Oil and Gas Tax Credit Reform

CS HB247(RLS)\D

Department of Revenue

Initial Response to Rules Committee Proposal

May 11, 2016

Major Bill Concepts in Governor's Proposal

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*

Credit Cost in Perspective

Credit Cost in Perspective

FY 2007 thru 2015, $7.4 Billion in Credits

North Slope

- $4.3 billion credits against tax liability
  - Major producers; mostly 20% capital credit in ACES and per-taxable-barrel credit in SB21
- $2.1 billion refunded credits
  - New producers and explorers developing new fields

Non-North Slope (Cook Inlet & Middle Earth)

- $100 million credits against tax liability
  - Another $500 to $800 million Cook Inlet tax reductions (through 2013) due to the tax cap still tied to ELF
- $900 million refunded credits (most since 2013)

Credit Cost in Perspective

Total Petroleum Revenue FY 2007 thru 2015

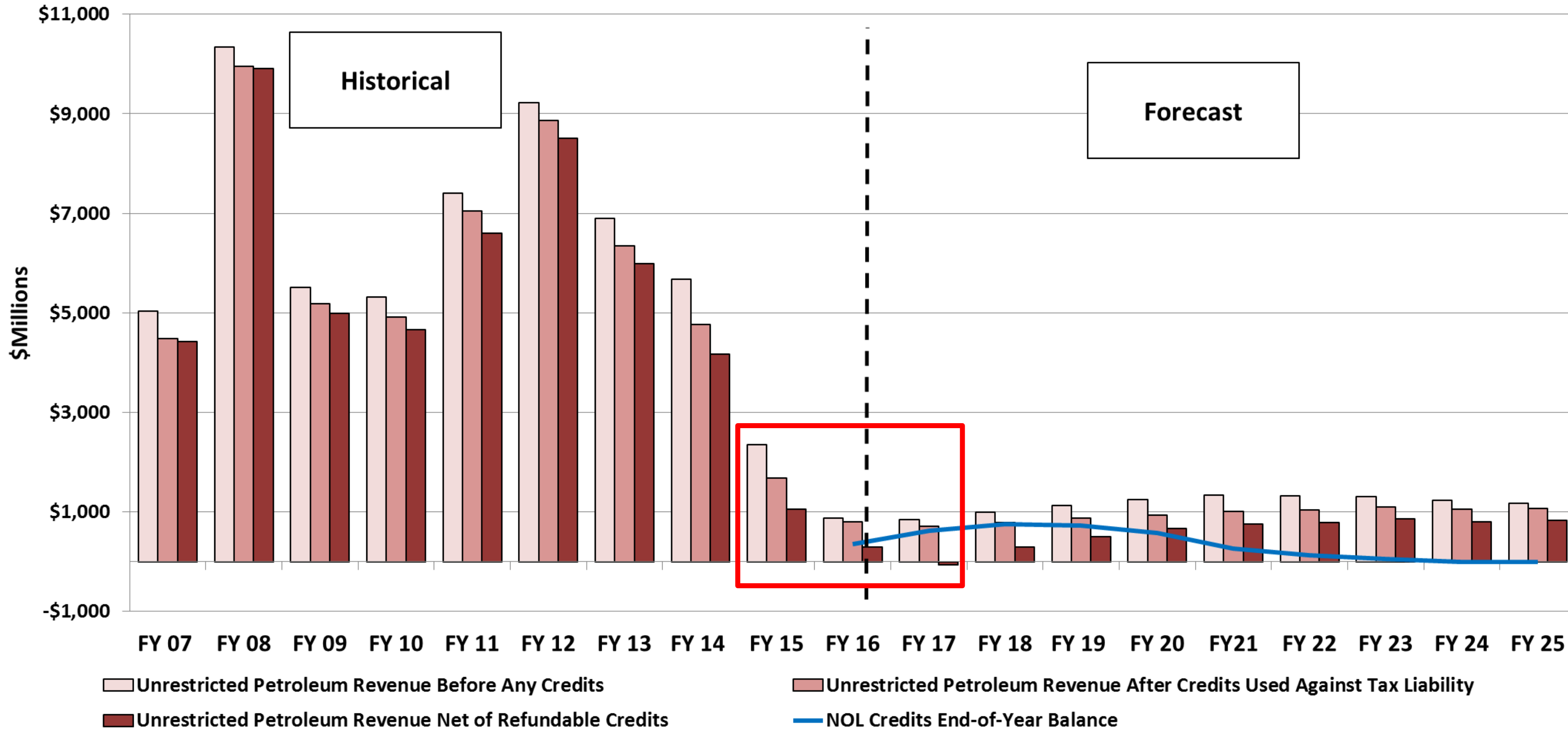
North Slope

Production Tax	$32.8 billion
Royalties (unrestricted)	$15.0 billion
Other GF Revenue	$4.7 billion
Restricted Revenue	$8.7 billion
Total	$61.1 billion

Non-North Slope (Cook Inlet & Middle Earth)

Production Tax	<$0.1 billion
Royalties (unrestricted)	$0.5 billion
Other GF Revenue	$0.3 billion
Restricted Revenue	$0.2 billion
Total	$1.0 billion

Credit Cost in Perspective



Credit Cost in Perspective

- FY16 Appropriation Capped at **$500 million**
  - $473 million paid out to date
  - About $200 million North Slope, $273 million non-NS
  - $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 expected via amended returns
- Remaining $120 million will be some CY2016 quarterly QCE and WLE's, "last minute" exploration claims, and the first LNG storage and refinery claims

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**

Response to Rules Committee Substitute

1. Introduction
2. Positive Features
3. Concerns
4. Summary of Fiscal Impact

Introduction

- The Rules Committee Substitute makes progress towards meeting several administration goals
  - Reducing future spending / rolling back credit programs
  - Limited strengthening of “floor”
  - Transparency

Introduction

- It also maintains several features that have been in many or most versions of HB247 / SB130
    - Inability to increase an operating loss using GVR
    - Substantial ramp down of Cook Inlet credits
    - Restores compound interest, with rate increase, for delinquent taxes
    - Municipal utility lease expenditure pro-rationing
    - Repeal of dormant programs and obsolete sections
    - Surety bonding with local vendor priority
    - Local hire repurchase priority

Introduction

- However, there are several major and minor concerns with the structure of the bill
  - Maintains large future liability through carried-forward lease expenditures
  - Shift in favor of incumbent producers and away from support for independents
  - Ongoing liability without any state pre-approval or other filter
  - Delay in GVR “graduation”
  - Hidden or inadvertent CAPEX tax cut
  - New and technical language changes that could have unintended consequences

Positive Features

Reduces Future Spending

- $75 million per company per year cap (for transition years; only small producers or developers)
  - No repurchases after 2020
  - Cook Inlet credits eliminated in 2019
  - At full implementation in FY2021, about a $300 million bill in total fiscal impact (revenue plus savings)

However:

- Extended transition period could lead to large credit liabilities outside existing forecasted projects

Positive Features

Limited Strengthening of Minimum Tax “Floor”

- With the elimination of Net Operating Loss credits, the minimum tax is hardened against future losses
  - The $0-$8 per barrel credit, which is currently limited by the floor, becomes a somewhat hardened limit
  - No fiscal impact until FY2020, because losses from before the effective date will take three years to be “used up,” zeroing out taxes from major producers

However

- Does not change ability to use $5 per barrel credit for “GVR” production to go below minimum tax
- Small Producer and Exploration credits, until they sunset, can also be used to go below the “floor”

Positive Features

Transparency

- Annually makes public the name of each person / company who received cash credits, and the total amount repurchased

  However:

  - No information about what the credits were used for
  - Written to exclude the so-called “corporate income tax” credits (Gas and LNG storage, Refinery)
  - With imminent elimination of cash credits, this is a fairly limited amount and duration of public information
  - Although this would be controversial, we believe there is strong benefit in making public the amount of carried-forward lease expenditures claimed by companies.

Concerns with Rules CS

Future liability through carried-forward lease expenditures

- Since Spring 2016 Forecast, administration emphasis has been on potential NOLs from major producers
- Substantial discussion of reducing, scaling, or eliminating the size of the NOL credit
- Issue is side-stepped by eliminating the credit but retaining carried forward “lease expenditures”
- This enables losses to be monetized against future taxes <u>at the full 35% tax rate</u>
- At end of fiscal note period (FY26), producers will hold losses that will offset $715 million in future taxes

Concerns with Rules CS

Shift in favor of incumbent producers and away from support for independents

- Non-producers must also carry-forward their expenditures, eliminating cash support
- Our modeling showed that the administration's initial proposal of $25 million cap did not have dramatic impact on smaller projects, but greatly reduced the economic viability of larger ones
- Zero cash support after 2019 would impact different companies very differently
  - Incumbent producers will be able to monetize their losses as soon as prices recover, whereas independents must wait for production

Concerns with Rules CS

Ongoing liability without any state pre-approval or other filter

- No limit on potential state liability
- Could be corrected with pre-approval process or a state loan mechanism
- During transition period, the "plan of development" filter includes plans of exploration, which could broaden the potential applicants
- "Smith Bay" issue: a $100 million exploration project in a remote location that is many years from viable

Concerns with Rules CS

Hidden or inadvertent CAPEX tax cut

- (We were told this will be fixed by amendment)
- Repeal of AS 43.55.165(e)(18) as a conforming amendment to elimination of the QCE credit
- This adds 30 cents / barrel in allowable deductions, which actually costs the state $15-$20 million / year once prices get above minimum tax level

Concerns with Rules CS

Delayed GVR graduation

- In amendments during SB21, and in prior committees, has been in five to seven year range
- Ten years greatly reduces benefit to the state as by that point many fields are well into their decline
- Reverse of Enalytica analysis: if longer term benefit has minimal impact on producers, it is also of minimal benefit to the state

Concerns with Rules CS

New and technical language changes that could have unintended consequences

- In the 3-year transition period, credits can be earned by any company with a plan of development, including majors (should just be non-producers)
- Definition of “regular” production for time clock to graduate the GVR (suggesting “sustained” definition)
- Carried-forward lease expenditures are not kept separate by “segment,” which can distort the eventual net profit tax paid once the expenditures are applied
- Carried forward expenditure change in .160(a) doesn’t account for the tax changes scheduled for 2022, which is in .160(h). Need to replicate this language.

Summary of Fiscal Impact

Summary Analysis of Bill Versions ($millions)

(based on Spring 2016 Forecast)

	FY 2017			FY 2018			FY 2019			FY 2020		
	HB247 (GOV)	CS HB247 (FIN) amd	CS HB247 (RLS)	HB247 (GOV)	CS HB247 (FIN) amd	CS HB247 (RLS)	HB247 (GOV)	CS HB247 (FIN) amd	CS HB247 (RLS)	HB247 (GOV)	CS HB247 (FIN) amd	CS HB247 (RLS)
Reduced Spending												
Credits Eliminated or Reduced												
North Slope	$15	$0	$0	$15	$15	$15	$25	$25	$30	$20	$25	$115
Cook Inlet / Mid Earth	$35	$20	$5	$65	$50	$30	$45	$45	$45	$35	$50	$110
Credits Deferred												
North Slope	$30	$0	$0	$80	$0	$0	$95	$0	$0	$45	$0	$0
Cook Inlet / Mid Earth	$0	$0	$0	$30	$0	$0	$40	$0	$0	$20	$0	$0
Budget Subtotal	**$80**	**$20**	**$5**	**$190**	**$65**	**$45**	**$205**	**$70**	**$75**	**$120**	**$75**	**$225**
Increased Revenue												
Floor "Hardening"	$130	$0	$0	$185	$0	$0	$185	$0	$0	$160	$0	$70
Floor Increase to 5%	$45	$0	$0	$45	$0	$0	$55	$0	$0	$80	$0	$0
CI Credit Repeal	$15	$5	$0	$10	$15	$0	$15	$15	$10	$15	$15	$15
Revenue Subtotal	**$190**	**$5**	**$0**	**$240**	**$15**	**$0**	**$255**	**$15**	**$10**	**$255**	**$15**	**$85**
Total Bill Impact	**$270**	**$25**	**$5**	**$430**	**$80**	**$45**	**$460**	**$85**	**$85**	**$375**	**$90**	**$310**
NOL Carry-Forward	**$773**	**$595**	**$610**	**$1,128**	**$708**	**$720**	**$1,226**	**$666**	**$660**	**$1,223**	**$498**	**$685**

Thank You!

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