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HB 111

Castle Gap Advisors, LLC.
February 29th , 2017

House Resources Committee

Message Summary

- Castle Gap was asked to look at HB 111 and offer an opinion on the terms contained therein
  – Experience has shown it's best to first step back and take a look at the whole before jumping in to fix a few parts
    - What are the state's long term goals?
    - Is the existing system falling short of meeting those goals? If so, how?
  – A quick look, plus learnings from prior taxation assignments, shows that Alaska has a competitive and functioning but relatively very complex petroleum taxation system
  – The intent of the first review was to create a common understanding of the overall general state of play with respect to petroleum taxation systems around the world
  – Regimes have evolved over time creating more durability. The second review introduced options for consideration to create durability for Alaska by greatly reducing complexity, converting principles to self-correcting terms while essentially leaving the same net effective taxes in place
  – Today, we are offering views as to the specific aspects of HB 111

HB 111 Viewed within Strategic Framework

Long Term Goals

- Keep oil flowing through TAPS as long as possible
- Encourage the exploration for and development of new fields
- Encourage new operators to come to Alaska
- Understand and capture upside value from existing fields
- Create a durable petroleum taxation system

Short Term Objectives

- Keep industry activity and flowing production as high as possible during a period of low to negative margins
- Ensure a steady flow of income to the state from hydrocarbon production
- Pursue offering incentives without burdening the state with cash reimbursement payments

Further Observations

- The current compendium of legislation is the result of
  - Some major overall changes such as PPT, ACES, SB21;
  - As well as more narrowly focused fixes as issues surfaced

- Underpinning the overall taxation policy was also a desire to provide as much balance as possible such that all industry participants, regardless of size or location, are all impacted or rewarded on par

- As noted previously, Alaska's petroleum tax code is a very complex system
  - Both the producers and the state need to commit significant resources just for basic administration
  - Personally, each reading of the legislation raises new questions and identifies nuances relative to how certain aspects are handled globally
  - While reviewing the legislation for this HB 111 review, we have identified an inaccuracy contained in our credits versus NOL model from Monday evening and a corrected update will be prepared and provided to the committee

Alternative Options

- An alternative option was presented as a means of
  - Simplifying the current system without really changing the effective tax rates resulting from the existing system; and
  - By inference fixing many of the issues HB 111 is trying to solve

- This was done to inform the committee of the range of possibilities and to demonstrate a few tools that could be used if or when a decision is made to enact any overarching type changes

- The following pages present our views on the aspects of HB 111 underneath the strategic framework and without any major changes

HB 111 - Increasing Taxation

- There are a number of items in HB 111 that minimize downside risk to the state
  - Raising the gross minimum tax to 5%
  - Hardening the floor
  - Reducing NOLs to credits conversion percentage from 35% to 15%
  - Reducing the amount of per barrel credits

- Recognizing the state's current fiscal issues, the desire to increase government take is understandable
  - This represents Alaska increasing take when the majority of other regimes are lowering their take
  - Increasing the minimum tax creates a larger hurdle to for new project economics to overcome (may likely see more requests for royalty relief)
  - In a possible future scenario of prices remaining in the $50 to $80 range, without further detailed modeling it is hard to predict what magnitude of the overall impact would be

HB 111 – Handling Credits

- There are a number of items in HB 111 that impact the creation and handling of NOLs and associated credits
  - Lowering the NOL conversion rate
  - Changing the production level for qualification
  - Limiting the amount annually payable to a person

- Eligible costs being deducted from hydrocarbon revenue is the norm and any reduction to this concept would put Alaska at the bottom of world rankings
  - For existing producers, recommend NOLs to be carried forward and offset against future PTV
  - For non-producers, where an NOL is created by exploration, appraisal and development of a declared discovery, NOLs are to be carried forward, with some uplift level to be determined, then deducted against developed production revenues
  - For non-producers, where the NOL is created by spending that results in a dry hole, allow the NOLs to be converted to a cashable credit subject to a set of prerequisites such as
    - Data delivery/transparency, service contractors all paid, leases relinquished
  - If payouts of past credits are significantly deferred, recommend offering some level of uplift to be determined until state funds are available to payout those credits

HB 111 and Other Associated Bills – Things To Consider

- In order for Alaska to remain competitive and to continue to attract investment to increase state production, when discussing possible amendments to HB 111 or consolidation with other oil tax bills that have been introduced this year, it is recommended that you:
  – Stay with a net based taxation system
  – Stay with ring fencing by operator
  – Simplify when possible
  – If sliding scales are to be used base them on margin and not price
  – As stewards of the state's resources, establish a comprehensive data transparency program

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