Alaska Oil and Gas Association

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AOGA CONCERNS ON CSHB 247(RLS)
As of May 16, 2016

Section 1:

This provision allows the Alaska Retirement Management Board to purchase transferable tax credit certificates from taxpayers at a fixed price of 60% of face value.

- Establishing a fixed price interferes with free marketability of such certificates by establishing a price ceiling.
- Would make it difficult if not impossible for any certificate holder to receive reasonable value from any other potential purchaser.
- Should not be tax policy of the state to diminish value of critical tax certificates in effort to defray state unfunded pension liabilities.
- It is unclear what standards the state would apply when purchasing these credit certificates.
- Very new concept, with no public hearing or discussion, making it very unclear how this would work in practice.

Section 8:

This section would raise the interest rate to 5% plus prime, compounding quarterly for four years, and then remain at 5% plus prime without compounding.

- The current interest rate is a reasonable rate - particularly considering the lengthy statute of limitations that provides the Department of Revenue with six years to audit a company's production tax return.
- Raising the interest rate to 5% plus prime and instituting quarterly compounding could be an incentive for the State to further delay the completion of audits to allow for more interest to accrue.

Section 13:

This section would repeal effective January 1, 2019 the tax caps for Cook Inlet oil and gas and for gas produced outside of the Cook Inlet and used within the state.

- Would dramatically impact and derail the renaissance realized in Cook Inlet and potential future gas supplies for south central Alaska.
- This would substantially and significantly increase the taxes on the Cook Inlet and likely will dramatically impact future oil and gas exploration and development in that region.

- Increasing the tax on gas used in the state could lead to significant price hikes on gas used in state on ultimate end users.
- These tax caps were originally scheduled to sunset at the end of 2021 – adding change now further increases instability of Alaska's fiscal regime and negatively impacts economics of potential investments.

Section 14:

This provision would raise the gross minimum tax rate on North Slope oil and gas production from 4% to 5% when ANS is more than $70/barrel effective January 1, 2017.

- Raising the minimum tax rate on gross revenues is a regressive tax increase and will have significant adverse effects on future investments.
- Industry has testified that a 1% increase in the minimum tax would likely lead to the reduction of a drilling rig for at least half a year.
- The loss of any drilling rig means lost production, jobs and long-term sustainable revenues to the state.
- For companies not yet in a taxable position, this provision when applied represents an immediate tax hike on those companies increasing the tax from zero all the way to five percent. This represents a significant tax increase and in fact an 'infinite' tax increase on those companies as described by the tax director.

Section 15:

This provision would subject North Slope gas used in the state to the gross minimum tax effective January 1, 2019.

- As indicated under comments to section 14 raising the minimum tax rate on gross revenues is a regressive tax increase and will have significant adverse effects on future investments.
- Increasing the cost to produce such gas would remove an essential incentive for supplying such gas and would increase the likelihood of price hikes on gas used in-state on ultimate end users.

Sections 17 & 18:

This provision's adding subsection (a)(10) on page 20 is confusing in its drafting and potential application. If it is intended to prevent legacy field sliding-scale tax credits under .024(j) from reducing the monthly installment payments below the minimum tax it is unnecessary as under current law those credits cannot reduce the minimum tax in the base case. If it is intended to prevent the .024(i) $5 per barrel tax credit incentivizing new oil from being able to offset the gross minimum tax starting in 2017, then it not only would be an immediate tax increase but the provision arguably would not work. The provision would prevent the use of the $5/bbl tax credits to reduce a monthly installment from going below the minimum tax (such credits are allowed to reduce the minimum tax under current law), but the production tax is an annual tax which means all this provision would do as written is require producers to pay higher than needed monthly installments only to seek a refund when they file their annual tax return.

If it is the administration's intent to revise the language to change current law to prevent the $5/bbl tax credits from being used against the minimum tax – then it would represent a significant change to SB 21 and in essence is a tax increase – a tax increase against future production tax liabilities.

- The new oil tax credit was a critical incentive included in SB 21's overall balance tax reform as they provide tax relief to new production from fields where development may be economically challenging.
- The change would reduce the economic value and attractiveness of those opportunities and reduces the ability of investors to realize the true economics of the underlying investments in those new oil and gas developments.

"Migrating Tax Credits"

According to testimony by Director Alper it appears that the change addressed above in Section 17 was actually a drafting error. Per Director Alper, the administration apparently wants to reinstate a proposal from the original HB 247 which would prevent companies from using excess allowable and available tax credits from one month against its total annual tax liability.

- That proposal at its core would be nothing but a disguised tax increase.
- The production tax is not a monthly tax – it is an annual tax paid in monthly installments or monthly "estimates."
- The proposal would substantively change the current tax law by in effect converting or migrating the current production tax into more of a monthly tax.
- Many variables (e.g., estimates of costs, deductions, prices, etc) go into determining a producer's monthly installments – that is why the monthly filings are referred to as "estimates."
- At the end of the calendar year the producer is required to file a "true-up" or "final tax installment" - to allow the correct amount of production tax to be paid based on the producer's entire calendar year of operations.
- By preventing a company from being able to utilize all of its available tax credits, this provision would in essence require a producer to file basically "perfect monthly estimates "or run the risk of losing valuable tax credits – and being subjected to a tax increase.

Section 22:

This provision would repeal the critical 20% qualified capital expenditures for Cook Inlet effective July 1, 2016.

- This change would not only materially impact future investments but would in essence be a retroactive tax increase to current year investments and developments that are ongoing.
- Many plans have been made, contracts executed and developments commenced based on the availability of this critical incentive being available for at least through the balance of this calendar year.
- Such an immediate and draconian tax increase severely reduces promised economics of essential Cook Inlet investments.

<u>Section 23:</u>

This provision would reduce the critical 20% qualified capital expenditures for Middle Earth down to 10% after 2016.

- This change would negatively current investments being made in reliance of the continuation of the 20% incentive but also future investments that might have been made.

<u>Section 24:</u>

This provision would essentially eliminate the recovery of net operating losses for many companies after 2016 and represents a substantive and negative change to the overall balance tax reform brought by SB 21.

- SB 21 raised the base tax rate to 35% and as part of that tax rate increase, allowed net operating losses to also be carried forward at that tax rate.
- The proposed reduction of NOL rates from 35% to 25% over 10 years also creates an imbalance. Net operating losses must be tied to the base tax rate to maintain the balance of the net based production tax system. If such a policy decision were to be included in any future proposal, a commensurate reduction in the base tax rate should also be included.
- Recovering net operating losses when a company earns a future profit is a cornerstone or defining feature of any net based tax system.
    - Alaska's production tax –is a "net based production system" – which was modeled more on a net income tax system than a gross production tax regime.
    - It is the deductibility of such costs that differentiates a net system from a gross tax system.
- Allowing a company (regardless of production levels) to carry forward costs that cannot be deducted in a current year in which they were incurred because the company is in a net loss position is essential to the concept of a net based tax system and critical in balancing revenues and expenses.
- Disallowing companies from recovering valid lease expenditures against their overall tax liabilities would represent an immediate and significant tax increase.

<u>Section 24 Gross Value Reduction</u>

The proposed language appearing at the top of page 34 would remove the gross value reduction from the determination of a net operating loss.

- This in essence is also a tax increase – a tax increase against future production tax liabilities.
- Gross revenue exclusions provide tax relief to new production from new fields and production from new participating areas within existing fields, particularly where development may be economically challenging.
- Preventing gross revenue reductions, which are critical to encouraging "new oil" production, from being utilized to determine the gross revenue at the point of production when a producer has a net operating loss penalizes those producers and reduces the economic value and attractiveness of those opportunities and reduces the ability of investors to realize the true economics of the underlying investments in those new oil and gas developments.

Section 27:

The provision reduces and restricts the availability of the well lease expenditure tax credits – especially for the Cook Inlet.

- The provision reduces the current 40% credit down to 20% for the Cook Inlet effective for 2017 and then repeals it entirely by 2018.
- This change would materially impact future and ongoing investments in the Cook Inlet and would dramatically impact and derail renaissance realized in Cook Inlet and potential future gas supplies for south central Alaska.
- Increasing the tax on gas used in the state could lead to significant price hikes on gas used in state on ultimate end users.

Section 28:

This provision sets an arbitrary production number to qualify for refundable credits currently a significant decrease from the current 50,000 per barrel qualifying amount. This is a new concept that has not been fully vetted in committee process, nor included in any other committee substitute.

- Additionally, this section now excludes explorers and small developers looking to explore in other areas not with in an approved unit plan of development.
- Those exploring for new oil and gas resources represent a critical piece of ensuring Alaska's has new oil coming online as other resources diminish.
- This is a very dramatic policy shift. Alaska's has actively attracted and incentivized explorers since the early 2000s and the continual search for new resources remain a good investment.

Section 34:

This provision would limit the amount of refundable tax credits a company can redeem to no more than $70M per year.

- Under current law there is no restriction.
- Reducing the level of annual refundable tax credits to such a low level will significantly impact companies relying on the ability to receive immediate recovery of prior investments in order to continue funding current year investments.

Section 35:

This provision would establish a preference based on Alaska resident hire for companies trying to redeem critical tax credits.

- The industry strongly supports hiring as many Alaskans as possible. It makes economic sense for the industry to do so.
- The current language of this provision is unclear to what extent this provision applies – sub contractors, sub subcontractors, worldwide employees? Additionally, it creates questions of retroactivity and questions of implementation, all of which creates additional uncertainty for industry. Companies may not have the contractual ability to go back in time to determine subcontractors' resident hire.

Section 41:

This provision would, effective in 2017, further raise the production tax by changing the way the gross value at the point of production is determined and applied – by preventing the gross value at the point of production from going below zero.

- This provision represents a disguised tax increase and a substantive change in the production tax law.
- Under current law - a producer does not file a field by field or unit by unit production tax return – the producer's production tax is determined and filed on a segment by segment basis.
    - This means the producer determines its production tax based on the true economics of all of its investments and operations from that single segment.
    - Thus if the gross value at the point of production at one or more fields or units within that segment is negative, the costs that gave rise to the negative value are not lost.
- This proposed provision would prevent the gross value at the point of production from falling below zero but offers no explanation or clarity as to the utilization of the excess marine transportation or pipeline tariff costs that gave rise to the negative gross value at the point of production – or whether a taxpayer would now be required to determine the gross value at the point of production on a field or unit basis instead of for an entire segment.
    - The proposal would adversely impact the economics of investments and penalize producers from making prior year investments – and would create uncertainty as to how a producer is to evaluate potential investment opportunities or calculate its production tax obligations.

Section 44:

This provision would materially shorten and devalue a critical component of SB 21's balanced tax reform – the gross value reduction.

- The limiting of the gross value reduction severely reduces the tax relief added by SB 21 to new fields and production from new participating areas within existing fields, particularly where development may be economically challenging.
- Reducing or eliminating the gross value reductions, which are critical to encouraging "new oil" production, reduces the economic value and attractiveness of those opportunities and reduces the ability of investors to realize the true economics of the underlying investments in those new oil and gas developments.
    - GVR introduced as a way to incentivize new oil, and was a trade out for the removal of the North Slope qualified capital lease expenditure tax credit under SB 21.
    - The Legislature's own consultant, Enalytica, testified that 15 years' worth of the gross value reduction is a minimum of do no harm on this provision.

Many marginal, but important, projects are only economic moving forward above a price north of $70. Therefore, only the 3 year GVR would apply making this provision essentially worthless to such projects.

Section 60:

This provision would establish a Legislative Working Group to make recommendations for further tax changes in Cook Inlet basin. The working group recommendations would be prohibited from suggesting refundable credits, carry-forward lease expenditures, or any direct monetary support.

- This is the definition of instability for Cook Inlet. HB 247 makes considerable alterations to the tax system, and this group would be charged with coming back with further changes, which could be implemented next year.

Section 68:

This provision would allow the DOR and DNR to retroactively implement, interpret, make specific, or otherwise carry out the law. Retroactive changes in regulations could render provisions in the tax law/contractual leases neither durable, predictable, nor administrable.