ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE
March 19, 2016
1:00 p.m.

MEMBERS PRESENT

Representative Benjamin Nageak, Co-Chair
Representative David Talerico, Co-Chair
Representative Bob Herron
Representative Craig Johnson
Representative Kurt Olson
Representative Paul Seaton
Representative Andy Josephson
Representative Geran Tarr
Representative Mike Chenault, Alternate

MEMBERS ABSENT

Representative Mike Hawker, Vice Chair

COMMITTEE CALENDAR

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."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 247
SHORT TITLE: TAX;CREDITS;INTEREST;REFUNDS;O & G
SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

01/19/16	(H)	READ THE FIRST TIME - REFERRALS
01/19/16	(H)	RES, FIN
02/03/16	(H)	RES AT 1:00 PM BARNES 124
02/03/16	(H)	Heard & Held
02/03/16	(H)	MINUTE(RES)
02/05/16	(H)	RES AT 1:00 PM BARNES 124
02/05/16	(H)	-- MEETING CANCELED --
02/10/16	(H)	RES AT 1:00 PM BARNES 124
02/10/16	(H)	Heard & Held
02/10/16	(H)	MINUTE(RES)
02/12/16	(H)	RES AT 1:00 PM BARNES 124
02/12/16	(H)	Heard & Held
02/12/16	(H)	MINUTE(RES)
02/13/16	(H)	RES AT 1:00 PM BARNES 124
02/13/16	(H)	-- MEETING CANCELED --
02/22/16	(H)	RES AT 1:00 PM BARNES 124
02/22/16	(H)	Heard & Held
02/22/16	(H)	MINUTE(RES)
02/24/16	(H)	RES AT 1:00 PM BARNES 124
02/24/16	(H)	Heard & Held
02/24/16	(H)	MINUTE(RES)
02/25/16	(H)	RES AT 8:30 AM BARNES 124
02/25/16	(H)	Heard & Held
02/25/16	(H)	MINUTE(RES)
02/25/16	(H)	RES AT 1:00 PM BARNES 124
02/25/16	(H)	Heard & Held
02/25/16	(H)	MINUTE(RES)
02/26/16	(H)	RES AT 1:00 PM BARNES 124
02/26/16	(H)	Heard & Held

02/26/16	(H)	MINUTE(RES)
02/27/16	(H)	RES AT 10:00 AM BARNES 124
02/27/16	(H)	Heard & Held
02/27/16	(H)	MINUTE(RES)
02/29/16	(H)	RES AT 1:00 PM BARNES 124
02/29/16	(H)	Heard & Held
02/29/16	(H)	MINUTE(RES)
02/29/16	(H)	RES AT 6:00 PM BARNES 124
02/29/16	(H)	Heard & Held
02/29/16	(H)	MINUTE(RES)
03/01/16	(H)	RES AT 1:00 PM BARNES 124
03/01/16	(H)	Heard & Held
03/01/16	(H)	MINUTE(RES)
03/02/16	(H)	RES AT 1:00 PM BARNES 124
03/02/16	(H)	Heard & Held
03/02/16	(H)	MINUTE(RES)
03/02/16	(H)	RES AT 6:00 PM BARNES 124
03/02/16	(H)	Heard & Held
03/02/16	(H)	MINUTE(RES)
03/07/16	(H)	RES AT 1:00 PM BARNES 124
03/07/16	(H)	Heard & Held
03/07/16	(H)	MINUTE(RES)
03/07/16	(H)	RES AT 6:00 PM BARNES 124
03/07/16	(H)	Heard & Held
03/07/16	(H)	MINUTE(RES)
03/08/16	(H)	RES AT 1:00 PM BARNES 124
03/08/16	(H)	Heard & Held
03/08/16	(H)	MINUTE(RES)
03/09/16	(H)	RES AT 1:00 PM BARNES 124
03/09/16	(H)	Heard & Held
03/09/16	(H)	MINUTE(RES)
03/11/16	(H)	RES AT 1:00 PM BARNES 124
03/11/16	(H)	-- MEETING CANCELED --
03/14/16	(H)	RES AT 1:00 PM BARNES 124
03/14/16	(H)	Heard & Held
03/14/16	(H)	MINUTE(RES)
03/14/16	(H)	RES AT 6:00 PM BARNES 124
03/14/16	(H)	Heard & Held
03/14/16	(H)	MINUTE(RES)
03/16/16	(H)	RES AT 1:00 PM BARNES 124
03/16/16	(H)	Scheduled but Not Heard
03/18/16	(H)	RES AT 1:00 PM BARNES 124
03/18/16	(H)	Scheduled but Not Heard
03/19/16	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

GARY ZEPP, Staff
Representative Benjamin Nageak
Alaska State Legislature
Juneau, Alaska
POSITION STATEMENT: On behalf of the co-chairs of the House Resources Standing Committee, introduced the proposed committee substitute (CS) for HB 247, Version P.

MS. RENA DELBRIDGE, Staff
Representative Mike Hawker
Alaska State Legislature
Juneau, Alaska
POSITION STATEMENT: On behalf of the co-chairs of the House Resources Standing Committee, provided a summary of changes and a sectional analysis of the proposed committee substitute (CS) for HB 247, Version P.

KEN ALPER, Director
Tax Division
Department of Revenue (DOR)
Juneau, Alaska
POSITION STATEMENT: On behalf of the governor, answered questions related to the proposed committee substitute (CS) for HB 247, Version P.

JANAK MAYER, Chairman & Chief Technologist
enalytica
Washington, DC
POSITION STATEMENT: As consultant to the Legislative Budget and Audit Committee, Alaska State Legislature, provided a PowerPoint presentation, "CS HB 247: Impact of Proposals," regarding the proposed committee substitute (CS) for HB 247, Version P.

ACTION NARRATIVE

1:00:27 PM

CO-CHAIR BENJAMIN NAGEAK called the House Resources Standing Committee meeting back to order at 1:00 p.m. [the meeting was previously recessed at 2:21 p.m. on 3/18/16]. Representatives Johnson, Olson, Seaton, Josephson, Herron, Talerico, and Nageak were present at the call to order. Representatives Tarr and Chenault (Alternate) arrived as the meeting was in progress.

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

1:00:55 PM

CO-CHAIR NAGEAK announced that the only order of business is 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."

1:01:09 PM

CO-CHAIR TALERICO moved to adopt the proposed committee substitute (CS) for HB 247, Version 29-GH2609\P, Shutts, 3/18/16, as the working document.

REPRESENTATIVE JOSEPHSON objected for purposes of discussion.

1:01:57 PM

GARY ZEPP, Staff, Representative Benjamin Nageak, Alaska State Legislature, on behalf of the co-chairs of the House Resources Standing Committee, said the proposed work draft is the result of 20 committee hearings. The committee heard from the Walker Administration; independent legislative consultants; explorers, developers, and producers operating in Alaska's oil and gas industry; representatives of support services organizations; and the public. These are difficult times for Alaska and for the oil and gas industry. Alaska has serious budget problems in light of low oil prices. The oil and gas industry is operating at losses in Alaska, it costs more to get barrels of oil out of the ground than is being received for the oil. The co-chairs recognize Alaska's budget problems and want to support a balanced resource policy that protects investment, maintains production, and provides state revenues over the short term and into the future. The right balance between exploration and production is critical. The exploration success over the next three to five years becomes the production for twenty years and into the future. The revenues support Alaska's government services. The co-chairs requested and received permission from Representative Hawker to have Ms. Rena Delbridge assist the co-chairs and their staff in the technical provisions of this legislation and to assist the co-chairs and staff in developing the CS. He said Ms. Delbridge will provide a summary of the changes and a sectional analysis for the CS.

1:03:50 PM

RENA DELBRIDGE, Staff, Representative Mike Hawker, Alaska State Legislature, on behalf of the co-chairs of the House Resources Standing Committee, reviewed the summary of changes included in the proposed CS, Version P. She explained that overall for the North Slope, Version P would maintain the existing fiscal system that was put into place in 2013. Version P would not make changes to the gross minimum tax or to the tax floor. Version P would prevent the use of the gross value reduction (GVR) for new oil from increasing the size of a loss. Version P would provide that statewide the state can reimburse each eligible company per year a maximum of $200 million from the oil and gas tax credit fund. For Cook Inlet and Middle Earth, Version P would reduce the well lease expenditure credit from 40 percent today, to 30 percent in 2017, and to 20 percent in 2018. For Cook Inlet and Middle Earth, Version P would reduce the 25 percent net operating loss credit to 10 percent effective January 1, 2017. Version P would maintain the current transferability and refundability options subject to the annual cap of $200 million per company.

MS. DELBRIDGE explained that Version P would also maintain the current interest rate on delinquent taxes at three points above the Federal Reserve rate, which today is an interest rate of about 4 percent. Version P would change from simple interest to interest compounding quarterly beginning in 2017. Version P would ensure that municipal entities that are producers are eligible for credits only in proportion to the production that they have that is subject to production taxes; the work draft would require them to proportion those lease expenditures to the taxable production. In case of companies with an outstanding liability to the state related to their oil and gas activity, Version P would allow the Department of Revenue (DOR) to withhold the amount of that liability from any repurchase of a credit certificate. The applicant would be able to authorize the payment of that liability out of that amount withheld so that DOR could make that payment on behalf of the taxpayers. For Cook Inlet, Version P would create a legislative working group to develop system reform for evaluation by the full legislature in 2017; this would be a comprehensive review of the entire Cook Inlet and Middle Earth fiscal systems.

1:06:42 PM

MS. DELBRIDGE reviewed the sectional analysis for Version P. She said Sections 1-5 provide conforming language that relates to the repeal in Section 28 of a Department of Natural Resources (DNR) exploration program that applied pre-2007 [AS 41.09]; those provisions were also in HB 247. She said Section 6, page 3 of Version P, relates to interest and provides that the interest rate on delinquent taxes remains at the current amount of 3 percent [three points above the Federal Reserve rate], but would be compounded quarterly beginning in 2017. Section 7, page 3 of Version P, provides conforming language related to the new outstanding liability to the state provisions that are in Section 17. Section 7 applies to the natural gas storage facility credit so that the new Section 17 rules would apply to that credit as well. Section 8 likewise provides conforming to the new outstanding liability language; it ensures that for the purposes of the liquefied natural gas (LNG) storage facility credit, the outstanding liability language in the new Section 17 apply. Section 9 similarly applies the new Section 17 outstanding liability provisions to the in-state oil refinery infrastructure expenditures credit. Sections 10 and 11 provide conforming language related to the repeal in Section 28 of the two Department of Natural Resources exploration credit programs [in AS 38.05.180(i) and 41.09].

MS. DELBRIDGE explained that Section 12, page 5 of Version P, makes some of the key changes related to this legislation. First, for the area south of 68 degrees North latitude, this section reduces the amount of the carried-forward annual loss [tax credit] from 25 percent to 10 percent. Second, lines 19-22 on page 6 ensure that the application for a gross value reduction (GVR) for new oil on the North Slope is not used to increase the amount of a loss. In regard to Section 13, she noted that later in this legislation the qualified capital expenditure (QCE) credit of 20 percent in Cook Inlet is maintained, but the work draft sunsets that credit with the rest of the Cook Inlet regime in 2022. The sunset of the QCE and the well lease expenditure (WLE) credits in Cook Inlet in 2022 results in a great number of reforming sections to this bill. The current definition of a qualified capital expenditure in many sections of the tax statute says the definition in the QCE credit is how a QCE expenditure is defined. So, if the credit is repealed in 2022, any place where the credits definition is used means that a new definition must be created and conform those statutes to that new definition. Section 13 provides conforming to the change in placement of the QCE definition [in Section 27] related to the QCE [credit] repeal [in Section 29]. Section 14 provides conforming language to the repeal of the QCE credit in 2022.

1:10:41 PM

MS. DELBRIDGE said Section 15, pages 7-8 of Version P, is material in that in Cook Inlet it reduces the well lease expenditure (WLE) credit from 40 percent to 30 percent beginning January 1, 2017, and from 30 percent to 20 percent on January 1, 2018. Section 15 also makes a conforming change related to the repeal of the two DNR exploration credits. Ms. Delbridge related her understanding that the co-chairmen may in the future be offering an amendment to this section as it was an oversight to retain the 20 percent WLE stepdown into 2022. She explained that the WLE credit is an additional amount of incentive for a segment of the work that is already covered by the QCE credit. So, once the WLE credit reaches 20 percent, it is in effect no different than the QCE credit at 20 percent; the amendment repeal the WLE credit once it reaches 20 percent and not wait until 2022.

MS. DELBRIDGE noted that Section 16 is also a material change. For disbursements from the oil and gas tax credit fund when DOR purchases a credit certificate, DOR would not be able to purchase a total of more than $200 million in tax credit certificates from a single entity per year. She drew attention to the portion of Section 16 on page 8, lines 29-31, and said there is concern that a cap per company on the amount of overall credit refunds that a company can get from the state, could motivate a company to split into multiple versions of that same company for the purpose of getting the cap several times instead of once. This language protects against such splitting by ensuring that if DOR finds that a single entity has divided into multiple entities for the purpose of trying to evade this cap per company, DOR does not need to pay from this fund. The language is very similar to existing provisions related to the small producer credit already in statute.

1:13:22 PM

MS. DELBRIDGE specified that Section 17 is the new section related to outstanding liability. Section 17 provides that if an applicant seeking refund from the state for a tax credit certificate has an outstanding liability to the state that relates to the company's oil and gas activity, DOR may purchase only that part of a tax certificate that exceeds the outstanding liability. The effect is that DOR would withhold from refund the amount that is outstanding in liability somewhere else in the state. With the taxpayer's consent, DOR can actually use that withholding to pay off that liability on behalf of the taxpayer. If the department does that, it is clear in these lines that that does not affect the applicant's ability to contest that liability.

REPRESENTATIVE SEATON inquired whether the rest of the tax credits would still remain transferable.

MS. DELBRIDGE replied that this would only apply to the refundability. The company would get refunded for the amount less the liability that it owes.

REPRESENTATIVE CHENAULT asked whether that liability would go just to liability related to state issues or would it include any liability, such as a liability to subcontractors, contractors, or other private corporations that have done business with the company in question.

MS. DELBRIDGE responded it relates strictly for the applicant's liability to the state; if a company has an outstanding liability, something that has been assessed and not been paid, then that would apply. She said she will get back to the committee as to how broad that is related to subcontractors.

1:15:41 PM

MS. DELBRIDGE resumed her sectional analysis. She reiterated that Section 17 allows DOR to pay on behalf of the taxpayer to another entity and said it also allows the department to enter into contracts or agreements with other departments in order to do that. She noted that Section 18 is conforming to the 2022 repeal of the QCE and WLE credits in Cook Inlet. Section 19 conforms to the change in placement of the QCE definition since the QCE credit would be repealed in 2022. Section 20 conforms to the change in placement of the QCE definition in relation to the QCE repeal. Section 21, page 11, of Version P, conforms to the repeal of AS 43.55.165(j) and (k) in Section 29. These are sections of statute which include the QCE definition issue; however, they apply to tax years prior to 2010, so Legislative Legal and Research Services recommends they be repealed rather than to change the definitions. Section 22, page 12 of Version P, also conforms to the change in placement of QCE definition. Sections 23 and 24, page 15 of Version P, conform to the 2022 repeal of the QCE credit. Section 25 conforms to the change in placement of the QCE definition related to the 2022 repeal.

MS. DELBRIDGE explained that Section 26, page 16 of Version P, requires municipalities that are producers to allocate their lease expenditures and their tax credits between their taxable and exempt production. The effect is that a municipality would not receive credits for production that is not subject to production taxes. Section 27 provides the new definition for a qualified capital expenditure, which is necessary because of the repeal of the QCE credit where a capital expenditure is currently defined. Section 28 repeals two DNR exploration credit programs. The AS 41.09 credit was sunset in 2007, but remains on the books. The AS 38.05.180(i) program provides the authority for DNR to create a credit program, but it was never created and therefore this is a good time to repeal that. Section 29 repeals the QCE credit and the WLE credit in January 1, 2022, and repeals AS 43.55.165(j) and (k), which applied before 2010.

1:19:17 PM

MS. DELBRIDGE specified that Section 30, page 17 of Version P, creates a legislative working group that is charged with a thorough analysis of the existing Cook Inlet fiscal regime for oil and gas. It is tasked with recommending changes to the full legislature for consideration during the regular session in 2017. It is asked to account for a number of provisions: a tax structure that looks to the unique circumstances related to oil versus gas; consideration of all phases of oil and gas activity from exploration to development and production; consideration of Alaska's competitiveness in attracting new investors; consideration of the unique market features, or lack of market features, related to local energy supply; evaluation of alternative means of state support for that exploration, development, and production phases that might not be direct cash support via credits but may be programs where Alaska Industrial Development and Export Authority (AIDEA) might be able to provide some financing or support; evaluation of the need for public disclosure of some confidential information related to taxpayers and confidentiality in credits. The working group would be composed of legislative membership only and would be led by two co-chairs, one appointed by the speaker of the house and one by the president of the senate. Those co-chairs would determine the numbers and needs of the working group. Specific provisions are provided so co-chairs can create an advisory group to the working group that would include members who are not legislators but have expertise to bear on the industry, fiscal systems, and the unique gas supply issues related to Cook Inlet. The expectation is that consultants already under contract through the Legislative Budget and Audit Committee would be able to support this working group in its activities.

1:21:45 PM

MS. DELBRIDGE said Section 31, page 18 of Version P, provides applicability language related to the new requirements in Section 17 for purchasing transferrable tax credit certificates through the oil and gas tax credit fund. Section 32 provides transition language for the January 1, 2022, repeal of the QCE and WLE credits. The effect is to ensure that expenditures incurred before the repeal date are eligible for the credits even after the repeal date. Section 33, page 19 of Version P, provides transition language related to the Section 29 repeal of AS 43.55.165(j) and (k). Section 34 provides transition language that would empower the Department of Revenue and Department of Natural Resources to adopt regulations related to this bill. Section 35 provides transition language related to retroactive regulations. Section 36, page 20 of Version P, provides for an immediate effective date for the legislative working group and for the authority of DOR and DNR to write regulations. Section 37 provides a delayed effective date of

January 1, 2022, for the repeal of the QCE credit and the WLE credit; this applies to sections [13, 14, 18-25, 27, 29, 32, and 33]. Section [38] is an effective date of January 1, 2017, for all other bill sections.

1:23:31 PM

REPRESENTATIVE SEATON, regarding Section 12, asked what the effect is of reducing the net operating loss (NOL) credits from 25 percent to 10 percent, but then maintaining the QCE credits.

MS. DELBRIDGE answered that the three aforementioned items are the three levers to be pulled in Cook Inlet. The co-chairs looked hard at what degree those levers could be pulled and still protect the supply of gas for local consumption and to maintain as much support as possible for current investments without entering into a situation in which the state's substantial credit program offers incentive for whole newcomers to now enter Cook Inlet and undertake new activities that rely very heavily on this currently high level of 65 percent state support. The co-chairs had heard clearly from the legislative consultant, enalytica, that that 65 percent is high for what the state may be realizing in return for that work. So, the attempt was to bring the overall state support down. Right now with these changes after the WLE steps down, it would be up to about 30 percent. The NOL in particular is something that a non-producer, someone still in that early development stage, may be looking to. By reducing that, the intended effect is that while the Cook Inlet regime is examined in 2017 there is a limited number of newcomers to Cook Inlet that come strictly for the attractiveness of that credit system. The QCE is work related; it is for lease expenditures that are happening to develop production and it is very much a key supporting credit for work that is currently underway. Likewise, the WLE credit, which is a super-credit for a certain segment of QCE work, has proven very helpful in accomplishing the goal of energy security in Cook Inlet and is used fairly consistently. So the hope is to stepdown that WLE credit while maintaining that QCE level of support for that ongoing investment to maintain what is happening today, and to bring down that NOL lever as well.

REPRESENTATIVE SEATON remarked that he really wants to figure out the interaction because taking the net operating loss to 10 percent sounds like the state is not interested in anybody else coming in. He said he wants "to get a very fine definition on who and what types of companies that maintaining the qualified capital investment credit relates to instead of them using as a net operating loss and qualifying that same kind of investment as ... the net operating loss credit."

1:27:25 PM

REPRESENTATIVE CHENAULT clarified it is Section 38, not 36, that provides an effective date of January 1, 2017, for all other bill sections [not included under Sections 36 and 37].

MS. DELBRIDGE confirmed that it is a typographical error on the last page of the sectional analysis and she will correct it.

1:28:30 PM

REPRESENTATIVE JOSEPHSON, in regard to Cook Inlet, understood that Version P would reduce the state's outlays to roughly 40 percent effective January 1, 2017, and 30 percent effective January 1, 2018.

MS. DELBRIDGE requested the question be repeated.

REPRESENTATIVE JOSEPHSON noted the subtraction in the credits is 40 percent effective nine months from now and the credits would drop to 30 percent by January 1, 2018, from the 65 percent.

MS. DELBRIDGE replied yes, because in 2018 the WLE [credit] would have been stepped down to 20 percent, so the remaining credits available would be the 20 percent QCE and the 10 percent net operating loss.

REPRESENTATIVE JOSEPHSON recalled that the governor's original proposal would cut the state's deficit by $500 million, and by some accounts it could be $600 million. He inquired whether it is Ms. Delbridge's obligation to find out what the result would be under the CS.

MS. DELBRIDGE responded, "The fiscal note will be something that is forthcoming from the department. We have a general sense, based on the reductions of overall support, that this would have reductions to the outlay of state credits that would then certainly affect the state's budget."

REPRESENTATIVE JOSEPHSON said he sees some things that are interesting for him from his perspective, but that the state's problem is now as well as 2022. He asked whether there is any sense of what Version P would do to the budget.

MS. DELBRIDGE answered that HB 247 as presented by the administration had immediate and retroactive effective dates. The immediate effective dates would have occurred in July 2016, which is the middle of the tax year. The direction from the co-chairmen was that changes should be responsibly made to the effect of providing companies ample time to adjust their investment and spending for a tax year, and therefore provisions should not take effect until the beginning of the new tax year in January 2017. That would then have the impact of not having immediate budgetary impacts for the state's budget this year.

1:31:59 PM

REPRESENTATIVE JOSEPHSON, regarding Version P, said he does not understand the sequence of making very serious changes to the Cook Inlet credit system and then later doing a [legislative] working group.

MS. DELBRIDGE responded that the co-chairs heard clearly from enalytica, the legislature's consultant, that the current Cook Inlet direct state support is excessive and the state may not be receiving benefit proportional to its direct investment through the credit system. This is an attempt now to immediately curb that direct state support while providing some level of protection for current investments during the undertaking of a wholesale regime evaluation. The reason the co-chairs wanted to establish the [legislative] working group is that they heard equally clearly from the consultants that a good regime that is stable and predictable and lasts 10 years is the right thing to do to maintain industry's investment and interest in Alaska and the production that is needed. To establish the kind of regime that is going to have lasting power of 10 or more years requires time and great deliberation and a very serious deep inquiry. Doing this over the interim with it coming back to the legislature in 2017 provides a grace period to ensure that everything is being examined top to bottom related to this regime - gas supply, gas security, gas rates, oil, and the rest of the world. The co-chairs were also hesitant to make wholesale regime changes right now in a very challenging fiscal environment under which industry is suffering greatly due to low oil prices. The existing Cook Inlet regime sunsets in 2022 per statute. Having a working group undertake this evaluation sooner rather than later so as to have something under evaluation by the legislature in 2017 allows time for this working group to determine how to phase in or make effective those changes that have the least damaging effects possible on current investment and activity.

1:35:08 PM

REPRESENTATIVE TARR addressed the selection of credits that Version P is choosing to use. She noted that the original bill moved much more to the net operating loss framework while Version P would keep several credits. She requested Ms. Delbridge to talk further about why the preference of keeping all three credits rather than consolidating into net operating loss as a simpler way to address that.

MS. DELBRIDGE answered that the net operating loss concept as kept in the original version of HB 247 would sort of mirror what is in existence on the North Slope. However, on the North Slope there is also a tax of substance and the net operating loss is designed to be equivalent to that same production tax. In Cook Inlet there is very little to no production tax, although the state receives benefit via royalties and economic gains of jobs. There are certainly companies that may not be in a loss position necessarily in Cook Inlet should oil prices increase a little bit, but that may still need to draw on a degree of state support to continue building their business in Cook Inlet and continue their investment. So, maintaining that level of a QCE credit that supports that capital investment and continues work underway seemed like a reasonable route forward to the co-chairs. Once a Cook Inlet regime is established, understandably there may be a tax and maybe a proportional loss provided as well.

1:37:20 PM

REPRESENTATIVE JOSEPHSON, relative to the [legislative] working group, asked whether the intent in Version P is that provisions such as the January 1, 2017, stepdown of the WLE [credit], for example, could be undone "if the facts would take us where they lead us" and that the credit system as it exists may be made fully whole if the case is made that it should be. He said he is saying this in the context where in 2008 the state paid $53 million and this year it is $650 million, which he thinks is a 1,200 percent increase. He further asked whether that is sustainable. Responding to Ms. Delbridge, he clarified that for the term "fully whole" his is meaning that if this bill became law, soon into the Thirtieth Alaska State Legislature this work would be undone and the WLE be made 40 percent again.

MS. DELBRIDGE replied the co-chairs felt that while a whole regime change is being undertaken it is appropriate to stepdown the WLE [credit] in particular. The WLE [credit] is an extra benefit for a segment of work that came about through the 2010 Cook Inlet Recovery Act. It was in a sense a fire-alarm-pull emergency measure related to rolling brownouts and a fear of serious gas supply shortages and the prospect of importing LNG to Southcentral. It accomplished the desired effect and Cook Inlet has pulled out of the situation somewhat with gas under contract mostly for the next 10 years or so. The co-chairs were equally clear that they do not intend to pull the rug from underneath businesses that are doing work in exchange for that benefit. Stepping it down was therefore a logical thing to do through that interim period. Other than to present the plan to the legislature in 2017 regular session, there are no requirements in the working group's direction as to whether its newly developed regime should not take effect until 2022 when the current regime sunsets, whether it should take effect immediately for some reason, or whether it should also phase in. On the North Slope, Senate Bill 21 [passed in 2013, Twenty-Eighth Alaska State Legislature] had a provision for sort of a two-year interim period. Transitional investment credits were also offered for the production profits tax (PPT) [passed in 2006, Twenty-Fourth Alaska State Legislature] to Alaska's Clear and Equitable Share (ACES) [passed in 2007, Twenty-Fifth Alaska State Legislature]. So, it is not uncommon to phase something in or out. This starts to stepdown that support, acknowledges that the WLE [credit] has worked to a large degree related to energy security and was an amplified benefit for a special reason that can start being stepped down.

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REPRESENTATIVE SEATON noted that Section 16 of Version P would limit the repurchase of tax credits to $200 million [per company per year], while the limit in the original bill was $25 million. He questioned whether that number is at all effective, whether it is any limit at all. For example, he pointed out, four or more players on all of the major fields would bring the total to $800 million per year.

MS. DELBRIDGE suggested this question be posed to enalytica, but said the thinking of the co-chairs was that $200 million is a generous limit and rather than being an immediate-year budgetary protection it is intended to cap the state's potential liability against an outlier development, a development that is on a much greater scale than the work seen to date. Multiple companies could certainly be participating, it would not be capped per project. The $25 million cap was the starting point brought forward by the Department of Revenue in the administration's bill. She believed the number to be similar to the number in the PPT era, adjusted for inflation maybe $40 million today; Version P says $200 million. For as many partners as someone brings in to a field, she continued, those partners would all be needing to spend a great deal of money in order to receive up to $200 million of a net operating loss, and each partner brought in would further dilute the original company's reward. So, while it is a possibility that eight players could be brought in so that all eight players can get $200 million apiece, it might be hard to truly identify a situation where a partner will feel that it is in its interest to bring in that many partners that then reduces its reward in the end.

REPRESENTATIVE SEATON pointed out that the current major fields all have more than four partners. He said he would like the committee to look at the aforementioned as it goes forward.

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REPRESENTATIVE SEATON noted that Section 27 would repeal the QCE credit and inquired why qualified capital expenditures would be redefined if they are no longer being used for credits.

MS. DELBRIDGE replied that the term "qualified capital expenditure" is used in conjunction with other tax provisions not related to the credit. For other tax purposes Alaska statutes say that certain things must be a qualified capital expenditure. Instead of defining it on its own, the bill says that means what it means in the credit. So, if qualified capital expenditure no longer exists defined in the credit, a definition of what that is needs to be supplied elsewhere in statute so that it can continue to apply to the other sections of tax statute. Responding further to Representative Seaton, she agreed to provide the committee with a listing of those other places in statute.

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REPRESENTATIVE HERRON commented that Senate Bill 21 looked at credit reform on the North Slope while [HB 247] looks to the Cook Inlet. Neither the administration's bill nor Version P address other credits that are expiring soon, he noted, and those expiring credits are going to save the state money and reduce cash-back credits. Regarding the proposed [legislative] working group, he said the target audience is actually the legislature because of the state's deficit and so the legislature is who the target audience has to be. He agreed the working group should be done during the coming interim. He requested that Mr. Alper be able to provide an initial comment on Version P later today.

1:47:10 PM

REPRESENTATIVE TARR addressed the "very generous" $200 million limit and the possibility of it encouraging unwanted behavior. She recalled that a criticism of the ACES regime was that the capital credits were not linked directly to production and led to spending that did not result in new oil production. In this current low price environment, she continued, it has been said that this system is still encouraging activity and she would like to know why [the co-chair's] would feel comfortable saying that this would not occur should prices reach $50-$60 and a company has not yet reached a profit point.

MS. DELBRIDGE understood that Representative Tarr's concern is about a situation of not a rock bottom price but not quite good profitability yet, and what would prohibit someone from spending a lot of money to hit that $200 million cap on production.

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REPRESENTATIVE TARR pointed out that [the cap] is not directly linked to production, but to overall spending. She questioned whether it is being ensured that it is not so generous that it encourages spending that is not directly linked to production, a criticism of ACES, and the state would then have a substantial liability related to that. She asked whether this was thought about when $200 million was recommended as the right number. Responding to Ms. Delbridge, she confirmed that her question is referring to what used to be called "the gold plating."

MS. DELBRIDGE responded by looking at what the $200 million cap would actually apply to. It only applies to refunds per year. A legacy producer with more than 50,000 barrels of production a day does not get any refunds, so this producer can be taken off the table. That leaves a small producer with a loss that can get a refund or a newcomer without any existing production that is developing something. A company's continued expenditure on a development might not be directly related to the current price of oil, but to the company's expectation of profit and expectation of oil price farther out into the future. There did not seem to be a real concern that there would be amplified gold plating because this credit limit is quite high and, based on what is seen in the Revenue Sources Book, most likely is not necessarily something that is being reached anyway. To have this situation occur it would have to be assumed that a company, because there is now a limit that it has not reached yet anyway, would be spending more. She urged that this question be posed to enalytica.

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REPRESENTATIVE TARR, regarding North Slope [legacy producers], noted that even though the state is not making a cash outlay, it is essentially not getting money. She posited that this does impact the overall budget picture because those are dollars that would otherwise be paid as production tax. She surmised that for the North Slope [the co-chairs] feel comfortable that [a cap of $200 million] would not encourage gold plating.

MS. DELBRIDGE answered that that was not a concern because in such an instance the company is at a loss position already, so it seemed difficult to construe of a company interested in driving itself deeper into a loss situation in order to get more of a credit that is going to be applied against its future tax liability. There are rules related to how a company can take the 35 percent net operating loss deduction and for what. Maintaining that status quo of a company's ability to calculate that loss and to carry it forward was something that the co-chairs wanted to maintain.

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REPRESENTATIVE JOSEPHSON on this same subject, recalled Director Alper using Armstrong Oil & Gas Inc.'s Pikka unit as an example of a 75,000 barrel model where in the out-years the people of the state would benefit if it all came to fruition, but in the near term the state would be out well over $1 billion. In this case, he maintained, the state would own it metaphorically - the state would become attached to this field and burdened by that. While the state could tighten its belt and try getting through those tough years to the golden egg at the end, it would be tough to do. He expressed his concern that Armstrong might delay its development slightly in order to benefit from $200 million a year.

MS. DELBRIDGE replied that generally speaking industry that is invested far more than the state's contribution in development is going to want to get production as soon as possible to start realizing that benefit. The $200 million would certainly be a cap against what is the state's exposure related to that kind of a development. She said she believes there was not real concern that a company might delay development to be able to continue incurring a loss when it had production in sight that was going to help start the returns on its own investment, which is multiple times what the state's investment would have been, in cashing out a loss.

1:55:00 PM

REPRESENTATIVE HERRON noted the governor's proposal [of a $25 million cap] was much less than $200 million. He asked why $200 was chosen and not $175 or $150.

MS. DELBRIDGE responded there was much discussion about this. Ultimately the co-chairs' approach was not to set some arbitrary limit that would potentially have impact on today's activities, but simply to protect against an outlier, something that is so much bigger than what is known as regular business today and could be beyond the reach of the state to continue supporting. The $200 million was not meant to curtail what anyone today is able to receive in that refundability, but to protect against outliers. The $200 million is a generous cap, but the approach is from a resource development perspective as opposed to an immediate deep cut related to the state's budget.

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REPRESENTATIVE TARR inquired whether the proposed legislative working group is envisioned to be bi-partisan, given the language does not designate seats for members of the minority.

MS. DELBRIDGE offered her belief that an assumption was made that the two chairs of this working group would be very responsible that way and be reflective of the legislature as a body, which would account for respecting that there are majority and minority members in the legislature. This was a fairly broad starting point to provide the two co-chairs a lot of discretion as to numbers and things like that. She imagined that the co-chairs would entertain an amendment being more explicit about the membership.

CO-CHAIR NAGEAK added that there was deliberation regarding including as many people as possible.

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REPRESENTATIVE SEATON, regarding the legislative working group, commented that there will be some select legislators who are going to work on this when the legislature has committees that have this as their responsibility. There are committees that are already formed that have people who have been working on this issue for months. There is the possibility of having legislators who are just starting to get up to speed on this issue and it seems like it might be a committee process that might need to be there as well. He urged that at some point it needs to be determined why the committee structure cannot work on the problem in the way that is being proposed.

CO-CHAIR NAGEAK replied it is always nice to get other ideas from people not related to this subject, but said the suggestion will be taken under consideration.

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CO-CHAIR NAGEAK recognized Mr. Ken Alper.

KEN ALPER, Director, Tax Division, Department of Revenue (DOR), explained he is here today to answer questions [on behalf of the governor]. He said the Department of Revenue will be providing a structured presentation on 3/21/16.

1:59:31 PM

REPRESENTATIVE HERRON understood that in developing the proposed CS the co-chairs asked questions of Mr. Alper. He requested Mr. Alper to provide an initial reaction to the proposed CS.

MR. ALPER clarified he is not before the committee as himself but as a representative of the administration and to his knowledge the governor has not seen the proposed committee substitute. He explained that [DOR] needs to speak to its own superiors before providing any formal reaction. He noted that the administration's bill had four sets of things that the administration was looking to change. One related to the North Slope regime and certain limitations on repurchase, one related to the Cook Inlet regime, one related to the minimum tax, and then a number of miscellaneous provisions. Therefore, any reaction he might have is going to be somewhat different in that the elements of the bill have been capped or modified somewhat differently related to the four different themes. Regarding the North Slope side, he said he appreciates the co-chairs' determination to maintain the core provisions of Senate Bill 21. Senate Bill 21 was very much of a North Slope tax change and was protected and defended through the referendum process, and there was limited desire to make those changes. He further said he appreciates the maintenance of the gross value reduction (GVR) and net operating loss comingling issue that Mr. Mayer [of enalytica] referred to as something of an unanticipated circumstance and that will maintain value.

MR. ALPER said he has some concern with the use of a $200 million per company per year limit. Addressing Representative Seaton's concern about the potential for this being multipliable through multiple partners in the same project, he recalled that [during the committee's 1:10 p.m. meeting on 3/7/16] he provided a life cycle analysis of something comparable to what the Armstrong project [Pikka Unit] would look like. This analysis showed the state's credits peaking at about $800 million per year. With a couple of partners that does not make that much of a material difference in a $200 million limit. Yesterday, upon receiving a preview of Version P from the co-chairs, he reviewed historic records to see where that sort of limit had been approached in the past and found one instance in a prior year where a single company received more than $200 million in a single tax credit refund. He therefore expressed his hope that the committee might consider something of an in-between number.

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MR. ALPER, in regard to the Cook Inlet side, offered his appreciation for the desire to phase things in. He said the administration was looking for a much more immediate effective date with two major changes. The administration was looking to go from a level of 65 percent at max to 25 percent. [Version P] would go to a 30 percent level and would provide about an 18-month delay in getting to that 30 percent level, but that is not a tremendous hurdle. In regard to members earlier questions about what the difference is between offering a 25 percent operating loss versus a 30 percent combo-credit that includes the capital, he said the main difference has to do with who would be benefitting from it. Specifically, the administration was looking to reduce to zero any benefit through cash to producers that were in production earning a profit not paying taxes due to the tax cap but under current law were still eligible to receive the well lease expenditure and capital credits. [Under Version P], those sorts of entities would continue to be able to earn credits at the 20 percent level even if profitable and not paying taxes. In his opinion that is the primary difference between the two different structures, the 5 percent difference between the 25 and 30 being less material.

MR. ALPER said the administration came before the committee with changes to the minimum tax and given that those have been eliminated wholesale from Version P there is really not a lot to comment on. He added he does think there is a very substantial difference between the conversation over going between 4 and 5 [percent], which did in many ways speak to core provisions of Senate Bill 21, and certain hardening of the floor issues. If he were to try to debate and pushback, he would personally be pushing back on the hardening provisions, but he does not yet have his direction from above.

MR. ALPER, regarding the miscellaneous provisions, offered his belief that Version P does a very good job of preserving some of the smaller less material issues that the administration raised as technical issues that were discovered in current statute, such as the municipal credit pro rata issue and the other liability to the state issue. Stating his belief that compound interest was an oversight in the last committee substitute of Senate Bill 21 when it was in the House Finance Committee, he offered his appreciation for the restoration of compound interest, but said he personally believes the rate is still too low. Alaska is entering a world where state government is going to be operating on the earnings from the state's savings. There is an opportunity cost to that, he pointed out, and an interest rate tied more closely to opportunity cost is an appropriate mechanism. He said he will provide more details on 3/21/16.

2:05:38 PM

REPRESENTATIVE JOSEPHSON understood it would be illegal for Mr. Alper to tell the committee who the single company was that received over $200 million [in a single tax credit refund].

MR. ALPER replied correct.

REPRESENTATIVE JOSEPHSON said his sense is that the $500 million in savings might be reduced in the coming fiscal year to less than $100 million. In that event, he surmised, the only comprehensive fiscal plan that he has seen, the governor's plan, does not balance and something would have to change about the governor's change.

MR. ALPER responded that the comprehensive fiscal plan the governor brought to the legislature had nine different bills as well as certain expectations about the use of savings in the future, and it did not get to balance until 2019. [Version P] would certainly be a rollback from that balancing point and will require other measures. Other caveats are that all nine bills do not seem to be moving this year. Nothing that DOR will be providing the legislature and the public a spring revenue forecast update on 3/21/16, he said the other issue is that it will be seen that the state has less money than was thought because the price of oil is lower than was expected when the update was done in December. There is going to be a number of updates to the bottom line and how that might inform the discussion for how to balance the budget in years to come. Regarding the total fiscal impact of this bill, he said he does not want to get into numbers prematurely because that is ongoing work. The $500 million that DOR suggested as an initial impact of HB 247 was an initial year number, it decreased in the years going forward simply because of DOR's limited knowledge of what the credit spend is going to be two, three, and four years from now. The department does not know and cannot predict company behavior, the department only knows what the companies tell it. That baseline number itself is going to be changing due to the forthcoming spring forecast update. Of the number that DOR brought before the committee, about $100 [million] was on the revenue side related to the minimum tax, and he can comfortably tell the committee that the new number is zero. He confirmed that the other $400 million, which is the savings from reduced or deferred credit payment, is going to be a substantially smaller number.

2:08:28 PM

REPRESENTATIVE TARR noted that Version P has no provisions about confidentiality or sharing of information, and asked whether Mr. Alper has an initial reaction to that. She said the committee has heard that this might be difficult because the structure of HB 247 relied more on the net operating loss credit and what that might tell about the entire company profile. Given Version P would maintain the QCE and WLE credits, she surmised it would be easier, then, to get at that confidentiality.

MR. ALPER concurred that Version P removes the provision in the governor's original bill that would have made public certain information about which companies receive tax credits and how much. He shared that DOR was concerned that in a world of almost entirely net operating losses the reporting of the amount of a net operating loss credit would effectively enable someone to back-in to the size of a company's loss, which is currently a taxpayer confidential number. Version P would have a broader mix of credits remaining, possibly ameliorating that problem somewhat. He suggested that Ms. Delbridge might have additional insight into what the thinking might be in regard to future potential language on the confidentiality issue. He pointed out that Version P also removes the original bill's data sharing provision relating to the Department of Natural Resources (DNR) and the exploration and seismic data. He said his understanding of why is because some of that authority remains in the existing AS 43.55.023(a), which is no longer being repealed. However, he qualified, he does not fully understand the details of that since he has not yet spent that much time with Version P.

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MS. DELBRIDGE confirmed that the sharing of certain information about companies that are receiving credits is not included in Version P. She said there were concerns about whether requiring a taxpayer to waive confidentiality that is essentially provided by the federal and the state constitutions had broader implications; it certainly concerned the taxpayers a great deal. The co-chairs acknowledge that the net operating loss (NOL) is a greater concern, as was stated by Mr. Alper. The NOL is still there on the North Slope as the sole credit available. In that instance there would always be those concerns related to confidential information and what Mr. Alper described as the way for someone to back-in to a company's proprietary information related to disclosure of the NOL. In Cook Inlet the NOL remains but is decreased, and the well lease expenditure [credit] would, via a forthcoming amendment from the co-chairs, be gone in a few years. The qualified capital expenditure [credit] would remain and certainly that is one credit remaining to which someone may want to look. In regard to the significant list of other credits that will sunset in statute this year through inaction to renew them rather than through this bill, she said those certainly were very targeted and some very generous, and without those in place there may be less of a need to understand precisely what in a public forum.

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MS. DELBRIDGE noted that in regard to data sharing provisions, the 30-40 percent alternative credit for exploration expires this year for both the North Slope and Cook Inlet, but continues until 2022 in the Middle Earth. Use of that significant credit has resulted in data sharing for exploration and seismic work to DNR. As Mr. Alper testified, the discontinuation of that credit drove the desire to backfill some of that with data sharing via other credits. This was discussed at length. The qualified capital expenditure (QCE) credit and the well lease expenditure (WLE) credit both have two parts to them. The first part is for lease expenditure work and the second part is for exploration and seismic. Explorers applying for those two credits would still be incumbent to abide by the data sharing provisions in statute in AS 43.55.025(f)(2), the data sharing provisions for the alternative credit for exploration. Current statute provides that for exploration and seismic work a company is still subject to that data sharing, there would still be credit incentives that through the statute "subs" directly relate to exploration and seismic. If fewer people are doing this work and getting credits for it because of the sunset of the big credit, the alternative exploration credit, there might be a reduction in that data. The Alaska Oil and Gas Conservation Commission (AOGCC) receives data from companies for producing wells and well developments on existing leases that is not exploration and seismic. Most of the data is publically posted on AOGCC's website within 30 or 60 days, she believed, and extensive information is also available on AOGCC's website for the non-explorer seismic. Because AOGCC does not have duties and responsibilities related to seismic activity it does not get the seismic data.

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REPRESENTATIVE HERRON agreed that Section 30 probably needs some more detailing done to it. He inquired whether there should be a review of repealing the Oil and Gas Competitiveness Review Board that is currently in place.

MS. DELBRIDGE answered that the Oil and Gas Competitiveness Review Board has multiple missions, one being the ongoing review of the state's competitiveness on the North Slope regime. She said it is certainly up to the committee to determine whether the value of that is ongoing. This board was also specifically tasked with considering the Cook Inlet regime. In looking at this there was a desire to be more immediate and legislatively focused as to a 2017 examination of the Cook Inlet regime. Therefore the review board's task for Cook Inlet may be accomplished through the [legislative] working group proposed in Version P. The review board's big mission related to Alaska's competitiveness with jurisdictions around the world for big investment dollars on the North Slope is separate from that.

REPRESENTATIVE HERRON stated that in his questioning he forgot that he wanted it to be narrower about leaving the duty to study Cook Inlet and for the board to do the global review which he knows is necessary. He asked Mr. Alper whether the review board's task on the Cook Inlet should be suspended and to let the legislature review it because the target audience is the legislature given it is an important policy call.

MR. ALPER qualified he is speaking off the cuff, but that there is a fundamental difference between the North Slope and the Cook Inlet. The primary mission of the Cook Inlet has historically been to provide energy for Alaskans, although there is certainly an export component and an industrial component. [The mission] of the North Slope is being Alaska's big revenue generator. So, there are different missions in trying to attract investment. The existing Oil and Gas Competitiveness Review Board is in many ways kicked to the administration, it is staffed out of the Department of Revenue and DOR works in researching and reporting with legislative entities, whereas the [proposed legislative] working group would very much be a legislative-led committee. He said he does not know that there is necessarily a need for two, maybe just a need for consensus over how to structure it and what is the appropriate forum in which the analysis should be done. He said he is more than happy to not take on a major new task inside the Tax Division in an era of major budget cuts.

2:18:25 PM

REPRESENTATIVE JOSEPHSON, relative to the [proposed legislative] working group, recalled that Senator Giessel had a working group that met about six times, generally three hours per meeting. The House Resources Standing Committee has met 20 times. The committee also met in Nikiski around June 16 [2015] for several hours, at which Mr. Alper and the commissioner testified as did the legislature's consultant, enalytica. Senator Giessel invited basically anyone from industry who wanted to appear and they did. A large report was written. As someone who believes in scholarship, he said he believes it is great to keep asking questions and be searching. He inquired whether the proposed CS was designed to transition the WLE [credit] slower because of a belief that the working group was essential given this background where there is now 900 pages of documents and scores of hours of hearings.

MS. DELBRIDGE replied that to sunset the WLE [credit] slower would essentially mean to withdraw it completely now. The proposed CS would stepdown the WLE [credit] beginning in 2017, reducing it from 40 percent to 30 percent, and the next year it would be 20 percent. As mentioned, there was an oversight in Version P, it would potentially be amended by the co-chairs to repeal at that point. So, it is a slow stepdown over two years, this year and next year. It is not tied to the working group's activities. The stepdown was related to the concept that companies are using this today in Cook Inlet to provide gas and oil. [The co-chairs] would like to moderate the companies' potential changes in investment behavior by stepping it down over these two years rather than withdrawing it all at once. It is correct that [Senator Giessel's] working group has spent a great deal of time and work and the WLE [credit] stepdown is not related to those timelines.

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REPRESENTATIVE SEATON noted that at about $700 million a year the oil and gas tax credits is one of the largest expenditures in the state's entire budget. He said he thinks $73 million is allocated in the house and the senate budget for this. He argued that the proposed CS would not make significant budgetary progress for fiscal year 2017, because it does not start to make any difference in Cook Inlet until halfway through fiscal year 2017 and there is no difference at all in the refundable tax credits for the North Slope. He said he is having difficulty with the slow ramp-down in Cook Inlet and the exclusion of any effect at all on North Slope refundable tax credits as to where the state will get those funds because those funds must be generated from somewhere. He added that he is having a very difficult time with taking $1,000 from every person's dividend and then using it to go right back out to pay tax credits. Some members will be thinking things are too much and some thinking too little. Reducing refundable tax credits on the North Slope cannot be ignored in any bill that the committee goes forward with, because that is a huge budgetary expense. The talk is about needing to do budgets and almost no budget cuts are seen here. He urged that as the committee goes forward the parameters be looked at for what needs to be done for the state's budgetary situation and to move things a little quicker and more holistically across both basins.

MS. DELBRIDGE answered that the direction from the co-chairs to the staff who helped develop the CS was to be cognizant of the state's budgetary situation. However, the co-chairs are not in a position on this committee where they are hearing fiscal bills as a whole picture and there is then a balancing act to look at. In this committee the co-chairs wanted to focus somewhat on responsible resource development policy. So, while aware of the budgetary concerns, the potential impacts to industry of immediate and dramatic changes in order to resolve a short-term or immediate-term budget problem could have fairly significant effects to the state's production in future years where, for better or worse, the state is still looking to a single industry for the majority of its revenue coming in. The co-chairs were clear that there is this balance to be had at some point. If the bill progresses from this committee it would go to the House Finance Committee, which is hearing a number of fiscal related bills and is perhaps in a position to truly assemble the pieces in a manner in which the ultimate package has the impacts that Representative Seaton is articulating.

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REPRESENTATIVE SEATON clarified he was not at all knocking staff or saying that staff was not following direction, rather he is talking about the committee's work in the direction of the CS. He reiterated that some people will think it is too much and some will think it is too little as the committee goes forward. As a legislature, members are involved in a number of these topics to figure out where to make cuts and where the revenues are going to be, and this is one of the most significant places to look for cuts. He understands staff is following direction, he continued, but he is not sure the committee can afford to ignore that direction. If these oil prices are maintained, he is not sure the statement is correct that oil is going to be the significant funder of the state; that may not be revenue the state can rely on when deficits are three times more than revenues. Therefore, he is drawing members to that as the committee considers the bill going forward.

CO-CHAIR NAGEAK responded that that is what is being done and the co-chairs are cognizant that the biggest funder of the state is in dire straits also. Something must be done, a discussion has been started, and the co-chairs are continuing on with the conversation knowing that if nothing is done there will be even more problems later. Everything must be discussed that drives the state to come up with something that will be workable with all concerned. It must be a deliberate process, everyone must be heard from if the state is going to continue working with tax credits and other things, and it must be ensured that everyone understands why this is being done.

2:30:10 PM

REPRESENTATIVE TARR, regarding where the committee is headed with Version P, recounted that a criticism of ACES was that it made small producers winners over the "big three" on the North

Slope. Senate Bill 21 was supposed to correct some of that and did not really deal with Cook Inlet. She said it appears that Version P would create winners and losers in Cook Inlet and would discourage any new entrants over this two-year period as things are scaled back. The proposed stepping down is so that companies currently doing work are not disadvantaged, but the net effect could be that it disadvantages new entrants going forward. This concerns her, she continued, because in the committee's discussions about gas supply it was stated that 10 years of supply are under contract. However, it has been stressed that exploration, development, and production all need to be encouraged at all times to preclude a lag in the supply chain. Those early stages of work must be ensured, particularly if the market becomes less constrained due to reopening of the Agrium plant or the ConocoPhillips [LNG export] facility.

MS. DELBRIDGE agreed that something like Agrium reopening or the renewal of exports because prices changed would be a game changer for people who have currently made big investments in Cook Inlet, particularly those with gas having potentially a difficult time finding a market for that gas. She recalled Mr. Webb of Furie Operating Alaska, LLC, ("Furie") testifying that as of a few weeks ago Furie had only one contract at that point in time for its gas and that the revenue to Furie from that gas is insufficient for Furie to meet its debt. Since then, she has seen a contract from Furie at the Regulatory Commission of Alaska (RCA), and while not for a huge volume, every bit helps. The co-chairs' position is not to discourage new entrants; it is to suggest that if it is felt that 65 percent support upfront in cash by the state is too much, then it is a concern to bring new entrants into Cook Inlet to produce gas that people producing now cannot necessarily find a market for or to find oil for which the state may get royalty income and jobs but no production tax revenue from. To moderate that level of state support now while examining the entire regime would be the responsible action so that the state is not putting out terms saying it wants to continue paying 65 percent state support to newcomers when the state is suggesting that the gain resulted from that is not what the state was perhaps targeting. Certainly the co-chairs' intent is not to discourage new investment, but simply to do it in a way that does not require that high level of state upfront support and becomes attractive to companies where the system looks sustainable, fair, and balanced for long-term business decisions.

REPRESENTATIVE TARR said a timeline needs to be put out of when these other credits are going to expire. Another of her concerns, she explained, is that as a policy it is being said that once a company is making a profit the state is going to let the company have credits. The North Slope is a bit different. In some ways it is a lack of consistency, she continued. It has been heard repeatedly that the state is trying to create systems that have some stability or durability to them. She surmised that Ms. Delbridge is acknowledging not getting there today by including a [legislative] working group in the proposed CS. To the extent [the legislature] can get closer to that, she said she feels strongly about how hard [legislators] should get to work there because that dominates so much of their time and also because [legislators] have other important matters to think about relative to the entire budget.

2:35:48 PM

CO-CHAIR NAGEAK asked whether Representative Josephson maintains his objection to adopting Version P as the working document.

REPRESENTATIVE JOSEPHSON maintained his objection to adopting Version P as the working document.

2:36:05 PM

The committee took a brief at-ease.

2:36:28 PM

REPRESENTATIVE JOSEPHSON withdrew his objection to adopting the proposed committee substitute (CS) for HB 247, Version 29-GH2609\P, Shutts, 3/18/16, as the working document. He noted he is withdrawing his objection in anticipation of further discussion of amendments in the coming week. There being no further objection, Version P was before the committee.

2:36:48 PM

The committee took an at-ease from 2:36 p.m. to 2:43 p.m.

2:43:54 PM

CO-CHAIR NAGEAK announced that enalytica, the legislature's consultant, will provide a presentation on Version P of HB 247.

JANAK MAYER, Chairman & Chief Technologist, enalytica, as consultant to the Legislative Budget and Audit Committee, provided a PowerPoint presentation, "CS HB 247: Impact of

Proposals." Drawing attention to slide 2, "CS HB247 SUMMARY," he addressed the North Slope provisions included in Version P. On the North Slope, he explained, Version P would keep intact the overall architecture of Senate Bill 21, but two key changes would be made. The first change would remove the impact of the gross value reduction (GVR) in calculating the net operating loss (NOL). This refers to the issue raised by Mr. Alper that under current statute it is possible to effectively get more than 35 percent NOL support for North Slope spending in certain circumstances, in particular for a new development on the North Slope because the gross value reduction was included in the way the net operating loss was calculated. The provision in Version P would end that possibility. The second change would provide a per company cap of $200 million on refundability of credits. This would not have a major impact on the amount of refundability that occurs at the moment, but would protect against potential larger development in the future.

MR. MAYER continued on slide 2, next discussing the Cook Inlet provisions included in Version P. Three principle credits apply in the Cook Inlet, he said: the 20 percent qualified capital expenditure (QCE) credit; the 40 percent well lease expenditure (WLE) credit; and the 25 percent net operating loss (NOL) credit. Version P would maintain the 20 percent QCE credit. It would reduce the WLE credit to 30 percent in 2017 and would effectively phase it out after [2018] by making it the same level as the qualified capital expenditure credit. As per Ms. Delbridge's testimony, he understood that a future amendment would sunset the WLE credit at that point since the well lease expenditure is a strict subset of the work that is eligible for the qualified capital expenditure. Version P would reduce the net operating loss credit from 25 percent to 10 percent.

MR. MAYER continued on slide 2 and reviewed the three overall general provisions included in Version P. He said the first would provide for compound interest, as opposed to simple interest, on delinquent taxes. The second would provide the ability to withhold from refundable tax credits the existing liabilities to the state that a company has from its oil and gas production. The third provision would establish a [legislative] working group to look at a [new] Cook Inlet tax regime and present that to the 2017 regular [legislative] session.

2:48:08 PM

MR. MAYER turned to the chart on slide 3, "BIG DIFFERENCE BETWEEN NORTH SLOPE AND COOK INLET," and looked at the credits refunded by the state versus the total revenues brought into the state under the current fiscal system. He said there is a very big difference between the revenue that comes from the North Slope in production taxes, and especially royalties at these price environments, versus the low to nonexistent production tax in Cook Inlet and small amount of royalty that comes from the much higher production volumes in Cook Inlet. In general when looking across the years there is a fairly even balance between the amounts of credit refunds in those two places. But, for fiscal year 2015, which the chart depicts, credit refunds are higher in Cook Inlet than the North Slope - $[404] million in Cook Inlet versus $224 million on the North Slope. "The difference in those two situations," he continued, "is a key reason for the difference in those two impacts of the two areas in terms of what this bill does."

2:49:34 PM

MR. MAYER moved to slide 4, "GVR RAISES NOL CREDIT ABOVE 35% OF ACTUAL LOSS," to discuss the North Slope changes and impacts. One of the two key areas on the North Slope, he said, is the question of the interaction of the gross value reduction and the net operating loss. The aim of the gross value reduction is to lower the effective tax rate on new production. It does that by focusing on the gross revenue part of the equation rather than the actual tax rate itself. Because Alaska's tax system does not ring fence, does not distinguish on the project level between different projects, it is very hard to take a new development and say it should receive a lower tax rate. However, those differences can be tracked at the level of production out of revenue. The surprising and counter-intuitive effect [of the gross value reduction is that it raises the effective rate of the NOL credit]. Current statute describes the NOL as the ability to deduct costs against production tax, and that production tax level is calculated using the gross value reduction. The effect is to cascade that gross value reduction into the way the net operating loss credit is calculated, which means that rather than 35 percent of an actual operating loss it is possible in some circumstances for a company to be reimbursed for 35 percent of a gross-value-reduction-enhanced operating loss, one that exists as a function of that allowance, not because it is an actual loss.

MR. MAYER provided an example of the aforementioned by bringing attention to the two graphs on slide 4. He explained that the left chart looks at the after-tax cash flow of a new development at a price of $70 per barrel and the right chart looks at that same development at a price of $40 per barrel. In both these cases there is a small difference in the cash flows under the current law of Senate Bill 21 versus Version P. The difference in the two lines on the chart is the impact of addressing this issue with the interaction of the gross value reduction and the net operating loss. This is something that applies at a wide range of prices, but is particularly exacerbated at low prices. The issue here is that in the early years of a new development by a new company with no existing tax liability, there is no effect of the gross value reduction because the company has no production and no revenue. The gross value reduction goes into effect once production starts, once the company has revenue. During the early years of production with ongoing drilling, a company's costs are greater than the revenue the company receives from production, making a net operating loss. However, the effect of the gross value reduction is to further lower the gross value of that production, the production tax value, and all the rest, and when that flows on into the NOL it increases the value of the NOL. So, the difference in the dotted lines between what Version P would do rather than current law, is that the NOL would remain in place but would be strictly 35 percent support for government spending and is the same as any other company. He added that this would be consistent with what he thinks was the legislative aim of Senate Bill 21, which was to say uniform 35 percent government support for all actors.

2:53:19 PM

REPRESENTATIVE SEATON, regarding the graph at the price of $40, observed that the difference between the lines for Senate Bill 21 and Version P goes both above and below zero. He asked whether zero is the point at which a net operating loss is generated so that everything above zero is no effect at all.

MR. MAYER replied that things are counter-intuitive here because a few pieces affect this picture. One is how state, federal, and corporate income tax are treated; these are applied "further down the stack" after calculation of production tax and the net operating loss there. Most of enalytica's modeling assumed that a company with a new development still had other broader federal tax liability and that therefore losses a company makes could possibly be of benefit to the rest of its operations, and so from an overall company perspective that it is possible essentially to receive negative federal income tax. Thus, there may be times when from a production tax value perspective a company is at a net operating loss but may be very slightly cash flow positive after considering the impacts of federal income tax on the overall operations. So, zero is not a strict line in terms of the way things on this graph are represented at which an NOL is no longer payable, but it is very close to that and is something slightly above zero at which a company no longer becomes NOL eligible. Exactly how far depends on the direction of numerous different bases of the system.

REPRESENTATIVE SEATON understood the graphs represent after-tax cash flow for a new development and are from the company's perspective, not the state's perspective for losses of revenues. The graphs are from the company's perspective as far as the company's cash flow instead of this interaction with the net operating loss and the gross value reduction.

MR. MAYER responded correct, although the difference between these two things is attributed to one thing only - the treatment of the gross value reduction. The point of slide 4 is to say that the impact of this is much greater at low prices than at higher prices. The new development depicted in these graphs is of the sort that enalytica modeled and previously presented to the committee, which is $1-$1.5 billion in capital spending and peak production around 20,000 barrels a year. At a price of $40, the impact of this difference is less than $10 million a year for most years and is limited to those years of ongoing drilling in the early years of production. That difference across the time period is sort of between $0 and $10 million a year, and in most cases between $0 and $5 million a year. In the graph for $40, the difference between those two lines is the additional revenue to the state that would come from a project such as this.

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REPRESENTATIVE TARR commented that due to the X axis being in increments of $50 million it is hard to determine the difference between the two lines. She understood Mr. Mayer to be saying that generally that is about $5 million.

MR. MAYER answered that broadly speaking it is between $0 and $6 million for this particular model at these prices. He directed attention to the fifth line of text on the slide that states an impact of less than $10 million a year.

2:58:19 PM

MR. MAYER resumed his presentation. He addressed slide 5, "REFUNDABILITY LIMIT FOCUSED ON FUTURE LIABILITIES," regarding the second of the two key areas on the North Slope. He said the key aim of the refundable net operating loss is to provide the same benefit to new developers that existing producers have in the way they are impacted by the tax system. What this means in the vast majority of circumstances is that the impacts of a new development on the producer, as well as the state, are the same as if that new development had been done by an incumbent producer. For example, if the hypothetical project modeled by enalytica of $1-$1.5 billion in capital costs, 800 million barrels in recovered resources, and 20,000 barrels a day at peak production was undertaken by an incumbent producer, all of those costs would be deducted against the producer's liabilities and would reduce the producer's taxes paid to the state by that amount. If a completely new company developed that hypothetical project, the state would instead pay the company the refundable net operating loss credit. In the vast majority of potential price circumstances those two things are completely equivalent to the state. The cash payment to the small producer is exactly the same as the reduction in taxes for the larger producer. Elaborating, Mr. Mayer noted that the big impact of refundability [on the North Slope], particularly in a low price environment when the budget is strained, is a timing issue much more than an absolute spending issue. For instance, the original version of HB 247 provided a very tight cap on how much could be refunded. But a bill could provide that the net operating loss is not refundable at all. If, over the course of the entire project life, prices were sufficient to enable that credit to be recovered from project revenues further down the line, the total cost to the state (not considering the time value of money) for an upfront refund versus a deferred credit taken against future taxes is identical in the vast majority of price cases. In that sense, this is a question of timing and when those costs occur, and the fact that for a new development they occur now versus a number of years into the future. This has a big impact essentially on who can make development on the North Slope work.

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MR. MAYER illustrated the aforementioned by bringing attention to the left chart on slide 5 depicting cumulative cash flow of this hypothetical new development with and without refundable credits [on the North Slope at a price of $70 per barrel]. A company developing this project under the current system of a 35 percent refunded net operating loss credit might need about $300 million in total capital to enable the project to occur. But, if the NOL is non-refundable, a company might need $500 million or more to make the project occur. Because this is all about the timing of cash flows, not the total value across the project life, the fact that for a new developer these come early rather than later at the tail of the project means that, although the total cash flows are identical, the internal rate of return (IRR) is much higher under the current refundable scenario than under a non-refundable scenario.

MR. MAYER stressed that those cash flows coming early lead to substantial impacts. Making the NOL non-refundable or lowering the limit to $25 million per company, and making it effective immediately or very soon, would have a major impact on projects that are presently being developed. There are two possible solutions to that, he advised: one would be to take stricter action but find ways to grandfather in existing developments; the other would be to do something that does not place such a tight limit on refundability. Tight limits on refundability, whether that is a low per company cap or no refundability at all, have a big impact on what sort of companies can undertake investments on the North Slope. In particular, smaller less well capitalized companies and companies that rely on private equity participation for a substantial part of their investment structure, require solid rates of return. Some of those companies are currently able to make projects work on the North Slope, but would be much less likely to be able to do so without the refundable credits.

3:04:18 PM

MR. MAYER noted that the approach in Version P of $200 million is a very high limit relative to the $25 million proposed in the original bill. This would effectively avoid impacts on current investment while, in principle, offering some protection against future outlier projects. There is an important discussion to be had as to what exactly that limit is and should be and what sort of project there is concern about in the future, he said. There was discussion earlier in committee about a hypothetical new development roughly the magnitude of another Kuparuk, which to date has recovered more than 2.5 billion barrels. A hypothetical new development of 2 billion barrels that required as low as $12 per barrel of reserves to develop would be a $24 billion development. If one-fourth of that spending was on facilities capital expenditures that would be spent before major drilling started and before this field began production, then that would be $6 billion in pure net operating loss refunds. Thirty-five percent of that $6 billion would be $2.1 billion in total credits, which is a big number and one to be concerned about in terms of potential future impact. That would not all be in one year. For example, spread across three years it would be $700 million a year, which is about the same number the Tax Division talked about when it foresaw $800 million as a possible future risk, and in which case the question is, How many companies is that split between and what is the optimal level of a limit that seeks to minimize its impacts on current projects but constrains some of the state's potential liability in that scenario? That is an important discussion to have, he reiterated.

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REPRESENTATIVE SEATON asked whether the purpose of the net operating loss is to deform the market so that companies do not have to take other partners and can proceed without needing other capitalization, but that the limit would be the exact opposite which would force companies to take other partners so that they could get the $200 million limit in multiple partners. He further asked whether these two objectives are a kind of juxtaposition.

MR. MAYER replied he would not say that the net operating loss credit and its refundability distorts the market. In principle it exists to make the economics of a new development, the impact of the tax system and the actual tax that is received by the state, the same for a new developer without a liability as it is for a larger developer with a liability. The alternative of protecting the state by not offering the NOL in a refundable form is to say that the state understands that the economics are substantially more difficult for projects to be developed by new companies than by incumbent ones. That the economics naturally look much better for incumbent companies than for new ones and that the support, the cash that is provided through the tax system, is effectively higher for incumbent companies than it is for new ones. That is certainly a policy call that can be made, he said, and he does not think there is an absolute right or wrong on that. The purpose of refundability is not to distort the system as much as it is to make the impact as even as possible. It certainly mean that projects by smaller companies are possible that might not be otherwise. An important question to consider if this were to be changed is, What would be the impacts in terms of the resource base on the North Slope to be developed? Who might come in? Would things that are currently being developed or might potentially be developed still be developed in those scenarios? Regarding the possibility that a limit of $200 million could encourage splitting up a major project between more companies, Mr. Mayer said that when the really low limit [of $25 million] was being discussed, he was less concerned about this because it would be really hard to bring in enough companies to make that work. But, at a limit of $200 million, he can certainly see a case where a development that might otherwise be undertaken by two or three companies could end up being done by, say, four or five. It is a valid question to raise, he advised. A further look in statute could be taken as to whether there are ways to protect against that or whether the amount of the limit needs to be considered further.

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REPRESENTATIVE TARR addressed the right chart on slide 5 showing the internal rate of return (IRR) sensitivity under the current law of GVR with refundable NOL versus a nonrefundable NOL. She interpreted the graph as showing that to achieve a 15 percent IRR would push it out from [a price of $70 under current law to a price of] $80 under Version P.

MR. MAYER responded no, this would be if a stricter approach was taken on refundability. So, if there are no companies with existing development that are meeting that $200 million limit at this moment, "then you're still on the solid black line of the refundable net operating loss world." The purpose of these two [graphs] is to say if one took a stricter approach, whatever that stricter approach is, whether that was completely nonrefundable or some type of cap, one is starting to push out along those lines.

3:11:54 PM

MR. MAYER returned his presentation. Showing slide 6, "COMPOUND INTEREST AND CREDIT WITHHOLDING," he explained that the bill's key feature of moving to compound interest rather than simple interest would increase the penalty for delinquent taxes. At the current effective interest rate of 4 percent and the current six-year statute of limitations, that impact would be pretty small, a couple of million dollars. However, it would be a very big difference under a timeframe of multiple decades. He said he agrees with Mr. Alper that going from compound to simple interest was an oversight in the drafting of Senate Bill 21; compound interest is almost standard and makes much more sense. Mr. Mayer said another key feature of the bill relates to concerns around refunding credits to taxpayers that have existing liabilities related to oil and gas production, for example on royalties. It would not be that no refundable credit would be given, but rather that that liability would be withheld from any certificate issued and the taxpayer presumably would have the option to then say that that withholding is the way in which that liability will be discharged.

REPRESENTATIVE JOSEPHSON questioned what would actually change here if in the state's view there is a delinquency or a contest. He argued that a taxpayer would not agree to the discharge because in not paying it the taxpayer is clearly contesting it. He surmised that the advantage to the state is that this is essentially a sort of escrow system where monies are subtracted and held in abeyance pending resolution of the contest.

MR. MAYER agreed the aforementioned seems like a reasonable way to characterize it.

3:14:44 PM

MR. MAYER continued his presentation. Addressing slide 7, "REDUCTION IN COOK INLET SPENDING SUPPORT," he said the biggest impact of Version P is in terms of the level of overall support for spending in Cook Inlet. He reminded members that support on the North Slope primarily means how much can be deducted against an existing tax rate. However, he continued, support in Cook Inlet is much more about credits that are a form of subsidy provided to incentivize investment against a number of aims, in particular security of supply of gas to Anchorage, not effective investment that will be recouped through the tax system. Cook Inlet [currently] has three credits: the 25 percent net operating loss (NOL) credit that is then stackable with either a 20 percent qualified capital expenditure (QCE) credit or a 40 percent well lease expenditure (WLE) credit that is applied to a subset of capital expenditures specifically related to drilling wells. That means a company receives either 45 or 55 percent support, depending on how much of its spending qualifies at a 20 percent level capital credit and how much of its spending qualifies at the 40 percent well lease expenditure level. If an even split is assumed, then on average, total support is about 55 percent under the status quo assuming that the company is eligible for all of these things including the net operating loss. For an incumbent producer not eligible for net operating loss, support is about 20, 30, or 40 percent depending on how much of the producer's spending is QCE-eligible versus WLE-eligible. Version P would change this to 10 percent net operating loss credit for the carried-forward annual losses, stackable with effectively just a 20 percent QCE credit. The intervening year of 2017 would have a 30 percent WLE credit and after that the only credit remaining other than the 10 percent NOL is a 20 percent qualified capital expenditure credit.

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REPRESENTATIVE JOSEPHSON recalled that there was testimony limited to the question of the WLE [credit] being redundant in terms of what it covers or subsumed into the QCE [credit]. He expressed his concern about the effective phase out, noting that [Version P] does not technically phase it out in language, but says it becomes 20 percent in 2018. Given he is not an expert in what a WLE is and has only been told that it has something to do with deep water in the middle of the inlet, he inquired how he is to know the WLE [credit] is going to be phased out because it covers the same thing as the QCE [credit].

MR. MAYER answered he understands an amendment will be offered that would sunset the WLE credit after 2018 or in 2018. The reason is because expenses that are eligible for the WLE [credit] are a strict subset of those that are eligible for the QCE [credit]. To be eligible for the QCE [credit] an expenditure has to be a qualified capital expenditure and there are definitions under the tax code as to what that is. To be eligible for the WLE [credit] it must be both a qualified capital expenditure and meet some other definition of intangible drilling costs under the Internal Revenue Service tax code. By definition one is a subset of the other.

MR. ALPER suggested that Representative Josephson may be confusing this with the so-called jack-up rig credit, the deepwater Cook Inlet credit. He explained that the well lease expenditure is a broad credit for all well related expenditures. The term of art used in statutes is "intangible drilling costs." The key point is that to qualify for the 40 percent WLE [credit] a qualified capital expenditure must otherwise qualify for it plus meet these additional criteria. The intent of Version P is to step-down the WLE [credit]. Ms. Delbridge was trying to say that at the moment where it hits that 20 percent level, effectively there is no difference; to be a WLE it must already be a QCE, so whether it is kept in statute or repealed becomes immaterial at that point.

REPRESENTATIVE JOSEPHSON asked whether Mr. Alper agrees with Ms. Delbridge.

MR. ALPER responded, "Ms. Delbridge and I have discussed and we agree that to be a WLE ... it is a subset and must also qualify for a QCE; so if the intent is to maintain 20 percent support it shouldn't matter whether or not we repeal and it would be cleaner for statutory purposes to simply repeal the WLE at the point when it hits 20 percent."

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REPRESENTATIVE SEATON surmised that if the well lease expenditure is a subset of the qualified capital expenditure, then when the 40 percent well lease expenditure [credit] is eliminated at the start of the fiscal year, all of the projects would still qualify at that point in time for 45 percent tax credit because they would have the 20 percent qualified capital expenditure [credit] plus the 25 percent net operating loss [credit], which are stackable. He inquired whether he is correct in his understanding.

MR. MAYER asked whether Representative Seaton's question is meaning if one maintained the NOL [credit] at its current level.

REPRESENTATIVE SEATON replied yes, if at the start of the July 1 date the NOL [credit] was maintained at 25 percent and would be stackable with the qualified capital expenditure [credit], then that would be 45 percent state support for the project at that point in time.

MR. MAYER responded that if there were no WLE [credit], then, yes, that is correct.

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REPRESENTATIVE SEATON restated his question for Ms. Delbridge to answer. He posed a scenario in which the 40 percent well lease expenditure [credit] goes away because it is a subset of the qualified capital expenditure [credit], and there is still a 25 percent net operating loss [credit] and a 20 percent QCE [credit] on July 1, the start of the state's fiscal year. He asked whether the state would still at that point be providing 45 percent support for a project.

MS. DELBRIDGE replied she realizes the state's fiscal year starts in July, but explained that Version P would not have things effective until January 1, 2017, to coincide with the new tax year. If in fact the WLE [credit] is not in place, and a 25 percent NOL [credit] is retained and a 20 percent QCE [credit] is retained, then under her understanding a taxpayer could have up to 45 percent state support if that taxpayer actually is eligible for a loss. It would be a company-specific situation.

REPRESENTATIVE SEATON understood, then, that if a company was making money and did not have a net operating loss, it would at that point in time qualify for a 20 percent qualified capital expenditure [credit].

MS. DELBRIDGE responded that if a company is not eligible for the NOL then it would have the ability to use the 20 percent QCE [credit] for certain lease expenditures. Rephrasing her statement, she said there are ways that a company "might be able to be making money and still have a loss in the sense of making money is one thing and having production tax ..."

REPRESENTATIVE SEATON restated his question by noting that if a company has a net operating loss it is not making money. "You could be making money and ..."

MS. DELBRIDGE answered that if a company is eligible for a net operating loss, it has losses.

3:26:05 PM

MR. MAYER resumed his presentation and summarized slide 7, "REDUCTION IN COOK INLET SPENDING SUPPORT." He explained that for new developments the producer would be eligible for a net operating loss [credit], particularly in the early years of capital spending when there is not yet production or spending is greater than the production revenue that is occurring. Under Version P, support for new developments in most circumstances would be 30 percent - 20 percent qualified capital expenditure [credit] plus 10 percent net operating loss [credit]. That compares to 55 percent in those circumstances under the status quo or 25 percent in the original bill. Under Version P, support for current production which in almost all circumstances is not eligible for a net operating loss credit, would be 20 percent. That compares to the status quo of somewhere between 20 and 40 percent, say 30 percent on average, or 0 percent in the original bill because the original bill would provide ongoing support only through the 25 percent net operating loss [credit] versus the qualified capital credit. Elaborating, Mr. Mayer said the approach taken by the original bill was that any ongoing amount that is spent should only be effectively on new developments by new taxpayers. The approach taken by Version P is that this should be broad-based, that there should be 20-30 percent support for all companies undertaking this sort of work regardless of whether they are eligible for the net operating loss [credit]. So, it is not that new developments are disadvantaged in Version P, they would receive 30 percent support for spending versus 25 percent in the original bill. Version P would also provide spending support for those not eligible for a net operating loss credit, which was not the case in the original version of HB 247.

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REPRESENTATIVE SEATON surmised that enalytica's recommendation or analysis here, even in these times of the state not having the money and having to raise other taxes to do it, is that state support should be given on an equity basis between ongoing production that is making money and new operations that are having a net operating loss; not because it is necessarily needed, but because it is an equity kind of situation.

MR. MAYER replied that this is not something enalytica is making a recommendation on, but simply enalytica's analysis of what the original bill did and what Version P would do. He said enalytica's previously presented analysis looked at three types of projects in Cook Inlet, as do [slides 8-13] in today's presentation. One type is completely new developments that are being developed to produce and sell gas into a highly constrained market that is currently well matched in supply capacity and that is only going to change slowly over time. Projects in a highly constrained market have difficult economics in almost all circumstances; credits make that slightly better, but they are still much challenged projects. Another type is unconstrained demand for such a new project, either because a major new use of gas is found, such as export, or because some other major customer comes into existence. In this instance the economics of a new development look pretty workable in most circumstances. If there is a need for support it is much less in this type of environment and high prices can probably go much of the way to making those projects work. The third type of project is ongoing infill drilling and other capital work in existing mature fields and enalytica's analysis is that this is pretty solidly economic in most imaginable circumstances.

MR. MAYER continued his answer, advising that the next question is really a policy call. Given the importance of gas security to Southcentral Alaska, given the state's limited financial resources, and given the desire to write a new regime, he said the question is how quickly to withdraw support, whether that should be done across the board, and whether to target specifically for new development. Clearly, there is a strong argument to be made that completely new development will ultimately be what is needed to bring online the next tranche of supply that is most difficult to develop at the moment but will be most essential in five or ten years' time. That is a difficult policy call to make. One could have the alternative view that presently most of the supply is being met from ongoing investment in the mature fields, but be concerned about whether that will continue to the extent it has in the past if support is cut off too quickly. That work is solidly economic in most imaginable circumstances, according to enalytica's high level economic analysis. However, Mr. Mayer cautioned, he cannot tell the committee that therefore it will continue on an ongoing basis if there is much less support, particularly if that support is withdrawn immediately. Also, there is no certainty as to what the ongoing fiscal terms are, at least for another year. The sponsors of the committee substitute have taken a cautious approach here, but this is all about a judgement call as to what one thinks the right balance is.

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REPRESENTATIVE SEATON asked whether his understanding is correct that the balance, or maintaining qualified investment credits as a larger portion of this mix, would enable credits to flow to profitable companies, whereas if it was more net operating loss, then profitable companies would not receive the credits.

MR. MAYER responded that broadly speaking this characterization is correct. If support is channeled solely through the net operating loss credit, then only companies that make a net operating loss would be eligible to receive that support. If support is channeled through the qualified capital expenditure credit, then all companies that spend, regardless of whether they have substantial production and profits, would receive it and that is spent more broadly on a wider range of activities.

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REPRESENTATIVE TARR, in regard to avoiding the picking of winners and losers between new entrants and producers, asked why not have a 25 percent NOL [credit] and a phase out of the WLE [credit], but have the QCE [credit] be 25 percent. She posited that this would make the opportunity match up better for the company not in production as well as the company that is.

MR. MAYER answered that there are difficult trade-offs to make and many good arguments for numerous possible structures. He said he does not see this as picking winners. The proposed level of support for new developments is higher in Version P (30 percent) than in the original version of HB 247 (25 percent). The original bill's approach of solely channeling support through the net operating loss credit was very much about picking winners and losers because only companies making a net operating loss would receive support, although this approach may have some merit. The effect in Version P is to make this be broader based, to less pick winners, because the overall support is more similar between companies that make a loss because they are developing new projects versus companies not making a loss because they have substantial existing production.

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MR. MAYER recommenced his presentation, noting that slides 8-13 are updates of the modeling work for the three types of projects that enalytica previously presented to the committee. He said slide 8, "COOK INLET #1: MARKET CONSTRAINED (ASSUMPTIONS)," models a new development in a constrained market. [Because of the limited ability to sell gas], a well can only be drilled every few years. Referring to the left chart, he said that in this model the developer drills four wells, two in the early years and then another two to maintain the plateau. Production in the early years is 15 million cubic feet per day (Mmcf/d), rising to 40 Mmcf/d in the later years. This is really difficult economics to make work, he said. Referring to the cash flow chart on the right, he noted that the [purple] bars represent the spending of about $400 million in total capital expenditure for a big facility to produce the gas. However, because only a few wells can be drilled, this large initial capital spending is only very marginally recovered even at a gas price of $6 per thousand cubic feet (Mcf). Even though the economics of this are pretty marginal, a net operating loss only occurs for those first three years. What this means in net operating loss credits versus capital credits is that for a new project being done by a completely new developer, the developer would be eligible in those first three years for the net operating loss credit, whether that is 25 percent or 10 percent. In the subsequent years, additional spending is primarily on the drilling of wells when the company is no longer eligible for a net operating loss [credit]. If the only support that is given is through the net operating loss [credit], then that additional work does not receive any support. If the support is through the qualified capital credit, that work would continue to receive 20 percent support. Under the original bill, a project like this would receive 25 percent through the net operating loss [credit] just for those first three years. Under Version P, a project like this would receive 30 percent for all of this work rather than just the first three years.

MR. MAYER turned to the six graphs on slide 9, "COOK INLET #1: MARKET CONSTRAINED (RESULTS)." He pointed out that under the status quo the level of government take is low with a negative value to the State of Alaska, yet still a very strained project in terms of ability to generate value for the company. Under the original HB 247 with just a 25 percent NOL [credit], this project would become much more strained; only at very high prices of $8.59/Mcf or more does this project become net present value (NPV) positive in terms of internal rate of return. Under Version P, this project would be slightly better due to (indisc.) and the fact that it would be 30 percent for all of the spending, not just the first three years in development.

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REPRESENTATIVE SEATON referred to the top row of charts showing the net present value split for the status quo, the original version of HB 247, and Version P of HB 247. He observed that the state would have a net operating loss at prices up to $7/Mcf under HB 247 and up to $9.50/Mcf under Version P. He inquired whether he is correct in concluding that at the current gas price of $8.19/Mcf which goes through the year 2023, there would be a net operating loss to the state for any project development in a constrained market.

MR. MAYER clarified that these charts are about the net present value to each of the parties. It is not talking about net operating losses, but rather whether the overall value received in discounted terms is positive or negative. He confirmed that Representative Seaton is correct. Under the status quo, the credits that are spent on a project like this are pure subsidy and are a net cash flow loss in terms of the value of that cash over time to the state. The credits are provided as a subsidy for other purposes, not as a means of recouping revenue in the future. Under both the original bill and Version P, that is moderated to some extent insofar as there are prices under which it could eventually be present value positive for the state. Because the credits are slightly higher in the CS than in the original bill, the price at which that occurs is substantially higher under the CS than under the original bill.

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MR. MAYER resumed his presentation. Moving to slide 10, "COOK INLET #2: UN-CONSTRAINED (ASSUMPTIONS)," he explained that this model is for the same project, but in a hypothetical un-constrained world. If there were the ability to sell gas to an additional customer, then this project with the same upfront facilities investment could go ahead with full field development and produce an optimal amount of gas, in this case a plateau of around 140 or 130 Mmcf/d. Drawing attention to the six charts on slide 11, "COOK INLET #2: UN-CONSTRAINED (RESULTS)," he continued his discussion of this project. Under the status quo, he noted, this project would be a net present value positive investment for a company. The rate of return would be solid, especially with all the currently existing support for spending. [Under the provisions of the original version of HB 247], most of that support would be withdrawn and would be limited only to the 25 percent net operating loss [credit], which would occur only in those first three years or so of development. In this case the project would be less highly valuable but would still look like an investment that could work across a fairly broad range of prices in that environment. Under the provisions of the CS, Version P, things would be similar. The economics look very marginally better for the company and very marginally worse for the state. It is all differences at the margin and that is because the core difference between Version P and the original bill is 30 percent support rather 25 and support throughout all of the years of ongoing drilling as opposed to support only during the first three years of new project development for a company that does not already have production.

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MR. MAYER reviewed slide 12, "COOK INLET #3: DRILLING EXISTING FIELD (ASSUMPTIONS)," explaining that this type of project is an existing mature field where there is already infrastructure so no money needs to be spent for starting capital. Expenditure is limited to the cost of drilling and higher operating costs. Moving to slide 13, "COOK INLET #3: DRILLING EXISTING FIELD (RESULTS)," he continued his review of an existing field. He said this type of project would be solidly economic in a wide range of gas price environments, with double digit internal rates of return. The original version of HB 247 would provide no credits for this type of project because in almost any circumstance drilling in an existing field would not be making a net operating loss, but according to enalytica's analysis it would still be solid economic work to undertake. Under the CS, Version P, there would be a 20 percent capital credit [and again would be economic to undertake].

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REPRESENTATIVE JOSEPHSON compared slide 9, constrained market, to slide 13, drilling existing field, and understood that a constrained market is the world of Cook Inlet today.

MR. MAYER replied correct.

REPRESENTATIVE JOSEPHSON surmised that at today's prices and lower, the companies that are producing would enjoy a [net operating loss (NOL) credit].

MR. MAYER responded that slide 9 is not about any given year for eligibility of an NOL. The charts on slide 9, particularly the top row of charts, are about total value to the company, federal government, and state government over the entire lifespan of the project. In regard to the eligibility for an NOL, he brought attention to the right chart on slide 8 for the cash flow at a price of $6/Mcf and noted that a company is definitely eligible for an NOL for those first three years in which it has strongly negative cash flow from having spent $400 million on building a facility. After that point the company probably does not have negative cash flow and may well not be eligible for a net operating loss at any point after that point in time. That does not change the fact that under the status quo at $6/Mcf, this is still a value destroying project if the cash flow is discounted at a 10 percent rate of return.

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REPRESENTATIVE JOSEPHSON directed attention to the top middle graph on slide 9 and observed that [for a new project in a constrained market under the original version of HB 247], the company would enjoy an NOL of 20 percent. In the top middle graph on slide 13 [for drilling in an existing field under the original version of HB 247], there would be no credits because the project would be in the black. He requested Mr. Mayer to explain further.

MR. MAYER pointed out that slides 9, 11, and 13 are presenting the same series of charts for three different scenarios of development. The left column on all three slides is the status quo, the middle column is the original version of HB 247, and the right column is the CS for HB 247, Version P. Slide 9 depicts the development of a completely new project in a market constrained environment. In that circumstance a developer would have a net operating loss credit in the first three years and under the original bill that is the only credit the developer would have. Slide 13 depicts drilling in an existing field, which means drilling wells but never having to spend $400 million of capital up front to build an entirely new platform, pipelines, and all the rest. They have very different economics because they are very different projects. The middle column depicts the projects under the original version of HB 247. This column on slide 13 says no credits because this is a company that would under most circumstances have substantial existing production and substantial existing profits, and would never be eligible for the NOL credits. This column on slide 9 includes the NOL credits because it is a new development and that new development would be eligible for the net operating loss credits in those first three years of spending on all those facilities.

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REPRESENTATIVE TARR addressed slide 8 and noted that in year two [the capital expenditure] reaches almost $200 million. She observed that in this type of development the company would approach [Version P's] proposed $200 million cap, whereas that cap was $25 million in the original bill. She asked Mr. Mayer for his thoughts on what the impact would be if the cap was somewhere in between those two numbers.

MR. MAYER answered that the thing to remember is that the cap is on the refundability of the credit and the credit itself is 25 percent under existing statute and under the original bill, and is 10 percent under Version P. If it is assumed that the peak spending year, the second year, of development is almost $200 million, then a 25 percent net operating loss credit would be $50 million and a 10 percent net operating loss credit would be $20 million.

MR. MAYER noted that he had finished his presentation and was available for questions.

3:54:57 PM

CO-CHAIR NAGEAK advised that committee members have until March 21, at 5:00 p.m. to review and propose amendments. All amendments must be drafted by Legislative Legal Services and Research Services based on [Version P], and given to both co-chair's offices.

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REPRESENTATIVE CHENAULT asked whether the committee will meet at 1:00 p.m. on Monday to hear from the administration.

CO-CHAIR NAGEAK agreed, and said the committee is scheduled to hear from the Department of Revenue on [Version P].

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REPRESENTATIVE SEATON requested that at some point the committee give consideration as to whether the state would really want to invest its limited resources in a scenario of no market for the gas. The state would be expending tons of money that it would never recover in any price scenario. In his opinion, this type of project [a new development in a constrained market] should be taken off the list. If there is not a market identified for the gas so that once the wells are drilled the producer can sell that gas, then he does not think the state, in its constrained fiscal system, can be putting money into a development from which the state will never recover its resources.

CO-CHAIR NAGEAK responded, "So noted."

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REPRESENTATIVE TARR remarked that under Version P there would be great variability in the provisions depending upon if the location is the North Slope, Middle Earth, or Cook Inlet. She asked Mr. Mayer whether that variability is a cause for concern, given it is often heard that it is important to have predictability and durability in the state's systems.

MR. MAYER replied that having two different fiscal regimes by itself is not a cause for concern. Many places have distinct defined regimes that apply to either distinct geographic areas, distinct types of production, or other distinctions. It is very clear, he said, that the basic fiscal regime in Cook Inlet is not sustainable and is unresolved, and trying to resolve that sooner rather than later is very important to the ongoing ability to attract investment into that basin.

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REPRESENTATIVE JOSEPHSON understood that Mr. Mayer just stated it is not sustainable in Cook Inlet and then said something about incentivizing development into that basin. He requested Mr. Mayer to restate what he said.

MR. MAYER noted that slide 3 shows the picture of revenue and spending in Cook Inlet versus the picture of revenue and spending on the North Slope. He said he does not think anyone can look at that picture and think that it is a sustainable picture. A certain amount can be done at the moment simply through trying to lay back some of those credits, but in the long run for the health of ongoing investment, producers need to understand that all of these questions are resolved not just in terms of marginal changes here or marginal changes there, but from an overall look at the Cook Inlet fiscal regime and the ability to set a regime for the long term that everyone thinks is both fair and stable and durable.

[HB 247 was held over.]

4:00:39 PM

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 4:00 p.m.