Alaska Oil and Gas Association

AOGA

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

TESTIMONY OF THE
ALASKA OIL AND GAS ASSOCIATION
TO THE SENATE FINANCE COMMITTEE
REGARDING CSSB 2001(JUD)

November 9, 2007

SUBMITTED IN WRITING INTO THE RECORD INSTEAD OF
BEING PRESENTED ORALLY TO THE COMMITTEE

Mr. Chairman and Members of the Committee:

My name is Marilyn Crockett and I am the Executive Director of the Alaska Oil and Gas Association ("AOGA"). AOGA is the trade association for the oil and gas industry in Alaska. Our 17 members account for the majority of oil and gas exploration, development, production, transportation, refining and marketing activities in the state. Our membership includes Agrium, Alyeska Pipeline Service Co., and Alaska's instate refiners. It includes companies new to this state, hoping for the opportunity to explore. It includes companies that are active today and do not yet have production (but hope to in the future). And it includes companies that are producing today and have been producing here for years.

As one of its important functions, AOGA provides a forum for its members to consider regulatory and legislative proposals, and to reach agreement about industry positions on those proposals. Normally, to establish an AOGA position, a 5/6 vote is required. This ensures that, when AOGA voices a position, regulators and legislators can be assured that that position is the position of the overwhelming majority of Alaska's oil and gas industry.

But on tax issues, AOGA takes this approval process to the highest level. We take positions about taxes only if there is <u>complete</u> consensus in our Tax Committee about what is to be said. Every member receives a copy of each proposed statement on taxes while it is still only in draft form, and if any of them objects to something in a proposed statement, either that portion of the statement is rewritten to satisfy the objection, or else it is deleted. My testimony today has been developed and approved under this principle, with no dissent.

Throughout this special legislative session, individual companies have presented their views based on their operations and the impact of the proposed legislation to their individual companies. The role for AOGA is obviously different, and we have focused our testimony on two key areas.

First, we've strived to put into perspective the critical importance of continued and future industry investment needed to address the most significant issue facing Alaska's future—declining production to the State of Alaska.

Second, through AOGA's Tax Committee, we've provided very specific comments on the numerous technical components of the versions of the legislation before each committee. We've relied heavily on the expertise and experience of our Tax Committee members who have years of experience operating within the state's tax structure.

We've heard it said repeatedly that our industry will "game the system" to take unfair advantage of the State — even to the point, some have asserted, of improperly claiming costs for lobbying, advertising or donations to Alaskan charities, despite assurances by the Administration that those costs are not allowed under the present law and will not be tolerated on audit. Accusations of "gaming the system" implies the companies will cheat on their taxes and cheat on the way they do business, if they think they can get away with it. Not only is that against the law, it is an insult to the integrity of the thousands of honest Alaskans who work in our industry.

Further, we all probably know, or know of, individuals who "game the system" a little bit when they report and pay their own income taxes to the IRS. They might pad a deduction, or fail to include cash income they got, or fudge their tax a little in some other way. To the extent someone might do this, it is because he or she feels the odds of being audited and caught by the IRS are small enough to make it worth taking that chance. But do you know anyone who would "game the system" if the chances of being audited by the IRS were 100 percent? Of course not. Well, oil companies are audited twice. First, by each other to ensure no unnecessary or inflated costs are charged to one another when they jointly operate a field. And these audits are every bit as aggressive as the IRS in making sure no costs are improperly included in the bills they have to pay. Second, oil company returns are audited for every state tax they report and pay to the State, for every tax period. The State's present oil and gas tax auditors are smart, experienced and professionally qualified, and we expect the new ones to be hired will be equally good.

Most recently, we hear it being said that the Gaffney Cline economic model shows Alaska can safely raise the production tax far beyond PPT's current levels without jeopardizing investments for the North Slope. I'm no expert, so I left their Capex Multiplier, Opex Multiplier and Production Multiplier at 100%. Then, when I plugged zero in as the value of the oil, the model came up with the totally unexpected result that the producer's internal rate of return is 156 percent. I got the same result when I plugged zero in as the volume of oil being produced, instead of plugging it in as the price.

After I testified about this to the House Finance Committee yesterday, Gaffney Cline was invited to the witness table and explained to that Committee that the model is including the results from several prior years' worth of in-fill drilling as well as those from the new investment. Gaffney Cline said, of course the model would still show profits because those prior investments are still making a lot of money under the model. And that's true.

But this answer has made me wonder, who in the world makes new investment decisions on the basis of how well or poorly past investments are performing? Industry's investments today have to stand or fall on their own merits, not on past successes or failures.

The point I was trying to make to House Finance, and which AOGA is now making to you in Senate Finance, is that the Gaffney Cline model has very clear and rigid limitations about how it should be used, and about the validity of its results in predicting future investment behavior. Rolling the success of past investments into the analysis of current ones is but one issue. Yet Gaffney Cline has testified that its model's conclusions about degree of economic success for the combined success of several years of in-fill drilling means this Legislature does not have to fear that investments in the Prudhoe Bay or Kuparuk fields will dry up if Alaska raises its production tax as has been proposed. It is this latter part of Gaffney Cline's testimony that we see as so dangerous for Alaska's future.

For one thing, the model relies a great deal on the internal rate of return of an investment and its net present value. These can be useful tools for evaluating an investment opportunity, but there are other very important metrics for judging investments as well. Suppose, for instance, I pay you everything I have right now, and at the end of 10 years you will give me 75 times what I'm giving you, but you will give me absolutely nothing between now and then. The internal rate of return on this "investment" is about 54% and its net present value, at 15%, is 17 ½ times my "investment" — nice enough figures even compared to some of the results of the model. But the problem with this "investment" is, if I want to feed, house and clothe my family anytime in the next 10 years, I won't have the cash to do it with this investment. The point is, it is often as important, or more so, to look at the cash with an investment as it is to look at its internal rate of return. But Gaffney Cline have focused on internal rates of return and net present values to the exclusion of other ways that investors use to evaluate investment opportunities.

Gaffney Cline doesn't say much about the economics of the other, more significant kinds of investments that will have to be made in order to meet the challenge of declining oil production. These other kinds of investments have materially different patterns and timing of cash flows from those for drilling an in-fill well. The engineering and design, fabrication, shipment to the Slope, and installation of a new production module to replace a 30-year-old gathering center in a "legacy field," for instance, will require years of capital outlays totaling hundreds of millions of dollars before the first barrel is ever produced through the new module. The effects of the time-value of money for this investment are very different from what they are for drilling a well.

The Gaffney Cline model does not reflect the difference in patterns and timing of cash flows for all types of investments.

Gaffney Cline also doesn't say much about differences in risk between different kinds of investment. They point out that new technology today allows an in-fill well to be drilled within feet of the desired path all the way to its target. They acknowledge that there is some risk to this, not very much — a point AOGA will concede, for the sake of argument, in the case of an in-fill well. However, a small risk in the case of in-fill drilling does not mean all investments in a "legacy field" have comparably small risk. Take, for example, the production module for infra-structure renewal that was just mentioned. What if the barge sinks or capsizes on the say to the Slope? Hundreds of millions of dollars would be sunk along with the module. There is nothing comparable to such a devastating risk. But the Gaffney Cline model doesn't take such differ-ences in risk into account. Or if it does, we have not heard them describe that modeling and its results in their testimony.

Gaffney Cline doesn't say much about the differences between producing conventional oil and viscous or heavy oil either. Oh, no doubt you can twist one of the knobs on their model to increase the operating costs and then say that this amounts to an approximation of the higher operating costs for viscous or heavy oil. But is it really? The friable nature of the West Sak and Schrader Bluff reservoir rock and the viscosity of that oil mean that large quantities of find particles like silt come up with the oil. It takes special equipment, or special modifications of equipment, in order to separate this silt from the oil. It is not easy or inexpensive to do, either in terms of capex or opex. Once that oily silt is separated, it becomes legally a "hazardous substance" that has to be handled and disposed of in accordance with very strict health, safety and environmental safeguards and procedures.

And heavy oil from the Ugnu formation may end up being produced by a technique that, in effect, creates streams of sand-like rock underground that flow through the reservoir rock, carrying the oil along with the flow of sand into the wells. The challenges and costs of separat-ing so much sand from the oil and then disposing of that sand are even greater than for separating silt from the less-thick viscous oil. Tweaking a knob on the model to triple the opex and capex for an in-fill drilling investment doesn't begin to approximate either the degree of costs, nor the timing of when they are incurred, for viscous and heavy oil development, nor does it recognize the discounted price that then heavy oil would be sold at to markets. Depending on the technological challenges are overcome, the economics of heavy oil development might actually turn out to resemble those for a mine more than they resemble the economics for a conventional oil field.

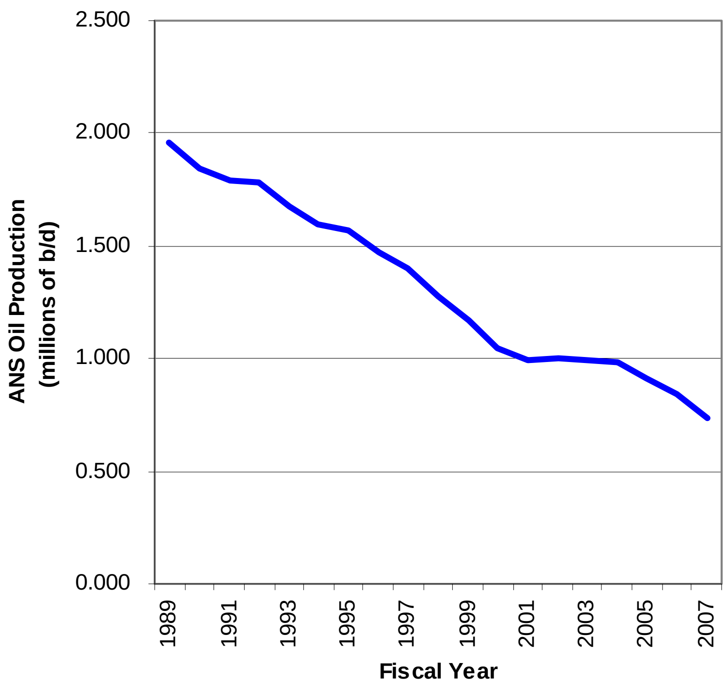
In summary, AOGA is not saying the Gaffney Cline model is seriously wrong. Rather, we're saying their model is incomplete. It deals with the in-fill drilling scenario with very impressive graphics, but it doesn't seem to deal at all with the very different economics for the investments that offer the greatest long-term effects and opportunities for Alaska. In addition, the model excludes future costs associated with the well, including operating, repairs and abandonment.

To state this point another way, if Alaska oil and gas opportunities are so very profitable, as the Gaffney Cline model leads one to believe, then why is production less than one third of its peak, and why have we only produced less than one quarter of the oil potential in Alaska? Even Pioneer and ENI have recently requested royalty relief for their developments. Doesn't that send a message on the challenges facing new explorers and future development of Alaska's resources? We believe that the focus needs to be on how to encourage the increasing diverse investment needed to develop Alaska's resource potential. Raising taxes will not help.

The realities that confront Alaska are these: First, nearly 90% of the discretionary money that the State is spending this fiscal year is coming from oil production, and the Department of Revenue ("DOR") predicts that oil revenues will account for over 80% of the State's unrestricted discretionary revenues through Fiscal Year 2013, and 70% or more of those revenues from FY 2014 to the end of its forecast period, FY 2017.[1] These percentages are before factoring in state revenues from a natural gas pipeline and from its associated natural gas production. Oil production has been, is today, and promises to remain the cornerstone of the finances of state government.

Second, production decline is eroding this cornerstone. On the next page is a graph showing how the average daily production rate for North Slope oil has become less and less since FY 1989. It is a historical fact that, on average from FY 1997 to FY 2007, North Slope production each year has been 6.2% less than the year before, while Cook Inlet oil production declined at an average of 8.0% a year.[2]

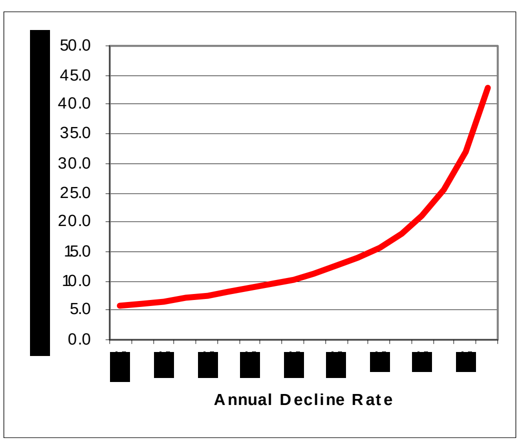
Third, it is going to cost billions and billions of dollars to slow this decline down. The North Slope's historical decline of 6% a year has occurred despite industry's investment of over

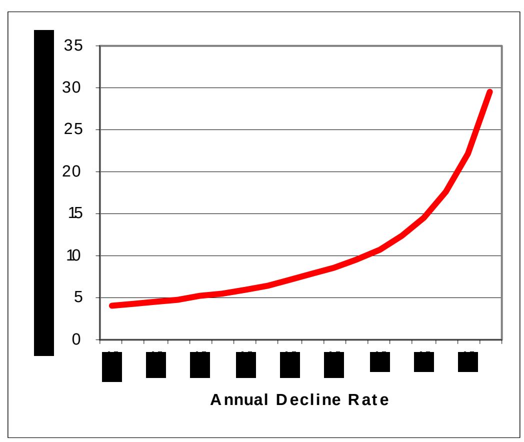


two billion dollars a year to produce more oil. Slowing the rate of decline below 6% will require each year massive increases beyond industry's already substantial, historic level of investment. We believe the investment level needs to increase to be over $3 to $4 billion to mitigate production decline. That is almost double the current level of investment being undertaken. Even the DOR's production forecast shows what increasing level of investment is needed. How do you attract the significant increase in investment needed? We don't believe increasing taxes will attract more investment, we believe it will slow down the investment levels needed. Increasing taxes will reduce the attractiveness of new projects and opportunities.

The difference between an ongoing decline of 6% a year and, for instance, 3% may not sound like much, but the difference for Alaska's future is profound. At present it seems the ultimate limit for North Slope oil production may be determined by the minimum capacity of TAPS to pump oil through the pipeline. The new pumps that Alyeska Pipeline Service Company is installing along the pipeline have a rated minimum capacity of 200,000 barrels a day, according to testimony cited during the House Resources Committee's hearings last week on HB 2001. However, the president of Alyeska earlier this year said publicly that the pipeline's minimum capacity with the new pumps will be about 300,000 barrels a day.

Whether the new pumps' operating threshold is 200- or 300,000 barrels a day, the point is the same: There is a big difference between a 6% decline and 3% in terms of how long it would take to get to either threshold from this fiscal year's projected level of 740,000 barrels a day.[3] Below are two graphs that show how big this difference is. I should emphasize that these charts are not predictions. They show only the purely mathematical results that flow from the decline rate one chooses.[4]





The chart on the left shows the time to decline from 740,000 barrels a day in FY 2007 to a 200,000-barrel-a-day threshold, the one on the right shows the time to get to 300,000 barrels a day. At a 6% rate of decline the 200,000-barrel threshold is hit in 21 years, but at a 3% decline it would take 43. If the threshold is 300,000 barrels a day, it would be hit after 15 years at 6% and 30 years at 3 percent. For either threshold, the difference between 3% decline and 6% decline gives enough additional time for almost an entire new generation of Alaskans to grow up. When AOGA says the choices facing this Legislature can affect the next generation, we mean it literally.

Fortunately for Alaska, the opportunities exist that should allow the rate of decline to be slowed below 6 percent. These opportunities are in oil and gas exploration, in the development of the huge resources of heavy and viscous oil that are already known to exist, and in the renewal and continued development of the existing fields. In our testimony before the committees previously considering this legislation, we have explained how all three kinds of investment in production will be needed if Alaska is to meet the challenge of production decline. The pattern and timing of the cash flows are different between one kind of investment and another, as is the amount of risk that each entails. But one thing is certain, they all are needed to maximize the resource recovery for Alaska.

One point that bears repeating is that the heavy and viscous oil resource lies within the areas of the so-called “legacy fields,” as does the preponderance of the remaining opportunities for squeezing more “conventional” oil out of currently producing fields. The renewal of the existing fields will become increasingly important, as the existing production facilities need to be adapted, retrofitted or perhaps even replaced in order to be fit for service for the coming decades. At the same time, in-fill drilling to drain the spaces between the existing wells, or develop new oil, offers the best promise of slowing decline in the short term. The pattern and timing of the cash flows are very different between in-fill drilling and renewal of major production facilities on the surface. So even within a classic “legacy field” without considering its resource of heavy and viscous oil, there is significant variation among the investments to be made, the economics for those investments, and the incentives for them. It would be a serious mistake to treat the “legacy fields” as economic monoliths, impervious to how they are taxed and unaffected by the incentives that may be granted them or withheld.

The last point I would like to make today is about destabilizing the investment climate here. In 2005 Governor Murkowski disregarded procedures established by regulation (15 AAC 55.027) and ordered DOR to aggregate certain fields within the Prudhoe Bay Unit, including fields with heavy oil in the West Sak formation, with the main field for ELF purposes. The result was an administratively created change in the tax law of over $120 million a year. Last year the Legislature enacted the PPT, further increasing the production tax by over $800 million during the last nine months of 2006 alone. And it did this retroactively back to April first of last year.

As I have explained, you have been allowed to have serious misimpressions about what the Gaffney Cline model really shows and about how limited its proper use actually is. These misimpressions have, in turn, led to a serious underestimating of the effects of this newest change on future investment decisions about exploration, heavy and viscous oil development, and the renewal and ongoing development of existing "conventional" fields. The laws of economics say there will be adverse impacts on investment decisions here if the Senate CS becomes law.

It is unfortunate that so many in the public, and even in the halls here, do not believe the warnings being given by the explorers and producers here. Perhaps even this AOGA testimony will change no one's mind. But I have to hope it will. The future of Alaska is at stake, and we urge this Legislature to pull back to safer ground.

Thank you for giving AOGA this opportunity to testify.

SPECIFIC COMMENTS ABOUT CSSB 2001(JUD).

Instead of proceeding section by section through the Bill, our comments are organized around four kinds of issues that the Judiciary CS raises — namely, issues about incentives for investment under the tax, issues about tax clarity, issues about sound tax policy, and issues about stability.

<u>A. Issues about Incentives for Investment</u>

<u>Tax rate</u>. We have said it before, no one ever taxed economic activity and prosperity into existence. Raising the base rate from 22.5% to 25% (Bill Section 18) moves away from the goal of attracting more investment to Alaska.

<u>Progressivity</u>. AOGA is not asking to change progressivity from the present tax. However, the Judiciary CS would significantly increase progressivity from what it is now (Bill Sections 18 & 19). The threshold where progressivity begins would drop from $40 a barrel to $30, and the slope would increase from 0.25 percentage points per dollar to 0.4 percentage points. The resulting increase in progressivity under the CS falls within our caveat about taxing investments into existence.

If progressivity is going to be changed, one important reform that should be made is to adjust the threshold price for inflation. Even if inflation averages only 3% a year for the next decade, $40 then will be have the buying power that $29.50 has today, and $30 then will equal a mere $22.12 in today's dollars.

<u>Minimum tax</u> (Bill Section 17). One element that increases the attractiveness of a tax system is the sharing of risk by the government with the investor, whether the risk turns out well or poorly. With progressivity, Alaska would take a greater share for itself of the upside for price risk. But a minimum tax would avoid or reduce the State's exposure on the downside of price risk. Having a minimum tax along with progressivity would harm Alaska's investment climate.

<u>Annual-loss credits</u>. The present law, AS 43.55.023(b), allows a tax credit for a "carried-forward annual loss" that occurs when a producer's lease expenditures during a year exceed the gross value at the point of production of its oil and gas. However, the present tax rate is 22.5%

while credit is only 20% of the surplus (unused) lease expenditures that give rise to the annual loss. This hurts explorers and those who are about to become producers but aren't quite into production yet. They don't have any value of production to subtract their lease expenditures from, and the resulting 20% credit puts them at a disadvantage relative to those with current production, because the benefit of deducting lease expenditures for a current producer is 22.5% of the amount deducted.

The Judiciary CS would increase the tax rate to 25% (Bill Section 18), which will widen this disparity between producers and those not yet having production. The CS should be amended by adding a Bill Section increasing the percentage for the "carried-forward annual loss" credit under AS 43.55.023(b) so it matches the non-progressivity portion of the tax rate.

<u>TIE credits</u>. AS 43.55.023(i) allows a 20% tax credit ("TIE credit")[*] for capital expenditures ("capex") made during the five-year period ending March 31, 2006, but the amount of TIE credit is limited by a two-for-one rule in which each dollar of old capex must be matched by two dollars of new capex in order for the TIE credit from the old capex dollar to be claimed. The Judiciary CS (Bill Section 29) would change AS 43.55.023(i) so that only new producers who didn't have production before 2008 could take TIE credits, and their new capex under the two-for-one rule would have to be incurred during the 21 months beginning April 2006 and ending December 2007. These changes to the TIE credit would be retroactive to January 1, 2007 (Bill Section 72(b)). The effect of this retroactivity would be that old producers, with production before 2008, could only use new capex incurred during the last nine months in 2006 under the two-for-one rule to get TIE credits and then they would be cut off from any further TIE credits.

AOGA objects to this disparity in treatment under the two-for-one rule between old producers, who would get only nine months of new capex for purposes of using the rule, and new producers who would get 21 months. If the period for making new capex is to be cut back at all from its present five years, it should be cut back to 21 months instead of only nine.

But, more fundamentally, cutting the present five-year period for new capex would prematurely abandon a very effective incentive for companies with production to invest more during the period ending with 2013,[5] both by expanding their plans and by accelerating projects forward into this period. Cutting off the TIE credits may represent a savings for the State in the short run, but it is one that is not needed at the present time, while cutting them off risks the additional production that promises to result from increased investments made in response to the incentive from the TIE credits.

<u>Credits against minimum tax</u>. The Judiciary CS (Bill Section 31) would eliminate existing references to AS 43.55.011(f) in AS 43.55.024(c) and thereby make the annual "small producer" credit inapplicable against the minimum tax. This change raises the question about which is more important — ensuring that the minimum tax sets a true minimum on a taxpayer's

---

[*] "TIE" stands for "transitional investment expenditures" which is the term used in the statute creating this credit, AS 43.55.023(i).

tax liability, or maximizing the incentives for new investment that tax credits will offer. Since the minimum tax can go to down to a zero-percent rate if West Coast prices average $15 or less during a year,[*] there is no minimum tax liability that it establishes or defends, and so this cannot be a very important consideration. Getting all the investments that will be needed to meet the challenge of declining North Slope oil production, however, is the lynchpin for Alaska's economic future. So this is a simple decision: let the "small producer" credit continue to be allowed against the minimum tax.

Consistent with this conclusion, new Bill Sections should be added to the Judiciary CS to amend AS 43.55.023(a) and (b) so they will allow the application of the capex and "annual loss" credits, respectively, against the minimum tax.

<u>The "oil and gas tax credit fund"</u>. This fund would be established (Bill Section 42) so explorers and producers who don't yet have production could sell their tax credit certificates at full face value instead of at a discount. We believe that a major reason there might not have been a great deal of demand to purchase such certificates is the limitation under AS 43.55.023(e) that forbids a taxpayer from using purchased certificates to reduce its tax liability below 80% of what it is before applying those certificates. For companies that are otherwise willing to purchase tax credits, lowering this limit from 80% would allow them to purchase more certificates, thereby stimulating demand for them. This, in turn, could reduce the demands on the Oil and Gas Tax Credit Fund to purchase certificates.

We support the establishment of the Oil and Gas Tax Credit Fund, provided future Legislatures will appropriate the necessary funds for it to work. We also urge reducing the 80% limitation in AS 43.55.023(e).

<u>Inappropriate and excessive penalties</u>. The Judiciary CS (Bill Section 49) would establish a new penalty of 20% for a "substantial understatement of tax" on a production tax return, and another new one of 40% for a "gross understatement" on a return. The threshold for an "understatement" to be "substantial" is 10% of the correct amount of tax or $10 million, whichever is less. For it to be "gross" these are 20% or $20 million, whichever is less. The amount of these penalties is based on the total amount of tax that should have been reported, not on the amount of the "understatement."

AOGA objects to these penalties for four reasons. First, unlike the existing penalties of 5% for negligent underpayment[6] and 25% for failure-to-pay,[7] these penalties are based on the total amount of tax due, not the amount of the underpayment. This is excessive and unfair. Second, these penalties are in addition to the 5% negligence and 25% failure-to-pay penalties, which are themselves cumulative.[8] This makes them even more excessive than they would be standing alone.

---

[*] AS 43.55.011(f)(5): "The levy of tax ... may not be less than ... (5) zero percent of the gross value at the point of production when the average price per barrel ... is $15 or less."

Third, these penalties are to be imposed on a "strict liability" basis. There is no relief from them even if there is reasonable cause for the underpayment. Given that the classification of an expenditure as capex instead of opex[9] under federal income tax principles will have a great effect on the tax credits that a taxpayer will have, and given further that the annual "PPT tax return" is due March 31st of the following year while partnership tax returns for federal income tax are not usually filed until October 15th of that following year, it is all but impossible even to achieve the 20% accuracy that is the standard for "gross understatement[s,]" much less the 10% standard for being only "substantial[ly] understate[d.]" This "strict liability" standard, together with the massive size these penalties threaten to be, makes them arbitrary and capricious and a denial of basic Due Process.

Fourth, what kind of welcoming message would these egregious penalties give to potential new explorers and producers, to make them feel that Alaska is open and ready to do business with them?

B. Issues about Tax Clarity

Tax cap for non-Cook Inlet natural gas. This may be an example of good intentions with unintended consequences. The Judiciary CS would enact a new subsection (o) in AS 43.55.011, which would put natural gas produced anywhere in the state outside the Cook Inlet sedimentary basin under the same cap on its tax rate that exists for Cook Inlet gas, provided that non-Inlet gas is being used in state (Bill Section 24 [10]). This non-Inlet cap under subsection (o) would expire in 2022.

AS 43.55.011(o) may have been put into the Bill so that production tax on natural gas that is liquefied and trucked in liquid form to Fairbanks for sale as gaseous natural gas to about 1,000 residential consumers would not have a 22.5% or 25% "premium" rolled into its price to reflect production tax on that gas.

AOGA would not object to this purpose if indeed it is why subsection (o) is in the Bill. However, applying the Cook Inlet ceiling to North Slope gas would unnecessarily complicate the taxes for North Slope oil and gas production. Lease expenditures and tax credits would have to be allocated between oil and gas production, and the order in which tax credits could be applied, if at all, against the tax on the gas production would be tightly limited.

These complications could be avoided while still achieving the objective of avoiding a tax "premium" in the price for North Slope natural gas being used in state, if a specific portion of the value of that gas is excluded from the determination of the taxable "production tax value" under AS 43.55.160.

For instance, suppose the applicable Cook Inlet cap is the one under AS 43.55.011(j)(2) for leases or units coming into production after March 31, 2006, and suppose further that under (j)(2) the "average tax rate that was imposed under this chapter on taxable gas produced from all leases or properties in the Cook Inlet sedimentary basin for the 12-month period ending on March 31, 2006" was 4% under the ELF, and that the "average prevailing value for gas delivered in the Cook Inlet area" during that 12-month period is the $3.585 average for DOR's published Cook Inlet prevailing values for that period.[11] Then the maximum tax for North Slope gas being used in state would be 4% of $3.585, or 14.34¢ per thousand cubic feet ("Mcf"). Now suppose that the tax rate under AS 43.55.011(g) is 30% because of progressivity. Dividing 14.34¢ by 30% yields the value of the gas at which the new tax equals the cap under the old ELF-based tax. This value is 47.8¢ per Mcf. To limit the tax to 14.34¢ per Mcf, all that is necessary is to exclude the value of the gas in excess of 47.8¢ from the calculation of the taxable "production tax value" under AS 43.55.160.

Instead of amending AS 43.55.011 by adding subsection (o) with all its complications for North Slope producers, it would be easier and just as effective to amend AS 43.55.160. Suggested language for such an amendment appears in the endnotes to the written version of this testimony.[12]

<u>What is being "confirm[ed]" under paragraph (2) in Bill Section 1?</u> Bill Section 1 sets out certain legislative intent regarding the enactment of the Bill. Paragraph (2) of that statement of intent declares that the enactment of AS 43.55.075(b) in Bill Section 50 "confirms by clarification the long-standing interpretation of AS 43.05.260 by the Department of Revenue[.]" AS 43.05.260 is the present statute of limitations for auditing and making tax assessments, which applies generally to all taxes under AS 43 except those few having their own specific statutes of limitations. Unless and until the proposed production-tax statute of limitations (AS 43.55.075) is enacted, AS 43.05.260 is, and has always been since its enactment, the statute of limitations that applies to production-tax audits and assessments.

Rather than leaving it open for dispute about what DOR's "long-standing interpretation" of the general tax statute of limitations might be, a Bill Section should be added to the Judiciary CS to amend AS 43.05.260 so that it says exactly what DOR intends it to mean under that "long-standing interpretation" — including, in particular, anything about reopening tax periods that are otherwise already closed under this statute of limitations, so that DOR could then claim additional tax due to retroactive decisions that change the parameters for calculating the tax for those tax periods. Then, if there is disagreement over whether that amendment is constitutional, the dispute can start directly with those constitutional issues, instead of both sides having to skirmish their way through these pointless preliminary questions.

If DOR cannot tell you specifically how AS 43.05.260 should be amended, that would be all the more reason to delete paragraph (2) in the statement of legislative intent in Bill Section 1. If even they cannot tell you exactly what it is they want, you shouldn't give it to them until they can.

I should add that, whichever way SB 2001 might end up doing it, the retroactive change in meaning that DOR is seeking for AS 43.05.260 would be unconstitutional if applied to tax periods already closed unless there is a closing agreement that specifically provides for such a redetermination of the tax for those periods.

Advisory bulletins. The Judiciary CS would enact a new subsection (g) in AS 43.55.110, which would authorize DOR to issue "advisory bulletins stating the department's interpretation of provisions of this chapter and of regulations adopted under this chapter" (Bill Section 51). Although subsection (g) says these bulletins would be "for the information and guidance of producers, explorers, and other interested parties," it also says the statements in the bulletins "are not binding on the department or others" unless DOR provides otherwise by regulation. Such a regulation could only make a specific statement binding, rather than establishing a general rule to make all statements in the bulletins binding. This is because, to the extent a particular statement would be binding, it is a "regulation" for purposes of the Administrative Procedure Act[13] and would have to be formally adopted as a regulation in accordance with the APA in order for it to be valid.[14]

We see little or no practical use for such "advisory bulletins." The Alaska Supreme Court, in its 1982 *Wien Air* decision,[15] has held that even when a taxpayer acted in good faith after its accounting firm twice checked with DOR about its interpretation of a federal tax law adopted by reference for Alaska income tax purposes, DOR was not bound by the advice it had given. In other words, if taxpayers act in reliance on the DOR "interpretation[s]" of the production tax statutes and regulations as set out in these bulletins, they would do so at their peril under *Wien Air*. Unless and until *Wien Air* is overruled by the Court or overridden by legislation changing the tax laws, advisory bulletins of the type contemplated promise only to be traps for the unwary.

Qui tam. The Judiciary CS would enact a new subsection (h) in AS 43.55.110, which would allow DOR to compensate whistleblowers who report noncompliance with the production tax to DOR. The amount of this compensation could not exceed $1 million or 10% of "the additional tax, penalty, or interest collected as a result of the information" provided by the whistleblower, whichever is less. Payment of the compensation would be subject to legislative appropriation.

The whole concept of *qui tam* proceedings is inapplicable and inappropriate in the context of petroleum production taxes. Because of the confidentiality of tax information, the only people who know the particulars of a company's production taxes are the folks in that company who are involved in preparing and filing those taxes, and the state employees, principally in DOR, who administer and enforce this tax. No one working for the company in preparing and filing the tax returns is a plausible candidate for becoming a *qui tam* relator because those tax returns are filed "under oath," and the penalties for perjury would be applicable if a false or erroneous return were knowingly filed. And it would be completely improper to allow state employees who review or audit the company's tax returns to be *qui tam* relators because it is already their job to find erroneous, false or fraudulent information in taxpayers' returns.

Transportation costs in determining gross value at the point of production. The Judiciary CS proposes amendments to AS 43.55.150(a) allowing DOR to require "reasonable costs" of transportation based on its "market value" instead of "actual costs" if, one, the "parties to the transportation are affiliated[,]" two, the transportation contract is neither "an arm's length transaction" nor "representative of the market value of that transportation[,]" or, three, the "method of transportation being used is not reasonable in view of existing alternative methods of transportation" (Bill Section 52). Currently the statute requires all three conditions to be met before DOR may set aside a producer's "actual costs" of transportation.

DOR has done very well in defining clearly what the "actual costs" are for unregulated transportation that is by a carrier affiliated with the shipper or is otherwise at less than arm's length. It has very specific regulations about the kinds of operating costs incurred that are deductible for netback purposes,[16] and even more specific regulations about capital expenditures, their deemed recovery through depreciation, the portion of the capital investment made with borrowed funds, and a reasonable allowance for an after-tax return on the remaining unrecovered equity portion of the capital investment.[17] We see no reason for DOR to go charging off after some "market value" for transportation instead of DOR's tightly defined "actual costs" for it, particularly since DOR's own experience with "market value" in the past has often found it to be either unduly subjective or unacceptably circular in terms of what it is based upon.[18]

The Judiciary CS also would amend subsection (b) of the statute so that only transportation tariffs that have been "adjudicated" to be "just and reasonable" by a regulatory agency like the Regulatory Commission of Alaska or the FERC are deemed on their face to be "reasonable costs" of transportation (Bill Section 53). Currently the statute deems tariffs "properly on file" with such a regulatory agency to be "reasonable" on their face, which means the regulatory agency is allowing those tariffs to be charged and collected from the shippers shipping oil or gas through the regulated transportation facility.

AOGA takes no position about what any regulated transportation tariff should be, or about how the amount of such a tariff should be determined. These latter issues are controversial and disputed, and AOGA has members on opposite sides of them.

However, we can say that, whatever the amount may be that a shipper pays to a government-regulated carrier for any transportation of oil or gas occurring between its point of production and its eventual destination or delivery point, the amount so paid should be deducted as a transportation cost in determining what the gross value at the point of production is under AS 43.55 for that oil or gas.

To do what the Judiciary CS proposes would create uncertainty and innumerable tax disputes about when an "adjudicat[ion]" has been made about whether a particular tariff is "just and reasonable[.]" Is it when the agency issues its decision, or when that decision is finally affirmed and cannot be appealed or collaterally attacked any further? If the latter, what does the taxpayer use as its transportation cost for that transportation before the regulatory agency's decision ultimately becomes final? What happens if, once the agency's decision does become final, the regulated carrier issues a new tariff to replace one that has just been "adjudicated" not "just and reasonable"? Can such a new tariff be used as a taxpayer's transportation cost until the regulatory agency "adjudicate[s it] as just and reasonable"?* Or is it to be set aside in favor of some other interim or provisional "cost," and if so, who determines that "cost" and under what standards and procedures?

These are terribly important issues for taxpayers, especially in light of the colossal new penalties being proposed in Bill Section 49. Clarity about the answers to all these questions and others will be essential in order for taxpayers to be able to comply with the tax and pay the tax that is due as it becomes due. Clarity on these matters will be equally essential for tax auditors to be able to enforce the tax because, without that clarity, they may have to answer these questions on their own without clear guidance, and different auditors might reach inconsistent answers.

In contrast to the situation that would arise under Bill Section 49, DOR now provides great certainty with the present version of AS 43.55.150(b) with its "prima facie" use of tariffs "on file" with the regulatory agencies that allow those filed tariffs to come into effect.

C. Issues about Sound Tax Policy

Confidentiality – public disclosure of aggregated information. The oil and gas industry has been, and in prudence must be, especially sensitive to antitrust considerations and the more recent Securities and Exchange laws. In addition, companies in our industry, like those in any other industry or business, are highly competitive against one another. No one wants their business plans or strategies, or any other information and material of a competitive or proprietary nature, to be disclosed to a competitor. For these business reasons and because of the severe criminal penalties and harsh public censure that would arise from violating antitrust or Securities and Exchange laws, each company in our industry is very careful and cautious about providing anyone outside the company with commercially sensitive information or materials that even potentially have antitrust concerns.

This great caution applies even to providing information and materials to government agencies, unless there are clear legal safeguards in place to ensure that those agencies can and will preserve the confidentiality of that information and material. We may not use government as a means to circumvent the law, nor may government become an instrument for doing so. Questions of state sovereign immunity aside, state employees seem unlikely to be personally immune from prosecution for violating federal antitrust or Securities and Exchange laws or for "conspiring" to violate them if they start publicly disclosing confidential and commercially sensitive tax information of a potentially antitrust nature.

This brings us to the new public-disclosure statute, AS 43.55.890, that would be enacted under Bill Section 63 of the Judiciary CS. Under paragraph (1) of this new statute, the existing tax confidentiality law simply would not apply if DOR publishes otherwise confidential tax information, so long as it has been "aggregated among three or more producers or explorers[.]"

---

* Of course, if the carrier's replacement tariff is not "adjudicated as just and reasonable" by the regulatory agency, then we're back to the earlier question about what a taxpayer is supposed to use as its cost for that transportation under AS 43.55.150 while the regulatory agency's decision is being appealed or collaterally attacked.

This published information may be "by month or calendar year and by lease or property[or] unit[.]" Consider what this language would allow DOR to do. The Prudhoe Bay, Kuparuk River and Duck Island (Endicott) units each have at least three working-interest owners, so DOR could publish specific operating and capital cost information for past years or the current one, as well as planned operating and capital budgets for each participating area in these units in the coming years. A working-interest owner's share of these unit or participating-area costs is determined by its working-interest percentage in that property, and those percentages are public information. So DOR's published information would allow anyone to calculate a working-interest owner's specific share of the costs for any of these units or participating areas. Any working-interest owner having no producing interests outside the Prudhoe Bay, Kuparuk River and Duck Island units could calculate precisely that owner's total costs or budgets for its entire production operations in the state. As if to confirm this dangerous possibility, paragraph (2) of the new statute specifically allows DOR to publish "the total amount of lease expenditures for <u>each</u> producer required to report under AS 43.55.040(5)" (emphasis added).

DOR says it wants this new statute only so it will be able to share with the Alaskan public specific details about how the production tax is working with respect to "legacy field" operations, heavy and viscous oil development, and exploration. DOR adds that it doesn't intend to disclose any tax information. But this is not what they have written in this legislation. Existing law already allows DOR to publish "statistical" information based on confidential materials, and nothing prevents those statistics from being specifically for "legacy fields" as a whole, for heavy and viscous oil development as a whole, and for exploration as a whole. Bill Section 63 in the Judiciary CS is dangerous and unnecessary, and should be dropped from the Bill.

<u>Confidentiality – information-sharing from DOR to DNR</u>. Land ownership and the management of owned lands are not inherently sovereign functions and actions. Any private person or corporation could own the acreage at Prudhoe Bay the same as the State does, could lease that land the same as the State has, and would have the same rights and authorities to enforce those leases as the State has under its leases. The fact that the actual owner of those lands happens also to be a sovereign does not change or augment its property rights in the land, nor its contractual rights, privileges or obligations under those leases. To the contrary, under the Contract Impairment clauses of the United States and Alaska constitutions,[19] the State cannot use its sovereign powers to alter unilaterally the terms and conditions of the oil and gas leases it has entered into.

The rights of the Department of Natural Resources ("DNR") to have a royalty share of the oil or gas produced from a state lease and to choose to take that share in value (royalty in value or "RIV") or in kind as physical oil or gas (royalty in kind or "RIK") are created and exist under the contractual terms of the individual oil and gas leases that DNR has entered into. Taking state royalty in kind and marketing it are no more inherently sovereign in nature than any of the State's other rights or obligations under the leases. So when DNR is actively marketing RIK oil or gas, or is planning to, it is a competitor against the very lessees producing the oil or gas from which RIK production is taken.

If DOR gives DNR tax information under AS 43.55 about a producer's current budget or budget plans for any lease, property or unit, DOR will be giving that information to a competitor if DNR is actively marketing RIK oil or gas, or is planning to, at that time. Depending on the specific information given to DNR and on DNR's specific plans or activities regarding RIK production, that sharing of information might constitute a violation of antitrust or Securities and Exchange laws. DOR has testified that it will observe all federal laws, but such good intentions won't prevent forbidden information-sharing through inadvertence, and they can't guarantee that prosecutors after the fact won't conclude that the sharing of specific information with DNR did indeed violate such a law. We believe these risks could be minimized if the information-sharing provisions in the existing tax confidentiality statue, AS 43.05.230, were amended to suspend the DOR's sharing of tax information with DNR while DNR is marketing RIK production or is actively planning for the marketing of RIK production

We are also concerned that DNR might obtain from DOR information about individual producers' budgets and planned budgets for exploration and bidding in lease sales in the current year or subsequent ones. DNR has no right to information about what potential bidders might be planning to bid in upcoming state leases, and it would be improper for DOR to give such information to DNR. By setting the schedule for holding lease sales of promising exploratory acreage so they occur when certain companies have larger budgets or plans for this purpose or when other companies have smaller budgets or plans, DNR could influence who wins and who loses in the bidding. An important explorer has testified to other committees during this special session that this possibility is of serious concern to it, and AOGA is telling you that this is of serious concern to the rest of our membership as well.

The Judiciary CS would already amend AS 43.05.230 (Bill Sections 13 & 14), so it would be appropriate to include provisions in the Bill to suspend information-sharing when DNR is about to compete actively in the marketplace against other producers, and to prevent the disclosure of information about budgets and plans for exploration or participation in lease sales for state lands.

The Judiciary CS would also provide that an explorer must give DNR extensive confidential and proprietary information from its exploratory work as a pre-condition for getting exploration credits for that work under AS 43.55.025 (Bill Section 36). This new information is so extensive it takes the better part of three pages in the Bill[20] with bold underlined font to list it all. It is inappropriate to use the taxation power to require a producer to provide such extensive proprietary information that is, at most, of insubstantial use in administering the tax law. The real purpose is to give DNR that information, which it would not otherwise be entitled to receive. And by releasing that information to the public after just two years, DNR would destroy the value of the explorer's investment to gain that information.

In terms of tax policy, Bill Section 36 promises to undercut almost all the incentive for exploration that the exploration credits under AS 43.55.025 are intended to provide. It is far more important for Alaska's future to have the exploration, than to take the results of that exploration and put them into the public domain after just two years.

Who should benefit from tax credits arising from expenditures for oil and gas exploration, development and production by the North Slope Borough and the Municipality of Anchorage, the State or the ratepayers of the municipality's utility? The Judiciary CS has a provision forbidding the sale of exploration credits under AS 43.55.025 by "an entity that is exempt from taxation" under the production tax (Bill Section 37). The original version of SB 2001 as introduced also contained a provision against the issuance of sellable tax-credit certificates under AS 43.20.023 to such tax-exempt entities.[21]

It is a matter of public record that the North Slope Borough owns the Barrow Gas Field and produces gas for the residents of Barrow,[22] and that the Municipality of Anchorage owns a one-third working interest in the Beluga River Gas Field[23] through its operating division, Municipal Light & Power. If the municipalities can get production-tax credits which they then sell to the Oil and Gas Tax Credit Fund or to producers who can use those credits, the proceeds from those sales will reduce the operating costs of the utilities run by these municipalities, and presumably the Regulatory Commission of Alaska will ensure that the resulting savings in operating costs are passed on to the utilities' respective ratepayers. If the municipalities cannot get and sell these tax credits, then those municipal expenditures will generate no tax credits to be applied against the production tax or sold to the Tax Credit Fund, and the benefit that those credits would have had will flow into the state General Fund as tax revenue.

The proposed disallowance of tax credits for expenditures by these municipalities raises a tax policy question that the Legislature, not the Administration, should answer. The Administration has declined to identify these two municipalities, citing taxpayer confidentiality despite the fact that municipalities are not taxpayers and despite the further fact that information about these municipalities owning gas production and using that gas as utilities is already in the public domain. As a result, no one but AOGA has told the Legislature that it has to make a choice here between giving the benefits from the municipalities' credit-generating expenditures to the ratepayers of the respective municipal utilities, or giving those benefits to the state government. We are doing so again.

This is properly a policy call for the Legislature to make, and AOGA has no position about which way the Legislature should make this call. Our concern is only that the Legislature will make that call with an awareness that it is making a call. Whichever way the Legislature decides, we believe its choice should be a deliberate, knowing one.

Law by Regulation Bill Section 57 of the Judiciary CS would amend the definition of what constitutes deductible "lease expenditures" in AS 43.55.165(a), so it would read in pertinent part:

> For purposes of this chapter, a producer's lease expenditures for a calendar year are (1) costs ... that are ... (B) allowed by the department by regulation.... [emphasis added]

Grammatically the phrase "by regulation" modifies the verb "allowed" by showing how this "allow[ing]" is to be done. As a result, the regulation it calls for is as part of the actual substance of the law, instead of being a regulation merely to interpret or apply the law, as regulations ordinarily are.[1] This difference from an interpretive regulation is illustrated by the language calling for such an interpretive regulation in the same statute, on lines 26-27 on page 40 of the Judiciary CS: "a reasonable allowance ... as determined under regulations adopted by the department" (emphasis added).

DOR has testified that it intends "allowed ... by regulation" to mean that it could adopt a regulation listing the kinds of costs that are "direct" costs, which is one of the conditions for being a deductible lease expenditure. But AS 43.55.165(b)(1)(G) in lines 22-23 on page 41 of the Judiciary CS specifically covers this, by including in its list of "direct" costs any and all "other direct costs as may be established in regulations adopted by the department" (emphasis added). So the provision phrase "by regulation" in section 165(a)(1)(B) is not needed in order to establish DOR's intended list of other "direct" costs.

There are really only two meanings that "allowed ... by regulation" can reasonably have. One is that DOR will adopt a regulation to "allow" costs for a particular unit, or for a particular producer, or perhaps even on an item-by-item basis. This is possible, but seems unnecessary in light of the interpretive regulation called for under section 165(b)(1)(G) in lines 22-23 on page 41 of the Judiciary CS. Such a regulation might also lack the "general application" required to be a real regulation.[24]

The other meaning for "allowed ... by regulation" is that this regulation may actually dis-"allow" expenditures that are otherwise "direct" under section 165(b), "ordinary and necessary" under section 165(j)(2), and incurred for oil and gas exploration, development or production. This is tantamount to letting the regulation override the provisions on these other subsections of the statute. And if the regulation can narrow the scope of subsections (b) and (j)(2), what would stop it from being able to narrow the scope of paragraphs in subsection (e) that disallow certain categories of costs from being lease expenditures?

In effect, this "allowed ... by regulation" language could be read as allowing DOR in this regulation to overrule the balance that the Legislature has crafted about what kinds of costs can be included in deductible lease expenditures and what kinds cannot. While we are doubtful that the Legislature, under the Separation of Powers Doctrine,[25] could delegate so much legislative power to DOR in the Executive Branch, it is not AOGA who will give the definitive answer on this. Meanwhile, until there is such an answer, there is the chance that DOR — perhaps in some future Administration — might attempt to apply the "allowed ... by regulation" language in this way. That would place the very law of this production tax under the will of whoever is administering it.

AOGA is not calling for a radical change in the Judiciary CS to forestall even the possibility of such a bizarre situation. All that is needed is the deletion of the words "by

---

[1] " '[R]egulation' means every rule, regulation, order, or standard of general application ... adopted by a state agency to implement, interpret, or make specific the law enforced or administered by it[.]" AS 44.62.640(3).

regulation" that appear in line 16 on page 40 of the Judiciary CS.

Enforcement by taxation of contractual lease obligations. The Judiciary CS would amend AS 43.55.165(e)(6) so that "costs arising from ... failure to comply with an obligation under a lease" would be excluded from a taxpayer's deductible lease expenditures (Bill Section 59). As explained earlier, a person's obligations under a lease are contractual in nature, and the penalties for violating those obligations are prescribed in the lease.[26] It is inappropriate for the State to use its sovereign taxation powers to advance DNR's contractually based, non-sovereign authority to enforce obligations under the leases it enters into.

Disallowance of costs for legal notices required by law. The Judiciary CS would amend AS 43.55.165(e)(8) so that "costs of ... advertising" would be excluded from a taxpayer's deductible lease expenditures (Bill Section 59). AOGA agrees that the costs of commercial advertising to sell a taxpayer's products or to enhance its reputation are not "direct" or "ordinary and necessary" costs of exploring for, developing or producing oil or gas. However, we are concerned that "advertising" might be broadly construed or applied so as to include the costs of legal notices or legal advertisements that a taxpayer is required to make in order to obtain a permit, license or similar authorization or permission from a governmental agency for oil and gas exploration, development or production activities. Our proposed change to the Judiciary CS to avoid this unintended result appears in the endnotes.[27]

Disallowance of the entire cost in transactions between related parties. The Judiciary CS would amend AS 43.55.165(e)(12) so that expenditures under a transaction between affiliates or related parties would be disallowed unless the taxpayer "establishes to the satisfaction of the department" that those expenditures do not exceed the "fair market value" for them (Bill Section 59). There are two problems with the proposed change. First, to prevent DOR from arbitrarily withholding its approval of such an expenditure, the taxpayer should establish "to the reasonable satisfaction" of the department that it doesn't exceed fair market value for it. Second, if the taxpayer cannot make the showing to DOR's satisfaction, the entire expenditure is disallowed instead of the portion of it that exceeds fair market value. AOGA believes that, if an expenditure has actually been incurred, it should be allowed except for any part of it that is found to exceed fair market value. But disallowing the entire cost, instead of the portion of it that exceeds fair market value, is itself excessive and undercuts a major purpose of this tax, which is to provide incentives for investment.

Allowance or disallowance of overhead costs. The Judiciary CS has inconsistent provisions about whether any allowance should be made for overhead costs. Bill Section 57 would repeal and reenact AS 43.55.165(a) so that paragraph (2) of that subsection would authorize "a reasonable allowance for that calendar year, as determined under regulations adopted by the department, for overhead expenses that are directly related to exploring for, developing, or producing, as applicable, oil or gas deposits." At the same time Bill Section 59 would add paragraph (22) to AS 43.55.165(e) disallowing "overhead, office, or administrative expenses, and all other indirect costs of oil or gas exploration, development, or production."

When an operator bills the non-operator participants in a unit or other oil and gas operation, "typical industry practices and standards"[28] call for an allowance for overhead to be included in the amount billed. For those non-operators, the overhead component of the bill is just as real, and costs just as much, as the rest of the expenditures being billed. Under its regulations called for in AS 43.55.165(a)(2), DOR would have control over deductible overhead. It is necessary to delete paragraph (22) appearing in lines 3-4 on page 46 of the Judiciary CS.

Disallowance of dismantlement and removal costs incurred in renewal of aging facilities. The Judiciary CS would amend AS 43.55.165(e)(15) so that all "costs incurred for dismantlement[or] removal ... of a facility, pipeline, well pad, platform, or other structure" would be disallowed (Bill Section 59).

The problem with this is that many of the production facilities on the North Slope are 25 years old or older. This means they not only have the normal wear and tear from use for such a long time, but it also means that they may not have the best design to handle the produced fluids that these fields will have in the coming decades as increasing amounts of viscous and heavy oil are anticipated to come into production. Renewal is the retrofitting, refurbishment or replacement of these facilities so the fields will be ready for the long-term future.

The complete disallowance of dismantlement and removal of a facility being replaced as part of this renewal process would be a disincentive against renewal. AOGA believes the partial disallowance of dismantlement and removal costs under the present language in AS 43.55.-165(e)(15) is more appropriate than the complete disallowance proposed in the Judiciary CS. The CS should be changed from line 18 on page 43 through line 8 on page 44 so that the existing language in paragraph (15) is not changed.

Prudhoe Bay corrosion in 2006. The Judiciary CS contains two changes to AS 43.55.-165(e)[29] with the apparent objective of disallowing deductions or credits for costs incurred in association with the replacement of corroded oil transit lines that leaked a small quantity of oil in August 2006 and led to a temporary partial shutdown of the Prudhoe Bay Unit (Bill Section 59). The disallowance of those Prudhoe Bay costs appears to be the objective because paragraph (a) of Bill Section 72 would make those changes retroactive to April 1, 2006.

AOGA offers no opinion about the constitutionality or other legality of making those changes retroactive to April first of last year. However, the precedent to be set by that retroactivity would be poor tax policy in terms of encouraging investment. Potential investors will be very wary about committing large amounts of money to Alaskan projects when their expectations for those investments can be materially altered by retroactive changes to the tax laws such as this one.

AOGA opposes the proposed new paragraph (19) that would be added to AS 43.55.-165(e) by Bill Section 59, to the extent it would set a rule for the future. Paragraph (19) would disallow "costs incurred for repair, replacement, or deferred maintenance" that causes or results from an "unscheduled interruption or, or reduction in the rate of, oil or gas production" or an "unpermitted release of a hazardous substance [*e.g.*, oil] or of gas[.]" The standards for relief from this disallowance are unreasonably narrow and unrealistic, which reflects the basic punitive intent that the drafters had regarding Prudhoe Bay corrosion. Also, although the Administration touts these "unscheduled" or "unauthorized" triggering events as clear-cut, there is nothing about how severe the interruption or reduction of production must be in order to be a triggering event, nor is there anything about how great the discharge must be in order to trigger the disallowance.

If, despite our counsel against it, the Legislature chooses to enact a retroactive change to AS 43.55.165(e) to disallow costs from the Prudhoe Bay corrosion matter, AOGA would urge the simultaneous repeal of AS 43.55.165(e)(18), which creates the flat 30¢-a-barrel exclusion from capital expenditures. When Dr. Pedro van Meurs proposed the 30¢ exclusion, and again in his testimony at the start of this special session, he was clear that it was a clear and simple response to the Prudhoe Bay corrosion that would avoid getting bogged down in disputes about which costs ought to be disallowed because of the corrosion situation and how much those costs were. If the corrosion-related costs are disallowed, there is no sound reason for the State to double-dip those costs by the 30¢ disallowance.

<u>Deletion of clarification of what constitutes an "upstream" cost</u>. The Judiciary CS, in lines 5-11 on page 42, would amend AS 43.55.165(b) by deleting existing language that clarifies that an activity does not have to be physically located on or near the premises of a unit, field or exploration prospect in order for the costs of that activity to qualify as "upstream" expenditures under AS 43.55.165(a)(1)(B)(i) in lines 19-20 on page 40 of the Judiciary CS.

The deletion of this clarifying language could mean that the costs of fabricating a production module in Anchorage or Outside and transporting it to the North Slope or transporting a drilling rig would no longer be deductible expenditures incurred for oil and gas exploration, development, or production in this state. It is not possible to construct and install production facilities from scratch on the North Slope in the same way one might build a house from scratch in Southeast Alaska. As you may have heard in prior testimony, there is also a shortage of available drilling rigs in Alaska. Drilling rigs are required to be contracted months in advance of the scheduled exploratory work and then transported to Alaska. The proposed amendment would disallow those necessary costs, discouraging, not encouraging, exploration activities the PPT was designed to encourage. To avoid these and other absurd and unrealistic results, the clarifying language must be restored in AS 43.55.165(b).

<u>Limitation on deductible property taxes</u>. The Judiciary CS proposes to amend AS 43.55.165(b)(1)(B) by limiting deductible property tax payments to those taxes paid "for properties on which oil and gas exploration, development, or production is taking place" (Bill Section 58). Whoever drafted this never looked at the state property tax statutes to see what kinds of property are taxable. Properties "on which" oil and gas operations are taking place are the leases, which are not subject to property tax.[30] The properties that are subject to state and municipal property taxes under AS 43.56 are the facilities, equipment, and supplies primarily used or contractually committed for use in oil and gas exploration, production or pipeline transportation.[31] Obviously, property taxes on pipelines are not "direct" or "ordinary and necessary" costs of oil and gas exploration, development or production, and so they are not

deductible under the definition of deductible lease expenditures in AS 43.55.165(a). We believe AS 43.55.165(b)(1)(B)(i) needs only to say "(i) property taxes; and" for it to work properly.

Presumptions about audit claims and burden of proof. The Judiciary CS proposes to amend AS 43.55.050 by adding a new subsection (b) to it establishing a presumption that determinations by DOR of the amount of tax due are correct, and putting the burden of proof on the taxpayer "to prove that the determination by the department is incorrect and to prove the correct amount of tax due under this chapter" (Bill Section 48). This presumption is completely redundant with the existing provisions in AS 43.05.245, applying generally to taxes levied under AS 43. In pertinent part, AS 43.05.245 provides:

> If a taxpayer fails to file a return or report required by this title in the time required by law or regulation, or makes an erroneous or fraudulent return, the department shall proceed to assess the license fees, tax, penalties, or interest and make a return from information that it obtains. An assessment or a return subscribed by the department in accordance with this section is presumed sufficient for all legal purposes. However, nothing prevents a taxpayer from presenting evidence or other information in an informal conference under AS 43.05.240 or in an appeal under AS 43.05.241 in order to rebut the presumed sufficiency of an assessment or return subscribed by the department, nor does the presumption of sufficiency alter the parties' respective burdens of proof once the taxpayer has presented evidence or other material information to rebut that presumption. [emphasis added]

The question of the respective burdens of proof once the taxpayer meets its burden of rebutting the presumption of correctness was addressed in the Alaska Supreme Court's decision in *Gulf Oil Corp. v. State, Dept. of Revenue*, . In that case, one of the questions was whether it would be unfair under the Multistate Tax Compact (AS 43.19.010)[32] to treat certain taxes that Gulf Oil paid to foreign governments as nondeductible income taxes. Gulf Oil offered three different arguments why treating those taxes as nondeductible costs would be unfair. After considering each argument and finding it inadequate, the court declared:

> ... each of the methods proposed by Gulf would result in a lower tax. However, we do not equate "lower" with "more fair." Each method is at least as arbitrary as the DOR's strict application of AS 43.20.031(c). We find Gulf did not carry its burden of establishing that its proposed methods are more fair than the legislature's clearly-expressed preference that "the taxpayer is not entitled to deduct any taxes based on or measured by net income." [emphasis added; citation and footnote omitted]

As *Gulf Oil* indicates, the case law in Alaska and other jurisdictions generally seems to be that taxpayers have the burden of proof in showing that a tax or audit claim for additional tax is incorrect.[33] Also, AS 43.05.455(c) provides, "The taxpayer bears the burden of proof on questions of fact by a preponderance of the evidence unless a different standard of proof has been set by law for a particular question" when tax appeals are being heard in the Office of

Administrative Hearings pursuant to AS 43.05.405 – 43.55.499.

The proposed enactment of subsection (b) in AS 43.55.050 under Bill Section 48 is unnecessary and redundant with existing law, and therefore Bill Section 48 should be deleted from the Judiciary CS.

D. Issues about Tax Stability

The last point I would like to make today is about destabilizing the investment climate here. In 2005 Governor Murkowski disregarded procedures established by regulation (15 AAC 55.027) and ordered DOR to aggregate certain fields within the Prudhoe Bay Unit with the main field for ELF purposes, including fields with heavy oil in the West Sak formation. The result was an administratively created increase in the tax law of over $120 million a year at the prices back then.

Last year the Legislature enacted the PPT, further increasing the production tax by over $800 million during the last nine months of 2006 alone. And it did this retroactively back to April first of last year.

Now the Judiciary CS before you proposes to increase the production tax yet again, and even more massively — on the order of one billion, eight hundred million dollars a year above even the PPT at $80 real prices, according to DOR's fiscal note for the Judiciary CS. And, once again, it being proposed to make this change retroactive, this time to the first of this year.

As I have explained, you have been allowed to have serious misimpressions about what the Gaffney Cline model really shows and about how limited its proper use actually is. These misimpressions have, in turn, led to a serious underestimating of the effects of this newest change on future investment decisions about exploration, heavy and viscous oil development, and the renewal and ongoing development of existing "conventional" fields. Not even a state legislature can repeal the laws of economics, any more than it could repeal the law of gravity. And believe me, the laws of economics say there will be adverse impacts on investment decisions here if the Judiciary CS becomes law.

It is unfortunate that so many in the public, and even in the halls here, do not believe the warnings being given by the explorers and producers here. Perhaps even this AOGA testimony will change no one's mind. But I have to hope it will. The future of Alaska is at stake, and we urge this Legislature to pull back to safer ground.

Thank you for giving AOGA this opportunity to testify.

ENDNOTES

---

[1] DOR, *Revenue Sources Book Spring 2007*, p. 17, Figure 2-13 ("Total Unrestricted General Purpose Revenue, FY 2006 and Forecasted FY 2007-2017"), column captioned "Percent From Oil".

[2] When production declines at X% a year, this means the production rate after one year (P_1) is $(1 - X\%)$ of the initial production rate (P_0), or $P_1 = P_0 \times (1 - X\%)$. After the second year the production rate (P_2) is $(1 - X\%)$ of the rate after one year of production, or $P_2 = P_1 \times (1 - X\%) = [P_0 \times (1 - X\%)] \times (1 - X\%)$, which can be simplified as $P_2 = P_0 \times (1 - X\%)^2$. After 10 years of decline, the rate P_{10} is $P_0 \times (1 - X\%)^{10}$. North Slope production was 1.404 million barrels a day in FY 1997 and 740 thousand barrels a day in FY 2007, while Cook Inlet produced 37 thousand barrels a day in '97 and 16 thousand barrels a day in '07. *See* DOR, *Revenue Sources Book Spring 2007*, pp. 97-98. So for the last 10 years of North Slope production decline,

$$1{,}404{,}000 \times (1 - X\%)^{10} = 740{,}000.$$

Dividing both sides of this equation by 1,404,000 gives:

$$(1 - X\%)^{10} = 740{,}000/1{,}404{,}000 = 0.5271.$$

One can solve for $(1 - X\%)$ by taking the 10th root of both sides of this latter equation:

$$\sqrt[10]{(1 - X\%)^{10}} = \sqrt[10]{0.5271}\text{, or}$$

$$(1 - X\%) = 0.9380.$$

Since $(1 - X\%)$ is the same as $1 - X\%$, one can subtract 1 from each size of the equation to get:

$$-X\% = -0.0620,$$

and then dividing both sides by –1 yields:

$$X\% = 6.20.$$

In other words, the rate of decline averaged 6.20% a year for the North Slope. The same calculations for Cook Inlet, using beginning and ending production of 37,000 and 16,000 barrels a day respectively instead of 1,404,000 and 740,000, yields an average annual decline rate of 8.0 percent.

[3] DOR, *Revenue Sources Book Spring 2007*, p.

[4] Here is the math for the 300,000-barrel-a-day threshold shown in the right-hand graph: From the analysis in Endnote 1 above, we know that for a given decline rate R, the volume of production after N years of decline is $P \times (1 - R)^N$. So for each decline rate in the table, you use that as the value of R in the formula, and then you solve for X as the value of N that gives 300,000 barrels a day as the rate. The equation for this is:

$$740{,}000 \times (1 - R)^X = 300{,}000.$$

When you take the logarithm of both sides of this equation, you get the following equation:

$$\log[740{,}000 \times (1 - R)^X] = \log[300{,}000].$$

The reason for using logarithms is that they have the property that the logarithm of two numbers being multiplied together equals the sum of the logarithms for each of them, while the logarithm of a number raised to an exponent X equals X times the logarithm of that number. Using this gives the following restatement of the prior equation:

$$\log[740{,}000] + X \times \log[(1 - R)] = \log[300{,}000].$$

Subtracting log[740,000] from both sides of the last equation yields the following: [continued on next page]

$$X \times \log[(1 - R)] = \log[300{,}000] - \log[740{,}000].$$

Now you can solve for X by dividing both sides of the last equation by $\log[(1 - R)]$, which yields:

$$X = \frac{\log[300{,}000] - \log[740{,}000]}{\log[(1 - R)]}.$$

By plugging the decline rate of your choice into this last equation as the value of R, the value of X can be calculated by simple arithmetic and a set of logarithm tables, or with a calculator or computer that can compute logarithms. This straightforward calculation has been done for each of the decline rates shown in the right-hand graph. The equations and arithmetic are the same for the left-hand graph, except that 200,000 replaces 300,000 in the equations.

[5] For producers without production before April 1, 2006, the period ends at the end of the sixth calendar year after the one when they first take a TIE credit against tax due under AS 43.55.011(e) on their production. *See* AS 43.-55.023(i)(3)(A)(ii).

[6] AS 43.05.220(b).

[7] AS 43.05.220(a). Technically the failure-to-pay penalty is 5% per month for each month that the tax remains underpaid, up to a maximum of 25 percent. It would be extremely rare for DOR to discover the underpayment and issue the failure-to-file penalty before it has reached its 25% cap.

[8] 15 AAC 05.220(a). In addition, if the 5% negligence penalty is assessed, DOR automatically assesses the 25% failure-to-pay penalty as well. 15 AAC 05.210(g).

[9] We have already used "capex" in this testimony to mean capital expenditures under federal income tax principles. We now use "opex" to mean operating expenses under those federal principles.

[10] Bill Sections 22, 23 and 54 make conforming changes in other parts of the production tax laws to reflect the enactment of a new subsection (o) in AS 43.55.011 that would occur under Bill Section 24.

[11] SOURCE: DOR, Tax Division, "Summary of Published Prevailing Values for Cook Inlet Gas"; available online at www.tax.state.ak.us/programs/oil/prices/prevailingvalue/cookinlet.asp (last visited 6 November 2007). The published data are for calendar quarters, and the March 31, 2006 termination date for the 12-month period is also the last day of the first quarter of 2006. Therefore, the average of the published prevailing values for the last three quarters of 2005 and the first quarter of 2006 will give the necessary result. Those prevailing values are $3.372 for 2Q05, $3.581 for 3Q05, $3.642 for 4Q05 and $3.745 for 1Q06. The average of these is $3.585.

[12] Changes that could be made to CSSB 2001(JUD) to limit the taxable value of non-Inlet gas in this manner are:

A) Strike "**, other than gas subject to AS 43.55.011(o),**" in lines 21-22 and in line 29 on p. 38;

B) After "is" in line 21 and in line 29 on p. 38, insert "**, except as otherwise provided in (f) of this section,**"

C) Insert "**before 2022**" after "**sedimentary basin**" in line 17 on p. 39;

D) Strike "**;**" at the end of line 14 and all material in lines 15-22 on p. 39 except "." at the end of line 22;

E) Insert the following new Bill Section after line 22 on p. 39 and renumber the remaining Bill Sections accordingly:

" *** Sec. 55.** AS 43.55.160 is amended by adding a new subsection to read:

"(f) For gas taxable under AS 43.55.011(e) that is produced during a month from a lease or

---

> property outside the Cook Inlet sedimentary basin before 2022 and used in the state, the portion, if any, of its gross value at the point of production that exceeds the amount of the product under AS 43.55.011(j)(2) that would be calculated for it if it were produced in the Cook Inlet sedimentary basin shall be excluded from the determination of the monthly production tax value under (a)(1) and (a)(2), as applicable, of this section."

[13] AS 44.62.640(3) defines "regulation" to be "every rule, regulation, order, or standard of general application or the amendment, supplement, or revision of a rule, regulation, order, or standard adopted by a state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure, except one that relates only to the internal management of a state agency[.]"

[14] AS 44.62.300 says in pertinent part: "An interested person may get a judicial declaration on the validity of a regulation by bringing an action for declaratory relief in the superior court. In addition to any other ground the court may declare the regulation invalid (1) for a substantial failure to comply with AS 44.62.010 - 44.62.320" which, *inter alia*, specify the procedures to be followed in adopting regulations.

[15] *Wien Air Alaska, Inc. v. Dep't of Revenue*, 647 P.2d 1087 (Alaska 1982).

[16] *See* 15 AAC 55.191(j).

[17] *See* 15 AAC 55.191(b)(3)(C) and (D), 15 AAC 55.191(b)(4)((B)(iii) and (iv), 15 AAC 55.191(b)(6) – (8), 15 AAC 55.195, 15 AAC 55.196, and DOR's publication *Computation of a Cost-of-Capital Allowance under 15 AAC 55.196, Incorporating Depreciation and Return on Invested Capital for Marine Vessels and Improvements* (Second Edition: September 19, 2003), which is adopted by reference under 15 AAC 55.196(d) as part of 15 AAC 55.196.

[18] Subjectivity becomes significant if there is no reliable third-party source or sources to report or quote transportation costs based on actual and current transactions in the open market. In the absence of authoritative and reliable empirical market data about the transportation costs being charged, the determination of what the "market value" is for that transportation can quickly degenerate into little more than one "expert" opinion versus another. Or sometimes, objective empirical market data are available, but they are based too much on data reported for the very transportation that DOR is trying to find the "market value" of — which brings about the circularity that DOR would want to avoid. The latter was the problem DOR perceived in using "USFRA" quotes for costs of marine transportation in Jones Act vessels between U.S. ports in the late 1970s.

[19] Article I, section 10, clause 1 of the United States Constitution provides in pertinent part: "No State shall ... pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts[.]" Article I, section 15 of the Alaska Constitution provides in pertinent part: "No law impairing the obligation of contracts, and no law making any irrevocable grant of special privileges or immunities shall be passed."

[20] The pages in question are pages 24 – 26 of CSSB 2001(JUD).

[21] *See* SB 2001 p. 22, Bill Section 31.

[22] *See, e.g.*, Alaska Oil & Gas Conservation Commission, Conservation Order No. 233 (September 30, 1987), Finding 9: "The Barrow Gas Field was conveyed to the North Slope Borough from the Federal [*sic*] government in 1984."

[23] *See, e.g.*, DNR, Division of Oil & Gas, *Cook Inlet oil and Gas Unit Ownership* (map), available online at

www.dog.dnr.state.ak.us/oil/products/maps/cookinlet/images/cook%20inlet%20maps%202007/CI_OandG_UnitOwnership_March07.pdf (last accessed 8 November 2007), showing "Municipality of Anchorage" with a "33.33%" interest as one of the three owners of the Beluga River Unit.

[24] AS 44.62.640(3) defines "regulation" in pertinent part to be "every rule, regulation, order, or standard of general application" (emphasis added).

[25] *Public Defender Agency v. Superior Court, Third Judicial District*, 534 P.2d 947, 950 (Alaska 1975): "... it can be fairly implied that this state does recognize the separation of powers doctrine." *Hammond v. Bradner*, 553 P.2d 1 (Alaska 1976) (invoking Separation of Powers to hold unconstitutional a law enacted over the governor's veto that required legislative confirmation of deputy commissioners and 19 specified division directors, in addition to the legislative confirmation specifically authorized under Article III, §§ 25 and 26, respectively, for the individuals or boards that head principal departments of the Executive Branch):

> ... the underlying rationale of the doctrine of separation of powers is the avoidance of tyrannical aggrandizement of power by a single branch of government through the mechanism of diffusion of governmental powers. It is clear that the doctrine is not a common law concept; it is, however, a brooding omnipresence by virtue of its conceptually central role in the structure of American constitutional government.
>
> A problem inherent in applying the doctrine of 'separation of powers' stems from the fact that the doctrine is descriptive of only one facet of American government. The complementary doctrine of checks and balance must of necessity be considered in determining the scope of the doctrine of separation of powers. Both doctrines address and are designed to resolve the problem of efficient government versus tyrannical government and have as their goal the protection of the electorate from tyranny. [footnotes omitted]

Cf .State, Dept. of Revenue v. A.L.I.V.E. Voluntary, 606 P.2d 769 (Alaska 1980), rejecting a Separation of Powers argument that, because the adoption of regulations involves a delegation of law-making power to the Executive Branch, the Legislature can annul a regulation by passing a concurrent resolution of annulment, instead of enacting a law annulling it. The court in *A.L.I.V.E.* said that, if the Legislature uses its power to make or change the law, it must obey the procedures specified in the Alaska Constitution for enacting legislation, which include allowing the Governor to veto an Act and the Legislature to override such a veto. Annulling a regulation changes the law, but passing a concurrent resolution of annulment does not include the procedures for veto or override. Hence annulment of a regulation by a concurrent resolution does not follow the procedures that the Legislature must follow in exercising its power to make, amend and repeal laws, and therefore annulment in this manner is unconstitutional.

[26] *See, e.g.*, DNR, Division of Lands, Form DL-1 (revised 1963), ¶ 34 ("Default; Termination"). Various other paragraphs throughout Form DL-1 provide for the expiration or termination of the lease if certain specific acts are not performed when due, such as the termination of the lease on each anniversary date unless the lessor pays an annual rental of $1.00 an acre to the State before that anniversary date (¶ 9).

[27] In line 27 on page 42 of the Judiciary CS, insert after "**advertising**" the following: "**other than legal notices or advertisements legally required in order to obtain a permit or other governmental action for operations of a lease or property or an exploration prospect that is not a lease or property**"

[28] The quoted language is from AS 43.55.165(b), defining "direct" costs, as it would be amended under the Judiciary CS.

[29] The particular changes are the addition of "violation of law" in paragraph (6) in line 23 on page 42 of the Judiciary CS, and the addition of paragraph (19) beginning in line 22 on page 44.

---

[30] AS 43.55.017(a) provides in pertinent part: "Except as provided in this chapter, the taxes imposed by this chapter are in place of all taxes now imposed by the state or any of its municipalities, and neither the state nor a municipality may impose a tax on (1) producing oil or gas leases" (emphasis added). AS 43.55.017(b) similarly prohibits municipal taxes on "nonproducing oil or gas leases or properties."

[31] AS 443.56.210(5) defines "taxable property" as follows:

> (5) "taxable property"
>
> (A) means real and tangible personal property used or committed by contract or other agreement for use within this state primarily in the exploration for, production of, or pipeline transportation of gas or unrefined oil (except for property used solely for the retail distribution or liquefaction of natural gas), or in the operation or maintenance of facilities used in the exploration for, production of, or pipeline transportation of gas or unrefined oil; "taxable property" includes
>
> (i) machinery, appliances, supplies, and equipment;
>
> (ii) drilling rigs, wells (whether producing or not), gathering lines and transmission lines, pumping stations, compressor stations, power plants, topping plants, and processing units;
>
> (iii) roads, tank farms, tanker terminals, docks and other port facilities, and air strips;
>
> (iv) aircraft and motor vehicles owned by a person whose principal business in the state is the exploration for, production of, or pipeline transportation of gas or unrefined oil and whose operation of the aircraft or motor vehicle directly relates to the conduct of that business;
>
> (v) maintenance equipment and facilities, and maintenance camps and other related facilities; and
>
> (vi) communications facilities owned by a person whose principal business in the state is the exploration for, production of, or pipeline transportation of gas or unrefined oil and whose operation of the communications facilities directly relates to the conduct of that business;
>
> (B) does not include
>
> (i) permanent residences;
>
> (ii) office buildings requiring substantial local government services;
>
> (iii) oil and gas pipeline systems owned and operated by a public utility that is certificated under AS 42.05.221 and is regulated by the Regulatory Commission of Alaska;
>
> (iv) aircraft and motor vehicles, except aircraft and motor vehicles taxable under (A)(iv) of this paragraph; and
>
> (v) communications facilities, except communications facilities taxable under (A)(vi) of this paragraph[.]

[32] Article IV, section 18 of AS 43.19.010 (Multistate Tax Compact) allows DOR to grant relief if the regular method of apportioning income to Alaska "do[es] not fairly represent the extent of the taxpayer's business activity in this state." The kinds of relief available in such a situation include "(a) separate accounting; (b) the exclusion of any one or more of the [regular apportionment] factors; (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

[33] For instance, later in the *Gulf Oil* decision, the Alaska Supreme Court cited the U.S. Supreme Court's decision in *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983) for the rule if a taxpayer seeks to show that an apportionment-based income tax is unconstitutional, there is "a steep burden on the taxpayer to prove by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportion to the business transacted ... in that state, ... or has led to a grossly distorted result." *Gulf Oil* (ellipses in original; citation and internal quotation marks omitted).