

SENATE FINANCE COMMITTEE
March 12, 2013
10:13 a.m.

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CALL TO ORDER

Co-Chair Meyer called the Senate Finance Committee meeting to order at 10:13 a.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

Senator Lyman Hoffman

ALSO PRESENT

Senator Lesil McGuire; Suzanne Armstrong, Staff, Senator Kevin Meyer; Roger Marks, Legislative Consultant, Legislative Budget and Audit Committee; Michael Pawlowski, Advisor, Petroleum Fiscal Systems, Department of Revenue; Joe Balash, Deputy Commissioner, Department of Natural Resources; Janak Mayer, Manager, Upstream, PFC Energy.

SUMMARY

SB 21 OIL AND GAS PRODUCTION TAX

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

#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."

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Co-Chair Kelly MOVED to ADOPT the proposed committee substitute for SB 21, Work Draft 28-GS1647\P (Nauman/Bullock, 3/11/13).

Co-Chair Meyer OBJECTED for the purpose of discussion.

SUZANNE ARMSTRONG, STAFF, SENATOR KEVIN MEYER, presented the committee substitute (CS) and provided a sectional analysis. She explained a number of changes from the Senate Resources version. Section 1, Section 3, Section 5, Section 6, Section 8, Section 14, Section 21, Section 38, Section 39, and Section 40 were conforming amendments that correlated to changes to AS 43.05.225 found in Section 4 of the bill. Section 4 amended the statute by decreasing the interest rate on delinquent taxes to either the lower of 3 percentage points above the applicable annual federal rate or at the annual rate of 11 percent. The amended statute was included as a response to concerns raised by the Alaska Oil and Gas Association and industry. The combination of the six year statute of limitations coupled with the high interest rate penalty and the method of calculating the tax left open the possibility of additional taxes imposed by the Department of Revenue (DOR) on the underpaid taxes after audit. The interest rate penalty did not reflect current financial conditions. She noted that not all of the sections referenced earlier specifically pertained to oil and gas taxes; however, the penalty or interest rate under other titles of law were tied to the interest rate so conforming changes were necessary.

Ms. Armstrong continued with Section 2. She explained that the Community Revenue Sharing (CRS) fund was currently tied to 20 percent of the revenue from the calculation of progressivity on the production tax. The CS eliminated

progressivity and stipulated that the legislature may contribute an unspecified amount to the Community Revenue Sharing fund. The provision did not change the formula for revenue sharing in current statute. She mentioned that the \$60 million contribution limit and the total fund balance limit of \$180 million remained intact.

Ms. Armstrong referenced Section 7 that concerned the qualified oil and gas industry service expenditure credit applicable to the corporate income tax. She reported that the tax was not altered from the Senate Resources Committee version of SB 21. After discussion with DOR, a future amendment will address changes to the provision that would "tighten down" the credit and reduce the ten year statute of limitations to seven years.

Ms. Armstrong commented that Section 9 established the base rate of 30 percent for the oil and gas production tax. She reported that no changes were made to Section 10 that related to gas used in-state outside of Cook Inlet. She noted that Section 10 in the CS corresponded to Section 4 in the resources version of SB 21. She mentioned that Sections 11 and 12 pertained to tax payment and was unaltered from the resources version. The only change to Section 12 reflected the 30 percent base rate and the calculation of the GRE (Gross Revenue Exclusion). She pointed out that Page 10, lines 4 to 6 addressed the calculation of the GRE. She noted that line 6 contained an error and the 30 percent figure should be 20 percent.

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Ms. Armstrong added that Section 13 addressed the payment of tax and was the same as Section 7 of the resources version. She remarked that Section 15 corresponded to tax credits or losses on expenditures and limited the tax credit for qualified capital expenditures incurred north of 68 degrees for expenditures incurred before January 1, 2014 and did not change from the resources version. She noted that Section 16, Section 17, Section 18, Section 23, and Section 29 pertained to the net operating losses and the carry forward annual loss credit.

ROGER MARKS, LEGISLATIVE CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE, discussed Section 17, the treatment of net operating losses. He suggested that the language in Section 17 needed refinement. He explained the intent of the

section. A net operating loss (NOL) meant that expenditures were greater than revenue. Under current law the state monetized net operating losses in the following year. In instances when the tax floor was zero and a producer cannot use all of its incurred expenditures on the tax to minus zero, current law allowed converting the loss to a credit at a rate of 30 percent. The state "bought" the credit in the following year. The resources CS modified the section so that the loss was carried forward with 15 percent interest until the time that the producer earned offsetting income. He expounded that the finance CS diverged from the previous version and applied the provision to the first 10 years of the well on the Gross Revenue Exclusion (GRE). He believed that the NOL credit provision in the resources CS carried forward for ten years would not enable the full benefit of the NOL credit. He judged that current law was preferable to the resources CS; NOL's converted to a credit monetizable to the state in the year they occurred. The committee wanted to incite expenditures and limited the NOL's to the amount of expenditures monetized the next year. Without the spending, the unused credit would carry forward at 15 percent interest until there was offsetting income.

Co-Chair Meyer interjected that the intent was also to have the money spent in Alaska. Mr. Marks concurred.

Ms. Armstrong continued. She noted that Section 18, Section 23, and Section 29 would also need altering with any changes to Section 17. Section 24, dealt with the small producer tax credit and was extended to 2022, which corresponded to Section 17 of the resources version. She reported that Section 26 referring to the \$5 per barrel allowance was maintained in the finance CS. She continued that the exploration incentive credits in Section 27 and Section 28, established in the resources CS were extended to 2022. The three mile boundary from the bottom hole of a pre-existing well drilled for oil and gas was maintained as well as the eligibility qualifiers for the credit under AS 43.55.025.

Ms. Armstrong referred to Section 30 and Section 31 pertaining to the oil and gas credit fund and reported that no changes occurred from the resources CS. Sections 32 and 33 also remained the same. Section 34, Section 35, and Section 36 pertained to the determination of the production tax value and did not change.

Ms. Armstrong detailed that Section 37 established the qualifiers for the GRE. The mechanisms were different from the resources version. The CS established that the gross value at the point of production that met certain criteria was reduced by 20 percent for 10 years from the production date. She listed the criteria: oil and gas produced from a well within a lease or property that did not contain a lease from within a unit on January 1, 2003; the oil or gas produced from a well within a participating area established after December 31, 2011 that is within a unit formed under AS 38.05.180(p) before January 1, 2003 if that participating area does not contain a reservoir that had previously been in a participating area before December 31, 2011, and lastly; the oil or gas produced from a well that the producer can demonstrate to the Department of Revenue (DOR) that drains a reservoir that the Department of Natural Resources (DNR) had certified and approved upon review of a plan of development that the oil was not contributing to production before December 31, 2012.

She furthered that collaboration between DNR, DOR, and Department of Law (DOL) was ongoing on the final criterion in order to ensure that the bill's language allowed for the correct calculation to confirm "new oil."

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Ms. Armstrong concluded that the remaining provisions in the CS remained the same as the resources version.

Co-Chair Meyer interjected that "preliminary" discussions were held with the administration regarding the definition of new oil from legacy fields and whether making the determination was possible. Ms. Armstrong confirmed the discussions and noted the designation of new oil was under review.

Co-Chair Meyer highlighted the changes. He applauded the resources version and mentioned the efforts of Senator Giessel. He noted that very few changes occurred in the finance CS. He offered that the base rate was changed to 30 percent down from 35 percent, but the \$5 per barrel allowance remained. He mentioned the GRE was dropped from 30 percent to 20 percent. The GRE was expanded to proven new oil in the legacy fields. A ten year time limit on the GRE was added. The competitive review board was eliminated from the finance CS. The CRS was unchanged. The NOL and the

carry forward were changed to reflect the intent that the expenditures would be reinvested in Alaska; suggested by Vice-Chair Fairclough. The manufacturing credit against state income tax, exploration incentive credits, small producer credit, elimination of the qualified capital credit, and the effective dates remained the same. He offered that the committee repealed progressivity because as the price of oil raised the amount of money the state collected increased. The committee's goal was to levy a similar tax rate at all prices of oil.

Co-Chair Meyer expressed that the goal of the legislation was to become competitive and to get more oil into the pipeline. He hoped that the CS would meet the objective.

Senator Dunleavy cited Section 4, Page 2 and questioned whether the producer would "always" receive the lower interest rate. He asked about the percentage points in an inflationary period. He wondered whether the lower rate would still apply. Ms. Armstrong answered in the affirmative.

Senator Olson asked about the Alaska Municipal League and its comments on any revenue impacts or confusion about the effects of the bill on revenue sharing. Ms. Armstrong offered to contact the league.

Senator Olson requested a comparison of the different versions of SB 21 to Alaska's Clear and Equitable Share (ACES). Ms. Armstrong replied that a comparison was forthcoming.

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Ms. Armstrong addressed the question regarding revenue sharing. She disclosed that a new formula for the CRS fund was established in 2008 and was tied to progressivity in ACES. The CS provision did not tie the fund to a specific funding source, which provided more security. The formula would work the same way; every year the legislature may appropriate the funding specified by the formula.

Co-Chair Meyer asked the administration for preliminary comments on the CS.

MICHAEL PAWLOWSKI, ADVISOR, PETROLEUM FISCAL SYSTEMS, DEPARTMENT OF REVENUE, cited Section 17, Page 14 regarding

the loss carry forward provisions. He summarized the committee's intent to ensure that a loss carry forward credit reimbursement was balanced by spending in the year the company was claiming the credit. The spending occurred in the same year the credit reimbursement was issued. Otherwise, the credit was carried forward and offset against the tax liability as contained in the resources version. He referred to Section 30, Page 24 and explained that the provision reflected a conforming change in the governor's version. He cited AS 43.55.028 that provided the mechanism for payment of credits. He suggested that the committee focus on the mechanism that writes the check for the credit instead of adjusting the credit. Placing restrictions on AS 43.55.028 and restricting when a credit could be turned in for cash payment would accomplish the same outcome in a simpler manner.

Co-Chair Meyer restated the question regarding the determination of new oil in legacy fields. Mr. Pawlowski wanted to defer the question to DNR.

Co-Chair Meyer wished to better understand the net operating loss and the tax credits. He asked for clarification.

Mr. Pawlowski provided an explanation of the loss carry forward. He related that the loss carry forward provided equal treatment for a company without a tax liability. Currently, when a company spends money it was deductible against its taxes. A benefit was granted to the company based on the tax rate. At a 30 percent net tax rate taxes decreased by 30 cents on each dollar. Without the liability, a loss was created and was not shared by the state. The loss carry forward attempted to provide an equivalent for the new entrant similar to the existing producer. The new entrant's credit would be carried forward until the point in time a production tax liability was incurred. He stated that the reduced GRE and the higher base rate affected the economics for the new entrant. The CS offered an opportunity for a new entrant to receive an "upfront" cash payment provided the company continued to spend in the state. The value for the new entrant provided access to capital to continue its investment. The intent was to "strike a balance." The investment occurred in "many stages" and money was spent before production began. He summarized that the loss carry forward was attempting to

equalize treatment between companies that had tax liabilities and new entrants that do not.

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Co-Chair Meyer cited exploration tax credits or small producer tax credits as examples of the types of credits entitled to loss carry forwards. He wondered whether the taxes were "stackable." Mr. Pawlowski replied that some were stackable. The small tax credit was non-transferable and not monetizable. A small producer qualified for the basic credit on production. The ability to stack credits was more complicated for the exploration incentive credit.

Co-Chair Meyer asked whether the concept of spending tax credit refunds in the state was part of ACES. Mr. Pawlowski discerned that the previous tax systems were attempting to balance offsets of credits and tax rates. The CS before the committee attempted to flatten the tax rate system offset by incentives against production. Loss carry forward's were based on lease expenditures and only the expenditure qualified.

Co-Chair Meyer remarked that he favored targeted capital tax credits for new wells. He believed the credits provided relief for upfront costs for development on the North Slope. However, the loss of revenue to the state's treasury was dramatic. The committee opted instead for the GRE.

Mr. Pawlowski added that the targeted tax credit liability to the state grew in proportion to the investment. Lots of new investment grew the liability to the state.

Senator Bishop asked whether the NOL carry forward could include exploration credits that did not result in production. Mr. Pawlowski answered in the affirmative. He expounded that how valuable the credit would be was determined by how much the company continued to spend in the state. The company must spend additional money to turn the credit into cash. If production was never realized many credits would fall under "non-cashable" carry forwards that without production became worthless.

JOE BALASH, DEPUTY COMMISSIONER, DEPARTMENT OF NATURAL RESOURCES, answered, in response to a question by Senator Bishop, that the 025 exploration credits mandated that the company comply with information requirements. Generally all

geologic data became public at some point in the future, but the state obtained 025 credit data at an earlier time.

Vice-Chair Fairclough recalled that the governor wanted simplicity in a new tax structure and was a reason for the elimination of progressivity. The administration had concerns over credits and the impact on the states cash flow in the future. She proposed that if the state provided credits and "had skin in the game" then the money should stay in Alaska and not migrate to outside fields. She wanted the money reinvested in wells and specifically support the smaller producers. She hoped for increased production. She stated that Alaska was incentivizing future production with Alaskans money.

Co-Chair Meyer added that the committee supported the idea but it was "still a work in progress."

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Mr. Balash explained DNR's process to determine new oil in legacy fields. The Division of Oil and Gas utilized unitization and participating areas "mechanisms" to "count" new oil. He pointed out that the resources version of SB 21 included the expansion of participating areas. The finance version required that the lessee must prove to DNR that a certain volume of oil was not counted as previous production. A producers drilling plan must demonstrate that the oil was new and would be recovered. The producer would then qualify for a GRE in the legacy unit. He relayed that the department would "refine" the definition of new oil in order to clearly specify who had the "burden of proof" and that DNR approval was compulsory for the GRE.

Co-Chair Meyer interjected that the industry testified that oil was plentiful in the legacy fields, but it was more difficult to obtain. Mr. Balash confirmed that "billions of barrels" of recoverable oil remained in the legacy fields. He stated that the amount recovered was "in part a function of the rate of decline." The more work done to reduce the decline the more of the oil would be recovered. He was aware of the industry's efforts to find and recover the additional "pockets" of oil. The bill placed the burden on industry to demonstrate how the new oil would be identified and recovered. He thought the state should help incentivize the production of new oil under those circumstances.

Co-Chair Meyer mentioned Norway's tax credit to incite new oil production and the desire to circumvent new capital tax credits, which lead to using the GRE as an incentive for new oil production in legacy fields. He requested an explanation of the GRE.

Mr. Pawlowski explained that a tax credit was an upfront payment but the GRE was a reduction in the taxable value. He added that 20 percent of the gross value of eligible new oil was subtracted from the production tax value or net profit, subsequently; the 30 percent tax rate was applied. The GRE reduced the corporation's total tax liability. An upfront payment was not required with credits. The CS limited the GRE to ten years per well. The GRE concept was introduced, because of auditing complications in trying to attribute specific costs to specific projects. Calculating gross values at the point of production was a relatively simple calculation; number of barrels times gross value. He summarized that 20 percent of the value of approved new oil was an additional deduction on the overall corporate tax rate.

Co-Chair Meyer emphasized that the tax reduction was only available for the production of new oil. Mr. Pawlowski confirmed.

Co-Chair Meyer requested comments on the GRE's 10 year time limit. He expressed concern that production would accelerate. Mr. Pawlowski replied that analysis was ongoing and advised that comments would be better deferred.

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Senator Dunleavy asked about a credit for manufacturing in the state. Mr. Pawlowski responded that the credit was retained in the CS and found on Section 7, Pages 3 to 4, beginning on line 15.

Vice-Chair Fairclough responded to the GRE time limit. She postulated that all oil became gross oil revenue exclusion recipient with time if not limited in some manner. She thought that it depended on the type, size, and the life cycle of the project. She wanted to see the modeling done by the consultants and the administration to determine a "sweet spot" to best utilize the GRE and establish fair time limits for the producer and the state. She believed that the calculation was a "complicated" policy decision.

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Senator Bishop appreciated Vice-Chair Fairclough's comments. He hoped for detailed modeling and further discussions on various scenarios.

Mr. Pawlowski pointed out that in determining the committee's intent regarding the amount of production that qualified for the GRE helped the department determine how much production did not qualify for the GRE.

Senator Olson wondered whether other tax regimes used the GRE and how successful it was to incite new production. Mr. Pawlowski recalled that the GRE was discussed last session. He recommended that PFC Energy address the effectiveness question.

JANAK MAYER, MANAGER, UPSTREAM, PFC ENERGY, offered that the GRE was discussed in the committee last year when examining ways to differentiate between existing and new production. The overall tax system calculated production and costs on a companywide level. Differentiating between different streams of production was more complicated. The GRE was simpler and provided a tax benefit based solely on the revenue side. Similar approaches were taken in other regimes, specifically the Brown Field Allowance used in Great Britain. He noted that the GRE's impact from the CS reduced government take from approximately 63 percent to 60 percent.

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Senator Olson restated his question about other tax regimes in the world employing the GRE and its impact on increased production. He was looking for a clear measure of success. Mr. Mayer responded that the Brown Field Allowance was the most comparable tax. Presently, new production could not be attributed to the allowance but increased investment was indicated.

Senator Kelly asked when the allowance was enacted. Mr. Mayer replied that enactment occurred within the last year.

Senator Dunleavy asked whether the investment activity increased immediately. Mr. Mayer replied that the response within the legacy fields was swift.

Co-Chair Meyer asked whether the CS improved Alaska's competitiveness on a global basis. Mr. Mayer answered that the taxes made Alaska more competitive when compared to other "peer jurisdictions."

Co-Chair Meyer thought that some elements of ACES worked such as the capital tax credits, but that progressivity was not competitive.

Senator Bishop remembered that industry committed \$45 billion for new projects with and additional increase of \$100 billion with the Brown Field Allowance. Mr. Mayer understood that the figures included decommissioning existing fields, which did not create new oil.

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

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ADJOURNMENT

[11:21:00 AM](#)

The meeting was adjourned at 11:21 a.m.