SENATE FINANCE COMMITTEE
March 23, 2012
1:26 p.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 1:26 p.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Dennis Egan
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

Senator Lesil McGuire, Vice-Chair
Senator Johnny Ellis

ALSO PRESENT

Janak Mayer, Manager, Upstream and Gas, PFC Energy

PRESENT VIA TELECONFERENCE

SUMMARY

SB 192 OIL AND GAS PRODUCTION TAX RATES

SB 192 was HEARD and HELD in Committee for further consideration.

#SB192
SENATE BILL NO. 192

"An Act relating to the oil and gas production tax; and providing for an effective date."

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Co-Chair Stedman discussed housekeeping. He informed the committee that a consultant from PFC Energy would be coming

forward to present concepts surrounding progressivity tax; the portion of oil and hydrocarbon tax that is added on to profit oil. He explained that industry was concerned that progressivity rates rising rapidly, as oil prices rise, would complicate the economics of incremental production in Alaska's oil basin. He furthered that there were concerns with production in existing fields. He relayed that as different levers of taxation were moved it was important to keep track of the bottom line and cash flow as it vacillated. He pointed out to the committee that the numbers being discussed were conceptual and were being offered in the hypothetical.

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JANAK MAYER, MANAGER, UPSTREAM AND GAS, PFC ENERGY, presented a PowerPoint Presentation, "Discussion Slides: Alaska Senate Finance Committee, March 23, 2012" (copy on file). He discussed Slide 2: "Progressivity takes away upside at high prices…" which briefly examined the impact of progressivity on the returns to a company investing in the Alaska North Slope (ANS) at higher oil prices. The graph on the left was created using Department of Revenue (DOR) FY13 input data. The graph on the right illustrated a more conceptual look of the declining base portion of an existing producer's portfolio. The bottom axis in both charts was ANS crude price.

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Co-Chair Stedman requested further clarification of each graph for the benefit of the viewing public.

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Mr. Mayer explained that the value of the "Y" axis on the left represented the cash flow retained by the producer; on the right was a discounted measure of net present value over the lifecycle of an asset. The "X" axis was a sensitivity of ANS crude price. The bend in the red and yellow lines was the bend that resulted from progressivity as increasing tax rates at higher oil prices benefited the state. The red line represented ACES and the yellow line represented the current version of SB 192. He noted that the right side reflected a greater divergence between the two at prices above $170 to $180 per barrel. The diversion on the right was more than the graph on the left as a

result of inflation and "bracket creep" due to the 60 percent cap in place under SB 192. The cap was binding only at the highest prices discussed on the slides. He stated that because of the impact of inflation, the cap was steadily binding at lower prices. He explained that the dotted blue line was a conceptual representation of what a more neutral taxation system would look like; one in which the overall share of revenue between producer and state was shared at a more constant rate. He noted that at the $80 to $110 per barrel market price the progressivity curve and marginal rate were at their greatest. He offered that a number of proposals had been discussed, some in which bracketing substantially reduced progressivity and overall government take at prices from $80 to $230 per barrel. He furthered that at $100 per barrel the state was in a sound financial situation, but would be less so if the government take were to be reduced at that level. He shared that the basic question that informed the slides in front of the committee was: what measures could be taken to address some of the problems with progressivity, in terms of creating a more neutral and less highly progressive fiscal system, without strongly changing the amount of revenue to the state at the $100 per barrel mark. He added that the slides would also briefly touch on the question of progressivity at steep marginal rates; it was one thing for lower cost, mature assets with good economics to have the high progressivity rate, it was another thing when discussing very high cost potential new project that face challenging economics from conception. He referred to Slide 3: "…and particularly challenges economics for new projects." which illustrated the curve of progressivity for higher cost new development that would result in projects that, under a more neutral regime would break even at the $70 to $80 per barrel mark, instead doing so at the $100 per barrel mark; further economically challenging new development.

Mr. Mayer testified that under ACES the overall government take was very high at the $100 per barrel mark. He referred to Slide 4: "Regime Competitiveness: Average Government Take.", which illustrated that at the $100 per barrel mark the overall government take for Alaska was among the highest in the Organisation for Economic Co-operation and Development (OECD). He continued to Slide 5: "Regime Competitiveness: Average Government Take" which illustrated that at the higher price of $140 per barrel the level of government take becomes too high for producers.

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Mr. Mayer continued to Slide 6: "ACES (Existing Producer)". He suggested options for dealing with the issue that would not dramatically reduce government take at the $100 per barrel level, but would reduce the steadily escalating take at prices higher than $100 per barrel. The slide illustrated the options under ACES using the analysis of an existing portfolio of approximately 200,000 barrels per day. The government take levels were 69 percent at the $60 or $70 per barrel mark, rising to 74 percent at the $100 per barrel mark, and as a high as 83 percent by the $230 mark.

Co-Chair Stedman requested further clarification regarding Slide 6.

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Mr. Mayer responded that the slide was an economic analysis of the overall government take; including lifting and ongoing maintenance costs for a hypothetical producer producing 200,000 barrels per day with a 6 percent decline, and spanning current day production into the next 30 years. He stated that blue bars on the chart at top left represented the steady decrease of revenue as production decreased, the yellow bars represented capital expenditures, and the red bars represented operating expenditures. The black line was the overall after tax cash flow (ATCF). The chart at the bottom left showed different levels of ANS West Coast crude price ranging from $40 to $230 per barrel, and the absolute levels of government take. He noted that in reality, as oil prices increased so did costs. He reiterated that the numbers in the charts were conceptual for the purpose of the hypothetical discussion.

Mr. Mayer continued. He pointed out to the committee that the bottom left graph depicted the absolute level of government take by the different forms of tax through which government take occurred. The bottom right detailed the percentage of government take, the data of which was reflected in the top right chart. The top right chart showed a 69 percent government take split between royalty, production, property and state taxes at $70 per barrel. At $230 per barrel the total government take could be as high as 83 percent.

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Mr. Mayer continued to Slide 7: "CSSB 192 (Existing Producer)" which calculated the same analysis from Slide 6 under SB 192. He noted the slight moderation, starting at per barrel prices of $150 - $160, of relative government take. He reiterated that because each bracket was denominated in nominal terms, inflation should be taken into consideration when examining the numbers. He highlighted that greater impact of progressivity was reflected on the chart because it incorporated future years with the consideration on inflation. He said that the very slight reduction of the numbers on Slide 6, reflected on Slide 7, were due to the decreased progressivity rate under SB 192.

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Mr. Mayer admitted that Slide 7 reflected a reduced level of government take, but left the overall government take relatively high. He stated that there was little difference between ACES and SB 192 when looking at $100 per barrel oil. He continued to Slide 8: "CSSB 192 with 50 percent Cap (Existing Producer)" which detailed what would happen if the 60 percent cap in SB 192 were reduced to 50 percent. He said that the level of government take at the $100 per barrel level remained the same, but as the price of oil moved north, the level of government take held at a relatively steady rate. He noted that the overall line on the bottom right chart showed a leveling off under the system. He suggested that one possibility could be to take the numbers even further to level out the numbers of overall government take.

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Co-Chair Hoffman mentioned that lower numbers for net present value (NPV) had been considered in previous projections. He wondered if those numbers could be presented again before the committee. Mr. Mayer replied that the numbers could be provided in the near future. He added that the numbers on Slide 8 had been provided in the interest of expediency.

Senator Olson queried why the federal government corporate income tax (CIT) in the upper right hand chart was high at

lower prices, then lowered and flattened out at higher prices.

Mr. Mayer explained that the numbers reflected percentages of divisible income; all of the revenue produced by a given project, minus project costs.

Senator Olson reiterated that he did not comprehend why the federal CIT flattened out at 14 percent. Mr. Mayer replied that many complicated factors were involved when calculating the CIT. He offered to provide a more comprehensive answer at a later date.

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Mr. Mayer spoke to the flattening out of the progressivity curve in order to reduce the marginal tax rate under ACES, and to some extent SB 192, at $110 - $120 per barrel. He understood that industry believed that the existing base rate was already too high. He felt that it was valuable for all parties to explore the possibility of further flattening the rate, while maintaining existing levels of government take, which could be done by counteracting the reduction of progressivity with an increased base rate. He directed attention to Slide 9: "30 percent Base rate, 0.02 percent Progressivity, 40 percent Cap (Existing Producer)" which provided an example of a 30 percent base rate with 0.02 percent progressivity, capped at 40 percent. Under this premise the level of government take at $100 to $110 per barrel was reduced by 4 percent and remained flat up to $230 per barrel. He stated that the lower progressivity rate of 0.02 percent substantially reduced marginal take. He added that under the proposed system on Slide 9, the split between the state and producers of increased revenue from higher price levels would be equitable.

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Co-Chair Stedman asked if the chart on the lower right of the slide illustrated the more equitable split. Mr. Mayer replied in the affirmative.

Co-Chair Stedman wondered if the chart represented a full cycle. Mr. Mayer replied that the chart projected future numbers for an existing producing portfolio with low cost production values.

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Mr. Mayer discussed Slide 10: "Impact on Upside" which illustrated by using the cash returned to producers at a range of prices the NPV Lifecycle for an existing producer. The lines on the chart represented as follows: gold; SB 192, light blue; ACES, violet; SB 192 with an increased maximum cap rate of 50 percent, beige; SB 192 with a 30 percent base rate and 0.2 percent progressivity. He noted that under the beige line the overall distribution of revenue became more balanced between the state and the producer. He pointed out that at $100 per barrel the results of all of the systems would be similar.

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Mr. Mayer discussed Slide 11: "25 percent Flat Production Tax, Progressive Severance Tax (Existing Producer) which depicted removing progressivity from the production tax altogether, and assessing it as a severance tax based on gross production net revenue. The slide suggested a starting level of $60 per barrel at 2.25 percent progressivity, up to a 20 percent progressivity level at a $160 per barrel. He reminded the committee of earlier concerns of achieving more under ACES without imposing administrative difficulties, such as decoupling oil and gas. Decoupling could prove desirable under ACES; introducing gas production into the production stream, under the current progressive system of production taxation, would result in lowered production taxation levels. He countered that the problem with decoupling under ACES was that it became difficult to differentiate costs between oil and gas streams. He added that it could require two separate tax returns from producers and increased auditing by the state.

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Mr. Mayer furthered that if progressivity were removed completely from the production tax, resulting in a flat tax at the current 25 percent base rate (as modeled on Slide 10), progressivity and the level of taxation would depend solely on the price of oil production. The progressive severance tax could vary, as productions streams varied, negating the need to specifically assign the tax. If production tax applied to all costs across the board; severance tax could be applied solely to oil and not gas.

He concluded that if the production tax alone was not progressive with regard to price, but at a fixed rate, the question of decreased production tax income resulting from gas production was eliminated. Similarly, if the progressive aspect of the tax regime was not part of production tax incentives, but instead was leveled at the gross revenue point, there were many incentives that could be provided through the severance tax mechanism. The system could be implemented with relative ease because the costs associated with the two production streams would not need to be delineated.

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Mr. Mayer continued to Slide 12: "FY 2013 Revenue Analysis" which provided a view of the number of different ways the systems could achieve different levels of government take.

Co-Chair Stedman observed that to move the calculation from expenses after royalties, would be a new concept. He added that the shift could be further hypothesized in the same way eliminating progressivity had been discussed. He stated that the legacy fields should retain progressivity. He reiterated that decoupling would be an issue. He relayed that streamlining the tax system would prevent further cumbersome tax calculations on separating costs. He pointed out to the committee the possibility of a combination of the proposed systems, for example; 30 percent base tax, minus progressivity, combined with progressive severance tax. He said that understanding the cash flows was important because what appeared as a tax increase could really be a net tax decrease.

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Co-Chair Hoffman understood that industry was concerned with the steep slope of progressivity at 30 percent.

Co-Chair Stedman replied in the affirmative. He said that the 30 percent base tax would cut progressivity in half.

Mr. Mayer returned Slide 12, which illustrated the FY13 revenue perspectives at different price levels under ACES, SB 192, and SB 192, with 50 percent cap. He reiterated that the analysis on the slides reflected the moving of one variable while holding all others constant. In each analysis price moved, but cost did not move

correspondingly, this gave a sense of sensitivity to price. He added that all the analysis had been done using the relevant figures for production and costs provided in the FY13 DOR Cost Revenue Book.

Mr. Mayer pointed out to the committee that Slide 12 showed that under ACES, at $110 per barrel, production tax reviews were approximately $4.8 billion, which matched the Revenue Source Book projections using a $109 per barrel model. Both state and municipal take equaled $8.7 billion and total government take equaled $11.7 billion including federal income tax. Under SB 192 the production tax fell to 4.5 billion, and to 11.5 government take. If the 50 percent cap were considered the figures for state and total government take became identical because the cap would not be binding at $110 per barrel. As the price increased, substantially reduced levels of revenue would be revealed.

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Mr. Mayer continued to Slide 13: "FY 2012 Revenue Analysis" which showed both the 30 percent base, with .2 percent and a 40 percent cap, and the flat production rate with the severance tax option. He shared that under the 30 percent base scenario production tax revenue was approximately $4.4 billion at the $110 per barrel level. Revenue increased slightly at lower prices because of the higher base, and flattened out at higher prices. The severance tax example depicted similar numbers.

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Co-Chair Stedman figured out that at $200 a barrel the state was moving significant cash flows. He said at $22.45 billion, under 30 percent base tax, the state would drop to $17.7 billion; a difference of $4.3 billion. The current bill had a $.2 billion drop. He added that SB 192 dropped the FY13 revenue approximately $231 thousand at $100 per barrel. The scenario on slide 13 projected a drop of $362 thousand. He conceptualized that that would move $130 million to producers at $110 per barrel. He felt that more modeling was necessary, as was the need to come to consensus with producers concerning what defined meaningful and significant tax change. He opined that of state take at higher oil prices leveled out and while only maintained at the $110 per barrel level. He offered that the numbers at the $100 per barrel level were less egregious.

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Co-Chair Hoffman reminded the committee that industry had complained of needing relief on the high end of oil prices. He felt that the legislation would provide billions in reductions for producers at $150 to $230 per barrel. He remarked that the reduction of billions should be considered meaningful.

Co-Chair Stedman added that at $100 per barrel the 30 percent base tax and .2 percent progressivity at a 40 percent cap would result in a $120 million augmentation of the FY 13 budget. He shared that he had requested that PFC Energy merge the two concepts on the slide; take the progressive severance tax and see if it worked with the increased base tax. He estimated that the combined systems could serve the state better than either one would alone. He acknowledged that progressivity was a problem at high oil prices.

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Senator Olson referred to Slide 13. He understood that the difference in total state take between $100 per barrel oil under ACES, and the 30 percent base system was $120 million.

Co-Chair Stedman explained that he had subtracted the projected total state take under the 30 percent base concept, from the total state take under ACES, using $100 per barrel oil.

Senator Olson agreed with Co-Chair Hoffman that the possible billions in reductions for producers would be meaningful.

Co-Chair Stedman noted that different systems would be compared and contrasted in the effort to craft sound policy.

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Senator Egan questioned the usefulness of the severance tax. He noted that there had been concerns about severance taxes under the Economic Limit Factor (ELF).

Co-Chair Stedman agreed that severance tax under ELF had faced problems. He stated that once an agreement on progressivity could be reached it could be examined further weather the base would need to be adjusted.

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Mr. Mayer interjected that there seemed to be an immediate desire by the state to differentiate between production streams for taxation perspective. He said that ACES as it was currently working was a problem due to its profit based system, which required cost accounting for each production stream. He added that ACES was a complex system that industry had a difficult time understanding, and that the state had difficulty administering. He suggested that if differentiation between production streams was a goal for the state, it would be easier to achieve by removing the element of progressivity.

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Senator Egan thought that the complexity of severance tax had been a problem in the past. He wondered if it would be made less complicated.

Mr. Mayer replied that he was not an expert on how the prior systems had worked. He observed that ACES was a highly complex system, and SB 192 as well, and that both would be made more complex with the addition of decoupling. He concluded that the severance proposal would only require two data points: oil price and production costs.

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Co-Chair Stedman solicited committee input concerning discussion points to be reviewed before the next committee meeting.

#
ADJOURNMENT

2:25:33 PM

The meeting was adjourned at 2:25 PM.