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Sectional Analysis, HB 247 (29-GH2609\A)

Governor's Oil and Gas Tax Credit Reform Bill

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AOGA Comments/Questions italicized

Sec. 1-5. Conforming language related to the repeal of AS 41.09 in Sec. 40 of the bill. The repeal is a currently unused exploration incentive credit program.

Sec. 6. Conforming language related to changes to reporting requirements and confidentiality rules in Sec. 8 of the bill.

Sec. 7. Changes the interest rate for delinquent taxes from 3 percent above the Federal Reserve Discount Rate to 7 percent above. This would currently result in an interest rate of about 8%; about halfway between the current 4% and the 11% that was in place before the passage of SB21 in 2013. If the state were to begin using earnings from our major savings account, the Permanent Fund, to fund government operations, there would be an "opportunity cost" that comes from unpaid taxes. Our interest rate on these unpaid taxes should reflect the expected rate of earnings on our savings.

[AOGA Comment]: AOGA supports the current rate and believes it is reasonable particularly considering the lengthy statute of limitation that provides the Department of Revenue with six years to audit a company's production tax return.

Raising the interest rate and returning to compound interest could be an incentive for the State to delay the completion of its audits so more interest can accrue. With the long six-year statute of limitations for auditing, these changes to the calculation of interest will increase unpredictability in Alaska's tax system and undercut Alaska's position in the competition for scarce investment dollars to keep oil flowing through the pipeline.

Sec. 8. Provides an exception to the general taxpayer confidentiality statutes, so that the name of each company claiming credits, the amount they claim, and a general description of their activities can be made public.

[AOGA Comment]: This information is currently confidential, and to protect that confidentiality, the law (AS 43.55.890(11)) allows the Department of Revenue ("DOR") to disclose information about tax credits only on an "aggregated" basis for a group of three or more taxpayers. The impetus for Section 8 arises from credits that are being earned by only one or two taxpayers — too few for disclosure on an aggregated basis.

Confidentiality of tax information is the mechanism by which taxpayers' constitutional privileges and immunities regarding private, proprietary and commercially sensitive information and materials are reconciled with DOR's goal of having taxpayers report and pay their taxes correctly, and with its need to audit them to ensure they are correct. Without confidentiality, DOR's

authority to require information and documents from taxpayers would be materially curtailed by these constitutional constraints.

For taxpayers, however, confidentiality is basically an all-or-nothing proposition — the constitution does not prohibit partial waivers of a privilege or immunity that a limited only a specific information or materials, but it does not authorize partial waivers either. Thus a taxpayer cannot agree to the disclosure of specified information or materials for a tax without the risk that doing so will waive the privilege and immunity for all of its tax information for that tax.

Section 8 reflects none of this. Nor does it indicate what the Administration specifically hopes to achieve by this change to confidentiality.

Sec. 9-11. Amends the Gas Storage Facility, LNG Facility, and In-State Refinery Tax Credits so that these cannot be paid if the taxpayer has any outstanding liability to the state.
Currently this is restricted to only a tax liability.

[AOGA Comment]: There is an existing limitation on using certain tax credits when the party using them has an outstanding tax liability to the State. Section 39 of the Bill changes the definition of "outstanding liability" so that it is any liability — no matter what the non-tax liability may be, how trivial it is, or whether it is being appealed. Thus this change is overly broad and threatens to lead to denial or delay of valuable redeemable tax credits.

If the taxpayer has valid redeemable tax credits but is issued an audit assessment before applying for cash reimbursement, will the taxpayer now have to wait until resolution of the audit before redeeming the tax credits for what might be critically important funds for current investments?

Sec. 12. Increases the minimum tax rate in AS 43.55.011(f) to 5% at all oil prices. Currently it is 4% at any oil price above $25 per barrel, stepping down at lower prices. The minimum tax applies only to production from the North Slope.

[AOGA Comment]: An increase of one percentage point in the rate of tax might not sound significant, but it would be a 25 percent increase for each taxpayer subject to the minimum tax because West Coast prices, so far at least, are still over $25 a barrel — putting the rate for minimum tax at four percent. In fact, according to DOR's presentation, oil prices would need to climb to approximately $85 a barrel before the minimum tax will not apply.

For smaller companies or newcomers to the state who have yet to make a profit in Alaska, they don't pay the 4% tax now, so under this provision they would go from paying zero in production tax because they don't make a profit, to immediately being hit with a 5% gross tax represents an increase of over 100 percent, or as Director Alper referred to it as "an infinite increase."

Implementing or raising taxes on companies who are in negative cash flow positions is like kicking someone who is already down. It is not wise, nor feasible, long-term solution to Alaska's production problem or sound tax policy.

Sec. 13. Changes the description of monthly installment payments in AS 43.55.020(a), to conform with the higher minimum tax rate in Sec. 12. (long technical section)

[AOGA Comment]: This change would require companies to pay the higher of the new 5% minimum tax or regular net tax effective with July 1 production.

Sec. 14-16. Conforming language related to the repeal of AS 43.55.020(a)(1) and (2) in Sec. 40 of the bill. The repeal is obsolete installment payment language related to production prior to 2014.

Sec. 17. Strengthens the minimum tax in two distinct ways:

(b) Prevents several credits that currently can be used to reduce payments below the 4% level from being used for this purpose. Those credits would be carried-forward until the taxpayer had sufficient tax liability against which to use them.

(c) Prevents the circumstance in which per-taxable-barrel credits that could not be used in the month in which they were earned, because of the limitations of the minimum tax, could be claimed at annual tax true-up. This effectively turns the per-taxable-barrel credit into a monthly rather than an annual calculation. Currently if there is substantial price volatility within a year it could result in large tax refunds.

[AOGA Comment]: This is nothing more than a disguised tax increase.

The production tax is an annual tax paid in monthly installments, which reflects the fact that producers keep their accounting books and records on an annual basis and do not close and balance them at the end of each month, nor even at the end of each calendar quarter.

Each installment reflects one-twelfth (1/12) of the spending budget for the entire year, but actual expenditures routinely run over or under budget, and no one can forecast how much these variances from the budget will be. Furthermore, the budget can increase or decrease during the year in response to unanticipated factors. And on the revenue side of the ledger, each installment can reflect the actual prices for the current month and prior ones, but can only include one's assumptions about future prices during the rest of the year.

Since these key factors in the calculation of the tax for the full year — including the calculation of whether minimum tax is greater than the normal tax, as well as the calculation or application of tax credits from ongoing expenditures during the year — cannot be known for the full year until after the year is over, the sum of the monthly estimated payments will not equal the total tax for that year except by sheer coincidence. This is why, at the end of the calendar year, the producer is required to file a "true-up" or "final tax installment" reflecting the correct amount of production tax for the entire calendar year of operations.

Section 17 not only disregards these real and unavoidable uncertainties in monthly installments and their respective variances from the full-year figures, it would also punish a producer by locking down the monthly portion of any credit a producer earns or has available to the amount reflected in the installment for that month, instead of the actual and correct monthly amount for that credit as determined at true-up. This limitation creates uncertainty about the actual amount of credits a producer would earn or have available to use during its operations for a year, since the sum of the monthly credits can only be less than the amount for them based on the full-year's figures. And this new, wholly unnecessary and artificial risk about the credits will tend to reduce a company's desire to make investments in the state.

Worse, for those credits which are not allowed to be carried forward or transferred, they would be lost under this provision, which would be a significant and permanent tax increase.

Sec. 18. Modifies the carried-forward annual loss credit in AS 43.55.023(b) so that, for "new" oil production eligible to receive the Gross Value Reduction (GVR), the GVR cannot be used to increase the size of an annual loss. Thus, if a company has oil production but is operating at a loss, their loss credit is limited to the actual size of the loss. Currently there are circumstances in which a company could receive credit refunds for amounts in excess of 100% of their loss.

[AOGA Comment]: This provision represents another tax increase.

The provision would prevent gross revenue reductions — which are incentives critical to encourage "new oil" production — from being utilized to determine the gross value at the point of production when a producer has a net loss, meaning the economic value and attractiveness of that incentive in current policy is dramatically undercut.

The provision would significantly penalize those companies who have made critical investments since the enactment of the GVR incentive in order to produce "new oil," by preventing them from recovering part of this reward for making that investment.

Sec. 19. Amends AS 43.55.023 so that credits in that section cannot reduce tax liability below the minimum tax, rather than zero as in current statute. Also establishes a sunset when certain credits must be carried forward instead of being cashed out; in these circumstances the credits can only be carried forward for 10 years.

[AOGA Comment]: This provision is still another significant tax increase and represents nothing more than a flagrant money grab at a time when the state should be encouraging industry to continue making vital investments in the state.

For those companies, large and small, that may have exploration, drilling, or tax loss credits from prior year investments and may be in a loss situation due to the low prices and thus are depending on using those tax credits to support continued investment in the state, the proposal would delay or possibly deny that economic recovery at the very time when the companies need it the most.

This change would penalize companies who made important prior year investments in the state and are trying to recoup part of those investments in order to allow them to continue to make more investments in the state at a time when they are losing money – this would be poor tax policy and would lessen the state's global competitive position to attract investment dollars.

This change is analogous to the federal government not allowing corporate losses to be applied against their corporate income tax.

This provision, especially when accompanied with an increase to the minimum tax floor itself, will represent a significant increase to the amount of taxes paid by companies that are already struggling.

Sec. 20. Establishes a sunset in which credit certificates can only be held for 10 years before they expire.

[AOGA Comment]: This provision, especially when combined with the administration's proposal to limit the annual amount of redeemable tax credits to $25M, could put critical redeemable tax credits at risk.

Sec. 21. Conforming language related to the repeal of AS 43.55.023(a) in Sec. 40 of the bill. The repeal is the "qualified capital expenditure" credit outside of the North Slope.

[AOGA Comment]: The provision to remove the "qualified capital expenditure" tax credit for non-North Slope investments is another significant tax increase that will erode capital investment that is critical to the long-term sustainability of oil and gas development in Cook Inlet and Middle Earth.

The qualified capex tax credit was an important and needed incentive that enabled new players and developments in the Cook Inlet. Coupled with the dramatic changes to net operating loss credits and elimination of other Cook Inlet credits, repealing these credits could make it very challenging to attract key investment dollars and projects to Alaska, especially in this low price environment when companies are low on cash.

Sec. 22. New language adding the notice and data sharing requirements that are currently part of the alternative credit for exploration, and applying them to other credits. This will enable DNR to continue to receive seismic and downhole information after the sunset of the exploration credits.

[AOGA Comment]: This appears to now expand the data submission requirements for explorers to now existing producers as well. If that is the case, this requirement on producers could be duplicate to the well data provided to the Alaska Oil and Gas Conservation Commission. This would flood Department of Natural Resources with reams of unnecessary data.

Has DNR requested this information? Why do they need it?

How is the information DNR will make public different than the information being considered for public disclosure by the DOR in proposed section 8?

What tax policy purpose is being served?

Why would producers be required to submit "exploration data"? This could seriously impact activities in existing fields and cause significant administrative burdens as producers may now be required to submit lengthy and potentially proprietary data on virtually all well work being considered.

Sec. 23. Amends AS 43.55.024 so that the small producer credit cannot be used to reduce tax liability below the minimum tax. Although this credit will be closed to new recipients in May of 2016, some companies will continue to receive this benefit until approximately 2024.

[AOGA Comment]: Here is yet another tax increase – this time aimed at smaller companies that may depend on continuing to use the small producer credit against potential minimum tax in order to be able to make critical ongoing investments in the state.

This provision in essence penalizes those smaller companies who made prior year investments despite losing money, by denying them the benefit of the small producer credit which underpinned their original investment decision.

Since these credits are not transferable or redeemable, any lost credits would represent a permanent tax increase.

Sec. 24. Amends AS 43.55.024 so that the $5 per-taxable-barrel credit received by GVR eligible North Slope oil production cannot reduce tax liability below the minimum tax. Currently this can be reduced to zero; only the sliding-scale credit for non-GVR oil is limited by the minimum tax.

[AOGA Comment]: The $5 per-taxable-barrel credit for "new oil" is not transferable and cannot be carried forward, so any loss of those credits in a given year represents a permanent tax increase.

This provision — like the limitation on the use of the GVR in Section 18 — is eating the State's seed corn. The "new oil" credit and GVR are significant incentives for developing reservoirs and bringing into production reservoirs that have not yet been developed. They are even more important at this time of low oil prices than they were when they were enacted.

Sec. 25. Amends AS 43.55.025 so that exploration credits cannot reduce tax liability below the minimum tax.

[AOGA Comment]: Another tax increase.

This provision in essence penalizes those companies willing to commit critical and limited exploration dollars to Alaska, by denying them the ability to receive the promised economics of their high risk investments.

This goes against the long-term policy of the state to encourage exploration and development activity and will discourage long-term exploration activity in the state.

Sec. 26. Amends AS 43.55.028(e) to add limitations on which companies can receive refunded tax credits versus which must hold their certificates and use them against tax liability:
(2) Companies with any liability to the state are ineligible to receive payment for their tax credit certificates. Currently this is restricted to only a tax liability.
(5) Limits cash repurchase to only companies whose gross revenues in the previous year were less than $10 billion.
(6) Limits annual per-company repurchase to $25 million.

[AOGA Comment]: This proposal lacks a factual foundation and defies common sense. Why should the annual revenues of a company have any bearing on its eligibility to be paid for its tax-credit certificates? How is a large company somehow less worthy than a small one in getting its tax certificates paid? There is no reason why certain dollars invested in Alaska are better for Alaska than others. And whether an explorer/producer is investing or its financier is making the investment possible, a tax certificate cannot exist unless that investment has, in fact, been made. Different producers have different needs and uses for credits, and the size of projects vary tremendously.

Is the administration's goal to prevent larger taxpayers from wanting to invest in Alaska?

Setting arbitrary limits on companies ($25 million) is unreasonable and will not be an incentive for investment. This size of net operating loss (NOL) tax credit availability is made truly insignificant and will render the NOL credit mostly useless and will most certainly result in chilling existing and new project investments.

Sec. 27. Adds a new limitation to a company's ability to receive a cash repurchase of their tax credits. The state can only repurchase that percentage of a certificate that equals that company's percentage of Alaska resident hire in the previous calendar year.

[AOGA Comment]: Companies try every day to hire as many eligible Alaskans possible. Establishing mandatory local hire requirements as a precondition for a tax credit would make it difficult to plan and evaluate investments and would further challenge new investment to the state. It would also raise significant constitutional issues, as Alaska-hire preference in building the Trans Alaska Pipeline System was struck down by the U.S. Supreme Court.

It is also unjust to single out the oil and gas industry when other industries operating in Alaska employ much higher numbers of non-Alaskans.

Sec. 28-30. Conforming language related to the repeal of AS 43.55.023(a) and / or (l) in Sec. 40 of the bill. The repeal is the "qualified capital expenditure" and "well lease expenditure" credits outside of the North Slope.

Sec. 31. New section specifying that the Gross Value at the Point of Production, defined as sales price less eligible transportation costs, may not be less than zero.

[AOGA Comment]: On a superficial level this explanation of Section 31 may seem to be "just common sense," but in fact it is another example where the State would be sacrificing its long-term interests in order to meet its short-term spending needs.

How is this section expected to work or be applied?

If oil prices get to the point where the Gross Value at the Point of Production ("GVPP") for the North Slope is less than zero at one or more fields or units, that would be exactly the wrong time for the State to raise taxes on the producers of that oil. The GVPP of the producers' share of the oil will also be less than zero, which means that none of the cash-flow demands on the producers for continuing to operate the fields or units is being covered by the value of the oil.

A negative GVPP does not necessarily mean the State has to start paying out a "negative tax" to the producers. That would harm the State in much the same way as the producers stand to be harmed under Section 31 — such a payout of "negative tax" would worsen state cash flows.

Instead of having one side or the other cover cash-flow impacts on the other side from negative GVPPs, perhaps the recognition of the negative GVPP could be deferred until GVPP becomes positive and then be taken into account gradually if GVPP then continues to rise. In effect, the negative GVPP would be treated as if it were a "loan" of GVPP to the State that keeps the resulting tax at zero instead of being negative, and this "loan" would be repaid from a portion of future positive GVPPs.

Sec. 32. Conforming language related to the repeal of AS 43.55.165(j) and (k) in Sec. 40 of the bill. The repeal is the "standard deduction" limitation on lease expenditure inflation that expired in 2010.

Sec. 33-36. Conforming language related to the repeal of AS 43.55.023(a) in Sec. 40 of the bill. The repeal is the "qualified capital expenditure" credit outside of the North Slope.

Sec. 37. In the case where a municipal entity has an interest in oil and gas production, and sells only a portion of that production to an outside party, their ability to deduct lease expenditures and claim credits is limited in proportion to their taxable production.

Sec. 38. Adds a definition for "qualified capital expenditure" to the general definitions section of AS 43.55. This replicates the definition that was in AS 43.55.023 which is repealed because the .023 "qualified capital expenditure" credit is also being repealed in Sec. 40.
Most of the conforming sections that currently reference AS 43.55.023(a) use this definition.

Sec. 39. Adds a definition for "outstanding liability to the state." This conforms with the changes made in Sections 9, 10, 11, and part (2) of 26.

[AOGA Comment]: Our comments above regarding Sections 9-11 apply here as well.

Sec. 40. Repeals multiple sections. All of these have been specifically referenced elsewhere in this analysis or are technical repeals that conform to other repealed statutes.

[AOGA Comment]: The provision will lead to reduced capital investment critical to the long-term sustainability of oil and gas development in the Cook Inlet and Middle Earth. Including the repeal of the AS 43.55.023(a) tax credit for the 20% of Qualified Capital Expenditures outside the North Slope and the repeal of the 43.55.023(l) tax credit for 40% of Well Lease Expenditures outside the North Slope, the provision represents another significant tax increase.

Coupled with the dramatic changes to net operating loss credits and elimination of other Cook Inlet credits, repealing these credits will make it very challenging to attract key investment dollars and projects to Alaska, especially in this low price environment.

Continued and significant investments are critical to maintain a reliable gas supply for Alaska's largest population base. Removing these incentives will only deter necessary spending to support Alaskans' energy needs. In a mature basin such as Cook Inlet, natural decline rates range from 15-50% annually.

New entrants to the Cook Inlet basin have already stated that without these credits they will not move ahead with plans to drill for gas. Removing these credits will cause an increase in the already high cost of doing business in Alaska and consequently an increase in energy costs for Alaskans.

Sec. 41. Applicability section with multiple sub-parts. In general, ensures that the changes only apply to production after the effective date. Also provides that applications that come in later for credits related to expenditures before the effective date are protected under the former program. Clarifies the timing related to the new 10-year sunset for carried-forward annual loss credits.

Sec. 42-43. Transition language enabling DOR and DNR to draft regulations to implement the changes in this Act, and establishing that regulations may be retroactive to the effective date if they are finalized after the effective date.

Sec. 44. Section 17 is retroactive to January 1, 2016. This is the key floor-hardening provision preventing certain credits from being used against the minimum tax, and is related to the specific concern that one or more major producers could have an operating loss in 2015 and use the carried-forward credit to

reduce 2016 tax payments below the minimum tax to zero.
This is the only provision of the bill for which we are seeking this retroactivity.

Sec. 45. Immediate effective date for the transition and regulatory language.

Sec. 46. Effective date of July 1, 2016 for the rest of the Act.

[AOGA Comment]: An effective date of July 1, 2016 for implementation of any substantive changes, whatever they may be, is far too soon. It is now February, and companies' operational plans for the entire calendar year 2016 have already begun to be implemented. Contracts have already been entered into, work has commenced, and financial commitments have been made by the companies – all based on the existing tax structure. Any sudden increase in the taxes and/or reduction in the tax credits on such short notice would therefore be, in effect, a retroactive tax change. This would result in a long-term serious impact to Alaska's oil industry, as well as having a strongly negative impact on the state's reputation throughout the global banking and financial community.