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**ALASKA OIL AND GAS ASSOCIATION**
**TESTIMONY ON COMMITTEE SUBSTITUTE SENATE BILL 21(FIN) am(efd fld)**
**TO THE HOUSE RESOURCES COMMITTEE**
**March 27, 2013**

Good afternoon. My name is Kara Moriarty and I am the Executive Director of the Alaska Oil and Gas Association, commonly known as "AOGA". AOGA is the professional trade association that represents 15 member companies who account for the majority of oil and gas exploration, development, production, transportation and refining of oil and gas onshore and offshore in Alaska. These comments regarding Senate Bill 21, and specifically Committee Substitute Senate Bill 21 (FIN) am(efd fld), have been reviewed by all members and have been approved unanimously.

In short Mr. Chairman, my members believe the proposed Committee Substitute represents a base for significant and crucial tax structure reform of ACES that will help move the State's fiscal policy toward Governor Parnell's four "core principles". While we are encouraged by the Committee Substitute and the efforts by the Legislature and the Administration thus far to try and significantly improve Alaska's overall global attractiveness, AOGA believes additional changes are still needed for the bill to truly change investment behaviors to the benefit of Alaskans.

The industry's greatest challenge today, which we share with the State is the decline of oil production from the North Slope. A healthy oil and gas industry is one that sees the economic benefits of continuing to invest in projects in Alaska and keeping its employees here, where they volunteer their time, talent and treasure to make Alaska a better place to live for us all. Corrections to the ACES tax regime will remove impediments to development and exploration and assist the industry in investing in projects that could both extend the life of TAPS and open up new resources to long term development. We want to create developments that will last for decades more, creating jobs for our children and opportunities for our communities to flourish.

If a restructuring and tax rate reduction make investments here more competitive, or better yet, “attractive”, companies will want to make more investments here for that upside. Deciding to make long term investments in Alaska’s North Slope requires the industry to see potential upside to their investments and assessing that the essential risks of those investments are offset by the opportunities afforded in success. Without that potential opportunity in Alaska, investment dollars will be spent elsewhere, where risks are less and opportunity is greater.

**Core Principles to Address North Slope Production Decline**

Throughout my testimony today, I will reference Governor Parnell’s four “core principles” so it is important to restate them here as they offer an excellent cornerstone for you as you consider potential solutions to the challenge production decline creates for Alaska:

- “First, tax reform must be fair to Alaskans.”
- “Second, it must encourage new production.”
- “Third, it must be simple, so that it restores balance to the system.”
- “Fourth, it must be durable for the long term.”

We believe the addition of a fifth such principle would be required to meet Alaska’s goals, because the challenge is not that there are too many companies pursuing opportunities, but that there are too few. Alaska should therefore avoid tax changes that artificially create “winners” and “losers.”

Our goal today is to offer insights into how the CSSB21 impacts industry and we have ideas of how the current tax structure can be modified to better suit the needs of the State.

**1. Repealing Progressivity**.

**AOGA endorses the elimination of progressivity.**

Impact of Progressivity as part of the ACES tax rate in industry investment decision making is the single most influential component of Alaska’s tax structure negatively impacting investment decisions related to Alaskan projects. Taxes are paid by the industry in virtually every jurisdiction in which we function and so we are very familiar with how they work. But the uniformity and consistency in the application of tax impacts as they relate to investment decision making found in almost every jurisdiction is missing in Alaska. As my member companies have testified in the past, investment decisions are driven by combining high and low case scenarios where costs and revenues are estimated and best case cash flows and worst case cash flows are measured, risked and analyzed. Each potential project, in every jurisdiction, is measured and compared and only some are funded. As one of the legislative consultants, Roger Marks, pointed out recently, the international investment climate is characterized by plenty of opportunities, fluid capital, but finite capital. To choose what they can and cannot fund, companies have compared each potential project, no matter the jurisdiction, by application of a uniform investment decision measuring formula. When Alaska's tax system is quantified and added to this measure for proposed Alaskan projects the best cases are always burdened with an excessively high tax rate and as the assumed high cases get better, the burden only increases. We can find almost no other jurisdiction that so burdens investment return where the better the cases assumed for the decision, the higher the tax burden that applies.

And as I have testified to before, progressivity brings extraordinary complexity to the tax, not only in calculating what the tax is, but also in analyzing what the amount of the progressivity is for any particular item that affects a taxpayer's Production Tax Value (PTV).

The repeal of progressivity is consistent with all the principles outlined above. Its removal improves fairness because operators that increase margins through efficiency would no longer be automatically penalized. Its removal encourages new production because it reduces the tax burden on investment, as discussed above. Its removal is a significant step toward simplicity. And, lastly, its removal enhances durability because it satisfies the three preceding core principles.

**2. Increasing the base tax rate from 25 to 35%.**

**AOGA does not endorse increasing the base tax rate to 35%.**

Let's go back to the industry investment decision process again. Increasing the base tax rate, burdens every investment case with a higher tax rate. The burden of a 35% versus a 25% rate is easy to envision as every middle case and every worst case scenario is burdened with an additional 10% tax rate. This assumed cost will negatively impact the potential returns deemed available for any Alaskan project and drive investments to be made elsewhere. Increasing the base tax rate is contrary to the second core principle; there is not any reasonable argument that suggests increasing the base tax rate would encourage new production. Indeed, using the progressivity formula as a benchmark, the ten percentage point increase in the base tax rate could be viewed as equivalent to a sustained reduction in oil price of $25 per barrel, all else being equal.[1]

[1] In other words, a sustained $25 per barrel price change would be needed under progressivity to get the same 10% change in the base tax rate. Under progressivity, each $1 increase in PTV (or price, all else equal) per barrel would result in a 0.4% increase in the tax rate surcharge. Thus, a 10 percentage point change in the tax rate under progressivity would be equivalent to a $25 change in PTV or price because 25 = 10% divided by 0.4%.

**3. Tax Credits**

Industry makes investments to seek returns. In general, tax credits, because they act to offset a part of the costs of certain investments when the expenditure is made are an important tool in reducing the deemed risks of those expenditures.

It is important to reinforce that there is no tax credit liability for the State at all until an investor invests here. So it costs the State nothing to offer the credit until the investment is made and at that point the tax credit has already succeeded in what it is supposed to do – namely to attract investment dollars here.

**A. Repeal of the Qualified Capital Expenditure ("QCE") Tax Credit.**

**AOGA does not support the repeal of the Qualified Capital Expenditure Tax Credit.**

Even while the elimination of progressivity would improve the competitiveness of Alaskan investments from the present ACES tax, the elimination of the QCE Credit would claw back one important financial incentive and a part of ACES that actually acts to improve the competitive environment. The QCE Credit depends entirely on how much is invested here, and provides benefits for investments even when oil prices are lower. While the benefit from ending progressivity, which depends on the price of oil relative to a producer's lease expenditures, helps when oil prices are higher the QCE provides benefits across all price levels. At low to mid-range of oil prices the loss of QCE Credit would outweigh the benefit from the end of progressivity.

Repeal of the QCE credit is contrary to the second core principle. Furthermore, because every producer's costs are different and prices will impact them differentially, AOGA fears the repeal of the QCE Credit is worse than creating "winners" and "losers" because it only creates "losers" artificially among producers, and we see no sound tax policy justification for doing so.

For these reasons, AOGA believes the elimination of the QCE tax credits would not serve to attract new business to Alaska. Instead of that, one possibility might be to expand the scope of the "well lease expenditure" tax credit under AS 43.55.023(l) so it is available to producers on the North Slope. This credit has several meaningful advantages. First, it focuses investment incentives on subsurface intangible-drilling expenditures, which are a reasonable proxy for direct spending on well activity and, in turn, production. Second, the credit is clear because it uses already established concepts in the federal Internal Revenue Code. Third, it is fair because it applies equally to well-related spending in all areas of the state, without creating winners and losers merely on the basis of geography.

**B. The $5 dollar per barrel tax credit.**

**AOGA is concerned that the potential benefit of a $5 dollar per barrel tax credit under AS 43.55.024(i) will be offset by other burdens.**

There are multiple issues to balance when taking in the numerous proposed changes found in CSSB21. The removal of progressivity, the increase in base rate, elimination of the QCE credit all create interrelated issues and while a $5 dollar per barrel tax credit would provide benefits both in real tax costs and in investment decision making, the weight of the benefit in respect to the other changes is hard to measure. AOGA applauds the concept of tying incentives to the goal of increased production and as such allowing a tax credit per barrel.

**C. Small-Producer and Exploration Credits.**

**AOGA supports amending CSSB21 to extend the small-producer tax credit under AS 43.55.024 and exploration tax credits under AS 43.55.025 from the present sunset dates in 2016 to a later date.**

The State had sound policy reasons for creating these small producer and exploration tax credits, and those reasons are just as valid today as they were then. The current CSSB21 does not extend the sunset dates beyond 2016, even though AOGA believes these credits have increased the likelihood of participation by new industry players and act to increase the opportunities that could be found by expanding exploration. The purpose of the small-producer tax credit was to attract new players to Alaska who might otherwise have been deterred from coming here by presumptions of increased risks and of higher-than-average costs and expenses. The success of the credit in attracting new participants is a fact that cannot be denied. AOGA sees this success in its own membership, and in other companies that have come here and are now active. Smaller producers often have a different perspective about the opportunities around them, and as such can bring with them new ideas and opportunities. New participants with new ideas can only strengthen and improve the Alaskan petroleum industry and help the state stem the decline in production. We know from testimony that the small-producer tax credit has made a material difference in individual companies' decisions to do business and invest in Alaska.

The purpose and justification for the exploration tax credits under AS 43.55.025 are equally clear. Huge parts of this state remain unexplored or underexplored. Again, these tax credits are only earned when actual expenditures for exploration occur. The credits tangibly reduce the risks faced by an explorer and as such incentivize them to go out and search for oil and gas that is much needed.

Increased exploration leads to increased development and these credits act to increase exploration and should be extended as well. Just as with the QCE credits for capital investments, there is no exploration tax credit without real money having first been spent on exploration work that qualifies for these tax credits.

**D. Maintaining transferability of "carried-forward annual loss" tax credits**.

**AOGA supports the transferability of these losses.**

We applaud that the CSSB21 maintains the transferability of the current "carried-forward annual loss" tax credits under AS 43.55.023(b). New participants and new explorers are many times not yet producing in the state or only producing small volumes of oil and gas and as such have little or no production tax liabilities. The ability to transfer their losses to others allows them to monetize the investments they have already made, both reducing their cost exposure on the original expenditure and hopefully at the same time acquiring additional capital for more investment.

**E. New credit for Manufacturing**

**AOGA supports the new proposed manufacturing credit.**

Although this credit is directed to the incentivizing of development and manufacture of drilling and exploration methods and materials, it may not have a great impact on the reduction of the current production decline. However, it is a step in the right direction to incentivize jobs and additional investment, and having more jobs and investment in Alaska is never a bad thing.

**4. Gross Revenue Exclusion.**

**AOGA endorses the proposed 20% gross revenue exclusion or GRE, but has concerns on breadth of applicability.**

The GRE would, in calculation of the taxable Production Tax Value, exclude 20% of the Gross Value at the Point of Production of what we'll call "non-legacy" production, and attempts to apply to new oil within legacy fields. AOGA supports the concept of a GRE, and initially we were concerned that it was too narrowly focused because it would have only applied to those areas outside existing Units.

The Governor's second "core principle" for tax legislation is that "it must encourage new production." But, in order to get results from such encouragement, the tax legislation must incentivize the best opportunities that Alaska has for getting results. The current CSSB21 attempts to expand the application of the GRE and tries to include legacy fields, which is where at least 80 – 90 percent of the 3 billion-barrel opportunity in the central North Slope that Econ One identified as economically recoverable earlier this session.

However, the current language causes concern because of the uncertain nature of the applicability and the problem that companies won't know if they get the GRE until after the investment is made, so in essence, companies cannot utilize the GRE in modeling economics of future projects in legacy fields. Additionally, we have concerns that the determination methodology will be defined after the bill is passed and be placed in future regulations.

AOGA believes our concerns can be addressed by additional language to provide clarity and certainty so the GRE is effective for industry.

**Oil and Gas Competitiveness Review Board**

**AOGA does not support the formation of the Competitiveness Review Board.**

The proposed Board provides an oversight and review process that we believe would be burdensome to the industry and contravenes the Governor's principles relating durability in the long term. The perspective that the proposed changes found in the Bill would provide a long term solution to problems we know exist are placed in jeopardy because the very certainty that is required for sound investment decision making would be placed in question with each annual report of the Board. Instead of moving forward with projects that might help stem decline, industry resources would be used to assist the Board in collecting and understanding complex information of long term consequence. Finally, the documentation and information the Board might request or require is of the highest proprietary value to oil and gas companies and confidentiality concerns and related complexities would hinder the efforts of the industry as well as the Board. While we appreciate the ability to represent industry on the proposed board, our concerns cause AOGA to question both the viability and the effectiveness of the proposed Board and as such we cannot support its proposed formation.

**Reduction in Statutory Interest Rate**

**AOGA supports the lowering of the statutory interest rate.**

As we have testified to in the past, the statute of limitations under AS 43.55.075(a) is six years from the date when the tax return was filed for the tax being audited, while the limitations period for other taxes under AS 43.05.260(a) is three years from the filing date of the tax return. Under both statutes, the period may be extended by mutual consent of the taxpayer and the Department of Revenue

(DOR).

The current statutory rate of interest under AS 43.05.225(1) for tax underpayments is "five percentage points above the annual rate charged member banks for advances by the 12th Federal Reserve District as of the first day of that calendar quarter, or at the annual rate of 11 percent, whichever is greater, compounded quarterly as of the last day of that quarter[.]" Currently the Federal Reserve rate is very low, so 11% APR is the applicable rate.

A lower statutory interest rate is very much supported by industry, because it provides some certainty to taxpayers.

**Issues that the current draft does not address.**

There are several significant problems in the present ACES tax that are not addressed in CSSB21, and I will address a few of them this morning.

**A. Minimum tax for North Slope production.** AS 43.55.011(f) sets a minimum tax that is targeted solely against North Slope production. That tax is based on the gross value of that production instead of the regular tax based on "net" Production Tax Value. The rationale for adopting it was to protect the State against low petroleum revenues when prices are low.

The minimum tax only complicates potential new investors' analyses of what their tax would be if they invest here instead of someplace else, and consequently it has, if anything, driven investments away. AS 43.55.011(f) should be repealed or consideration given to significantly reducing the rate of the minimum tax.

**B. Joint-interest billings.** Instead of starting with the joint-interest billings that participants in a unit or other joint operation receive from the operator, DOR regulations reflect an assumption that each non-operating participant has information, in addition to the operator's billings to them, that allows them to determine which expenditures are deductible as allowed "lease expenditures" under AS 43.55.165 and which are not. Instead of one audit of the expenses by a joint venture for any given period, the Department audits each participant separately for its respective share of the same pool of expenses.

We are not asking for legislation to put the Department's regulations on a different track. But there are some in the Department who believe that the repeal by the 2007 ACES legislation of AS 43.55.165(c) and (d) — which specifically authorized the Department to rely on joint-interest billings — means the Department cannot legally rely on them now. While we disagree with this position (which is also at odds with what the Department testified to during the enactment of the 2007 ACES legislation), we do think it would be appropriate to restore language specifically authorizing the Department to rely on joint-interest billings if it chooses to do so.

**Conclusion**.

If I leave you with one thing today, it would be the word “enormous”. While AOGA believes that Alaska’s potential is enormous we are grounded by the reality that our competition is enormous as well, and they are just starting to heat up. It is estimated that the fields of South and West Texas alone could produce over FOUR MILLION barrels of oil equivalent per day by 2020. That’s more than some OPEC countries. Alaska should ask themselves if they really believe a “middle of the pack” policy for the state will attract new investment capital against that type of competition.

We believe it is up to you, and the Governor, to shape an attractive oil fiscal policy that is supported by strong principles that will win additional capital, arrest North Slope production decline and will lead Alaska towards a prosperous future for the long-term.

As I mentioned at the beginning of our testimony, overall, AOGA’s members believe the Bill represents a base for significant and crucial tax structure reform that move toward Governor Parnell’s four “core principles” — fairness for Alaskans, encouraging new production, simplicity with balance, and durability for the long term, but as I have outlined today, AOGA members believe additional changes should be included for this bill to truly change investment behaviors to the benefit of Alaskans. You have a difficult task ahead and AOGA stands ready to assist you throughout this process.