State of Alaska Department of Revenue
HB331: Oil & Gas Tax Credit Bonds

Presentation to the Senate Finance Committee

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May 8, 2018

Bill Objective #1: Critical component to Governor's economic stimulus package

- **From 2015 – 2017, private sector jobs are down ~3.8% (9,200 jobs.)**
  - Oil and Gas industry jobs are down ~30.8%
  - For 2018, ISER forecasts year over year losses of an additional 0.7%

- **This bill will both provide an initial boost of funding and resolve the uncertainty surrounding these payments.**
  - Provide $700 million or more economic stimulus in 2018 to the oil and gas sector
  - Resolve the uncertainty hanging over this sector and allow small producers to plan
    - Seeks to unfreeze Alaska credit markets
    - Seeks to incentivize new spending in Alaska
    - This could mean substantial numbers of new jobs

Bill is Structured to Balance Competing Interests

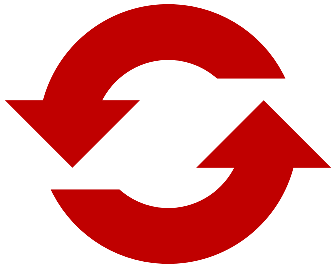
The Balance:

- The Credit holders to pay for the cost of the borrowing
- Provides Small Producers certainty and cash they need to invest
- Maintains the state's credibility by acknowledging our part in creating this situation

State Fiscal Budget

Forecasted FY 19 deficit of ~$300M after PF Draw

Deficit increases $155M without this program



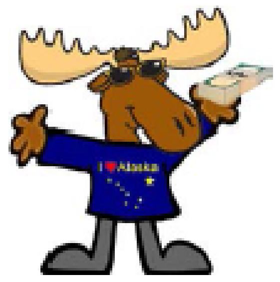
Maintain State Credibility

The state encouraged investment based on promises of support

Support Small Producers

Strategic interest in maintaining small producers

Bank lending has essentially stopped



For the entire lifecycle of your project, the State of Alaska is there for you. We do not just talk big, we follow through big – with cash! Here is what you can expect when you come to Alaska:

- Cash-refundable tax credits for shooting seismic and/or drilling wells
- Cash-refundable tax credits for capital spend
- Many of the credits may be combined for up to 65% in credits

Excerpt of promotional brochure used by DOR at oil industry conferences, c. 2013

Oil & Gas Tax Credit Background

- 2003: First oil & gas tax credits created to incentivize new exploration. Credits could only offset the company's taxes
- 2006: Transferable tax credits introduced with transition to profits-based tax

  New credits for capital expenditures and operating losses expanded incentives to include small field developers

  State repurchases authorized, with caps and limits
- 2007: Oil & Gas Tax Credit Fund established, with statutory formula tied to production tax revenue. Annual per-company caps eliminated
- 2010: Cook Inlet Recovery Act incentivized new production to offset gas shortages in Southcentral. New incentive tied to drilling costs

  Because of minimal Cook Inlet taxes, credits were not expected to be supported by new revenues
- 2013: SB 21 eliminated capital credit on North Slope, replaced with per-barrel credit tied to price and production
- 2016-17 HB247 and HB111 wind down cashable credit programs

Oil & Gas Tax Credit Background

➢ Oil & Gas Tax Credits Have Helped Heat Alaskans' Homes

- Incentivized Hilcorp to take over aging Cook Inlet assets and extend field life
- Brought new companies into Alaska, (Bluecrest, Furie, etc.) to look for gas
- Southcentral gas supply shortage essentially solved
- Threat of brown-outs gone
- Protected energy security of tens of thousands of Alaskans

➢ Oil & Gas Tax Credits Have Created Potential for More Production

- New fields potentially mean new oil: Pikka, Nuna
- Governor's economic stimulus goal
  - More revenue from production equals
  - New jobs, new royalties, new revenues for schools and government services
  - Economic ripple effect

Oil & Gas Tax Credit Background: The Challenge

- **Historically (FY08-15), the State paid tax credits annually as presented**
  - FY16-FY18 state unable to pay all pending tax credits
  - FY2016 veto set total payment at $500 million
  - FY2017-18 appropriations at statutory calculation ($30 million & $77 million)

- **The O&G Tax Credit Fund statute (AS 43.55.028) sets out a formula for computing the appropriation to the fund for cash payment of tax credits**
  - The formula is based on a percentage of the profits tax calculation (AS 43.55.011) before application of credits, based on the projected oil price for the coming year
    - At a projected price of $60 or higher, the statutory formula is 10% of the tax calculation
    - At a projected price of less than $60, the statutory formula is 15% of the tax calculation
  - Most recent FY19 forecast, per the Spring RSB Update, is $63/bbl

Oil & Gas Tax Credit Background: The Challenge

Annual statutory appropriation schedule per Spring forecast

	FY19	FY20	FY21	FY22	FY23	FY24
Estimated Statutory Payment ($mm)	$184	$168	$168	$167	$170	$89*

(note: based on credits held to-date, all will be paid by FY2023; *final forecasted credits in FY2024)

- Impact of reducing payments to the Statutory Formula
  - Exploration and development in some cases halted
  - Some banks have frozen supply of further credit for Alaska oil and gas exploration
- Reduction below this figure without passage of a replacement program such as in this bill could further depress development

Proposed Solution: Issue Bonds and use proceeds to pay off Tax Credits
Credit holders cover the cost of borrowing by accepting a discount on credits

Example: Assume Credit holder has $100M in Credits:

$50 million issued in 2016 + $50 million issued in 2017

Program offers two alternative discount rates

- 5.1% represents the State's cost of borrowing
  - Estimated 3.6% Total Interest Cost +1.5%
- 10% is mid-point between State's cost of borrowing and the credit holder's Weighted Average Cost of Capital (WACC)

10% is the Base Rate. To qualify for the lower rate, the Credit Holder must:

- Agree to an Overriding Royalty Interest (ORRI)
- Commit to reinvest the money in Alaska within 24 months
- Agree to early waiver of confidential seismic data, or
- Have Refinery or Gas Storage Credits

The Discount is applied to each year of payments starting in Year 2

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COMPANY X Tax Credits: Potential Impact of HB331 / SB176

REVISED April 2018- appropriation schedule per Spring forecast

Total certificates in "2016" basket	$50,000,000
Total certificates in "2017" basket	$50,000,000
Total conditional 2017 certificates	$0
Total	**$100,000,000**

Anticipated Prorated Payments and Estimated Discounted Value

			Discount Rates	
	Face Value	**Years Disc.**	**10%**	**5.10%**
FY2019	$23,097,751	0	$23,097,751	$23,097,751
FY2020	$21,089,251	1	$19,172,046	$20,065,891
FY2021	$20,704,189	2	$17,110,900	$18,743,591
FY2022	$20,435,296	3	$15,353,340	$17,602,436
FY2023	$14,673,513	4	$10,022,207	$12,026,056
FY2024	$0	5	$0	$0
Total	**$100,000,000**		**$84,756,245**	**$91,535,725**
Percentage of Face Value			**84.8%**	**91.5%**

At the forecasted oil price and resulting statutory formula, this theoretical company would expect to receive all their credit payments over five years.

Participating in the bond program would cost them between 8.5% and 15.2% of face value.

The 5.10% discount rate is for illustrative purposes only.
The actual reduced discount rate will be established several weeks prior to any bond offering.

What the Bill Does

Five Essential Parts of HB331:

1. Creates the Alaska Tax Credit Certificate Bond Corporation, with various powers and authorities defined
2. Amends existing provisions of the tax credit fund, AS 43.55.028, to conform the existing program with the new bonding alternative
3. Creates new subsections in AS 43.55.028 to establish the process for offering, valuing, discounting, and purchasing credit certificates
4. Authorizes the Department of Natural Resources to negotiate overriding royalty interests (ORRIs) as a mechanism to obtain a reduced discount rate
5. Repeals the delayed sunset of the tax credit fund itself, so as to avoid complex conforming language in the future. This does not change the elimination of new cashable tax credits

Proposed Solution: Issue Bonds and use proceeds to pay off Tax Credits
Credit holders cover the cost of borrowing by accepting a discount on credits

- **Step 1: Secure commitment from Credit Holders to participate in Program.**
  - Provide definitive statement of proceeds available under the program.
  - Interested credit holders make irrevocable commitment.

- **Step 2: Issue Bonds**
  - First issuance (for existing certificates):
    - Face Value: $807mm (for the purposes of this analysis, we are assuming no credits will be sold to major producers to offset taxes)
    - Bond Issuance: $683mm-$738mm, could be issued as soon as August 2018
  - Future issuances, for anticipated certificates
    - Face Value: $130-180mm (est.), issued in August 2019-August 2021

Proposed Solution: Issue Bonds and use proceeds to pay off Tax Credits Credit holders cover the cost of borrowing by accepting a discount on credits

- **Step 3: Purchase Tax Certificates at Fair Discount Rate**

  Two options: 10% discount rate or discount rate equal to state cost of capital (approx. 5.1%)

  - Option 1: 10% rate – no strings attached
    - Balances State's and credit holders' interests
    - Greater than State's cost of capital, less than tax credit holders' cost of capital
    - Covers State's costs of financing
  - Option 2: 5.1% rate (approx.—State's cost of capital) – strings attached
    - Tax credit holder can get lower discount rate (less discount from face value) in exchange for any one of four options:
      1. **Overriding royalty of equivalent value**
      2. **Investment commitment of equivalent value within 24 months**
      3. **Waiver of seismic data confidentiality waiver, or**
      4. **Refinery / gas storage credit**

Proposed Solution: Issue Bonds and use proceeds to pay off Tax Credits
Credit holders cover the cost of borrowing by accepting a discount on credits

- **Step 4: Discount Covers State's Bonding Costs**

  Bond terms are not described in bill, but current our thinking is:
  - 10 year term for each bond issue
  - All-in Cost of Funds (estimated) is 3.6%
  - Back-loaded debt service to match projected profile of state revenues
  - For initial bond issue, years 1-2 interest only; years 3-5 year increasing debt service; years 6-10 flat payment to fully pay off debt
  - For subsequent bond issues, years 1-9 interest only with balloon payment in year 10. These will be comparably smaller issues
  - Objective with each purchase option is cost equivalency: **Present Value (PV) of total debt service will be equal to or less than PV of appropriations under the statutory payment formula**

Major Changes Made in the House

- 45-day time limit for constitutional challenges to the bond program
- Reduce calculation of future appropriations to the tax credit fund, and expectation of future payments, to companies who do not participate in the bond program
- Additional conditions and information related to the "reinvestment" provision as a mechanism to obtain the lower discount rate
  - Maximize Alaska hire and use of Alaska contractors
  - Move project towards production
  - "Clawback" of incremental payment if investment targets not met
- Repeal of delayed sunset of "028" fund and conforming changes, which was by HB111 set to repeal after the last credit is paid
- Stylistic rewrite due to first CS of governor's bill (LAW to Leg Legal)

Benefits of Program:
Move cost into periods where state revenues match cash flow

	Statutory Payment Schedule*	Debt Service Payments (assumes all at low discount rate)				
		Cohort 1	Cohort 2	Cohort 3	Cohort 4	Aggregate Payment
FY2019	$ 184	$ 26.98				$ 26.98
FY2020	$ 168	$ 26.98	$ 2.52			$ 29.50
FY2021	$ 168	$ 61.64	$ 2.52	$ 1.34		$ 65.50
FY2022	$ 167	$ 91.82	$ 2.52	$ 1.34	$ 0.47	$ 96.15
FY2023	$ 170	$ 113.26	$ 2.52	$ 1.34	$ 0.47	$ 117.59
FY2024	$ 89	$ 123.25	$ 2.52	$ 1.34	$ 0.47	$ 127.58
FY2025		$ 123.25	$ 2.52	$ 1.34	$ 0.47	$ 127.58
FY2026		$ 123.25	$ 2.52	$ 1.34	$ 0.47	$ 127.58
FY2027		$ 123.25	$ 2.52	$ 1.34	$ 0.47	$ 127.58
FY2028		$ 123.25	$ 2.52	$ 1.34	$ 0.47	$ 127.58
FY2029			$ 69.73	$ 1.34	$ 0.47	$ 71.54
FY2030				$ 37.02	$ 0.47	$ 37.49
FY2031					$ 12.91	$ 12.91
Total	**$ 946**	**$ 936.93**	**$ 92.41**	**$ 49.08**	**$ 17.14**	**$ 1,095.56**
NPV5	**$ 809.75**					**$ 782.61**

Discounted value of debt service payments would be less than the present (discounted) value of the current statutory payment schedule

* Per Spring Revenue Forecast, total cashable credits outstanding ($807 million) plus those estimated to be claimed ($139 million) equals $946 million.
Assumes no credits are sold to major producers to offset taxes

Impact on debt capacity and credit rating

- Proposed program would have limited impact on capacity, as the credits are an existing obligation
- Similar to state PERS/TRS payments on behalf of employers
- Neutral to positive impact on credit rating
- Reduces FY 2019 payment from 8.1% of UGF revenue to 1.1% of UGF revenue, and results in a more predictable and level annual payment
- Financially beneficial to State
- Provides financial alternative to State's primary revenue generation industry

Impact on debt capacity and credit rating

State of Alaska Debt Service as a Percentage of Unrestricted General Fund Revenues
Based on Current Actuals and the Spring 2018 Revenue Forecast of the Department of Revenue
(Analysis limited to initial bond issue for existing credits as of 12/31/17, $807 million)

Fiscal Year	Unrestricted Revenues (Millions)	State G.O. Debt Service (%)	State Supported Debt Service (%)	School Debt Reimburse-ments (%)	Statutory Payment to PERS/TRS (%)	Subtotal: Current Obligations without Tax Credits (%)	Statutory Payment of Tax Credits (%)	Total: Current Obligations with Statutory Payments (%)	Tax Credit Debt Service Payments (%)	Total: Current Obligations with Credit Bond Payments (%)
2018	$ 2,337.3	3.8	1.0	4.8	7.9	17.5	3.3	20.9	N/A	N/A
2019	$ 2,259.1	4.0	1.0	4.7	13.2	22.9	8.1	31.0	1.1	24.0
2020	$ 2,276.4	3.4	1.0	4.3	15.2	23.9	7.4	31.3	1.1	25.0
2021	$ 2,336.5	3.3	1.0	4.1	16.4	24.8	7.2	31.9	2.5	27.3
2022	$ 2,342.5	2.8	1.0	3.5	16.8	24.1	7.1	31.2	3.7	27.8
2023	$ 2,401.2	2.8	0.9	3.5	16.8	23.9	5.0	28.9	4.5	28.4
2024	$ 2,468.2	2.7	0.9	2.8	16.8	23.1	0.0	23.1	4.8	27.9
2025	$ 2,624.6	2.3	0.9	2.3	16.2	21.7	0.0	21.7	4.5	26.2
2026	$ 2,783.2	2.2	0.8	1.7	15.8	20.5	0.0	20.5	4.2	24.8
2027	$ 2,830.8	2.1	0.8	1.5	16.2	20.7	0.0	20.7	4.2	24.8

Fiscal Note Discussion

The Department of Revenue has three separate Fiscal Note for HB331

- OMB Component 121: Appropriates annual agent fees of $2,500 to the Treasury Division beginning in FY2020 (UGF)
- OMB Component 3211: Appropriates estimated FY2019 debt service payment for bond program ($27 million UGF)
- OMB Component 123: Appropriates estimated FY2019 bond proceeds to the Commissioner of Revenue to purchase outstanding tax credits at a discounted value ($737.9 million DGF; new fund code 1253)
- The numbers in the second and third Notes are based on assumptions:
  - All $807 million in certificates outstanding on 1/1/18 participate in the program
  - All achieve the reduced discount rate of 5.1%, maximizing the payout
- No expected regulations, no recurring staff or operating costs

Conclusion: Oil & Gas Tax Credit Solution

- Governor's economic stimulus: We expect substantial reinvestment in Alaskan projects
- Support Small Producers - Unfreeze pending development projects
  - Current bank financing to fields generating tax credits is frozen in some cases
  - Need to pay off credits so projects under development can be completed
  - State has a strategic interest in maintaining viability of small producers as it increases competition in the basin
- Need to Re-establish Alaska as a Premier O&G E&P Basin
  - Alaska has reputational issues re: oil and gas exploration and development that need to be addressed now
  - Alaska is highly prospective
  - Alaska is a stable environment in which long-term projects can be mutually successful
- More Revenue from Production is the Goal
  - Future royalties equals: jobs, funding for schools and gov't services, economic growth
- Move cost into periods that match cash flow

<u>A healthy and growing Alaska economy benefits all Alaskans!</u>

THANK YOU

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