

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 11, 2013

1:02 p.m.

MEMBERS PRESENT

Representative Eric Feige, Co-Chair
Representative Dan Saddler, Co-Chair
Representative Peggy Wilson, Vice Chair
Representative Mike Hawker
Representative Craig Johnson
Representative Kurt Olson
Representative Paul Seaton
Representative Geran Tarr
Representative Chris Tuck

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Representative Andrew Josephson

COMMITTEE CALENDAR

HOUSE BILL NO. 72

"An Act relating to appropriations from taxes paid under the Alaska Net Income Tax Act; relating to the oil and gas production tax rate; relating to gas used in the state; relating to monthly installment payments of the oil and gas production tax; relating to oil and gas production tax credits for certain losses and expenditures; relating to oil and gas production tax credit certificates; relating to nontransferable tax credits based on production; relating to the oil and gas tax credit fund; relating to annual statements by producers and explorers; relating to the determination of annual oil and gas production tax values including adjustments based on a percentage of gross value at the point of production from certain leases or properties; making conforming amendments; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 72

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/16/13 (H) READ THE FIRST TIME - REFERRALS
01/16/13 (H) RES, FIN
02/11/13 (H) RES AT 1:00 PM BARNES 124

WITNESS REGISTER

DAN SULLIVAN, Commissioner
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: On behalf of the governor, co-introduced HB 72 with Commissioner Bryan Butcher, Department of Revenue (DOR), by way of a PowerPoint presentation.

BRYAN BUTCHER, Commissioner
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: On behalf of the governor, co-introduced HB 72 with Commissioner Dan Sullivan, Department of Natural Resources (DNR), by way of a PowerPoint presentation.

MICHAEL PAWLOWSKI, Oil & Gas Development Project Manager
Office of the Commissioner
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: Provided a PowerPoint overview of HB 72 and answered questions related to the bill.

JOE BALASH, Deputy Commissioner
Office of the Commissioner
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: Answered questions related to HB 72.

ACTION NARRATIVE

1:02:51 PM

CO-CHAIR ERIC FEIGE called the House Resources Standing Committee meeting to order at 1:02 p.m. Representatives Hawker, Johnson, Tuck, Olson, Seaton, P. Wilson, Saddler, and Feige were present at the call to order. Representative Tarr arrived as

the meeting was in progress. Representative Josephson was also present.

HB 72-OIL AND GAS PRODUCTION TAX

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CO-CHAIR FEIGE announced that the only order of business is HOUSE BILL NO. 72, "An Act relating to appropriations from taxes paid under the Alaska Net Income Tax Act; relating to the oil and gas production tax rate; relating to gas used in the state; relating to monthly installment payments of the oil and gas production tax; relating to oil and gas production tax credits for certain losses and expenditures; relating to oil and gas production tax credit certificates; relating to nontransferable tax credits based on production; relating to the oil and gas tax credit fund; relating to annual statements by producers and explorers; relating to the determination of annual oil and gas production tax values including adjustments based on a percentage of gross value at the point of production from certain leases or properties; making conforming amendments; and providing for an effective date."

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DAN SULLIVAN, Commissioner, Department of Natural Resources (DNR), began his co-introduction of HB 72 with Commissioner Bryan Butcher, Department of Revenue (DOR), by way of a PowerPoint presentation entitled, "A Durable Tax System that is Competitive for the Long Term." He said HB 72 is important to the state, present-day Alaskans, and future generations. The presentation will provide a background of the Trans-Alaska Pipeline System (TAPS) challenges, review the investment that is happening throughout the U.S. and the world which is hitting all-time records, and show that the TAPS throughput decline is not inevitable. He said the basis for the bill comes from the integrated efforts of DNR and DOR. He shared that he just returned from the North American Petroleum Expo (NAPE) meeting in Houston, Texas, where the state made a presentation and he had the opportunity to meet with several companies.

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COMMISSIONER SULLIVAN said TAPS is a critical state and national energy infrastructure asset [slide 2]. The history of TAPS shows the important role played by the federal government, and Congress in particular, in getting TAPS up and running. That

federal partnership is needed to turn around the throughput decline, but it has not been seen. At one point TAPS carried 2.2 million barrels a day, representing 25 percent of U.S. domestic production [slide 3]. [The decline] is important and urgent to the state. Referring to the "giveaway" discussion that has occurred over the past several years, he maintained that the ultimate giveaway is the loss of 40,000 barrels per day over the past year that is no longer in the pipeline or in Alaska's economy. That is about 14.7 million barrels lost over the past year, which at \$100 per barrel is about \$1.5 billion that is gone and no longer in the Alaska economy, whether in state coffers or circulating around the economy. That is the giveaway the administration is trying to turn around.

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COMMISSIONER SULLIVAN turned to a graph depicting the challenge of declining Alaska North Slope (ANS) production [slide 4]. He stressed that a mature field, like Prudhoe Bay, is not the same thing as a mature basin. Significant opportunity for both conventional and unconventional oil still exists on the North Slope. He related that in his meetings with other companies, the consistent theme is that almost every company sees this basin as providing enormous opportunity.

COMMISSIONER SULLIVAN pointed out the urgency to the state of the TAPS throughput decline challenge [slide 5]. Two years ago TAPS had a shutdown when it was 40 degrees below 0, and although the state dodged the bullet it was not clear at that time whether the pipeline could be brought back up. This issue is not a scare tactic, but a problem that is in the present. The lesson learned is that the lower the TAPS output, the more risk like what happened two years ago. Companies are certainly going to be spending more dollars to maintain the infrastructure to avoid these kinds of technical challenges, but that has consequences for tariffs and less revenue for the state, and for companies that want to come to Alaska. The best way to address any of these challenges in technical aspects of a premature TAPS shutdown is to get more oil in the pipeline.

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COMMISSIONER SULLIVAN said the state has many positive things going for it to address this challenge [slide 6]. Number one is that the North Slope is a world class hydrocarbon basin that is still relatively unexplored. He related that the administration thinks the state has enough resources, and the potential for

resources, to secure the state's future for decades to come, an important point for how to address the TAPS throughput challenges. Turning around the TAPS throughput challenge is going to require billions of dollars of additional investment [slide 7]. The North Slope is one of the few places in North American where both large conventional and shale oil plays can be looked for at the same time.

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COMMISSIONER SULLIVAN stated that when looking at HB 72, an important consideration is the energy production going on in the U.S. and globally [slide 8]. The "World Energy Outlook 2012" report, put out by the International Energy Agency (IEA), predicts that the U.S. will be the largest producer of oil and gas by 2020. This huge renaissance of oil and gas production bodes well for Alaska. Plus, there has also been a huge boom in global investment in oil and gas exploration and production. Last year the Financial Times estimated that about \$600 billion was spent on exploration, much of that going to countries in the Organisation for Economic Co-operation and Development (OECD), which includes the U.S. The good news is that for 2013, [exploration and production] spending is projected to be \$650 billion. The more depressing news is that in 2012 Alaska got about one-half of one percent of that, despite sitting on still one of the world's great hydrocarbon basins. He said Alaska needs to be leading, not an anchor, on this American energy production renaissance and needs to be focused on becoming more competitive to get in on this boom in exploration and production investment that is predicted to continue this year.

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COMMISSIONER SULLIVAN said the administration, as well as the companies, believe Alaska has the geology [slide 9]. A global investment boom is happening, but the question still remains as to whether [Alaska's production decline] can be turned around. The administration looked at whether other basins have turned around their throughput declines and found that their declines have not only flattened out but have come back up. The articles shown on slide 9 are examples of what is predicted to be a very strong investment boom in the United Kingdom's (UK) oil and gas sector. A couple years ago the UK raised its oil and gas production taxes and not surprising was a decline. So the UK government reformed its taxes which resulted in an immediate and significant impact on investment and jobs, an analog to Alaska that is very relevant.

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COMMISSIONER SULLIVAN pointed out that there are many examples in individual fields, as well, one example being the Forties Field in the North Sea [slide 10]. Apache Corporation acquired that field from BP and with investment and technology the decline was reversed. It is important to learn lessons from the many examples that are being seen all over the globe, he said. Alaska is one of the few big basins not seeing a turn around and it is important to address that [slide 11]. The administration is addressing that by undertaking a comprehensive plan. A missing piece with regard to competitiveness is the issue of making Alaska's tax regime more competitive. Common themes heard at last week's North American Petroleum Expo (NAPE) were the recognition of a huge resource basin on the North Slope, enormous opportunity, but also the cost. In particular, questions were being asked about Alaska's taxes and more specifically about progressivity. He found that companies are keeping an eye on what is happening in Alaska this legislative session and Alaska's competitiveness is at the forefront for those companies that want to invest in the state.

COMMISSIONER SULLIVAN said important activity is happening in Alaska [slide 12], but that only the surface is being scratched in terms of the multiple billions of dollars of investment in Alaska necessary to turn around the TAPS throughput challenge - and those dollars are out there. While there is a good start with a diversity of players and resource plays, a lot more can be done and tax reform is a critical component of that.

1:21:01 PM

BRYAN BUTCHER, Commissioner, Department of Revenue (DOR), reviewed the governor's four principles of tax reform [slide 13]. He said the base of looking at these principles has to come from a point of trying to make Alaska competitive. At current prices, Alaska has the highest oil taxes in the U.S., the highest in North America, and the second highest of all OECD countries, being second to Norway. If oil prices went up \$10 per barrel, Alaska's taxes would surpass Norway. Alaska has extremely high taxes at the high oil prices seen over the last five years. Combined with Alaska being one of the most expensive places to explore, develop, and produce oil, it is no surprise that Alaska is not seeing a lot of the investment, development, and production that is occurring in many other

areas in the world, including many jurisdictions with far less oil than the state of Alaska.

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COMMISSIONER BUTCHER specified that the first of the governor's four principles is that tax reform must be fair to Alaskans, which means Alaska needs to be competitive while keeping a fair share in both the short and long term. The second principle is to encourage new production. While this needs to be done in new smaller fields, it is vital that it also be done in the current legacy fields. The DOR long-term production forecast predicts that, over 10 years out, over 50 percent of the oil expected to be produced will come from legacy fields. The third principle is that it needs to be simple so that it restores balance to the system. Right now Alaska takes a disproportionately large share on the high end and a very small percentage on the low end. The result is that when the price of oil is low and the state really needs the income, it sees very little income; and on the high end the state brings in larger surpluses than needed to meet its budget. The bill looks at trying to balance the system in this regard.

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COMMISSIONER BUTCHER, continuing his discussion about the third principle, said that in addition to restoring balance, Alaska's tax structure needs to be simple. Alaska has one of, if not the most, complex tax structures for oil in the world. Companies looking at investing in Alaska have had difficulty figuring out the entire picture for Alaska's [complex] oil tax structure: what it means at certain price levels, how the progressivity works, how the tax credits work. For example, Texas has just the 1 percent and North Dakota has 8.5 percent up to \$50 per barrel and then 11 percent. In talks with jurisdictions all over North America as they were turning around and Alaska was not, the emphasis was on simplicity. A good example is the state of North Dakota which has just one person working on oil taxes because it is simply a matter of multiplying what is produced times the price times a certain percentage. It is very difficult for a new company to understand Alaska's tax system well enough to be able to explain to its board of directors what an investment in Alaska would mean. That the tax has to be calculated monthly, rather than yearly, makes it even more difficult.

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COMMISSIONER BUTCHER moved to the governor's fourth principle: the tax system needs to be durable for the long term. He said Alaska's oil taxes have been changed a number of times in the last seven years and now it's looking at changing them again. When a state is constantly changing its tax structure, a company that is contemplating where to invest is unable to determine what is going to happen to its investment over the 10-year to 30-year period of investment. He related that the governor is hoping to set up a tax system that will work short-term and long-term and will work for current producers and new entrants and that over a longer period of time is something the companies can rely on.

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COMMISSIONER BUTCHER noted the team working on [oil tax reform] is much more integrated than it has been previously, with expertise from DOR and DNR brought to the table, along with the expertise of consultant, Econ One Research, Inc., that was asked to analyze where Alaska is and is not competitive. Econ One is familiar with Alaska, having worked over the years on oil taxes and gas issues for the administration and the legislature. He highlighted the process the team went through [slide 14], saying the team began with a review of previous work by both the administration and the legislature from the time of the economic limit factor (ELF) to the production profits tax (PPT) to Alaska's Clear and Equitable Share (ACES). The team identified what it considers problems with the current tax system: declining production, competitive environment, progressivity, and tax credits. Additionally, the team looked at the impacts of production decline not just on revenues, but also on the Trans-Alaska Pipeline System (TAPS).

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COMMISSIONER BUTCHER next looked at the jurisdictions in North America that are the largest oil producers along with the state of Alaska [slide 15]. He explained that the green dotted line on the graph is the price of oil, which bounced up and down between 1977 and the mid-2000s but which has had a sustained price increase over the last 8 years except for one dip that came right back up. Turning to the states depicted on the slide, he noted that North Dakota had very little production for decades, but then had a giant jump when the price of oil went up, surpassing Alaska in production. He explained it was not economic to produce shale oil in North Dakota until oil rose

above \$70 a barrel; therefore, if today's price was \$40-\$50, that upturn would not have been seen. Higher oil prices combined with technology created the jump in North Dakota. He said this same thing happened in Alberta - once oil prices became sustained at higher than \$30 per barrel it became economic and profitable to produce northern Alberta's oil sands.

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COMMISSIONER BUTCHER, continuing his look at oil producing states [slide 15], directed attention to a comparison of Texas and Alaska. He pointed out that Texas, which has produced oil much longer than Alaska, began a production decline in the mid-1970s while Alaska was on its production increase that peaked in the late 1980s at 2.1 million barrels a day, at which point Alaska and Texas come together. For the most part over the next decades the Alaska and Texas declines were almost identical. Then came the 2004/2005 jump in oil prices, at which point Texas flattened out and then began turning around. Alaska, unfortunately, has continued the decline that Texas would have seen had the price of oil not jumped. Unlike North Dakota where the increased production is from shale oil, the turnaround in Texas was almost 100 percent from conventional oil, until the upward shot of the past two years that is almost entirely due to oil shale. Thus, the high prices allowed a state that was on the same decline as Alaska to turn around. Commissioner Butcher added that, similar to Alaska, the North Sea had a mature field that was declining; but this area has been turned around a couple of times. "The idea that once an oil field is declining is simply not true," he said. He related that the U.S. Geological Survey (USGS) does not consider Alaska's North Slope to be a mature oil field because over 70 percent of it remains minimally explored, if at all. The tendency is to think specifically about only Prudhoe Bay and Kuparuk, but Alaska has lots opportunities and their sizes and levels need to be found.

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COMMISSIONER BUTCHER compared a 50 million barrel development in Alaska to comparable developments in the Lower 48, Norway, and the United Kingdom's North Sea [slide 16]. At a price per barrel of \$100 and a net present value (NPV) discounted at the industry standard of 12 percent, a company would earn: \$4.07 in Alaska, \$5.52 for unconventional oil in the Lower 48, \$2.34 in Norway, and \$8.25 in the North Sea's brownfield, which has seen the real jump in investment over the last year. Ideally, Alaska would be more competitive with countries and states that are

seeing jumps in investment; the closer Alaska gets to Norway the less likely its competitiveness.

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COMMISSIONER BUTCHER said progressivity is complicated and unpredictable, for both the state and investors [slide 17]. Alaska's tax includes a 25 percent base rate, increasing by 0.4 percent for every \$1 per barrel that the production tax value exceeds \$30 per barrel up to \$92.50 per barrel, at which point it goes down to 0.1 percent per dollar until the total tax rate equals 75 percent, a cap the state has yet to come close to. He noted the production tax value (PTV) is the price per barrel minus transportation costs minus lease expenditures. Progressivity is calculated monthly. He pointed out that when state-by-state comparisons are made on oil tax rates, Alaska is frequently listed as 25-75 percent. Unrealistic as that 75 percent number is, when companies are looking at 7 percent in Texas they may take a step back before even digging into the complex nature of progressivity. Alaska's tax system also has high marginal tax rates. At today's higher oil prices, 80 percent of each increasing dollar goes to the government, most to the State of Alaska, some to the federal government. Alaska's high marginal rate means that at high prices, companies do not get as big a bite as they would in other jurisdictions [to make up for losing money at low oil prices].

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COMMISSIONER BUTCHER reviewed a graph of Alaska's production tax credits [slide 18], saying this was a piece the administration looked at when focusing on what should be in the bill. Shown on the graph in red are credits applied against production tax liability; these are companies that take their tax credits off what they owe in taxes to the state. Shown in grey are tax credit certificates refunded; these are companies doing work that qualifies for tax credits but that are not producing, are not paying taxes to the state, so the state pays the credits in cash to these companies. The state is paying a tremendous amount of money in credits, he said. To determine whether these credits are leading to new production, DOR put together a five-year look back from ACES to today. A direct connection between the tax credits and production was not seen, but rather a connection to increased spending. In particular, the state is looking at \$800 million in the current fiscal year and potentially \$1 billion in fiscal year 2014. At high oil prices these numbers tend not to be noticed because they are one piece

taken out of a very large amount of money coming into the state. However, Commissioner Butcher cautioned, as everyone knows, oil prices go up and down, and if oil prices dropped to \$80 or \$90 per barrel the State of Alaska would find itself in billions of dollars of deficit. These tax credits are not price sensitive, so if oil prices dropped to \$60 or \$80 per barrel the state would still owe \$1 billion. While the focus is on areas in the budget that need to be funded, there is still that number of \$1 billion. This number would mean one thing if it was directly connected to a future production, but it means quite another if there is not that connection.

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REPRESENTATIVE P. WILSON asked whether DOR's look back found that tax credits were given to companies for doing maintenance that would have been done anyway.

COMMISSIONER BUTCHER replied that, until this current year, this was something DOR was unable to define in enough detail to know. When DOR started this process two years ago, the department heard from this committee that it needed to be known what the state was getting for these tax credits. In DOR's defense, he pointed out that the department had to write up and administer over 70 regulations with the passage of ACES, so the focus was on that rather than this detail. In its five-year look back, DOR asked the companies to voluntarily provide more information, but this information could not be required because DOR was looking back. While the companies were helpful and are following the law, it was still not enough information to define specifically and DOR was unable to connect it directly to production. Starting this calendar year, 2013, DOR is requiring much greater detail from the companies, so going forward DOR will be able to provide a better snapshot.

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CO-CHAIR SADDLER concluded from slide 18 that lots of cash is walking out the door - \$800 million to \$1 billion. He inquired whether there is any importance or information that should be attached to the ratios of what is actually being applied to production versus not.

COMMISSIONER BUTCHER responded DOR focused on that but did not really come out with a determining. [The ratio] has been more or less 50:50, but DOR has not figured out specifically why that might go back and forth.

COMMISSIONER SULLIVAN interjected that the [graph on the] slide makes the point that the grey areas are cash payments out the door without any kind of tie to any production.

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REPRESENTATIVE SEATON remarked that he is confused as to DOR's direction here. He recalled industry's strong testimony during development of PPT and ACES that trying to tie directly to production was counterproductive because the lead time from investment to actual production was so long that the value of the state's participation was drastically diminished if it was based on sometime proving that oil went into the pipeline rather than based on investment up front. He further recalled industry testifying that it most needed help with exploration because of the potential for a dry hole. However, what he is hearing from DOR now is that the state does not want to give credits to risky exploration but instead to tie credits only to things that can be demonstrated as production.

COMMISSIONER BUTCHER pointed out that the administration is not looking at eliminating these credits, but at reimbursing them when there is production. In looking back over a six-year period, DOR did not need to see exactly that receipt of X produced Y, but the department did not see anything. In looking at the fields potentially coming on over the next 5 to 10 years, there is not a whole lot there. The expectation in spending billions of dollars from the state treasury was that it would lead to something. The North Sea saw \$50-\$60 billion in investment. If, as hoped for, Alaska got \$20 billion in new investment from new companies over a number of years, the state would be looking at paying out \$8-\$12 billion in cash to these companies. He said he does not even know that the treasury could make it to the point in which there would potentially be production if the state got the kind of boom and investment under its current tax structure that Commissioner Sullivan's work would hope to lead to.

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COMMISSIONER BUTCHER, returning to his presentation, discussed tariffs in TAPS [slide 19]. He shared that a growing concern was identified with DOR's revenue modeling, which did not dynamically link throughput with TAPS tariff rates or capture any added capital expenditure ("capex") or operating expenditure ("opex") for low-throughput mitigation measures. This means DOR

would look forward one to three years to determine what would happen to the tariff as lower throughput occurred and what the expected effects would be to the State of Alaska. [Preliminary observations are that] low flow mitigation capital and operating expenditures could increase tariffs by as much as \$1 (18 percent) per barrel by 2019 and as much as \$2.50 (33 percent) per barrel in 2022. [Assuming the price, production, and tariff used] in DOR's Fall 2012 Revenue Sources Book, a \$1 increase in the TAPS tariff will decrease state oil and gas revenue by an average of \$110 million. While there can be argument about how many decades the pipeline has left, he stressed it is known that the decline in throughput is causing more problems due to cooling of the oil and more water, which requires more capital spending which then results in tariff increases that subsequently reduce the revenue the state gets from its 12.5 percent royalty oil.

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COMMISSIONER BUTCHER highlighted the proposals in HB 72 [slide 20], saying the bill would: eliminate progressivity and credits based on capital expenditures; reform remaining credits to be carried forward to when there is production and a company is paying taxes; and establish a gross revenue exclusion for newer units and for new participating areas in existing units. The benefit of the gross revenue exclusion is that it can be used to focus on other more challenged developments. Lastly, the bill would not make any changes to Cook Inlet and Middle Earth; these two areas would be held harmless because the bill specifically applies to north of 68 degrees North latitude.

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COMMISSIONER BUTCHER compared current law with HB 72 [slide 21]. He said the current base tax rate of 25 percent would remain at 25 percent under the proposed bill. Progressivity in current law would be removed by HB 72. Some of the current tax credits, cash reimbursements and reduced tax revenue to the state, would be altered and some would be eliminated. The proposed bill would provide a gross revenue exclusion (GRE) for new oil. For fiscal year 2014, eliminating progressivity would reduce state revenue by \$1.5 billion, but changing the tax credits would reduce the amount the state pays out by \$1 billion; therefore HB 72 has a much more modest fiscal note than did [the governor's previous proposal in] House Bill 110.

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REPRESENTATIVE SEATON, referring to slide 10, said that a year ago DOR was asked for examples and the only example the department could come up with was the turnaround of the Forties Field. The lesson was that the Forties Field was owned by a single legacy producer unwilling to re-invest in the field, so the field was sold to a more nimble independent that invested and turned around the field. The three legacy owners on the North Slope - Prudhoe Bay being the biggest field - have joint operating agreements under which each owner must agree to an investment, otherwise that investment does not go forward. Now, he continued, the proposal is to change the tax structure for the legacy owners when the example provided to the committee is for a field that the legacy owner was unwilling to invest in to turn around. Members need some information and some security that there will be a reversal in the attitude of the legacy owners about investing in and turning around their fields. He asked why the Forties Field is a good example for the situation on the North Slope, given that the legacy owners would not be selling the fields to someone with a different attitude.

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COMMISSIONER SULLIVAN replied the point of today's overview is to give the committee a sense, at a high level, of what is going on in different fields and basins and what is driving the different production decline turnarounds, whether it is in fields basin-wide, which is what slide 15 is focused on, or whether it is the North Sea incentives, or more specific fields themselves. The idea was not to get into details of exactly why BP [sold] or Apache purchased a field, or what the implications are for a veto power of the operating agreement at Prudhoe Bay, but to give the committee a sense of what is happening basin-wide and can happen to specific fields. Sometimes in the debate it is heard that this is Alaska's future and nothing can be done about it. [The administration] does not believe that, and more importantly, there are examples all over the world showing that that does not have to be Alaska's future. The point of the various slides was to demonstrate at a high level that this turnaround, that is absolutely fundamentally critical to the future of Alaska, is doable. This tax reform proposal is also to help with getting more competition on the North Slope - more investors, huge investors, medium-sized investors, small investors. More investors on the North Slope would provide Alaska the opportunities that can either turn around fields or discover new fields. It is not just focused on the legacy producers. Growing the pie is what this tax reform proposal is

ultimately about. While the question is a good one, [slide 10] was meant to give an overview sense, not the detail, that a turnaround in production decline is doable in Alaska.

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REPRESENTATIVE SEATON clarified he was not saying it was not doable. If, as in the example, it took a change in ownership, a change in the structure of the investors, instead of a change in the tax rates to make the change, should the state take a look at the structural change that took place to do that? He said he wants to ensure that the actual structural impediments to turning around the fields are addressed instead of just assuming that a change of one thing will address those structural changes.

COMMISSIONER SULLIVAN allowed the aforementioned is a valid point. He said [the administration] is trying to address the throughput decline across a number of areas, some of which have to do with tax reform and some of which do not, but tax reform is a fundamental element.

[2:03:39 PM](#)

CO-CHAIR SADDLER, regarding slide 16, requested an expansion on the \$4.07 per barrel that would be earned under ACES in Alaska at a price of \$100. While he understood that the net present value of 12 percent changes the calculation, he said people have heard that there is lots more profit per barrel than the \$4.07 that is shown on the slide.

MICHAEL PAWLOWSKI, Oil & Gas Development Project Manager, Office of the Commissioner, Department of Revenue (DOR), first noted he is the advisor for petroleum fiscal systems to the Department of Revenue. He then replied that looking at the net present value (NPV) is but one of several financial metrics. The net present value per barrel takes the lifecycle earnings over the entire future development of this field and pulls all of that expense in cash back to the first years; so, it is just one way of looking at something. The earnings that people talk about typically are thought of as the cash margins that are earned each year on that development, which is actually a different metric than what this slide is showing. In the Econ One presentation included in the committee packet, it can be seen that each region is compared not just on net present value or internal rate of return, but rather on a range of metrics where each tells a different story about what the actual economics

look like. Slide 16 is showing that after the costs and after the cash flows have been brought all the way back to today this is the way they look like for this specific field. In the past, the use of analytics, one analytic versus another, has been limited, so going forward there will be focus on the variety because each one will show Alaska in a different context.

2:06:06 PM

REPRESENTATIVE TUCK, returning to the BP/Apache example on slide 10, recalled that at a joint committee meeting last year PFC Energy stated BP does not specialize in getting the last drop of oil and oftentimes sells to companies that are experts in this regard. He further recounted that PFC said Alaska is clearly in a harvest mode and that ACES was working well for that harvest mode situation. He concurred that more competition, not less, is needed on the North Slope, but said the hard part is trying to get the legacy people to move and how to get them to move. He said he, too, is concerned about the amount of money going out and that it is unknown what the state is getting for it. However, the governor's bill of the past [House Bill 110] did not guarantee anything either and he does not know about HB 72. He understood the legacy fields have an advantage in that an unsuccessful well has better tax advantages than those for the new companies. Profits on the North Slope are very good right now, he opined, but the companies [are not increasing production] because it is not in their best interest to do that right now based on what they have going on in the rest of the world. A nice thing about Alaska's current tax credit system is the state is guaranteeing that those investments are happening in Alaska and that is what is happening with those new companies. It would be nice to know what information the state is receiving for the money it is spending so that legislators can make better decisions going forward. He offered his hope that if this information is not in the sectional analysis or the bill that the administration will allow the legislature to put those provisions in the bill to ensure that the right decisions are made going forward.

COMMISSIONER SULLIVAN responded that everyone agrees on the importance of legacy producers as well as getting new investors up to Alaska to explore and to maybe partner with some of the legacy producers. He said no one sees the progressivity aspect of ACES as a positive element in their decision making to come to Alaska. It is an issue raised by every company he has talked to and he is very convinced that it affects new entrants as well as the legacy producers.

[2:09:17 PM](#)

REPRESENTATIVE TUCK, referring to slide 16, inquired whether the brownfield is located in the North Sea.

COMMISSIONER BUTCHER confirmed that it is.

CO-CHAIR FEIGE added that the difference between the terms brownfield and greenfield is that greenfield is open land and brownfield already has some development on it.

[2:09:47 PM](#)

REPRESENTATIVE TARR drew attention to slide 18 and recalled that Commissioner Sullivan stated the credits are not helping in terms of investment. Presuming that fiscal years 2013 and 2014 are based on the Fall 2012 Revenue Sources Forecast, she asked why there is a jump upward in those two fiscal years for tax credits if the companies were not investing [in Alaska].

COMMISSIONER SULLIVAN answered there might be some correlation between the investment credits, the exploration credits, and new companies coming up to explore. By nature of the way those are designed right now, there is no requirement, no nexus, between the spending [and production]. The governor's bill would tighten that nexus significantly with regard to not just spending, but credits that relate to [indisc.], something with which most legislators would agree.

COMMISSIONER BUTCHER interjected that tax credits incentivize spending, but it is not known that they incentivize production. For companies currently producing there is a spending jump of over \$100 million from fiscal year 2013 to 2014, but the question is whether the state is getting more production for those dollars.

[2:12:46 PM](#)

MR. PAWLOWSKI then provided a PowerPoint overview of HB 72 entitled, "Overview of HB 72 Oil & Gas Production Tax," noting the purpose of his presentation is to familiarize members with the bill's different sections and the specific provisions that they relate to. He reiterated the governor's four principles [slide 2]: tax reform must be fair to Alaskans, must encourage new production, must be simple so that it restores balance to the system, and must be durable for the long-term. He said

these principles are all geared toward the ultimate goal of making Alaska competitive while adhering to these principles.

[2:14:09 PM](#)

MR. PAWLOWSKI reviewed highlights of the proposal [slide 3], saying that HB 72 balances the elimination of progressivity and credits based on qualified capital expenditures. First, not all of the credits are being reformed or gone through by the bill; for example, the exploration stage credits under AS 43.55.025 are not adjusted by HB 72. Credits being adjusted are the qualified capital expenditure credit, the net operating loss carry forward credit, and the small producer [credit]. The key is to look at progressivity as a revenue generator, with its own impacts and issues, balanced against credits that are based on purely capital expenditures. Second, the credits being retained would be reformed to be carried forward to when there is production, the principle of being fair to Alaskans in that when the state gives an incentive there is corresponding production in revenue to pay for the incentive being given. Third, is establishing a gross revenue exclusion for the newer units and the new participating areas within existing units, encouraging new production by offering an incentive that is geared directly towards that new production. Both the second and third proposals are geared towards new production - the incentives, credits, are received by a company when it produces oil. The gross revenue exclusion is given when the new oil is produced.

[2:16:08 PM](#)

REPRESENTATIVE P. WILSON understood that net would still be used in the rest of Alaska's tax system, except for the proposed exclusion that would use gross.

MR. PAWLOWSKI replied correct. The bill would maintain the base 25 percent net tax, which is the core of the current tax system. The progressivity and the qualified capital expenditure credits would be removed. Currently, the net operating loss credit, which is an additional 25 percent, can be cashed out from the state by someone who does not have a tax liability. In HB 72, that credit would have to be carried forward to be used when the producer actually has a tax liability.

[2:17:17 PM](#)

REPRESENTATIVE SEATON surmised the gross revenue exclusion is just another mechanism and understood it would lower the revenue

by one-fifth, or 20 percent. He inquired whether there is any difference between that and just saying the tax rate for new oil is going to be 20 percent instead of 25 percent.

MR. PAWLOWSKI replied the aforementioned is right conceptually, but the difference is in the execution. Previous proposals by the administration had functionally different tax rates in recognition that some of this new development for infrastructure has much more challenged economics that a lower tax rate is necessary for. However, different tax rates for different fields causes the Department of Revenue a serious problem with apportioning costs by field back through the net system. A gross revenue exclusion allows the ability to offer a lower tax rate on that new production because it only taxes 80 percent of the value and it avoids all of the complicated accounting and apportioning costs that come up when there are separate tax rates. Remembering that one of the core principles is trying to be simple, it was decided that the gross revenue exclusion was a better mechanism to get to the ultimate goal of providing incentive for new oil without complex accounting.

[2:18:49 PM](#)

REPRESENTATIVE SEATON concluded that although it is a different mechanism the effect is the same as lowering the tax rate to 20 percent on new oil.

MR. PAWLOWSKI responded he would have to look at the specific math that 20 percent is the exact number because it would move around based on costs and the way the gross revenue works. However, it is effectively correct that it is just offering a lower tax rate in a simple way.

[2:19:16 PM](#)

MR. PAWLOWSKI returned to his presentation, stating the fourth highlight of HB 72 is that the majority of the bill relates to the no changes to the Cook Inlet and Middle Earth provisions.

[2:19:30 PM](#)

MR. PAWLOWSKI next provided a sectional analysis of the bill [slide 4], beginning with the elimination of progressivity under [Sections 1, 2, and 26]. Section 26, page 23, line 12, would repeal AS 43.55.011(g), which is the identification of the progressive part of the tax. Repeal of AS 43.55.011(g) causes multiple other things within the statute to then happen. The

first of those impacts is in Section 1, beginning on page 1, line 12. Under current law, a portion of progressivity is directed to the community revenue sharing fund. The idea was to have three years of funding for community revenue sharing in an account that could forward fund a balance for revenue fund sharing in the future. Eliminating progressivity eliminates that fund source for community revenue sharing. The first of two important changes is on page 2, line [2], which eliminates the language "an amount equal to 20 percent of the". The concern about this language is that it limits the amount of money available to go into the revenue sharing fund. As can be seen from page 2, lines 5-6, the revenue sharing fund is intended to be \$60 million per year or, when needed, up to \$180 million. Twenty percent of progressivity when prices are low and when there is no progressivity is zero. When the governor looked at this issue, it was to meet the intent of the actual financial benchmarks for community revenue sharing that are set at \$60 million and \$180 million. The 20 percent language was seen as a limitation and could potentially lead to underfunding the community revenue sharing fund, so that problem is dealt with by eliminating the language "an amount equal to 20 percent of the". Page 2, line 3, moves the revenue source for funding of the community revenue sharing fund to AS 43.20.030(c), receipts from the Alaska Net Income Tax Act. This tax is paid by other corporations as well as oil and gas companies, thus providing a broader and more stable source of funding. In fiscal year 2013 the total amount of revenue from this tax was a bit over \$660 million and is projected to be a bit over \$700 million in fiscal year 2014.

[2:23:47 PM](#)

CO-CHAIR FEIGE surmised the better Alaska's economy does overall the more money will be available for revenue sharing.

MR. PAWLOWSKI answered correct.

[2:23:58 PM](#)

REPRESENTATIVE P. WILSON inquired whether all money from [the net income tax] currently goes into the general fund or whether some goes into the permanent fund.

MR. PAWLOWSKI replied the money that goes into the permanent fund is a function of the royalties, bonuses, and leases paid to the state. [The net income tax] is just tax revenue so it is general fund revenue, just as the progressivity revenue is

general fund revenue. With elimination of progressivity the source of funding to community revenue sharing goes away, so another source had to be found.

[2:24:41 PM](#)

REPRESENTATIVE SEATON recalled that when this was developed the state was in deficit spending and had eliminated the municipal and community revenue sharing program entirely. This was put in so that when there were surpluses through progressivity there would be funding for the fund because during times of deficit spending the legislature has historically not taken money out of savings to give away through municipal and community revenue sharing. He asked whether, with this change, the governor is now saying that he is committed to funding municipalities and communities at \$60 million a year even if the state is in deficit spending and taking money out of savings, which is different philosophy than the legislature had when it put in the mechanism of funding municipal revenue sharing with surpluses.

MR. PAWLOWSKI responded he will take that question to the Office of Management & Budget for an answer because he is not equipped to speak to the actual spending plans. However, the point was to ensure that the revenues for community revenue sharing were replaced with a different mechanism.

[2:26:32 PM](#)

REPRESENTATIVE SEATON said an answer from the Office of Management & Budget would be appreciated.

MR. PAWLOWSKI added that corporate income taxes are necessarily subject to income. As incomes rise the more money available to go into the community revenue sharing fund. Corporate income tax has risen as oil prices have gone up, so there is a sensitivity. If there was no income for the companies there would be no corporate income tax receipts and therefore no money for the revenue sharing. However, in this instance it is better diversified because there are other businesses that pay into the net income tax.

[2:27:36 PM](#)

REPRESENTATIVE TARR recalled the thinking behind the funding of municipal revenue sharing through oil development was that it is a common property resource, so that wealth would be shared with and distributed to local communities. Therefore, the proposal

seems like a fundamental shift in the way those funds are acquired. While those funds would be going into the general fund, would there be a reason to be concerned about that in terms of the way that change would change the situation, she asked.

MR. PAWLOWSKI allowed that is a fair point, but noted that mining and fisheries businesses pay a corporate income tax. So, the broad breadth of resources is now related through the net income tax system towards the community revenue sharing. Eliminating progressivity takes away the money that was designated directly to community revenue sharing. The importance of the principle is the commitment to community revenue sharing, the degree to which is subject to ultimate budgets and appropriations, but the bill makes a commitment to putting money into that fund.

[2:28:51 PM](#)

REPRESENTATIVE TARR inquired whether there could be a [future] situation where, for example, tough times for oil revenue would create increased pressure on the other industries to help put [money] into that fund.

MR. PAWLOWSKI answered he would have to think about that with the department and talk about projections to corporate income tax receipts. Regarding the number of \$60 million, he said he is not sure the circumstance of which corporate income taxes on a diversified basis would drop below that.

[2:29:35 PM](#)

JOE BALASH, Deputy Commissioner, Office of the Commissioner, Department of Natural Resources (DNR) followed up on the points made relative to progressivity and revenue sharing. He pointed out that in forecasts for the very near term, expected revenues are projected to be below expected expenses. The state will be in a deficit in the near time with plenty of progressivity coming in the door. Thus, progressivity by itself is not a demonstration of the state having itself in good fiscal health.

CO-CHAIR FEIGE interjected it is still up to the legislature to appropriate the money as appropriate.

[2:30:16 PM](#)

MR. PAWLOWSKI, continuing his presentation, said [Section 1] moves away from the core of the bill, which is reform of the oil and gas fiscal system. However, given the importance of the community revenue sharing fund, he thought it important to spend a few minutes talking about the mechanism. Returning to discussion of the way HB 72 relates to oil and gas taxes, Mr. Pawlowski stated that Section 2, on page 2, lines 8-18, is a further reform necessary to the statute because of the repeal of AS 43.55.011(g). The annual production tax before credits, as it currently exists under AS 43.55.011(e), is the combination of the 25 percent [base rate] plus the progressivity, which is "the sum, over all months of the calendar year, of the tax amounts determined under [AS 43.55.011(g)]". In that the progressivity is eliminated, the sum language needs to go away. The 25 percent base rate is maintained.

[2:31:36 PM](#)

MR. PAWLOWSKI next addressed the conforming sections related to the elimination of progressivity [Sections 5, 6, 22, and 23]. Drawing attention to Section 5, beginning on page 5, line 27, he explained that there are monthly installment payments for Cook Inlet and Middle Earth that exist for one year until progressivity is repealed. Section 5 amends Section 4 of the Act which had to be amended to preserve the current tax ceilings and treatments there, but Section 5 is when the monthly progressivity installment payments go away and the language needs to be changed to reflect that. Throughout Section 5 it can be seen that Cook Inlet and Middle Earth are broken out; for example, page 6, line 11, takes out "the sum of" because it is no longer the sum of 25 percent plus a progressivity, it is just the 25 percent. The important difference there is on page 7, lines 3-5, which is an adjustment for the gross revenue exclusion that occurs later in the bill. The section being dealt with is the calculation of the monthly installment payments which are currently the sum of 25 percent plus the taxpayer's progressivity as adjusted by the tax ceilings. In that the progressivity is going away, the monthly installment payment section must be adjusted.

[2:33:59 PM](#)

CO-CHAIR FEIGE understood that Section 5 is basically amending a previous change in the law that was put in Section 4.

MR. PAWLOWSKI replied yes.

CO-CHAIR FEIGE requested clarification for why it is being done this way.

MR. PAWLOWSKI explained Section 4 makes amendments to reflect the different tax ceilings and preferential tax treatment put in place over the years for: the Cook Inlet basin, the area south of 68 degrees North latitude [known as] Middle Earth, and gas produced and used in-state. In adjusting progressivity, sections of law are referenced that are all interrelated. For example, Section 4, page 3, line 4, adds the language "not subject to AS 43.55.011(o) or (p)"; AS 43.55.011(o)-(p) includes the different treatments such as tax ceiling and special tax rate for gas produced and used in-state. If passed, the effective date of the bill and repeal of progressivity is January 1, 2014. Since it is currently the calendar year 2013, there will be a one-year period in which these monthly installment payments will still be made. So this is a cleanup of the [tax ceiling and preferential tax treatment] language for that one-year time period and then an amendment to the cleanup in the immediate next year.

[2:36:40 PM](#)

MR. PAWLOWSKI returned to his presentation, explaining that Section 22, page 21, line 10, deals with the different ceilings. What remains after progressivity goes away are separate buckets of different types of oil and gas that under current law are treated and taxed differently. While progressivity does not apply to them now, cleaning up the statute makes it easier for the future. So Section 22 attempts to organize the statute in a way that is clearer to people trying to do business in the state and to companies that are investing. He reminded members that the price of oil minus transportation cost is the gross value at the point of production, minus the lease expenditures is the production tax value, which can be thought of as the cash flow to which taxes are applied. Section 22 addresses the different ways that taxes are applied to the different types of oil and gas that have been given preferential treatment in different pieces of law throughout time.

[2:38:35 PM](#)

MR. PAWLOWSKI read paragraph (1) of Section 22, page 21, lines 21-23, which states, "oil and gas produced from leases or properties in the state that include land north of 68 degrees North latitude, other than gas produced before 2022 and used in the state;". He said that is by and large North Slope oil and

gas and the main target of HB 72 is the North Slope. He then drew attention to paragraph (2) of Section 22, page 21, lines 24-30, which states, "oil and gas produced from leases or properties in the state outside of the Cook Inlet sedimentary basin, no part of which is north of 68 degrees North latitude ..." and said this is the Middle Earth section that is not the North Slope and not Cook Inlet. He next read subparagraph (A) which states, "gas produced before 2022 and used in the state; or" and subparagraph (B) which states, "oil and gas subject to AS 43.55.011(p);" and explained that AS 43.55.011(p) is the language included in legislation last year that provided a 4 percent gross tax ceiling for oil and gas produced from the Middle Earth area.

[2:39:53 PM](#)

MR. PAWLOWSKI continued reading the remaining paragraphs of Section 22, which state:

(3) oil produced before 2022 from each lease or property in the Cook Inlet sedimentary basin;

(4) gas produced before 2022 from each lease or property in the Cook Inlet sedimentary basin;

(5) gas produced before 2022 from each lease or property in the state outside the Cook Inlet sedimentary basin and used in the state, other than gas subject to AS 43.55.011(p);

(6) oil and gas subject to AS 43.55.011(0) produced from leases or properties in the state;

(7) oil and gas produced from leases or properties in the state no part of which is north of 68 degrees North latitude, other than oil or gas described in (2), (3), (4), (5), or (6) of this subsection.

MR. PAWLOWSKI said paragraph (7) is looking to the future because paragraphs (1)-(6) all have expiration dates of 2022. After all of those exclusions expire in 2022, a section in law had to be created where they could all fall back into. After those 2022 dates go away, all of the oil and gas produced in the state will default into the general 25 percent flat taxes.

[2:41:14 PM](#)

CO-CHAIR SADDLER understood the 4 percent gross tax ceiling for oil and gas produced from the Middle Earth area was a provision of Senate Bill 23 enacted into law in [September] 2012.

MR. PAWLOWSKI replied correct. Responding further to Co-Chair Saddler, he expounded on the process that would happen after 2022. He drew attention to page 21, line 29, which states, "gas produced before 2022 ...", and said that is the way the law was drafted and adopted. Page 21, line 31, is "oil produced before 2022 ..." and that language is also in paragraphs (4) and (5). He read from AS 43.55.011(p), which states:

(p) For the seven years immediately following the commencement of commercial production of oil or gas produced from leases or properties in the state that are outside the Cook Inlet sedimentary basin and that do not include land located north of 68 degrees North latitude, where that commercial production began after December 31, 2012, and before January 1, 2022, the levy of tax under (e) of this section for oil and gas may not exceed four percent of the gross value at the point of production.

That is for seven years before 2022, he continued. In statute it must be looked forward to the fact that 2022 might happen and the legislature or the public might not actually change the law to address Cook Inlet or Middle Earth before then. So, a statutory construction needed to be made to allow clearly what actually happens once those expire. In the current law these statutes kind of spread throughout the statute. Section 22 is an orderly clarification of the different oil or gas tax treatments that have been passed by the legislature set out in a very deliberative fashion.

[2:43:25 PM](#)

MR. PAWLOWSKI explained that Section 23 is an amendment to conform to the changes that were made in Section 22 so that the production tax value is calculated under [AS 43.55.160] (a)(3), (4), (5), or (6) rather than (a)(1)(C), (D), (E), or (F).

[2:44:06 PM](#)

MR. PAWLOWSKI then reviewed Section 8, a provision in HB 72 related to North Slope qualified capital expenditure (QCE) credits. Drawing attention to page 10, lines 16-18, he said that the QCE credit, which is the 20 percent of capital expenditures, will be allowed for 2013, but an expenditure made on the North Slope after January 1, 2014, will no longer qualify for a QCE credit.

2:45:08 PM

REPRESENTATIVE SEATON understood the QCE credits are allowed at the time the expenditures are made rather than when the work is done. He said information has been received that some operators have been paying service companies for well work overwork but not having the work done. He offered his belief that that is legal under the law because it is when the expenditure is made and allowed it would be reasonable if the company was anticipating that the work would be done in the next year. He asked if DOR is tracking whether the work is being frontloaded and not performed at the time and whether DOR has any audits on that. He further asked whether this [proposed] deadline for the end of 2013 will result in companies paying for work that will be done in the future and legitimately claim the capital expenditures this year.

MR. PAWLOWSKI responded "in that expenditures are made legally and qualify in 2013, the bill does not change the treatment of those credits for expenditures in 2013." As to the department's internal controls for the credit, he said the deputy commissioner and auditors are on line and may be able to provide the detail about what and how the department tracks the concern about frontloading expenditures. He said it is up to the committee as to the detail it would like.

REPRESENTATIVE SEATON said it would be fine for DOR to get back to the committee with the details.

2:47:46 PM

CO-CHAIR FEIGE suggested the companies themselves be asked this question. He concluded from Representative Seaton's description that the companies are making the expenditure early to get the tax benefit, but said he did not think they would put too much money out there without getting the work done because that would not make much business sense.

MR. BALASH interjected that some vendors have had challenges getting payment after the work was done, so there may be some commercial value to having payment up front in certain cases.

REPRESENTATIVE SEATON recounted that when these credits were being talked about it was discussed that investment could be stimulated during high prices by allowing payment for something like a total pipeline replacement and getting a lot more state

participation in that pipeline at those high tax rates. So, it is not necessarily a nefarious thing, but this proposed change could stimulate something that has been marginal up to this point.

[2:49:37 PM](#)

MR. PAWLOWSKI returned to his presentation and discussed the conforming sections for the North Slope QCE credit provision. He explained that under current law, a capital expenditure credit, which is based on 20 percent of that expenditure, is divided into two certificates for the North Slope - half the credit may be used in the year it is earned and the other half must be carried forward. Under conforming Section 7, page 9, lines 21-22, the requirement that not more than half of the tax credit may be applied for in a single year is deleted. Credits earned for expenditures in 2013, therefore, would be used in one certificate instead of two. The impact of using the credits in one year instead of over two is reflected in the fiscal note for fiscal year 2014. Because [Section 8] shuts down the QCE program for the North Slope after calendar year 2013, this provision is intended to take care of the liability in one year and finish the program.

[2:51:24 PM](#)

MR. PAWLOWSKI pointed out that Section 7 does not include AS 43.55.023(m), that portion of statute for QCE credits earned south of 68 degrees [North latitude] and which are not required to be divided into two years. Therefore, since the credit would be taken in one year, conforming Section 11, page 11, line 8, replaces the word "certificates" with "certificate". Also, page 11, line 20, replaces the word "two" with "a" to reflect the current practice [under AS 43.55.023(m)] of one certificate for south of the North Slope. Given there would no longer be any qualified capital expenditure credits for the North Slope, this change goes back to the simple principle - making it clear in every section of the law that it is one certificate, not two.

[2:53:16 PM](#)

CO-CHAIR SADDLER understood that because the qualified capital expenditure credit would be phased out, Section 7 bumps up the taking of the credits to one year; other credits will remain, but instead of two years it will be one year.

MR. PAWLOWSKI replied that the remaining credits are currently one-year credits. The only credit that would be eliminated is the current two-year credit. So, moving forward, why leave other sections of statute conflicting?

[2:54:04 PM](#)

MR. PAWLOWSKI, continuing his discussion of conforming sections for the proposed elimination of North Slope QCE credits, drew attention to Section 12, beginning on page 11, line 29. He said the conforming language in this section is just being clear that "except for a tax credit based on lease expenditures incurred after December 31, 2013 ... north of 68 degrees [North] latitude", a person may take a tax credit.

[2:54:32 PM](#)

MR. PAWLOWSKI moved to the other major proposals included within HB 72 [slide 5], noting that another primary credit related to qualified capital expenditures is the net operating loss carry forward credit under AS 43.55.023(b), which is 25 percent of a company's loss. The bill would maintain that credit, but it would be carried forward to when there is production. Sections 9 and 15 are the changes to the way that credit is treated. Since this net operating loss credit is being eliminated only for the North Slope and not for other regions, Section 9, lines 21-24, makes this credit subject to the new subsections (p)-(u) that are added under Section 15 of the bill. Section 15, beginning on page 13, line 15, adds new subsections (p)-(u) [to AS 43.55.023] to govern how that 25 percent net operating loss carry forward credit for North Slope expenditures is treated. Subsection (p), beginning on page 13, line 16, states that the tax credit for lease expenditures located north of 68 degrees North latitude, i.e. the North Slope, may not be applied until two calendar years after the expenditure is made, which is basically under current law when a company would be getting the credit. So, a company can make the expenditure and then use the credit the next year, but does not have to bring it to the state for a credit certificate until the second year. This is just recognizing the natural flow through DOR of the way these credits are earned and processed.

[2:57:03 PM](#)

MR. PAWLOWSKI said the important limitation is that each of these credits is only good for a time period of 10 years, after which each one of these credit certificates expires (page 13,

line 23). The importance of the time limit for when this credit can be used to offset production taxes can be seen in subsection (r), page 14, line 2. Under current law, a company receives a cash payment from the state for the credit. Recognizing that there is a time value to money, the value of the credit being carried forward increases at a rate of 15 percent per year, starting in the second year after the money is expended. The goal was to provide an increase that is comparable to the other opportunity the company may have to invest that capital somewhere else and earn a rate of return. So, the way the net operating loss carry forward credit works is the expenditure is made, 25 percent of the value of that expenditure is turned into a credit and carried forward. Under the governor's plan, rather than cash being paid out, the value of that 25 percent increases at 15 percent a year starting in the second year after the credit has been issued and ends at year 10. If the credit has not been earned by year 10 it is not useable at all.

[2:58:43 PM](#)

CO-CHAIR SADDLER understood that credits used sooner are more valuable than credits used later. He asked whether any consideration was given to losing a percent per year over the 10 years, or was the consideration that just having a two-year wait period was enough value to encourage things upfront.

MR. PAWLOWSKI replied that when the administration's consultants come forward it will be seen just how important the carry forward credit rate is to improving the net present value of the project in a way that is fair to the producers but also does not put a burden on the treasury. The credit is being deferred so the state is not paying it out until there is production to charge the credit against.

[2:59:46 PM](#)

MR. PAWLOWSKI, returning to his presentation, explained that to protect the state, new subsection (q), page 13, beginning on line 25, would implement the "first earned, first used" rule. Since credits are being earned every year and each is increasing at a rate, in time the first credit earned is the one that must be used first and then the second credit earned is the second credit used.

[3:01:01 PM](#)

REPRESENTATIVE TUCK understood that the net operating loss carry forward credit for the North Slope would grow 15 percent each year. He asked whether after 10 years the credit would stop growing but still be a valid credit or would the credit become null and void altogether.

MR. PAWLOWSKI responded that the credit is null and void.

[3:01:25 PM](#)

REPRESENTATIVE SEATON said it seems to him that the current system for net operating loss credits has been greatly successful for Alaska, given all the new players on the North Slope and almost half of the credits coming back. Previous testimony by the people out drilling the holes and building pipelines has been that it is important to get the credit back as quick as possible for reinvestment. Changing the system so that the credits cannot be received for two years and so they are lost if it takes a company longer than 10 years to get the oil into the pipeline seems to eliminate the value that has produced the investment the state has been looking for. He requested that when there is time he would like to be apprised of the basic structural philosophy as to how this is going to stimulate the investment that the current credit has achieved.

[3:03:24 PM](#)

MR. PAWLOWSKI allowed that is an important question and said it will be seen in Econ One's presentation that the credits offered up front were intended to stimulate that new activity in that new development. There is a difference between the exploration stage and the development stage and that is why HB 72 does not change the exploration credits, but rather the credits that work in the development stage. Because of progressivity and because of the lifecycle economics, the ability to get to development is not working with the credits, which will be seen in the Econ One models. The bill, in context, is attempting to dramatically improve the overall economics which will drive the development decision.

[3:04:16 PM](#)

CO-CHAIR FEIGE held over HB 72.

[3:04:28 PM](#)

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 3:04 p.m.