Alaska Oil and Gas Association

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

TESTMONY BY THE

ALASKA OIL AND GAS ASSOCIATION

TO THE SENATE JUDICIARY COMMITTEE

REGARDING SB 2001 & CSSB 2001(RES)

ON THE TOPIC OF "CORROSION"

October 30, 2007

Mr. Chairman and Members of the Committee:

For the record, my name is Thomas K. Williams, and I am Senior Royalty & Tax Counsel for BP Exploration (Alaska) Inc. I am appearing before you today to testify in my role as chair of the AOGA Tax Committee.

My present testimony pertains to the topic of "Corrosion" as scheduled for consideration today.

The Administration's proposed paragraph (19) to be added to AS 43.55.165(e) would, unless a situation is caused by a "super" *force majeure*, disallow any cost incurred for the repair, replacement or deferred maintenance undertaken in response to a failure, problem or event that results in an unscheduled interruption of or reduction in the oil or gas production or is undertaken in response to or is otherwise associated with an unpermitted release of a hazardous substance or gas. Not only is the language of this proposed revision ambiguous and likely to lead to additional audit exceptions and disputes, the entire provision is unnecessary.

The proposed provision states that otherwise ordinary and necessary, and thus deductible, costs would be disallowed if the Department of Revenue determines such costs were in response to a "failure, problem or event" that results in an unscheduled interruption of or reduction in production. What constitutes a "failure, problem or event" and under what standards would any of those be determined? Cost associated with any temporary, unforeseen shutdown or minor interruptions, regardless how minor, could now be disallowed by an auditor even when such an "event" arises despite otherwise prudent and necessary business operations.

Yet the issue of determining what portion of any maintenance costs should be disallowed, if related to improper maintenance or production interruption, was thoroughly debated when the Legislature was considering the PPT and again in recent legislative sessions. Each time amendments such as the one the Administration is now advocating failed because the difficulties with such subjective standards were immediately apparent. The State turned to Dr. Pedro van Meurs,

an international gas consultant retained by the State, who recommended a flat 30¢ per barrel exclusion from what would otherwise be a producer's capital portion of its lease expenditures.

As Dr. van Meurs explained,

> it should be noted that in most oil and gas fields, assets will have to be replaced after the technical life of such assets has expired. Therefore, such replacements are reasonable lease expenditures and required to protect the health and safety of the workers and to protect the environment. The US $0.30 per BTU equivalent barrel is based on reasonable capital maintenance costs of fields for which I have (confidential) information.

van Meurs, "Enhancement of the Gross Character of the PPT Bill" (August 5, 2006). Dr. van Meurs further testified that

> maintenance is a reasonable deduction for PPT; but is sometimes hard to decide which expenditures fall into that classification. The simplest solution is to take some base expenditure that really will be replacement and over the next 20-30 years disallow a modest floor of the capital expenditures.

Senate Special Committee on Natural Gas Development, *Minutes* (August 9, 2006).

Dr. van Meurs' recommendation was adopted and become section 43.55.165(e)(18) of the PPT. The flat 30¢ per barrel exclusion sets a floor for maintenance cost and avoids the problems of case-by-case decisions as to whether maintenance (repair or replacement) is required because equipment or facilities have been improperly maintained or resulted in an unscheduled interruption. To adopt the Administration's proposed amendment while leaving the flat 30¢ per barrel exclusion in the law would result in a double disallowance of the same costs.

Dr. van Meurs' flat 30¢ exclusion also avoids all questions and disputes about which categories of costs were incurred due to a triggering event and are nondeductible as a result, and about how much was incurred in each cost category so disallowed.

Finally, the 30¢ per barrel exclusion applies every year, whether there is a triggering event or not. Over time the 30¢ figure may well prove to be a reasonably accurate approximation of the average amount of costs that would be disallowed by auditing and verifying exactly which cost categories are disallowed and how much cost is in each category. A flat rate disallowance greatly furthers the goals of clarity, certainty and efficiency in tax administration, enforcement and compliance. Paragraph (19), in contrast, would undercut each one.

Thank you for giving AOGA this opportunity to testify.