Alaska Oil and Gas Association

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ALASKA OIL AND GAS ASSOCIATION TESTIMONY ON HOUSE BILL 72 TO THE HOUSE RESOURCES COMMITTEE

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Good Afternoon. For the record, my name is Kara Moriarty and I am the Executive Director of the Alaska Oil and Gas Association, commonly known as "AOGA". AOGA is the professional trade association that represents 15 member companies who account for the majority of oil and gas exploration, development, production, transportation and refining of oil and gas onshore and offshore in Alaska. These comments regarding House Bill 72 have been reviewed by all members and were approved unanimously.

The greatest, and most urgent challenge facing Alaska today is the decline of oil production from the North Slope. And the greatest, most urgent issue facing this Legislature is how you will address this problem.

For someone who is happy and content to see Alaska continue along the path it is headed on, the answer to this question is — do nothing; leave the present tax system alone.

But most Alaskans would disagree that this is the future they want. They hope for a robust industry on the North Slope beyond their own lifetimes. They want their children and grandchildren to have the benefits from the oil industry that this generation of Alaskans, and the one before, have enjoyed. They want the good jobs that the industry offers to continue, and they want industry to continue to support the education and skills training that are needed to qualify for many of those jobs. They want their friends and neighbors who work for the industry to stay here. They want all the volunteer community services to continue that industry employees perform, and that companies themselves do directly. The want the activity and growth in the Alaskan economy that industry stimulates to continue. And, of course, they like the fact that industry pays for a great majority of the costs of government and hope that this, too, will continue.

The role of AOGA, and of individual companies doing business here, is not to tell Alaska how much it ought to collect from oil and gas, nor should that be our role. Rather, we should tell you about

how Alaska's tax regime is affecting our businesses, about the parts of the present tax laws that are not working as intended, and about ways to improve the tax structure to get more of the intended results. With that knowledge, you can then make sound, informed decisions about how much tax to collect, how to collect that amount, and when to collect it.

For several years there has been a red herring in the public discussion about oil taxes. This is the notion that any change in tax structure that reduces tax revenues below the projections in the Revenue Sources Book is a "giveaway." This reflects an assumption that those forecasted oil and gas taxes are somehow a "given" — something like money already in the bank, and all the State Treasury needs to do is wait for it to be deposited into the State's account. The fact, however, is that industry has to spend roughly $2 billion dollars each year just to slow the production decline from what it would naturally be, in order even to approach the level of production published in the Revenue Sources Book. And just like any other investment industry makes here, these production-sustaining investments have to beat the competition elsewhere for those investment dollars: they are both not a "given."

Worse, the "tax giveaway" argument assumes the production in the Revenue Sources Book is all that will be produced. These critics factor in nothing for any additional production and revenue resulting from a tax reduction. Instead it looks only at the downside and ignore the upside. The upside, though, is real. If a tax reduction makes investments here more competitive, companies will want to make more investments here for that upside. And they will do so even though they, like the State, lack the gift of prophecy and cannot know beforehand exactly what the upside will turn out to be for any particular investment.

As you consider solutions to the momentous challenge that production decline creates, it will be wise and useful to identify the principles you want the tax system to embody, and the specific goals you want it to achieve. AOGA believes Governor Parnell's four "core principles" offer an excellent cornerstone for this:

- "First, tax reform must be fair to Alaskans."
- "Second, it must encourage new production."
- "Third, it must be simple, so that it restores balance to the system."
- "Fourth, it must be durable for the long term."

We believe a fifth such principle will be prudent as well, because the challenge facing Alaska is not that there are too many companies pursuing opportunities they see here, but that there are too few. Alaska should therefore avoid tax changes that artificially create "winners" and "losers."

With respect to House Bill 72, there are four major features in it that we wish to address, and the Bill omits several others that we would like to draw your attention to.

The major features in the Bill are the elimination of progressivity, changes to the present system of tax credits, a "gross revenue exclusion" for certain new production, and the timing for these changes to occur. Here are our thoughts on them.

1. Repeal of Progressivity. AOGA endorses the elimination of progressivity. First, progressivity directly attacks and destroys one of the few strategic advantages that Alaska has, which lies in its economic remoteness. It costs $9.42 on average to ship a barrel of oil from the North Slope to the West Coast, according to the Fall 2012 Revenue Sources Book, Appendix D-1b. This means Alaska starts off with a disadvantage of $9.42 a barrel against Outside competition, so other parts of an Alaskan investment must be pretty strong in order to overcome this disadvantage. Otherwise they won't be made.

If oil prices turn out to be higher than what they were projected to be in the investment analysis, nearly 100% of each extra dollar in price flows directly into the Gross Value at the Point of Production (GVPP) and then, after royalties and taxes, flows straight into the investor's bottom line. This, in turn, improves the economic performance of an Alaskan investment relative to an equally competitive one Outside, because the Alaskan baseline was $9.42-a-barrel lower and an additional dollar in price is a larger percentage of that baseline than for the percentage for the Outside investment. This can be particularly significant for potential investors who are bullish on oil prices.

Currently, progressivity in conjunction with a 25% base tax will take half of each dollar from higher prices when the West Coast price is $132.38 (using the Fall 2012 Source Book numbers) — a price that has already been seen, although somewhat higher than today's. So, even for investors who are bullish on oil prices, progressivity destroys half of the one strategic advantage that Alaska's economic remoteness provides. And the more bullish they are, the more this advantage is undone because they will see higher rates for progressivity at those prices in their investment analysis.

Second, progressivity brings extraordinary complexity to the tax, not only in calculating what the tax is, but also in analyzing what the amount of the progressivity is for any particular item that affects a taxpayers Production Tax Value (PTV). This complexity exists because the tax rate for progressivity depends on the taxpayer's PTV per barrel, and then the resulting rate is applied to the very same PTV that set the rate. This circularity in the tax calculation leads to bizarre effects. For instance, simply the fact that oil prices fluctuate during a year instead of remaining perfectly flat increases the tax even though the average of the fluctuating prices is the same as the flat price — and the greater the fluctuation, the greater the tax from progressivity becomes. There is no objective economic or financial reason for the tax to go up; instead, this occurs entirely because the progressivity calculation is circular.

2. Tax Credits

In general, tax credits, whether they be for drilling a well, building a facility to gather new oil or the pipe to build a flowline, represent a direct reduction in the amount that a potential investor puts at