

SB

80

**SENATE COMMITTEE REPORT
First Committee of Referral**

DATE: 2/9/07

FURTHER: Finance

Date of 5-Day Notice: _____
(in accordance with Uniform Rule 23)

DATE TURNED
IN TO OFFICE: 5/1/07

Resources Committee considered SENATE BILL NO. 80

SB 80 OIL & GAS PRODUCTION TAX: EXPENDITURES

"An Act relating to allowable lease expenditures for the purpose of determining the production tax value of oil and gas for the purposes of the oil and gas production tax; and providing for an effective date."

and recommends:

- be replaced with SCS or CS SB 80 (RES)
- adopt previous SCS or CS _____ (_____)
- attached amendment(s)
- adopt _____ Letter of Intent
- further referral to _____ Committee

SENATE BILL:	
<input checked="" type="checkbox"/>	Same Title
<input type="checkbox"/>	New Title
<hr/>	
HOUSE BILL:	
<input type="checkbox"/>	Same Title
<input type="checkbox"/>	Technical Title Change
<input type="checkbox"/>	New Title w/ SCR # _____

NEW FISCAL NOTE(S):

PREVIOUS FISCAL NOTE(S):

Department	Date			
AOM	4/26			✓
DEC	2/20			✓
REV	2/20	✓		

Department	Date			

APPROPRIATION - no fiscal note

SIGNATURES AND RECOMMENDATIONS					
	Green			✓	
	McBurnie			✓	
	Stutman			✓	
	Wielechowski				✓
	WAGONER				✓
CHAIR:				X	

FISCAL NOTE

STATE OF ALASKA
2007 LEGISLATIVE SESSION

Fiscal Note Number: SB80-DOR-TAX-2-20-07

Bill Version: SB 80

() Publish Date: _____

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						
TOTAL OPERATING	124.9	124.9	124.9	124.9	124.9	124.9

CAPITAL EXPENDITURES	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013

CHANGE IN REVENUES ()	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013

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)						
TOTAL	124.9	124.9	124.9	124.9	124.9	124.9

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

**STATE OF ALASKA
2007 LEGISLATIVE SESSION**

BILL NO. SB 80

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: SB 80-DEC-SPAR 2/2007
 Bill Version: SB 80
 () Publish Date: _____

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: Senate Resources Component No.: 1382

Expenditures/Revenues (Thousands of Dollars)

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

OPERATING EXPENDITURES	FY 2006	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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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)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

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

REVISED FISCAL NOTE

STATE OF ALASKA
2007 LEGISLATIVE SESSION

Fiscal Note Number: SB080-DOA-AOGCC 4-5-07
 Bill Version: SB080
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Administration
 Title: Oil and Gas Production Tax RDU: AOGCC
 Component: AOGCC
 Sponsor: Senators Wagoner, Theriault, Dyson, et al.
 Requester: Senate Resources 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	50.0	50.0	40.0	30.0	20.0	20.0
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
TOTAL OPERATING	50.0	50.0	40.0	30.0	20.0	20.0

CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
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CHANGE IN REVENUES ()	0.0	0.0	0.0	0.0	0.0	0.0
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipt:	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	50.0	50.0	40.0	30.0	20.0	20.0
TOTAL	50.0	50.0	40.0	30.0	20.0	20.0

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)

If SB 80 is passed, the Alaska Oil and Gas Conservation Commission, in conjunction with other State agencies, would be charged with determining whether a taxpayer followed standard industry practices for purposes of eligibility for deductions of costs related to the repair and replacement of improperly maintained property or equipment.

The estimate in this fiscal note is based upon our understanding that the work we may be called upon to perform will be within our traditional area of regulatory oversight (i.e., downhole and at the wellhead); and, that the Petroleum Systems Integrity Office (PSIO) will provide consultation and conduct investigations at the point where our jurisdiction ends.

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

Phone: 783-1221
 Date/Time: 3/9/07 10:30 AM
 Date: 3/9/07 11:00 AM

REVISED FISCAL NOTE

STATE OF ALASKA
2007 LEGISLATIVE SESSION

Fiscal Note Number: SB080-DOA-AOGCC 4-26-07
 Bill Version: SB080
 () Publish Date: _____

Revision Date/Time (Note if correction): _____

Dept. Affected: Administration

Title: Oil and Gas Production Tax

RDU: AOGCC

Component: AOGCC

Sponsor: Senators Wagoner, Theriault, 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
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
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CHANGE IN REVENUES ()	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
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

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. Colombia, 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, #427

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

DATE: February 13, 2007

TO: Senator Charlie Huggins, Chair
Senate Resources Committee

FROM: Senator Tom Wagoner *Tom*

RE: Hearing Request on SB 80 – Oil & Gas Production Tax:
Expenditures

As you know, I asked the Senate Resources Committee to have an update on the BP Corrosion Issue. My goal was to have that hearing and then have the referenced bill heard by the committee.

Since the Committee will be having an update on the Corrosion Issue this Wednesday, February 14, 2007, I respectfully request you consider scheduling SB 80 for next week's Committee meeting.

I have been in contact with the Departments of Environmental Conservation, Revenue, Natural Resources, and the AOGCC in regards to their position with the bill. I have asked AOGA for their input as well.

My expectation is that they will be able to testify to the Committee by next Wednesday, February 21, on this bill.

I am attaching a current packet on the bill for your review and inclusion as a packet before the Committee. I also expect to have additional information from the Departments.

Thank you for your time and consideration.



Official Business

ALASKA STATE LEGISLATURE

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SB 80 **Disallow PPT Reductions for** **Improperly Maintained Facilities**

Attachments:

1. Press Release – 1 page
2. Fact Sheet – 1 page
3. Sponsor Statement – 1 page
4. Sectional Analysis – 1 page
5. SB 80 - 4 pages + 1 page showing updated co-sponsors = 5 page
6. Minutes Aug. 9, 2006 - 3 pages

Total pages with this cover sheet – 13 pages

2-09-07/mj



25th ALASKA STATE LEGISLATURE SENATE REPUBLICAN CAUCUS

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

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

WILDA LAUGHLIN
PRESS OFFICER
465-4747, CELL 321-4369
wilda_laughlin@legis.state.ak.us

Press Release www.aksenateminority.com
FOR IMMEDIATE RELEASE: February 8, 2007

No. 07-06

Wagoner Bill Would Make Oil Companies Pay *Bill disallows deductions for improper maintenance*

JUNEAU—Sen. Tom Wagoner plans to introduce a bill on Friday that would prevent oil companies from deducting costs for repairs due to improper maintenance of property or equipment.

“Basically this bill was the aftermath of the lack of action on an amendment that was offered in the Special Committee on Natural Gas Development last year,” said Senator Tom Wagoner, R-Kenai. “I thought we should follow up and re-introduce this amendment as a bill amending the PPT legislation because the state of Alaska should not in any way pay for the maintenance of a system that is not maintained properly.”

Wagoner’s bill, which has not yet been assigned a number, allows the commissioner of the Department of Revenue, in consultation with the commissioner of the Department of Environmental Conservation and the chair of the Alaska Oil and Gas Conservation Commission, to disallow costs determined to be related to the repair or replacement of improperly maintained property or equipment.

“I think we should at least have that ability in law so they have the right to do that. I think this could wind up, if not done properly, could cost the state tens of millions of dollars, not only with the BP problem, but other similar situations that we may see in the future,” Wagoner said.

For the purpose of determining the value subject to tax, the petroleum production tax passed in August of 2006 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. The issue of tax credits for repairs became a concern when corrosion in a 30-inch pipeline in Prudhoe Bay caused some 200,000 gallons of oil to leak onto the tundra.

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For sound actualities by Sen. Tom Wagoner, click the following links:

<http://www.aksenateminority.com/media/25/wagoner2007020801a.mp3>

www.aksenateminority.com/media/25/wagoner2007020802a.mp3

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25th ALASKA STATE LEGISLATURE
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STATE CAPITOL ROOM 427, 465-4797 (FAX 465-3884)

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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: SB 80

Sponsor: Senator Thomas Wagoner

Short Title: OIL & GAS PRODUCTION TAX: EXPENDITURES

Summary:

- Empowers the commissioner of the Department of Revenue, in consultation with the commissioner of the Department of Environmental Conservation and the chair of the Alaska Oil and Gas Conservation Commission, to disallow costs or that portion of costs determined to be related to the repair or replacement of improperly maintained property or equipment for the purposes of determining the taxable value of oil and gas production.

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 having to shoulder the costs of repairing or replacing improperly maintained equipment.
- Encourages companies to properly maintain equipment by penalizing poor maintenance practices.
- Removes the potential for rewarding companies with tax credits for the repair of failed, improperly maintained facilities.
- 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, which was passed by the 24th Legislature during a special session on August 10, 2006. For the purpose of 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 would prevent 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.

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Official Business

ALASKA STATE LEGISLATURE

SENATOR THOMAS H. WAGONER

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

Feb 08
[Signature]

Session: January - May
 State Capitol, #427
 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 - Disallow PPT Reductions for Improperly Maintained Facilities

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. It failed by a vote of 5 yea - 7 nay.

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 Chair of the Alaska Oil and Gas Conservation Commission and relying on industry standards.

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

SS SB : 2-08-07: mj





Official Business

ALASKA STATE LEGISLATURE

SENATOR THOMAS H. WAGONER

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

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Juneau, AK 99801
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Sectional Analysis

SB 80 Disallow PPT Reductions for Improperly Maintained Facilities

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 improperly maintained property or equipment.

The costs are to be determined by the Commissioner of the Department of Revenue, in consultation with the Commissioner of Environmental Conservation and the Chair of the Alaska Oil and Gas Conservation Commission and reliance on industry standards.

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 petroleum production tax.



Official Business

ALASKA STATE LEGISLATURE

SENATOR THOMAS H. WAGONER

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

Feb 16
~~_____~~

Session: January - May
State Capitol, #427
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 Chair of the Alaska Oil and Gas Conservation Commission and relying on industry standards.

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

SS SB : 2-16-07: mj



Official Business

ALASKA STATE LEGISLATURE

SENATOR THOMAS H. WAGONER

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

Session: January - May
State Capitol, #427
Juneau, AK 99801
Phone: 907-465-2828 Fax: 907-465-4779

Interim: May - December
145 Main Street Loop, Suite 226
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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 improperly maintained property or equipment.

The costs are to be determined by the Commissioner of the Department of Revenue, in consultation with the Commissioner of Environmental Conservation and the Chair of the Alaska Oil and Gas Conservation Commission and reliance on industry standards.

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.

Bill History/Action Display



BILL: SB 80

BILL VERSION:

CURRENT STATUS: (S) RES

THEN FIN

SHORT TITLE: OIL & GAS PRODUCTION TAX:
EXPENDITURES

STATUS DATE: 02/09/07

SPONSOR(s): SENATOR(S) WAGONER, Thernault, Dyson, Wilken, Elton, French, Kookesh, Thomas, Wielechowski,
Green, Stevens, Olson, Davis, Stedman, Ellis

TITLE: "An Act relating to allowable lease expenditures for the purpose of determining the production tax value of oil and gas for the purposes of the oil and gas production tax; and providing for an effective date."

Bill Root:

[Display Bill Root](#)

[Next Bill](#)

[Full Text](#)

[Sponsor Statement](#)

[Committee Action with Bill History](#)

Jrn-Date	Jrn-Page	Action
02/09/07		(S) READ THE FIRST TIME - REFERRALS
02/09/07		(S) RES, FIN
02/09/07		(S) REFERRED TO RESOURCES

Similar Subject Match or Exact Subject Match

OIL & GAS

PIPELINES

RESOURCES

REVENUE

TAXATION

Bill Root:

[Display Bill Root](#)

[Next Bill](#)

[To Report Problems with Basis Inquiry](#)

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[Return to Basis Main Menu \(25 Legislature\)](#)

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SENATE BILL NO. 80

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FIFTH LEGISLATURE - FIRST SESSION

BY SENATORS WAGONER, Therriault, Dyson, Wilken, Elton, French, Kookesh, Thomas, Huggins

Introduced: 2/9/07

Referred:

A BILL

FOR AN ACT ENTITLED

1 **"An Act relating to allowable lease expenditures for the purpose of determining the**
2 **production tax value of oil and gas for the purposes of the oil and gas production tax;**
3 **and providing for an effective date."**

4 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

5 *** Section 1. AS 43.55.165(e) is amended to read:**

6 (e) For purposes of this section, lease expenditures do not include

7 (1) depreciation, depletion, or amortization;

8 (2) oil or gas royalty payments, production payments, lease profit
9 shares, or other payments or distributions of a share of oil or gas production, profit, or
10 revenue;

11 (3) taxes based on or measured by net income;

12 (4) interest or other financing charges or costs of raising equity or debt
13 capital;

14 (5) acquisition costs for a lease or property or exploration license;

- 1 (6) costs arising from fraud, wilful misconduct, or gross negligence;
- 2 (7) fines or penalties imposed by law;
- 3 (8) costs of arbitration, litigation, or other dispute resolution activities
- 4 that involve the state or concern the rights or obligations among owners of interests in,
- 5 or rights to production from, one or more leases or properties or a unit;
- 6 (9) costs incurred in organizing a partnership, joint venture, or other
- 7 business entity or arrangement;
- 8 (10) amounts paid to indemnify the state; the exclusion provided by
- 9 this paragraph does not apply to the costs of obtaining insurance or a surety bond from
- 10 a third-party insurer or surety;
- 11 (11) surcharges levied under AS 43.55.201 or 43.55.300;
- 12 (12) for a transaction that is an internal transfer or is otherwise not an
- 13 arm's length transaction, expenditures incurred that are in excess of fair market value;
- 14 (13) an expenditure incurred to purchase an interest in any corporation,
- 15 partnership, limited liability company, business trust, or any other business entity,
- 16 whether or not the transaction is treated as an asset sale for federal income tax
- 17 purposes;
- 18 (14) a tax levied under AS 43.55.011;
- 19 (15) the portion of costs incurred for dismantlement, removal,
- 20 surrender, or abandonment of a facility, pipeline, well pad, platform, or other
- 21 structure, or for the restoration of a lease, field, unit, area, body of water, or right-of-
- 22 way in conjunction with dismantlement, removal, surrender, or abandonment, that is
- 23 attributable to production of oil or gas occurring before April 1, 2006; the portion is
- 24 calculated as a ratio of the amount of oil and gas production, in barrels of oil
- 25 equivalent, associated with the facility, pipeline, well pad, platform, other structure,
- 26 lease, field, unit, area, body of water, or right-of-way occurring before April 1, 2006,
- 27 to the total amount of oil and gas production, in barrels of oil equivalent, associated
- 28 with that facility, pipeline, well pad, platform, other structure, lease, field, unit, area,
- 29 body of water, or right-of-way through the end of the calendar month before
- 30 commencement of the dismantlement, removal, surrender, or abandonment; a cost is
- 31 not excluded under this paragraph if the dismantlement, removal, surrender, or

1 abandonment for which the cost is incurred is undertaken for the purpose of replacing,
 2 renovating, or improving the facility, pipeline, well pad, platform, or other structure;
 3 for the purposes of this paragraph, "barrel of oil equivalent" means

4 (A) in the case of oil, one barrel;

5 (B) in the case of gas, 6,000 cubic feet:

6 (16) costs incurred for containment, control, cleanup, or removal in
 7 connection with any unpermitted release of oil or a hazardous substance and any
 8 liability for damages imposed on the producer or explorer for that unpermitted release;
 9 this paragraph does not apply to the cost of developing and maintaining an oil
 10 discharge prevention and contingency plan under AS 46.04.030;

11 (17) costs incurred to satisfy a work commitment under an exploration
 12 license under AS 38.05.132;

13 (18) that portion of expenditures, that would otherwise be qualified
 14 capital expenditures as defined in AS 43.55.023(k), incurred during a calendar year
 15 that are less than the product of \$0.30 multiplied by the total taxable production from
 16 each lease or property, in BTU equivalent barrels, during that calendar year, except
 17 that, when a portion of a calendar year is subject to this provision, the expenditures
 18 and volumes shall be prorated within that calendar year;

19 (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 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) 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.

31 * Sec. 2. The uncoded law of the State of Alaska is amended by adding a new section to

1 read:

2 **APPLICABILITY.** Section 1 of this Act applies to oil and gas produced after
3 March 31, 2006.

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

6 **TRANSITIONAL PROVISIONS.** (a) A person that filed a statement under
7 AS 43.55.030 before the effective date of this Act and deducted lease expenditures that may
8 not be deducted under AS 43.55.165(e), as amended by sec. 1 of this Act, shall file an
9 amended return and pay any additional tax within 90 days after the effective date of this Act.

10 (b) A person required to make an installment payment of estimated tax under
11 AS 43.55.020(a) for a period not included in a return required to be filed before the effective
12 date of this Act shall determine the amount of the underpayment, if any, that is attributable to
13 lease expenditures that may not be deducted under AS 43.55.165(e) as amended by sec. 1 of
14 this Act. The amount of any underpayment determined under this subsection shall be paid
15 within 90 days after the effective date of this Act.

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

18 **RETROACTIVITY.** Section 1 of this Act is retroactive to April 1, 2006.

19 * **Sec. 5.** This Act takes effect immediately under AS 01.10.070(c).

Minute

Aug 09, 2006

CSHB 3001(FIN) - OIL/GAS PROD. TAX

Chair Seekins opened the floor to public testimony on HB 3001. Hearing none, he closed the floor to public testimony and advised that he would consider amendments to HB 3001 after a short at ease.

At ease from 10:27:39 AM to 10:34:37 AM

10:36:22 AM

SENATOR WAGONER moved to adopt Amendment 5 Labeled 24-GH2096 P.33. Chair Dyson objected for discussion.

^AMENDMENT 5

Page 32, lines 21 - 27:

Delete all material and insert:

"(17) costs incurred for containment, control, cleanup, or removal in connection with any unpermitted release of oil or a hazardous substance and any liability for damages, fines, and penalties imposed on the producer or explorer for that unpermitted release;"

CHAIR SEEKINS removed his objection.

SENATOR BEN STEVENS asked what agency would be responsible for imposing the fines and penalties referred to on line 5 of the amendment.

SENATOR WAGONER responded that it would probably be Department of Environmental Conservation (DEC).

CHAIR SEEKINS said he could have someone from DEC address the committee.

SENATOR BEN STEVENS clarified that he wants to know what agencies would be involved in imposing those fines on the producers.

CHAIR SEEKINS responded that it would probably be DEC or the Environmental Protection Agency (EPA).

SENATOR BEN STEVENS recommended the amendment specify that they will be imposed by the state.

10:39:19 AM

SENATOR DYSON suggested that the committee go on to the next amendment and come back to this one when the DEC representative arrives.

SENATOR BUNDE concurred with Senator B Stevens, that the amendment should simply specify that the state of Alaska would impose the penalties.

Yea: Senator Kookesh, Senator Bunde, Senator Dyson,
Senator Wilken, Senator Elton, Senator Wagoner

Nay: Senator Hoffman, Senator B. Stevens, Senator
Stedman, Senator Olson, Senator Green, Senator Seekins

The amendment failed adoption by 6 yea - 6 nay.

SENATOR WAGONER moved Amendment 13 (24-GH2096\F.37), which
replaces Amendment 9.

AMENDMENT 13

Page 32, line 29, following "AS 38.05.132":

Insert ":

(19) costs or that portion of the costs
determined by the commissioner, in consultation with
the commissioner of environmental conservation and the
chair of the Alaska Oil and Gas Conservation
Commission and relying on the standard practices of
the industry, to be

(A) related to the repair and
replacement of improperly maintained property or
equipment; or

(B) incurred to maintain the
operational capability of facilities or equipment
shut down or for the incremental cost of
operating at diminished capacity because of
improper maintenance of property or equipment"

SENATOR BEN STEVENS objected.

SENATOR WAGONER explained that the difference between Amendment
13 and Amendment 9 is found on line 3, where "a" was replaced by
"that", and line 9 after the second "or", where "incremental
cost of" was added.

SENATOR THERRIAULT noted that the second change Senator Wagoner
referred to is on line 10, where the drafter also added "or for"
before the words "the incremental cost". The drafter also
modified lines 5-6 to specify that the commissioners could rely
on "the standard practices of the industry" in determining
whether the equipment was improperly maintained.

4:01:06 PM

SENATOR WAGONER moved Amendment 1 to Amendment 13, to renumber
paragraph (19) on line 3 to (20), because the committee did pass
a paragraph (19) previously.

There being no objection, Amendment 1 to Amendment 13 was
adopted.

4:01:26 PM

CHAIR SEEKINS said that, while he understands that the state
does not want to authorize deductions for improper maintenance,
he is extremely nervous about the size of the bureaucracy that
will result from this amendment, and the process that the
producers will have to go through to make a pre-determination of
what costs should be considered repair or replacement due to
improper maintenance based on other standards in the industry.
He is not concerned about catastrophic events, but those that
effect the day-to-day operations.

4:06:02 PM

SENATOR GREEN suggested that the words "gross deviation" be inserted on line 5, before "standard".

SENATOR THERRIAULT replied that the addition of that language would set the standard very high and make it difficult to prove.

4:07:18 PM

The roll was called on Amendment 13.

Yea: Senator Dyson, Senator Wilken, Senator Elton,
Senator Kookesh, Senator Wagoner

Nay: Senator Olson, Senator Hoffman, Senator B.
Stevens, Senator Stedman, Senator Bunde, Senator
Green, Senator, Senator Seekins

Amendment 13 failed adoption by 5 yea - 7 nay.

4:08:17 PM to 4:10:30 PM

CHAIR SEEKINS asked for the will of the committee on CSHB 3001 (FIN) as amended.

4:10:52 PM

SENATOR GREEN moved to report CSHB 3001(FIN) as amended from committee with individual recommendations and attached fiscal note.

4:11:11 PM

SENATOR ELTON objected. He explained that he believes the work this committee has done has improved the bill that came over from the House, and that his vote against it does not reflect any lack of appreciation for the hard work done by the committee.

4:11:57 PM

SENATOR ELTON withdrew his objection.

There being no objection, SCS CSHB 3001(NGD) was reported from the Senate Special Committee on Natural Gas Development.

Bill Root:

Display Bill Root

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ALASKA STATE LEGISLATURE

Sen. Charlie Huggins, Chair
Sen. Bert Stedman, Vice Chair
Sen. Lyda Green
Sen. Gary Stevens
Sen. Lowell McGuire
Sen. Bill Wielechowski
Sen. Thomas Wagoner



State Capital, Room 119
Juneau AK 99801-1182
907-465-3878
Fax: 907-465-3265
800-862-3878

Senate Resources Committee

Wednesday February 28, 2007
3:30 p.m. - 5:00 p.m.

AGENDA

+ **Workdraft [25-LS0425\M] CSSB 80 - Allowable lease expenditures for the purpose of determining the production tax value of oil and gas for the purposes of the oil and gas production tax**

Available for Questions

Mary Jackson, Staff to Senator Wagoner

Larry Dietrick, DEC

Available online for Questions

Kevin Banks, Dept. of Natural Resources

John Norman, Ak Oil & Gas Conservation Commission

John Iverson, Dept. of Revenue

3-5-07 NB128
out of H 076
now in HRES

February 28, 2007
Senate Resources Bill Packet

next to FIN

SB 80 – Oil and Gas Production Tax: Expenditures

Enclosures:

Inside front cover: Fiscal Notes

- 1. Fact Sheet 1 page**
- 2. Sponsor Statement 1 page**
- 3. Sectional Analysis 1 page**
- 4. SB 80 (version SB0080A) 4 pages**
- 5. CSSB 80 (work draft 25-LS0425\M)..... 4 pages**
 - Differences between original & work draft..... 1 page**
- 6. Agency Letters:**
 - a. DNR Letter dated 2/15/07 2 pages**
 - b. AOCGG letter dated 2/16/07 2 pages**
 - c. DEC email dated 2/19/07 1 page**
 - d. DOR letter dated 2/28/07 & 2/20/07 4 pages**
- 7. Affected Party Comment**
 - a. BP letter dated 2/15/07 2 pages**
- 8. Memoranda**
 - a. v. Meurs August 5, 2006**
 - b. v. Meurs August 8, 2006**
- 9. Legal Svcs Memo re: Ex post Facto (Bullock 2/26/07)..2 pages**

1. **Gavel In:**

2-28-07

Call to Order: Senate Resources Committee
Time _____

Date Wednesday February 28, 2007

Members Present:

ViceChair, Senator Bert Stedman
Senator Gary Stevens
~~Senator Lyda Green~~
Senator Lesil McGuire
Senator Bill Wielechowski
Senator Tom Wagoner
& myself, Senator Charlie Huggins

Members by Teleconference:

2. Today we're continuing with SB 80

3. On line from DNR: Kevin Banks & Jack Hartz

DOR: John Iverson

AOGCC: John Nerman

DOL: Rob Mintz

4. Here in the room from DOL: Ethan Falatko

DEC: Larry Dietrick

5. Public Testimony

Expecting BP; Conoco Phillips
& likely other public

6. Meeting adjourned at _____.

February 28, 2007
Senate Resources Bill Packet

SB 80 – Oil and Gas Production Tax: Expenditures

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25th ALASKA STATE LEGISLATURE

SENATE REPUBLICAN CAUCUS

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

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: SB 80

Sponsor: Senator Thomas Wagoner

Short Title: OIL & GAS PRODUCTION TAX: EXPENDITURES

Summary:

- Empowers the commissioner of the Department of Revenue, in consultation with the commissioner of the Department of Environmental Conservation and the chair of the Alaska Oil and Gas Conservation Commission, to disallow costs or that portion of costs determined to be related to the repair or replacement of improperly maintained property or equipment for the purposes of determining the taxable value of oil and gas production.

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 having to shoulder the costs of repairing or replacing improperly maintained equipment.
- Encourages companies to properly maintain equipment by penalizing poor maintenance practices.
- Removes the potential for rewarding companies with tax credits for the repair of failed, improperly maintained facilities.
- 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, which was passed by the 24th Legislature during a special session on August 10, 2006. For the purpose of 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 would prevent 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.

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RESPONSIBLE

CONSERVATIVE



Official Business

ALASKA STATE LEGISLATURE

SENATOR THOMAS H. WAGONER

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

Session: January - May

State Capitol, #427

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 Chair of the Alaska Oil and Gas Conservation Commission and relying on industry standards.

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

SS SB : 2-16-07: mj



Official Business

ALASKA STATE LEGISLATURE

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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 improperly maintained property or equipment.

The costs are to be determined by the Commissioner of the Department of Revenue, in consultation with the Commissioner of Environmental Conservation and the Chair of the Alaska Oil and Gas Conservation Commission and reliance on industry standards.

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.

SENATE BILL NO. 80

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FIFTH LEGISLATURE - FIRST SESSION

BY SENATORS WAGONER, Therriault, Dyson, Wilken, Elton, French, Kookesh, Thomas, Wielechowski, Green, Stevens, Olson, Davis, Stedman, Ellis, Huggins

Introduced: 2/9/07

Referred: Resources, Finance

A BILL

FOR AN ACT ENTITLED

1 **"An Act relating to allowable lease expenditures for the purpose of determining the**
2 **production tax value of oil and gas for the purposes of the oil and gas production tax;**
3 **and providing for an effective date."**

4 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

5 *** Section 1. AS 43.55.165(e) is amended to read:**

6 (e) For purposes of this section, lease expenditures do not include

7 (1) depreciation, depletion, or amortization;

8 (2) oil or gas royalty payments, production payments, lease profit
9 shares, or other payments or distributions of a share of oil or gas production, profit, or
10 revenue;

11 (3) taxes based on or measured by net income;

12 (4) interest or other financing charges or costs of raising equity or debt
13 capital;

14 (5) acquisition costs for a lease or property or exploration license;

- 1 (6) costs arising from fraud, wilful misconduct, or gross negligence;
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4 that involve the state or concern the rights or obligations among owners of interests in,
5 or rights to production from, one or more leases or properties or a unit;
6 (9) costs incurred in organizing a partnership, joint venture, or other
7 business entity or arrangement;
8 (10) amounts paid to indemnify the state; the exclusion provided by
9 this paragraph does not apply to the costs of obtaining insurance or a surety bond from
10 a third-party insurer or surety;
11 (11) surcharges levied under AS 43.55.201 or 43.55.300;
12 (12) for a transaction that is an internal transfer or is otherwise not an
13 arm's length transaction, expenditures incurred that are in excess of fair market value;
14 (13) an expenditure incurred to purchase an interest in any corporation,
15 partnership, limited liability company, business trust, or any other business entity,
16 whether or not the transaction is treated as an asset sale for federal income tax
17 purposes;
18 (14) a tax levied under AS 43.55.011;
19 (15) the portion of costs incurred for dismantlement, removal,
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21 structure, or for the restoration of a lease, field, unit, area, body of water, or right-of-
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23 attributable to production of oil or gas occurring before April 1, 2006; the portion is
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28 with that facility, pipeline, well pad, platform, other structure, lease, field, unit, area,
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 3 for the purposes of this paragraph, "barrel of oil equivalent" means

4 (A) in the case of oil, one barrel;

5 (B) in the case of gas, 6,000 cubic feet;

6 (16) costs incurred for containment, control, cleanup, or removal in
 7 connection with any unpermitted release of oil or a hazardous substance and any
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3 March 31, 2006.

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15 within 90 days after the effective date of this Act.

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

18 **RETROACTIVITY.** Section 1 of this Act is retroactive to April 1, 2006.

19 * **Sec. 5.** This Act takes effect immediately under AS 01.10.070(c).

SENATE BILL NO. 80

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FIFTH LEGISLATURE - FIRST SESSION

BY SENATORS WAGONER, Therriault, Dyson, Wilken, Elton, French, Kookesh, Thomas

Introduced:

Referred:

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1 "An Act relating to allowable lease expenditures for the purpose of determining the
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26 lease, field, unit, area, body of water, or right-of-way occurring before April 1, 2006,
27 to the total amount of oil and gas production, in barrels of oil equivalent, associated
28 with that facility, pipeline, well pad, platform, other structure, lease, field, unit, area,
29 body of water, or right-of-way through the end of the calendar month before
30 commencement of the dismantlement, removal, surrender, or abandonment; a cost is
31 not excluded under this paragraph if the dismantlement, removal, surrender, or

1 abandonment for which the cost is incurred is undertaken for the purpose of replacing,
 2 renovating, or improving the facility, pipeline, well pad, platform, or other structure;
 3 for the purposes of this paragraph, "barrel of oil equivalent" means

4 (A) in the case of oil, one barrel;

5 (B) in the case of gas, 6,000 cubic feet;

6 (16) costs incurred for containment, control, cleanup, or removal in
 7 connection with any unpermitted release of oil or a hazardous substance and any
 8 liability for damages imposed on the producer or explorer for that unpermitted release;
 9 this paragraph does not apply to the cost of developing and maintaining an oil
 10 discharge prevention and contingency plan under AS 46.04.030;

11 (17) costs incurred to satisfy a work commitment under an exploration
 12 license under AS 38.05.132;

13 (18) that portion of expenditures, that would otherwise be qualified
 14 capital expenditures as defined in AS 43.55.023(k), incurred during a calendar year
 15 that are less than the product of \$0.30 multiplied by the total taxable production from
 16 each lease or property, in BTU equivalent barrels, during that calendar year, except
 17 that, when a portion of a calendar year is subject to this provision, the expenditures
 18 and volumes shall be prorated within that calendar year;

19 (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 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) 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.

31 * Sec. 2. The uncodified law of the State of Alaska is amended by adding a new section to

1 read:

2 **APPLICABILITY.** Section 1 of this Act applies to oil and gas produced after
3 March 31, 2006.

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

6 **TRANSITIONAL PROVISIONS.** (a) A person that filed a statement under
7 AS 43.55.030 before the effective date of this Act and deducted lease expenditures that may
8 not be deducted under AS 43.55.165(e), as amended by sec. 1 of this Act, shall file an
9 amended return and pay any additional tax within 90 days after the effective date of this Act.

10 (b) A person required to make an installment payment of estimated tax under
11 AS 43.55.020(a) for a period not included in a return required to be filed before the effective
12 date of this Act shall determine the amount of the underpayment, if any, that is attributable to
13 lease expenditures that may not be deducted under AS 43.55.165(e) as amended by sec. 1 of
14 this Act. The amount of any underpayment determined under this subsection shall be paid
15 within 90 days after the effective date of this Act.

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

18 **RETROACTIVITY.** Section 1 of this Act is retroactive to April 1, 2006.

19 * **Sec. 5.** This Act takes effect immediately under AS 01.10.070(c).

25-LS0425M
Bullock
2/21/07

CS FOR SENATE BILL NO. 80()
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-FIFTH LEGISLATURE - FIRST SESSION

BY

Offered:
Referred:

Sponsor(s): SENATORS WAGONER, Therriault, Dyson, Wilken, Elton, French, Kookosh, Thomas, Wielechowski, Green, Stevens, Olson, Davis, Stedman, Ellis, Huggins, Hoffman

A BILL

FOR AN ACT ENTITLED

1 **"An Act relating to allowable lease expenditures for the purpose of determining the**
2 **production tax value of oil and gas for the purposes of the oil and gas production tax;**
3 **and providing for an effective date."**

4 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

5 *** Section 1. AS 43.55.165(e) is amended to read:**

- 6 **(e) For purposes of this section, lease expenditures do not include**
 - 7 **(1) depreciation, depletion, or amortization;**
 - 8 **(2) oil or gas royalty payments, production payments, lease profit**
9 **shares, or other payments or distributions of a share of oil or gas production, profit, or**
10 **revenue;**
 - 11 **(3) taxes based on or measured by net income;**
 - 12 **(4) interest or other financing charges or costs of raising equity or debt**
13 **capital;**
 - 14 **(5) acquisition costs for a lease or property or exploration license;**

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- (6) costs arising from fraud, wilful misconduct, or gross negligence;
- (7) fines or penalties imposed by law;
- (8) costs of arbitration, litigation, or other dispute resolution activities that involve the state or concern the rights or obligations among owners of interests in, or rights to production from, one or more leases or properties or a unit;
- (9) costs incurred in organizing a partnership, joint venture, or other business entity or arrangement;
- (10) amounts paid to indemnify the state; the exclusion provided by this paragraph does not apply to the costs of obtaining insurance or a surety bond from a third-party insurer or surety;
- (11) surcharges levied under AS 43.55.201 or 43.55.300;
- (12) for a transaction that is an internal transfer or is otherwise not an arm's length transaction, expenditures incurred that are in excess of fair market value;
- (13) an expenditure incurred to purchase an interest in any corporation, partnership, limited liability company, business trust, or any other business entity, whether or not the transaction is treated as an asset sale for federal income tax purposes;
- (14) a tax levied under AS 43.55.011;
- (15) the portion of costs incurred for dismantlement, removal, surrender, or abandonment of a facility, pipeline, well pad, platform, or other structure, or for the restoration of a lease, field, unit, area, body of water, or right-of-way in conjunction with dismantlement, removal, surrender, or abandonment, that is attributable to production of oil or gas occurring before April 1, 2006; the portion is calculated as a ratio of the amount of oil and gas production, in barrels of oil equivalent, associated with the facility, pipeline, well pad, platform, other structure, lease, field, unit, area, body of water, or right-of-way occurring before April 1, 2006, to the total amount of oil and gas production, in barrels of oil equivalent, associated with that facility, pipeline, well pad, platform, other structure, lease, field, unit, area, body of water, or right-of-way through the end of the calendar month before commencement of the dismantlement, removal, surrender, or abandonment; a cost is not excluded under this paragraph if the dismantlement, removal, surrender, or

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abandonment for which the cost is incurred is undertaken for the purpose of replacing, renovating, or improving the facility, pipeline, well pad, platform, or other structure; for the purposes of this paragraph, "barrel of oil equivalent" means

- (A) in the case of oil, one barrel;
- (B) in the case of gas, 6,000 cubic feet;

(16) costs incurred for containment, control, cleanup, or removal in connection with any unpermitted release of oil or a hazardous substance and any liability for damages imposed on the producer or explorer for that unpermitted release; this paragraph does not apply to the cost of developing and maintaining an oil discharge prevention and contingency plan under AS 46.04.030;

(17) costs incurred to satisfy a work commitment under an exploration license under AS 38.05.132;

(18) that portion of expenditures, that would otherwise be qualified capital expenditures as defined in AS 43.55.023(k), incurred during a calendar year that are less than the product of \$0.30 multiplied by the total taxable production from each lease or property, in BTU equivalent barrels, during that calendar year, except that, when a portion of a calendar year is subject to this provision, the expenditures and volumes shall be prorated within that calendar year;

Revised

(19) costs or that portion of the costs determined by the commissioner, in consultation with the commissioner of environmental conservation, the commissioner of natural resources, and the Alaska Oil and Gas Conservation Commission and taking into consideration the standard practices of the industry, to be

barrel dips on flat rate

(A) related to the repair and replacement of property or equipment that was not maintained or was improperly maintained;

(B) incurred to maintain the operational capability of facilities or equipment shut down because of a lack of or improper maintenance of property or equipment; or

(C) incremental operating expenses incurred as a result of operating facilities or equipment at diminished capacity when that diminished capacity is caused by the lack of or improper maintenance of

describes what happens after "improper maintenance" trigger is pulled

1 property or equipment.

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

4 APPLICABILITY. Section 1 of this Act applies to oil and gas produced after
5 March 31, 2006.

6 * Sec. 3. The uncodified law of the State of Alaska is amended by adding a new section to
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8 TRANSITIONAL PROVISIONS. (a) A person that filed a statement under
9 AS 43.55.030 before the effective date of this Act and deducted lease expenditures that may
10 not be deducted under AS 43.55.165(e), as amended by sec. 1 of this Act, shall file an
11 amended return and pay any additional tax within 90 days after the effective date of this Act.

12 (b) A person required to make an installment payment of estimated tax under
13 AS 43.55.020(a) for a period not included in a return required to be filed before the effective
14 date of this Act shall determine the amount of the underpayment, if any, that is attributable to
15 lease expenditures that may not be deducted under AS 43.55.165(e) as amended by sec. 1 of
16 this Act. The amount of any underpayment determined under this subsection shall be paid
17 within 90 days after the effective date of this Act.

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

20 RETROACTIVITY. Section 1 of this Act is retroactive to April 1, 2006.

21 * Sec. 5. This Act takes effect immediately under AS 01.10.070(c).

Draft CS SB 80

Differences between original bill and this draft:

Page 3:

Line 21:

Add "commissioner of natural resources"

Delete "the chair of"

- Intent is to include DNR as part of consulting group and also have all members of AOGCC, not just the chair.

Delete "relying on" and replacing with "taking into consideration"

- This language is more general in nature.

Line 24:

Subsection (a) clarifying language to make certain that "not maintained" was also established as criteria.

Line 27:

Insert "a lack of"

To clarify that both improper or no maintenance is involved.

Line 29: delete previous subsection (c). insert new language:

"Incremental operating expenses incurred as a result of operating facilities or equipment at diminished capacity when that diminished capacity is caused by the lack of or improper maintenance of property or equipment."

To clarify incremental expenses for diminished capacity as result of lack of or improper maintenance of facilities.

STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

DIVISION OF OIL & GAS

SARAH PALIN, GOVERNOR

550 WEST 7TH AVENUE, SUITE 500
ANCHORAGE, ALASKA 99501-5000PHONE: (907) 269-8200
FAX: (907) 269-8200

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 Simons, Acting Coordinator PSIO
Marie Croasley, DO&G

STATE OF ALASKA

SARAH PALIN, GOVERNOR

ALASKA OIL AND GAS CONSERVATION COMMISSION

333 W. 7th AVENUE, SUITE 100
ANCHORAGE, ALASKA 99501-3630
PHONE (907) 278-1483
FAX (907) 278-7542

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/inadequate 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

Mary Jackson

From: Hay, Linda [Linda_Hay@dec.state.ak.us]
Sent: Monday, February 19, 2007 12:29 PM
To: Mary Jackson; Konrad Jackson
Subject: SB 80 DEC Comments

Attachments: Hay, Linda.vcf



Hay, Linda.vcf (541
B)

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
907-465-5290 direct

STATE OF ALASKA

DEPARTMENT OF REVENUE

Tax Division

Sarah Palin, Governor

□ State Office Building
PO Box 110420
Juneau, AK 99811-0420
907.485.2320

● 550 W 7th Ave Suite 500
Anchorage, AK 99501-3555
907.269.0820

www.tax.state.ak.us

February 28, 2007

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

Dear Senator Wagoner:

You requested additional comments on SB 80 after changes were made in response to suggestions from the agencies. Specifically, you asked for the department's position on the revised SB 80 and the language of the bill, and the department's ability to promulgate regulations to implement the revised bill.

The administration believes that expenses related to repairing and replacing property or equipment that was not maintained or was improperly maintained should not be deductible or allowed as credits against taxes. While we will take the steps that we can take by law to exclude such deductions and credits, we would need to prevail in arguing that costs associated with improper maintenance were not deductible or could not form the basis for a credit to the extent they were, for example, attributable to gross negligence, were not ordinary and necessary business expenses, or were impermissible billings by an operator to other working interest owners under an arm's length, negotiated operating agreement.

If we drafted regulations that incorporated the standards of SB 80, such regulations would not find explicit support under current law, and could be legally challenged. The question would be whether such regulations were a reasonable interpretation of the statute. Therefore, we recommend that if the legislature desires that costs associated with improper maintenance definitely not be deductible or allowed as credits, the legislature ensure that such explicit language is in a statute.

The Department's concern is not with the intent or necessity of SB 80, it is with implementing the bill. The Department does not want to lose its discretion to deny deductions or credits under current law, nor does it want SB 80 to swallow the intent of allowing deductibility and credits for regular maintenance costs.

Subject to
challenge unless statutory
language included

Page 2
Senator Wagoner
February 28, 2007

Changing "relying on" into "taking into consideration" standard industry practices on line 22 of the bill has remedied these concerns; the Department may consider standard industry practices where appropriate, but it need not rely exclusively upon them.

✓ The Department supports SB 80, with the caveat that the bill not limit the Department's discretion to deny deductions or credits under current law. As revised, the bill does not restrict the Department's discretion under current law and the Department can promulgate regulations accordingly.

Sincerely,



Jonathan E. Iversen
Director

STATE OF ALASKA

DEPARTMENT OF REVENUE

Tax Division

Sarah Palin, GOVERNOR

State Office Building
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Juneau, AK 99811-0420
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907.269.6620

www.tax.state.ak.us

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
 - (29) facilities or equipment at diminished capacity that is caused by improper
 - (30) maintenance of property or equipment [for operating facilities or
 - (31) equipment at diminished
 - (32) capacity in proportion to the amount of diminished capacity that is caused
 - (33) 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

bp



Doug Suttles

President

February 15, 2007

BP Exploration (Alaska) Inc.
PO Box 198812
900 E. Benson Boulevard
Anchorage, Alaska 99519-8812

Honorable Members
Alaska State Legislature
State Capitol
Juneau, AK 99801

Dear Ladies and Gentlemen:

A number of questions have been raised about BP's intent to deduct certain costs related to the Prudhoe Bay field shutdown last August. I am writing to confirm our position on this issue and at the same time reiterate BP's commitment to and plans for our business in Alaska.

Direct 907 564 5422
Main 907 561 5111
Fax 907 564 5900
doug.suttles@bp.com

With respect to the deductibility of costs, we can only speak for BP. Taxes are paid on a company wide basis rather than a field specific basis and BP cannot speak for the other Prudhoe Bay owners on tax issues.

BP follows the law when it files its taxes. Accordingly, BP will assume the appropriate deductions & credits for the costs associated with the repair and replacement of the Prudhoe Bay Oil Transit Lines (OTLs). Specifically, BP will deduct appropriate costs associated with repair of the OTLs and will seek authorized credits for capital costs to replace them. Similarly in compliance with the PPT Laws, we will not seek to deduct costs associated with cleaning up the oil spills.

To put this issue into context, I would like to openly share our estimated 2006 production taxes.* For the final nine months of 2006, the period over which PPT was applicable, we estimate that BP's production taxes will almost triple from \$180 million under the old ELF-based tax to more than \$500 million under PPT. Over the same period, BP's share of the deductions and credits associated with the costs of inspection, business resumption, and replacement of the OTLs will result in a total deduction of around \$11 million in 2006, which we have included in our 2006 production tax estimate.

We believe our approach is appropriate for the following reasons:

- 1) It is important to realize that the OTLs are some 30 years old and were sized for significantly higher production than we will have in the future. The OTLs would have been replaced in the normal course of business, even if the events of last year had not taken place.
- 2) We are in the process of building a new state of the art pipeline system for the future life of Prudhoe Bay. This is not a like-for-like replacement. Rather, we are investing in a brand new system, with pipe diameter sizes very different than the original design to reflect the reduced production from these maturing oilfields. The new system will have new chemical injection systems, upgraded pig launchers/receivers, upgraded leak detection system, and a Fusion Bond Epoxy external coating for longer life. The system will be in operation for decades to come. We believe this investment is in the best interests of the State of Alaska and the North Slope producers.

We appreciate the opportunity yesterday to discuss our Alaska business with the Senate Resources Committee and update them on the commitments we made in August 2006.

February 15, 2007

Page 2 of 2

BP remains fully committed to the ongoing integrity of its facilities. As we embark on a vision of our next 50 years in Alaska, we will continue to make significant investment in facility renewal. This is not about replacement. It is about designing and constructing new facilities in a way that underpins the future and ensures the operability of the North Slope for decades to come.

With respect to PPT, last year the Legislature held long and difficult debates that ultimately led to the passage of PPT. The regulations are still being formalized as this legislation has not been in place for very long. We are only just preparing to submit our first tax returns under this new system. As a result, we believe it is premature to consider changes to the structure or intent of the current legislation. We believe it would be prudent for all parties, including producers and the State, to wait until PPT is fully implemented and we have real experience of its operation and impact before making any changes.

I hope I have provided you with the clarity of BP's intentions that many of you have been seeking and the reasoning behind the decisions we have made.

I look forward to working with the legislature as we progress our vision for our business in Alaska, including the commercialization of Alaska Gas, and as we bring our vision of a 50-year future to reality.

Sincerely,

A handwritten signature in black ink, appearing to read "Doug Suttles". The signature is stylized with large, sweeping letters and a prominent flourish at the end.

Doug Suttles

- * Please note that, in disclosing in this letter certain specific tax information and BP's tax positions regarding PPT, BP does not intend to waive the confidentiality of any of its tax materials and information under applicable law (including AS 43.05.230), other than the particular information disclosed.

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.

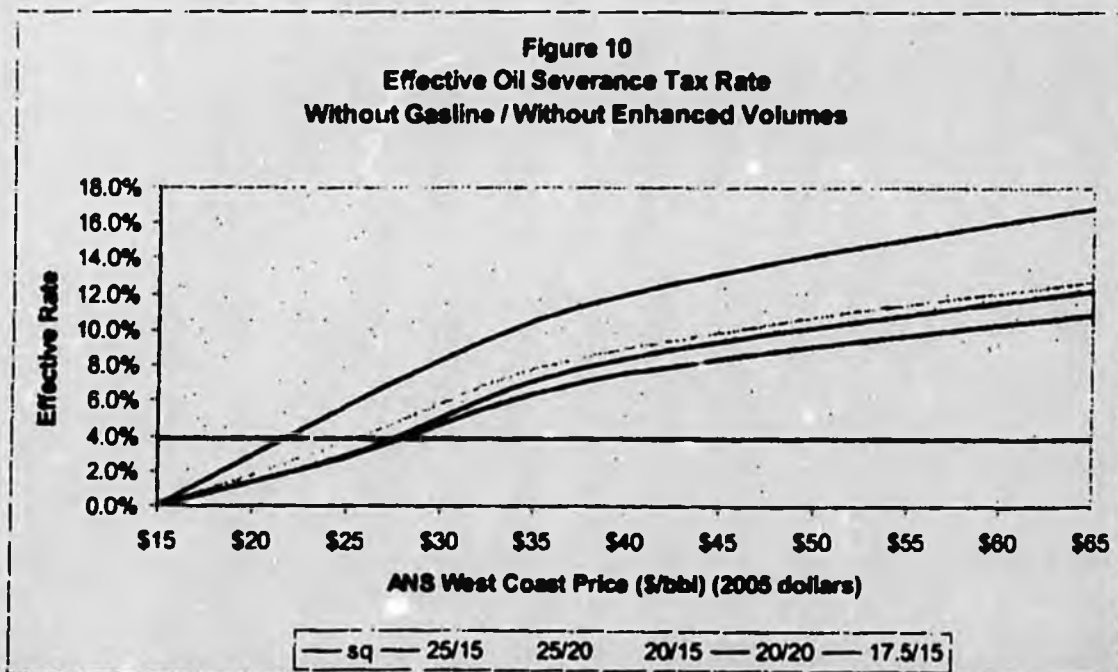
FLOOR

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 loose 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.

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.

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 466-2450
FAX (907) 465-2029
Mail Stop 3101

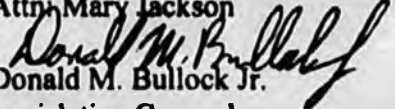
State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 120 6th St., Rm. 329

MEMORANDUM

February 26, 2007

SUBJECT: Ex post facto (SB 80; Work Order No. 25-LS0425)

TO: Senator Thomas Wagoner
Attn: Mary Jackson

FROM: 
Donald M. Bullock Jr.
Legislative Counsel

You asked whether enactment of SB 80 would violate the prohibition against *ex post facto* laws in the United States and Alaska Constitutions¹ because the disallowance of certain deductions applies retrospectively to April 1, 2006, the effective date of the PPT.

The answer is no.

During the meetings of the Senate Resources Committee on SB 80 and the House Special Committee on Oil and Gas on HB 128, a person appearing before the committees stated that the retrospective effect of the bills is prohibited under the *ex post facto* clauses. I have been unable to find any authority for this statement regarding the change in tax law offered in these bills.

To the contrary, both the United States Supreme Court and our own Supreme Court have upheld retrospective tax legislation.

In 1912, the United State Supreme Court noted that, "It is however, settled that [the *ex post facto* prohibition of Art. I, § 9 of the Constitution] is confined to laws respecting criminal punishments, and has no relation to retrospective legislation of any other description."² The proposed disallowance of expenses resulting from the lack of maintenance or improper maintenance are not criminal punishment provisions and only

¹ Art. I, sec. 9, Constitution of the United States; art. I, sec. 15, Constitution of the State of Alaska.

² *Johannessen v. United States*, 225 U.S. 227, 242; 32 S. Ct. 613, 617; 56 L. Ed. 1066, 1072 (1912). The *Johannessen* case involved an immigration issue, but the principle that the application of the *ex post facto* clause is limited to laws regarding criminal punishment is cited as authority for denying an *ex post facto* challenge in cases reviewing tax laws with retrospective effect. See, e.g. *Mathes v. Commissioner of Internal Revenue*, 63 T.C. 642, 644 (1975).

Senator Thomas Wagoner
February 26, 2007
Page 2

affect the amount of tax for which a producer is liable. Though any taxpayer may consider a greater amount of tax as "punishment," the bill you are sponsoring does not involve the type of criminal punishment addressed by the ex post facto clause.

The United States Supreme Court has also upheld retrospective tax legislation against a due process challenge. In *United States v. Carlton*,³ the court upheld the retroactive application of a curative measure in 1987 to a provision enacted the prior year; the actual retroactive effect of the 1987 amendment extended for a period only slightly greater than one year. In *Carlton*, the court noted that "Congress acted promptly and established only a modest period of retroactivity," and "Congress 'almost without exception' has given general revenue statutes effective dates prior to the dates of actual enactment." The Court noted a 1938 decision upheld a Wisconsin income tax enacted in 1935 that imposed a tax on dividends in 1933 for the proposition that, "the 'recent transactions' to which a tax law may be retroactively applied 'must be taken to include the receipt of income during the year of the legislative session preceding that of its enactment.'"⁴ SB 80 proposes to amend tax legislation that was became effective August 20, 2006, just over 6 months ago.

Note that retrospective application of changes in tax laws on the oil industry have been upheld by the Alaska Supreme Court. In 1985, the Alaska Supreme Court upheld the retrospective effect of oil and gas income tax legislation that was signed into law in July 1978 and was retroactive to January 1, 1978.⁵ Seven years later, the same court upheld the retrospective effect of a change in the economic limit formula applicable to the production tax on oil and gas; in that case, the Act was effective August 6, 1989, and was retroactive to January 1, 1989.⁶ In neither case did the taxpayers assert the ex post facto prohibition as authority for challenging the retrospective application of the tax, but unsuccessfully argued that the retrospective application was effectively an "effective date" that required a two-thirds majority vote under art. II, sec. 18 of the state constitution.

In my opinion, the retrospective application of SB 80 or HB 128 would survive a challenge under the ex post facto clauses of the United States and Alaska constitutions.

If I may be of further assistance, please advise.

DMB:ljw
09-100.ljw

³ *United States v. Carlton*, 512 U.S. 26; 114 S. Ct. 2018; 129 L. Ed. 2d 22 (1994).

⁴ *Carlton*, 512 U.S. at 33, 114 S. Ct. at 2023, 129 L. Ed. 2d at 30, citing *Welch v. Henry*, 305 U.S. 134, 83 L. Ed. 87, 59 S. Ct. 121 (1938).

⁵ *Atlantic Richfield Company v. State, Dep't of Revenue*, 705 P.2d 418 (Alaska 1985), appeal dismissed, 474 U.S. 1043, 106 S. Ct. 774, 88 L. Ed. 2d 754 (1986).

⁶ *ARCO Alaska, Inc. v. State, Commissioner of Revenue*, 824 P.2d 708 (Alaska 1992).

ALASKA STATE LEGISLATURE

Sen. Charlie Huggins, Chair
Sen. Bert Stedman, Vice Chair
Sen. Lyda Green
Sen. Gary Stevens
Sen. Lesil McGuire
Sen. Bill Wielechowski
Sen. Thomas Wagoner



State Capitol, Room 119
Juneau AK 99801-1182
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Senate Resources Committee

Butrovich – Room 205

Friday, April 20, 2007

3:30 p.m. – 5:30 p.m.

AGENDA

- **SB 111 – KODIAK NARROW CAPE PUBLIC USE AREA**
 - Senator Gary Stevens, Sponsor
 - Doug Letch, Legislative Aide to Sen. Stevens

- **SB 80 – OIL & GAS PRODUCTION TAX: EXPENDITURES**
 - John Norman, Commissioner/Chair, AOGCC
 - Commissioner Pat Galvin, Department of Revenue
 - Kevin Banks, Director, Division of Oil & Gas

- **HB 186 – SPORT FISHING GUIDE RECORDS**
 - Tom Wright, Legislative Aide to Speaker John Harris, Sponsor
 - Doug Vincent-Lang, Alaska Department of Fish and Game

SRES

4-20-07

— SB 80

①

— Michael Hurley: testimony against SB80 says — the 30k exemption ~~also~~ already covers maintenance

— Wagoner —

30k ~~may~~ never meant to cover expenses due to negligence

Spoke from "Timeline - PPT" — (not passed out to comte by Wagoner)

— Stedman — guess we'd have to go back & ck. record

— C.H. lets call Pedro and he can speak to it.

— alt — Q to M. Hurley — re. page 27 of PPT bill hand-out

— Kevin Banks — Dir. Div of O&G

— comments about "proper maintenance"

- Kevin Banks -

- a process over time will allow us to better glean "improper maintenance"

- developing maintenance timeline reqs is part of the battle - need to develop our "ck list"

Stedman - Q's re when reqs will be commenced

K. Banks - we staffing up the new PSIO
(teleconf) (pipeline systems integrity office)

- John Jackson (teleconf) - just started ramping up on reqs - some time late fall 2007 expected

- Pat Galvin - re: two memos from Pedro V

Aug 8 memo - Day after

- Pat thinks 304 was only to deal w/ improperly maintained equipment - all inclusive

4*20*07

3

P Galvin

FY

30d FY 08 \$70 million - tax rec'd \$38.6 million
exclusion

- Have received 1st set of returns from PPT
- Tax payers & state are in midst of information exchange
- Evaluation & adjustment phase on part of state & taxpayers

McGuire? have to determine what "improperly maintained" means

Galvin Bill (SB 80) structured to rely on standards set by PSIO.

from P.P. Tax

1 would cause an annual production tax value calculated under (a)(1) of this section of
2 taxable oil or gas produced during the calendar year to be less than zero may be used
3 to establish a carried-forward annual loss under AS 43.55.023(b). In this subsection,
4 "producer" includes "explorer."

5 **Sec. 43.55.165. Lease expenditures.** (a) Except as provided under (c) - (e) of
6 this section, for the purposes of AS 43.55.160, a producer's lease expenditures for a
7 calendar year are the ordinary and necessary costs upstream of the point of production
8 of oil and gas that are incurred during the calendar year by the producer after
9 March 31, 2006, and that are direct costs of exploring for, developing, or producing oil
10 or gas deposits located within the producer's leases or properties in the state or, in the
11 case of land in which the producer does not own a working interest, that are direct
12 costs of exploring for oil or gas deposits located within other land in the state. In
13 determining whether costs are lease expenditures, the department shall consider,
14 among other factors,

15 (1) the typical industry practices and standards in the state that
16 determine the costs, other than items listed in (e) of this section, that an operator is
17 allowed to bill a working interest owner that is not the operator, under unit operating
18 agreements or similar operating agreements that were in effect before December 2,
19 2005, and were subject to negotiation with at least one working interest owner with
20 substantial bargaining power, other than the operator; and

21 (2) the standards adopted by the Department of Natural Resources that
22 determine the costs, other than items listed in (e) of this section, that a lessee is
23 allowed to deduct from revenue in calculating net profits under a lease issued under
24 AS 38.05.180(f)(3)(B), (D), or (E).

25 (b) For purposes of (a) of this section,
26 (1) direct costs include
27 (A) an expenditure, when incurred, to acquire an item if the
28 acquisition cost is otherwise a direct cost, notwithstanding that the expenditure
29 may be required to be capitalized rather than treated as an expense for financial
30 accounting or federal income tax purposes;
31 (B) payments of or in lieu of property taxes, sales and use

ALASKA STATE LEGISLATURE

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Senate Resources Committee Butrovich – Room 205

Friday, April 27, 2007
3:30 p.m. – 5:30 p.m.

AGENDA

- **HB 186 -- SPORT FISHING GUIDE RECORDS**
- **SJR 4 – NATURAL GAS FOR STATE RESIDENTS**
- **SB 80 – OIL & GAS PRODUCTION TAX: EXPENDITURES**
- **SB 57 – MARINE PARKS ADDITION/HUNTING ALLOWED**

April 27, 2007

Senate Resources Bill Packet

1. Fact Sheet - SB 80 – OIL & GAS PRODUCTION TAX: EXPENDITURES	1 page
2. SB 80 Sponsor Statement.....	1 page
3. SB 80 Sectional Analysis	1 page
4. SB 80 (version AB0080A)	4 pages
5. CSSB 80 (work draft 25-LS0425M)	4 pages
Differences between the original and work draft).....	1 page
6. Amendments Nos. M.1, M.2, and M3	3 pages
Legal Svcs Memo- Amendments Nos. M.1 and M.2 to CSSB 80 (Bullock 4/4/07)	3 pages
7. Legal Svcs Memoranda	
A. Disallowance of Costs (CSSB 80) (Bullock 3/12/07)	3 pages
8. Agency Letters relating to SB 80:	
A. DNR letter dated 2/15/07.....	2 pages
B. AOGCC letter dated 2/16/07	2 pages
C. DEC email dated 2/19/07	1 page
D. DOR letters dated 2/28/07 and 2/20/07	4 pages
9. Affected Party Comment	
A. BP letter dated 2/15/07	2 pages
10. Memoranda	
A. P. v. Meurs dated 8/5/06; P. v. Meurs and 8/8/06.....	7 pages
12. Legal Svcs Memoranda re SB 80	
A. Ex-Post Facto (Bullock 2/26/07).....	2 pages
13. Testimony from John Norman, 4/20/07).....	4 pages
14. PPT timeline and anonymous BP email, courtesy of Sen. Wagoner	2 pages



25th ALASKA STATE LEGISLATURE
SENATE REPUBLICAN CAUCUS

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

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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: SB 80

Sponsor: Senator Thomas Wagoner

Short Title: OIL & GAS PRODUCTION TAX: EXPENDITURES

Summary:

- Empowers the commissioner of the Department of Revenue, in consultation with the commissioner of the Department of Environmental Conservation and the chair of the Alaska Oil and Gas Conservation Commission, to disallow costs or that portion of costs determined to be related to the repair or replacement of improperly maintained property or equipment for the purposes of determining the taxable value of oil and gas production.

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 having to shoulder the costs of repairing or replacing improperly maintained equipment.
- Encourages companies to properly maintain equipment by penalizing poor maintenance practices.
- Removes the potential for rewarding companies with tax credits for the repair of failed, improperly maintained facilities.
- 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, which was passed by the 24th Legislature during a special session on August 10, 2006. For the purpose of 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 would prevent 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



Official Business

ALASKA STATE LEGISLATURE

SENATOR THOMAS H. WAGONER

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

Session: January - May

State Capitol, #427

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 Chair of the Alaska Oil and Gas Conservation Commission and relying on industry standards.

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

SS SB : 2-16-07: mj



Official Business

ALASKA STATE LEGISLATURE

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

Session: January - May

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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 improperly maintained property or equipment.

The costs are to be determined by the Commissioner of the Department of Revenue, in consultation with the Commissioner of Environmental Conservation and the Chair of the Alaska Oil and Gas Conservation Commission and reliance on industry standards.

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.

SENATE BILL NO. 80

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FIFTH LEGISLATURE - FIRST SESSION

BY SENATORS WAGONER, Therriault, Dyson, Wilken, Elton, French, Kookesh, Thomas, Wielechowski,
Green, Stevens, Olson, Davis, Stedman, Ells, Huggins, Hoffman, McGuire

Introduced: 2/9/07

Referred: Resources, Finance

A BILL**FOR AN ACT ENTITLED**

1 "An Act relating to allowable lease expenditures for the purpose of determining the
2 production tax value of oil and gas for the purposes of the oil and gas production tax;
3 and providing for an effective date."

4 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

5 * Section 1. AS 43.55.165(e) is amended to read:

6 (e) For purposes of this section, lease expenditures do not include

7 (1) depreciation, depletion, or amortization;

8 (2) oil or gas royalty payments, production payments, lease profit
9 shares, or other payments or distributions of a share of oil or gas production, profit, or
10 revenue;

11 (3) taxes based on or measured by net income;

12 (4) interest or other financing charges or costs of raising equity or debt
13 capital;

14 (5) acquisition costs for a lease or property or exploration license;

1 (6) costs arising from fraud, wilful misconduct, or gross negligence;

2 (7) fines or penalties imposed by law;

3 (8) costs of arbitration, litigation, or other dispute resolution activities
4 that involve the state or concern the rights or obligations among owners of interests in,
5 or rights to production from, one or more leases or properties or a unit;

6 (9) costs incurred in organizing a partnership, joint venture, or other
7 business entity or arrangement;

8 (10) amounts paid to indemnify the state; the exclusion provided by
9 this paragraph does not apply to the costs of obtaining insurance or a surety bond from
10 a third-party insurer or surety;

11 (11) surcharges levied under AS 43.55.201 or 43.55.300;

12 (12) for a transaction that is an internal transfer or is otherwise not an
13 arm's length transaction, expenditures incurred that are in excess of fair market value;

14 (13) an expenditure incurred to purchase an interest in any corporation,
15 partnership, limited liability company, business trust, or any other business entity,
16 whether or not the transaction is treated as an asset sale for federal income tax
17 purposes;

18 (14) a tax levied under AS 43.55.011;

19 (15) the portion of costs incurred for dismantlement, removal,
20 surrender, or abandonment of a facility, pipeline, well pad, platform, or other
21 structure, or for the restoration of a lease, field, unit, area, body of water, or right-of-
22 way in conjunction with dismantlement, removal, surrender, or abandonment, that is
23 attributable to production of oil or gas occurring before April 1, 2006; the portion is
24 calculated as a ratio of the amount of oil and gas production, in barrels of oil
25 equivalent, associated with the facility, pipeline, well pad, platform, other structure,
26 lease, field, unit, area, body of water, or right-of-way occurring before April 1, 2006,
27 to the total amount of oil and gas production, in barrels of oil equivalent, associated
28 with that facility, pipeline, well pad, platform, other structure, lease, field, unit, area,
29 body of water, or right-of-way through the end of the calendar month before
30 commencement of the dismantlement, removal, surrender, or abandonment; a cost is
31 not excluded under this paragraph if the dismantlement, removal, surrender, or

1 abandonment for which the cost is incurred is undertaken for the purpose of replacing,
 2 renovating, or improving the facility, pipeline, well pad, platform, or other structure;
 3 for the purposes of this paragraph, "barrel of oil equivalent" means

4 (A) in the case of oil, one barrel;

5 (B) in the case of gas, 6,000 cubic feet;

6 (16) costs incurred for containment, control, cleanup, or removal in
 7 connection with any unpermitted release of oil or a hazardous substance and any
 8 liability for damages imposed on the producer or explorer for that unpermitted release;
 9 this paragraph does not apply to the cost of developing and maintaining an oil
 10 discharge prevention and contingency plan under AS 46.04.030;

11 (17) costs incurred to satisfy a work commitment under an exploration
 12 license under AS 38.05.132;

13 (18) that portion of expenditures, that would otherwise be qualified
 14 capital expenditures as defined in AS 43.55.023(k), incurred during a calendar year
 15 that are less than the product of \$0.30 multiplied by the total taxable production from
 16 each lease or property, in BTU equivalent barrels, during that calendar year, except
 17 that, when a portion of a calendar year is subject to this provision, the expenditures
 18 and volumes shall be prorated within that calendar year;

19 (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 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) 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.

31 * Sec. 2. The uncodified law of the State of Alaska is amended by adding a new section to

1 read:

2 **APPLICABILITY.** Section 1 of this Act applies to oil and gas produced after
3 March 31, 2006.

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

6 **TRANSITIONAL PROVISIONS.** (a) A person that filed a statement under
7 AS 43.55.030 before the effective date of this Act and deducted lease expenditures that may
8 not be deducted under AS 43.55.165(e), as amended by sec. 1 of this Act, shall file an
9 amended return and pay any additional tax within 90 days after the effective date of this Act.

10 (b) A person required to make an installment payment of estimated tax under
11 AS 43.55.020(a) for a period not included in a return required to be filed before the effective
12 date of this Act shall determine the amount of the underpayment, if any, that is attributable to
13 lease expenditures that may not be deducted under AS 43.55.165(e) as amended by sec. 1 of
14 this Act. The amount of any underpayment determined under this subsection shall be paid
15 within 90 days after the effective date of this Act.

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

18 **RETROACTIVITY.** Section 1 of this Act is retroactive to April 1, 2006.

19 * **Sec. 5.** This Act takes effect immediately under AS 01.10.070(c).

25-LS0425M
Bullock
2/21/07

CS FOR SENATE BILL NO. 80()

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FIFTH LEGISLATURE - FIRST SESSION

BY

Offered:

Referred:

Sponsor(s): SENATORS WAGONER, Therriault, Dyson, Wilken, Elton, French, Kookesh, Thomas, Wielechowski, Green, Stevens, Olson, Davis, Stedman, Ellis, Huggins, Hoffman

A BILL

FOR AN ACT ENTITLED

1 **"An Act relating to allowable lease expenditures for the purpose of determining the**
2 **production tax value of oil and gas for the purposes of the oil and gas production tax;**
3 **and providing for an effective date."**

4 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

5 *** Section 1. AS 43.55.165(e) is amended to read:**

6 **(e) For purposes of this section, lease expenditures do not include**

7 **(1) depreciation, depletion, or amortization;**

8 **(2) oil or gas royalty payments, production payments, lease profit**
9 **shares, or other payments or distributions of a share of oil or gas production, profit, or**
10 **revenue;**

11 **(3) taxes based on or measured by net income;**

12 **(4) interest or other financing charges or costs of raising equity or debt**
13 **capital;**

14 **(5) acquisition costs for a lease or property or exploration license;**

- 1 (6) costs arising from fraud, wilful misconduct, or gross negligence;
- 2 (7) fines or penalties imposed by law;
- 3 (8) costs of arbitration, litigation, or other dispute resolution activities
- 4 that involve the state or concern the rights or obligations among owners of interests in,
- 5 or rights to production from, one or more leases or properties or a unit;
- 6 (9) costs incurred in organizing a partnership, joint venture, or other
- 7 business entity or arrangement;
- 8 (10) amounts paid to indemnify the state; the exclusion provided by
- 9 this paragraph does not apply to the costs of obtaining insurance or a surety bond from
- 10 a third-party insurer or surety;
- 11 (11) surcharges levied under AS 43.55.201 or 43.55.300;
- 12 (12) for a transaction that is an internal transfer or is otherwise not an
- 13 arm's length transaction, expenditures incurred that are in excess of fair market value;
- 14 (13) an expenditure incurred to purchase an interest in any corporation,
- 15 partnership, limited liability company, business trust, or any other business entity,
- 16 whether or not the transaction is treated as an asset sale for federal income tax
- 17 purposes;
- 18 (14) a tax levied under AS 43.55.011;
- 19 (15) the portion of costs incurred for dismantlement, removal,
- 20 surrender, or abandonment of a facility, pipeline, well pad, platform, or other
- 21 structure, or for the restoration of a lease, field, unit, area, body of water, or right-of-
- 22 way in conjunction with dismantlement, removal, surrender, or abandonment, that is
- 23 attributable to production of oil or gas occurring before April 1, 2006; the portion is
- 24 calculated as a ratio of the amount of oil and gas production, in barrels of oil
- 25 equivalent, associated with the facility, pipeline, well pad, platform, other structure,
- 26 lease, field, unit, area, body of water, or right-of-way occurring before April 1, 2006,
- 27 to the total amount of oil and gas production, in barrels of oil equivalent, associated
- 28 with that facility, pipeline, well pad, platform, other structure, lease, field, unit, area,
- 29 body of water, or right-of-way through the end of the calendar month before
- 30 commencement of the dismantlement, removal, surrender, or abandonment; a cost is
- 31 not excluded under this paragraph if the dismantlement, removal, surrender, or

1 abandonment for which the cost is incurred is undertaken for the purpose of replacing,
2 renovating, or improving the facility, pipeline, well pad, platform, or other structure;
3 for the purposes of this paragraph, "barrel of oil equivalent" means

4 (A) in the case of oil, one barrel;

5 (B) in the case of gas, 6,000 cubic feet;

6 (16) costs incurred for containment, control, cleanup, or removal in
7 connection with any unpermitted release of oil or a hazardous substance and any
8 liability for damages imposed on the producer or explorer for that unpermitted release;
9 this paragraph does not apply to the cost of developing and maintaining an oil
10 discharge prevention and contingency plan under AS 46.04.030;

11 (17) costs incurred to satisfy a work commitment under an exploration
12 license under AS 38.05.132;

13 (18) that portion of expenditures, that would otherwise be qualified
14 capital expenditures as defined in AS 43.55.023(k), incurred during a calendar year
15 that are less than the product of \$0.30 multiplied by the total taxable production from
16 each lease or property, in BTU equivalent barrels, during that calendar year, except
17 that, when a portion of a calendar year is subject to this provision, the expenditures
18 and volumes shall be prorated within that calendar year;

19 (19) costs or that portion of the costs determined by the
20 commissioner, in consultation with the commissioner of environmental
21 conservation, the commissioner of natural resources, and the Alaska Oil and Gas
22 Conservation Commission and taking into consideration the standard practices
23 of the industry, to be → "good oil field practices"

24 (A) related to the repair and replacement of property or
25 equipment that was not maintained or was improperly maintained;

26 (B) incurred to maintain the operational capability of
27 facilities or equipment shut down because of a lack of or improper
28 maintenance of property or equipment; or

29 (C) incremental operating expenses incurred as a result of
30 operating facilities or equipment at diminished capacity when that
31 diminished capacity is caused by the lack of or improper maintenance of

must mean something other than "gross" (already in (6) so must mean "ordinary"

1 property or equipment.

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

4 **APPLICABILITY.** Section 1 of this Act applies to oil and gas produced after
5 March 31, 2006.

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

8 **TRANSITIONAL PROVISIONS.** (a) A person that filed a statement under
9 AS 43.55.030 before the effective date of this Act and deducted lease expenditures that may
10 not be deducted under AS 43.55.165(e), as amended by sec. 1 of this Act, shall file an
11 amended return and pay any additional tax within 90 days after the effective date of this Act.

12 (b) A person required to make an installment payment of estimated tax under
13 AS 43.55.020(a) for a period not included in a return required to be filed before the effective
14 date of this Act shall determine the amount of the underpayment, if any, that is attributable to
15 lease expenditures that may not be deducted under AS 43.55.165(e) as amended by sec. 1 of
16 this Act. The amount of any underpayment determined under this subsection shall be paid
17 within 90 days after the effective date of this Act.

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

20 **RETROACTIVITY.** Section 1 of this Act is retroactive to April 1, 2006.

21 * **Sec. 5.** This Act takes effect immediately under AS 01.10.070(c).

Draft CS SB 80

Differences between original bill and this draft:

Page 3:

Line 21:

Add "commissioner of natural resources"

Delete "the chair of"

- Intent is to include DNR as part of consulting group and also have all members of AOGCC, not just the chair.

Delete "relying on" and replacing with "taking into consideration"

- This language is more general in nature.

Line 24:

Subsection (a) clarifying language to make certain that "not maintained" was also established as criteria.

Line 27:

Insert "a lack of"

To clarify that both improper or no maintenance is involved.

Line 29: delete previous subsection (c). insert new language:

"Incremental operating expenses incurred as a result of operating facilities or equipment at diminished capacity when that diminished capacity is caused by the lack of or improper maintenance of property or equipment."

To clarify incremental expenses for diminished capacity as result of lack of or improper maintenance of facilities.

AMENDMENT

OFFERED IN THE SENATE

BY SENATOR WAGONER

TO: CSSB 80()

- 1 Page 3, lines 22 - 23:
- 2 Delete "the standard practices of the industry"
- 3 Insert "good oil field practice"

AMENDMENT

OFFERED IN THE SENATE

BY SENATOR WAGONER

TO: CSSB 80(), Draft Version "M"

1 **Page 4, lines 9 - 10:**

2 **Delete "lease expenditures that may not be deducted"**

3 **Insert "costs that may not be treated as lease expenditures or claimed as a credit based**
4 **on costs that may not be claimed as lease expenditures"**

5

6 **Page 4, line 10:**

7 **Delete "AS 43.55.165(e), as amended"**

8 **Insert "AS 43.55.165(e)(19), as enacted"**

9

10 **Page 4, line 13, following "AS 43.55.020(a)":**

11 **Insert "before the effective date of this Act"**

12

13 **Page 4, line 15:**

14 **Delete "lease expenditures that may not be deducted"**

15 **Insert "costs that may not be treated as lease expenditures or attributable to a credit**
16 **based on costs that may not be claimed as lease expenditures"**

17 **Delete "AS 43.55.165(e) as amended"**

18 **Insert "AS 43.55.165(e)(19), as enacted"**

19

20 **Page 4, following line 17:**

21 **Insert a new subsection to read:**

22 **"(c) Interest on an additional amount of tax due under (a) of this section or on the**
23 **amount of the underpayment of an installment under (b) of this section does not begin to**

1 accrue until 90 days after the effective date of this Act."

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

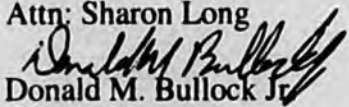
State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 129 6th St., Rm. 329

MEMORANDUM

April 4, 2007

SUBJECT: Amendments M.1 and M.2 to CSSB 80(), Draft Version "M"
(Work Order No. 25-LS0425\M.1 and M.2)

TO: Senator Charlie Huggins
Chair of the Senate Resources Committee
Attn: Sharon Long

FROM: 
Donald M. Bullock Jr.
Legislative Counsel

You faxed over two amendments to CSSB 80(), currently before your committee, and asked about the effect of the amendments on the bill and existing law.

Amendment 25-LS0425\M.1

Amendment M.1 replaces "the standard practices of the industry" with "good oil field practice". This amendment was requested by the administration as a better standard for the commissioner to take into consideration when determining whether the repair or replacement of property or equipment was related to no maintenance or improper maintenance.

"Good oil field practice" is described in the *Manual of Oil and Gas Terms*¹ as:

A term occasionally used to indicate that operations are carried out in a proper and workmanlike manner. It has been used in the same way as the phrase "everything is A.P.I.," which refers to the American Petroleum Institute's set of standards covering aspects of petroleum operations.

The State of California has used the term in a regulation relating to oil field facilities and equipment maintenance. That part of the regulation describing "good oilfield practice"² is as follows:³

¹ Howard R. Williams & Charles J. Meyers, *Manual of Oil and Gas Terms* at 495 (12th ed., 2003).

² The California regulation uses "oilfield" rather than "oil field."

³ 14 CCR 1774 (2007).

(e) Pipelines shall be designed, constructed, tested, operated, and maintained in accordance with *good oil field practice* and applicable standards, such as the American Petroleum Institute (API) (API Rec. Prac. 1110, 3rd Ed., Dec. 1991, and API Spec. effective 1990) or American Society for Testing and Materials (ASTM) (ASTM Designation Stand. Spec., 1991), Code of Federal Regulations 49, Part 192, or other applicable standards for the transportation of oil, gas, produced water, and other fluids.

Good oilfield practice includes, but is not limited to:

(1) Utilization of preventative methods such as cathodic protection and corrosion inhibitors, as appropriate, to minimize external and internal corrosion.

(2) Employment, where practical, of equipment such as low-pressure alarms and safety shut-down devices to minimize spill volume in the event of a leak.

(3) Evaluating the applicability of locating any new pipelines or parts of a pipeline system that are being relocated or replaced above ground.

The use of pipe clamps or screw-in plugs are not considered good oilfield practice for permanent repair of pipeline leaks.

[Emphasis added.]

One reason that I have found it difficult to describe the standard for the maintenance of oil and gas production facilities is that Alaska seems to be unique, or within a very limited group,⁴ that get involved with production costs upstream from the point of production. This was a new concept introduced as part of the petroleum production tax (PPT) legislation. When taxes are based on the value at the point of production, which is the general rule for production taxes, upstream costs are not a factor. Thus, there is little law on the categorization of costs. A reference to "good oil field practice" will provide at least some guidance to the Department of Revenue when it is establishing an acceptable level of maintenance for which a deduction of cost is allowed, and then the disallowance of costs when the maintenance is absent or improper.

So far as the bill relates to existing law, the bill adds a paragraph to AS 43.55.165(e). That subsection describes costs that may not be deducted as lease expenditures when computing the taxable value of oil and gas production. The amendment merely provides

⁴ I have not found another state that allows a deduction for upstream production costs for the purpose of calculating a tax on oil and gas production.

Senator Charlie Huggins

April 4, 2007

Page 3

additional direction to the commissioner of revenue when the commissioner is determining which expenditures relating to an oil and gas lease are deductible.

Amendment 25-LS0425M.2

Amendment M.2 makes technical and not substantive corrections to the bill. Page 1, lines 2 - 4 and 14 - 16, clarify those costs that are not deductible.

Page 1, lines 7 - 8 and 17 - 18, change the reference to the specific paragraph added by the bill rather than referring to the amendment of the entire subsection.

Page 1, lines 6 - 18, clarify language in the uncodified sections of the bill.

Page 1, line 21, through page 2, line 1, adds a subsection to the transitional provision explaining when interest would apply to an underpayment of a tax or installment payment resulting from the enactment of the bill.

If I may be of further assistance, please advise.

DMB:ljw
07-194.ljw

okay

AMENDMENT

OFFERED IN THE SENATE

BY SENATOR WAGONER

TO: CSSB 80(), Draft Version "M"

1 Page 3, lines 21 - 22:

2 Delete "Alaska Oil and Gas Conservation Commission"

3 Insert "person in the Department of Natural Resources who is the lead person for
4 exercising oversight over the maintenance of oil and gas facilities, equipment, and
5 infrastructure in the state"



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,

- Page 4 of 5
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.

Page 3 of 3
/s/Sarah Palin
Governor

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

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Mail Stop 3101

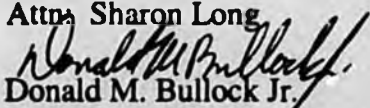
State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 129 6th St., Rm. 329

MEMORANDUM

March 12, 2007

SUBJECT: Disallowance of costs associated with lack of or improper maintenance (CSSB 80()); Work Order No. 25-LS0425\M)

TO: Senator Charlie Huggins
Chair of the Senate Resources Committee
Attn: Sharon Long

FROM: 
Donald M. Bullock Jr.
Legislative Counsel

You asked for an explanation of AS 43.55.165(e)(19)(B) and (C), as offered in CSSB 80() that is being considered by your committee.

CSSB 80() proposes to amend AS 43.55.165(e) by adding an additional category of lease expenditures that are not deductible for the purpose of determining the production tax value of oil and gas. The production tax value of oil and gas is taxed at the rate stated in AS 43.55.011 and is generally determined by deducting certain lease expenditures from the gross value of oil and gas at the point of production.¹ AS 43.55.165(a) provides that, with certain exceptions, the lease expenditures are "the ordinary and necessary costs upstream of the point of production of oil and gas." AS 43.55.165(e) lists 18 types of expenditures that may not be included as lease expenditures for the purpose of determining the production tax value of oil and gas.

CSSB 80() adds an additional category of expenditures that may not be considered lease expenditures. The expenditures that would be disallowed under the bill are expenditures that were incurred because property or equipment had not been maintained or had been improperly maintained. The proposed new paragraph identifies three categories of costs that would be disallowed when the reasons for those costs are related to the failure to maintain property or equipment in accordance with the standard determined by the commissioner of revenue with the advice and counsel of the commissioner of environmental conservation, the commissioner of natural resources, and the Alaska Oil and Gas Conservation Commission.

¹ AS 43.55.160(a).

Senator Charlie Huggins

March 12, 2007

Page 2

The first category of disallowed expenses are the costs of repairing and replacing the actual property or equipment that was neglected.² These costs are described in AS 43.55.165(e)(19)(A), in sec. 1 of the bill.

The costs disallowed under AS 43.65.165(e)(19)(B) and (C) are costs that directly result from the maintenance failure. For illustration purposes, assume that some component of a production facility fails because the operator had not maintained that component as expected, taking into consideration the standard practices of the industry. The costs of replacing or repairing that component would be disallowed under paragraph (19)(A).

Now assume that the component failure took two days to repair and during those two days oil was not delivered to a treatment facility and that facility was then shut down. While that repair was being made, there was no flow of oil, no production tax because no oil was being produced, and there were costs associated with maintaining the shutdown and non-productive facility. Under AS 43.55.165(e)(19)(B) as offered in sec. 1 of the bill, the costs incurred to maintain the facilities or equipment shutdown as the result of failure of the component that had to be repaired or replaced may not be deducted.

Change the facts a little so that the flow to the facility is not completely stopped, but the volume is cut in half. Assume further that the facility described in the previous paragraph continues to operate, but of one-half of the level at which it operates when the failed component is operational. If the costs of operation at one-half the normal volume are actually three-quarters of the cost of operating at full capacity, the difference between half the costs and three-quarters of the costs would be disallowed under AS 43.55.165(e)(19)(C) as proposed in CSSB 80(). The disproportionate costs that resulted from the reduced flow would be disallowed under the bill.

CSSB 80() presents two issues for consideration by the committee. First is the level of diligence expected from a taxpayer with regard to the maintenance of production facilities. Should the state expect a level of diligence consistent with a standard that is determined by taking into consideration the standard practices of the industry, something less, or something more?

Second, if costs associated with a lack of maintenance or improper maintenance are disallowed, should the disallowance of the costs be limited to the failed equipment or all costs that result from that failure? In sec. 1 of CSSB 80(), AS 43.55.165(e)(19)(A) disallows the cost related to the repair or replacement of the equipment that failed and (e)(19)(B) and (C) disallow costs that would not have been incurred or would have been proportionately less had the neglected equipment not failed.

If I may be of further assistance, please advise.

DMB:med
07-166.med

² I use the word "neglected" here as a short hand for "not maintained or improperly maintained" and not to introduce a standard not contemplated in the language of the bill.

STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

DIVISION OF OIL & GAS

SARAH PALIN, GOVERNOR

650 WEST 7TH AVENUE, SUITE 800
ANCHORAGE, ALASKA 99501-8000
PHONE: (907) 269-8000
FAX: (907) 269-8000

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

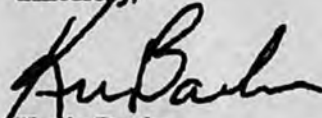
2/15/07

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 Simons, Acting Coordinator PSIO
Marie Crosley, DO&G

STATE OF ALASKA

SARAH PALIN, GOVERNOR

ALASKA OIL AND GAS CONSERVATION COMMISSION

333 W. 7th AVENUE, SUITE 100
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FAX (907) 278-7842

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/inadequate 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,

A large, stylized handwritten signature in black ink, appearing to read "John K. Norman".

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

Mary Jackson

From: Hay, Linda [Linda_Hay@dec.state.ak.us]
Sent: Monday, February 19, 2007 12:29 PM
To: Mary Jackson; Konrad Jackson
Subject: SB 80 DEC Comments

Attachments: Hay, Linda.vcf



Hay, Linda.vcf (541
R)

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
907-465-5290 direct

STATE OF ALASKA

DEPARTMENT OF REVENUE

Tax Division

Sarah Palin, Governor

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907.465.2320

● 550 W 7th Ave Suite 500
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February 28, 2007

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

Dear Senator Wagoner:

You requested additional comments on SB 80 after changes were made in response to suggestions from the agencies. Specifically, you asked for the department's position on the revised SB 80 and the language of the bill, and the department's ability to promulgate regulations to implement the revised bill.

The administration believes that expenses related to repairing and replacing property or equipment that was not maintained or was improperly maintained should not be deductible or allowed as credits against taxes. While we will take the steps that we can take by law to exclude such deductions and credits, we would need to prevail in arguing that costs associated with improper maintenance were not deductible or could not form the basis for a credit to the extent they were, for example, attributable to gross negligence, were not ordinary and necessary business expenses, or were impermissible billings by an operator to other working interest owners under an arm's length, negotiated operating agreement.

If we drafted regulations that incorporated the standards of SB 80, such regulations would not find explicit support under current law, and could be legally challenged. The question would be whether such regulations were a reasonable interpretation of the statute. Therefore, we recommend that if the legislature desires that costs associated with improper maintenance definitely not be deductible or allowed as credits, the legislature ensure that such explicit language is in a statute.

The Department's concern is not with the intent or necessity of SB 80, it is with implementing the bill. The Department does not want to lose its discretion to deny deductions or credits under current law, nor does it want SB 80 to swallow the intent of allowing deductibility and credits for regular maintenance costs.

Page 2
Senator Wagoner
February 28, 2007

Changing "relying on" into "taking into consideration" standard industry practices on line 22 of the bill has remedied these concerns; the Department may consider standard industry practices where appropriate, but it need not rely exclusively upon them.

The Department supports SB 80, with the caveat that the bill not limit the Department's discretion to deny deductions or credits under current law. As revised, the bill does not restrict the Department's discretion under current law and the Department can promulgate regulations accordingly.

Sincerely,



Jonathan E. Iversen
Director

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 or] 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**



Doug Suttles

President

February 15, 2007



BP Exploration (Alaska) Inc.
P.O. Box 198612
900 E. Benson Boulevard
Anchorage, Alaska 99519-8612

Honorable Members
Alaska State Legislature
State Capitol
Juneau, AK 99801

Dear Ladies and Gentlemen:

A number of questions have been raised about BP's intent to deduct certain costs related to the Prudhoe Bay field shutdown last August. I am writing to confirm our position on this issue and at the same time reiterate BP's commitment to and plans for our business in Alaska.

Direct 907 564 5422
Main 907 561 5111
Fax 907 564 5900
doug.suttles@bp.com

With respect to the deductibility of costs, we can only speak for BP. Taxes are paid on a company wide basis rather than a field specific basis and BP cannot speak for the other Prudhoe Bay owners on tax issues.

BP follows the law when it files its taxes. Accordingly, BP will assume the appropriate deductions & credits for the costs associated with the repair and replacement of the Prudhoe Bay Oil Transit Lines (OTLs). Specifically, BP will deduct appropriate costs associated with repair of the OTLs and will seek authorized credits for capital costs to replace them. Similarly in compliance with the PPT Laws, we will not seek to deduct costs associated with cleaning up the oil spills.

To put this issue into context, I would like to openly share our estimated 2006 production taxes.* For the final nine months of 2006, the period over which PPT was applicable, we estimate that BP's production taxes will almost triple from \$180 million under the old ELF-based tax to more than \$500 million under PPT. Over the same period, BP's share of the deductions and credits associated with the costs of inspection, business resumption, and replacement of the OTLs will result in a total deduction of around \$11 million in 2006, which we have included in our 2006 production tax estimate.

We believe our approach is appropriate for the following reasons:

- 1) It is important to realize that the OTLs are some 30 years old and were sized for significantly higher production than we will have in the future. The OTLs would have been replaced in the normal course of business, even if the events of last year had not taken place.
- 2) We are in the process of building a new state of the art pipeline system for the future life of Prudhoe Bay. This is not a like-for-like replacement. Rather, we are investing in a brand new system, with pipe diameter sizes very different than the original design to reflect the reduced production from these maturing oilfields. The new system will have new chemical injection systems, upgraded pig launchers/receivers, upgraded leak detection system, and a Fusion Bond Epoxy external coating for longer life. The system will be in operation for decades to come. We believe this investment is in the best interests of the State of Alaska and the North Slope producers.

We appreciate the opportunity yesterday to discuss our Alaska business with the Senate Resources Committee and update them on the commitments we made in August 2006.

February 15, 2007
Page 2 of 2

BP remains fully committed to the ongoing integrity of its facilities. As we embark on a vision of our next 50 years in Alaska, we will continue to make significant investment in facility renewal. This is not about replacement. It is about designing and constructing new facilities in a way that underpins the future and ensures the operability of the North Slope for decades to come.

With respect to PPT, last year the Legislature held long and difficult debates that ultimately led to the passage of PPT. The regulations are still being formalized as this legislation has not been in place for very long. We are only just preparing to submit our first tax returns under this new system. As a result, we believe it is premature to consider changes to the structure or intent of the current legislation. We believe it would be prudent for all parties, including producers and the State, to wait until PPT is fully implemented and we have real experience of its operation and impact before making any changes.

I hope I have provided you with the clarity of BP's intentions that many of you have been seeking and the reasoning behind the decisions we have made.

I look forward to working with the legislature as we progress our vision for our business in Alaska, including the commercialization of Alaska Gas, and as we bring our vision of a 50-year future to reality.

Sincerely,

A handwritten signature in black ink, appearing to read "Doug Suttles". The signature is stylized with a large initial "D" and "S".

Doug Suttles

* Please note that, in disclosing in this letter certain specific tax information and BP's tax positions regarding PPT, BP does not intend to waive the confidentiality of any of its tax materials and information under applicable law (including AS 43.05.230), other than the particular information disclosed.

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.

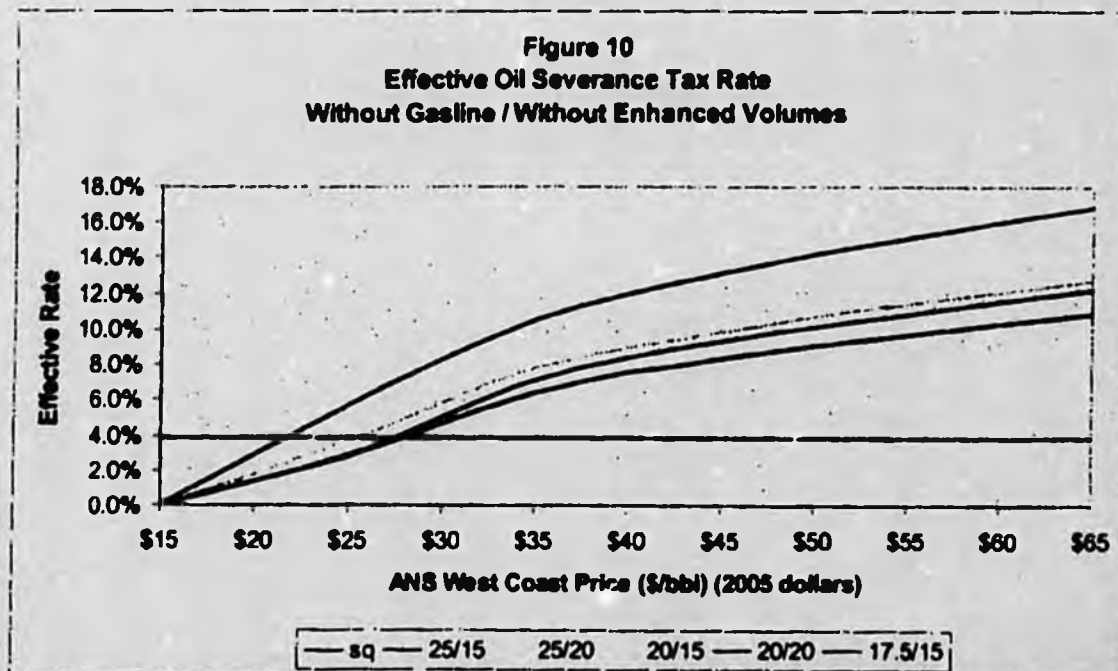
FLOOR

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.

APR
 May

FY 07	44m
FY 08	38.6m

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 pipeline 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.

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
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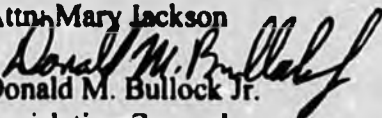
State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 129 6th St., Rm. 329

MEMORANDUM

February 26, 2007

SUBJECT: Ex post facto (SB 80; Work Order No. 25-LS0425)

TO: Senator Thomas Wagoner
Attn: Mary Jackson

FROM: 
Donald M. Bullock Jr.
Legislative Counsel

You asked whether enactment of SB 80 would violate the prohibition against ex post facto laws in the United States and Alaska Constitutions¹ because the disallowance of certain deductions applies retrospectively to April 1, 2006, the effective date of the PPT.

The answer is no.

During the meetings of the Senate Resources Committee on SB 80 and the House Special Committee on Oil and Gas on HB 128, a person appearing before the committees stated that the retrospective effect of the bills is prohibited under the ex post facto clauses. I have been unable to find any authority for this statement regarding the change in tax law offered in these bills.

To the contrary, both the United States Supreme Court and our own Supreme Court have upheld retrospective tax legislation.

In 1912, the United State Supreme Court noted that, "It is however, settled that [the ex post facto prohibition of Art. I, § 9 of the Constitution] is confined to laws respecting criminal punishments, and has no relation to retrospective legislation of any other description."² The proposed disallowance of expenses resulting from the lack of maintenance or improper maintenance are not criminal punishment provisions and only

¹ Art. I, sec. 9, Constitution of the United States; art. I, sec. 15, Constitution of the State of Alaska.

² *Johannessen v. United States*, 225 U.S. 227, 242; 32 S. Ct. 613, 617; 56 L. Ed. 1066, 1072 (1912). The *Johannessen* case involved an immigration issue, but the principle that the application of the ex post facto clause is limited to laws regarding criminal punishment is cited as authority for denying an ex post facto challenge in cases reviewing tax laws with retrospective effect. See, e.g. *Mathes v. Commissioner of Internal Revenue*, 63 T.C. 642, 644 (1975).

affect the amount of tax for which a producer is liable. Though any taxpayer may consider a greater amount of tax as "punishment," the bill you are sponsoring does not involve the type of criminal punishment addressed by the ex post facto clause.

The United States Supreme Court has also upheld retrospective tax legislation against a due process challenge. In *United States v. Carlton*,³ the court upheld the retroactive application of a curative measure in 1987 to a provision enacted the prior year; the actual retroactive effect of the 1987 amendment extended for a period only slightly greater than one year. In *Carlton*, the court noted that "Congress acted promptly and established only a modest period of retroactivity," and "Congress 'almost without exception' has given general revenue statutes effective dates prior to the dates of actual enactment." The Court noted a 1938 decision upheld a Wisconsin income tax enacted in 1935 that imposed a tax on dividends in 1933 for the proposition that, "the 'recent transactions' to which a tax law may be retroactively applied 'must be taken to include the receipt of income during the year of the legislative session preceding that of its enactment.'"⁴ SB 80 proposes to amend tax legislation that was became effective August 20, 2006, just over 6 months ago.

Note that retrospective application of changes in tax laws on the oil industry have been upheld by the Alaska Supreme Court. In 1985, the Alaska Supreme Court upheld the retrospective effect of oil and gas income tax legislation that was signed into law in July 1978 and was retroactive to January 1, 1978.⁵ Seven years later, the same court upheld the retrospective effect of a change in the economic limit formula applicable to the production tax on oil and gas; in that case, the Act was effective August 6, 1989, and was retroactive to January 1, 1989.⁶ In neither case did the taxpayers assert the ex post facto prohibition as authority for challenging the retrospective application of the tax, but unsuccessfully argued that the retrospective application was effectively an "effective date" that required a two-thirds majority vote under art. II, sec. 18 of the state constitution.

In my opinion, the retrospective application of SB 80 or HB 128 would survive a challenge under the ex post facto clauses of the United States and Alaska constitutions.

If I may be of further assistance, please advise.

DMB:ljw
09-100.ljw

³ *United States v. Carlton*, 512 U.S. 26; 114 S. Ct. 2018; 129 L. Ed. 2d 22 (1994).

⁴ *Carlton*, 512 U.S. at 33, 114 S. Ct. at 2023, 129 L. Ed. 2d at 30, citing *Welch v. Henry*, 305 U.S. 134, 83 L. Ed. 87, 59 S. Ct. 121 (1938).

⁵ *Atlantic Richfield Company v. State, Dep't of Revenue*, 705 P.2d 418 (Alaska 1985), appeal dismissed, 474 U.S. 1043, 106 S. Ct. 774, 88 L. Ed. 2d 754 (1986).

⁶ *ARCO Alaska, Inc. v. State, Commissioner of Revenue*, 824 P.2d 708 (Alaska 1992).

Testimony by John Norman, Chair
& Commissioner AOGCC

Dated: 4-18-07

Alaska Oil and Gas Conservation Commission's
Comments regarding SB 80/HB128-OIL and
GAS PRODUCTION TAX: EXPENDITURES

This legislation is proposed as a law of general application throughout the State of Alaska. With that in mind the Alaska Oil and Gas Conservation Commission's ("AOGCC") comments are framed without regard to any particular incident and instead with a view to how the law might apply throughout the state and in particular to new investors contemplating oil and gas operations in Alaska.

1. Policy Considerations:

- a. Is it advisable to deny leasehold expenditure deductions for costs resulting from errors which are not the consequence of fraud, willful misconduct, or gross negligence? Subsection (6) of AS 43.55.165(e) already disallows deductions for the expenses arising from fraudulent, willful misconduct or gross negligence.

Proposed subsection (19) would extend cost disallowance to acts other than those already addressed by subsection (6). Subsection (6) addresses costs related to willful misconduct or gross negligence, so we interpret subsection (19) as intended to disallow costs arising because of ordinary negligence. This would impose a penalty on the operator beyond what is customary in agreements between co-owners who enter into operating agreements for development of a commonly owned resource. Such agreements almost always absolve an operator of liability for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct. If it were otherwise and operators were liable for ordinary negligence (which is another way of saying making a mistake) they would be in the position of guaranteeing a trouble free operation. No operator would be willing to make that guarantee. It is generally recognized in the business world that mistakes happen but only when they result from willful misconduct or gross negligence is an operating partner normally penalized.

With the foregoing in mind subsection (19) departs from normal business practice and sets a higher standard than business partners in the oil and gas industry normally demand of each other. Similar reasoning could be applied to new operators contemplating operations in the State of Alaska under what they might perceive as a tax structure unforgiving of mistakes.

- b. Denial of Facility Shut Down Expenses. Subsection (19) (B) would deny expenses incurred to maintain operational capability of facility or equipment shut down because of improper maintenance. Is it good policy

to deny operational maintenance costs if the operator believes that the best course of action is to shut down the entire facility in order to carry out necessary repairs? Denial of operational capability maintenance costs could discourage operators from shutting down when in fact a complete shut down is the most prudent course of action.

- c. Should Not Discourage Innovation. The oil and gas industry is constantly evolving. A tax regime should not discourage innovative techniques. Examples of such techniques are the astounding advances that have been made in recent decades in the area of directional drilling, coiled tube drilling, and subsea completions. Any attempt to rigidly codify "good oilfield practices" could inadvertently retard the natural learning experience that comes with allowing operators to experiment with differing techniques.

2. Practical Considerations:

- a. Standard Terminology. The phrase "Standard Practices of the Industry" in subsection (19) is vague and ambiguous. On the one hand it could mean the written standards adopted by professional organizations intended as guidance documents for the industry; or it could simply mean the standard practice prevailing in the industry in a particular locale.

In determining whether an operator's conduct has resulted in waste of a resource the AOGCC has generally used "good oilfield practices" as a standard by which to measure an operators practice in installing operating and maintaining equipment. See AS 31.05.170(15).

- b. AOGCC's preferred term. Good oilfield practices is the term used to indicate that operations are carried out in a proper and workman like manner. It is used in the same way as the phrase "everything is A.P.I.," which refers to the American Petroleum Institute's set of standards covering aspects of petroleum operations. Williams & Meyers, Manual of Oil and Gas Terms (13th ED.) p 453. It is therefore, AOGCC's recommendation that the phrase "good oilfield practices" be substituted for the current phrase "standard practices of the industry".
- c. Absence of Regulatory Guidelines for Maintenance. There is lack of current regulatory guidelines. Much of the equipment and systems in oilfields that are subject to maintenance are not currently regulated by either AOGCC or DEC. This raises questions about how to gauge "improper maintenance" in the absence of regulatory responsibility for such systems and equipment.

- d. Regulations. There will be a need for AOGCC and other agencies to promulgate regulations if AOGCC is assigned responsibility under this bill. These regulations should provide general guidance to the industry, including new operators coming into the State, concerning what constitutes "good oilfield practices." Toward this end we would look to the American Petroleum Institute's standards and recommended practices, as well as standards recognized by the National Association of Corrosion Engineers (NACE), the American Society of Mechanical Engineers (ASME), the International Standards Organization (ISO) and similar respected organizations.
- e. Agency Expertise. There is a need for specialized expertise. AOGCC geologists and engineers work to regulate operations downhole and immediately around the production string but traditionally have not moved further downstream except when required to determine whether a failure of equipment resulted from an operator's failure to employ good oilfield practices thereby resulting in "waste" of hydrocarbon resources.

We are aware that Governor Palin has announced activation of the Petroleum Systems Integrity Office ("PSIO") and AOGCC is one of the agencies designated to participate on that team. We contemplate that the PSIO staff will implement a quality assurance program with inspections conducted by or under the direction of PSIO to ensure compliance with approved programs. AOGCC will have a designated representative working with PSIO and AOGCC expertise can be called upon as necessary to consult with the Department of Revenue through PSIO. Such an arrangement will avoid duplication of effort and ensure consistency of standards, directives, and inspection reports since all would be coordinated through PSIO.

3. Difficulties In Determining Root Cause:

In some instances it will be obvious that there has been improper maintenance. In other instances, the AOGCC would be required to consider design, installation, operation, and maintenance, all of which are integral to a determination of negligence. Additionally some determinations will require detailed investigation including but not limited to destructive and non-destructive metallurgical testing and application of other expertise not readily available within the AOGCC.

4. Date Stamping Negligent Conduct:

Standards are continually evolving and it will be important to decide whether conduct that led to the failure should be judged in light of the standards prevailing when

the original decisions were made or judged by the most current standards. Additionally, properties are often sold or traded within the industry. Is it good policy to deny a good faith purchaser the benefit of leasehold expenditures incurred as result of mistakes which may have been made many years before by the prior owner?

TIME LINE - PPT

PPT Concept Introduced	PPT Overview - H & S Resources	1/18/2006
Joint Finance Meeting	PPT Overview - H & S Finance	2/1/2006
PPT SB 305	Introduced	2/21/2006
PPT SB 305	1st Hearing S Res	2/22/2006
BP Spill Incident	5:45am 3/2/06: GC-2	3/1/2006
PPT SB 305	S Res Moved out	3/29/2006
Senate Resources Mtg.	BP Spill Update	4/26/2006
PPT SB 305	Failed to concur 10:10	5/9/2006
PPT SB 2001	Introduced	5/20/2006
PPT SB 2001	CC Report Failed	6/8/2006
PPT HB 3001	Introduced	7/12/2006
Draft Gross Tax Bill	Distributed by Sen. Wagoner	7/27/2007
PVM Memo #1	Memo to Wagoner - "Gross"	8/5/2006
BP Shutdown	August shut down corrosion	8/7/2006
PPT HB 3001	Transmitted to Senate	8/7/2006
PPT HB 3001	NGD Heard & Held	8/7/2006
PPT HB 3001	NGD Heard & Held	8/8/2006
PVM Memo #2	Memo re 30 cent - unknown recipient	8/8/2006
Amend #7	30 cent provision	8/9/2006
Amend #9	improper maintenance	8/9/2007
Amend #10	replaced #7 30 cent provision	8/9/2006
Amend #11	floor for gross - passed	8/9/2006
Amend #13	replaced #9 improper maintenance	8/9/2006
PPT HB 3001	NGD Amendments - Moved out	8/9/2006
PPT HB 3001	Transmitted to House	8/10/2006
PPT HB 3001	House Concur	8/10/2006
Joint Resources Mtg.	BP Corrosion Issue Hearing	8/18/2006

as an "anonymous" email he received

Inter ofc communication from BP

From: [redacted]
Sent: Friday, June 04, 1999 6:48 PM
To: [redacted]
Subject: FW: PW Inhibitor at GC2 and GC3

Here's one for our HSE files. We'll see if this is a "safe" way to do business
[redacted]

From: PBU, CIC Prod Chem Todd/Spino
Sent: Friday, June 04, 1999 11:42 AM
To: PBU, GC2 OpsTmLdr; PBU, GC2 Lead Techs; PBU, GC3 OpsTmLdr; PBU, GC3 Lead Techs
Cc: PBU, M&M Coord - FOC; PBU, CIC NS TL Fells/Phillips; Crawford, Gary R; Patsley, Dominic M.; Woolam, Richard C.; 'RA Brown'; Sprague, Kip P
Subject: PW Inhibitor at GC2 and GC3

All,

Due to budgetary constraints, the decision has been made to discontinue the PW inhibitor (EC1081A) currently being injected at GC2 and GC3. The GC2 bulk tank should run out within the next two days and it will not be refilled. Please shut the pump down and flush the equipment with water once the tank is empty. The GC3 tank was recently filled and is estimated to last about 13 more days (around June 17th). Again, when the tank is empty, please shut the pump down and flush the equipment with water.

The current plan is to inject the remaining inventory of EC1081A into the high risk S-69 line that runs from M to S pads. At a 40 ppm rate, we will have enough product to treat this 40,000 BWD for about 250 days.

Best Regards,

John Todd

Sharon Long

From: John Norman [John_Norman@admin.state.ak.us]
Sent: Wednesday, April 25, 2007 1:20 PM
To: John Norman; Sharon Long
Subject: Re: [Fwd: AOGCC Comments regarding SB 80/HB128-OIL and GAS PRODUCTION TAX: EXPENDITURES]
Attachments: John_Norman.vcf

John Norman wrote:

Subject:AOGCC Comments regarding SB 80/HB128-OIL and GAS PRODUCTION TAX: EXPENDITURES
Date:Fri, 20 Apr 2007 15:43:17 -0800
From:John Norman <John_Norman@admin.state.ak.us>
Organization:State of Alaska
To:Mary Jackson <Mary_Jackson@legis.state.ak.us>
CC:Patrick S Galvin <patrick_galvin@revenue.state.ak.us>, Kevin R Banks <kevin_banks@dnr.state.ak.us>

Mary:

This is in reply to your e-mail sending the PSIO amendment to SB # 80 that Senator Wagoner intends to introduce. We reviewed the proposed amendment and believe it will improve the bill.

Attached are written comments we sent to the committee on Wednesday when asked to be available to testify on SB 80. This proposed amendment specifically addresses a concern expressed in section 2 (e) of our attached comments which recommended PSIO be the designated lead because of its responsibility to oversee facility and equipment maintenance. Pursuant to section 2 of Administrative Order No. 234, dated April 18, 2007, AOGCC is one of the participating agencies and will be able to provide coordinated advice and consultation to the Department of Revenue through PSIO.

We also suggested at lines 22 and 23, p.3 of the bill, that the term "good oilfield practices" be substituted in place of "the standard practices of the industry". We don't know if this was considered.

As you know, we have the utmost respect for the sponsors of this bill. Other comments (in our attachment) identify policy considerations we felt obligated to bring forward. Having done so, you may assure Senator Wagoner we will do our absolute best to implement this bill in whatever form it is adopted.

These comments reflect the views of the commissioners of the AOGCC and you may distribute this e-mail as you see fit.

John K. Norman
Chair,
AOGCC

4/25/2007

Previous SB80
packet inserts

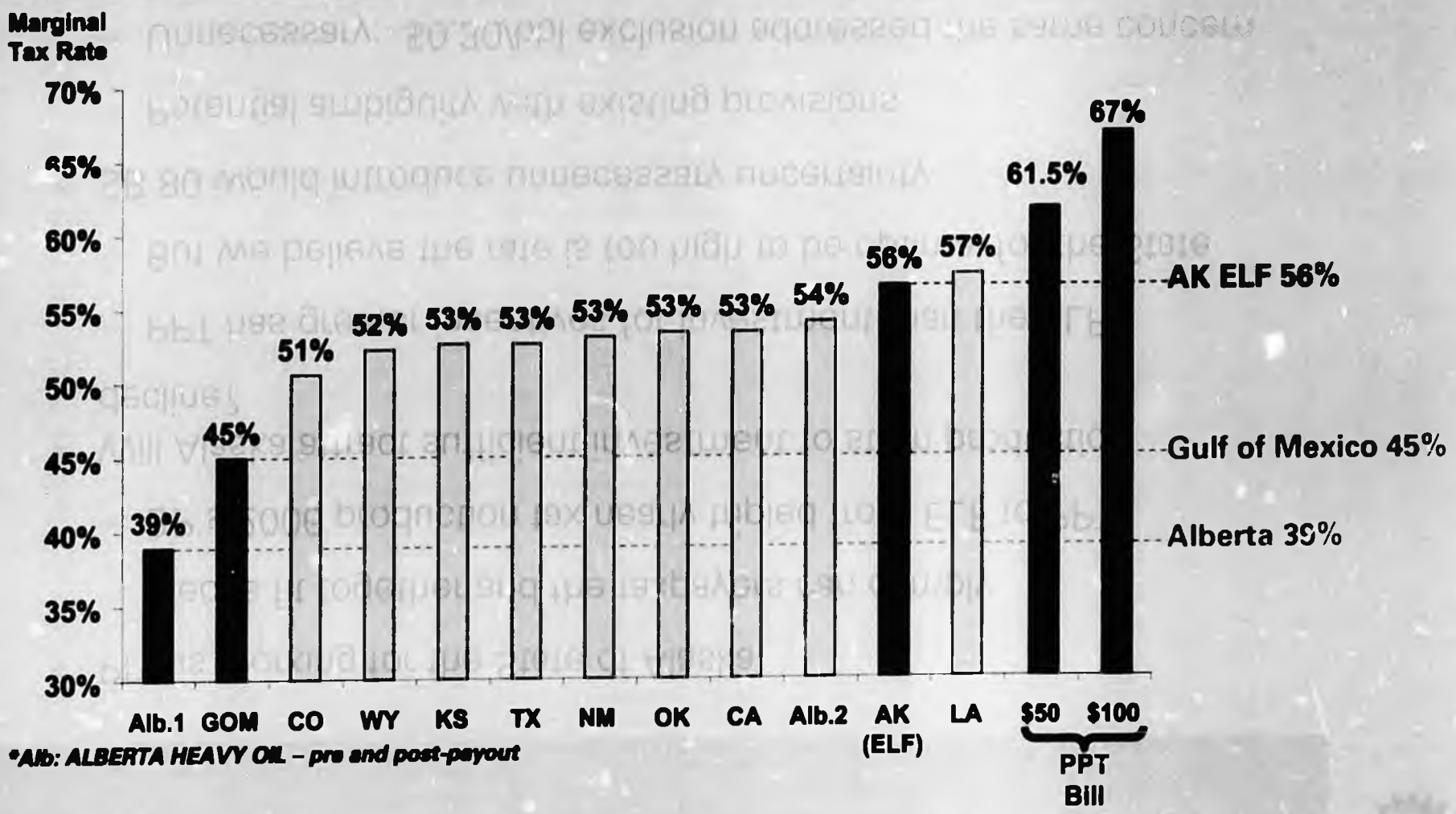
BP Presentation to the Senate Resources Committee

Juneau, February 28th 2007



- PPT is working for the State of Alaska:
 - Pieces fit together and the taxpayers can comply
 - BP's 2006 production tax nearly tripled from ELF to PPT
- Will Alaska attract sufficient investment to stem production decline?
 - PPT has greater incentives for investment than the ELF
 - But we believe the rate is too high to be optimal for the State
- SB 80 would introduce unnecessary uncertainty
 - Potential ambiguity with existing provisions
 - Unnecessary: \$0.30/bbl exclusion addressed the same concern
- Five year period to review success of PPT (AS 43.55.180)

Alaska has adopted the highest marginal tax rate in the North America



Alberta & Gulf of Mexico are booming while Alaska production is declining

ALASKA STATE LEGISLATURE

Sen. Charlie Huggins, Chair
Sen. Bert Stedman, Vice Chair
Sen. Lyda Green
Sen. Gary Stevens
Sen. Lesil McGuire
Sen. Bill Wielechowski
Sen. Thomas Wagoner



State Capitol, Room 119
Juneau AK 99801-1182
907-465-3878
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800-862-3878

Senate Resources Committee

Wednesday February 28, 2007
3:30 p.m. – 5:00 p.m.

AGENDA

+ **Workdraft [25-LS0425\M] CSSB 80 - Allowable lease expenditures for the purpose of determining the production tax value of oil and gas for the purposes of the oil and gas production tax**

Available for Questions

Mary Jackson, Staff to Senator Wagoner

Don Bullock, Attorney, Legislative Legal & Research Svcs

Larry Dietrick, DEC

Available online for Questions

Kevin Banks, Director, Div. of O & G, DNR
AND JACK HARTZ, Petroleum Engineer, DNR
John Hartz, Petroleum Engineer, Div. of O & G, DNR

John Norman, Ak Oil & Gas Conservation Commission

John Iverson, Dept. of Revenue

1. Gavel In:

Call to Order: Senate Resources Committee
Time _____

Date Wednesday February 28, 2007

Members Present:

ViceChair, Senator Bert Stedman
Senator Gary Stevens
~~Senator Lyda Green~~
Senator Lesil McGuire
Senator Bill Wielechowski
Senator Tom Wagoner
& myself, Senator Charlie Huggins

Members by Teleconference:

2. Today we're continuing with SB 80
3. On line from DNR: Kevin Banks & Jack Hartz
DOR: John Iverson
AOGCC: John Norman
DOL: Rob Mintz
4. Here in the room from DOL: Ethan Falatko
DEC: Larry Dietrick
5. Public Testimony
Expecting BP; Conoco Phillips
& likely other public
6. Meeting adjourned at _____.

1. Gavel In:

Call to Order Senate Resources Committee
Time _____

Date **Wednesday February 21, 2007**

Members Present:

**ViceChair, Senator Bert Stedman
Senator Gary Stevens
Senator Lyda Green
Senator Lesil McGuire
Senator Bill Wielechowski
Senator Tom Wagoner
& myself, Senator Charlie Huggins**

Members by Teleconference:

- 2. Today we're hearing SB 80 concerning allowable lease expenditures for the purpose of determining the production tax value of O & G for the purposes of the O & G production tax
+ Ms. Mary Jackson, staff to Sen. Wagoner will present the bill.**
- 3. Open bill to public testimony. Consider time limit on testimony**
- 4. Close public testimony**
- 5. Note: We will not meet on Friday. Next meeting Monday Feb. 26.**
- 6. Meeting adjourned at _____.**

February 28, 2007

Senator Charlie Huggins, Chair
Senate Resources Committee
State Capital Room 205
Juneau, AK 99801-1182

The Honorable Chair & Members of the Senate Resource Committee,

The Alaska State Chamber of Commerce is concerned about SB 80. SB 80 changes the tax structure of the recently enacted Petroleum Production Tax (PPT). The State Chamber believes changing the tax structure so quickly will have long-term negative impacts on the future of Alaska's economy. We believe that the consequences as a result of SB 80 have not been fully considered with regards to all businesses in Alaska.

The State Chamber of Commerce strongly believes that SB 80 takes the wrong approach in creating a fair business environment. No business can possibly prosper or operate in a rapidly changing business climate. We urge the legislature to not pass this legislation from committee.

With the passing of the PPT legislation last year, the state effectively tripled the production taxes on the oil industry in Alaska. Last year's action will result in roughly a \$1 billion increase in revenues to the state this fiscal year. Under the enacted legislation, Alaska's oil producers are allowed to deduct operating costs from taxes. In addition, they are also allowed to take a 20% tax credit for capital investments as an incentive for improving North Slope infrastructure. To counter-balance deductions the legislature implemented language that disallows deductions arising from fraud, willful misconduct, or gross negligence.

SB 80 aims to preclude expenditures associated with improper maintenance of property or equipment. What exactly is improper maintenance? SB 80 does little to define improper maintenance, potentially creating more confusion and litigation. SB 80 appears to limit any type of deduction if shown it was due to improper maintenance. Doubtfully, any company would throw away millions of dollars in shipping Alaska's oil just to save a few dollars on pipe. Any company grossly negligent in its operations is already unable to use any deduction whether it is for maintenance or anything else. Then for what purpose does SB 80 serve Alaska? Enacting SB 80 won't give Alaska more oil, will not make up for lost state revenues due to offline pipe nor will it create more jobs or force any company to sign a gas pipeline contract.



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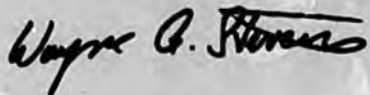
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www.alaskachamber.com

The State Departments of DEC, DNR and the AOGCC have all raised critical concerns about SB 80, primarily the ability to implement the legislation should it become law. These departmental concerns also note that the words "improperly maintained" may have serious conflicts with existing standards to protect the state from faulty maintenance.

SB 80 seems incongruent with existing state agencies while creating instability in the business environment by re-addressing the same tax structure in less than a year. No business can possibly prosper or operate in a rapidly changing business climate. The State Chamber of Commerce strongly believes that SB 80 takes the wrong approach in creating a fair business environment. We urge the legislature to not pass this legislation from committee.

Yours in economic prosperity,



Wayne A. Stevens
President/CEO



**TESTIMONY
OF
BP EXPLORATION (ALASKA) INC.
TO THE
SENATE RESOURCES COMMITTEE
REGARDING
SB 80 AND THE RESOURCES CS FOR IT**

February 28, 2007

INTRODUCTION BY BERNARD W. HAJNY

Mr. Chairman and Members of the Committee, for the record my name is Bernard Hajny, and I am the Manager of Production Tax and Royalty for BP Exploration (Alaska) Inc. I would like to start by thanking the Committee for this opportunity to testify on this important legislation, Senate Bill 80.

I am joined today by Tom Williams, our Senior Counsel for Tax and Royalty in Alaska. For the benefit of Committee Members who may not know him, Mr. Williams worked for the State in the critical years before, during and after the construction of the oil pipeline and the start of oil production from the North Slope. He was Director of Petroleum Revenue responsible for administering the State's oil and gas taxes from 1975 to '79 and was Commissioner of Revenue for Governor Hammond from '79 to '82. He is known as the "father of the ELF" by many and personally wrote nearly all of Alaska's original oil and gas tax regulations and many key statutory provisions in the State's tax laws. He has worked in private practice and as general counsel for Cook Inlet Region Inc. (CIRI), before joining BP. Mr. Williams has a unique combination of perspectives on oil and gas matters in Alaska.

Before turning the presentation over to him, I would like to clarify that our testimony today focuses on the specific provisions of SB 80 and their impact on the new Petroleum Production Tax, or "PPT." We offer our perspective as people within BP charged with complying with the PPT. For the avoidance of doubt, we are tax professionals and are not experts in Oil Transit Lines, corrosion, pipeline operations or pigging; and it would be inappropriate for us to address many of the questions you may have in those areas. We are of course very happy to talk about Senate Bill 80 and its implications for BP as one of Alaska's largest taxpayers.

Two weeks ago, senior BP technical and operations management, Tony Brock and Mike Utsler, updated this Committee on the status of our efforts to address the issues we discovered at Prudhoe Bay last year. I can confirm that both Tony and Mike are available in the future should this Committee require further updates on the technical and operations issues relating to Prudhoe Bay.

And now, with that introduction, here is Mr. Williams.

TESTIMONY BY THOMAS K. WILLIAMS

Mr. Chairman, for the record my name is Thomas K. Williams, and I am Senior Tax and Royalty Counsel for BP in Alaska. I join Mr. Hajny in thanking you for this opportunity to testify on SB 80.

There are two slides for my presentation today, which are printed out on the front and back of a one-sheet handout that has been distributed to you. Please look at the first slide on my handout, which is the one entitled "BP Presentation to the Senate Resources Committee."

The PPT is working for the State of Alaska, and I mean "working" in three senses of the term. First, it is "working" in the sense that the PPT regulations by the Department of Revenue clarify in several crucial ways how the pieces of the PPT fit together. Taxpayers know what is expected of them in computing and making monthly installment payments, and in making the annual true-up on March 31st of the following year.

Second, the PPT is "working" in the sense of providing a major increase in state production tax revenues last year. For BP, its production tax nearly tripled from about \$180 million for the last nine months of last year, to over \$500 million. This is fully in line with the Legislature's expectations about the PPT's revenue effects.

Third, the PPT has promise to "work" in response to the question on my slide that asks, "Will Alaska attract sufficient investment to stem production decline?" The bulk of the known and likely opportunities in Alaska for investing in production are concentrated in the existing fields — that is, investing to slow their decline, to increase the ultimate recovery from them, and to discover ways to develop and produce the 20+ billion barrels of heavy and viscous oil that are already known. The PPT is significantly better suited for this future than the ELF ever was. In addition, through its credit for capital expenditures, it provides an investment incentive that was absent from the old ELF-based tax.

But even though the PPT structurally has promise in attracting the new investment that will be needed to deal with the threat of declining production, BP believes the PPT is suboptimal for the State because the tax rate is too high. If you will look at the graph on the back of the one-page handout, you will find Alaska at the wrong end of the spectrum in terms of its "take" at the margin. Investments in Alaska must compete successfully against opportunities elsewhere, and by lowering the PPT rate Alaska would increase the competitiveness of its investment opportunities. The resulting increase in production will, we are convinced, increase the total revenues from Alaska's property and income taxes and royalties by more than any reduction in the PPT that might result.

Now, I would ask you please to turn back to the slide on the front of the handout.

SB 80, and the CS for it, would introduce unnecessary uncertainty into the PPT. We agree with the AOGA testimony given by Judy Brady last week about the overlap

between existing terms in the PPT and the new standard of "improper" maintenance under this Bill, which either makes the Bill unnecessary or means its enactment will create serious ambiguities. I will not repeat that testimony now.

But the issue of "improper" maintenance only governs when the new provisions of SB 80 would be triggered. What I would like to focus on is what happens under SB 80 after that trigger is pulled. So I'd ask you to imagine a hypothetical future situation that, by definition, arises from improper maintenance.

If you look at page 3 of the CS, beginning at line 24, you will see three subparagraphs in paragraph (19) which are designated "(A)", "(B)" and "(C)". It is these subparagraphs that specify what happens once the improper-maintenance trigger is pulled.

For the moment I would like to skip over subparagraph (A) in order to talk about (B) and (C), which raise similar questions about sound tax policy. Then I'll come back to (19)(A), which presents an entirely different kind of issue.

Subparagraph (19)(B) disallows any costs determined by the Commissioner of Revenue to have been "incurred to maintain the operational capability of facilities or equipment shut down because of ... improper maintenance of property or equipment[.]" The first thing to note is that the disallowance is not limited to stand-by costs for keeping up the operational capability of improperly maintained property or equipment. What is disallowed are the costs of sustaining the operational capability of shut-down "facilities or equipment", while the trigger is improper maintenance of "property or equipment[.]" Nothing in (B) says that the improperly maintained "property or equipment" must be the same as the shut-down "facilities or equipment" whose operational capability is being kept on stand-by. So, (19)(B) would permit disallowance of all costs of standing by and staying ready to resume production — even the portion of stand-by costs for facilities and equipment that were properly maintained.

Does this make sense? (19)(B) penalizes spending money to "maintain ... operational capability" by disallowing those costs. If it were up to me as a former Revenue Commissioner, I would want a field to get back up and running as soon as possible after a shut-down, but (19)(B) apparently doesn't.

Subparagraph (19)(C) similarly disallows costs determined by the Commissioner of Revenue to be "incremental operating expenses incurred as a result of operating facilities or equipment at diminished capacity when that diminished capacity is caused by ... improper maintenance of property or equipment." Here, again, the disallowance is not limited to diminished capacity of the "property or equipment" that was improperly maintained, but includes diminished capacity of any "operating facilities or equipment[.]"

Does this make sense from a tax policy point of view? Again, I don't think so. Subparagraph (19)(C) is effectively saying that if it costs more to run a field at diminished capacity, the State will deter a producer from doing so by disallowing those costs. I

should think that having part of a field in production, even at a higher-than-normal operating cost, is better than having it completely shut down — especially in light of state royalties and income tax which are both enhanced by keeping the field in production. If anything, (19)(C) should be reducing the PPT as an incentive for keeping as much of a field in production as possible, but it does precisely the opposite instead.

Thus, I submit, neither (19)(B) nor (19)(C) is sound tax policy for the State, and both of them should be taken out of the Bill.

This gets me back to subparagraph (19)(A) on page 3 of the CS at lines 24 – 25. Under this subparagraph any costs determined by the Commissioner of Revenue to be “related to the repair or replacement” of the improperly maintained property or equipment are disallowed. The problem with this new disallowance is that it “double-dips” on the flat-rate 30 cents-a-barrel disallowance under paragraph (18). Last week Judy Brady explained how this 30-cent disallowance by Pedro van Meurs was directed at exactly the same issue that (19)(A) addresses, and how the Senate Special Committee on Natural Gas Development then rejected a proposal like (19)(A) twice in favor of the van Meurs flat-rate disallowance in paragraph (18). I will not repeat those details now.

Even paragraph (18) went too far and was ill-advised. Other provisions in the PPT law already address, and deal with, the questions about adequate maintenance, and do so in a fair and reasonable way. If the objective is to make the PPT a better law for the future, then SB 80 should repeal paragraph (18). Instead, the CS proposes to compound the error not only by keeping paragraph (18), but also by adding subparagraph (19)(A) to double-dip on the very same costs that paragraph (18) already disallows.

This concludes our testimony on SB 80 and this Committee’s Committee Substitute for it. Thank you again for this opportunity to appear before you.



THE ALLIANCE

... for responsible development of Alaska's Oil, Gas & Mineral Resources

Feb. 26, 2007

The Honorable Charlie Huggins
Chairman, Senate Resources Committee
Alaska State Legislature
State Capitol (MS 3101)
Juneau, Alaska 99801-1182

Dear Senator Huggins,

The Alaska Support Industry Alliance, a trade association whose 400 members provide goods and services to Alaska's oil, gas and mining industries and more than 30,000 jobs for Alaskans, would like to express our opposition to Senate Bill 80. We believe the bill is unnecessary, unfair and premature. It will accomplish little but to spawn disputes and uncertainty, and it will be a further disincentive to the long-term oil and gas investment that's the lifeblood of Alaska's economy. We urge you not to pass it out of the Senate Resources Committee.

The bill is unnecessary. Current legislation already denies tax credits for lease expenditures resulting from fraud, willful misconduct or gross negligence, and disallows costs related to spills.

The bill is unfair, and would result in double taxation. The flat 30-cent-per-barrel tax credit exclusion in the new Petroleum Production Tax (PPT) explicitly was intended to cover all maintenance expenditures - those resulting from "proper" and "improper" maintenance. SB 80's additional exclusion for costs incurred due to "improper maintenance" constitutes double taxation. Producers across the board are denied deductions for maintenance costs under the umbrella of the 30-cent-per-barrel provision of the PPT, then would be denied additional tax credits on a case-by-case basis for some of the same maintenance expenditures under SB 80.

The bill is a petri dish for tax disputes. Terms in SB 80 such as "improper" maintenance and "diminished" capacity are vague and undefined, leaving interpretation in the hands of several commissioners, headed by the commissioner of Revenue. By contrast, the 30-cent provision offers clarity and certainty. We may not like it, but at least everyone understands the rules.

ALASKA SUPPORT INDUSTRY ALLIANCE

300 W. Benson Blvd., Suite 200 • Anchorage, Alaska 99503 • Phone: (907) 563-2226 • Fax: (907) 561-8870 • www.alaskaalliance.com

Alliance opposition to SB 80
Page 2

The bill is premature. It's been less than 6 months since the legislature retroactively imposed the largest tax increase in Alaska's history on North Slope producers, roughly tripling severance taxes. Regulations for the new PPT haven't even been drafted yet, and SB 80 proponents already want to change it. The Alliance believes additional changes at this time will further undermine Alaska's reputation as a stable and predictable place to invest, resulting in fewer jobs and business opportunities for Alaskans.

SB 80 may seem like prudent politics to some, but it's poor public policy. The Alliance opposes this proposed legislation and urges you not to move it out of the Senate Resources Committee. Thank you for your consideration.

Sincerely,

PAUL LAIRD

Paul Laird
General Manager

TESTIMONY
OF
THE ALASKA OIL AND GAS ASSOCIATION
BEFORE THE SENATE RESOURCES COMMITTEE
REGARDING
SENATE BILL 80

February 21, 2007

Good afternoon, 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.

Just last August the Third Special Session of the Twenty-fourth Legislature passed a version of a new "Petroleum Production Tax" or PPT after the Regular and prior Special Session that year had failed to find consensus over it. The PPT has replaced the previous ELF-based production tax and establishes significantly higher tax rates than those under the ELF. According to a recent, publicly released letter from BP's new Alaska president, Doug Suttles, to the members of this Committee and the rest of the Legislature, the change from the ELF-tax to PPT nearly tripled BP's Alaska production taxes from \$180 million to over \$500 million just for the nine months in 2006 when the PPT was in effect. While I am not in a position to say with similar detail what the effects have been for other companies, I can assure you that the PPT was a major tax increase for the industry as a whole.

In fact, one of the two goals of the new tax was to increase tax revenues to the State of Alaska in times of higher prices. The second goal was to encourage new exploration and production and to that end the new tax offered credits and shared the risk of certain categories of costs.

Not surprisingly, many legislators were enthusiastic about the higher taxes to the State, and not as enthusiastic about the credits or the concept of the State sharing some of the risk by providing incentives for certain categories of cost.

There were literally dozens of concerns about this new approach to tax legislation. And there were, I believe, literally dozens of hours of hearings and work sessions to work through these concerns: what costs would be included; how to decide if a cost was appropriate; what standards of review would be used; how to prevent the State "being gamed" by the companies; how to prevent the companies "being gamed" by the State; how the credits could be used; what should the tax rate be; when should the progressive factor kick in?

AOGA Testimony to Senate Resources on SB 80

February 21, 2007

Page 2

On August 6 last year BP discovered a leak in the Flow Station 2 Oil Transit Line in the Prudhoe Bay field, notified the appropriate regulatory authorities, implemented procedures to stop the leak and clean up the spill, and began the process for suspending production from the entire field. The House of Representatives was informed just before it voted on final passage in Third Reading of CSHB 3001(FIN), the bill to enact the PPT, which then passed the House by a 29-10 vote.

As more information was released, the level of concern regarding the effect of the spill under the proposed new tax legislation heightened. Legislators did not want the State of Alaska to end up paying for the result of spills under the PPT if the standards had been ignored.

As a result, Section 1 AS 43.55.165(e) – the identification of what “lease expenditures” would *NOT* include, and setting the standards for review, received even closer scrutiny.

While there was discussion of various other standards, the final standards adopted by the legislature, were based on words that have meaning in law: “lease expenditures would not include costs arising from *fraud, willful misconduct or gross negligence*”.

It was further decided that “costs incurred for containment, control, cleanup, or removal in connection with any *unpermitted* release of oil or a hazardous substance” would not be included as lease expenditures.

On August 9, the Senate Special Committee on Natural Gas Development – the so-called Super Committee, because a majority of the Senate was members of it – reviewed a new amendment with the exact same language as SB 80 which is in front of us today. The language was introduced twice, once as Amendment 9 and once as Amendment 13. The difficulties with the amendment were immediately apparent: What does “improperly maintained” mean? “What does “diminished capacity” mean? Who decides in the first place – an auditor? How can Commissioners without specialized expertise make these findings? Does there have to be an incident, like a spill. If so that is already taken care of under “unpermitted releases”. If no incident takes place, does that mean the State can decide what maintenance costs are appropriate under every circumstance?

Legislators and State Department of Revenue personnel expressed concerns about the difficulties of interpretation. After debate, neither amendment was adopted.

Instead the Senate Special Committee on Natural Gas Development adopted an amendment proposed by Dr. Pedro van Meurs, an international gas consultant retained by the State. The van Meurs amendment had been presented to the Super Committee as an alternative. It provided for a flat 30¢ per barrel exclusion from what would otherwise be a producer's “capital” portion of its “lease expenditures.” The van Meurs amendment became AS 43.55.165(e)(18) in SCS CSHB 3001(NGD), the Super Committee's committee substitute for House Bill 3001. The following day the Senate passed the Super Committee's version of the PPT bill, the House concurred, and it went to the Governor for signature.

Dr. van Meurs explained in the hearing that "maintenance is a reasonable deduction for PPT; but is sometimes hard to decide which expenditures fall into that classification. The simplest solution is to take some base expenditure that really will be replacement and over the next 20-30 years disallow a modest floor of the capital expenditures." (August 9, 2006 Minutes Senate Special Committee on Natural Gas Development)

The flat 30¢ per barrel exclusion – which sets a floor for maintenance cost and avoids the problems of case-by-case decisions as to whether maintenance (repair or replacement) is required because equipment or facilities have been improperly maintained - was adopted. Amendment 13, requiring case-by-case decisions as to the reason for the repair or replacement – almost identical to SB 80 was not adopted. Dr. van Meurs favored using a proxy in order to have clarity and certainty and to avoid disputes.

Now the legislature is again debating the same amendments that failed on August 9 – and the same problems with it exist.

I would note that the legislature is not debating whether to amend the PPT legislation to drop the 30 cent per barrel proxy cost which accrues for every producing company - whether there is an incident or not. What is being proposed here is a "per activity decision" of proper maintenance – in addition to the flat surcharge that was intended as a proxy for such a decision.

However, it may be helpful that this amendment be debated again. For PPT to function effectively, it is important that both the legislators and the industry understand how the legislation works and why it should work as intended. If either side feels "gamed", we will be in court forever, regardless of what kind of tax it is.

AOGA opposes SB 80 for four reasons.

First, we believe that the state is already protected from being inappropriately charged with lease expenditures as a result of spill incidents under the current law.

Second, SB 80 has unintended, but potentially significant, implications that could well extend far beyond the specific situation at Prudhoe Bay that was the impetus behind the Bill.

Third, it is an *ex post facto* law that is forbidden under the federal and Alaska constitutions.

Fourth, SB 80, because of the ambiguity of its language, creates ambiguity throughout the entire PPT legislation related to costs and credits.

Before detailing AOGA's specific concerns with this proposed legislation, we would like to express our general concern with the premature and possibly unwarranted assumptions regarding the Prudhoe Bay oil leaks. SB 80 is aimed directly at Prudhoe Bay and appears to be based on the assumption that because the corrosion on the Prudhoe Bay transit lines was more severe than expected, then those lines were "improperly maintained" This is to judge BP's conduct, and that of Atlantic Richfield, as the operator of the eastern side of the Prudhoe Bay field before the BP ARCO merger in 2000, without having the decisions of the federal and state regulators and/or the courts. We like to believe that companies, like individuals, are innocent until proven guilty. There certainly does need to be the level of concern and scrutiny exhibited by the industry and

the state and federal regulators. What we hope to avoid is legislation, based on an assumption of wrong doing, that will not only not solve a problem, but create new ones.

AOGA's concerns are as follows:

1. The State is already protected from being inappropriately charged with lease expenditures as a result of spill incidents under the current law. The PPT laws already on the books specifically disallow "costs arising from fraud, willful misconduct, or gross negligence [.]". See AS 43.55.65(e)(6). In addition, the definition of "lease expenditure" in AS 43.55.160(a) states in pertinent part:

... a producer's lease expenditures for a calendar year are the ordinary and necessary costs ... that are direct costs of exploring for, developing, or producing oil or gas deposits located within the producer's leases or properties in the state

SB 80, in contrast, would introduce a completely new and subjective term for judging whether maintenance-related costs would be "lease expenditures"; and this new term would be the "improper"-ness of the maintenance in question.

The already existing statutory terms in AS 43.55.165 — "willful misconduct", "gross negligence", "ordinary and necessary costs", and "direct costs of exploring for, developing, or producing oil or gas" are already clearly and fully defined. "Willful misconduct" and "gross negligence" are terms from the common law, specifically the law of torts, and the judicial precedents establishing their meanings go back literally hundreds of years. "Direct costs" are defined in a substantive sense by the examples in AS 43.55.165(b)(1), and in a geographical sense by AS 43.55.165(b)(2).

To the extent that the concept of "improper" maintenance is encompassed by any or all of these other, already existing statutory terms, it is superfluous. To the extent it may mean something different from the terms already in the statute, the concept of "improper" maintenance is ambiguous because there is nothing to guide taxpayers or tax administrators about which of the existing terms it is different from and in what ways it is different from each of them.

2. Implications extend statewide. 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 30th anniversary of the start of its production in June of this year. But in the Cook Inlet a number of fields will have their 40th 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 operations in the Inlet area that will eventually need to be replaced or significantly repaired 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 are "capital" portion of those costs will be fully allowed, could lead to fields or facilities being permanently shut-in instead of remaining in production even longer.

3. Ex post facto legislation is forbidden under the federal and Alaska constitutions. On this point let me begin by saying I am not a lawyer, but I was chief administrative judge of a federal appeals board for 8 years so have some familiarity with constitutional issues.

Section 10 of Article I of the United States Constitution declares that "[n]o State shall ... pass any ... ex post facto Law[.]" According to *Black's Law Dictionary* an *ex post facto* law is:

[a] law passed after the occurrence of a fact or commission of an act, which retrospectively changes the legal consequences or relations of such fact or deed.

....

How would SB 80 fall within this definition? First, it clearly would be a law with retrospective effect because Bill Section 2 makes the changes "appl[icable] to oil and gas produced after March 31, 2006" and Bill Section 4 explicitly says those changes are "retroactive to April 1, 2006." The Bill then seeks to change the consequences or relations of these prior operational activities after the fact. Thus, SB 80 constitutes an *ex post facto* law which, if passed, would be unconstitutional.

4. SB 80 creates ambiguity that threatens the effective implementation of the PPT. With respect to providing clarity about how the taxes work, SB 80 promises to create ambiguity between its "improper"-ness standard and the other, well-defined statutory standards already in place for determining which expenditures are proper under the PPT. With respect to providing certainty about what a taxpayer owes, this ambiguity under SB 80 promises to engender countless disputes about whether maintenance was "improper" or not, and to the extent it was, how much of the costs of repairing it or otherwise dealing with the situation should be disallowed as a result.

The question of what costs are deductible is central to the concept of the PPT as an incentive to new investment and new production. The tax rate under the legislation is extremely high – the tradeoff was, in part, related to cost sharing and credits.

AOGA has already testified that we believe the tax rate is too high. Now we are placed in the position of testifying that along with the high tax rate, the determination of costs and credits will spiral off into a black and never ending hole of litigation.

If SB 80 passes the question of what costs are deductible becomes open at each audit. Auditors will be obligated to test each "cost" submitted against a standard of "improperly maintained" or "diminished capacity". This simply is not workable. The determination is not even related to an incident - such as an unpermitted spill - but rather to the act of "repair and replacement".

I will paraphrase the same comments to you as we provided to the Department of Revenue during the hearings on the first regulations under the PPT:

"We want to avoid long years of court battles over the application and interpretation of the statute and regulations. We experienced enough of those battles in the 1970s, '80s and early '90s. What we need to avoid a repetition of that hard experience are statutes and regulations that will give clear answers to the questions of what the taxable value of oil and gas is and which costs are deductible in determining that value."

We strongly believe that SB 80 is a step backward in achieving effective clarity in the PPT.

One final observation: There is consensus that Alaska's future challenge is focused on declining oil and gas production, and about how this decline can be slowed. If North Slope production continues to decline at 6.5% a year as it has steadily been doing since the early 1990s, it will be down to 400,000 barrels a day by the end of 2017. It is this reality that drives the need for a gas pipeline and the need for new oil production as the continued base of Alaska's economy. It is this reality that led legislators to take an entirely new approach to oil and gas tax - one that would encourage investment and production by sharing some of the cost. This does not translate into taking a smaller share than the State should have - it is about encouraging more production so the State continues getting its share. SB 80 goes in the wrong direction from this prudent tax policy. For all these reasons, then, AOGA opposes SB 80, and we respectfully urge you not to move it out of your committee.

Thank you again for this opportunity to testify today.

Sharon Long

From: Sharon Long
Sent: Wednesday, February 28, 2007 11:19 AM
To: 'deborah_behr@law.state.ak.us'
Cc: Sharon Long
Subject: SB 80 ?'s for SRES 2/28/07

Hi Deborah, below please find some questions which may be raised to the **Dept. of Law** in this afternoon's meeting.

Many thanks,

Sharon J. Long, Staff

Senate Resources Committee

(907) 465-4907

1. Some legislators have expressed concern that the standards and protections already in the PPT are insufficient to protect the state. Do you agree with this? Can you give us some examples of how the courts view "fraud, willful misconduct or gross negligence" when ruling on equipment failures? Could the Department of Law provide a memorandum on this?
 - 2) The concern has been raised that this is an ex post facto law that is forbidden under federal and Alaska constitutions. Can you respond to that concern? Do you intend to do so in a written legal opinion?
 - 3) Three of the agencies involved (AOGCC, DNR, DOR) have raised concerns regarding the standards set out in this legislation including the "improper maintenance" standard as well as using "standard practices of the industry" as a guide. Have you made a legal evaluation of these standards and if so, what is your conclusion?
 - 4) Since all of the agencies have problems with the language, how will the administration coordinate proposed changes that all of the agencies agree with?
 - 5) Will the Department of Law be making a recommendation for a different standard?
 - 6) Regardless of the standard that might be adopted, how do you anticipate such a decision would be made? Would there be hearings, witnesses, briefings, etc?
 - 7) Which agency do you believe would make the final decision? Would each Commissioner and AOGCC have to sign off. What if there is disagreement among the agencies?
 - 8) Federal agencies also have oversight over pipelines and facilities and the standards are different. How do you anticipate the state and federal decisions would be coordinated?
-

Sharon Long

From: Sharon Long
Sent: Wednesday, February 28, 2007 11:54 AM
To: Lesh, Melanie G (DNR)
Subject: SB 80 ?'s for Kevin Banks

**Hi Melanie, Can you get these to Kevin please, and thank you, b4 this afternoon's meeting?
Thanks,
sjl**

Sharon J. Long, Staff
Senate Resources Committee
(907) 465-4907

Questions for Kevin Banks - [REDACTED]

1) Governor Palin has announced that she is preparing legislation to set up a Petroleum System Integrity Office to deal with pipeline and facilities issues and in your comments on SB 80 you said that DNR is preparing to closely review the issue of system integrity AND will have the leading role in coordinating system integrity issues with other agencies.

- * How do you see the relationship between SB 80 and the Petroleum system Integrity Office?
- * Will the Petroleum System Integrity Office have different standards for maintenance than SB 80?
- * There is concern that there will be conflicts between the requirements of SB 80 and the Petroleum System Integrity Office? Can you address that concern?
- * Department of Revenue, Department of Natural Resources, Department of Revenue and the AOGCC all seem to have roles in SB 80 and are anticipated to have roles in the Petroleum System Integrity Office.
- * Which agency do you see making the "final decision" under SB 80 and the Petroleum System Integrity Office?

2) You also mention there are currently 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" and suggest as an alternative: "practices undertaken by a reasonable and prudent operator under the same or similar circumstances". Do you know if there is a legal framework for that alternative? How would you go about making such a decision?

Sharon Long

From: Kara Moriarty [moriarty@aoga.org]
Sent: Wednesday, February 21, 2007 11:30 AM
To: Sharon Long
Subject: Judy's Information
Importance: High

Sharon:

Information for the hearing:

Judy Brady, Executive Director, Alaska Oil and Gas Association


Thanks! Kara

Kara Moriarty
External Affairs Manager
Alaska Oil & Gas Association
121 W. Fireweed Lane, #207
Anchorage, AK 99503
(907) 272-1481
Cell: (907) 351-1116
Fax: (907) 279-8114
moriarty@aoga.org

Sharon Long

From: Mary Jackson
Sent: Tuesday, February 20, 2007 10:33 AM
To: Sharon Long
Subject: SB 80 Testimony

the following people will be available for questions from the committee, if any.

 Kevin Banks, DNR - Anchorage 269-8781 (offnet)
John Norman, AOGCC - Anchorage 793-1234 (offnet)
John Iverson, DOR - 269-1033 (offnet)
Larry Dietrick, DEC - in person in Juneau

i will present the bill for Sen. Wagoner and Don Bullock, Leg. Legal, will be at the meeting as well.

thanks,

mary j

possible changes

0 220607 5RM

(19) costs or that portion of the costs determined by the commissioner, in consultation with the commissioner of environmental conservation, the commissioner of natural resources, and ~~the chair of~~ the Alaska Oil and Gas Conservation Commission and ~~relying on~~ taking into consideration the standard practices of the industry of a reasonable and prudent operator, to be

(A) related to the repair and replacement of improperly maintained property or equipment;

(B) incurred to maintain the operational capability facilities or equipment shut down because of improper of maintenance of property or equipment; or

(C) ~~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.~~ 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.

Kurt Olson } on
Les Gunn } house
 } side

17 Senate

21 House

SB 80 pts

Dated: 4-18-07

**Alaska Oil and Gas Conservation Commission's
Comments regarding SB 80/HB128-OIL and
GAS PRODUCTION TAX: EXPENDITURES**

This legislation is proposed as a law of general application throughout the State of Alaska. With that in mind the Alaska Oil and Gas Conservation Commission's ("AOGCC") comments are framed without regard to any particular incident and instead with a view to how the law might apply throughout the state and in particular to new investors contemplating oil and gas operations in Alaska.

1. Policy Considerations:

- a. Disallowance of expenses resulting from operator negligence. Is it advisable to deny leasehold expenditure deductions for costs resulting from errors which are not the consequence of fraud, willful misconduct, or gross negligence? Subsection (6) of AS 43.55.165(e) already disallows deductions for the expenses arising from fraudulent, willful misconduct or gross negligence.

Proposed subsection (19) would extend cost disallowance to acts other than those already addressed by subsection (6). Subsection (6) addresses costs related to willful misconduct or gross negligence, so we interpret subsection (19) as intended to disallow costs arising because of ordinary negligence. This would impose a penalty on the operator beyond what is customary in agreements between co-owners who enter into operating agreements for development of a commonly owned resource. Such agreements almost always absolve an operator of liability for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct. If it were otherwise and operators were liable for ordinary negligence (which is another way of saying making a mistake) they would be in the position of guaranteeing a trouble free operation. No operator would be willing to make that guarantee. It is generally recognized in the business world that mistakes happen but only when they result from willful misconduct or gross negligence is an operating partner normally penalized.

With the foregoing in mind subsection (19) departs from normal business practice and sets a higher standard than business partners in the oil and gas industry normally demand of each other. Similar reasoning could be applied to new operators contemplating operations in the State of Alaska under what they might perceive as a tax structure unforgiving of mistakes.

- b. Denial of Facility Shut Down Expenses. Subsection (19) (B) would deny expenses incurred to maintain operational capability of facility or

equipment shut down because of improper maintenance. Is it good policy to deny operational maintenance costs if the operator believes that the best course of action is to shut down the entire facility in order to carry out necessary repairs? Denial of operational capability maintenance costs could discourage operators from shutting down when in fact a complete shut down is the most prudent course of action.

- c. Should Not Discourage Innovation. The oil and gas industry is constantly evolving. A tax regime should not discourage innovative techniques. Examples of such techniques are the astounding advances that have been made in recent decades in the area of directional drilling, coiled tube drilling, and subsea completions. Any attempt to rigidly codify "good oilfield practices" could inadvertently retard the natural learning experience that comes with allowing operators to experiment with differing techniques.

2. Practical Considerations:

- a. Standard Terminology. The phrase "Standard Practices of the Industry" in subsection (19) is vague and ambiguous. On the one hand it could mean the written standards adopted by professional organizations intended as guidance documents for the industry; or it could simply mean the standard practice prevailing in the industry in a particular locale.

In determining whether an operator's conduct has resulted in waste of a resource the AOGCC has generally used "good oilfield practices" as a standard by which to measure an operators practice in installing operating and maintaining equipment. See AS 31.05.170(15).

- b. AOGCC's preferred term. Good oilfield practices is the term used to indicate that operations are carried out in a proper and workman like manner. It is used in the same way as the phrase "everything is A.P.I.," which refers to the American Petroleum Institute's set of standards covering aspects of petroleum operations. Williams & Meyers, Manual of Oil and Gas Terms (13th ED.) p 453. It is therefore, AOGCC's recommendation that the phrase "good oilfield practices" be substituted for the current phrase "standard practices of the industry".
- c. Absence of Regulatory Guidelines for Maintenance. There is lack of current regulatory guidelines. Much of the equipment and systems in oilfields that are subject to maintenance are not currently regulated by either AOGCC or DEC. This raises questions about how to gauge "improper maintenance" in the absence of regulatory responsibility for such systems and equipment.

- d. **Regulations.** There will be a need for AOGCC and other agencies to promulgate regulations if AOGCC is assigned responsibility under this bill. These regulations should provide general guidance to the industry, including new operators coming into the State, concerning what constitutes "good oilfield practices." Toward this end we would look to the American Petroleum Institute's standards and recommended practices, as well as standards recognized by the National Association of Corrosion Engineers (NACE), the American Society of Mechanical Engineers (ASME), the International Standards Organization (ISO) and similar respected organizations.

- e. **Agency Expertise.** There is a need for specialized expertise. AOGCC geologists and engineers work to regulate operations downhole and immediately around the production string but traditionally have not moved further downstream except when required to determine whether a failure of equipment resulted from an operator's failure to employ good oilfield practices thereby resulting in "waste" of hydrocarbon resources.

We are aware that Governor Palin has announced activation of the Petroleum Systems Integrity Office ("PSIO") and AOGCC is one of the agencies designated to participate on that team. We contemplate that the PSIO staff will implement a quality assurance program with inspections conducted by or under the direction of PSIO to ensure compliance with approved programs. AOGCC will have a designated representative working with PSIO and AOGCC expertise can be called upon as necessary to consult with the Department of Revenue through PSIO. Such an arrangement will avoid duplication of effort and ensure consistency of standards, directives, and inspection reports since all would be coordinated through PSIO.

3. **Difficulties In Determining Root Cause:**

In some instances it will be obvious that there has been improper maintenance. In other instances, the AOGCC would be required to consider design, installation, operation, and maintenance, all of which are integral to a determination of negligence. Additionally some determinations will require detailed investigation including but not limited to destructive and non-destructive metallurgical testing and application of other expertise not readily available within the AOGCC.

4. **Date Stamping Negligent Conduct:**

Standards are continually evolving and it will be important to decide whether conduct that led to the failure should be judged in light of the standards prevailing when

the original decisions were made or judged by the most current standards. Additionally, properties are often sold or traded within the industry. Is it good policy to deny a good faith purchaser the benefit of leasehold expenditures incurred as result of mistakes which may have been made many years before by the prior owner?

Jody Simpson

From: Anne Kilkenny [annekilkenny@hotmail.com]
Sent: Monday, April 02, 2007 6:28 AM
To: Sen. Charlie Huggins
Subject: SB80 Wagoners Oil & Gas Tax

Senator Huggins,

Noting SB80 in committee makes it appear that you are in the pocket of the oil & gas industry.

Please expedite this important legislation to close the loophole that would allow BP to write off its expenses for repairing the pipeline that it allowed to deteriorate.

Think of what the money would do for education!

Anne

Anne Kilkenny
P. O. Box 870163
Wasilla, AK 99687-0163
907 376-6225

Trying to help

Live Search Maps - find all the local information you need, right when you need it.
<http://maps.live.com/?icid=hmtag2&FORM=MGAC01>

Questions for John Iverson – DOR:

- 1) You have stated that DOR supports this legislation, but in your letter of Feb. 20 you raised a series of problems in regard to the current language. You note that there will be problems with the term “standard practices of the industry” and said you believed section (19)(c) was “unclear” . You also said you were going to propose changes. Are you prepared to propose changes now? If not now, when?

- 2) Under this bill, the auditors will apparently be expected to be the first to identify a possible problem with giving a credit. How will this work in practice? Auditors are not engineers or operations experts. What do you anticipate would be the “red flag” to an auditor that would kick off a round of investigation – or would every capital expense be investigated?

- 4) You are still in the process of drafting a second round of regulations for the PPT. Do you see possible conflicts between those regulations and this legislation as drafted? Do you think the issues raised with this piece of legislation could be dealt with in regulation? Do you think that it is necessary to have it in statute?

For all of the agencies:

- 1) What agencies currently have jurisdiction over surface facilities and what standards do they currently use?

- 2) If the state were to adopt additional standards, such as “improper maintenance”, what kind of process would be necessary to ensure that these new standards are not in conflict with current standards?

- 3) As you continue to study this legislation have you identified other issues of concern or come up with further resolutions to the issues raised in your written comments?

Questions for Kevin Banks - DNR: ✓

1) Governor Palin has announced that she is preparing legislation to set up a Petroleum System Integrity Office to deal with pipeline and facilities issues and in your comments on SB 80 you said that DNR is preparing to closely review the issue of system integrity AND will have the leading role in coordinating system integrity issues with other agencies.

* How do you see the relationship between SB 80 and the Petroleum System Integrity Office?

* Will the Petroleum System Integrity Office have different standards for maintenance than SB 80?

* There is concern that there will be conflicts between the requirements of SB 80 and the Petroleum System Integrity Office? Can you address that concern?

* Department of Revenue, Department of Natural Resources, Department of Revenue and the AOGCC all seem to have roles in SB 80 and are anticipated to have roles in the Petroleum System Integrity Office.

* Which agency do you see making the "final decision" under SB 80 and the Petroleum System Integrity Office?

2) You also mention there are currently 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" and suggest as an alternative: "practices undertaken by a reasonable and prudent operator under the same or similar circumstances". Do you know if there is a legal framework for that alternative? How would you go about making such a decision?

Questions for representative from the Attorney General/Dept. of Law's office:

1. Some legislators have expressed concern that the standards and protections already in the PPT are insufficient to protect the state. Do you agree with this? Can you give us some examples of how the courts view "fraud, willful misconduct or gross negligence" when ruling on equipment failures? Could the Department of Law provide a memorandum on this?
- 2) The concern has been raised that this is an ex post facto law that is forbidden under federal and Alaska constitutions. Can you respond to that concern? Do you intend to do so in a written legal opinion?
- 3) Three of the agencies involved (AOGCC, DNR , DOR) have raised concerns regarding the standards set out in this legislation including the "improper maintenance" standard as well as using "standard practices of the industry" as a guide. Have you made a legal evaluation of these standards and if so, what is your conclusion?
- 4) Since all of the agencies have problems with the language, how will the administration coordinate proposed changes that all of the agencies agree with?
- 5) Will the Department of Law be making a recommendation for a different standard?
- 6) Regardless of the standard that might be adopted, how do you anticipate such a decision would be made? Would there be hearings, witnesses, briefings, etc?
- 7) Which agency do you believe would make the final decision? Would each Commissioner and AOGCC have to sign off. What if there is disagreement among the agencies?
- 8) Federal agencies also have oversight over pipelines and facilities and the standards are different. How do you anticipate the state and federal decisions would be coordinated?

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: Larry Dicklick
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_fy06/060302301/060302301_index.htm

www.dec.state.ak.us/spar/perp/response/sum_fy07/060806301/060806301_index.htm

The state has incurred costs for response, overnight, 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

February 28, 2007

Senator Charlie Huggins, Chair
Senate Resources Committee
State Capital Room 205
Juneau, AK 99801-1182

The Honorable Chair & Members of the Senate Resource Committee,

The Alaska State Chamber of Commerce is concerned about SB 80. SB 80 changes the tax structure of the recently enacted Petroleum Production Tax (PPT). The State Chamber believes changing the tax structure so quickly will have long-term negative impacts on the future of Alaska's economy. We believe that the consequences as a result of SB 80 have not been fully considered with regards to all businesses in Alaska.

The State Chamber of Commerce strongly believes that SB 80 takes the wrong approach in creating a fair business environment. No business can possibly prosper or operate in a rapidly changing business climate. We urge the legislature to not pass this legislation from committee.

With the passing of the PPT legislation last year, the state effectively tripled the production taxes on the oil industry in Alaska. Last year's action will result in roughly a \$1 billion increase in revenues to the state this fiscal year. Under the enacted legislation, Alaska's oil producers are allowed to deduct operating costs from taxes. In addition, they are also allowed to take a 20% tax credit for capital investments as an incentive for improving North Slope infrastructure. To counter-balance deductions the legislature implemented language that disallows deductions arising from fraud, willful misconduct, or gross negligence.

SB 80 aims to preclude expenditures associated with improper maintenance of property or equipment. What exactly is improper maintenance? SB 80 does little to define improper maintenance, potentially creating more confusion and litigation. SB 80 appears to limit any type of deduction if shown it was due to improper maintenance. Doubtfully, any company would throw away millions of dollars in shipping Alaska's oil just to save a few dollars on pipe. Any company grossly negligent in its operations is already unable to use any deduction whether it is for maintenance or anything else. Then for what purpose does SB 80 serve Alaska? Enacting SB 80 won't give Alaska more oil, will not make up for lost state revenues due to offline pipe nor will it create more jobs or force any company to sign a gas pipeline contract.



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The State Departments of DEC, DNR and the AOGCC have all raised critical concerns about SB 80, primarily the ability to implement the legislation should it become law. These departmental concerns also note that the words "improperly maintained" may have serious conflicts with existing standards to protect the state from faulty maintenance.

SB 80 seems incongruent with existing state agencies while creating instability in the business environment by re-addressing the same tax structure in less than a year. No business can possibly prosper or operate in a rapidly changing business climate. The State Chamber of Commerce strongly believes that SB 80 takes the wrong approach in creating a fair business environment. We urge the legislature to not pass this legislation from committee.

Yours in economic prosperity,



Wayne A. Stevens
President/CEO



Alaska Oil and Gas Association



121 W. Fireweed Lane, Suite 207
Anchorage, Alaska 99503-2035
Phone: (907)272-1481 Fax: (907)279-8114
Email: brady@aoga.org
Judith Brady, Executive Director

May 9, 2007

The Honorable Charlie Huggins
Alaska State Senate
Alaska State Capitol
Juneau, AK 99811-1182

Dear Senator Huggins:

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 companies who operate in Alaska.

We understand that SB 80 will be heard on the floor in the very near future. We do understand the concerns that generated the interest in this bill, but we truly believe those concerns are already resolved in current PPT statutes. We hope that those of you who have listened to the hearings in Senate Resources and Senate Finance have reached the same conclusion. After listening to the hearings and the comments by agency managers discussing the troublesome ambiguities and difficulties of implementation in this bill, 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.

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.

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 should or should not be included as "lease expenditures". Following the Flow Station 2 Oil Transit Line spill in the Prudhoe Bay field last August 6, legislators reviewing the still-pending PPT legislation made it abundantly clear that they did not want the State of Alaska to end up sharing costs under the PPT for this spill or for future spills. As a result, Section 1, AS 43.165(e) – the identification of what "lease expenditures" would NOT include received even closer scrutiny. An amendment with the exact language as that contained

in the original SB 80 was introduced twice to the Senate Special Committee on Natural Gas Development. The same problems that have been raised in the Senate Resources and Finance hearings this year were raised last year with the result that the amendment was not adopted. Instead, on the recommendation of 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" concerns related to spills and the "practical" concerns related to the need for investment in continued maintenance of aging fields. The adopted amendment became part of the PPT legislation that passed August 10.

We believe that, given the intense legislative scrutiny on what would qualify as "lease expenditures" both before and after the August 6 Flow Station 2 spill, the current law fully protects the State from being inappropriately charged with lease expenditures as a result of spill incidents. After listening to testimony from agency managers who would be responsible for implementing SB 80, we also believe that SB 80 does nothing to further protect the State's interest and as an unintended consequence, will inevitably result in production tax audit delays, litigation, and the unfortunate replay of the 1970's and 1980's where, because of ambiguous language and process, oil and gas tax disputes reached billions of dollars – much to the dismay of the companies and the State of Alaska.

We do appreciate the mandate to protect the State's interest. We hope you will review the hearing records, and especially the letters from the agency managers, to decide whether you are satisfied that Alaska's interest is protected under the current law. Following is a short summary of why we believe the State's interest is protected under current 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)]. This very tightly worded section was the subject of considerable discussion. The legislature concluded that they did not care who or what caused a spill; regardless of the cause, the company is entirely liable for all of the costs.
- The PPT explicitly disallows "cost arising from fraud, willful misconduct, or gross negligence" [AS 43.55.(e)(960)].
- 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. The shutdown of Prudhoe Bay prior to the passage of the PPT brought the question of cost sharing into sharp focus. 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. In an August 5, 2006 memo, 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]. The 30 cents a barrel is disallowed regardless of the circumstances and adds approximately \$47 million in taxes annually for the oil companies. This amendment was adopted by the Legislature last year.

- 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. The State has already drawn over \$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 have also outlined our concerns on this bill in testimony to both the Senate Resources and Senate Finance Committees. While speaking in favor of SB 80, which is supported by their administration, all of the agency managers raised serious concerns as regarding implementation. We are attaching these letters for your review.

While there has been an attempt in Committees to respond to some of these concerns, most of the problems identified still remain embedded in the proposed legislation. One outstanding serious problem, 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. In other areas of concern there are no “standards” as apparently envisioned by the drafters. Ambiguous language is an invitation to delay and litigation.

May 9, 2007

Page 4

Auditors must examine all expenditures, whether or not an incident has occurred. SB 80's general application to *all* capital expenditures, regardless of whether there has been an incident, will require state auditors to determine whether each capital cost proposed for deduction 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 the hearings about what those "red flags" might be ranged from "newspaper articles" to "large expenditures". The fact is that most oil company expenditures are large and newspaper articles would be related to an incident, which are already covered in the current law.

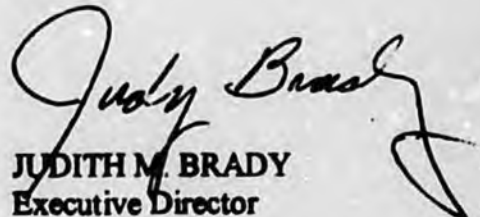
No final decision can be made before consultation among three agency commissioners and a "person" from the Petroleum Systems Integrity Office. Before any final decision is made as to whether an expenditure flagged by an auditor can be deducted, the Commissioner of DOR must consult with the Commissioner 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 capital 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.

In closing, it is important to remember that the implementation of the PPT statute is just beginning. The Department of Revenue has issued the first set of regulations and is drafting regulations related to expenditures. The Governor has signed an Administrative Order establishing the Petroleum Systems Integrity Office, which is an evolving concept. The Administration has also requested \$5 million for an integrated North Slope risk assessment from wellhead to terminal to provide a base for analysis.

Thank you for taking the time to read this letter and understand our concerns. In reviewing the hearing records on this legislation, we hope you will be satisfied that the State's interests are protected and vote no on SB 80.

Sincerely,


JUDITH M. BRADY
Executive Director

Attachments (6)

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

STATE OF ALASKA

ALASKA OIL AND GAS CONSERVATION COMMISSION

SARAH PALM, COMMISSIONER

232 W. 7th AVENUE, SUITE 100
ANCHORAGE, ALASKA 99501-0000
PHONE (907) 270-1400
FAX (907) 270-7902

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/inadequate 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.

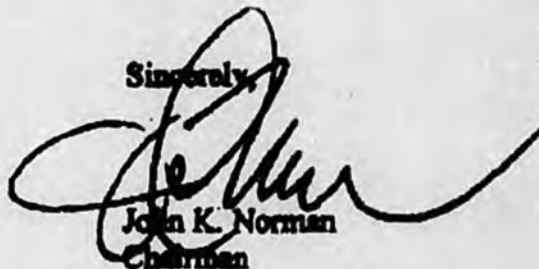
Finally, one can never lose sight of the fact that significant technological advances have occurred as a result of innovations which at the time were departures from standard industry practices. Also, engineers sometimes learn more through failure than from success. Often there is no indication something 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,

A large, stylized handwritten signature in black ink, appearing to read "John K. Norman".

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

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

SARAH PALIN, GOVERNOR

550 WEST 7TH AVENUE, SUITE 500
ANCHORAGE, ALASKA 99501-5000
PHONE: (907) 269-2800
FAX: (907) 269-2809

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.

Division of OR & Gas

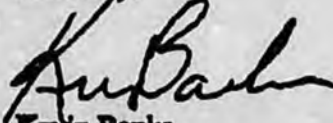
2/15/07

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 Simons, Acting Coordinator PSIO
Marie Crosley, DO&G

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 advances 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 40% 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.

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: Larry Dieckrick
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

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

ENHANCEMENT OF THE "GROSS" CHARACTER OF THE PPT BILL

August 5, 2006

Pedro van Moura

This memo has been written at the request of Senator Wagener. 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 Wagener with my professional advice on these ideas.

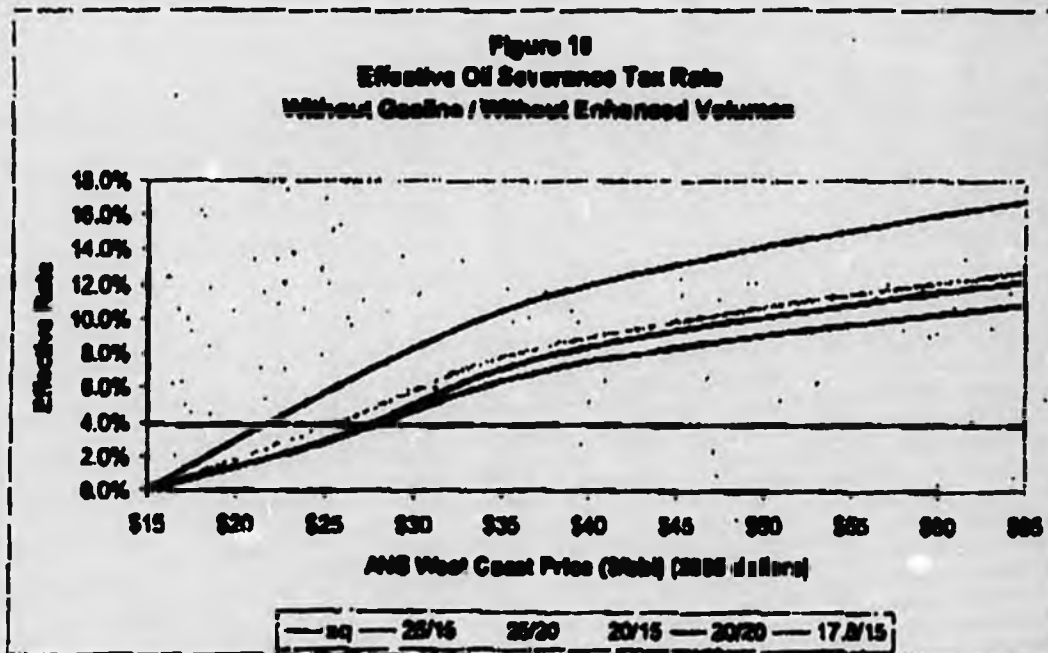
FLOOR

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.

④

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.

5

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.