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# Oil and Gas Tax Credit Reform

## SB130

Department of Revenue

**Presentation to Senate Resources Committee**

April 2, 2016

# Bill Title

"An Act relating to confidential information status and public record status of information in the possession of the Department of Revenue; relating to interest applicable to delinquent tax; relating to disclosure of oil and gas production tax credit information; relating to refunds for the gas storage facility tax credit, the liquefied natural gas storage facility tax credit, and the qualified in-state oil refinery infrastructure expenditures tax credit; relating to the minimum tax calculation for monthly installment payments of estimated tax; relating to interest on monthly installment payments on estimated tax; relating to limitations for the application of tax credits; relating to oil and gas production tax credits for certain losses and expenditures; relating to limitations for nontransferable oil and gas production tax credits based on oil production and the alternative ta credit for oil and gas exploration; relating to purchase of tax credit certificates from the oil and gas tax credit fund; relating to a minimum for gross value at the point of production; relating to lease expenditures and tax credits for municipal entities; adding a definition of "qualified capital expenditures"; adding a definition for "outstanding liability to the state"; repealing oil and gas exploration incentive credits; repealing the limitation on the application of credits against tax liability for lease expenditures incurred before January 1, 2011; repealing provisions related to the monthly installment payment for estimated tax for oil and gas produced before January 1, 2014; repealing the oil and gas production tax credit for qualified capital expenditures and certain well expenditures; repealing the calculation for certain lease expenditures applicable before January 1, 2011; making conforming amendments, and providing for an effective date." *(273 words)*

## *Suggested Informal Short Title*

An Act reforming oil and gas tax credits and strengthening the minimum oil and gas production tax.

# What We'll Be Discussing

1. Lay of the Land- Why Credit Reform is Needed
2. Credit Cost in Perspective
3. Work over Last Interim
4. Provisions of SB130
5. Impact of SB130 on Specific Industry Sectors
6. Fiscal Impact
7. Implementation
8. Future Presentations

# Lay of the Land: Why Tax Credit Reform is Needed

# *Why Credit Reform is Needed*

**FY 2007 thru 2016, $8.0 Billion in Credits**

**North Slope**

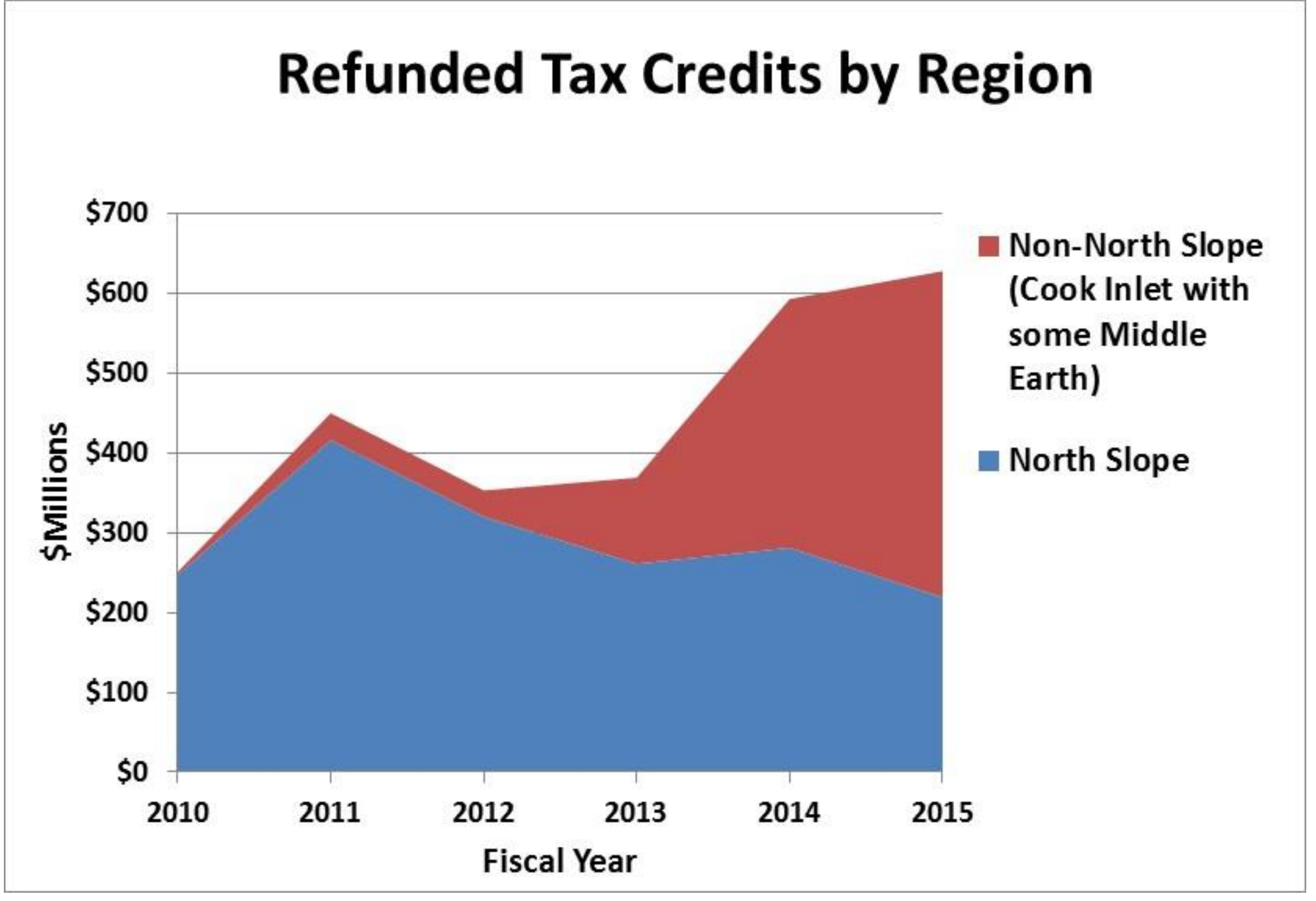
- $4.4 billion credits against tax liability
  - Major producers; mostly 20% capital credit in ACES and per-taxable-barrel credit in SB21
- $2.3 billion refunded credits
  - New producers and explorers developing new fields

**Non-North Slope** (Cook Inlet & Middle Earth)

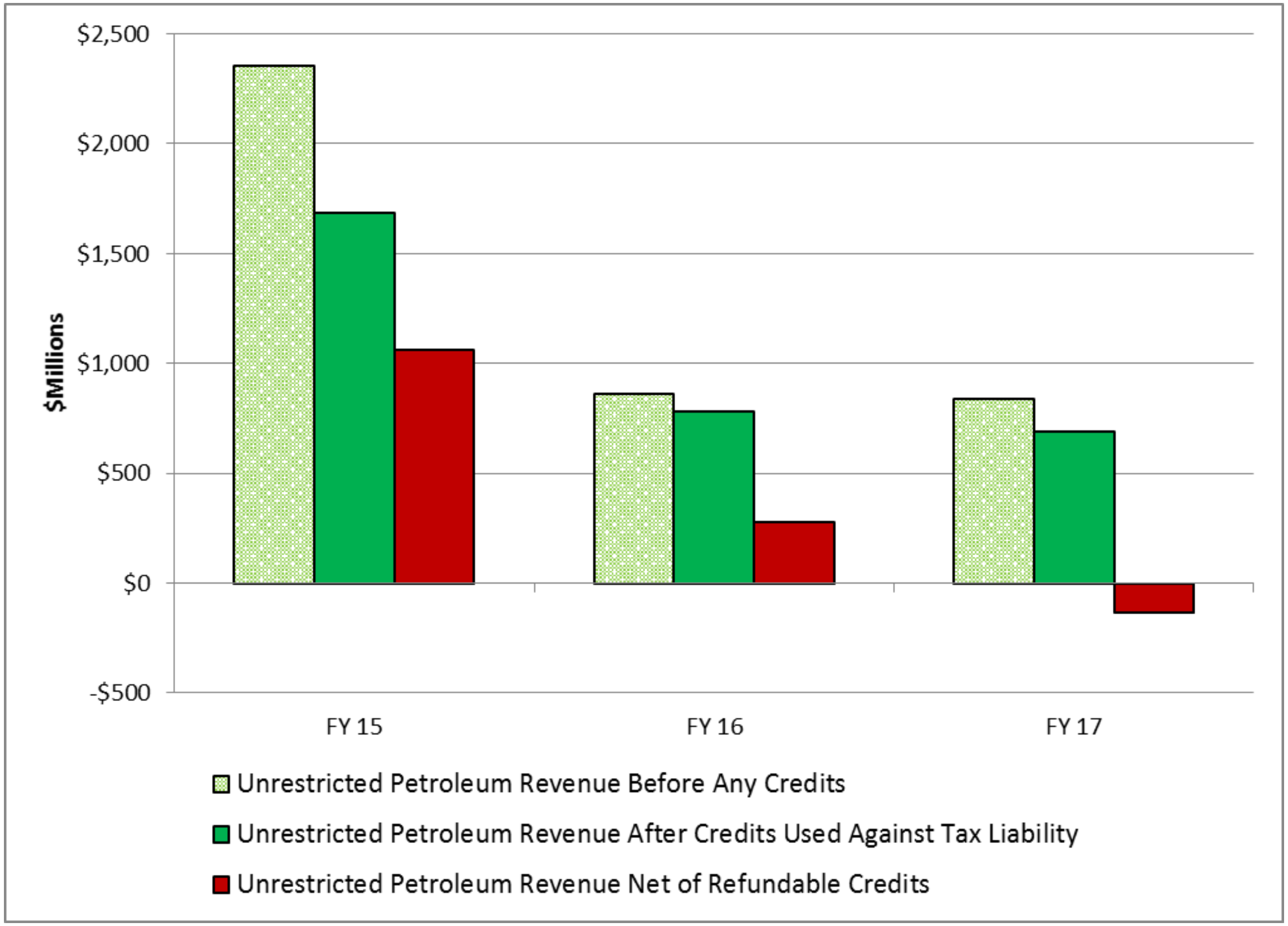
- $0.1 billion credits against tax liability
  - Another $500 to $800 million Cook Inlet tax reductions (through 2013) due to the tax cap still tied to ELF
- $1.2 billion refunded credits (most since 2013)

# *Why Credit Reform is Needed*

- Tremendous growth in non-North Slope (almost entirely Cook Inlet) refunded credits since FY10



# Why Credit Reform is Needed




*This graph shows net tax credits versus unrestricted petroleum revenue, which includes the petroleum property tax, petroleum CIT, production tax, oil and gas hazardous release surcharge, oil and gas conservation surcharge, rents, and petroleum royalties, bonuses, rents, and interest. Net tax credits include certain refinery credits under AS 43.20.

**Source : Department of Revenue - PRELIMINARY Spring 2016 forecast**

# Credit Cost in Perspective

# *Credit Cost in Perspective*

**Of the $3 billion in state-refunded credits through the end of FY15:**

- $1.45 billion went to six North Slope projects that now have production
- $650 million went to 13 North Slope projects that do not have any production. Some of these are abandoned, and some are in process
- $450 million went to six non-North Slope projects that have production
- $450 million went to eight non-North Slope projects that do not have any production

# *Credit Cost in Perspective*

## North Slope Refundable Credits

Of the $1.45 billion that was spent between FY07-FY15 supporting six producing projects:

- Total production through end of FY15 is 38.5 million barrels
- Total credits = **$37.30** / barrel
  - This number will decrease over time due to additional production from these fields
- Lease expenditures for these projects, through FY15, were $4.94 billion
  - Credit support was **29%** of lease expenditures

# *Credit Cost in Perspective*

## Cook Inlet Refundable Credits

Of the $450 million that was spent between FY07-FY15 supporting six producing projects:

- Total production through end of FY15 is 55.9 million BOE (much of this was gas)
- Total credits = **$7.80** / BOE or about **$1.30** / mcf
  - This number will decrease over time due to additional production from these fields
- Lease expenditures for these projects, through FY15, were $1.09 billion
  - Credit support was **40%** of lease expenditures

# *Credit Cost in Perspective*

## Cook Inlet Tax Caps

- Estimated value to industry $550-$850 over the years 2007-2013
- Total Production Estimate
  - Gas: ~ 250 million cubic feet / day for seven years = 640 BCF of gas or 106 million BOE
  - Oil: ~ 10,000 barrels / day for seven years = 26 million BOE
  - Total Production = 132 million BOE
- Using midpoint $700 million estimate, value of caps = **$5.30** / barrel or **$0.88** / mcf
- **Sum of Credits + Tax Caps: $2.18 / mcf**

# *Credit Cost in Perspective*

## Status of Credit Fund / Demand for FY16-17

- FY16 Appropriation Capped at **$500 million**
  - $473 million paid out to date
  - About $200 million North Slope, $273 million non-North Slope
  - $27 million left in fund with $4 million in-process claims
- Current DOR Work Pool $675 million
  - $10 million in older NOL credits
  - $22 million in older exploration credits
  - $552 million in 2015 NOL, QCE, WLE credits
  - $60 million in 2015 exploration credits
  - $31 million additional 2015 NOL, QCE, WLE expected via amended returns

# *Credit Cost in Perspective*

## Status of Credit Fund / Demand for FY16-17

- All the “in hand” applications, if eligible, result in a known demand for FY2017 of **$652 million**
- This is very current information, based on the CY15 tax “true-up” which was due on Thursday 3/31
- Expected credit applications during CY2016, which could also be paid in FY17:
  - Another $40 million in quarterly requests for QCE and WLE outside the North Slope
  - Another $60 million in “last minute” exploration claims
  - About $20 million in LNG storage and refinery claims
- Total, foreshadowing “final” Spring 2016 forecast, $775 million- slight reduction from $825 million

# *Credit Cost in Perspective*

- What impacts the change from $825 to $775?
  - Higher than expected NOL claims for CY 2015 (increases about $100 million)
  - Decision to treat all CY 2016 claims for NOL credits as FY 2018 obligations, whereas in the past we had treated them as partly FY17 and party FY18 (decreases about $150 million)
- So FY17 decreases by about $50 million, but FY18 and FY19 will increase by at least that amount

# Credit Cost in Perspective

## Growing Carried Forward NOL’s: A New Problem

- Since the beginning (2007) all companies except the three major producers have been able to receive cash for their tax credits. Majors must “carry them forward”
  - Companies producing less than 50,000 bbl /day
  - Hilcorp crossed over this threshold in 2015
- One or more of the majors had an operating loss in 2015. That becomes an NOL credit that can be used against taxes starting this January (to reduce payments below the minimum tax, as far as zero)
  - This only partly offsets minimum tax payments this calendar year. We still have some positive production tax income.
- With the Spring Revenue Forecast, we now see all three majors with much larger losses in 2016, and possibly for years beyond

# Credit Cost in Perspective

- By January 2017, production tax monthly payments will be effectively zero (mainly the private royalty tax)
- Loss credits from the majors, in excess of what it takes to reduce taxes to zero, are carried into a future year

**Production Tax and Carried Forward Production Tax Credits, per the spring forecast**

| Fiscal Year | ANS Oil Price | Production Tax Revenue ($millions) | Carried Forward Credits at Year End ($millions) |
|---|---|---|---|
| 2016 | $39.52 | $133.4 | $385 |
| 2017 | $38.89 | $45.6 | $632 |
| 2018 | $43.79 | $15.7 | $766 |
| 2019 | $48.89 | $10.7 | $747 |
| 2020 | $54.48 | $12.5 | $600 |
| 2021 | $60.29 | $32.2 | $284 |
| 2022 | $61.64 | $105.2 | $151 |
| 2023 | $63.03 | $216.9 | $74 |
| 2024 | $65.45 | $198.0 | $1 |
| 2025 | $65.90 | $272.1 | $0 |

# Work Over Last Interim

# *Work Since Last Session*

- Governor's line-item veto capped FY16 spending at $500 million
- Temporary liquidity crisis; many meetings with industry and others to help reassure lenders
- Multiple presentations with history, current practice, and possible changes
  - Joint Resources in Kenai, June 17
  - Three "regional" presentations to Senate Working Group September through November
  - All presentations on BASIS; we're prepared to go through similar information for the committee
- Development of reform legislation including plan for transition from current system

# *Recommendations of Senate Working Group*

1. Gradual implementation
2. Consider Timeline / Sector Impacts
3. Protect local venders at bankruptcy
4. Protect Minimum Tax “Floor”
5. Protect Frontier Basin Tax Breaks
6. Enhance Reporting Requirements

# Provisions of SB 130

# *Provisions of SB 130*

**Major Bill Themes**

1. Reduce the state's annual cash outlay;
2. Protect Net Operating Loss credits as a playing field leveler between legacy producers and newcomers;
3. Limit repurchases;
4. Strengthen the minimum tax;
5. Be more open and transparent;
6. Honor and pay credits earned to date and through any transition period.

# *Provisions of SB 130*

**Main Bill Components**

1. **Exploration Credits**- *sunset and transition*
2. **Cook Inlet Drilling Credits-** *phase out while retaining operating loss credits*
3. **Repurchase Limits-** *limit cash outlay*
4. **Remove Exceptions / Loopholes**
5. **Strengthen Minimum Tax-** *prevent certain credits from going below the floor,*
   *plus increase to 5%*
6. **Other Provisions-** *technical cleanup, transparency, interest rate reform*

# Exploration Credits

- On 7/1/16, the "Jack up Rig" and "Frontier Basin" credits expire
- Also, regular .025(a) credits expire for North Slope and Cook Inlet
  - .025(a) credits remain for "Middle Earth" until 2022
- **Administration policy is to let them expire.**
- Preemptively repeal other exploration credit programs that are not currently being used, in AS 38.05.180(i) and AS 41.90.
- Add .025 DNR data requirements to .023(b)

# Cook Inlet Drilling Credits

- **Repeal AS 43.55.023(a) and .023(l)**
  - SB21 repealed the "spending based" credits for the North Slope
  - Prevent profitable companies who pay zero taxes from receiving state credit payments
  - Need for a broader Cook Inlet tax reform before 2022
- **Reduce general Cook Inlet cash support for development to the 25% .023(b) credit**

# Repurchase Limits

- Expand current .028(e)(4) restriction saying companies who produce greater than 50,000 BOE / day can't have credit certificates repurchased, and must hold them to use against future production
  - **Any company with global annual revenue greater than $10 billion / year**
  - Restore PPT-era cap of $25 million / company / year
  - Percentage of repurchase tied to percentage of Alaska resident hire
  - **Carried-forward loss credits expire after 10 years**

## Remove Exceptions / Loopholes

- Provisions that artificially inflate net operating losses
  - **Can't use GVR (new oil value reduction) to increase the size of a Net Operating Loss** (has led to credits greater than 100% of loss)
  - If a municipal entity owns production and sells only a portion of that production to an outside party, only the pro-rata share of expenses can be deducted against revenue

## *Summary of Major Bill Provisions*

# Strengthen Minimum Tax

- **Can't use an operating loss credit,** small producer credit, or exploration credits **to reduce payments below the 4% floor**
  - This is an actual fiscal impact in FY16; in calendar year 2015 one or more major producers had a net operating loss. In that case, NOL credits can reduce minimum tax to zero beginning this year.
  - This one provision is retroactive to 1/1/16
- Extend 4% floor to GVR-eligible "new" oil
- Prevent per-taxable-barrel credits earned in one month from being used against another month's taxes at true-up
- **Increase from 4% (at prices above $25) to 5%**

# Other Provisions

- Interest Rate Reform
  - Eliminate error in SB21 that prevents compound interest on underpayments and assessments
  - **Increase interest rate to state's "opportunity cost," seven percent above Fed Discount Rate**
- Confidentiality Waiver
  - Name of company and how much they received in state repurchased credits
- Transportation Costs can't reduce Gross Value below zero
- Credit certificates must first be used to satisfy any obligation to the state

# Impact of SB 130 on Specific Industry Sectors

# *Bill Impact: Example Scenarios*

**North Slope Major Producer**

- Higher oil prices: no change
- Prices below ~$85: currently paying 4% minimum tax; must pay increase to 5%
- Extended period of very low prices: cannot use Net Operating Loss credit to reduce payments below the “floor”

# *Bill Impact: Example Scenarios*

**North Slope New or Smaller Producer**

- Higher oil prices: no change
- Prices below ~$85: must pay minimum tax. Currently per-barrel credit can reduce taxes to zero
- If company has an operating loss, the Gross Value Reduction cannot be used to increase the size of the loss to earn a larger NOL credit

# Bill Impact: Example Scenarios

**North Slope New Project Developer**

- Net Operating Loss Credits continue to be earned at the 35% level – no change
- Large Multinational Companies: must hold their credit certificates to be used against future tax liability
- Smaller Companies: limited by $25 million / company / year cap. Must carry forward all credits in excess of this

# *Bill Impact: Example Scenarios*

**Cook Inlet Existing Producer**

- Currently pays low to zero taxes due to Cook Inlet tax caps, yet is eligible for 20%-40% credit repurchase for Capital and Well Lease Expenditure credits
- Repeal of these credits means producers without an operating loss do not earn refundable credits. Tax caps remain through the end of 2021

# *Bill Impact: Example Scenarios*

## Cook Inlet New Field Developer

- Currently receives a 25% Net Operating Loss credit stacked with either the 20% Capital or 40% Well credit. State typically refunds 50-60% of costs
- With repeal of Capital and Well credits, will continue to receive 25% Net Operating Loss credit

- Large Multinational Companies: must hold their credit certificates to be used against future tax liability
- Smaller Companies: limited by $25 million / company / year cap. Must carry forward all credits in excess of this

# *Bill Impact: Example Scenarios*

## Interior / Frontier Area Explorer

- Currently receiving 65% state credits for exploration; 50-60% for development
- With repeal of Capital and Well credits, development projects will only receive the 25% Net Operating Loss credit
- However, exploration credits have been extended through 2022, meaning qualified expenditures continue to receive 65%

# Fiscal Impact of SB 130 on State of Alaska Budget

# *Fiscal Impact*

**At the time the bill was introduced,**
**FY17 Impact Est. $500 Million / year**

- Elimination of about $200 million / year in certificates
  - Mostly from repeal of .023(a) and (l) as well as elimination of so-called loopholes
- Deferral of payment on another $200 million / year in certificates that would have to be held for use against future tax liability
  - Based on various new repurchase limits
- Additional revenue of about $100 million
  - Strengthening minimum tax plus increase to 5%
  - Interest rate reform

## *Fiscal Impact*

**Based on the Spring 2016 Revenue Forecast, plus more granular modeling, FY17 Impact Est. $785 Million / year**

- Elimination of about $50 million / year in certificates
- Deferral of payment on another $550 million / year in certificates that would have to be held for use against future tax liability
  - Larger NOL’s due to lower prices
  - Larger exploration spending before program sunset
- Additional revenue of about $185 million
  - Added hardening; most producers will have 2016 NOL’s, further reducing revenue below floor

# *Fiscal Impact*

**In future years, our “status quo” credit forecast appears to decrease.**

**This can’t really be built into future budgets.**

- Our credit forecast only includes “known” projects
- Most “new” projects would add to the amount of projected credits
- Credit projections use the same conservative methodology as DOR’s production forecast

# Implementation

# Transition

- Bill is being written with an effective date of 7/1/16 for nearly all changes
- “Honoring Existing Credits” means:
  - Roughly $200 million FY2016 “overhang”
  - Estimated $625 million credits expected to be earned and payable in FY2017 (likely revised to $575)
  - Plus all credits earned in first half of CY2016 prior to the effective date
  - Total equals about $1 billion which will be paid via an appropriation to the .028 Tax Credit Fund
  - $926.6 million fund cap in fiscal note, in addition to $73.4 million in the operating budget

# Connection to Fiscal Plan

- SB130 was introduced as one of 10 bills that comprised the governor's fiscal plan.
- All the bills taken together, with anticipated budget cuts, proposed a balanced budget by FY19
- The broader fiscal package, and the specific tax credit bill, are intended to add certainty to industry regarding what support the state can provide and how we're going to continue to pay for government
- Original bill also assumed companion "AIDEA Loan" bill to help with projects that lost funding with credit changes
  - HB129 would create a new "fourth fund" at AIDEA to concentrate on oil and gas development loans, for proven reserves
  - Envisioned $200 million initial fund capitalization

# Administration

- The changes anticipated in this bill still require somewhat substantial reprogramming of the Tax Revenue Management System (TRMS) and Revenue Online (ROL) which allows a taxpayer to file a return online and update the current tax return forms
- We have received a preliminary estimate from the software developer, and currently assume a one-time cost of about $1.2 million to accomplish this
- We do not anticipate any additional costs to administer the tax program
- There will also be a need for substantial amendments to existing regulations to fully implement the changes

# Future Presentations

# *Content of Future Presentations*

**We've provided seven different presentations to other committees; all are on BASIS**

- History and development of tax credits, and history of the minimum production tax
- Various credits and how they have been used, which ones haven't been, and what is sunsetting
- Detailed forecasts and scenario analysis
- Details and modeling of specific provisions
- Life cycle modeling of typical new projects, with impact of legislation
- Explanation and modeling of changes made in other committees

# Thank You!

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