

HOUSE FINANCE COMMITTEE  
April 1, 2016  
5:30 p.m.

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CALL TO ORDER

Co-Chair Thompson called the House Finance Committee meeting to order at 5:30 p.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 Cathy Munoz  
Representative Lance Pruitt  
Representative Tammie Wilson

MEMBERS ABSENT

Representative Scott Kawasaki

ALSO PRESENT

Janak Mayer, Chairman and Chief Technologist, enalytica;

PRESENT VIA TELECONFERENCE

Nikos Tsafos, President and Chief Analyst, enalytica;

SUMMARY

HB 247 TAX;CREDITS;INTEREST;REFUNDS;O & G

HB 247 was HEARD and HELD in committee for further consideration.

Co-Chair Thompson discussed the meeting agenda.

#hb247

HOUSE BILL NO. 247

"An Act relating to confidential information status and public record status of information in the possession of the Department of Revenue; relating to interest applicable to delinquent tax; relating to disclosure of oil and gas production tax credit information; relating to refunds for the gas storage facility tax credit, the liquefied natural gas storage facility tax credit, and the qualified in-state oil refinery infrastructure expenditures tax credit; relating to the minimum tax for certain oil and gas production; relating to the minimum tax calculation for monthly installment payments of estimated tax; relating to interest on monthly installment payments of estimated tax; relating to limitations for the application of tax credits; relating to oil and gas production tax credits for certain losses and expenditures; relating to limitations for nontransferable oil and gas production tax credits based on oil production and the alternative tax credit for oil and gas exploration; relating to purchase of tax credit certificates from the oil and gas tax credit fund; relating to a minimum for gross value at the point of production; relating to lease expenditures and tax credits for municipal entities; adding a definition for "qualified capital expenditure"; adding a definition for "outstanding liability to the state"; repealing oil and gas exploration incentive credits; repealing the limitation on the application of credits against tax liability for lease expenditures incurred before January 1, 2011; repealing provisions related to the monthly installment payments for estimated tax for oil and gas produced before January 1, 2014; repealing the oil and gas production tax credit for qualified capital expenditures and certain well expenditures; repealing the calculation for certain lease expenditures applicable before January 1, 2011; making conforming amendments; and providing for an effective date."

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JANAK MAYER, CHAIRMAN AND CHIEF TECHNOLOGIST, ENALYTICA, relayed that he had acted as an advisor to the state for the past several years.

NIKOS TSAFOS, PRESIDENT AND CHIEF ANALYST, ENALYTICA (via teleconference), briefly provided information about his role in oil and gas advising.

Mr. Mayer introduced a PowerPoint presentation, "HB 247: Key Issues and Assessment" dated April 1, 2016 (copy on file). He addressed the contents of the presentation on Slide 2:

#### **AGENDA**

- **HB 247: Summary of Key Issues**
- **North Slope: Fiscal Regime Overview**
- **North Slope: Changes Proposed under HB 247**
- **Cook Inlet: key issues and Proposed Changes**
- **HB 247: Summary of Key Issues**

#### **APPENDIX**

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Mr. Mayer turned to Slide 3. He summarized the proposed changes of the original bill by saying that the bill had not sought to fundamentally redefine Alaska's fiscal system, but had offered a broad series of potential changes that when taken together would have a major impact in different ways on different companies. He relayed that some of the changes could be characterized as fixes to things that were genuine and debatable problems, such as the "hardness of the gross minimum tax floor" and whether the state needed to have limits on refundable credits. He stated that other issues surrounded incremental revenue raising; how things were calculated annually, versus monthly, and how things like the gross value at the point of production were calculated. He thought that the biggest concern when having these conversations was to recognize that stability was the most important aspect of any fiscal regime. He expressed concern from an industry perspective for the changes proposed in the original legislation, referring to the tactics in the bill as "salami tactics." He explained the going about fiscal regime change "slice by slice" left it unclear where the changes would end.

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Representative Guttenberg observed that the state, as the sovereign and partner with industry, should have a fiduciary responsibility to observe the nature of credits on a regular basis, particularly in times of volatility. He stated that it was important to examine whether the tax credits were prudent in times of fiscal volatility. He remarked on an earlier statement that the legislature would not be looking at the credits if oil prices were higher.

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Mr. Mayer did not completely disagree with the remarks. He elaborated that in the current environment no one could look at the size of the credit outlay, compared to incoming revenue, and not want to implement some kind of change. He felt that incremental revenue raising, like changing things from annual to monthly calculations, were tweaks that would not change the fundamental regime structure, as opposed to the deep and clear-cut policy rationale considered in the legislation.

Representative Guttenberg noted that the oil industry was laying off contractors due to the volatility of the market. He felt that there were parallels in the challenges faced by the state and industry.

Mr. Mayer felt that it was important to establish a balance between short-term help and long-term risk.

Co-Chair Thompson noted that Representative Craig Johnson was present in the committee room.

Representative Wilson asked whether the conversation surrounding SB 21, and oil tax credits, would be happening if the price of oil had remained high.

Mr. Mayer answered that many things come into sharp focus when money becomes scarce. He said that the price of oil had led to the conversation about Cook Inlet Tax Credits. He relayed that the amount of those credits were greater than they had been several years ago, and the lack of revenue had made discussion about those credits more difficult.

Representative Wilson was concerned about the reason for the conversation. She referred to earlier comments that the passage of SB 21 had been to incentivize oil coming down

the pipeline. She queried the primary reason for the changes proposed in SB 247.

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Mr. Mayer replied that questions of the hardness of the tax floor and limits to refundable credits were conversations that were occurring because of the drop in oil prices. He admitted that much less attention would be drawn on these issues were the price of oil higher.

Representative Wilson was not sure whether the \$100 million would have been available under another regime.

Representative Gara asked whether there was any other oil producing state in the U.S. that paid out as much in credits as Alaska. He noted that FY 15 through FY 18, Alaska paid out more in credits than it had received in Production Taxes.

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Mr. Mayer replied that he could not think of a U.S. comparison. He could not think of one that had a net profit tax. He shared that locations outside of the U.S. that had substantial net-profit tax regimes tended to have their equivalent of a net-operating loss system be deferred liabilities of the tax system, rather than things that were directly reimbursed. He thought there were reasons that Alaska had made the decisions it had, and that there would be consequences to try to change the regime, but the question of timing of cash flow was a particular issue for the state at the moment in a way that it was not for other regimes.

Representative Gara asked whether there was another jurisdiction in the world where a higher percentage of oil revenue was paid back to industry in oil tax credits.

Mr. Mayer answered that Alaska had a unique and hybrid fiscal regime, he could not think of a comparison.

Representative Gara restated his question asking whether there was any other regime in the world that paid out as high of a percentage in cash payments to companies compared to the oil revenue that it took in.

Mr. Mayer responded that he did not know. He would be surprised to see another location where a contrast was as large as the one in Alaska.

Vice-Chair Saddler corrected that the state was not paying more in credits than it was receiving in oil revenue. He said that the production tax was less than the oil tax credits that were paid out, but that the royalties, corporate income tax, and property taxes needed to be taken into account.

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Representative Munoz hoped that Mr. Mayer could advise the committee on the problems with the current tax system. She relayed that potential problems were often not considered when tax systems were crafted by the legislature. She noted that issues with Alaska's Clear and Equitable Share (ACES) had not been fully vetted in never anticipating \$40/bbl. oil. She asserted that her intent was not to try and get more money for the state, but to address where the problems were in the current tax policy.

Mr. Mayer agreed to highlight problems with the system proposed by the bill. He continued to address Slide 3, which offered the fiscal system feature under the status quo, under the original bill, the impact from the proposal in the original bill, and under the committee substitute out of the House Resources Committee:

**Fiscal System Feature**

Per-Barrel Credit and Gross Minimum Tax

**Status Quo**

Tax liabilities assessed annually, smoothing impact of price volatility.

**HB 247 Proposed Change**

Calculate \$/bbl. credit and Gross Minimum Tax interaction monthly.

**Impact**

State would have netted additional ~\$100mm in 2014 under this system.

**HRES CS HB247**

Maintain status quo - tax liabilities assessed annually

**Fiscal System Feature**

Gross Value Reduction and Net Operating Loss Credit

**Status Quo**

Gross Value Reduction artificially reduces Production Tax Value, and NOL credit is based on PTV, so 35% NOL credit can be given on loss greater than actual loss - effectively more than 35% support for spending.

**HB 247 Proposed Change**

Assess NOL credit on actual loss (not including GVR), so NOL is for 35% of actual loss, and all producers have 35% support for spending.

**Impact**

Net impact is to reduce state support for all spending to 35%. Questions exist about whether >35% spending support for GVR oil was deliberate incentive or unintended consequence under SB21.

**HRES CS HB247**

Adopt proposed fix to NOL calculation for GVR-eligible production

**Fiscal System Feature**

Gross Minimum Tax

**Status Quo**

4% rate, binding for legacy output if net value is positive. If net value is negative, NOL can reduce taxes below floor. "New," GVR-eligible production can take to zero due to \$5/bbl. and small producer credit

**HB 247 Proposed Change**

Harden floor for all production: NOL credits can't take below floor for legacy, and NOL, small Producer and \$5/bbl. can't take below floor for GVR eligible production. Increase rate from 4% to 5%

**Impact**

State revenues rise at low oil prices. For many new fields, taxes rise from 0 to 5% at current prices. For

legacy production, taxes rise at time when value is negative.

**HRES CS HB247**

Maintain status quo - no further floor hardening

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Mr. Mayer turned to Slide 4, which continued the summary of fiscal system features under the status quo, under the original HB 247, and under the HRES CS HB247:

**Fiscal System Feature**

Net Operating Loss credit reimbursement

**Status Quo**

Producers with >50 mb/d production must carry NOL forward, others can be reimbursed by the state

Representative Gara spoke to the net operating loss. He asked what was meant by rolling forward of the operating loss.

Mr. Mayer answered that it was the same as almost any income based tax was carried forward. He said that the loss could be applied to the following years taxes, and however many years into the future, until there was enough liability to deduct against a current year. Expenses that could not be deducted in a current year could be deducted in the future.

Representative Gara understood that bigger producers could roll forward the net operating loss as long as they had the tax liability and did not go below zero. He wondered whether the net operating loss could take a larger fields tax below zero.

Mr. Mayer answered that anyone producing more than 50,000 /bbl. could not go below zero, but would be forced to roll the credits forward. He added that producers could choose to be paid out in cash, rather than rolling credits forward.

**HB 247 Proposed Change**

\$25mm per company annual limit on reimbursement. Companies with annual revenues > \$10bn must carry forward, regardless of production level.

**Impact**

Limit substantially increases capital needs for new developments; and if effective July 2016 would have major negative impact on developments underway. Raises hurdle/break-even price for projects by \$5 to \$15/bbl.

**HRES CS HB247**

\$200mm per company annual limit on reimbursement.

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Mr. Mayer continued to address Slide 4.

**Fiscal System Feature**

Gross Value at Point of Production calculation

**Status Quo**

GVPP is calculated by subtracting transportation costs from sale price. If transportation costs for some production exceed price, GVPP is negative.

**HB 247 Proposed Change**

GVPP cannot go below zero

**Impact**

Could limit deductibility of some transport costs. Particularly likely to be an issue at current prices if applied on a per-unit or per field basis.

**HRES CS HB247**

Maintain status quo

Mr. Mayer discussed high tariffs and the underutilization of pipe built to a certain capacity; this could create streams with negative GVPP, and the costs of those pipelines would be written off slope-wide. How the feature would be applied of concern, which had resulted in the retention of the status quo in the current version of the bill.

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Mr. Mayer discussed the final point on Slide 4:

**Fiscal System Feature**

Cook Inlet Tax Credits

**Status Quo**

25 percent Net Operating Loss credit, 20 percent Qualified Capital Expenditure credit, 40 percent Well Lease Expenditure credit; up to 65 percent gov't support for spending and minimal production tax

**HB 247 Proposed Change**

Repeal QCE and WLS credits effective July 1 2016, leaving only 25 percent NOL credit

**Impact**

Cook Inlet credit regime is clearly unsustainable in current environment; repeal in present year may have major impacts on capital commitments already made, and the viability of producers who have made those commitments.

Representative Wilson asked why the credits were unsustainable.

Mr. Mayer replied that the answer would become apparent when the question of revenues and expenditures was address in future slides.

Representative Gara asked about GVPP calculation. He understood that the governor's proposal was to not let the floor fall below the Gross Minimum Tax Rate. He wondered where the GVPP calculation entered the equation.

Mr. Mayer responded reiterated that a pipe that was built for a high capacity would pay a high tariff regardless of the value of what was being transported through it. He said that, in net, across the entire North Slope this was not an issue, but that it had been agreed that all transportation costs could be deducted.

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Representative Gara suggested that the gross value was the value of the oil, minus minor costs. He hypothesized that a company paying the minimum tax, whose \$30 transportation costs cancelled their \$30 /bbl. gross oil, would pay no gross minimum tax.

Mr. Mayer responded that the question was really about whether or not the transportations costs could be deducted in-full.

Representative Gara thought that if the number was zero, 4 percent of zero would be zero.

Mr. Mayer explained that it was a question of whether a company would be able to deduct in full all of its transportation costs, or whether because one little segment was particularly expensive and could only be partly deducted.

**HRES CS HB247**

Reduce NOL credit to 10 percent, keep 20 percent QCE credit, reduce WLE credit to 20 percent by 2018.

Mr. Mayer turned to Slide 5, which illustrated a history of credit payouts. Refunded credits reached a new high in FY 15; refundable credits in FY 15 reached \$628 million, the highest point ever. In both 2014 and 2015, the majority of these credits went to non-North Slope producers. Under DOR's current forecast, credits would exceed \$1.3 billion across FY 16 and FY 17.

Representative Wilson asserted that you could not look at the tax credits alone, and then say that the state was paying too much or not enough, because all of the tax credits were connected to jobs and other revenue that could not be seen.

Mr. Mayer answered that on the North Slope credits were integral to the way that the tax system worked. He said that there were credits that did not show up in the chart on the slide, which were credits that were taken against tax payer liability (the dollar per barrel credits). He stated that the credits reflected in the chart on the slide were about the Net Operating Loss Credit, and that the conversation should be about whether the credits were deducted against future taxes, or have them paid out in cash. He said that in net, over time, the results were the same; the issue was a question of timing and how the timing worked. He relayed that the reason was to make the impact of the system the same for both large and small companies. He asserted that Cool Inlet differed because there was no profit based production tax there, no tax on oil, and a minimum gross tax on gas. He asserted that credits on the

North Slope were not intended to incentivize, but were part of the way the overall system worked and operated; the situation in Cook Inlet was the opposite. He related that credits in Cook Inlet were intended to incentives, which posed the question of what should be incentivized.

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Mr. Mayer moved to Slide 6, which discussed North Slope versus Cook Inlet Credits:

**BIG DIFFERENCE BETWEEN NORTH SLOPE AND COOK INLET:**

- The majority of refundable credits go to Cook Inlet producers
- Cook Inlet production, however, generates limited direct revenue for the state
- Credits on the North Slope are more limited but also a far smaller fraction of total value generated

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Mr. Mayer stated that looking back at 2015 revealed that the overall oil and gas fiscal system had yielded substantial revenue. The system had been designed to be more about royalties, which were regressive, and in the current price environment had provided the bulk of the revenue. He noted that 2015 had seen approximately \$1.5 billion in unrestricted revenue. He said that most of the revenue had come from the North Slope. He pointed out to the committee that the orange represented the royalties and settlements plus federal (restricted), the yellow was royalties (unrestricted), the green was property tax, the purple was corporate income tax, the grey was production tax, and the light grey was credits for potential purchase. He highlighted the difference between Cook Inlet and the North Slope. He felt that it was important to examine where royalties came from, and where the credits were paid out, in order to create reform that would make the system more sustainable in the future. He offered some background in the working of the North Slope oil structure.

Mr. Mayer turned to Slide 8, which discussed gross versus net taxes. He spoke of the difference between gross and net taxes, and the hardening and raising of the minimum floor. He stressed that base rates were a net rate; the 4 percent under the governor's proposal was a gross rate. He asserted

that gross taxes were highly regressive. He walked through an anecdote as to how regressive taxes worked.

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Representative Pruitt asked whether any other regime had tried to take advantage of both gross and net taxes combined.

Mr. Mayer replied that most of the U.S. was in a pure gross tax world, while Norway, Australia, and the United Kingdom were in a net tax world. He relayed that hybrid system did exist, but were uncommon. He discussed the advantages and disadvantages of gross and net taxes:

**Gross taxes**

Less volatile, shift risk to private sector  
Simple and easy to administer  
High/low government take at low/high prices  
Disadvantages marginal investment

**Net taxes**

More volatile revenues for government  
Harder to administer  
Efficient-do not distort decision-making  
Enable investment across commodity cycle

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Mr. Mayer continued to address Slide 8. He said that volatile revenues were more easily weathered when an economy was diversified and when a substantial sovereign wealth fund was available. He noted that because net taxes were harder to administer they could result in backlogs of audits.

Representative Wilson wondered what effect the audit backlog was having on assessing how well the credits were working. She assumed that the compounded interest was based on the backlogged audits.

Mr. Mayer answered that the backlog was not an ideal situation. He believed that everyone hoped for certainty in the equation and reducing the backlog was essential.

Representative Wilson asked about interest rates in the bill (simple versus compound). She wondered how big of an issue the compound interest issue would be.

Mr. Mayer replied that compound interest made a huge difference over a period of time, and that simple interest was an anomaly through the drafting process and not the original intent of SB 21.

Representative Wilson argued that the audit backlogs were the states fault. She wondered whether any other states allowed for audits to fall so far behind, and then charged companies compounded interest.

Mr. Mayer lamented that he did not have the details. He noted that this was a challenge only faced by net profit systems.

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Representative Gara interjected that the industry had never asked for additional auditors to handle the workload, and that attempts to add auditors had been defeated in committee. He mentioned taxing high on the gross at the low end, and high of profits at the high end. He asserted that the state's gross tax was much lower than other jurisdictions, and Alaska's profits tax at high prices was modest or lower than other jurisdictions.

Mr. Mayer replied that the idea of the slide was to illustrate that all fiscal systems were a balance. He felt that the state was unique in its hybrid between the gross royalty and the net profit tax. He stressed that Alaska could not be both Norway and North Dakota.

Representative Munoz spoke to the 4 percent gross tax. She asked whether the present system was reasonable or should it be solidified.

Mr. Mayer answered that there was a slide to address the question.

Co-Chair Thompson asked members to hold their questions until the end of the presentation.

Mr. Mayer moved to Slide 9, which discussed an overview of the North Slope and offered details of cash flow taxes

using a highly simplified cash flow and income example. The crux of the slide was to illustrate the difference between cash flow and income. Alaska's net profit tax was a cash flow tax and not an income tax. Cash flow taxes were more efficient and more volatile. The purpose of a net tax is to minimize distorting impact on investment, which is best achieved by making the state's fiscal cost/benefit as close as possible to the equity investor, and should result in outflows during development, receipts during investment.

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Vice-Chair Saddler surmised that Alaska was at the 25 percent cash flow line; if the state operated under the example tax system it would experience big losses, with no counter income. He highlighted the importance of observing the figures after the first 3 years, and thought those projections could inspire the movement of the bill.

Mr. Mayer addressed Slide 10, which offered an intellectual genesis of the tax system currently in place. He spoke to the original 2006 proposal, which began with a paper penned by Dr. Pedro van Meurs. The point of production tax (PPT) as proposed by Dr. van Meurs reflected a 25 percent flat cash flow tax, a credit for net operating losses (NOLs), and a 20 percent capital credits. He relayed that had the exact proposed system been put into place the state would have had a constant 45 percent government support for spending, both for new and incumbent players alike. He added that there would be a statewide floor of zero as the credits would be tradable rather than reimbursable.

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Mr. Mayer stated that the issue was what happened when oil prices were low (slide 10) and how would the state handle the timing of the various cash flows. He elaborated on the tradable versus the transferrable credits. He pointed out the impact of the 20 percent capital credit at \$80/bbl., would move the royalty line down. He said that even without the any of the questions of the progressivity that existed under ACES, the system was progressive because the 20 percent of the capital fluctuated with the price of oil. He believed that the system was intended to balance regressive and progressive elements. He noted that at prices above \$60/bbl., the royalties and the net tax remained parallel.

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Representative Edgmon referred to a point made by Vice-Chair Saddler earlier. He referred to Slide 9. He asked whether the net operating loss was incorporated into the example.

Mr. Mayer turned to Slide 10 and reminded the committee that the chart on the right was a snapshot in time. He said that that zero line on the chart assumed that any net operating loss had to be carried forward into the future. He hypothesized the 25 percent net tax going negative, which would be the same thing as having a 25 percent net operating loss credit, would result in the tax after credits being negative.

Representative Edgmon asked if he could apply the same logic to Slide 9.

Mr. Mayer replied in the affirmative.

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Mr. Mayer moved to Slide 11, which spoke to the role of the NOL. He stressed that the idea of the NOL credit was to equalize the tax system impact across large and small companies. He repeated the cash flow example; the incumbent could deduct spending against their liability at the marginal tax rate; a company without a liability would be paid out a credit, which would result in that much less revenue to the state. He noted that the issue would not exist with an income tax because no one would be able to immediately write the losses off against their taxes. He said that the existence of the NOL was the corollary of the fact that it was a cash flow tax that affected people equally.

Representative Wilson asked what the impact from asking all companies to carry forward their credits would be on the state.

Mr. Mayer answered that there was a slide later to address the question.

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Mr. Mayer continued with Slide 11. He noted that the original proposal would have enabled tradable, and not refundable, credits with the idea that the state would never get to the point where it was spending more on credits than on revenue coming in because the credit would be self-limiting. He stated that in reality many of the credits sold for much less than the face-value of the tax benefit, as a result, credits were made refundable by the treasury.

Mr. Mayer turned to Slide 12, which offered a comparison of the 2006 proposal and ACES. He spoke to the chart at the right; the green line represented the 2006 proposal and showed that the impact of the flat 25 percent tax rate, the 20 percent capital credit brought down the liability, and at \$60/bbl. there would be no liability in order to counteract the regressive royalty. He stated that ACES took the basic structure of the 2006 proposal, but instead of a flat 25 percent added progressivity on top. He noted the introduction of the 4 percent gross minimum floor, and he discussed the system under \$80/bbl. He concluded that, broadly speaking, in the same way that the 35 percent base rate under SB 21 could go below 35 percent, the 25 percent base rate under ACES could go above and below 25 percent, in both cases the effective credit was designed to create the progressive component. He relayed that the 20 percent Capital Credit would bring the effective tax rate down to zero under ACES, under SB 21 it was the Dollar Per Barrel Production Credit that was serving the same function.

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Vice-Chair Saddler requested to hear the high points of the presentation. He asked Mr. Mayer to pick the most important points in his presentation in order to provide the committee the information it needed more efficiently as it had been a long day.

Representative Gara suggested that the testifier could testify again before a better rested committee.

Representative Munoz asked whether there would be a continuation of the presentation the following day.

Co-Chair Thompson responded that there were other items on the agenda for the following day.

HB 247 was HEARD and HELD in committee for further consideration.

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AT EASE

7:00:36 PM

RECONVENED

Co-Chair Thompson relayed that the committee would recess until 8:30 a.m. the following day.

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RECESSED