State of Alaska
Department of Revenue

Commissioner Bryan Butcher

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The Honorable Bill Thomas, Jr
State Capitol Room 505
Juneau AK, 99801

March 28, 2011

The Honorable Bill Stoltze
State Capitol Room 515
Juneau AK, 99801

SUBJECT: Response to Questions from House Finance Meetings on March 24 and March 26, 2011

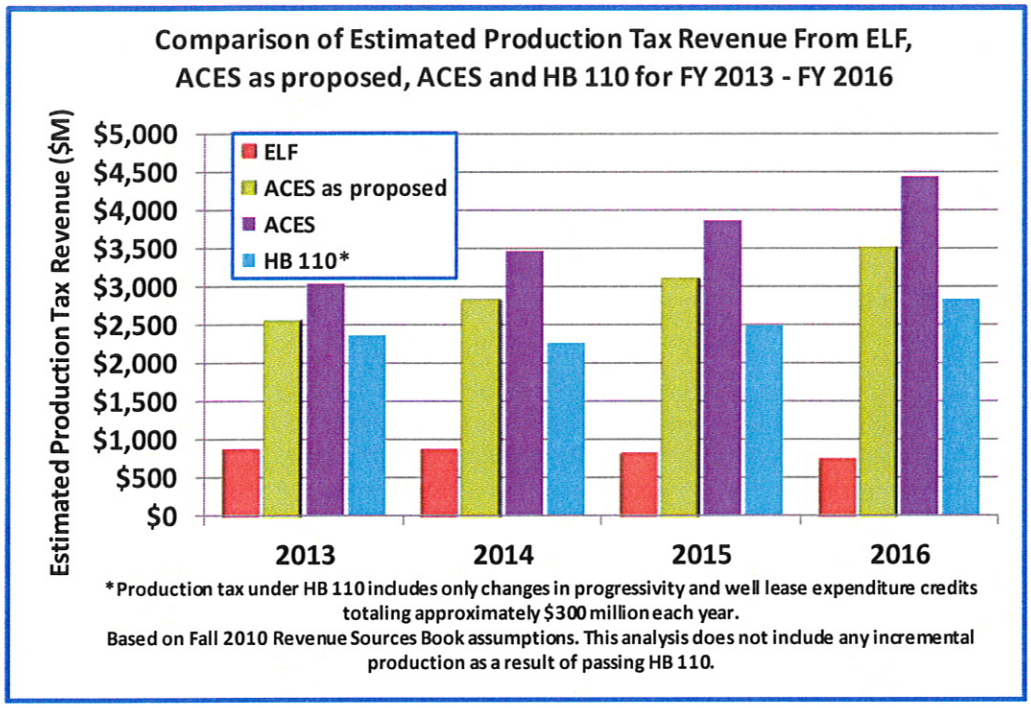
Dear Representatives Thomas and Stoltze:

The purpose of this document is in response to the follow-up questions from the House Finance Committee meetings on March 24 and 26, 2011. The requests/questions and responses follow.

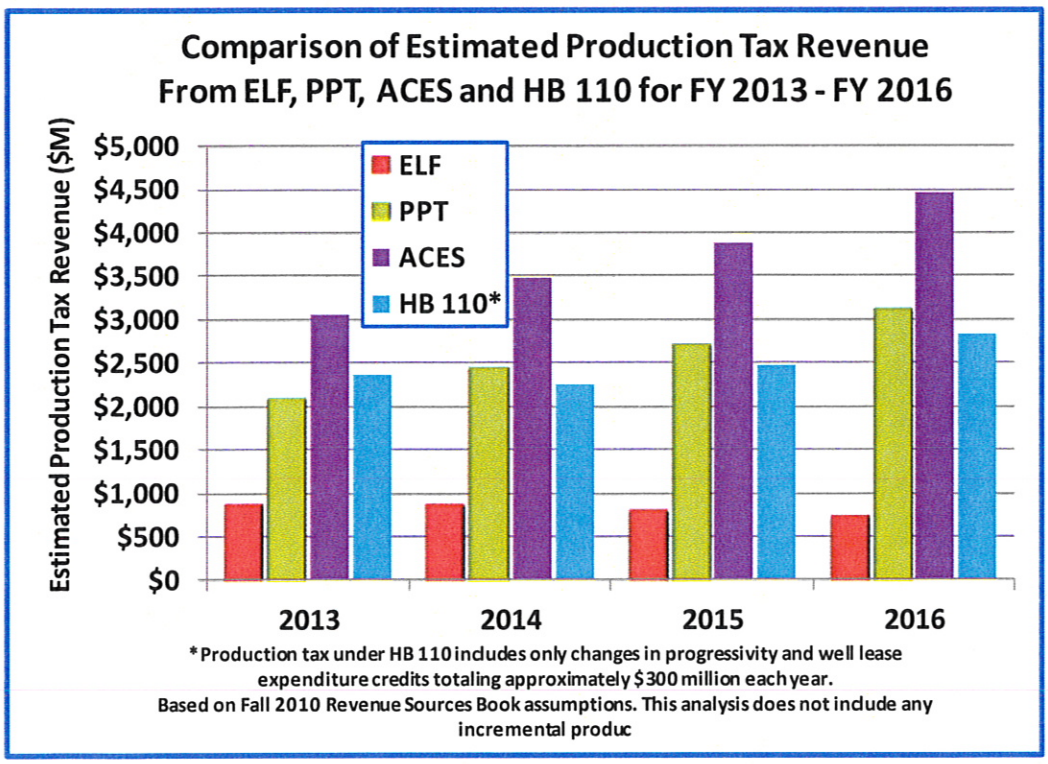
(1) Explain why the 40% well lease expenditure credit enacted last year was only made available for areas below 68 degrees north latitude.

The 40% well lease expenditure credit was included in HB 280 which became law in 2010. HB 280 was a broader package aimed at incentivizing additional exploration and production in the Cook Inlet area. Therefore, several provisions of HB 280 were applicable only to areas below 68 degrees north latitude. In 2010, the administration proposed separate legislation (HB 337) which would have created a 40% tax credit for well lease expenditures for all areas of the state, with the goal of incentivizing additional exploration and production in all areas of the state.

(2) Provide a chart comparing revenue in FY 2013-FY 2016 showing ELF, ACES, HB 110, and ACES as originally proposed in 2007.



(3) Provide a chart comparing revenue in FY 2013-FY 2016 showing ELF, ACES, HB 110, and PPT.

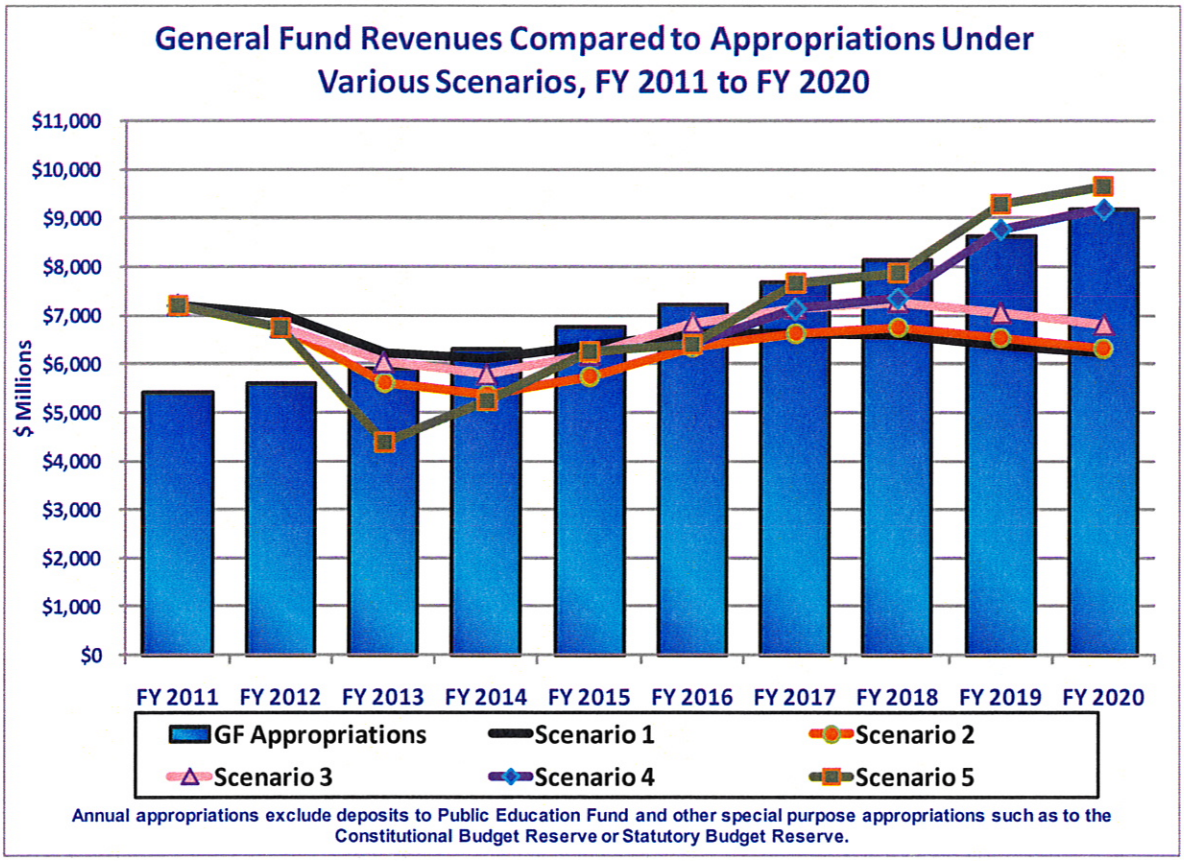


(4) Show all five fiscal scenarios presented in committee on the same chart.

The following chart provides a summary of the five scenarios presented to the committee on March 26, 2011. Please refer to the presentation for more information about the sources and assumptions behind these scenarios.

Summary of 5 scenarios presented in House Finance Committee March 26, 2011

The following chart provides a summary of the five scenarios presented to the committee on March 26, 2011. Please refer to the presentation for more information about the sources and assumptions behind these scenarios.



All Scenarios assume the Legislative Finance Division projection for General Fund expenditures, the DOR preliminary Spring 2011 price forecast, and the DOR preliminary Spring 2011 production forecast with adjustments described below.

Scenario 1: Impact of ACES assuming that the "Under Evaluation" component of the DOR forecast does not materialize and only 75% of "Under Development" component materializes.

Scenario 2: Impact of HB 110 on Preliminary DOR Spring 2011 production forecast.

Scenario 3: Impact of HB 110 assuming production is 10% higher than DOR forecast beginning in FY 2013

Scenario 4: Impact of HB 110 assuming 10% increment to forecast beginning in FY 2013, hypothetical new Alpine-size field on line in FY 2018 as presented by AOGCC, and hypothetical new fields development as presented by Brooks Range.

Scenario 5: Impact of HB 110 assuming 10% increments to forecast beginning in FY 2013 and FY 2017, hypothetical new Alpine-size field on line in FY 2018 as presented by AOGCC, and hypothetical new fields development as presented by Brooks Range.

(5) Where were all the wells drilled from 2007 to current located, relative to existing units?

Of the 41 exploration wells drilled since 2007, 11 wells were located inside existing units. The remaining 30 wells were located outside existing units; of those, 18 were on state land in the arctic slope area, 4 were on state land in the arctic foothills area, and 8 were on federal land in the NPR-A area. For purposes of this response only, the two Point Thomson exploration wells in 2010 were included in the "inside existing units" category.

Of the 41 exploration wells drilled since 2007, 25 of the wells applied for a 20% tax credit, 6 wells applied for a 30% tax credit, and 10 wells applied for a 40% tax credit.

(6) Provide a definition of a unit.

The term "unit" is defined for production tax purposes under AS 43.55.900 (23):

(23) "unit" means a group of tracts of land that is
(A) subject to a cooperative or a unit plan of development or operation that has been certified by the commissioner of natural resources under AS 38.05.180(p);
(B) subject to a cooperative or a unit plan of development or operation that has been certified by the United States Secretary of the Interior under 30 U.S.C. 226(m);
(C) subject to an agreement of the owners of interests in the tracts of land to validly integrate their interests to provide for the unitized management, development, and operation of the tracts of land as a unit, within the meaning of AS 31.05.110(a); or
(D) within the unit area of a unit created by order of the Alaska Oil and Gas Conservation Commission under AS 31.05.110(b)

In addition, if requested, the Department of Natural Resources is prepared to provide the committee with a brief presentation explaining the concepts of leases, units, and participating areas in more detail.

(7) Provide a matrix showing each element of HB 110 (including all amendments), what each section hopes to accomplish, and the fiscal impact of each section.

The matrix with the requested information is included on the following page.

Provisions in CSHB 110(RES) and their Revenue Impact as compared to Fall 2010 Forecasted Revenue

Brief Description of Provisions	Reason for the Provisions	Revenue Impacts of the Provisions ($mm)					
Provisions in HB110 as Proposed		**FY 2012**	**FY 2013**	**FY 2014**	**FY 2015**	**FY 2016**	**FY 2017**
1. Change in interest rate from greater of 5% above Fed Rate or 11% to lesser of 3% above Fed Rate or 11%.	This provision is applied to both interest due the State and interest due the tax payer. We have seen it go either way and believe the 11% is excessive and could expose the State to large payouts.	**Indeterminate**					
2. Lower the thresholds for the minimum tax.	DOR believes that if we are "giving some up" on the upper end, we should recover a bit more on the lower end. This would only apply under very low oil prices therefore we do not anticipate it coming into affect in the near future.	$0	$0	$0	$0	$0	$0
3. Change the tax rate for unitized areas from current ACES progressivity to a bracketed progressivity structure. Also change the calculation of the tax from a monthly to an annual calculation.	This is the most critical part of the bill and is reflected in the biggest impact on the fiscal note. This provision goes right to the heart of the issue in the Governor's mind - the incredibly steep progressivity at higher prices is making Alaska MUCH less attractive.	$0	-$382	-$961	-$1,126	-$1,341	-$1,423
4. Change the tax rate for non-unitized areas from current ACES to a base rate of 15% and a bracketed progressivity structure. Also change the calculation of the tax from a monthly to an annual calculation.	This is meant to incentivize exploration in the areas south of the North Slope which constitutes 75% of the State acreage.	**Indeterminate**					
5. Eliminate the provision that credits must be taken over two years.	Spread over 2 years makes it much more paper/labor intensive on DOR and impacts the smaller companies on a cashflow basis.	**Revenue neutral**					
6. Expand the well lease expenditure credit to include expenditures in areas north of 68 degrees North Latitude.	This provision was added last session in HB280 to address Cook Inlet. The Governor believes it would also be of great benefit to the NS when it comes to oil recovery from the existing large fields that supply 90% of our GF.	**-$200 to -$400 per year**					
7. Change the statute of limitations on the assessment of taxes from six to four years after the annual return is filed.	Still 1 year longer than under PPT. Was removed in HRES. DOR did not object.	$0	$0	$0	$0	$0	$0
8. DOR Agency Costs	Requires additional auditors, change in accounting system.	-$0.1	$0.0	-$0.3	-$0.3	-$0.3	-$0.3
Provisions that were added or changed in House Resources							
9. Expand exploration credits to include North Slope expenditures for wells that are (a) outside a unit; or (b) for certain expenditures for areas in units after June 30, 2008.	These provisions were added or changed in the House Resources Committee and the Department's position on each of the changes is neutral.	**Indeterminate**					
10. Extend the small producer, new area development, and alternative tax credit for exploration from 2016 to 2021.		**Indeterminate**					
11. Increase the small producer credit from $12 million to $15 million per year.		**Less than -$20 million per year**					
12. Add a credit in the amount that a producer's wages and compensation paid to Alaska resident workers exceeds 80% of all wages and compensation paid by the producer in the state.		**Indeterminate**					
13. Expand the tax information disclosure statute to include the disclosure of types of credits and expenditures		$0	$0	$0	$0	$0	$0
14. Eliminate change #7 above.		$0	$0	$0	$0	$0	$0
TOTAL REVENUE IMPACT		**-$120 to -$220**	**-$602 to -$802**	**-$1,181 to -$1,381**	**-$1,346 to -$1,546**	**-$1,561 to -$1,761**	**-$1,643 to -$1,843**

(8) Provide analysis of the financial impact of Section 17 (local hire credit). Are there any oil companies currently close to the 80% resident hire?

The local hire credit, which was added in Section 17 of the House Resources version of HB 110, is a credit for the percentage of total wages paid to Alaska residents that exceeds 80 percent. Although our sources do not provide a breakout of wages paid to residents versus non-residents, the table provided below provides some insight into the percentage of resident versus non-resident employees in oil and gas companies operating in the state. The data, provided by the Department of Labor and Workforce Development, provides resident hire information as of 2009.

Alaska Resident Workers in the Oil & Gas Related Industries 2009

Employer	Industry	Percent Resident
Alyeska Pipeline SVC CO INC	Pipeline Transportation	92.1
AMOCO Production Company	Oil and Gas extraction	24.3
BP Exploration Alaska Inc	Oil and Gas Extraction	73.7
Chevron USA Inc	Oil and Gas Extraction	92.1
ConocoPhillips Company	Oil and Gas Extraction	81.6
Exxon Mobil Corporation	Oil and Gas Extraction	65.6
Pacific Energy Resources LTD	Oil and Gas Extraction	100
Pioneer Natural Resources USA Inc	Oil and Gas Extraction	85.5
XTO Energy Inc	Oil and Gas Extraction	97.5

Source: Alaska Department of Labor and Workforce Development

The DOR does not have an official position on the local hire credit. The Department does note, however, that the provision could provide substantial tax benefits to companies who qualify for the credit. Benefits such as these could drive investor behavior to realize the tax savings, often at a significant cost to the state. We provide an analysis of example companies A, B, and C on the following page to illustrate potential consequences of the tax credit to the companies and to the state.

Hypothetical Analysis of Impact of Resident Wages Credit

Current Status Prior to Resident Wages & Compensation Credit

Company	Total # of employees	# of resident employees	Average compensation per employee	Total compensation paid	Compensation paid to residents	Resident compensation % of total	Tax Liability before credit
Company A	200	156	$125,000	$25,000,000	$19,500,000	78.0%	$100,000,000
Company B	500	375	$150,000	$75,000,000	$56,250,000	75.0%	$500,000,000
Company C	2000	1700	$100,000	$200,000,000	$170,000,000	85.0%	$1,000,000,000

Changes after Resident Wages & Compensation Credit Enacted

- Company A - Lays off 100 employees including 60 residents and 40 non-residents, contracts out work to an out-of-state firm.
- Company B - Provides pay raises in the amount of $100,000 to all resident workers.
- Company C - Makes no changes whatsoever to existing pay, compensation, or resident hire.

Status After Resident Wages & Compensation Credit Enacted

	Total # of employees	# of resident employees	Average compensation per employee	Total compensation paid	Compensation paid to residents	Resident compensation % of total	Tax Credit
Company A	100	96	$125,000	$12,500,000	$12,000,000	96.0%	16.0%
Company B	500	375	$250k / $150k	$112,500,000	$93,750,000	83.3%	3.3%
Company C	2000	1700	$100,000	$200,000,000	$170,000,000	85.0%	5.0%

Tax Credits Earned from Resident Wages & Compensation Credit

	Tax Liability before credit	Resident Wages & Comp Credit %	Resident Wages & Comp Credit $	Tax Liability after credit	Cost to company to achieve credit	Net gain to company
Company A	$100,000,000	16.0%	$16,000,000	$84,000,000	$0	$16,000,000
Company B	$500,000,000	3.3%	$16,666,667	$483,333,333	$37,500,000	($20,833,333)
Company C	$1,000,000,000	5.0%	$50,000,000	$950,000,000	$0	$50,000,000

Summary

- Company A - receives a $16 million benefit for laying off workers (including residents) and contracting out of state.
- Company B - Provided pay raises to all resident workers but no additional jobs; state paid 44% of the cost.
- Company C - Receives a $50 million benefit for maintaining their existing hire and compensation practices.

(9) Provide a legal opinion from Department of Law regarding Section 17 (local hire credit).

The Department of Law has provided a memorandum, dated March 28, 2011, on this topic. The memorandum references a previous legal review, dated April 23, 2008, which addressed the resident hire provisions of the film production tax credit. Both documents are included as attachments to this response.

We hope our responses fully answer your questions.

Sincerely,

Bruce Tangeman
Deputy Commissioner

Attachments:

March 28, 2011 Memorandum from Department of Law re: CSHB 110

April 23, 2008 Letter from Department of Law re: HCS CSSB 230

MEMORANDUM

State of Alaska

Department of Law

To: The Honorable Bryan Butcher
Commissioner of Revenue

Date: March 28, 2011

File No:

Tel. No.: (907) 465-3600

Fax: (907) 465-2417

From: Susan Pollard SRP
Assistant Attorney General
Oil, Gas & Mining Section

Subject: CS for HB 110, 27-GH1007\B, Section 17 – Constitutional Issues

You requested that I review Section 17 of the CS for HB 110. That section would amend AS 43.55.023 to add a provision allowing a credit against production taxes for a producer that incurs more than 80 percent of its wage and compensation expenditures for wages and compensation paid to Alaska residents. The CS is currently before the House Finance Committee.

Section 17 of the CS for HB 110, to the extent it provides a tax incentive for employment of resident workers, may raise constitutional issues under the Privileges and Immunities Clause of the United States Constitution. U.S. Const. art. IV, sec. 2. The privileges and immunities clause precludes discrimination against non residents for reasons of economic protectionism. Those constitutional issues were discussed in a 2008 Department of Law bill review letter for HCS CSSSB 230 (FIN), which provided for an additional 10 percent film tax credit for wages paid to Alaska residents. The points raised in the Department of Law review of that provision apply here. Therefore, I have attached the bill review letter HCS CSSSB 230 (FIN).

Although AS 01.10.030 provides that any law enacted by the Alaska legislature that lacks a severability clause shall be construed as though it had a severability provision, it may be advisable to add a severability clause to assure

that the other provisions of the bill would not be affected if section 17 were ruled invalid by a court.

Please let me know if I may be of further assistance.

Enclosure

Cc: John J. Burns, Attorney General
Jim Cantor, Deputy Attorney General

STATE OF ALASKA

DEPARTMENT OF LAW

SARAH PALIN, GOVERNOR

P.O. Box 110300
Juneau, Alaska 99811-0300
Phone: (907) 465-3600
Fax: (907) 465-2075

April 23, 2008

The Honorable Sarah Palin
Governor
State of Alaska
P.O. Box 110001
Juneau, Alaska 99811-0001

Re: HCS CSSSSB 230(FIN) -- establishing the film office in the Department of Commerce, Community, and Economic Development; and creating a transferable tax credit applicable to certain film production expenditures incurred in the state
Our file: 883-08-0054

Dear Governor Palin:

At the request of your legislative director, the Department of Law has reviewed HCS CSSSSB 230(FIN), establishing the film office in the Department of Commerce, Community, and Economic Development; and creating a transferable tax credit applicable to certain film production expenditures incurred in the state. Qualified film producers may receive up to 30 percent of the qualifying expenses that are directly related to the production of a film and are incurred in the state. Producers may receive a larger credit for payment of the costs of wages paid to Alaska residents, or for expenditures made in rural areas, or for expenditures made between October 1 and March 30. Credits must be used, sold, or transferred within three years of being granted by the state and may not have an aggregate value of more than one hundred million dollars ($100,000,000). A producer, if a corporation, may use earned credits to reduce its Alaska Net Income Tax (corporate tax) debt. The credits may also be sold or transferred to a corporate taxpayer.

The bill limits the type of expenditures that may be claimed for the credit. The expenditures must be incurred in the state and directly related to the film production. They must also be ordinary, reasonable, and not in excess of the fair market value of the

goods or services purchased. Also, they must be for real or tangible property, fees, services, state taxes, or local taxes.

The bill adds AS 44.33.235(c)(1) to Alaska law, which might appear to encourage discrimination against non-resident workers by allowing film producers to receive a 40 percent tax credit for wages paid to Alaska residents. Producers would only be permitted to take a 30 percent credit for wages paid to non-residents. Workers residing outside of Alaska might claim that AS 44.33.235(c)(1) violates the Privileges and Immunities Clause of the United States Constitution. U.S. Const. art. IV, sec. 2. They might find support in *Hicklin v. Orbeck,* 437 U.S. 518, 524 (1978), where the United States Supreme Court found that a nonresident's right to ply a trade, practice an occupation, or pursue a common calling within the state is a fundamental right protected by the Privileges and Immunities Clause.

The Privileges and Immunities Clause precludes discrimination against nonresidents when the governmental action "burdens" one of the privileges and immunities protected under the clause, and either the government does not have a "substantial reason" for the difference in treatment or the discrimination practiced against the nonresidents does not bear a "substantial relationship" to the government's objectives. *Supreme Court of New Hampshire v. Piper,* 470 U.S. 274, 284 (1985). The clause is implicated here because AS 44.33.235(c)(1) might appear to encourage employment discrimination in favor of Alaska residents.

In order for AS 44.33.235(c)(1) to survive a constitutional challenge, the state would have to demonstrate a substantial reason for encouraging the hiring of Alaska residents and that the discrimination bears a substantial relationship to the government's objectives. To prove a "substantial reason" the state would have the burden of proving there is a valid independent reason for the disparate treatment and that nonresidents are a "peculiar source of the evil" at which the statute is aimed. *Hicklin*, 437 U.S. at 526. The justification must be something other than to simply alleviate high unemployment, because that reason was rejected by the court in *Hicklin. Id.*

The State of Wyoming successfully defended a statute requiring its contractors to give a hiring preference to Wyoming residents by arguing the provision was not designed to eradicate general unemployment but rather to "prevent a qualified Wyoming worker's remaining unemployed while a nonresident goes to work on a government-funded construction project." *Wyoming v. Antonich*, 694 P.2d 60, 63 (Wyo. 1985). The Wyoming Supreme Court accepted this justification. The court also found that because the preference only discriminated against nonresidents trying to obtain work on government projects it presents a minimal affront to the privileges and immunities of nonresidents.

After publication of *Wyoming v. Antonich,* the Alaska Supreme Court struck down an Alaska hire bill in *Robison v. Francis*, 713 P.2d 259 (Alaska 1986). The *Robison* decision treated *Antonich* in a manner that offers little encouragement for anyone wishing to use the Wyoming decision to defend a provision like AS 44.33.235(c)(1).

An argument might be made that the additional 10 percent tax credit for wages paid to Alaska residents presents a different case because it requires no mandatory quota of Alaskans to be hired and represents a minor part of the total wages paid. As a result, it could be viewed as, in practice, unlikely to have a substantial discriminatory effect in favor of Alaska residents.

Even though there is some risk that AS 44.33.235(c)(1) could be found to be in violation of the Privileges and Immunities Clause, if a court found the provision unconstitutional, it could order that the provision be severed from the bill, allowing the balance of the bill to continue in effect. AS 01.10.030; *Lynden Transport Inc. v. State,* 532 P.2d 700 (Alaska 1975).

Another statute section that would be added to Alaska law by the bill, AS 44.33.236, also raises some constitutional issues. The section sets out a list of expenditures for which a film producer may receive a tax credit. Included are the costs of services provided by Alaska residents. For example, "costs of music, if performed, composed, or recorded by an Alaskan musician" would be an allowable expenditure under AS 44.33.236(a)(12).

If AS 44.33.236 stood alone, a court could find that it discriminates against non-resident musicians in a manner that violates the Privileges and Immunities Clause. By allowing a tax credit for services provided by Alaska residents only, AS 44.33.236 could also be seen to discriminate against interstate commerce in violation of the Commerce Clause of the United States Constitution at art. I, sec. 8. *See Bacchus Imports Inc. v. Dias*, 468 U.S. 263 (1984). In *New Energy Company v. Limbach,* 486 U.S. 269 (1988), the United States Supreme Court found that an Ohio tax provision violated the Commerce Clause by providing a tax credit for the use of ethanol produced in Ohio but not for the use of ethanol produced elsewhere.

Fortunately, the language used by the legislature in AS 44.33.236 does not make the list of allowable expenditures exclusive. The section provides that expenditures "may include" the types of costs set out in the list. Implicit in this is the intent to allow the film office to consider other types of expenditures. *See Turpin v. North Slope Borough*, 879 P.2d 1009, 1012-13 (Alaska 1994). Therefore, AS 44.33.236 does not, on its face, violate the Privileges and Immunities Clause or the Commerce Clause. We would recommend

that the film office, in cooperation with the Department of Revenue, consult with the Department of Law in implementing this provision.

The remaining legal issue about the bill concerns AS 44.33.233(c)(5), which prohibits the film office from awarding a tax credit to the producer of a film that contains sexually explicit conduct "as defined in 18 U.S.C. 2256." Although the federal Act that contained the definition is directed at criminal conduct involving sexually explicit conduct and children, the legislature's inclusion of only the definition creates an ambiguity: that the definition might be read in an overbroad fashion, to include the exercise of constitutionally protected speech that is not a crime. However, the bill allows the film office to adopt regulations, in cooperation with the Department of Revenue, to carry out functions under AS 44.33.231 - 44.33.239. *See* proposed AS 44.33.238. We would recommend the adoption of regulations to resolve the ambiguity in AS 44.33.233(c)(5) in a constitutional manner.

We do not believe that this bill has any other legal concerns or constitutional issues for your consideration.

Sincerely,

Deborah E. Behr

for Talis J. Colberg
Attorney General

TJC:DNB:jme