

HOUSE FINANCE COMMITTEE
February 17, 2015
9:02 a.m.

[9:02:44 AM](#)

CALL TO ORDER

Co-Chair Thompson called the House Finance Committee meeting to order at 9:02 a.m.

MEMBERS PRESENT

Representative Mark Neuman, Co-Chair
Representative Steve Thompson, Co-Chair
Representative Dan Saddler, Vice-Chair
Representative Bryce Edgmon
Representative Les Gara
Representative Lynn Gattis
Representative David Guttenberg
Representative Scott Kawasaki
Representative Cathy Munoz
Representative Lance Pruitt
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Janak Mayer, Partner, Enalytica; Nikos Tsafos, Partner, Enalytica.

SUMMARY

^ENALYTICA PRESENTATION: IMPACT OF OIL & GAS PRODUCTION TAX CREDITS AT LOW OIL PRICES

[9:03:40 AM](#)

JANAK MAYER, PARTNER, ENALYTICA, introduced himself and referenced his experience in providing advice and testimony on oil and gas production taxes and on Alaska' liquefied natural gas project (AKLNG). He relayed that he would be discussing Alaska's tax system and tax credits in the

current low oil price environment. He indicated that there were two papers that accompanied the presentation. One paper provided a general background of the oil market and the drivers of low oil prices. The second handout specifically addressed tax credits in the current environment. He stated that the presentation was an overview of the contents of both handouts. He turned the meeting over to his colleague to talk about the macro-level oil price picture.

NIKOS TSAFOS, PARTNER, ENALYTICA, introduced himself and provided his background over the previous ten years as an oil and gas consultant. He explained that he spent most of his time advising companies in natural gas. He furthered that he had spent time studying the global energy system including oil markets. He introduced the PowerPoint presentation, "Impact of Oil and Gas Production Tax Credits at Low Oil Prices."

9:06:03 AM

Mr. Tsafos began with slide 2: "Oil in 2015: Market Fundamentals." He noted that the price of oil had gone from about \$115 per barrel of oil in the previous summer to about \$55 to \$60 per barrel of oil. He stated that he would be explaining the change in the market but would not try to predict the market's future. His intent was to place legislators in the shoes of someone working at either an oil company, a bank, or a consulting firm that was attempting to interpret market activity. He wanted to discuss what kind of data points were evaluated. He referred to the three charts on the slide. The chart on the left-hand side showed two numbers. The first reflected the growth in U.S. production relative to January 2010 (shown in red). The red line indicated that the U.S. was producing significantly more oil. Basically, relative to January 2010, the U.S. added about 4.5 million to 5 million barrels of oil per day in production. He reported that as a reference the world market produced about 90 million barrels per day. Normally a large increase in production would lead to a reduction in market price. Although the U.S. was adding production, something else was happening elsewhere in the world to remove supply from the market. He was not referring to deliberate action by OPEC. Instead, he was referring to physical disruptions to supply. He pointed to the second line (depicted in green) that displayed unplanned outages. The green line showed a drastic increase

in outages in early 2011 that correlated to the beginning of the civil war in Libya. Libyan production was disrupted, resumed, then was followed by the start of the Syrian civil war. Syrian oil was taken off the market as a result of the war. Once the market stabilized the U.S. and its allies tightened sanctions on Iran resulting in Iranian production being taken off-line. The green and red lines were almost moving in tandem. He pointed out that whenever the U.S. was adding production somewhere else in the world production was being taken off of the market.

Mr. Tsafos moved to the middle chart on slide 2. He stated that the green line depicted actual oil production, whereas the red line showed the yearly average. He pointed to a small amount of growth in 2012 and an insignificant amount of growth from 2012 to 2013. He suggested that while the U.S. oil production was growing to 5 million barrels per day, the world was not seeing the benefit because of the changes in production in other places.

Mr. Tsafos turned his attention back to the chart on the left side of slide 2. By the middle of 2014 outages (represented by the green line) were declining significantly. He suggested that as U.S. production was increasing, other production, such as Libyan production, was also coming back online. Next, he explained that the red line on the middle chart showed the growth in the yearly average in oil production and highlighted the significant growth from 2013 to 2014 adding \$1.6 million barrels of oil per day. He reemphasized the large amount of growth in oil production.

Co-Chair Thompson acknowledged that Representative Gara had joined the meeting.

Mr. Tsafos moved on to discuss demand. He drew the committee's attention to the third chart on the right on slide 2 which showed demand expectations. He relayed that a number of analysts and observers published their forecasts predicting the world market. He mentioned that the International Energy Agency (IEA), the energy entity of the Organization for Economic Co-operation and Development (OECD), published a monthly report on oil markets available to the public. The U.S. Energy Information Administration and the Organization of the Petroleum Exporting Countries (OPEC) also published monthly reports on oil markets as well as some banks and consultants. Enalytica chose to

review the IEA report because it was the most widely read oil market report. In terms of representing a consensus, he felt IEA's report was the best to review. He explained that the green line on the chart showed IEA's forecast for growth in oil demand and how it changed over time. He detailed that in January 2014 and February 2014 IEA said that the oil market would grow by 1.4 percent. In March 2014 IEA reported a growth in oil production of 1.5 percent. In April IEA reported a decrease to 1.4 percent. In May and June IEA predicted that growth would return to 1.5 percent. In the summer of 2014 there was a sudden and drastic reduction to .7 percent growth in oil production. He reported that IEA's expectation for 2015 was similar. In the middle of 2014 IEA predicted that the growth in oil production would be about 1.5 percent. Six months later, IEA reduced its estimate to 1.0 percent. He maintained that there were several reasons for the change, some had to do with the global economy. A reduction in growth from 1.5 percent to 1.0 percent equated to a decrement of about 900 thousand barrels of oil. He continued that removing half a percentage point of growth in 2015 equated to another reduction of 450 thousand barrels of oil. He summarized that supply suddenly grew by 1.6 million barrels while demand dropped by 1.4 million barrels per day of demand expectation for the following one and a half to two years. He concluded that the crash in oil prices was due to changes in supply and demand and questioned why OPEC did not step in to stabilize prices.

Co-Chair Thompson announced that Representative Guttenberg had joined the meeting.

[9:14:49 AM](#)

Mr. Tsafos slide 3: "Oil in 2015: Role of OPEC." He reported that OPEC met in November 2014 and decided not to take any action removing an OPEC-enforced floor. As a result, the analysis of the oil market changed.

Mr. Tsafos wanted to present a history of OPEC in order to provide context. He pointed to the top graph on slide 3 which represented the market share of OPEC (OPEC production divided by global production). The bottom graph showed the quotas assigned to OPEC members. The Organization of the Petroleum Exporting Countries managed the market by setting a production quota for each member. He explained that a decrease in quotas represented an agreement to cut

production. Conversely, an increase in quotas signified an agreement to increase production. He pointed out the different colors on the chart identifying the parties that agreed to the quotas. He highlighted that green represented all of OPEC and that the agreement to the quota was an exception rather than the rule. He elaborated that sometimes Iran, Iraq and Kuwait (as in 1990 when the two countries were at war), Iraq and Iran, or Iraq and other countries were excluded.

Co-Chair Thompson announced Representative Wilson's arrival to the meeting.

Vice-Chair Saddler asked what "ex" stood for in the legend at the bottom of the chart. Mr. Tsafos clarified that "ex" meant except.

[9:17:54 AM](#)

Mr. Tsafos continued by noting the shades of grey on both charts on slide 3. He explained that the shades identified three broad OPEC behaviors. He reported that OPEC was formed in 1960 but did not institute quotas until 1982 which explained why the chart on the bottom covered a shorter period of time than the chart on the top. Until 1982, OPEC had other ways of attempting to manage the market. There was a period of time beginning in about 1970 when OPEC tried to set oil prices artificially high, especially after the Arab embargo of 1973. The chief way of setting prices high was to cut production and the way to keep production high was to ration supply. Since OPEC wanted to keep prices high it had to cut its own production. In OPEC's efforts to keep the market artificially high, more production entered the market including that of Alaska. Once the market share went from about 50 percent to about 30 percent producers started getting upset. In 1986, Saudi Arabia retorted by producing more which resulted in the oil price crash in 1986.

Mr. Tsafos continued to outline OPEC's history. He specified that from 1986 to the late 1990s OPEC followed the market. He detailed that oil was a long-term business; it took a long time to discover oil, plan the oil development, and actually develop the oil. Long-term businesses typically lead to cycles. The chief role for OPEC, because it had spare capacity, was to convert a long-term cyclical business into a short-term, less cyclical

business. He reported that the reason OPEC had significant spare capacity was because so much of it was built in the 1950s, 1960s, and 1970s prior to the nationalization of the oil industry in OPEC countries and due to the decline in production in the 1980s. He referred back to the top chart that showed the "follow market" period where OPEC's market share recovered. The same trend was seen in the market quotas where quotas continued to increase until they reached a stabilization point, effectively producing more to keep the market stable. He continued that the following phase in OPEC behavior was stabilization, an effort to actively manage the market.

9:22:02 AM

Mr. Tsafos directed attention to the lower chart pointing to April 1998 where the green line rose. He explained that a meeting occurred where OPEC decided to increase production just as the Asian financial crisis started which led to the following price crash. Oil Producing and Exporting Countries (OPEC) quickly realized its mistake and responded by cutting back on production. Eventually, OPEC decided to halt changing quotas each month.

Mr. Tsafos informed the committee that OPEC increased supply as needed to stabilize and follow the market from 2002 to the present financial crisis. In 2008 a financial crisis followed; Lehman Brothers closed in September and the price of oil dropped from \$147 per barrel to about \$40 per barrel in December. OPEC had successive cuts, as shown in the grey stabilization area on the lower chart, in which the blue line drops off then stabilizes as depicted in yellow. The production quota jumped one more time to approximately 30 million barrels per day and has remained the same. He suggested that OPEC did not control oil prices. Oil Producing and Exporting Countries took a huge hit to its market share when it succeeded in controlling market prices.

Mr. Tsafos summarized that OPEC tried to stabilize the oil market with a short-term disruption; one time it failed in the late 1980s, and another time it succeeded after the price crash in 2008. He continued that for a large part of its history, OPEC has been a follower of the market adding liquidity when needed. More recently, with significant new oil entering the market, OPEC allowed prices to drop to protect its own market share and surmised that the market

shares of active producers such as Texas and North Dakota would be damaged instead. However, he suggested that OPEC's logic was complicated because of the method in which oil was produced in the U.S.

[9:25:21 AM](#)

Mr. Tsafos advanced to slide 4: "Oil in 2015: US Lower 48." He indicated that the growth in U.S. Oil production created a fundamental shift in the oil market putting downward pressure on pricing. He also asserted that oil price forecasting became more difficult. He explained that prior to the U.S. discovery of tight oil the forecasting of oil pricing consisted of two exercises; the first was to identify, model, and monitor a group of projects to determine the marginal or the most expensive barrel of oil. For the previous 5 to 6 years the most expensive barrel of oil came from either Canadian oil sands or deep water production. He suggested that if the floor for a project was set at \$70, \$80, or \$90 and prices went below the floor, producers would not continue to invest resulting in less supply and higher prices. He continued to explain that modeling projects in these areas made it easy to determine the marginal barrel price within just a few weeks. He stated that it was very easy to determine whether the projects were moving forward.

Mr. Tsafos reported that the second exercise in oil forecasting was to determine the breakeven price of countries. It was important to know what a country needed to balance its budget or to balance its trade accounts. The logic was that if prices went below the breakeven point for a country, the country would step in to stop any losses. He opined that it was not difficult to determine the breakeven price for a country. The needed figures could be determined by taking the expenses and the production amount and multiplying those by the price.

[9:28:35 AM](#)

Mr. Tsafos relayed that when the U.S. entered the oil market it complicated it in three ways. He referred to the three words on slide 4; scalable, diffuse, and variable. He first addressed the word "scalable" citing the example of the Eagle Ford Shale Development. In about 2010 the development went from producing almost 0 to 1.5 million barrels of oil per day, a rare occurrence. In the history

of the oil market such an increase in production has happened twice outside of the U.S.; in Libya and in the North Sea of the United Kingdom. It also occurred in Alaska. He pointed out that it had occurred in two other areas in the U.S. including the Permian Basin Oil Field in Texas and in the Bakken Oil Field in North Dakota. In both cases the production did not start from zero like the Eagle Ford field, but the magnitude of growth was 1 million barrels of oil per day over a period of 2 to 3 years. He explained that in conventional oil adding 1.5 million barrels of oil per year took a much longer period of time. It also demonstrated how quickly the U.S. producing system could respond to high prices. Prices increased and producers responded by redeploying capital and resources, such as oil rigs and people, and drilling fervently. Significant production resulted. He reminded committee members that the chief benefit of OPEC for the oil market was to turn a long-term business into a short-term business. A business that decided to drill one day, began drilling within a month, and produced oil within the following 6 to 9 months was an example of a short-term business. Drilling could continue as long as the price remained attractive making production scalable.

Mr. Tsafos moved on to address the next item that he believed made forecasting the most difficult, "diffuse." He cited that there were three producers that produced the majority of oil in Alaska. There was also a hand full of smaller companies that were either producing small quantities or exploring in Alaska. Therefore, there were about 6 or 7 companies that determined what was going to happen in Alaska. He suggested that producers could cut back production, increase expenditures, or decrease expenditures.

[9:31:48 AM](#)

Mr. Tsafos continued by relaying that in Texas, two-thirds of the oil production was produced by 32 companies. Several other companies made up the difference in oil production in the state. Other places such as North Dakota had different competitive landscapes. In trying to determine what British Petroleum (BP), Conoco Phillips, and Exxon Mobile might do, there was a basic framework in considering each of these companies. However, there were oil companies such as the 32 in Texas that had to be considered. He observed that some companies had to repay debt and were more concerned with

going bankrupt than yielding a certain percentage of return on investment. Some companies were obligated to drill to avoid losing acreage. There were others that potentially hedged 50 percent to 60 percent of their output for the following 1 to 1.5 years. He purported that what made forecasting difficult was that the production profile was the result of many different players with different incentives, diverse financial capabilities, varying ambitions, and different constraints. He surmised that making sense of the oil production system was significantly more difficult. Not only was it more complicated for an analyst, it was also more difficult for a country such as Saudi Arabia. He explained that it was much harder to determine a country's breakeven price. He also speculated that a company might have to reevaluate its breakeven price more frequently because of the quickly changing market.

Mr. Tsafos discussed variability, the third and least understood factor that contributed to the challenge of forecasting. He stated that no two wells were alike surmising that one well could be vastly more productive than another. He mentioned a factor of 30. He expounded that two wells located side-by-side could have very different breakeven prices. For example, one could have a breakeven price of \$20 per barrel and the other with a breakeven price of \$130 per barrel. In some instances variability was due to geology. A company might reduce its investment and drilling activity due to the difference in variability. He maintained that variability accounted for what happened with gas. He reported that after Lehman Brothers filed for bankruptcy the price of gas collapsed from \$13 to about \$4 in the Lower 48. He reported that the rig count, a proxy for the amount of drilling taking place, was reduced by 50 percent due to a lack of drilling funds while production remained flat. He pointed out that there might be a 50 percent reduction in activity without impacting production due to significant variability. He speculated that reducing the activity of 30 bad wells might be equal to reducing or stopping the activity of 1 good well. The reason this mattered was because, although prices might be declining and producers might be short on funding for capital expenditures, producers could substantially reduce activity before greatly impacting production.

[9:35:50 AM](#)

Mr. Tsafos asserted that one of the things he paid attention to when evaluating a system was the number of players, financial objectives, and financial constraints. He relayed that three years prior the price of natural gas declined. At the time the general view was that the breakeven price for gas in the U.S. was about \$4. There was a build-up of concern when prices dropped below \$4. The price went to \$4 then to \$3.50 at which point it was thought that \$3.50 was the breakeven price. As the price continued to drop so did the breakeven price. The true breakeven price was about \$1.50 at which time cuts started being implemented. Trying to make sense of the market became even more difficult with so many people and factors involved. He reported that currently there was a process of price discovery. He indicated that Saudi Arabia was trying to figure out the breakeven price of oil. The country had two choices; it could dictate the price such as \$50, \$60, \$70, or \$80 and see how supply and demand reacted, or it could step back to see where the price settled. He wanted to provide an understanding about how the state got to where it was presently, why prices collapsed, and why the market was becoming truly uncertain and potentially volatile. He contended that in the past there were many assumptions consultants used to interpret the market that were no longer applicable. He summarized his portion of the presentation by saying that he understood even less than previously about the oil prices.

[9:39:05 AM](#)

Representative Guttenberg commented that Enalytica was not the first consultant to admit to not knowing what would happen to oil prices.

Vice-Chair Saddler asked if there had been any structural changes in the world energy market that would affect the price of oil.

Mr. Tsafos replied that, in the grand scheme of things, there had been a general substitution away from oil towards other fuels. In the U.S., oil made up a smaller percentage of energy use in America following World War II. He attributed the change to switching from oil to something else. There were still parts of the Northeast that used oil for residential and commercial use. He also reported some use in the power sector and in industry. He conveyed that there was also shifting in the transportation system,

mostly in the U.S. towards biofuels. He also claimed a broad improvement in efficiency, chiefly in car mileage. In reviewing the history of miles per gallon in the U.S. the number had decreased for a period of time indicating that cars were becoming less efficient. He relayed that with the first oil embargo in 1973 a huge shift occurred [in car mileage efficiency] jumping up for about 15 years then leveling off. Over the past 5 to 10 years there were a number of increases. Since 2005 or 2006 there were some behavioral changes in American consumers in which vehicle ownership decreased partly because in urban areas having a car was less useful. Also, consumers responded to increased fuel prices. He noted that in the U.S. market as vehicle ownership went down motorcycle ownership went up in similar numbers. He commented that although there were changes in consumer behavior, he was unclear whether the drop in prices would reverse behavior.

Mr. Tsafos illuminated that Europe was further ahead than the U.S. in terms of efficiencies, partly because of very high taxation of gasoline. The reversal of behavioral trends was more challenging because price differences were not as striking as in the U.S. In looking at the rest of the world the price the consumer paid at the pump was determined more by policy and regulation than by global markets. He highlighted that the consumer in Saudi Arabia was not seeing much of a difference in the price at the pump because the price is not determined with the price of crude oil and global markets. He pointed out that there was a large amount of consumption in the world in which the price was not changing. A drop in the price of oil would not necessarily lead to a change in consumption or consumption behavior.

[9:44:33 AM](#)

Mr. Tsafos conveyed that in short periods of time the amount of switching from oil to natural gas use was limited. For example, if a person lived in Anchorage and had natural gas in the home it would be unlikely that they would check the price of oil and gas to determine whether to heat their home with gas or oil, switching back and forth. However, industrial users did switch back and forth. He suggested that the amount of short-term switching back and forth was limited. As a result of the price differentials, there will be a small amount of demand pick-up for consumers that had the ability to switch. The real

question was whether the price drop be sustained. If the price drop remained at \$50 per barrel of oil for the following 5 years consumers would make different decisions. He provided examples of choices that might be considered.

Representative Gara commented that Mr. Tsafos had addressed the percentage of oil in comparison to other energy sources. He understood that one of the factors affecting price was demand. He asked about the current U.S. demand for oil. He wanted to know if the demand for oil had gone down or remained stable. Mr. Tsafos responded that in the U.S. demand had decreased primarily due to substitution of oil with other things rather than consuming less energy. He cited that approximately 80 percent of the drop in demand was because of fuel substitution while the remaining 20 percent was due to a decrease in energy use. The world continued to grow.

Representative Gara clarified that it was the worldwide demand for oil that continued to grow. Mr. Tsafos responded affirmatively. He added that OECD demand had peaked and was in decline. The growth stemmed from non-OECD countries.

Co-Chair Thompson asked if demand would begin to climb due to the drastic reduction in the price of gasoline. Mr. Tsafos responded that a brief uptick was possible. However, he offered that the uptick would be limited because of the change in technology. He explained that if a consumer decided to drive twice as much because gasoline was cheaper, that decision would have less of an impact on demand because cars were more efficient than five years prior. A person might have a change in behavior but technology would limit how much that behavior translated into demand growth.

Representative Pruitt commented that Mr. Tsafos had helped him understand why reports about the oil industry varied so much. He surmised that most people did not understand. He asked about the conventional wisdom concerning how much of the market share Saudi Arabia had to have before it would be willing to adjust its current strategy.

[9:48:57 AM](#)

Mr. Tsafos responded that if he was Saudi Arabia he would be looking at three things. First, he would be looking at the trajectory of U.S. oil production. He referred to the

red line on slide 4. He indicated that he would be paying attention each month to whether the market in the U.S. was stable, growing, or dropping.

Mr. Tsafos highlighted that he would also be looking at investment decisions regarding new conventional oil. Investments in deep water, the Gulf of Mexico, Brazil, or unconventional oil in Canada were important to be watching. For instance, if companies were canceling plans or delaying investments he would know that the current prices were lower than what companies needed to incentivize production.

Mr. Tsafos reported that the third item that he would be paying attention to was the broad spending patterns by companies. He would observe how much companies were cutting back on capital expenditures. He would have a better sense of how much people were buying, whether the prices were stable, and whether there was a level of comfort. He concluded that in observing the three items he would have a better sense of how the future supply of oil would be impacted. He mentioned that there were many other things he would also be looking at that he would not be covering in his presentation. Broadly speaking, he wanted to know if new supply was being held back. The clearest indication would be the U.S., the investment in new mega projects, and generally how much the industry was spending to develop new oil.

Representative Edgmon discussed natural gas pricing. He relayed that he understood natural gas pricing had not moved in tandem with worldwide oil prices but that someday it might have spot market prices or better correlate with the price of oil. He asked how long-term contracts would be affected for the building of a very large pipeline. He wanted to know what he should take from Mr. Tsafos' commentary in terms of the behavior of big companies and some small companies to build a mega project tied around long-term prices of liquefied natural gas. (LNG).

[9:52:40 AM](#)

Mr. Tsafos responded that Alaska was fortunate that its partners were large companies with deep pockets. He reported that the pre-feed phase of the AKLNG project would cost approximately \$500 million, and the FEED phase would cost between \$.5 billion and \$2 billion. He speculated that it was important to have sound partners that could afford

to invest in a viable project during a time when prices were falling and cuts were being made.

Mr. Tsafos highlighted that Alaska's partners were well aware that the business of natural gas was a commodity business. He offered that it was important to know whether money could be made over a 20-year to 25-year period and to determine the boundary of possible outcomes. The result of the current price drop had widened the range of outcomes. He used the example of the previous price of oil being \$80 to \$120 per barrel of oil versus \$50 to \$120 per barrel of oil. The price difference impacted the AKLNG project adversely. Currently, he noted that the project had a price tag of \$45 billion to \$65 billion. He concluded that if the cost of the project was \$65 billion and the price of oil was \$50 per barrel, the project would be very difficult and would make cost containment a large priority. It would also make managing and mitigating other risks, such as property taxes and fiscal systems, very important. He stated that in the current environment, the price drop had been too brief to completely reshape expectations. He believed that the price had overshot downward but anticipated it would rise again. He did not think anyone was panicking about the viability of the project at present.

Mr. Tsafos emphasized that how gas was sold in the global market and what kind of price exposure and volatility the state was willing to take were important considerations. One of the questions that was previously considered was whether the state wanted the price of natural gas tied to the price of oil like it had been historically in Asia or priced differently such as the Henry Hub price. In other words, he recommended that the state consider whether it wanted all of its income to be tied to the price of oil or subject to two different price systems and volatilities.

Mr. Mayer added that if everything with the AKLNG project went as planned, producing its first barrel of LNG for sale to buyers in Asia in 2024 or 2025, it would earn its return on investment between 2025 and 2045. He asserted that he was not concerned with the current price of oil or the price of oil in two years when considering the economic fundamentals of the project or its viability. He was looking at whether the capital invested in the project would be repaid over the span of time between 2025 and 2045.

[9:57:15 AM](#)

Mr. Mayer reviewed slide 5: "Tax Credits and SB 21: Two Types of Credits." The second part of the presentation focused on how the low price environment was effecting state finances, how much tax revenue was being generated, and what the state was spending on tax credits. He highlighted two numbers he would be discussing; the first was the total production tax revenue that the state received from the production tax system estimated to be about \$524 million, and the forecast amount of tax credits estimated to be \$625 million. He relayed that the point had been made that it was concerning that the amount of tax credits was larger than the amount of tax revenues. Through the overall production tax system the state was spending rather than receiving income. He offered that his presentation would look in detail at causes, concerns, fundamental problems, and how to address any problems.

Mr. Meyer clarified that he was currently only discussing the production tax system, one component of the State of Alaska's fiscal system. The state also generated revenue from oil and gas production, royalties, corporate income taxes, property taxes, and a range of other things. He estimated that the forecast for FY 15 was \$2.5 billion in total revenues from the oil and gas fiscal system, \$2.0 billion of which was in unrestricted revenue (\$1 billion from royalties, \$.5 billion from the production tax, and the remainder from other components of the system).

Mr. Mayer indicated that the core of the presentation would focus on analyzing the difference between the production tax revenues of \$524 million and the tax credits of \$625 million and whether the enactment of SB 21 [legislation passed in 2013 establishing the current oil and gas tax structure] was the reason for the decrement.

[10:01:04 AM](#)

Representative Gara wanted to clarify a term. He asked if Mr. Mayer was talking about credits in which the state reimbursed a portion of a company's spending. He noted that the tax rate changed with the price of oil. He relayed that some people called it a credit but had nothing to do with spending.

Co-Chair Thompson suggested that Mr. Mayer would be addressing the topic as part of his presentation.

Representative Gara interjected that he wanted to know what credit Mr. Mayer was talking about.

Mr. Mayer began with the first question whether the state was subsidizing companies through its tax system to produce its oil. He distinguished that there were two flows of money and indicated they were shown on the chart on slide 5. He explained that there were two categories of credits. The first type of credit was claimed by companies that had a tax liability that reduced the amount of tax paid. The second type of credit was claimed by companies that did not have any tax liability and that were allowed to be reimbursed in cash by the state. He furthered that the two types of companies were very different. He explained that companies with tax liability tended to be the companies such as BP, Exxon Mobile, and Conoco Phillips that had significant production from existing established assets and generated significant revenue from those assets. Companies that did not have a liability tended to be smaller producers, companies that did not have current production but were currently investing while making a cash loss.

Mr. Mayer offered that the numbers in the first three lines of the chart reflected companies in the first category that had a tax liability. He acknowledged that, overwhelmingly, the credits taken against a company's tax liability were credits that were a fundamental part of the tax system. He provided an example. He suggested that if just the 35 percent tax rate currently in statute was applied to current production figures the state would receive approximately \$1.2 billion in revenue. After applying the tax credit of \$1 per barrel, integral to the tax system, the revenue decreased by \$750 million to a total revenue of \$523 million. He suggested that it was better to think of the \$1 per barrel tax credit as a fundamental component of the tax system and that it did exactly what progressivity did under Alaska's Clear and Equitable Share (ACES). Alaska's Clear and Equitable Share (ACES) went from a 25 percent tax rate and escalated at higher prices. Similarly, under the current structure the tax credit started from the top at a 35 percent tax rate and decreased at lower prices. The way in which it was reduced was through the \$1 per barrel credit. He reiterated that the tax credit was a fundamental part of the tax system currently in place.

Mr. Mayer attributed the state's reduced oil revenue, primarily, to lower oil prices. He emphasized that there was a positive revenue flow particularly from the large oil producers. He mentioned that there was also \$1 billion or more dollars in state revenues, royalties, and other sources.

Mr. Mayer moved on to discuss a separate flow of cash. He spoke of cash that the state paid out from its coffers for credits purchased from small producers that did not have a tax liability. He reported that the credits for potential purchase in FY 15 equaled \$625 million. He revealed that about 50 percent of the credits were from Cook Inlet and the other 50 percent were from the North Slope. He furthered that the credits going out were for companies that did not have a tax liability but were developing and were essentially cash negative at present. He indicated that he would be discussing the reasons for the credits in greater detail. He wanted to clarify that there were two fundamentally different sets of flows. The state was receiving substantial revenue from the major producing companies. He surmised that the question was how the first flow compared to the entirely separate outflow to companies without a tax liability. The current tax system provided credits to incentivize new development of new resources on the North Slope and in Cook Inlet.

[10:06:57 AM](#)

Mr. Mayer continued to slide 6: "Tax Credits and SB 21: Positive Impact of SB 21 on Revenues." He explained that the chart showed a comparison between SB 21 and ACES. The purpose for the contrast was to identify whether what the legislature did with the implementation of SB 21 made things fiscally worse for the state. He believed it was important to understand how the current tax system was calculated versus how it was calculated under ACES. He relayed that in reviewing both tax systems he was using the current scenario of low oil prices and high investment. He asserted that revenue was not reduced as a result of SB 21. He highlighted that revenue was significantly increased under SB 21's tax structure. He elaborated that the intent of SB 21 was to strike a balance between reducing the state's take at high prices and better protecting itself at low prices.

Mr. Mayer conveyed that the basic way in which SB 21 equalized the tax system was by taking a 4 percent gross floor, a minimum tax level that had to be paid. In times of high investment and low oil prices the state compared what the profit-based tax generated versus what the state generated simply by taking 4 percent of the gross value at the point of production. If the 4 percent number was higher, that became the tax rate. The calculation existed in both the ACES tax system and from that in SB 21. He noted one significant difference between ACES and SB 21. He purported that under ACES the state calculated the 4 percent minimum then applied a 20 percent credit for a company's capital spending. Although a company could not go below zero it could accrue a liability for future years. Under SB 21 the capital credit was removed and was partially replaced with a fixed per barrel credit which effectively provided a progressive mechanism in the overall system. It reduced a company's tax rate as prices fell but only down to a certain level. In other words, the \$1 per barrel credit could not take a company below the 4 percent per barrel floor. He summarized that the 4 percent floor went from being something abstract, ineffective, and non-binding to being a hard floor in most circumstances. He concluded that the current tax system generated much more revenue than the ACES tax system would have generated under the same circumstances. He relayed that the current tax system generated approximately \$600 million in revenue from the North Slope based on the Department of Revenue Source Book. He mentioned that Enalytica's estimates (represented in grey) were numbers reflecting the ACES methodology. The numbers generated a little over \$200 million, a substantially lower dollar amount due to capital credits in ACES.

Mr. Mayer moved on to discuss the numbers for FY 16. The Department of Revenue forecast numbers remained high and the department forecasted even lower prices than in FY 15. The total North Slope revenues for FY 16 were estimated at \$286 million under SB 21. Under ACES there was no tax revenue in FY 16 and there would be a liability against future tax years of \$242 million. In answer to his question about whether SB 21 made the state's fiscal system worse, he responded, "No." He stressed that SB 21 improved the state's circumstances by protecting its bottom line.

[10:13:11 AM](#)

Representative Gara referred to Mr. Mayer's statement about the negative ACES revenue in FY 16. He asked him to confirm that the number could not go below zero. Mr. Mayer responded that the negative number would be a liability being carried forward into the following year.

Representative Gara referred to the \$286 million from SB 21. He commented that according to the state's most recent forecast it was receiving negative revenue in FY 16. He reiterated that in the most recent forecast the state would be receiving negative revenue from SB 21 in FY 15 and FY 16 and that the state would cap down at zero under ACES. He wanted to know why the information was not a part of the chart.

Mr. Mayer responded emphatically there was not a forecast of negative revenue in FY 15 and FY 16. He clarified that what Representative Gara was referring to was a comparison seen on the previous slide of revenue being \$523 million in FY 15 and \$308 million in FY 16. He continued that the numbers were slightly different because they were statewide and individual tax payer versus North Slope. He pointed to the revenue line [Production Tax Revenue] on slide 5 and the line on spending on other credits to smaller producers [Credits for Potential Purchase]. He explained that the tax system accounted for revenues and expenditures. He agreed that it should be a source of concern to anyone if expenditures were greater than revenues. However, the comparison was an even comparison between the two tax systems looking just at the revenue line [Secretary's note: unable to decipher what lines Mr. Mayer was referring to].

Representative Gara stated that the state was taking in less money than it was paying out. He said it was negative. He continued that ACES would bottom out at zero and carry the loss forward. He stated that under SB 21 the state was paying out more money than it was collecting. He did not understand how the number could be positive when the state was paying out more money.

Mr. Mayer maintained the importance of really understanding the numbers. He discussed the number on the second line [slide 2: Credit Used Against Tax Liability] that he indicated drove the idea of a net negative which included expenditures. The numbers on line 2 were derived from credits that existed for the previous several years and were applicable in either tax system. The comparison he

referred to was just on the revenue side of the equation. He clarified that the Department of Revenue accounted for revenue and tax spending. There were two flows; one inflow from tax payers and one outflow to companies without a tax liability. He asserted that the outflows had been embedded into the system for some time. He suggested that the line of outflow would be very similar in both circumstances. The comparison he was referring to was just looking at the inflows. He agreed that the net of credits, just looking at a North Slope analysis, would be negative. However, he asserted that the other would be more strongly negative because of starting from a base then paying out additional credits.

[10:16:56 AM](#)

Co-Chair Thompson asked Mr. Mayer if slide 6 reflected production. He wanted to know if he was correct in assuming that slide 5 had nothing to do with production. He asked for additional clarification.

Mr. Mayer agreed with Co-Chair Thompson and added that some of the credits were for exploration but the bulk of them were for development of newly discovered resources. He restated that the net credit balance was due to flows to two very different types of companies and were accounted for by the state in two different ways; the large producers were counted on the revenue side and the small producers on the spending side. The comparison was between the production tax revenue and then looking at the subsequent page [slide 6]. The credits for potential purchase applied to a different type of company and were part of a different flow.

Mr. Tsafos suggested taking the 625 number [slide 5] and minus 20 or minus 50. He relayed that in the present case the number would be 224 minus 625 bringing the number to minus 400. He continued to explain that the basic idea was that the number would be either minus 100 or minus 400 [Mr. Tsafos used slides 5 and 6 as references].

Representative Pruitt wondered if SB 21 only applied to the North Slope. He continued to phrase his question. He wanted to confirm that when discussing total credits the payout for Cook Inlet was included. He suggested that the state had a credit-heavy incentive program for investing in Cook Inlet. He believed that legislators had to take very

different approaches to two distinct basins when looking at how they impact the overall state budget and how credits were applied.

Mr. Mayer affirmed that Representative Pruitt was correct. He elaborated that of the \$625 million in FY 15 in credits for potential purchase about \$300 million went to Cook Inlet and the remainder went to the North Slope. He pointed out that in both cases credits went to small producers bringing new production online. He relayed that on the North Slope the investment was in future tax revenue. Whereas, in Cook Inlet the investment was a pure subsidy for producers because of the tax regime being very different.

Vice-Chair Saddler suggested hearing the remainder of the presentation.

[10:20:34 AM](#)

Representative Guttenberg understood that the state gave credits to encourage behavior. He was in favor of encouraging exploration, development, and production. He suggested that at times a negative number was not a problem depending on the forecast. He remembered that during the oil tax debate it was difficult to compare one set of behavior of one regime to another. He elaborated that, in terms of analysis, one regime filed under one tax structure and the other regime filed under a different tax structure. He wanted the forms to be significantly the same for the purpose of making comparisons. He mentioned that the backlog of audits was an additional barrier. He asked Mr. Mayer to comment on the difficulty of comparing both systems. Mr. Mayer asked if he was talking about comparing the revenue that came from both systems or comparing the investment and future production that came from both systems.

Representative Guttenberg proposed leaving the future production and the credits out of the question. He expressed the difficulty he was having in determining what method was best for the state. He wanted to know what was working and what was not working for the state. He reiterated that, in the discussions and debates he participated in, it was difficult to make comparisons based on the different filing types. He was just referring to

per-barrel production and taxes. He wanted to feel more confident about the numbers being presented.

10:23:07 AM

Mr. Mayer stated that he would be referring to the numbers listed in the back of Department of Revenue's Revenue Source Book where DOR explained, in a general way, how the tax system worked. Department of Revenue used a hypothetical scenario in which the tax revenue from the system came from one monolithic tax payer rather than a variety of different tax payers which might attribute to slight distortions in the analysis. However, it provided a good high-level understanding of how the tax system worked without getting into confidential tax payer information. The tax calculations were based on a certain set of assumptions such as price and investment forecasts from DOR. He expounded that if higher prices were used and investments were lower, the numbers would be significantly different. The resulting income would be much higher under ACES and much lower under SB 21. The basic idea behind SB 21 was that in times of high prices and low investment the state would take a more even share of the profits rather than the lion's share. In times of high investment and low prices the state was better protected. There were many different views about the different tax systems. He recapped that ACES was a good fiscal system in times of high oil prices and low investment because of the resulting cash revenue. It was also a tax structure that would lead to years of red ink at times of low oil prices and high investment. He suggested that in terms of other credits the state was starting at a higher floor because in the current circumstance the SB 21 tax system generated more revenue.

10:26:09 AM

Representative Wilson referred to the prior slide. She asked if it would be advantageous to introduce legislation in which the state would be obligated to purchase credits only if it generated an equal amount of revenue. Mr. Mayer commented that her question might be addressed further in his presentation. He reported that previous slides discussed the revenue side of the equation. The following few slides would address the credit side of the equation.

Mr. Mayer continued to slide 7: "Tax Credits and SB 21: Positive Impact of SB 21 on Revenues." The chart showed

credits used against tax liability versus credits for purchase by the state paid to small producers. The figures listed were from DOR. He pointed out that the yellow line [Credits Used Against Tax Liability] fell dramatically in FY 15 and FY 16. The decrease represented the impact of the 4 percent binding floor. At low oil prices and high investment the state would be paying out significantly more without the hard floor. He referred back to the example on the previous slide. He suggested taking the total tax before credits of \$1.3 billion and multiplying it by \$8 per barrel to total \$1.2 billion under Aces. Under SB 21 the state would only be paying \$720 million because of the 4 percent floor that was in place. He continued to explain that as oil prices fell the 4 percent floor kicked in and reduced the amount of credits. He suggested that the credit was significantly less than \$8 per barrel due to the floor. The line was decreasing because prices were low and there was a hard 4 percent floor. The line rose again in FY 17 because DOR's forecast was based on oil prices in the \$100 per barrel range.

He drew attention to the green line on slide 7 that showed a rise in credits for purchase by the state. He reported that they were fundamentally capital credits, either capital credits in the past under ACES, ongoing capital credits in Cook Inlet, or net operating loss credits. The credits were, effectively, state support for exploration and development by small producers on the North Slope or in Cook Inlet. He reported that more investment was being made by small companies in the two basins which attributed to the incline in the number of credits for purchase by the state.

[10:29:24 AM](#)

Mr. Mayer advanced to slide 8: "Tax Credits and SB 21: Credit Eliminations and Transitional Arrangements." He asserted that the previous slides addressed revenues and the following set of slides addressed credits being paid out to small companies without a tax liability. He intended to look at other changes resulting from SB 21 legislation and would be discussing whether the state needed to be concerned with increasing credits. He reported that SB 21 attempted to limit credits in several ways although those were not currently in effect. He elaborated that in the previous tax regime there was an alternative credit for exploration, a Frontier Basin credit, and a small producer

credit. In FY 14 these credits collectively cost the state approximately \$113 million. The tax system resulting from SB 21 legislation retained the sunset date of 2016 previously established in ACES. The small producer credit was limited to a period of 7 years after initial production. Another notable provision of SB 21 reduced government support for spending overall. Under ACES, a tax payer with a liability, based on progressivity combined with credits, received up to 80 percent support for government spending. A small producer without a tax liability claiming credits, received 45 percent support for government spending under the same tax system. The 45 percent credit was comprised of a capital credit of 20 percent and a net operating credit of 25 percent. Under ACES, the government would have effectively spent \$.45 for every dollar spent on new development to bring online for production. Under SB 21, the tax rate and the net operating loss credit were both 35 percent. This made the job of an underwriter easier; a large producer could reduce its tax liability by 35 percent by spending money and writing it off of taxes, and a small producer without a tax liability could do the same thing by getting the 35 percent back in cash from the state treasury. In making the change it reduced the total level of support for government spending 35 percent. Senate Bill 21 also provided a window of cushion for small producers by supporting spending at a 45 percent level until January 2016.

[10:33:23 AM](#)

Mr. Mayer slide 9: "Cook Inlet Credits." He indicated that SB 21 did not make any changes to the tax structure as it applied to the Cook Inlet basin. He added that of the \$625 million in total credits being paid out to small producers without a tax liability, about \$300 million was paid to Cook Inlet producers in FY 15. He continued that unlike North Slope producers, producers in Cook Inlet did not pay a profit-based production tax. Instead, they paid a low-fixed rate tax on gas similar to the Economic Limit Factor (ELF) system, paid virtually no taxes on oil, and had some concession royalty arrangements. He confirmed that all of the tax credits under ACES carried forward in SB 21 along with some additional special tax credits. The special tax credits included a 40 percent credit on capital spending on wells beyond the 20 percent capital credit and 25 percent carry forward loss credit under ACES. He pointed out that there was a very large government subsidy for small

producers. He purported that the subsidy for Cook Inlet producers for capital expenditures was close to 50 percent based on total capital spending and the total number of credits in the basin. He relayed that Cook Inlet production provided gas to Southcentral Alaska and that there had been a substantial turn-around in what was the decline of Cook Inlet, most likely, due to some of the credits. He opined that the state should do a full cost benefit analysis in the future that examined other ways to achieve the same benefit at a lower cost to the state. He specified that Alaska's Oil and Gas Competitiveness Review Board was scheduled to provide recommendations on the future of the Cook Inlet tax system in January 2017. He cited that the special treatment of the basin expired in 2022. He furthered that half of the credit outflow of \$600 million or more in FY 15 went to Cook Inlet. He suggested that it was not unlike the North Slope in investment in future tax revenue from the tax system, it was a subsidy for producers because of the state's concern about having more Cook Inlet gas.

Mr. Mayer scrolled to slide 10: "Conclusions." He recounted that there had been an oil price drop as a result of excess supply because of increased output in the Lower 48, reduced outages from places such as Libya and Syria, bearish demand, and Oil Producing and Exporting Countries (OPEC) acknowledging reality. He added that large producers were paying hefty sums, but in the current low-oil-price environment they were not enough to offset the credits paid to small producers on the North Slope and in Cook Inlet. He pointed out that SB 21 placed a more secure floor on state revenues in the current environment of low prices and high investment. The legislation also eliminated a number of credits. He suggested that the Cook Inlet tax system needed to be reevaluated in the future.

[10:37:43 AM](#)

Representative Munoz asked whether the ACES credits would be completely purchased by FY 16. Mr. Mayer responded that there were no additional ACES capital credits. The credits stopped when the ACES tax system was replaced by SB 21's regime. He conveyed that there was an inflated level of net operating loss or carried-forward annual loss credits in early 2016. He also reported carry-over credits such as the small producer tax credit and the Frontier Basin credit that were scheduled to stop in early 2016. He mentioned

that there was one exception having to do with the small producer tax. If a producer generated less than 50 thousand barrels of oil per day, their credit would be limited to a flat \$50 million credit against any tax liability and could be claimed for up to 7 years after they started initial production.

Representative Munoz asked if the combined 45 percent tax credit for the small producer lead to new production under ACES. Mr. Mayer responded that the small producer tax credit was introduced when ACES was targeting small producers to offset the prior system, the ELF system. He added that SB 21 also tried to provide benefits to small producers in other ways. He believed that the overall tax system had to be evaluated to determine what it did to incentivize investment.

Representative Munoz restated her question about whether the credits on the North Slope incentivized new oil production by small producers. Mr. Mayer explained that the larger credits more directly targeted new development, such as the capital credits and the net operating loss credits. The two credits together provided substantial state support to all companies including small producers. He asserted that the credits had a major impact in bringing in a number of projects that would not have been viable otherwise due to the capital constraints of a small producer. Implicitly the state was a silent partner. The state provided a credit up front and took in cash at the end, similar to bringing in a working interest partner. The credits fell from 45 percent to 35 percent under SB 21, the change being applied over a period of 2 years to allow for adjustment.

[10:41:58 AM](#)

Representative Munoz asked if the viable projects lead to new production. She asked for a yes or no answer. Mr. Mayer stated, "Absolutely, over the last several years we have seen a number of small producers bring online new projects in both the North Slope and the Cook Inlet." He added that he would have to review precise timelines in order to fully answer her questions. He asserted that he had seen a number of small projects come online.

Vice-Chair Saddler asked about the potential long-term effects on Alaskan oil production revenues if the North Slope tax credits were eliminated and everything else

remained the same. Mr. Mayer asked Vice-Chair Saddler to clarify whether he was talking specifically about the credits provided to small producers that did not have a tax liability or if he was also referring to the implicit credits within the tax system in the form of \$1 per barrel.

Vice-Chair Saddler replied, "The first, a good question." Mr. Mayer responded that particularly on the North Slope the credits were both an investment in future production and in future tax revenues. He emphasized that the credits existed to provide the same benefits to a small producer that did not have a tax liability as a large producer that did have a tax liability. For example, when a large producer with a tax liability spent \$1 billion, it was able to write-off that \$1 billion against taxes at a 35 percent tax rate. He concluded that 35 percent of the spending was essentially provided by the state through lower taxes. The 35 percent net loss credit provided the same benefit to the small producer. In both cases he suggested it was the basic idea of a profit-based tax system; the state was taking less money either through less taxes or through a cash outlay. The state was directly investing in both future production and future tax revenue. He stressed the importance of keeping the tax rate percentage equal. He added that the situation in Cook Inlet was somewhat different because there was no profit-based tax in place currently. The Cook Inlet credits were a direct subsidy. He detailed that there may be good reasons for a subsidy such as providing security of gas supply to Anchorage and to Southcentral Alaska. He identified a distinction between credit outlays as an investment in future production tax revenue (a question of timing of the flows) and direct subsidies that had nothing to do with future revenue and everything to do with securing gas supply.

[10:45:31 AM](#)

Representative Gara opined that much of the presentation was incredibly biased in favor of SB 21. He asked about the 4 percent floor. He wondered if the floor applied to any post 2002 production units. He also asked if a 4 percent floor applied to any of the fields such as Ooguruk, Nikaichuq, and Point Thomson, from 2002 forward and for any future fields. Mr. Mayer would have to verify the taxes. He stated that the only thing he could think of that applied specifically was the gross value reduction. He wondered if

the gross value reduction was what Representative Gara was referring to.

Representative Gara responded that for gross value reduction fields, which he purported had lower taxes, the 4 percent floor did not apply. Mr. Mayer informed the committee that he had not thought it through in detail because it was a small portion of the total tax.

Representative Gara interjected that it was a growing portion. Mr. Mayer believed that the fundamental distinction Representative Gara was trying to make was that the non-gross value reduction fields had a sliding \$0 to \$8 per barrel credit. He commented that because the credit inclined up to \$8 it needed to be limited on the downside. Each of the fields Representative Gara mentioned had a flat rate of \$5 per barrel. Depending on how the rate was applied, Representative Gara could be correct that the 4 percent minimum would not apply. He was unclear. He added that it did not make a substantial difference to the numbers but that Representative Gara's point was good.

Representative Gara commented that the impact would be larger in the future. He referred to slide 8 and suggested that there was a false comparison. He reread the list of small producer-focused credits that were scheduled to sunset in 2016. He argued that under ACES or SB 21 the legislature could review and extend the sunset in 2016. He insinuated that Mr. Mayer was making the assumption that the legislature would come back and erase the credits in 2016 because of the passing of SB 21. He also inferred that if ACES had remained the tax regime the legislature would have made the opposite decision. He did not think it was fair to lead committee members to think that there would have been a different result in 2016. He wanted to know why Mr. Mayer was making such an assumption.

Mr. Mayer responded that he had prefaced his remarks at the time by saying that SB 21 did not directly tackle the issue of reducing smaller producer-focused credits. The legislation left the sunset date intact and did not introduce any new language or provision to impose a new sunset. He relayed that it was a very conscious decision, after substantial discussion, to allow the credits to sunset as part of the new tax system.

Representative Gara commented that in 2016 when something sunset the legislature would review it under either tax system. Mr. Mayer responded that he hoped that a review would occur several years prior to 2016. He used the example of Cook Inlet where the credits sunset in 2022 and were scheduled to be reviewed in 2017. He inferred that the review of the tax credits happened when looking at SB 21.

Representative Gara responded that was not the way in which sunsets were reviewed in Alaska's legislature. He cited that review happened in the year of the sunset. He reiterated that he thought there was a false comparison. He remarked that there were legislators that thought SB 21 was a good system and there were legislators that thought making changes and improvements to ACES was a better idea. He emphasized that no legislators wanted ACES to remain the same. He contended that Enalytica was comparing SB 21 to a system that no one favored. He suggested making a comparison to a system proposed by others.

Mr. Mayer stated that at the start of his presentation he had prefaced that his purpose in presenting the numbers was not in any way to reopen the debate of SB 21 versus ACES. His aim was to examine whether SB 21 had had a negative impact on the state. He affirmed that it was important to go through the numbers to demonstrate how and why SB 21 had improved the state's situation. He did not set out to determine if it had been the best tax system, to look at alternatives, or to make comparisons. Instead, his goal was to answer the question as to whether the system had made things worse. He argued that the answer was "no".

[10:50:52 AM](#)

Representative Kawasaki referred to slide 6. He indicated that one of the selling points of SB 21 was that producers would increase investment and that under ACES producers would invest less in Alaska. He believed that all things were not the same. He agreed with Representative Gara that nobody was in favor of moving forward with ACES as the tax system. He commented that the investment amount under ACES should have been lower and there should have been a low investment category at times of low prices rather than what was reflected on the slide. He also referred to Representative Munoz's comment about the credits on the North Slope and whether they improved oil production. He mentioned the Indirect Expenditures Report generated by the

Legislative Finance Division. The report discussed the capital expenditures and whether they actually went to production. He also referred to Mr. Mayer's comments about upfront capital actually producing more oil in future years. He cited that in both the expenditure report and the independent audit that was conducted the credits did not produce the expected results. Instead, the companies used the investment such as maintenance, renewal, and renovation. He asked Mr. Mayer to comment.

Mr. Mayer responded to Representative Kawasaki' first point that the aim of the presentation was to show a side-by-side comparison. He did not want to impose a value judgement which was why he was presenting an equal comparison. He addressed Representative Kawasaki' question about capital credits and other credits that implicitly provided support for spending such as the net operating loss credit. He suggested that under the former system there was a wide range of means of government support for spending. He relayed that the highest government for spending under ACES was not only occurred through tax credits but also through the interaction of tax credits and progressivity. He reminded the committee that an existing producer did not receive an outflow of credits directly from the treasury. The biggest benefit came from being able to write off expenses against taxes. Under ACES a large producer could write off 80 percent of expenses, a very high level of government support for spending. He asserted that when examining the potential of a project the credits against tax liability provided significant support for spending on things that did not need to provide a stand-alone business case as to why a project was economic. He pointed out that the tax system encouraged financing from recurrent cash flow without the sanctioning of an investment committee. Under the previous tax regime the credits were an implicit part of a whole. The basic bargain of the system was high taxes upfront and high taxes at the end. The system worked particularly well for the small producer with capital constraints and finance concerns. The system did not help the large producer that did not want capital help upfront and measured things based on long-term cash flow.

[10:55:49 AM](#)

Representative Wilson wanted to discuss Cook Inlet. She remarked that she was tired of Fairbanks paying for all of the taxes on the North Slope. She asked about the subsidies

and whether they were being paid from the state treasury or coming out of a company's tax liability. Mr. Mayer indicated that the answer to her question was not clear cut. There was a small component of tax credits claimed against a very small liability. The bulk of credits were credits for potential purchase. He restated that of the \$625 million figure about \$300 million was being paid out to Cook Inlet producers.

Representative Wilson asked if there was any comparison between how the state was subsidizing Cook Inlet versus the North Slope. She was concerned with the amount of subsidy for Cook Inlet to produce gas and helping only one part of the state. She restated her question about a comparison and added that she wanted to know how much the state gained financially for the two basins. Mr. Mayer explained that it was difficult to perform an apples-to-apples comparison because the aims of the two basins were different. The aim of the North Slope was to spend money upfront as an investment in future tax revenue. The goal of the Cook Inlet was to spend money in order to incentivize more gas for Southcentral Alaska. He suggested that a really good cost benefit analysis of the credit system in Cook Inlet would provide better information than a comparison between the two basins. The analysis would also provide a picture of what things might look like without a credit system in Cook Inlet and to identify other means of creating that benefit. He provided the example of debt financing. He recounted that there was a report due from the Oil and Gas Competitive Review Board on the future of Cook Inlet's tax system.

Representative Wilson relayed that in the past when the state exported gas, subsidies were provided to areas. She continued that the gas was subsequently sold out of state rather than remaining in Alaska. She wanted to know if the board was going to not only look into the tax credits but also review their beneficiaries. She wondered if the state was the only entity to benefit because it sold the gas, or if other entities benefited within the state. She wanted to explore the answers to her questions further.

Co-Chair Thompson reviewed the agenda for the following meeting.

ADJOURNMENT

11:00:37 AM

The meeting was adjourned at 11:00 a.m.