

**TESTIMONY
OF
THE ALASKA OIL AND GAS ASSOCIATION
TO
THE SENATE FINANCE COMMITTEE
REGARDING CSSB 192(RES)**

March16, 2012

Co-Chairmen Stedman and Hoffman, and Members of the Senate Finance Committee:

Good Morning. For the record, my name is Kara Moriarty and I'm the Executive Director of the Alaska Oil and Gas Association, or AOGA. AOGA is a business trade association whose mission is to foster the long-term viability of the oil and gas industry here, which will benefit all Alaskans. Our member companies account for the majority of oil and gas exploration, production, transportation, refining and marketing activities in Alaska, and they reflect the breadth and scope of our industry across the state. My testimony today reflects a 100% consensus among the membership.

The adverse effect ACES has had on the continued production decline on the North Slope and its impact on the economic future of Alaska is a critical issue facing this legislature and all of Alaska. AOGA and its members appreciate your Committee's willingness to continue to analyze this critical issue and its goal of trying to improve the investment climate in the state. We also appreciate the efforts of the Senate Resources Committee in trying to improve ACES through the development of the Committee Substitute to SB 192 you have before you today.

However, AOGA opposes the CS that is before you today. This CS does not make meaningful changes and will not result in substantive changes to the investment decisions of AOGA's member companies, thus moving Alaska farther away from the Governor's goal of getting a million barrels a day going through TAPS again, instead of toward it.

Decoupling (Bill Sections 5 and 11).

The concept of decoupling gas from oil is not foreign to this Committee. Lengthy testimony was presented in the prior legislative session. The language in this CS is the same as what was in SB 305, with conforming language to other parts of the current CS not included in SB 305. Just as SB 305 created a tax increase in a number of price scenarios then for those that produce and sell oil and gas, so does this CS.

We recognize the need to eventually resolve the concern that combining the value of gas with that of oil to compute the ACES tax when significant gas sales occur will reduce the tax on the oil, unless they are calculated separately. However, as AOGA has testified in the past, we do not see why it is necessary to find and enact the ultimate

solution to that concern today. One could enact some trigger mechanism to ensure that future Legislatures will act in response to the actual circumstances that arise. AOGA is not opposed in principle to the idea of enacting such a trigger, although our position on any particular trigger proposal would depend on what it is and how it would work.

The “Petroleum Information Management System” (Bill Sections 2 - 4). The member companies of AOGA do not dispute that the Department of Revenue, Department of Natural Resources, the Department of Labor and Workforce Development, and the AOGCC have valid needs for information from the companies in order for these agencies to be able to do their work. Instead, our concerns here relate to other considerations, and there are four of them.

First, we are concerned that, by creating a petroleum information management system (PIMS) in the AOGCC “to improve the administration of the oil and gas production tax”, the new AS 31.05.031 threatens to blur or undercut the present clear authority and accountability that the Department of Revenue has in administering the production tax. The AOGCC wields Alaska’s Police Power, while Revenue implements the Legislature’s exercise of the Taxation Power. There are fundamental differences between these two Powers — for instance, a state’s Taxation Power can be contractually limited or suspended if the state’s constitution grants the authority to make such contracts, but the Police Power cannot be limited by contract. We do not believe it would be prudent public policy to mix the exercise of these two different Powers. In Alaska, the Department of Revenue is doing its job in administering the oil and gas production tax, while the AOGCC is similarly doing its job of policing oil and gas operations to ensure efficiency, maximum efficient recovery of the resources, and protection of the correlative rights of landowners. So we see no reason at all to justify the blurring of the currently clear authorities and accountability of these two agencies in implementing the respective Powers.

Second, we are concerned that AS 31.05.031 could lead to the companies’ having to file information for PIMS that is already reported to Revenue, DNR, and Labor and Workforce Development. It is true that the statute as proposed is silent about the companies, while subsection (c) speaks specifically only about DNR, Revenue, and Labor and Workforce Development providing information to AOGCC for PIMS. But paragraph (b)(8) requires the inclusion in PIMS of “other information that [AOGCC] determines [to be] necessary and relevant to the oil and gas production tax and to the exploration, development, and production of oil and gas resources.” Our concern is that this authority might lead the Commission to adopt a regulation to require reporting by companies directly into PIMS. Further, it is made more serious by the broad purposes of PIMS under subsection (a) of the statute, which are “to improve the administration of the oil and gas production tax and to facilitate exploration, development, and production of oil and gas resources.” Companies should not have to provide the same information to state agencies over and over again, or in different formats to different agencies. The prescriptive nature of the reported expenses for production tax would also lead to

confusion with what are allowed expenses for tax purposes versus what are a company's total expenses. As an example, a taxpayer reporting information to the DOR must report essentially the same information at least 3 times; for compliance purposes, again for audit purposes and a third time for forecasting purposes. Much of the same revenue and transportation information is also reported to the DNR. This is already a serious problem, and AS 31.05.031 only threatens to make it worse.

Third, we are concerned that the companies' proprietary or confidential information will not be adequately safeguarded against unauthorized or improper disclosure. It is not clear that PIMS will contain only "information [that] is [publicly] available and not confidential". Subsection (b) of the statute says PIMS "must include" all of the public, non-confidential information that it describes, but a requirement to include public information does not necessarily imply the exclusion of all non-public information. Moreover, it is often not entirely clear whether a specific piece of information is or isn't proprietary or confidential, and this could become especially murky with respect to "other information the [AOGCC] determines necessary and relevant to the oil and gas production tax and to the exploration, development, and production of oil and gas resources" and includes in PIMS under paragraph (b)(8) of the statute. At the very least, then, there should be procedures requiring notice to companies whose information is about to be included in PIMS and made public, giving them a reasonable opportunity to object and explain why the information is proprietary or should for tax purposes be kept confidential, and giving them – if necessary – the opportunity under Due Process to have judicial review of the agency's decision.

And fourth, we are concerned that proposed AS 31.05.031 promises to create unrealistic expectations about public access to certain specific kinds of information listed in subsection (b) of it. Such information includes, for example, "exploration work programs and budgets", "production work programs and budgets", "oil and gas sales, revenue, and pricing" and "operating and capital expenditures". Whether for exploration or development, individual companies' "work programs" are private business matters reflecting internal assumptions and expectations about future market conditions, as well as expectations about the results from those work programs. If publicly disclosed without appropriate disclaimers and cautions, such assumptions and expectations could affect the market value of the stock of the respective companies, particularly if the work programs are Alaskan-size in scope and could be material in terms of a company's overall business. The federal Securities and Exchange Commission forbids the public release of forward-looking statements or projections without the necessary disclaimers and cautions. Moreover, the public disclosure of companies' respective "oil and gas sales ... and pricing" would open the door for their competitors either to use that information to undercut their pricing — something the companies don't want — or to use it to match those prices even though the competitors might otherwise be willing to accept a lower price — something the Federal Trade Commission and the antitrust division in the U.S. Department of Justice don't want. And we cannot see how Alaska would want that result either.

We're not saying the competitors would actually do either of these; but our point is that neither the SEC nor the antitrust regulators want even the possibility of abuse. Unless these considerations are properly vetted with the federal agencies with respect to PIMS, it is quite possible that you and the Alaskan public may be disappointed about such information actually being available to the public through PIMS. If you are going to enact PIMS at all, then instead of enacting PIMS now without vetting it with the feds, we think it would be prudent for the State to consult with the feds about parameters acceptable to them with respect to the kinds of public disclosures along these lines that could be made, and about safeguards for how such disclosures should be made, and *then* to enact a statute to implement and reflect those parameters.

Progressivity and “base” tax rates (Section 5, 7 and 8). Unless one is satisfied to see North Slope oil production decline at about six percent a year, or 41,000 bpd (which is 15 million barrels a year) and possibly faster in the future, the present 25% base tax rate under AS 43.55.011(e)(1) is too high. The present tax imposes no progressivity on the first \$30 a barrel of taxable production tax value (PTV), but as soon as the PTV goes above \$30 a barrel the progressivity tax starts taking away part of that first \$30 as well as the part above \$30. A truly progressive tax increases the tax rate for value or income above a certain level, but leaves the rate unchanged for value or income up to that level. Under both the federal income tax and Alaska's own corporate income tax, tax brackets do this in specific stages as one's taxable income increases. The CS before you falls far short of reforming progressivity enough to make any material difference in North Slope decline, let alone keeping production ten years from now at the same level as today. The CS has no brackets for progressivity. It lowers the starting slope for progressivity by a mere one eighth, from 0.4 percent per dollar to 0.35 percent. And it changes the point when progressivity maxes out, from a PTV of \$342.50 per barrel now to “only” \$201.43 a barrel. According to the “Income Statement” in Appendix D-1b in last fall's Revenue Sources Book, projected transportation costs to market and deductible lease expenditures the current fiscal year come to \$33.00 a barrel, so a PTV of \$201.43 a barrel equates to an ANS spot price on the West Coast of \$244.43 a barrel. I don't know about you, but this makes me and my member companies think it might be a while before taxpayers see any actual benefit from the lowered cap on progressivity under the CS. And so the Resources CS for SB 192 merely goes through the motions of changing the progressivity tax, without providing the material change and reform that are needed.

Governor Parnell has expressed a goal of not merely slowing or arresting the decline of North Slope production, but increasing the volume of oil going through TAPS to a million barrels a day. The operators of the larger fields on the Slope have said they see technically feasible ways to have North Slope oil production 10 years from now at 600,000 barrels a day, the same as now, which would make it easier for new production from the OCS to fill the pipeline to the million-barrel-a-day level. What is needed is a change in the taxes to make the investments to achieve these great things more competitive. Putting brackets into progressivity would be an important first step, although not the only one, that the State could and should take to achieve this goal.

Rewarding increases in production (Bill Section 13). It is essentially impossible when an investment decision is being made to know in advance exactly how successful it may turn out to be, or even that it will be successful at all. The present ACES tax encourages investment here by rewarding taxpayers for making the decision to invest here, instead of rewarding them only if their investment actually succeeds in increasing production. In this, the ACES tax credits are like the credits for making movies in Alaska: they, too, reward the movie producer for spending the money here, rather than making the credit depend on whether the movie is a success at the box office.

Yet we do understand how the people of Alaska might want to see real results in slowing the production decline, in order to judge how well the incentives under ACES are succeeding in attracting investments here to arrest that decline.

The Resources CS proposes to reward actual increases in production from the prior year's level. This reward takes the form of a \$10 a barrel reduction in a taxpayer's PTV for a calendar year for each taxable barrel produced in excess of its production in the prior year.

The problem with this is that some North Slope fields may have declines rates substantially greater than the six percent average historical decline rate for the North Slope as a whole. And so under the CS — even if such a fast-declining field makes a significant reduction in its rate of decline from the prior years' decline rate, but falls short of surpassing that actual amount of the prior year's production — there is no reward for this success in keeping production significantly higher than it otherwise would have been.

A further problem with the CS is that subsection (g) of the proposed new AS 43.-55.162 would limit the effect of these \$10-a-barrel reductions in PTV, by preventing them from being considered for purposes of setting the progressivity tax rate. We fail to see the logic of this limitation.

Senator Wagoner, the co-chair of the Resources Committee, proposed a “tax holiday” amendment to that Committee’s CS that would provide a similar, but more effective reward for a producer’s success in slowing down its rate of decline. It would set a target level of production for each year by applying the decline rate during the three most recent years to the producer’s production in the prior year. If production in a year beats the target for that year, the above-target production would get a “tax holiday” by excluding its gross value at the point of production from the calculation of the PTV for the producer’s taxable production during that year. This would reduce the amount of PTV subject to tax, and if progressivity is applicable, it would also reduce the progressivity tax rate. Together these would provide a useful incentive to beat the target. Each year the target is beat, it raises the target for the next year. And for any year when the target is not beat, the “tax holiday” provides no tax benefit to the producer. While we have some technical concerns with the particular language of that amendment, its basic approach is sound. And to show Alaskans real barrels of additional production, the “tax holiday” is a clear and direct way to show it.

Rewrite of ANS Minimum Tax (Bill Section 6). The current version of AS 43.-55.011(f) sets a minimum tax for North Slope oil and gas that is based on the gross value at the point of production (GVPP) of that oil or gas, with the rate of this minimum tax being set on the basis of the average West Coast spot price of North Slope oil during the year. This minimum tax is payable whenever it is greater than the “regular” tax under 011(e) for the year.

The Resources CS would rewrite 011(f) so that, first, it would apply only to fields that have more than a billion barrels of cumulative production and more than 100,000 barrels a day on average during the most recent calendar year — in other words, it targets only the main Prudhoe Bay and Kuparuk River fields and does not apply to the other fields on the North Slope. Second, it would bar producers with production from one these two fields from using tax credits to reduce the tax on that field below 10% of the GVPP for that field’s production, nor could the producer use its otherwise deductible lease expenditures for that field to reduce its tax below 10% of the GVPP.

We concur with the concerns that DOR expressed about these changes. In addition, these changes to 011(f) do not fit in with the logic and structure of the rest of the tax. Generally, all of a producer’s North Slope production is lumped together and taxed on an aggregate basis. This means the tax benefits from deducting lease expenditures and taking tax credits are shared across all of a producer’s North Slope interests, rather than setting up potentially dangerous trade-offs between one North Slope field and another. But the new 011(f) would require the allocation of costs among the two large fields and a producer’s interests in their satellite fields and any other fields on the Slope, since costs must be allocated to the two giant fields in order to compare each one’s imputed “regular” tax, after credits, to the new 10%-of-GVPP minimum tax. This will undercut the inter-field neutrality for North Slope fields and could lead to undesirable economic distortions and the consequences flowing from them. One potential area for undesirable consequences is when raw production fluids from one field are run through the production facilities of another, and one or both of the fields is subject to the new 011(f). How do the adjustments under AS 43.55.170 for payments to use those production facilities interface with the determination of the imputed “regular” tax of a giant field under 011(f)? There is no answer — nor even a hint of one — in section 170 or in the proposed 011(f).

By limiting its application to just the Prudhoe and Kuparuk main fields, 011(f) singles out these two fields for a potentially severe economic penalty. AOGA strongly recommends against this approach. If the two giant fields fail because targeted state tax policy against them makes them fail, the other North Slope fields will quickly fall as well. The two giants are the economic mainstay that allows economic success for the other fields, and without the giants, the other fields simply cannot sustain themselves for very long.

In conclusion, Mr. Chair, AOGA’s message today is simple: The overall government take in Alaska, and particularly for the North Slope fields, it simply too high. It is

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too high not merely for industry's good; it is too high for the Alaska public's good. We support the Governor's progressivity brackets and other reforms as important first steps in providing meaningful change and reform. But further change and reform will become necessary or prudent as events unfold.

Tax policy does affect business decisions, and the Resources CS for Senate Bill 192 will not improve any AOGA member's ability to attract the investment dollars needed to change Alaska's course. If anything, it will weaken their case for investing here instead of somewhere else. The competition for these dollars is real, and it is intense. We encourage the Senate Finance Committee to change this CS so it will put Alaska in a better and more competitive position.

Thank you for this opportunity to testify, and I'm happy to take any questions the Committee may have.