxation over the next 30 years this may represent only 1%-2% more tax.

Nevertheless, it would make the economics of Point Thomson development less attractive on an incremental basis and it would therefore make the entire gas project less attractive economically.

An interesting side effect of this arrangement is that it would place Chevron and other minority interest holders in a much better position relative to the sponsors. These companies have expressed concern that they would be discriminated against relative to the three sponsors. If Chevron and others do not join the stranded gas contract or would not be able to enter into a uniform upstream contract, they would at least benefit considerably relative to the Sponsors since they would receive the full tax deductions and credits. At the same time such companies would, of course, have to pay the full PPT on their gas income and therefore it is logical to permit them these tax credits and deductions.

*Deemed Capital Maintenance Costs*

Another concern that is regularly expressed is that the State should not permit the deduction of costs related to replacing equipment that is becoming defective or gathering lines that need to be replaced because of corrosion or other problems. The argument is that these assets should have been better maintained in the first place.

It should be noted that in most oil and gas fields, assets will have to be replaced after the technical life of such assets has expired. Therefore, such replacements are reasonable lease expenditures and are required to protect the health and safety of the workers and to protect the environment. Nevertheless, it is possible to exclude them from the lease expenditures under AS 43.55.165 (e) if this is politically desirable. A section could be added as follows (*non legal language*):

- (20) deemed capital maintenance expenditures which shall be capital expenditures equal to US \$ 0.30 per BTU equivalent barrel taxable production.

The US \$ 0.30 per BTU equivalent barrel is based on reasonable capital maintenance costs of fields for which I have (confidential) information. Based on a production of 900,000 barrel equivalent per day, this means that about \$ 100 million in capital expenditures per year will not be deductible for PPT purposes. Based on a PPT rate of 22.5% and a tax credit rate of 20% this means that the companies will pay \$ 42.5 million more tax per year.

An interesting side effect is that companies that would have a low level of capital expenditure per barrel would feel the effect more on a relative basis than companies that would have a high level of capital expenditures per barrel. Companies that re-invest strongly are therefore harmed less by this provision than typical harvesters.

# MEMORANDUM

State of Alaska

Department of Environmental Conservation  
Division of Spill Prevention and Response

TO: Frank H. Murkowski  
Governor

DATE: November 20, 2006

FILE: 120 Hour Notification of Fund  
Access

THRU: James Clark  
Chief of Staff

TELEPHONE NO: 465-5250

FROM:   
Director

SUBJECT: Response Account Use  
Project Name: BP North Slope  
Pipeline Corrosion Investigation  
Incidents: GC-2/FS-2 Oil Spills  
#06399906101; #0639921801

The purpose of this memorandum is to notify you of the use of the Response Account of the Oil and Hazardous Substance Release Prevention and Response Fund. The Department of Environmental Conservation (DEC) is accessing funds from the Response Account at the request of the Department of Law (DOL) for their: 1) investigation of BP's pipeline maintenance and corrosion management practices associated with the GC-2 and FS-2 oil spills; 2) pursuit of appropriate enforcement and legal action for violations of state law; and 3) recovery of all state costs and lost revenues including fines and penalties.

AS 46.08.045(b) requires DEC to provide a written report to the Governor and to the Legislative Budget and Audit Committee within 120 hours of using money in the Response Account. The report must summarize the release, and the costs of the state's actions, both taken and anticipated.

Summary of the Release. The GC-2 oil spill occurred on March 2, 2006 and the FS-2 oil spill occurred on August 6, 2006. Both spills occurred from transit pipelines operated by BP in the Prudhoe Bay oil field. DEC previously accessed the Response Account for the GC-2 Transit Line Release on March 3 and March 20 and for the Flow Station 2 Release on August 10, 2006. This action was necessary to respond, and conduct oversight to ensure containment, cleanup, mitigation and restoration of the imminent and substantial threat posed by these spills. DEC has also participated in the investigation of the cause of these spills as well as conducting review and mitigation for assessment, repair and replacement of the pipelines and associated corrosion problems. Details concerning the releases and additional information are available on the Unified Command website for these incidents at:

[www.dec.state.ak.us/spar/perp/response/sum\\_fv06/060302301/060302301\\_index.htm](http://www.dec.state.ak.us/spar/perp/response/sum_fv06/060302301/060302301_index.htm)

[www.dec.state.ak.us/spar/perp/response/sum\\_fv07/060806301/060806301\\_index.htm](http://www.dec.state.ak.us/spar/perp/response/sum_fv07/060806301/060806301_index.htm)

The state has incurred costs for response, oversight, mitigation, assessment, repair and replacement of corroded pipelines. Moreover, the state incurred substantial losses in revenue from royalty, severance tax and corporate income taxes from the loss of crude oil production as a result of these spills. The Department of Revenue is preparing estimates of the lost revenue to the state.

Anticipated Costs.

DOL has requested \$8,752,970 to investigate the GC-2 and FS-2 spills and seek recovery of all state costs and lost revenues. Investigation costs are estimated as follows: personnel - \$585,370; travel - \$7,600; and contractual - \$8,160,000. The largest component of these estimated costs is associated with managing the BP document production which has been estimated by BP to involve over 208 million pages of documents. BP has retained national counsel Vinson & Elkins to assist it in responding to the state and federal subpoenas for these two incidents.

DOL is investigating and reviewing legal options for assessment of oil spill penalties against BP and recovery of all costs and damages incurred by the state, due to the spill related production shutdowns. DOL seeks to retain experienced outside counsel to assist with these claims.

DOL will act as the Project Manager responsible for budget management, obligations/expenditure approval, fund report documentation, justification and cost recovery for this action.

The balance of the Response and Response Mitigation Accounts, reported by the Department of Administration on November 15, 2006 is \$51,257,451.90. DOL's request will result in the imposition of the \$.01 per barrel of oil surcharge, since the cumulative balance in these accounts will be reduced to below \$50,000,000.

DEC is required to seek reimbursement promptly for the cost incurred in cleanup or containment of oil or a hazardous substance that has been released. The Department of Law will document all costs and seek recovery of all state costs and lost revenues in conjunction with the enforcement and legal actions taken for these releases.

Any additional use of the Response Account will be reported.

cc: Gene Therriault, Chairman, Legislative Budget and Audit Committee  
William Corbus, Commissioner, Department of Revenue  
Kurt Fredriksson, Commissioner, Department of Environmental Conservation  
David Márquez, Attorney General, Department of Law  
Scott Nordstrand, Commissioner, Department of Administration

# STATE OF ALASKA

## DEPARTMENT OF REVENUE

### Tax Division

Sarah Palin, GOVERNOR

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February 20, 2007

The Honorable Tom Wagoner  
State Senate  
Alaska State Capitol  
Juneau, Alaska 99801-1182

Dear Senator Wagoner:

Thank you for the opportunity to review SB 80 regarding allowable lease expenditures for credits and deductions under the Petroleum Production Tax. I would like to offer a few comments on the bill.

First, the term "standard practices of the industry" may be difficult for the agencies to apply. It is my understanding that "standard industry practices" are not well defined when it comes to corrosion and maintenance. It is thus unclear what mechanism the Tax Division would employ to allow or exclude a deduction or credit for a certain cost.

I am also concerned about "relying on" the "standard practices of the industry" because the taxpayers would be providing and setting the standard. Whether the concept of "standard practices of the industry" is an appropriate benchmark depends on whether the industry has set and followed an appropriate standard.

Accordingly, I suggest changing "relying on" to "taking into consideration." This change would expand what the Department of Revenue could consider in determining whether a taxpayer improperly maintained property or equipment. Changing the language to "taking into consideration" doesn't limit the inquiry to industry practices, where the industry practices are inappropriate.

In addition, section (19)(C) seems unclear. This section excludes costs "for operating facilities or equipment at diminished capacity in proportion to the amount of diminished capacity that is caused by the improper maintenance of property or equipment." A possible interpretation could be that the taxpayers should not operate facilities unless they are going full bore (not at diminished capacity). If there are other facility costs the bill is trying to exclude, the language may need to be more specific, with a focus on "incremental operating expenses incurred as a result of operating facilities or equipment at diminished capacity that is caused by improper maintenance of property or equipment."

Page 2  
The Honorable Tom Wagoner  
February 20, 2007

With these edits, the language of the bill would be as follows:

- (e) For purposes of this section, lease expenditures do not include:
- (19) costs or that portion of the costs determined by the
  - (20) commissioner, in consultation with the commissioner of environmental
  - (21) conservation and the chair of the Alaska Oil and Gas Conservation Commission
  - (22) and taking into consideration [relying on] the standard practices of the industry, to be
  - (23) (A) related to the repair and replacement of improperly
  - (24) maintained property or equipment;
  - (25) (B) incurred to maintain the operational capability of
  - (26) facilities or equipment shut down because of improper maintenance of
  - (27) property or equipment; or
  - (28) (C) incremental operating expenses incurred as a result of operating
  - facilities or equipment at diminished capacity that is caused by improper
  - maintenance of property or equipment [for operating facilities or
  - equipment at diminished
  - (29) capacity in proportion to the amount of diminished capacity that is caused
  - (30) by the improper maintenance of property or equipment].

It is worth noting that AS 43.05.230 and AS 40.25.100 protect sensitive taxpayer information through confidentiality. To the extent SB 80 would require the Department of Revenue to share such information with other agencies, those agencies would be subject to the confidentiality requirements.

The Tax Division is studying the bill and will likely have further suggestions. Thanks again for the opportunity to provide input. We look forward to working with you.

Sincerely,



Jonathan E. Iversen  
Director

From: Hay, Linda  
Sent: Monday, February 19, 2007 12:29 PM  
To: Mary Jackson; Konrad Jackson  
Subject: SB 80 DEC Comments

Mary & Konrad - Here are the initial reactions from our folks in the Spill Prevention and Response Division. I will be over in the Capitol this afternoon and can stop by if either of you would like. Based on the legislation as currently written, we will be issuing an indeterminate fiscal note. Please bear in mind that this could change with possible amendments:

SB 80 & HB 128 provides a mechanism whereby costs or that portion of the costs related to repair and replacement of improperly maintained property or equipment would not be considered lease expenditures and thereby precluded from consideration for certain deductions or credits.

The legislation requires the determination be made in consultation with the Commissioner of Environmental Conservation and chair of AOGCC.

Whether or not such costs should be considered lease expenditures is a Revenue policy matter outside DEC's jurisdiction.

The extent to which the DEC Commissioner can contribute to the determination is probably limited. DEC may or may not have information or access to information regarding the operation or maintenance of certain property or equipment. It is likely that DEC would not have information or access to information related to property or equipment that is not subject to DEC regulation or oversight. DEC also is not likely to have cost information for property or equipment it does regulate. For example actual spill response costs or costs for repair or replacement of pipelines is not something required by DEC where those costs are directly borne by the operator.

DEC can offer its technical expertise or insights so there is likely no downside to inclusion in the consultation process. It should just be recognized that DEC's ability to be definitive or to have information or access to information important to this determination is probably limited.

It is possible that Revenue or DNR has a better means for acquiring this information through their various leasing or taxing authorities and it would seem that adequate substantiation for such costs would be subject to accounting rules and justification to substantiate any requests. In that regard the PPT regulations might be an avenue where the justification for including any such costs as lease expenditures would have to be documented and substantiated to the extent needed for accountants and the state to make a determination.

Linda Hay  
Legislative Liaison  
Dept. of Environmental Conservation  
Commissioner's Office

## Disallowing "deemed capital maintenance" costs

August 8, 2006

Pedro van Meurs

The shut down of Prudhoe Bay has brought in sharp focus that some of the facilities on the North Slope may be in poor shape.

The repair of such facilities could involve billions of dollars over the next two decades.

This raises firstly a fairness issue. Should companies receive a tax deduction and tax credit together for 40% of the value (under the 20/20 system) for replacing a pipeline that was defective and not properly maintained (as BP admitted during their short presentation to the Senate Committee). The pipeline replacement may also be subject to the "2 for 1" formula which would raise the contribution of Alaska to 50%.

However, at the same time this raises a broader issue. It is likely that over time more defective equipment will be identified that needs repair or replacement. The Prudhoe Bay oil field is now 30 years old and the continued operation for the next 30 years may pose a variety of problems.

In cost control there has always been a rather important "grey area" between "repair" and "betterment or replacement".

Under accounting rules if expenditures are made to replace an asset or improve the asset in a manner that provides it with a longer technical asset life, these costs are typically considered "capital" expenditures, if an asset is merely repaired it is an "operating" expenditure. For auditors it is often difficult to determine the difference.

Under the PPT the capital expenditures can be deducted and also receive a tax credit of 20%. Operating costs can only be deducted. It is therefore logical for companies to try to consider repairs as much as possible as capital expenditures by arguing that they created a "betterment" of the equipment. Or they may decide to simply replace the asset even if it can be repaired because of the tax deductions and credits. This could be an area of misuse under the PPT. A significant percentage of the operating costs could slip into the capital costs to the detriment of the State.

For all these reasons one could simply disallow a small part of the total capital expenditures as "lease expenditures". In this case they cannot be deducted or used for tax credits.

My suggestion is to disallow the first \$ 0.30 per BTU equivalent barrel as "lease expenditures".

A section could be added to AS 43.55.165 (e) of the bill as follows under non deductible lease expenditures (*non legal language*):

- (20) deemed capital maintenance expenditures which shall be capital expenditures equal to US \$ 0.30 per BTU equivalent barrel taxable production.

The US \$ 0.30 per BTU equivalent barrel is based on reasonable capital maintenance costs of fields for which I have (confidential) information. Based on a production of 900,000 barrel equivalent per day, this means that about \$ 100 million in capital expenditures per year will not be deductible for PPT purposes. Based on a PPT rate of 20% and a tax credit rate of 20% this means that the companies will pay \$ 40 million more tax per year.

I believe that this would provide a good answer to possible public criticism that under the PPT we would provide 50% of the replacement costs of pipelines as a result of the Prudhoe Bay shut down. I believe this would be popular with the Senate and the House. This could enhance the probability that the PPT would pass.

STATE OF ALASKA  
DEPARTMENT OF NATURAL RESOURCES  
DIVISION OF OIL & GAS

SARAH PALIN, GOVERNOR

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The Honorable Tom Wagoner  
Alaska State Legislature  
State Capitol  
Juneau, Alaska 99801-1182

Dear Senator Wagoner,

This is in response to your letter to Tom Irwin dated February 12, 2007. Thank you for the opportunity to review SB 80 regarding certain credits and deductions against the Petroleum Production Tax. I would like to offer a few comments and suggestions regarding the bill. Some of these issues have been discussed with the State Pipeline Coordinator's Office, the Alaska Oil and Gas Conservation Commission (AOGCC), and the Department of Environmental Conservation (DEC).

I agree that the commissioner of Natural Resources should be one of the commissioners with whom the Department of Revenue (DOR) consults on certain costs related to improperly maintained property or equipment. The Department of Natural Resources (DNR), in representing the state as the landowner, is preparing to closely review the issue of system integrity and take necessary action as part of the function of the Petroleum System Integrity Office (PSIO). As the coordinating agency of the DNR, the PSIO will have the leading role coordinating system integrity issues with other agencies such as the DEC and AOGCC.

Second, I would point out that it may be difficult for the agencies to rely on "standard practices of the industry." Although "standard industry practices" is a commonly used term, it is not a term of art. You could attempt to define and reference standards, such as ISO standards and guidelines, set by various associations such as API and ASME. However, standards for corrosion control and monitoring are not well established. There are no standards that the Division of Oil and Gas is aware of that would provide a measure from which to base a decision for corrosion and maintenance of facilities and equipment.

As an alternative, the Division of Oil and Gas is recommending language be included that defines the standard as "considering practices undertaken by a reasonable and prudent operator under the same or similar circumstances."

It may also be difficult for agencies to define or establish "improper maintenance" or "improperly maintained" in order to use it as a standard for costs. The Division of Oil and Gas suggests that you consider wording such as "improper maintenance as indicated by an unanticipated failure." Alternatively, you might consider "proper maintenance" defined as the replacement of equipment based on a regular or routine surveillance of the property, equipment, or facilities.

*"Develop, Conserve, and Enhance Natural Resources for Present and Future Alaskans."*

Division of Oil & Gas

2/15/07

Page 2 of 2

Finally, I would suggest that DOR be required to provide its consulting agencies with specific data and records relevant to the repair, replacement, and maintenance of the property, equipment, or facility for which lease expenditures are being claimed under AS 43.55.165. Of course, the taxpayer confidentiality provisions in AS 43.05.230 would apply to this information.

DNR is continuing to study the bill and may have additional suggestions for you. Again, I appreciate the opportunity to offer comments and to work with you.

Sincerely,



Kevin Banks  
Acting Director

cc: Tom Irwin, Commissioner, DNR  
Jonne Slemons, Acting Coordinator PSIO  
Maris Crosley, DO&G

# STATE OF ALASKA

## ALASKA OIL AND GAS CONSERVATION COMMISSION

SARAH PALIN, GOVERNOR

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February 16, 2007

The Honorable Thomas H. Wagoner  
Alaska State Legislature  
State Capitol, #427  
Juneau, AK 99801

Re: SB 80

Dear Senator Wagoner,

This is in response to your February 12 letter requesting comments regarding the referenced legislation.

As an independent regulatory agency, the Alaska Oil and Gas Conservation Commission (AOGCC), does not have a position either in favor of or against this bill. We do, however, understand, and agree with the premise that an operator should not be allowed to shift costs resulting from substandard maintenance practices to the State through tax deductions for lease expenditures.

Our main concern with the bill is the absence of a precise definition of improper maintenance. The bill proposes relying on standard practices of the industry to gauge whether there has been improper maintenance; but often there are no established industry standards to rely upon. Even when standards have been established by the American Petroleum Institute (API) or similar professional organizations, they are normally only recommended practices. Also, such industry guidelines are subject to change, which raises a question about whether an operator should be held to the most recent standard or to the standard prevailing when the alleged improper maintenance decision was made.

In some instances it will be obvious that there has been improper maintenance. In other instances (particularly well systems and equipment) the AOGCC will be required to consider design, installation, operation, and maintenance (all are integral to a determination of impropriety); and, making some determinations will require detailed investigation (perhaps including testing- non-destructive, destructive, metallurgic, etc.) and application of expertise not readily available within this agency.

Another concern is the fact that much of the equipment and systems in an oilfield that are subject to maintenance (and thus failure due to improper/iradequate maintenance) are not regulated by either AOGCC or Department of Environmental Conservation. This raises questions about how to judge "improper maintenance" in the absence of regulatory authority and oversight responsibility for such systems and equipment.

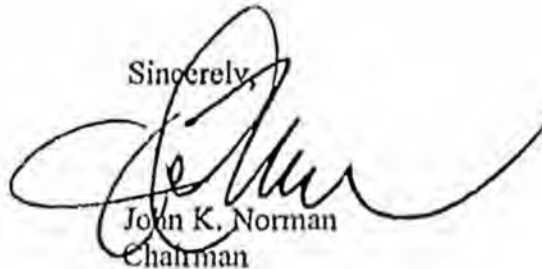
Finally, one can never lose sight of the fact that significant technological advances have occurred as a result of innovations which at the time were departures from standard industry practices. Also, engineers sometimes learn more through failure than from success. Often there is no indication something is being done improperly until a failure has occurred, but it is through analyzing the failure that the root cause can be determined and changes made going forward. This is simply the nature of engineering. In fact, there is a book entitled "To Engineer is Human: The Role of Failure in Successful Design" that describes and gives examples of this process.

Let me reiterate that we understand and agree with the intent of this legislation which is to prevent an operator from shifting financial responsibility to the State for costs resulting from the operator's improper maintenance practices. We do however, wish to point out some of the practical difficulties that may arise in determining whether maintenance has been improper.

One last point - we suggest deleting the words "the chair of" at line 22 on page 3. It is our supposition that the bill is worded this way to ensure prompt consultations on maintenance issues. We can assure you however that consultation with the commission (as opposed to just the chair) will not delay our response time should we be given this responsibility

Thank you for allowing us this opportunity to comment.

Sincerely,



John K. Norman  
Chairman

cc: Pat Galvin, Commissioner  
Department of Revenue

Larry Hartig, Commissioner  
Department of Environmental Conservation

Tom Irwin, Commissioner  
Department of Natural Resources



Sarah Palin  
GOVERNOR

STATE OF ALASKA  
OFFICE OF THE GOVERNOR  
JUNEAU

April 18th, 2007

## ADMINISTRATIVE ORDER NO. 234

I, Sarah Palin, Governor of the State of Alaska, under the authority of art. III, secs. 1 and 24, of the Alaska Constitution, and AS 44.17.060, name the commissioner of the Department of Natural Resources as the coordinator of oversight of facilities, equipment, infrastructure, and activities designed to explore for, produce, process, or transport oil and natural gas from, across, or within state oil and natural gas units or leases. This Order authorizes and directs increased and assertive oversight activities on state oil and natural gas units and leases by the Department of Natural Resources. These oversight activities include all activities relating to all facilities, equipment, and infrastructure. This Order also provides for coordination among state agencies of oversight on oil and natural gas matters on state land.

Nothing in this Order affects the authorities or responsibilities of state agencies with permitting, authorization, or oversight authority over oil and natural gas activities on state oil and natural gas units and leases, including advocacy by the Department of Law before the Federal Energy Regulatory Commission and state regulatory commissions, the development of fiscal terms under AS 43.82 or any later-enacted statute on development of such fiscal terms, or construction and maintenance of surface and air transportation infrastructure by the Department of Transportation and Public Facilities under other legal authority.

### FINDINGS

1. It is in the best interests of the people of this state and the nation that oil and natural gas exploration, production, and transportation facilities within this state be designed, constructed, operated, and maintained in a safe and environmentally sound manner. Oversight by state agencies with legal jurisdiction over the facilities, equipment, infrastructure, and activities designed to produce and transport oil and natural gas must be efficient, effective, and capable of ensuring compliance with state law.
2. It is in the best interests of the people of this state and the nation that oil and natural gas infrastructure in this state be designed, constructed, operated, and maintained to minimize the economic impacts to ongoing functions of state government caused by unplanned interruptions or reductions in oil and natural gas production in this state.

3. It is in the best interests of the people of this state and the nation that oil and natural gas infrastructure be maintained to avoid premature abandonment, which would cause waste of the state's resources.
4. It is in the best interests of the people of this state to utilize existing state government structures and processes to the maximum extent possible, and to effectively coordinate all state resources associated with oversight of facilities, equipment, infrastructure, and activities designed to produce oil and natural gas from state oil and natural gas units and leases.
5. The Department of Natural Resources has the authority under AS 38.05 and AS 44.37.020(a), and under state oil and natural gas leases, to exercise oversight of all oil and natural gas facilities, equipment, infrastructure, and activities on state oil and natural gas units and leases.

### ORDER

To further these findings, I, Sarah Palin, Governor of the State of Alaska, order and declare the following:

1. In regard to matters other than those relating to the development, and adoption or issuance, of regulations, standards, permits or other authorizations under federal, state, or local law, or to facilities subject to the United States Federal Highway Administration or the United State's Federal Aviation Administration oversight, the commissioner of the Department of Natural Resources is the lead official for communication and coordination with appropriate federal agencies, and with local governments, related to oversight of oil and natural gas exploration, production, and transportation on state oil and natural gas units and leases. The commissioner of the Department of Natural Resources may delegate duties under this Order to a qualified designee from the Department of Natural Resources.
2. The commissioner of the Department of Natural Resources is the lead official for communication and coordination among the following Designated Agencies regarding oil and natural gas infrastructure and activities on state oil and natural gas units and leases: Department of Environmental Conservation; Department of Fish and Game; Department of Public Safety; Department of Revenue; Department of Transportation and Public Facilities; Department of Labor and Workforce Development; Department of Law; Department of Natural Resources; Alaska Oil and Gas Conservation Commission; and the director in the Governor's Office in Washington, D.C.
3. The commissioner shall establish a Petroleum Systems Integrity Office (PSIO) and designate a Petroleum Systems Integrity Office Coordinator (PSIOC). The PSIOC is the lead state official in exercising oversight of the maintenance of facilities, equipment, and infrastructure for the sustained production and transportation of oil and natural gas resources in this state, including such facilities, equipment, and

infrastructure not currently within the jurisdiction of a Designated Agency.

4. Each Designated Agency shall appoint a Liaison Officer who shall report to the head of that Designated Agency. The Liaison Officer shall coordinate with the PSIOC. Liaison officers shall serve as the primary point of contact representing their respective Designated Agency.
5. The PSIOC shall establish, conduct, and coordinate through the Liaison Officers a process to comprehensively assess current state agency jurisdictions, standards, and practices on matters subject to this Order. That assessment shall identify all state agencies' detailed statutory and regulatory authority and practices; any gaps in statutes, regulations, resources, practices, or oversight regarding oil and natural gas facilities, equipment, infrastructure, and activities on state oil and natural gas units and leases; and the risks associated with any gaps. Analysis done under this paragraph is intended to preclude duplication of effort, and provide a comprehensive and cost-effective approach to determine the appropriate state oversight of oil and natural gas facilities, equipment, infrastructure, and activities on state oil and natural gas units and leases.
6. The PSIOC shall lead the interagency effort, through the Liaison Officers, to evaluate industry oversight of oil and natural gas facilities, equipment, infrastructure, and activities on state oil and natural gas units and leases. Designated agencies, to the extent authorized through existing legal authorities, shall require the industry businesses to provide a comprehensive description of current practices that includes the quality control, quality assurance, monitoring, inspection, and other practices the business uses to ensure the integrity and reliability of oil and natural gas facilities, equipment, infrastructure, and activities. The PSIOC shall coordinate the review of these evaluations and descriptions, identify gaps, and seek remedial action. The PSIOC shall make recommendations to the commissioner of the Department of Natural Resources regarding enforcement actions by the Department of Natural Resources and cases to be referred to other state, local, or federal agencies for appropriate civil or criminal penalties available under the law.
7. On an ongoing basis, the PSIOC shall coordinate the oversight activities of the PSIO with the Designated Agencies. The Designated Agencies shall participate in interagency activities led by the PSIO and provide other technical assistance as requested by the PSIO.
8. Unless contrary to any dispute resolution process in statute or regulation, in the event of an interagency dispute between Designated Agencies regarding a matter covered under this Order, Liaison Officers shall raise the issue to the PSIOC, who shall resolve the interagency dispute to the maximum extent possible in accordance with law. If the interagency dispute cannot be resolved by the PSIOC, the matter shall be elevated to the affected Designated Agency heads and the commissioner of the Department of Natural Resources. If an interagency dispute cannot be resolved by the affected Designated Agency heads and the commissioner of the Department of Natural Resources, the matter shall be elevated to the governor.
9. Consistent with AS 44.23.020, the attorney general, as legal advisor for the state, shall provide legal services to the PSIO, the PSIOC, and all Designated Agencies.

10. This Order is for administrative purposes only. It neither creates any third-party rights nor modifies the statutory and regulatory authority of Designated Agencies.
11. The PSIOC shall submit to the commissioner of the Department of Natural Resources and to the governor periodic progress reports that summarize evaluation, coordination, review, and oversight activities done under this Order and accomplishment of those activities.

## DEFINITIONS

In this Order,

1. "Designated Agencies" means the Department of Environmental Conservation; Department of Fish and Game; Department of Public Safety; Department of Revenue; Department of Transportation and Public Facilities; Department of Labor and Workforce Development; Department of Law; Department of Natural Resources; Alaska Oil and Gas Conservation Commission; and the director in the Governor's Office in Washington, D.C.;
2. "equipment" means machinery that is not a permanent fixture, is located on either a state oil and natural gas unit or lease, and is used to operate, construct, clean, or otherwise service oil and natural gas infrastructure and facilities;
3. "exploration facility" has the meaning given in AS 46.04.900;
4. "facilities" includes exploration facilities, oil terminal facilities, and production facilities;
5. "infrastructure" means all oil and natural gas pipelines, both onshore and offshore, including production facilities, line pipe, valves, and other appurtenances connected to line pipe, pumping units, and fabricated assemblies associated with pumping units, flow lines, separation facilities such as gathering centers and flow stations; transmission pipeline; above-ground oil storage tanks; oil or natural gas processing facilities, including seawater and produced water facilities; and all offshore platforms intended for use in oil and natural gas exploration or production
6. "Liaison Officer" means an officer or employee from a Designated Agency appointed to represent and report to the head of that Designated Agency and to serve as the primary point of contact between that Designated Agency and the PSIO and PSIOC;
7. "oil terminal facility" has the meaning given in AS 46.04.900;
8. "production facility" has the meaning given in AS 46.04.900;

- 9. "PSIO" means the Petroleum Systems Integrity Office established under this Order;
- 10. "PSIOC" means the Petroleum Systems Integrity Office Coordinator designated under this Order;
- 11. "transmission pipeline" has the meaning given in 18 AAC 75.990.

**REVOCATION OF AND RELATIONSHIP TO OTHER ADMINISTRATIVE ORDERS**

Administrative Order No. 229 is revoked. This Order supplements Administrative Order Nos. 134 and 187 and shall be interpreted as being complementary to those Orders. Unless contrary to any dispute resolution process in statute or regulation, any conflict among the Orders shall be resolved by the heads of the affected Designated State Agencies; if an interagency disagreement remains, the governor will resolve the conflict.

This Order takes effect immediately.

DATED at Juneau, Alaska, this 18th day of April, 2007.

/s/Sarah Palin  
Governor

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Administrative Orders 201-present | Contact the Governor | Webmaster | State of Alaska