ALASKA LEGISLATURE COMMITTEE FILES 2007-2008 SRES 12657

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

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

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?

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.

• Blacks 620 (8th Ed. 2004)

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 you 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 "finial 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

2-20-07 5PM

(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 Gara } 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 Skrupson

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,

Holding 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

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 proposed 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 "finial 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 you 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 Dietrick
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, 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

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.

ALASKA STATE CHAMBER OF COMMERCE

Headquarters
217 2nd Street
Suite 201
Juneau
Alaska 99801
(907) 586-2323
FAX 463 5515

Regional Office
601 W. 5th Ave.
Suite 700
Anchorage
Alaska 99501
(907) 278 2722
FAX 278 6643

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

Alaska Oil and Gas Association

AOGA

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 inevitability 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 inevitability 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 or 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.

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 inevitability 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

State Office Building
PO Box 110420
Juneau, AK 99811-0420
907.465.2320

550 W Seventh Avenue, Suite 500
Anchorage, AK 99501-3568
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."

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

SARAH PALIN, GOVERNOR

ALASKA OIL AND GAS CONSERVATION COMMISSION

333 W. 7th AVENUE, SUITE 100
ANCHORAGE, ALASKA 99501-3539
PHONE (907) 279-1433
FAX (907) 276-7542

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

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

SARAH PALIN, GOVERNOR

550 WEST 7TH AVENUE, SUITE 800
ANCHORAGE, ALASKA 99501-3560
PHONE: (907) 269-8800
FAX: (907) 269-8939

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.

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
Joanne Siemons, 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 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 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 Dietrick
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, 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 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.

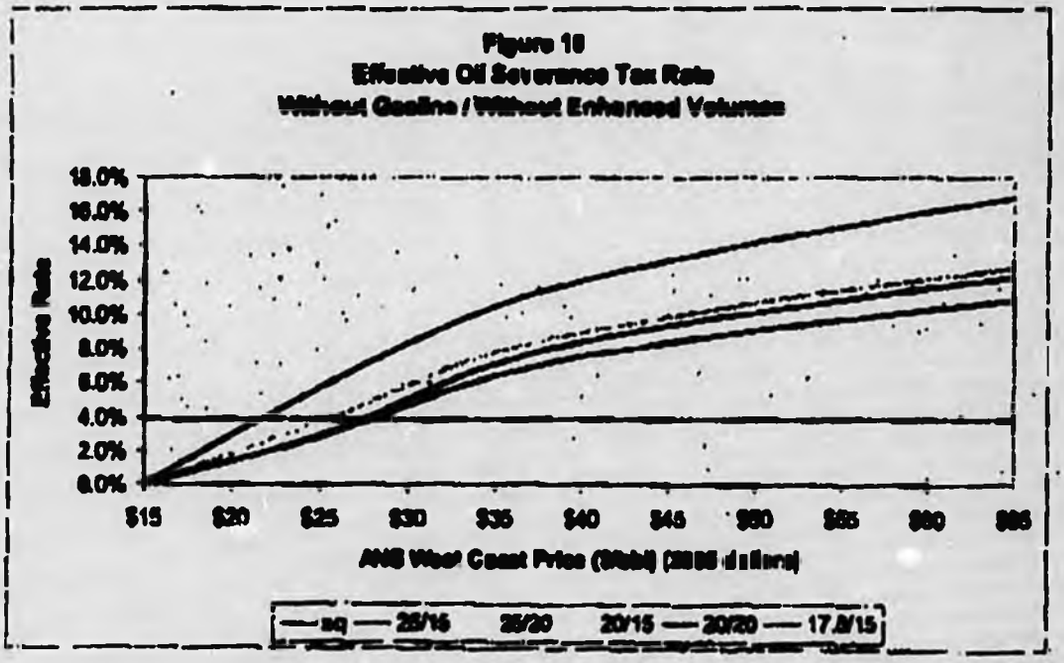
FLOOR

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 replacing 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.

SB

91

SENATE COMMITTEE REPORT
First Committee of Referral

DATE: 2/21/07

FURTHER: Judiciary

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

DATE TURNED
IN TO OFFICE: _____

Resources Committee considered SENATE BILL NO. 91

SB 91 POLLUTANT DISCHARGE PERMITS

"An Act relating to the authority of the Department of Environmental Conservation to require certain monitoring, sampling, and reporting and to require permits for certain discharges of pollutants; relating to criminal penalties for violations of the permit program; and providing for an effective date."

and recommends:

[✓] be **replaced** with [ ] **SCS** or [✓] **CS** SB91 (RES)

[ ] adopt **previous** [ ] **SCS** or [ ] **CS** _____ (_____)

[ ] attached amendment(s)

[ ] adopt _____ Letter of Intent

[ ] further referral to _____ Committee

SENATE BILL:
[✓] Same Title
[ ] New Title

HOUSE BILL:
[ ] Same Title
[ ] Technical Title Change
[ ] New Title w/ SCR #_____

NEW FISCAL NOTE(S):

Department	Date	Fiscal	Index	Agency	FN#

PREVIOUS FISCAL NOTE(S):

Department	Date	Fiscal	Index	Agency	FN#
DEC	1/10/07			✓	

[ ] **APPROPRIATION - no fiscal note**

SIGNATURES AND RECORDED VOTES	PRINTED NAME	DO PASS	DO NOT PASS	NOT	AMEND
	Green	✓			
	McGuire	✓			
	Stedman	✓			
	Wagoner	✓			
	Wielechowski			✓	
CHAIR:	McGuire	X			

STATE OF ALASKA

DEPT. OF ENVIRONMENTAL CONSERVATION
OFFICE OF THE COMMISSIONER

SARAH PALIN, GOVERNOR
410 Willoughby Ave., Ste 303
Juneau, AK 99801-1795
PHONE: (907) 465-5065
FAX: (907) 465-5070
http://www.state.ak.us/dec/

March 1, 2007

The Honorable Charles Huggins
Chairman, Senate Resources Committee
State Capitol, Room 119
Juneau, AK 99811

MAR 0 6 2007

Dear Senator Huggins:

The Department of Environmental Conservation (DEC) respectfully requests a hearing for SB 91 "An Act relating to the authority of DEC to require certain monitoring, sampling, and reporting and to require permits for certain discharges of pollutants."

In 2005, the Alaska legislature passed legislation which directed DEC to take all actions necessary to assume the National Pollutant Discharge Elimination System (NPDES) wastewater discharge permitting authority from the Environmental Protection Agency (EPA). The program includes responsibility for issuing and monitoring compliance with the permits.

EPA approval of a state NPDES Program requires that the state have comprehensive statutory authority to implement the program. EPA has identified a number of areas where current state statutes need to be amended to complete the statutory underpinnings for an Alaska NPDES program. Our attorneys agree with EPA's assessment and conclusions in this regard. SB 91 addresses all shortcomings in the current statutes. Correcting the identified statutory shortcomings is a prerequisite to further progress towards NPDES primacy for Alaska.

I have enclosed several documents for your information as you consider this important piece of legislation, including Governor Palin's transmittal letter and a copy of the Department's Annual Report to the Legislature on the status of the primacy effort. If you require further information, please contact me or Linda Hay, DEC's Legislative Liaison, at 465-5290.

Sincerely,

Larry Hartig
Commissioner

Enclosures

Senate Resources Committee 3:30 – 5:30 April 11, 2007

1. Gavel In & Call to order: Note time –Note members present

2. Presentation: Natural Gas Pricing & Trends N.Y. Ellis Island

Marianne Kah, Chief Economist, ConocoPhillips Inc, Houston

a. Ask presenter to place herself on the the record

3. SB 91 - Pollutant Discharge Permits

a. **Administration speaking to the bill** – will offer amendment

DEC Commissioner Larry Hartig (brief intro of legislation)

Lynn Kent, Director, Div. of Water

Cam Leonard, Assistant Attorney General

moved out w/ amend

b. **Public Testimony: Set time limit**

c. **Move bill?** **Judiciary is next cmte of referral**

4. SB 44 – Approp: Fire Island Wind Farm

a. **SPONSOR: Senator Lesil McGuire and/or Marit Carlson-Van Dort**

b. **Public Testimony – Set time limit**

heard & held

– more signed up to hear

Meeting Adjourned @_____

SARAH PALIN
GOVERNOR
GOVERNOR@GOV.STATE.AK.US

P.O. BOX 110001
JUNEAU, ALASKA 99811-0001
(907) 465-3500
FAX (907) 465-3532
WWW.GOV.STATE.AK.US

STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

February 20, 2007

The Honorable Lyda Green
President of the Senate
Alaska State Legislature
State Capitol, Room 111
Juneau, AK 99801-1182

Dear President Green:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill relating to the authority of the Department of Environmental Conservation (department) to require certain monitoring, sampling, and reporting and to require permits for certain discharges of pollutants, and to criminal penalties for violations of the permit program.

Under the federal Clean Water Act, discharges of pollutants to surface waters require a permit either from the United States Environmental Protection Agency (EPA), or from a state that has received approval from the EPA to administer the permitting program. Alaska has applied to the EPA for approval of a state permitting program, and the EPA is currently reviewing Alaska's application. Under federal law, the EPA cannot approve a state program unless it is as stringent as the EPA's program. This bill would revise certain provisions of law governing the department's permitting and enforcement authority, in order to align the state's permit requirements with the EPA's. The changes are all designed to help facilitate final approval by the EPA of Alaska's program.

Three of the proposed changes would involve current exclusions from the requirement of getting a discharge permit. The first exclusion is for sewage. Current state law provides that the discharge of sewage into a "sewerage system" does not need a permit. Federal law exempts only discharges of sewage into "publicly owned treatment works." The difference is that the federal exemption is for sewage going to a place where it will receive treatment; while the state exemption is broader and needs to be amended in order to reflect a treatment requirement. The solution offered by this bill would be simply to change the state exemption so that it matches the EPA's: only sewage discharged to a publicly owned treatment works would be exempt from the permit requirement.