

ALASKA LEGISLATURE COMMITTEE FILES 2007-2008 SRES 12655

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.

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

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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;
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).

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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2 production tax value of oil and gas for the purposes of the oil and gas production tax;
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10 revenue;

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13 capital;

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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;

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23 attributable to production of oil or gas occurring before April 1, 2006; the portion is
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25 equivalent, associated with the facility, pipeline, well pad, platform, other structure,
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27 to the total amount of oil and gas production, in barrels of oil equivalent, associated
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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;
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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

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10 **revenue;**
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- (6) costs arising from fraud, wilful misconduct, or gross negligence;
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- (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;
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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



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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
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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.

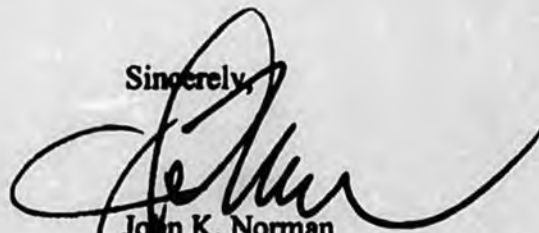
Finally, one can never lose sight of the fact that significant technological advances have occurred as a result of innovations which at the time were departures from standard industry practices. Also, engineers sometimes learn more through failure than from success. Often there is no indication something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

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907.269.0820

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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.

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

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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

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 a large, sweeping 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.

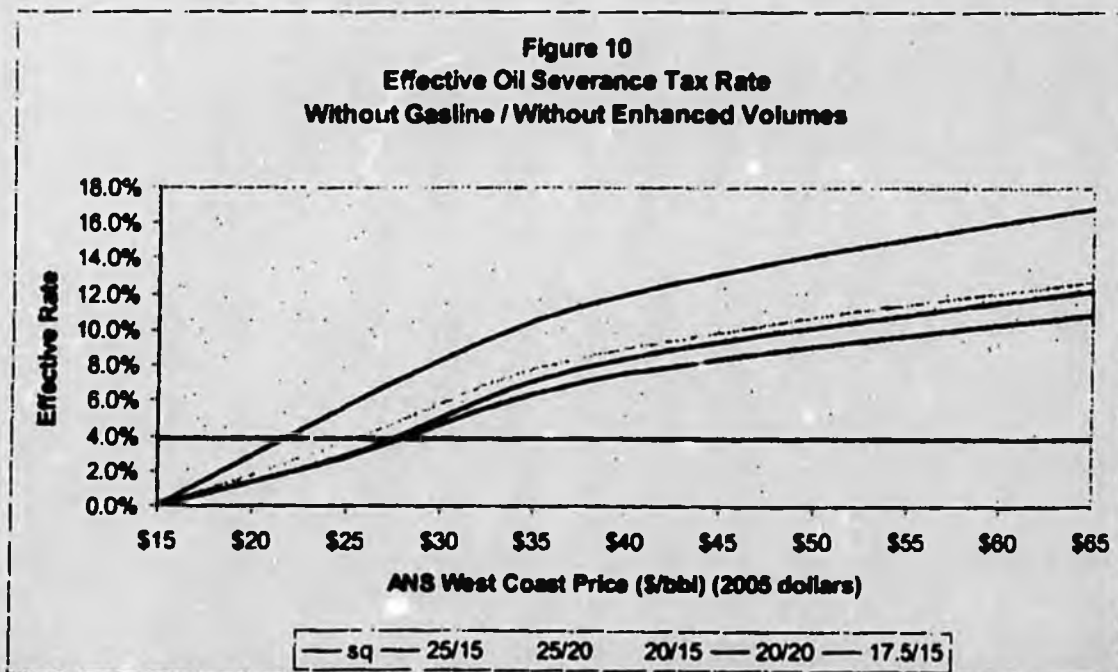
FLOOR

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.

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

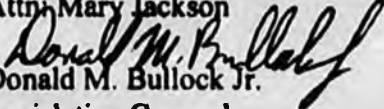
State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 120 6th St., Rm. 329

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



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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 Iverson (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

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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.

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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

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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

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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).