

SENATE FINANCE COMMITTEE  
February 18, 2010  
9:00 a.m.

9:00:51 AM

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:00 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Johnny Ellis  
Senator Dennis Egan  
Senator Joe Thomas

MEMBERS ABSENT

Senator Donny Olson  
Senator Charlie Huggins, Vice-Chair

ALSO PRESENT

Pat Galvin, Commissioner, Department of Revenue; Lennie Dees, Audit Master, Tax Division, Department of Revenue; Senator John Coghill; Senator Hollis French

PRESENT VIA TELECONFERENCE

None

SUMMARY

2010 OIL & GAS PRODUCTION TAX REVIEW

^PRODUCTION TAX CREDITS

9:02:47 AM           AT-EASE  
9:04:45 AM           RECONVENED

PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE, listed the agenda of the presentation and introduced Mr. Dees.

[9:07:15 AM](#)

LENNIE DEES, AUDIT MASTER, TAX DIVISION, DEPARTMENT OF REVENUE, related that he oversees the production tax audit group and the administration of the tax credit program. He stressed that many manual processes are used when administering the program. He stated that the tax credit is the part of ACES that created a lot of new activity and interaction with taxpayers, and as a result, the tax audit group had to change its structure.

Mr. Dees shared slide 2 - the overview of the presentation entitled, "Production Tax Credits" (copy on file): types of tax credits, credits applied against tax liability, transferable tax credit certificates, cash refund history, and tax credit analysis.

[9:10:09 AM](#)

Co-Chair Stedman commented on the significance of the credits. The state, through the credits, is increasing its share of the upfront capital cost going into the development. The credits are very sensitive; a change in the percentage of credit creates a huge shifting of cash flow between the industry and the sovereign. The larger the credit, the more the upfront development cost goes to the sovereign, and it significantly alters the rate of return to the industry.

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Mr. Dees began by discussing the types of credits - slide 3. Capital expenditure credits found in AS 43.55.023 are for capital activities that companies undertake in the production of oil and gas. Exploration credits consist of two types; one is for capital expenditures and one is for exploration incentives. The Net Operating Loss (NOL) Carry Forward Credits are for companies just starting up, for use before the revenue stream picks up. The Transitional Investment Expenditure Credit allows expenditures that were allowed before PPT came into effect. Small Producer Credits are self-explanatory.

[9:13:47 AM](#)

Mr. Dees turned to the Capital Expenditure Credits - slide 4. He said that 20 percent of qualified capital

expenditures (QCE) may also qualify for carry forward credit. They include drilling, construction of facilities, and new equipment, and may also qualify for NOL Carry Forward Credit. The same expenditures do not qualify for additional EIC credit. The expenditures must be spread over two years, a change that was made by ACES effective July 1, 2007. The credits may be cashed or transferred.

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Mr. Dees explained the two main types of exploration credits - slides 5 - 8. The capital credit for exploration activity is a 20 percent credit. Expenditures that qualify include geologic and geophysical exploration, or expenditures incurred in connection with drilling and exploration wells, and must be spread across two years. They may also qualify for NOL Carry Forward Credits and may be cashed or transferred. The exploration incentive credits can be 30 percent to 40 percent of qualified expenditures depending on well location and proximity to existing wells and unit boundaries. Qualified expenditures include expenses associated with seismic and geophysical exploration work, and exploration well drilling. These expenditures may qualify for NOL credits, but do not qualify for Capital Expenditure Credit. To receive credit, taxpayer must provide certain well data to DNR. These credits expire in 2016 and may be cashed or transferred.

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Co-Chair Stedman inquired about a hypothetical example of someone in Prudhoe/Kuparuk that would qualify for a 20 percent capital credit for a project and someone outside that arena who qualifies for a 40 percent credit going after that exploration. He wondered how much upfront cash the industry would have to provide and how much of the burden is on the sovereign, including the federal government.

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Co-Chair Stedman clarified that \$100 would be expended on a project with a capital credit. Commissioner Galvin responded that the \$100 would be deducted from the production tax value which will reduce the tax depending on the price of oil and progressivity. It could be 25 percent or higher. In addition, the expense would qualify for the

20 percent credit. Taxes would be reduced by at least 45 percent. An explorer outside the unit that qualifies for the exploration credit would be able to deduct a further 25 percent as well. He explained how the zero tax liability deduction is achieved. He gave an example of how a dollar amount would be divided by various taxes.

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Co-Chair Stedman requested a bar chart which would depict the impact of the credits to the various entities.

Senator Egan asked if the NOL credits could be transferred. Mr. Dees explained the NOL carry forward credit - slide 9. There is a 25 percent net operating loss applied against tax liability in the following year. The credit can be cashed or transferred. Senator Egan referred to the previous slide and asked about the expiration of the exploration incentive credits in 2016.

Commissioner Galvin explained how the expiration date works. The date is set and then the program is examined to see how it is being utilized. If it is being used then the expiration date tends to get pushed back. As 2016 approaches the legislature will determine whether or not to extend the date.

Commissioner Galvin addressed Senator Egan's initial question about whether the loss could be transferred. He explained that the loss itself cannot be transferred until it becomes a credit; however, it could be valuable to the company as a credit which is cashed back to the state or transferred to another taxpayer.

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Mr. Dees commented further on the NOL credits. The expenditures that do lead to the net operating loss include both operating and capital expenditures.

Mr. Dees turned to slide 10 - transitional investment expenditure (TIE) credits. The TIE credit equals 20 percent of qualifying capital expenditures that were incurred between March 31, 2001 and April 1, 2006 and do not exceed 10 percent of the capital expenditures incurred between March 31, 2006 and January 1, 2008. He explained that there was a limit on the amount of credit companies could take.

He continued to explain that ACES revised the statute to only cover producers or explorers not having production prior to January 1, 2008. The TIE credits are not transferable and may not be carried forward beyond 2013. The same capital expenditures may not qualify for exploration credit under AS 43.55.025.

Commissioner Galvin added that these were credits put into place by PPT as the "look back" or "claw back" and were intended to provide a recognition for investments companies had made leading up to the transition from ELF to PPT. When ACES changes were made, the TIE credits were eliminated - were capped at the date ACES become effective. Companies that did not have production earned a TIE credit. There are a small number of TIE credits outstanding.

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Mr. Dee explained the small producer credit - slide 11. There are two small producer credits. In AS 43.55.024(a) there is a \$6 million credit against tax liability. Small producer credits are available for companies producing less than 50,000 bbl/day of oil BTU-equivalent. Production must be from wells outside of Cook Inlet and the North Slope. The credit expires in 2016 or nine years after the first commercial oil or gas production if before May 1, 2016. The credits may not be cashed or transferred or carried forward.

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Mr. Dees explained the small producer credit under AS 43.55.02(c) - slide 12. This credit is available for companies producing not more than 100,000 bbl/day of oil BUT-equivalent. The credit ranges between \$12 million and zero, depending upon the level of production. Credit can only be applied against tax liability and production is not restricted by region.

Mr. Dees turned to slide 14 - credits applied against tax liability. The credits may be claimed in up to two ways: all credits may be applied against tax liability and some credits may be converted into a transferable tax credit certificate. He noted that the .023(a) credits must be split over two years. The NOL, TIE, small producer, and .025 credits must all be used in the current year. Some

credits may be converted into a transferable Tax Credit Certificate.

[9:39:19 AM](#)

Co-Chair Stedman asked if .025(a) credits are exploration credits. Mr. Dees said they were.

Mr. Dees explained a chart on slide 15 tax credits earned by producers by tax year. The numbers represent millions of dollars. He discussed each credit by year: Capital Expenditure, TIE, Small Producer, and Exploration Incentive Credits. Co-Chair Stedman asked if \$1,276,000 is what the state reimbursed the industry for drilling exploration and capital work. Mr. Dees said it was not what was reimbursed, but the credits companies claimed they earned. Co-Chair Stedman clarified that the companies are deducting the credits, which results in a direct impact on the state treasury. Mr. Dees disagreed and turned to slide 16 for more explanation.

[9:42:08 AM](#)

Mr. Dees related that the chart shows what the companies would eventually be able to deduct. Some of the deductions must be taken the second year. He noted that the law changed in 2007.

Co-Chair Stedman restated that the state treasury would be shy \$1,276,000 as shown in the previous slide. Commissioner Galvin pointed out that slide 15 is figured on an accrual basis and slide 16 is figured on a cash basis. Co-Chair Stedman stressed that these credits have huge impacts. He requested further information about who is paying exploration costs on a net basis.

[9:45:07 AM](#)

Senator Thomas asked if any company qualifies for the small producer credits. Mr. Dees replied that most of the credits were (c). Senator Thomas asked for a breakdown of (a) and (c) credits. Mr. Dees pointed out that the charts were derived from tax files. Senator Thomas requested more information about AS 43.55.024(a) and (c) credits. Mr. Dees summarized the request: how many small producer credits are for areas outside and inside Cook Inlet and the North

Slope. Co-Chair Stedman thought that information would be provided later on.

Senator Thomas asked if net operating loss credits could be converted to transferable credits. Mr. Dees said they could.

[9:47:56 AM](#)

Co-Chair Hoffman referred to slide 15 and asked about TIE credits, which are no longer available. He noted that the largest credit is now capital expenditure, which increased by \$140 million from 2006 to 2008. He wondered what happened in that area in 2009. Co-Chair Stedman inquired what might happen in 2010.

Commissioner Galvin referred to the capital expenditure level chart from yesterday. He stated that capital expenditure credits are expected to go up. Co-Chair Stedman asked for that information. Co-Chair Hoffman agreed it would be good to see those numbers. Co-Chair Stedman appreciated how slides 15 and 16 were set up.

[9:50:53 AM](#)

Commissioner Galvin explained how the charts were prepared based on tax returns. There are currently no tax returns available for 2009. He offered to provide an estimate.

[9:52:18 AM](#)

Co-Chair Hoffman saw capital expenditure credits on the rise. He thought the exploration incentive credits weren't working and suggested the industry should do more seismic drilling and exploration. Mr. Dees explained that this set of taxpayers is made up of producers. Exploration activity is from the explorers who don't currently have tax liability. He also informed the committee that the year 2006 shows information from only nine months, whereas 2007 and 2008 are full years. Co-Chair Stedman reminded the committee that the main capital expenditure credit expenditure of \$828 million is taken off the top. That figure does not appear in committee summary documents. An attempt is being made to show the total revenue with the capital credit taken off in order to keep better track of the credit.

Mr. Dees agreed it was one of the challenges.

[9:56:04 AM](#)

Mr. Dees turned to slides 17 and 18, which he said may help answer a previous question. They contains bar charts showing the credits applied against tax liability - credits claimed and credits applied against tax filings from 2006 to 2008.

Mr. Dees detailed the graph on slide 19 which shows both credits earned and applied to the tax. The gap in 2008 remained the same. There has been talk of taking the tax credit to sixty percent of the credits earned. This would result in an immediate impact to the state of about \$200 million.

[9:59:36 AM](#)

Mr. Dees moved to slide 21 - transferable tax credit certificates. Since 2001, 211 transferable credit certificates have been issued. Of those, \$228,900,000 have been for capital expenditure credits, \$64,900,000 have been for capital expenditures for exploration activities, and \$340,000,000 have been for NOL credits.

Co-Chair Stedman asked if there was information on the breakdown of the credits within the oil basins. Mr. Dees reported that he has information that will show where the capital expenditures are happening within the oil basins.

Commissioner Galvin explained that the department would provide representation of where the economic drivers are within the fields.

Senator Thomas asked when the "true up" is done. Commissioner Galvin replied that will be done on the annual return on March 31.

Senator Thomas asked about the dates on slide 21. Mr. Dees replied that the transferable tax credit certificates are current through February of 2010.

Commissioner Galvin informed the committee that the credit certificates can be applied for during the year expenditures are made.

[10:03:49 AM](#)

Mr. Dees detailed slide 22, transferable tax credit certificates - exploration tax credits, which originated in 2003. Since then, there have been 59 applications. Growth expenditures claimed total \$945,200,000. There are currently 23 applications in progress, which represent gross expenditures of \$439,900,000 requesting \$148,300,000 in credits.

Mr. Dees reviewed the bar graph on slide 23 depicting exploration tax credit applications since 2005. He noted that the applications received in 2007 and 2008 increased due to exploration activity. He explained that statute requires that within six months after the drilling activity the application for the exploration credits must be applied for. He noted the great amount of exploration activity in 2009.

[10:06:53 AM](#)

Mr. Dees discussed slide 25 - cash refunds history. In order for the state to purchase transferrable tax credit certificates, certain requirements must be met. In order to cash the certificates, they must be usable against tax liability. They also must show subsequent lease bids equal to the cash sought. They must have a zero tax liability owed in current and past years and have no more than 50,000 barrels per day of oil production.

Mr. Dees explained slide 26 - tax credits purchased by fiscal year. The total of credits purchased is \$400,200,000, a current figure through February 12, 2010. Slide 27 explains the oil and gas tax credit fund which has a current balance of \$90,000,000.

[10:09:25 AM](#)

Mr. Dees turned to slide 29 - tax credit analysis: qualified capital expenditure deductions. The slide is based on tax filings and is broken down by exploration area: Legacy Fields, Cook Inlet, and other North Slope Fields.

Co-Chair Stedman asked which fields were Legacy Fields. Mr. Dees said they were Kuparuk and Prudhoe. Co-Chair Stedman

wondered if they included Alpine. Mr. Dees explained that Alpine is included in the "Other North Slope" category.

Co-Chair Stedman looked at the total of \$1.76 billion for the Legacy Fields and wondered if the credit numbers would match. Mr. Dees referred back to slide 15 to explain the capital expenditure credits.

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Co-Chair Stedman asked about an estimate for FY 09. Mr. Dees did not know if the estimates were available. Co-Chair Stedman also wanted to know about credits for infrastructure in the Legacy Fields and other fields.

[10:14:55 AM](#)

Mr. Dees explained slide 30 - credits claimed under .023 against tax liability. This graph includes all fields that were reported on tax returns. It is about 20 percent for credits claimed for expenditures.

Co-Chair Stedman asked for a comparison of this chart with the previous one. Mr. Dees related that this is what the producers claim on tax files and are subject to audit.

Co-Chair Hoffman referred back to slide 16 and wished to compare that data to slide 30. Mr. Dees said he would have to check on it.

[10:17:21 AM](#)

Mr. Dees talked about slide 31 - capital credit certificates under .023(a)(1).

Senator Thomas referred to slides 21 and 22 and asked if the tax credits were current. Mr. Dees said they were.

[10:19:15 AM](#)

Mr. Dees discussed slide 32 - capital credit certificates under .023(a)(2) - for exploration activity. Slide 33 corresponds to slide 21 and shows expenditures versus NOL credit certificates.

Mr. Dees said that slide 34 shows expenditures versus .025 exploration credit applications.

10:21:14 AM

Mr. Dees concluded with slide 35. He summarized that the Legacy North Slope Fields increased in producers' capital expenditures from 2006-2008, but plateaued in capital deductions from 2007-2008. In the non-legacy North Slope fields and in Cook Inlet, there was a steady increase in capital expenditures. Since 2007, the exploration credit applications have more than doubled. There was an increase in .023(a)(2) and in NOL credits in 2007 and 2008, which suggests an increase in exploration activity.

Co-Chair Stedman returned to slide 22 and asked how Point Thomson would affect the chart. Mr. Dees pointed out that some capital expenditures were claimed in 2008. Co-Chair Stedman requested projected information for Point Thomson in 2009. Mr. Dees explained that he chose Legacy Fields as defined in statute to depict in the charts. He offered to provide the requested information.

10:24:23 AM

Co-Chair Stedman explained the reasoning behind the requests for more information. Exploration and development for new oil impacts the state's treasury now and will in the future.

Senator Ellis thought the presentation was helpful. He opined that the public lacks knowledge about this information. Co-Chair Stedman agreed that it is a complex topic.

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ADJOURNMENT

The meeting was adjourned at 10:25 AM.