SENATE FINANCE COMMITTEE
March 12, 2013
1:51 p.m.

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CALL TO ORDER

Co-Chair Meyer called the Senate Finance Committee meeting to order at 1:51 p.m.

MEMBERS PRESENT

Senator Kevin Meyer, Co-Chair
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

None

ALSO PRESENT

Janak Mayer, Manager, Upstream, PFC Energy; Joe Balash, Deputy Commissioner, Department of Natural Resources; Michael Pawlowski, Advisor, Petroleum Fiscal Systems, Department of Revenue; Senator Cathy Giessel; Senator Bert Stedman; Senator Bill Wielechowski;

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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JANAK MAYER, MANAGER, UPSTREAM, PFC ENERGY, summarized that the crucial provisions of CSSB 21(FIN) affecting government take and economics were a 30 percent base rate with the $5 per barrel allowance, a 20 percent Gross Revenue Exclusion (GRE) for 10 years on new production in new and legacy fields and a monetizable net operating loss credit. The system was revenue "neutral" with a government take of 62.5 percent across a broad range of oil prices. He declared that the CS was a "substantial improvement over ACES (Alaska Clear and Equitable Share)" in terms of competitiveness with "peer" oil and gas producers.

Mr. Mayer began a PowerPoint presentation titled: "Senate Finance Committee CSSB 21 Analysis" (3/12/13) (copy on file), and spoke to Slide 2 titled "Base Production." He pointed to the graph on the upper left corner of the slide and explained that the 30 percent base rate combined with the $5 dollar per barrel allowance was a "capped progressive element" of the tax system. The element "almost perfectly compensated the regressive nature of the royalty" system and resulted in a neutral system of government take ranging from prices of $65/bbl. (per barrel) up to $160/bbl. barrel. The neutrality corresponded to the value of production split between the state, producers and the federal government as illustrated in the graph on the top right of the slide.

Mr. Mayer turned to Slide 3 titled: "18/bbl. New Development with GRE, Standalone." He related that the system had a neutral government take of approximately 60 percent at prices over $80/bbl.

Mr. Mayer addressed Slide 4 titled: "25/bbl. New Development with GRE, Standalone." He noted the similar level of government take as illustrated in the graphs. He qualified that the "combination of higher costs for new development and the regressive nature" of the tax resulted in a 62 percent government take at $80/bbl. lowering to 61 percent at $100/bbl. of oil.

Mr. Mayer discussed Slide 5 titled: "18/bbl. New Development with GRE, Incremental to Incumbent." The slide looked at the after tax effect economics for an existing producer. He explained that the data examined the finished economics of base production cash flow of a large producer layered on the new field development and subtracted one from the other to determine the after tax effect for an existing producer. The results were slightly higher government take of 62.5 percent across a wide range of oil prices, which included the GRE (gross revenue exclusion) for new production.

Mr. Mayer addressed Slide 6 titled: "25/bbl. New Development with GRE, Incremental to Incumbent" and noted the very similar results as the previous slide. He thought that overall the bill realized the committee's desire of a revenue neutral system at a competitive level of 62.5 percent government take for existing production and 60 percent for new production. He continued with a global comparison of the tax structure.

Mr. Mayer spoke to Slide 7 titled: "Government Take Competitiveness-$80/bbl." The graph compared the proposed tax system to other world tax regimes at $80/bbl. of oil. He pointed out that under ACES, Alaska was the second highest tax regime in the Organization for Economic Cooperation and Development (OECD). The committee substitute (CS) ranked the state toward the center of the OECD countries.

Mr. Mayer moved to Slide 9 titled: "Government Take Competitiveness -$120/bbl." He observed that at $120/bbl. under ACES for new development, Alaska was the highest in the OECD. The CS kept Alaska in "the heart of the pack" at existing production and was even more competitive for new production.

Co-Chair Meyer asked for an explanation of Slide 8: "Government Take Competitiveness - $100/bbl."

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Co-Chair Meyer felt that some of the regimes characterized with blue lines were countries that Alaska was not competing with but that the countries denoted in yellow were similar. He observed that the ACES system was at the top of the list at $100/bbl. of oil. The CS placed government take in the middle at 63 percent for existing production and for new development Alaska was very competitive. He pointed out that under the CS; an existing producer in Alaska was more competitive than North Dakota.

Co-Chair Meyer stated that it appeared that the committee had met its goal of being competitive in global markets, especially for new oil. He inquired whether his deductions were correct. Mr. Mayer replied in the affirmative and turned to Slide 11: "Government Take Competitiveness" to illustrate his point. He offered that the graph summarized the competitiveness from a limited peer perspective of global producers. The slide depicted the peer tax regimes across a range of prices for comparison. The red bar portrayed $80/bbl., the yellow bar portrayed $100/bbl., the blue bar portrayed $120/bbl., and the green bar portrayed $140/bbl. He related that the set of bars that signified ACES marked by red arrows, depicted a steep slope for new development and base production which characterized progressivity; exclusive to Alaska. He pointed to the two sets of bars marked by blue arrows. The bars depicted the CS provisions for base production and new development and were level, which represented the neutral feature of the tax system of 62 percent to 60 percent government take. The figures placed Alaska in the competitively placed middle of the peer group.

Co-Chair Meyer appreciated the analysis and a job well done.

Co-Chair Meyer noted that the various tax credits were confusing and inquired whether there was a simpler way to offer credits. Mr. Mayer responded that the credit system under ACES was complicated and noted that the CS was simpler, which excluded capital credits. Options existed to streamline the proposed provisions in the CS. He elaborated that the net operating loss (NOL) credit was monetizable under the new CS under certain conditions. The NOL was only montizable if the producer had capital spending the following year sufficient to monetize the full value or the

balance was carried forward. He believed monetizing the NOL credit was sensible as long as the state's liability was "manageable." The system was designed for fairness to both an existing producer and a new producer. The tax liability should be "as similar as possible" to both. He stated that the monetizable NOL tax credit achieved fairness. An existing producer bore the full 30 percent of the tax liability but a new producer would not have a production tax liability. The monetizable NOL credits created equity amongst the tax liability. The existing producer's spending could take its tax liability below zero and for the portion of the negative liability can obtain a refundable credit. He pointed out that if NOL credits were monetizable without the restrictions the system could be further simplified.

Mr. Mayer remarked that the exploration credit was due to expire in 2016, but was extended to 2022 in the CS. He mentioned two issues with the exploration credit. The levels of government support for spending were very high. The exploration credit could be added to a tax liability or the NOL credit bringing the level of government support to over 70 percent. An existing producer under ACES can achieve over 100 percent support for exploration spending. He reported that the CS limited the amount of government support to 30 or 40 percent for exploration and eliminated "stacking credits." He qualified that an existing producer can still stack deductions against an existing tax liability with the exploration credit and still achieve 70 percent government support. He suggested addressing the exploration credit to level the playing field with new producers. He understood that most producers use the NOL credit for exploration. He recommended elimination of the exploration credit. He detailed that if the CS base credit was 30 percent and a fully monetizable NOL was 30 percent the same level of government support as the exploration credit would be available. He offered that the state did not need a separate level of credits. The same result was available through the NOL credit "with less complexity." The scenario also achieved equity between the small and large producer. Government support was set at 30 percent regardless of an existing tax liability.

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He discerned that the scenario also created a "completely level playing field between small producers and large producers." He questioned the need for a small producer

credit under the circumstances. A much simpler tax system could be achieved under the scenarios of reducing the number of credits and leveling the playing field.

Senator Olson asked what the potential impacts were with NOL credits coupled with the GRE and new production. He inquired whether the state was creating a future financial problem with credits. Mr. Mayer responded that the biggest liability to the state was with the capital credit. The capital credit could be stacked with the NOL available to both incumbent or new producer rather than only to new producers. Removing the capital credit eliminated the largest portion of the liability. He opined that maintaining a fully refundable NOL credit created a liability for the state but was "manageable" and "justified" in attempting to balance the tax system between new and incumbent producers.

Senator Bishop queried whether it was possible for Alaska to become too competitive by "starting a race to the bottom." Mr. Mayer responded that the Lower 48 states were not a "perfect" comparison but that a strong counterforce was the dependency on oil and gas production for revenue. He judged that in general, "very few countries wanted to aggressively pursue a race to the bottom because the costs were too great."

Co-Chair Meyer inquired whether eliminating the exploration and small producer tax credits would help the state's position regarding government take. Mr. Mayer responded that his comments were related to achieving the greatest possible simplicity and balance between new and existing producers within the tax structure. He acknowledged that the result had a fiscal impact to the state. The state would realize a "relative net positive" through elimination of the small producer credit. The financial benefits to the state were minimal through elimination of the exploration credit because of the NOL credit, but would substantially simplify and balance the tax system.

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RECONVENED

Co-Chair Meyer noted some committee concern regarding the GRE and how it dealt with new oil in legacy fields.
Vice-Chair Fairclough offered that the discussion had been whether the GRE should have a time limit or not. She relayed that there were arguments on both sides of the issue.

JOE BALASH, DEPUTY COMMISSIONER, DEPARTMENT OF NATURAL RESOURCES, explained that the administration had intended to apply the GRE to new oil reserves brought into production. He reported that Alaska had a "tremendous resource base" and that estimates required drilling to confirm reserve quantities and move the oil resource into the known "reserve" category. The goal was to incite new reserves development. The Department of Natural Resources (DNR) identified new units and "new participating areas" within legacy fields. He stated that the challenge and priority was identifying new oil within the legacy fields. He detailed that DNR's system of managing units included "participating areas." "A participating area was a reservoir within a unit that contributed to production." Oil wells within a unit might not be drilling all of the oil in individual reservoirs that comprise the unit. The department identified new participating areas within the legacy fields as new oil and extended the GRE to oil from new participating areas. He furthered that the Senate Resources Committee applied the GRE to oil in previously identified participating areas that was now recoverable through new technology. The Senate Resources committee qualified oil recovered from the expanded participating area for the GRE. He understood that the finance CS went even further and extended sections of existing participating areas that contained a geographic or other impediment to production. The section would become eligible for the GRE if it had not been producing but now would be and was approved by DNR. The intent was to target new oil reserves from previously unrecoverable oil in dormant sections of existing participating areas with new technology by extending the participating areas and applying the GRE.

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Senator Dunleavy recalled that according to public testimony there were large amounts of "known" oil that was being "sat on." He inquired whether this assertion was true and whether the more accessible known oil could be taxed

under the lower rate proposed in the CS. Mr. Balash replied that DNR was unaware of any large pockets of oil that remained undeveloped that were profitable to develop; however, the department was aware of small pockets ("bubbles") of oil within legacy fields and participating areas that could be developed with new sophisticated technology. He added that viscous and heavy oil deposits were large, but were not economic enough to be developed.

Senator Bishop continued that he had written the comments down that Senator Dunleavy was referring to and offered that the testifier cited a 600 million barrel field within BP's properties. He inquired how many barrels a "small bubble" quantified. Mr. Balash replied that a small bubble amounted to approximately 300,000 barrels.

Senator Olson reiterated his inquiry regarding what the potential impact on state revenue was from the NOL credits and the GRE on shale oil exploration and production by Great Bear. Mr. Balash replied that DOR pondered the same question when it was considering how to address the production tax system. He stated that the department wanted to avoid a situation where a company was profitable and state revenues were "in the red." Tax incentives potentially turned into subsidies that cost the state. He maintained that the underlying principle of the GRE was to create incentives for new oil production. The state would accept less now for new production in the future that would create value to the state. The way the NOL was structured a producer could not continue to produce and lose money. He added that Great Bear drilled for core samples but did not conduct a flow test. Without a flow test it was difficult to determine the economics of shale production. The department believed shale production was not predicted in the near future and was not factored into DNR's production forecast.

Mr. Balash segued into a response to Co-Chair Meyer's question regarding an unlimited GRE shifting legacy or currently producing oil to new oil. He explained that legacy fields were capable of producing oil for multiple decades depending on production costs and the price of oil. Existing production would remain under base production and was not eligible for the GRE. Over time more and more barrels would become GRE eligible barrels in the production model. He stressed that GRE barrels would not displace legacy barrels until existing oil production ceased.

Vice-Chair Fairclough communicated that the explanation was precisely the question. Considering the next generation of Alaskans, most of the oil would be taxed under the GRE. She inquired whether the state should continue the GRE beyond an initial recovery period for industry. Mr. Balash replied that the issue regarding the timing of the GRE was related to the level of the GRE. He stated that the administration set the GRE at 20 percent without a time limit. The resources version set the GRE at 30 percent. At that amount of reduction to the gross value a time limit seemed justifiable. The administration was "comfortable" with no time limit on a 20 percent GRE. The department did agree with the finance CS provision which established a time limit for the GRE on a well by well basis. The department could provide the committee with production rates and recovery factors for wells over a ten year period.

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Vice-Chair Fairclough recalled a scenario from previous testimony where the state created a threshold limit under a previous tax regime that resulted in unintended consequences for the state. She asked for clarification. Mr. Balash replied that the issue arose when ELF (Economic Limit Factor) was in effect. He delineated that ELF was a multiplier against a 15 percent gross tax rate and used productivity and field size in order to determine profitability. The system offered "marginal" incentives to produce a specific number of barrels in a well in order to optimize the ELF factor. He offered that the Kuparik oil field was developed under the system and produced more wells than necessary to "efficiently" recover the oil. The producers were "efficiently" recovering the oil in a manner that favored their tax liability.

MICHAEL PAWLOWSKI, ADVISOR, PETROLEUM FISCAL SYSTEMS, DEPARTMENT OF REVENUE, stated that the department was working on some cash-flow comparisons in order to examine the impact of the GRE versus monetizable credits and the effect on state revenues over time. He addressed Senator Olson's question regarding the "up front" monetization of loss carry forwards versus carry forwards only applied to a tax liability. He voiced that the practical impact to the state would be lost revenue either upfront revenue or future revenue. The issue was timing; when the state could

afford the lost revenue. He reminded the committee that in all versions of SB 21 the carry forward's value was increased and compounded, which reduced taxes in the future. The balance was between upfront payments and more tax revenue in the future compared to the GRE.

Vice-Chair Fairclough recalled testimony from industry that the major producers had stated that the GRE did not have any impact on their production. She asked for clarification from industry.

Co-Chair Meyer remembered that the industry favored "targeted capital credits" over the GRE. He remarked that capital credits did not favor the state's economics. He anticipated that the GRE would provide industry the same benefit; just not "upfront." The credit was only available if industry produced oil.

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

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ADJOURNMENT

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The meeting was adjourned at 2:48 p.m.