SENATE FINANCE COMMITTEE
February 28, 2013
9:09 a.m.

9:09:08 AM

CALL TO ORDER

Co-Chair Kelly called the Senate Finance Committee meeting to order at 9:09 a.m.

MEMBERS PRESENT

Senator Kevin Meyer, Co-Chair
Senator Pete Kelly, Co-Chair
Senator Anna Fairclough, Vice-Chair
Senator Click Bishop
Senator Mike Dunleavy
Senator Lyman Hoffman
Senator Donny Olson

MEMBERS ABSENT

None

ALSO PRESENT

Sarah Fisher-Goad, Executive Director, Alaska Energy Authority, Department of Commerce, Community and Economic Development; Nick Szymoniak, Project Economist, Alaska Energy Authority; Ted Leonard, Executive Director, Alaska Industrial Development and Export Authority; Representative Pete Higgins; Brian Rogers, Chancellor, University of Alaska Fairbanks; Daniel Sullivan, Commissioner, Department of Natural Resources; Bryan Butcher, Commissioner, Department Of Revenue; Michael Pawlowski, Advisor, Petroleum Fiscal Systems, Department of Revenue; Joe Balash, Deputy Commissioner, Department of Natural Resources.

PRESENT VIA TELECONFERENCE

Merrick Pierce, Self, North Pole; Luke Hopkins, Mayor, Fairbanks North Star Borough.

SUMMARY

SB 21 OIL AND GAS PRODUCTION TAX

SB 21 was HEARD and HELD in committee for further consideration.

SB 23 AIDEA: LNG PROJECT; DIVIDENDS; FINANCING

SB 23 was HEARD and HELD in committee for further consideration.

#sb23
SENATE BILL NO. 23

"An Act relating to development project financing by the Alaska Industrial Development and Export Authority; relating to the dividends from the Alaska Industrial and Export Authority; authorizing the Alaska Industrial Development and Export Authority to provide financing and issue bonds for a liquefied natural gas production system and natural gas distribution system; and providing for an effective date."

Co-Chair Meyer MOVED to ADOPT the proposed committee substitute for CS SB 23 (FIN) Work Draft 28-GS1738\C (Bailey, 2/16/13).

Senator Olson OBJECTED for the purpose of discussion.

9:10:23 AM
AT EASE

9:11:41 AM
RECONVENED

Senator Olson wondered what changes were proposed in the committee substitute. Co-Chair Kelly replied that the changes were mostly technical changes.

Senator Olson WITHDREW his OBJECTION. There being NO OBJECTION, the proposed committee substitute was ADOPTED.

SARAH FISHER-GOAD, EXECUTIVE DIRECTOR, ALASKA ENERGY AUTHORITY, DEPARTMENT OF COMMERCE, COMMUNITY AND ECONOMIC DEVELOPMENT, introduced herself.

NICK SZYMONIAK, PROJECT ECONOMIST, ALASKA ENERGY AUTHORITY, introduced himself.

TED LEONARD, EXECUTIVE DIRECTOR, ALASKA INDUSTRIAL DEVELOPMENT AND EXPORT AUTHORITY, introduced himself.

Ms. Fisher-Goad discussed the PowerPoint, "SB 23 AIDEA Development Project Financing for a Liquefied Natural Gas Production and Distribution System." She highlighted slide 2, "Interior Energy Plan."

-Opportunity to provide Alaskans with low-cost North Slope natural gas and propane
-Governor's finance package acts as a catalyst, bringing together LNG and propane customers with the private entities that will construct and operate the system
-AIDEA is investigating project feasibility and will only utilize their authorized finance tools if the project makes economic sense
-AIDEA will take an equity stake in project but will not outright build or operate the LNG plant or distribution system
-Governor's finance package is targeted at funding the initial capacity with future expansion funded by private/community investment

Ms. Fisher-Goad looked at slide 3, "Project Goals."

-Provide lowest-cost energy to Interior Alaska consumers as soon as possible
-Get gas first to the Interior while assuring long-term access to gas and propane from liquefaction plant for all Alaskans
-Utilize private sector mechanisms as much as possible

Ms. Fisher-Goad highlighted slide 4, "Project Description."

-Natural gas will be liquefied on the North Slope and trucked to Interior Alaska
-Propane will be produced and delivered to Interior and Rural Alaskans
-Primary LNG demand anticipated to be Fairbanks and North Pole
-LNG will be temporarily stored andre-gasified in Interior Alaska

-Natural gas distribution system with storage to supply natural gas for heating

9:18:20 AM

Mr. Szymoniak looked at slide 6, "LNG Lowers Energy Costs."

Expected Utility Price per Mcf
-Wholesale LNG: $10.15
-Natural Gas to home: $13.42-$17.00 per Mcf
-Delivered price is equal to $1.79 -$2.27 per gallon of fuel oil
Key Assumptions
-Initial costs associated with a 9 Bcf plant at start up
-Snapshot in time, costs change with expansion
-LNG plant bifurcated into two sections (industry and utility)
-$50 million capital cost reduction applied to 6.5 Bcf utility section

Mr. Szymoniak highlighted slide 7, "Heating Energy Supply Comparison."

Trucked LNG is the lowest-cost option for Interior Alaska heating

-Electricity would need to be $0.04 -$0.06 per kWh to compete with trucked LNG
-Electricity would need to be much cheaper to compete with fuel oil

Mr. Szymoniak looked at slide 8, "Plant Use and Expansion."

Plant Expansion

-LNG plant will expand as the demand for natural gas increases
-Size or timing of expansion is driven by demand
-Customer count includes residential and commercial users
-Second expansion is possible based on pipeline timing

9:24:55 AM

Vice-Chair Fairclough wondered if there was a consideration of the University related to future demand. Mr. Szymoniak

responded that there were discussions with the University regarding the use of LNG, and was not included as an explicit line item. Ms. Fisher-Goad furthered that there were discussions with the University of Alaska Fairbanks (UAF) about replacing the combined power plant, but the project was merely a possibility.

Vice-Chair Fairclough remarked that she was looking for a holistic plan to address the energy needs in the area, and the state was approached for a significant amount of money for the co-generation plant at UAF.

9:28:05 AM

Ms. Fisher-Goad remarked that AIDEA was incorporating what UA's issues and their potential plans into the discussion. She agreed that there should be a holistic approach, but felt that it was not as simple to address.

Senator Dunleavy wondered if the high end cost was incorporated into the gas the costumer purchased. Mr. Szymoniak replied in the affirmative.

Senator Dunleavy looked at slide 9, and wondered if there was going to be a gas conditioning plant on the slope that was not included in the plan. Mr. Szymoniak replied that the plant proposal was included in the LNG.

Senator Dunleavy wondered if the plant was located as a sub-set of the LNG. Mr. Szymoniak responded in the affirmative.

Mr. Szymoniak looked at slide 9, "Capital Cost Breakdown."

-Based on “Mid Cost” scenario

-Economies of scale achieved in LNG plant as additional 4.5 Bcf trains are added

-Costs for expansions are cumulative

-Does not include trucking capital

Mr. Szymoniak highlighted slide 10, "Household Heating Savings."

Typical Home Heating Savings

-$2,900 -$3,750 annually

-43 percent -55 percent reduction in cost

Key Assumptions

-Typical Interior Alaska household will use 225 Mcf of gas per year (equivalent to 1,700 gallons of fuel oil)

-Does not account for expected improvement in heating efficiency with natural gas

9:33:40 AM

Mr. Szymoniak discussed slide 11, "Reduce Fuel Price Uncertainty."

Reduced price variability

-Small portion of delivered LNG price is natural gas cost

-Fuel oil prices are much more volatile than trucked LNG

-Trucked LNG is cheaper even when oil prices drop

Key Assumptions

-Fairbanks fuel oil price is based on linear regression analysis

-Natural gas price uses publicly available information on LNG supply contracts

Mr. Szymoniak looked at slide 12, "Air Quality."

Conversion to natural gas should reduce air pollutant emissions in Fairbanks and North Pole

-Will reduce overall emissions of PM 2.5

-Fairbanks is presently a non-attainment area for PM 2.5

-Potential public health benefits of natural gas is substantial

Impact on Federal funding and economic development

-Alaska risks losing Department of Transportation and Public Facilities funding if State fails to submit an attainment plan to EPA

-Federal projects in the area face funding hurdles while area is non-attainment

-Cleaner, healthier air in Fairbanks will promote economic development

9:38:00 AM

Mr. Szymoniak highlighted slide 13, "Long Term Use of LNG Plant."

LNG Plant will be used after gas pipeline

-Plant can serve Rural Alaska before gas pipeline is constructed

-Expect opportunity to sell LNG to new industrial users both before and after pipeline

-Information in chart is for demonstration only

Senator Hoffman remarked that there should be a demonstration project for the river and highway system.

Senator Bishop felt that there were people in Fairbanks that needed propane soon.

Senator Dunleavy remarked that the LNG concerns were across the state. He wondered if the cost dealt with the main or to a residence. Mr. Szymoniak responded that the cost included from the main, but did not include the meter at the residence, and he agreed to provide that information.

9:45:58 AM

Senator Dunleavy surmised that there could be a main, but the resident may not be able to afford to get the gas. Mr.

Szymoniak replied that it was an aspect that AIDEA was examining, and announced that there were a variety of different programs that could help fund that.

Mr. Leonard stated that a proposal declared that a hookup would cost $300 to $400 for the family, with a conversion of the appliances at an additional cost. He felt that there would be an overall savings.

9:51:03 AM

Mr. Leonard looked at slide 15, "Governor's Finance Package."

$50 million General Fund appropriation
–Directly reduces the cost of LNG

$150 million AIDEA bonds
–3 percent to 4.5 percent interest rate (depending on tax-exempt status of component financed and market rates)
–$125 million SETS capitalization
–3 percent interest rate (set by SB23/HB74)
–Flexibility to provide optimal commercial structure

$325 million total 2013 package

$30 million natural gas storage credit
–$15 million tax credit per qualifying storage tank
–Created through previous legislative action
–$355 million total Governor’s package

Co-Chair Meyer asked for a description of the SETS program. Mr. Leonard responded that the SETS program was the Sustainable Energy Transmission and Supply Development Fund.

9:57:50 AM

Co-Chair Meyer noted that the money to fund the program came out of the general fund. Mr. Leonard responded that. the original loan participation fund started with an original amount that had grown 200-300 and was to grow the fund as more loans were issued. He stated that the interest back from the loan went to the state.

Co-Chair Meyer noted that there was a charge association with the debt service and inquired how it was factored into the loans. Mr. Leonard replied that if they issued bonds on loan participation there would also be interest revenue from the

Co-Chair Meyer stated that he understood the program itself and noted that the fiscal note did not show all the financing that as being proposed. Ms. Fisher-Goad agreed to provide more information.

10:03:49 AM

Co-Chair Meyer felt that the fiscal note should reflect the different financing. Mr. Leonard responded that // He stated that slide 16 reflected that concern.

10:07:46 AM
AT EASE

10:07:58 AM
RECONVENED

Co-Chair Kelly handed the gavel to Co-Chair Meyer.

Vice-Chair Fairclough looked at slide 2, and then slide 9. She surmised that the low cost startup was projected at $368 million, and the high cost startup was $481 million. Mr. Leonard agreed, and furthered that he hoped that the number would be narrowed soon. He explained that the numbers were based on the proposals from the letters of requests for interest.

10:10:51 AM

Vice-Chair Fairclough assumed that, if the state was providing $355 million at a low cost scenario, carrying 95 percent of the risk. Mr. Leonard agreed, but looked at slide 16. He shared that there would be $70 million from the private sector. He stressed that AIDEA had provided an explanation of their process and analysis that is undertaken to determine the different phases.

Vice-Chair Fairclough remarked that there needed to be equal insurance between the public sector contribution and the state's investment. Mr. Leonard responded that the state would be involved in the initial build out and

distribution. He explained that AIDEA's risk would only be involved in the original startup.

10:19:48 AM

Vice-Chair Fairclough noted that the state would have an equity interest at 86.4 percent, and a private sector investment of 3.7 percent. Mr. Leonard replied that one must look at the difference of the distribution system. He explained that AIDEA would not have an equity position in the distribution system, but it would have an equity position in the plant.

Vice-Chair Fairclough wanted the interior of Alaska to have low-cost energy, but remarked that the state was going "all in" on this investment. She pointed out that it was mitigated through bond packages and state structures. She queried the qualifications of the private investors, because their risk was mitigated by the state's investment. Mr. Leonard responded that AIDEA conducted a due diligence, to verify that the investors had the financial capacity to maintain their side of the deal with expertise to run a proposed plant.

Co-Chair Meyer commented that the state's storage credit was $30 million, the state appropriation was $50 million, and the SETS loan was $125 million, with total general fund capital at $205 million. He felt that those numbers should be outlined in the fiscal note.

10:25:49 AM

Senator Hoffman looked at slide 7, and commented that the risk should be analyzed based on what the users were currently paying with the probability of the cost of oil in Fairbanks exceeding $5 or falling below $2. He felt that the economy and the Fairbanks residents would suffer, if action was not taken quickly.

Mr. Leonard looked at slide 17, "SETS Loan Interest Rate."

SETS Loan interest rate has minimal impact on LNG Price

-Assumes 30-year loan term

-Reduces natural gas price by $0.25 per Mcf

10:34:01 AM

Mr. Leonard discussed slide 18, "Project Timeline and Milestones." He stated that AIDEA was embarking on the feasibility phase of the project, and planned to have that phase complete by June 2013. He explained that the end goal was to provide gas by the second quarter of 2015.

Vice-Chair Fairclough surmised that AIDEA could take no more than one-third equity interest. Mr. Leonard explained that the SETS program had a limitation that stated that without legislative approval, AIDEA could not participate in direct financing of a project under SETS. He remarked that AIDEA could participate in direct financing in other projects from between 23 percent to 100 percent ownership.

Co-Chair Meyer handed the gavel to Co-Chair Kelly.

10:39:35 AM

MERRICK PIERCE, SELF, NORTH POLE (via teleconference), testified in support of SB 23. He furthered that the bill should be amended to ensure that AIDEA was required to complete full due diligence in the best possible method for delivering natural gas to Fairbanks. He felt that LNG trucking was not the best method. He stressed that LNG had many problems including high out backs, it was the most dangerous method for transporting LNG, gas contracts would link the gas to the price of oil, and there was no propane availability.

LUKE HOPKINS, MAYOR, FAIRBANKS NORTH STAR BOROUGH (via teleconference), testified in support of SB 23. He commented that AIDEA had approached the legislation appropriately. He remarked that the legislation was important, because it backed a project that had viability. He remarked that the build out of the LNG plant and distribution was important to the community of Fairbanks.

10:45:13 AM

BRIAN ROGERS, CHANCELLOR, UNIVERSITY OF ALASKA FAIRBANKS, explained that UAF had a 50-year-old power plant that provided most of its heat and electricity. He stated that there were approximately 250 universities in the country that had similar combined heat and power plants, and most

of them were gas. He explained that UAF spent $9.8 million on heat and power for the campus.

Vice-Chair Fairclough was concerned about the operating costs and remarked that there would be $0.5 million in operating costs annually. She stressed that she wanted to find an overall solution, rather than an incremental solution.

Vice-Chair Fairclough stressed that the federal government tended to postpone coal plant permits. Chancellor Rogers understood that risk. He stressed that the plant would be a replacement plant, so it would reduce emissions. He also pointed out that it was lower than the regulatory limit.

SB 23 was HEARD and HELD in committee for further consideration.

10:50:24 AM
RECESSED

1:34:24 PM
RECONVENED

#sb21
SENATE BILL NO. 21

> "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."

1:36:28 PM

DANIEL SULLIVAN, COMMISSIONER, DEPARTMENT OF NATURAL RESOURCES, provided a Power Point presentation titled "Arresting TAPS Throughput Decline and Oil Tax Reform" (copy on file). He discussed that the department would provide an overview of the bill and would discuss the challenge related to TAPS throughput decline, it would also underscore that the continued decline was not inevitable.

Commissioner Sullivan looked at slide 2, "TAPS - A Critical State and National Energy Asset."

-The Trans Alaska Pipeline, 11 pump stations, several hundred miles of feeder pipelines, and the Valdez Marine Terminal constitute the Trans-Alaska Pipeline System (TAPS).

-At 800 miles long, the Trans Alaska Pipeline is one of the longest pipelines in the world; it crosses more than 500 rivers and streams and three mountain ranges as it carries Alaska's oil from Prudhoe Bay to Valdez.

-The U.S. Congress was instrumental in the approval and rapid development of TAPS. Congress approved construction of the pipeline with the Trans Alaska Pipeline Authorization Act of 1973.

-The principle focus of this Act is as relevant today as it was in 1973: "the early development and delivery of oil and gas from Alaska's North Slope to domestic markets is in the national interest because of growing domestic shortages and increasing dependence upon insecure foreign sources."

1:40:20 PM

Commissioner Sullivan turned to slide 3 with the same title.

-TAPS has transported over 16.3 billion barrels of oil and natural gas liquids since June of 1977. Production peaked at 2.2 million barrels per day in the late 1980s, representing 25 percent of U.S. domestic production

-Since its peak, however, throughput has steadily declined; today, TAPS is 2/3 empty and declining at an average of 6 percent per year

-TAPS throughput decline threatens economic disruption and the very existence of our pipeline

-We must encourage industry to invest in exploration and development of conventional and unconventional resources on state and federal land, onshore and offshore

-TAPS has plenty of capacity for increased throughput

-Most near-term critical economic issue facing the state

-Less oil in the pipeline year after year takes away revenue from future generations—the ultimate giveaway

-Reconfiguration, 1.2 million barrels/day

He directed attention to slide 4, "Oil Tax Reform - Production History." He stated that the opportunity on the North Slope continued to be "enormous." He looked at the urgency of the issue on slide 5, "TAPS Throughput Decline is an Urgent Problem." The discussion was not a scare tactic. He relayed that the issue was real and needed to be addressed. He referred to a prior shutdown of TAPS due to a pipeline leak, and opined that the state had dodged a bullet in the dicey situation. He pointed out that it had not been clear that the line would be restarted.

Commissioner Sullivan continued to discuss slide 5. The best way to address the technical issues was to increase throughput. There were significant consequences for the state and country.

Commissioner Sullivan moved to slide 6, "Alaska's North Slope Oil and Gas Potential."

USGS estimates that Alaska’s North Slope has more oil than any other Arctic nation

-OIL: Est. 40 billion barrels of conventional oil (USGS & BOEMRE)

-GAS: Est. over 200 trillion cubic feet of conventional natural gas (USGS)

Alaska has world-class unconventional resources, including tens of billions of barrels of heavy oil, shale oil, and viscous oil, and hundreds of trillions of cubic feet of shale gas, tight gas, and gas hydrates

-Positive methane hydrate test production

1:46:20 PM

Commissioner Sullivan turned to slide 7, "U.S. Energy Renaissance." The opportunity was enormous for the country. There had been a huge oil and gas investment boom in the past several years worldwide. He provided amounts including $650 billion. The state of Alaska received less than 1 percent of the total in the prior year. He stressed that the state needed to take back its lead in the production industry.

Commissioner Sullivan moved to slide 8, "Other Basins have Turned Decline Around." Every major basin was turning around their throughput decline with the exception of Alaska.

> “The expansion has been spurred by record-breaking levels of investment, with about £40bn set to be ploughed into North Sea production in the next three years…”
>
> “The surge in investment comes after the government relaxed the tax regime around North Sea development, prompting a record-breaking licensing round when the Department of Energy and Climate Change awarded 167 new licenses on 330 blocks last October.”

Commissioner Sullivan pointed to pages from the Wall Street Journal on slide 9. He quickly moved to slide 10 showing natural decline rates that had been turned around. He moved to slide 11 titled "Other Basins have Turned Decline Around - Historical Oil Production." He emphasized that the line chart was probably the most important slide that would be presented to the committee. He discussed that the yellow line represented Texas, Alaska was blue, North Dakota was red, and Alberta was brown. He discussed that movement had been remarkably similar for many years; however, all of the basins had started turning their production curve around." The only place that oil companies had not increased their

production was in Alaska. The department believed that it was directly related to Alaska's unfriendly tax regime.

1:53:44 PM

Commissioner Sullivan addressed slide 12 titled Secure Alaska's Future - Oil."

> Secure Alaska's Future—Oil is the State's comprehensive strategy to increase TAPS throughput to one million barrels a day.
>
> > I. Enhance Alaska's global competitiveness and investment climate
> >
> > II .Ensure the permitting process is structured and efficient
> >
> > III. Facilitate and incentivize the next phases of North Slope development
> >
> > IV. Promote Alaska's resources and positive investment climate to world markets

1:57:37 PM

Senator Hoffman did not believe there was one individual in the state that did not want to add more oil into the pipeline. He discussed the necessity of volume. He shared that the number heard from the industry in order to turn the investment field around was between $2 billion to $4 billion. Commissioner Sullivan responded that the department had worked to encourage production, but the growing sense that action was needed. He was reluctant to speak for the oil and gas industry, because it was important for them to address the committee directly. One of the items in the proposal was focused on balancing the system and increasing production. The imbalance made the state treasury incredibly vulnerable. He shared that DNR should be making the state more competitive with peers in other basins when the companies were most eager to invest. He discussed large tax credits for companies that did not commit to any production.

2:02:42 PM

Senator Hoffman stated that the issue was the most important facing the state for upcoming decades. He wanted to ensure that the state had enough revenue to provide services until the oil came online, but there would be a big question mark about when or if the oil would ever come online.

Senator Olson wondered how the state would not just provide giveaways to the oil companies. Commissioner Sullivan replied that the department had taken a hard look at the issue. The governor's initial proposal looked at balancing the system with a strong focus on incentivizing production. Many people did not know that explorers received cash checks from the state, so the incentives needed to be more closely tied to production.

2:06:11 PM

Senator Olson believed much of the bill addressed existing production. Commissioner Sullivan replied that the governor's bill was not a snapshot way to increase in state revenues, but it was a balance. At higher prices, ACES inhibited the needed investment. One of the challenges was related to progressivity and the bill was very focused on new production and credits for oil.

Senator Bishop pointed to slide 5. He discussed that the department had been onsite working around the clock. He relayed that there were workers responsible for getting the pipeline up and running. He stated that money was being well spent on workforce development. Commissioner Sullivan agreed. He added that there had been some problems with the Environmental Protection Agency (EPA).

Co-Chair Meyer pointed to slide 14 and asked where the governor's bill would put Alaska in the range on the slide. Commissioner Sullivan would follow up with an answer.

2:11:38 PM

BRYAN BUTCHER, COMMISSIONER, DEPARTMENT OF REVENUE, provided a Power Point presentation titled "Oil Tax Reform: Creating a Durable Production Tax System that is Competitive for the Long Term Benefit of Alaskans." He moved to slide 2, "Principles of Reform."

Tax reform must:

1. Be fair to Alaskans.

2. Encourage new production.

3. Be simple so that it restores balance to the system.

4. Be durable for the long-term.

Commissioner Butcher turned to slide 3 titled "Challenges in the Current Tax System." The department would discuss declining production, progressivity, and tax credits at a later time. He looked at slide 4 titled "Rising Prices and Declining Production." He directed attention to slide 5 titled "Rising Prices and Declining Production." He talked about gross value in production versus gross value of the ANS oil price.

2:19:29 PM

Commissioner Butcher pointed to slide 6, "Rising Prices and Declining Production."

Less production = less potential value for both the state and producers.

In FY 2008 an ANS price of $96.51 yielded approximately $20.4 billion in gross value.

By FY 14, a price that is $13 higher will yield a bit more than $3 billion less in gross value.

Commissioner Butcher looked at slide 7, "Rising Prices and Declining Production Observations."

1.High prices have generally offset declining production over the past several fiscal years.

2.As production has continued to fall however, the level of production tax generated by high oil prices has fallen.

3.But, the level of production tax revenues have fallen faster than production.

4.The question is why?

Commissioner Butcher moved to slide 9, "The Progressivity Function."

Found in AS 43.55.011 (g)

Based on the Production Tax Value (PTV)

When the PTV exceeds $30 per barrel of oil equivalent (BOE) the tax is levied at:

–.4 percent per dollar until the PTV/bbl = $92.50
–.1 percent per dollar that the PTV/bbl is greater than $92.50
–Maximum rate of 50 percent (in addition to 25 percent base tax)

Calculated monthly

A single statewide calculation on all oil and gas

Co-Chair Meyer wondered if DOR promoted a bracket of progressivity. Commissioner Butcher replied that DOR would like not progressivity.

2:26:20 PM

Commissioner Butcher looked at slide 10, "Progressivity: How it is Calculated."

Based on page 108 of the 2012 Fall Revenue Sources Book.

Taxable Production: 170,262,000

GVPP = Gross Value at the Point of Production.

PTV = Production Tax Value.

Commissioner Butcher presented slide 11, "Progressivity: How it is Calculated." He explained the following equations:

Calculating the Progressivity with a PTV/bbl = $64.87

$64.87 - $30 = $34.87
Because the PTV/bbl < $92.50

$34.87 x .004 ≈ 13.95 percent

The 13.95 percent progressive tax is then applied to the PTV/bbl of $64.87 not to the $34.87

$64.87 x 13.95 percent = $9.05 per barrel

Therefore: the $9.05 progressive tax + $16.22 (25 percent) base tax = $25.27 production tax per barrel before credits.

Multiplied by the taxable production (170,262,000 bbls) = $4,302 million

Commissioner Butcher discussed slide 12, "Observations."

Progressivity increases the overall tax rate as the overall profitability (before state and federal income taxes) rises.

Remember, progressivity is company specific and each company will have a different exposure because progressivity is sensitive to:

–The oil price.
–Spending.
–Production.

Progressivity is only one part of what makes the overall system progressive; it is not a factor at low oil prices.

2:30:06 PM

Commissioner Butcher looked at slide 13, "Example 1: New Capital Spending in Fiscal Year 2014."

Based on page 108 of the 2012 Fall Revenue Sources Book.

Taxable Production: 170,262,000.

Increased capital spending by $500 million from $3,338.6 million to $3,836.6 million.

CAPEX per barrel goes from $19.61 to $22.55 per barrel.

Commissioner Butcher highlighted slide 14, "Example 1: New Capital Spending in Fiscal Year 2014."

Calculating the Progressivity with a PTV/bbl = $61.93

-$61.93 - $30 = $31.93
-Because the PTV/bbl < $92.50
-$31.93 x .004 ≈ 12.77 percent

The 12.77 percent progressive tax is then applied to the PTV/bbl of $61.93 not to the $31.93

$61.93 x 12.77 percent = $7.91 per barrel

Therefore: the $7.91 progressive tax + $15.48 (25 percent) base tax = $23.39 production tax per barrel before credits.

Multiplied by the taxable production (170,262,000) = $3,983 million

Therefore – capital spending went up $500 million and state revenues went down $319 million before considering the credits.

Commissioner Butcher explained slide 15, "Observations."

Progressivity based on the net production tax incentivizes spending.

The level of the incentive depends on the price of oil and the cost structure of the investor not the project’s economics.

The value of the deduction often exceeds the value of the tax credits.

This benefit is only available to incumbent producers and doesn’t create a level playing field with new entrants.

Commissioner Butcher looked at slide 16, "Example 2: New Capital Spending in Fiscal Year 2014 with lower oil price."

Based on page 108 of the 2012 Fall Revenue Sources Book.

Taxable Production: 170,262,000.

Oil Prices decline $10 to $99.61

Increased capital spending by $500 million from $3,338.6 million to $3,836.6 million

CAPEX per barrel goes from $19.61 to $22.55 per barrel.

2:34:14 PM

Commissioner Butcher pointed to slide 17, "Example 2: New Capital Spending in Fiscal Year 2014 with lower oil price."

Calculating the Progressivity with a PTV/bbl = $51.93

-$51.93 - $30 = $21.93
-Because the PTV/bbl < $92.50
-$21.93 x .004 ≈ 8.77 percent

$51.93 x 8.77 percent = $4.56 per barrel

Therefore: the $4.56 progressive tax + $12.98 (25 percent) base tax = $17.54 production tax per barrel before credits.

Multiplied by the taxable production (170,262,000) = $2,986 million

The same equation run without the additional capital spending (Capital at $19.61 / bbl) derives $3,265 million.

Therefore the benefit of the deduction of an additional $500 million in capital spending at an oil price of $109.61 was $319 million but at an oil price of $99.61 was $279 million.

Commissioner Butcher looked at slide 18, "Observations."

Since the value of a deduction is dependent on the price of oil it is very difficult for a company to predict the value of the deduction especially with long lead time projects.

The reduction in taxes is temporary, since as soon as the spending is done the tax rate rises back to the higher rate.

Greater incentive to spend at higher prices than at lower prices – the opposite of what is needed to make projects economic.

MICHAEL PAWLOWSKI, ADVISOR, PETROLEUM FISCAL SYSTEMS, DEPARTMENT OF REVENUE, highlighted slide 19, "Example 3: Cutting Costs."

Again, based on page 108 of the 2012 Fall Revenue Sources Book.

Taxable Oil Production: 170,262,000

Reduce the capital cost per barrel by $5.

Mr. Pawlowski addressed slide 20, "Example 3: Cutting Costs."

Calculating the Progressivity with a PTV/bbl = $69.87

-$69.87 - $30 = $39.87
-Because the PTV/bbl < $92.50
-$39.87 x .004 ≈ 15.95 percent

$69.87 x 15.95 percent = $11.14 per barrel

Therefore: the $11.14 progressive tax + $17.47 (25 percent) base tax = $28.61 production tax per barrel before credits.

Before the cost savings, taxes per barrel were $25.27
Therefore a reduction in capital cost per barrel of $5 leads to a tax increase of $3.34 per barrel.

With progressivity, producer keeps $1.66 of the $5 in cost savings ($5-$3.34); without progressivity, producer keeps $3.75 of the $5 in cost savings ($5-$1.25)

Mr. Pawlowski explained slide 21, "Observations."

When cutting costs increases taxes it creates distortions in decision making and behavior.

Technology that improves economic value will create the same effect as cutting costs because it increases the production tax value and therefore, the progressive tax rate.

Similarly, things that reduce the production tax value reduce the tax rate.

Much stronger incentive to keep costs under control without progressivity – good for both producer and state.

Commissioner Butcher addressed a snapshot of monthly tax calculations in FY 09 on slide 22. He explained that a 50 percent tax rate would have been paid in July 2008, and would be higher than December and lower than July. He discussed different tax rates for every month.

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Co-Chair Meyer observed that the situation was probably a nightmare for DOR. Commissioner Butcher agreed.

Commissioner Butcher looked at slide 23 titled "Summary."

Progressivity is not simple:

–It reduces the cash margin per barrel in ways that leaves Alaska uncompetitive.
–It is highly sensitive to price, production, and spending—making it difficult to predict for the State of Alaska and taxpayers.
–It incentivizes spending—but not necessarily investments that lead to production.
–It mutes the incentive to save costs or utilize technology.
–It creates the decoupling dilemma.

Commissioner Butcher looked at a bar chart on slide 24 titled "Production Tax Credits Used and Forecast." He stated that the committee was looking at an obligation by the state of over a billion dollars. The budget would be looking at billions of dollars in deficit, and with the billion dollars it was obligated to pay.

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Co-Chair Kelly asked if people were talking about ACES when referring to billions of dollars that would be given away. Commissioner Butcher replied in the affirmative.

Co-Chair Kelly remarked that he was joking.

Vice-Chair Fairclough requested information showing the structure, by year for small producer credit. Commissioner Butcher replied that it was possible to the degree that the information was available to the department. He discussed a prior five-year look back. He agreed to provide more detailed information.

Vice-Chair Fairclough was interested in information by credit not company. She opined that credits had been given for five years, and she asked if it was correct. Commissioner Butcher replied in the affirmative.

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Vice-Chair Fairclough stated that she was trying to determine whether Alaskans provided credits five or ten years earlier and if they were still sitting in the ground.

Senator Hoffman wondered how far the state had come on audits and would any be done during the current legislative session. He asked about modeling on legislation proposed by the governor, would the modeling be done to provide a comparison on the legislation. He had heard that due to the price of oil, the value of oil in the ground exceeded the amount of oil that had been produced. Commissioner Butcher answered that the second part of the question would be best addressed by DNR. He looked at the first question related to modeling and audits. He relayed that the committee would see many models. He talked about audits, with 72 regulations that were adopted. The audits were not operational, and would not provide any insight into the tax credit structure. He stated that there had been minimal issues on the audits to date.

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Vice-Chair Fairclough discussed her position as the Legislative Budget and Audit committee chair. She stated that the committee moving through the audits.

Commissioner Butcher responded that DOR had not been able to hire the auditors. It was difficult to compete with salaries offered by the oil industry. The positions were filled and the department was looking to hire two more auditors.

Co-Chair Meyer asked what the department looked at in the audits. Commissioner Butcher answered that a thorough vetting of the return was conducted. He provided other

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Senator Dunleavy queried the original goal of ACES. Mr. Pawlowski recalled that the original goal of ACES was to increase production.

Senator Dunleavy asked why if ACES was to increase production it had not worked.

Co-Chair Meyer noted that it was important to keep in mind that oil prices had been at $140 per barrel at the time that ACES had passed. He remarked that it probably had not been a good time to reform oil tax policy.

Vice-Chair Fairclough discussed that several people had been held accountable and noted that ACES was where the fair share conversation had begun. She had not voted for ACES because it was about taking more money from the industry. She explained that supporters had wanted to increase production on the North Slope. She did not believe any legislator would have voted for something that they did not believe would have benefited Alaskans.

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Senator Dunleavy remarked that if the goal of ACES was to not increase production, he wondered what the intent of ACES had been. He felt it was important to understand ACES while reform conversations occur.

Senator Olson recalled that the state had gone from a regressive tax to a progressive tax. He discussed that 14 years ago had not been a fun time to compile a budget.

Senator Hoffman remembered that oil had been in the $80 range when ACES had passed. There had been no vision that oil would go above $110 or reach $140. The primary

discussion point had been that Alaskans should get their fair share.

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Co-Chair Kelly asked about progressive tax, and wondered if the progressive tax was actually considered a regressive tax. Commissioner Butcher replied that the tax was progressive for the state, because as the price of oil increases, the state takes a larger share.

Co-Chair Kelly remarked that a regressive tax was one that gets higher at the higher at the higher end. Mr. Pawlowski replied that that summation was incorrect. He explained a regressive tax was one that gets higher as prices get lower.

Commissioner Butcher moved to slide 26 titled "Production Tax Revenue Sensitivity."

> Rising prices + Declining production can equal lower revenue, considering…
>
> Alaska's current production tax revenues depend on:
>
> –Price
> –Production
> –Company Spending
>
> Tax credits depend on spending.
>
> Creates potential scenario where low prices coupled with high spending create significant revenue shortfalls for the state.
>
> Regardless of price, increased investment will lead to near term revenue shortfalls for the state.

Mr. Pawlowski addressed slide 27 titled "The Economics of High Cost Light Oil Development." He explained that the slide showed that having ACES made a project more economic than having no production tax. He pointed to the lower chart on the slide, and remarked that it was up to $120 per barrel.

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Commissioner Butcher looked at slide 28 titled "Senate Bill 21 and CS SB 21 (RES) Primary Provisions." He stated that the provisions would be kept under the governor's and RES bill instead of being tied to production with 20 percent exclusion for units formed after exploration.

Commissioner Butcher moved to slide 29 that showed an average government take.

Co-Chair Meyer asked if the average was approximately 63 percent for OECD jurisdictions. Mr. Pawlowski answered that it would be slightly regressive.

Vice-Chair Fairclough stated that the reason ACES was being addressed was because it is not competitive in the global market. She stressed that the current version of the bill was working to make the state more closely aligned with other OECD locations.

Senator Hoffman looked at slide 29, and he believed Alaska had been the first place to consider progressivity; now other locations had considered the tax. He wondered why progressivity was not a part of the bill. Commissioner Butcher noted that the question would be good for the legislature's consultant PFC Energy.

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Co-Chair Kelly wondered if Texas had the lowest tax in North America. Commissioner Butcher replied that North Dakota was second to Alaska and was working to lower its oil taxes at present.

Commissioner Butcher discussed production tax revenue on slide 30. The slide compared ACES with SB 21 and CSSB 21(RES). The difference between the two bills paled from the difference between the bills and ACES. He moved to production tax revenue on slide 31. The slide provided an idea of the dollar amount coming in under the two bills compared to ACES. Taking in more in the lower end and less in the higher end.

Co-Chair Meyer discussed that the introduction to the RES bill would occur the following morning. The consultant would present during the following afternoon.

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Commissioner Sullivan addressed a previous question by Senator Hoffman. He pointed to the DNR presentation, and remarked permanent fund would more closely resemble Norway's. He discussed USGS estimates that the numbers of the current prices with both conventional and unconventional oil. He discussed North Dakota and Texas, and stressed that much of the bump up in numbers in those locations was due to shale oil. The department believed the potential for shale oil play on the North Slope existed. He offered to provide more information.

Senator Hoffman agreed that he would like the information.

JOE BALASH, DEPUTY COMMISSIONER, DEPARTMENT OF NATURAL RESOURCES, explained that North America's shale resource for oil was experiencing something similar to the shale resource of gas. He remarked that it was an abundant resource with a high breakeven price, so there would be a reasonable long term base. He added that there would be a high-end to the price that may trigger additional resource plays as price signals get sent through the marketplace. He stated that there was a growing consensus in the forecasts that identify the marginal opportunities with the resource plays, providing a bracket that may not have been previously established.

Co-Chair Meyer discussed housekeeping.

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ADJOURNMENT
3:36:12 PM

The meeting was adjourned at 3:36 p.m.