

SENATE FINANCE COMMITTEE  
January 26, 2015  
9:02 a.m.

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RECONVENED: CONTINUATION OF RECESSED MEETING ON 1/23/15.

CALL TO ORDER

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

MEMBERS PRESENT

Senator Anna MacKinnon, Co-Chair  
Senator Pete Kelly, Co-Chair  
Senator Peter Micciche, Vice-Chair  
Senator Click Bishop  
Senator Mike Dunleavy  
Senator Lyman Hoffman  
Senator Donny Olson

MEMBERS ABSENT

None

ALSO PRESENT

Randall Hoffbeck, Commissioner-Designee, Department of Revenue; John Tichotsky, Chief Economist, Tax Division, Department of Revenue; Representative Liz Vasquez.

SUMMARY

^PRESENTATION: FALL 2014 FORECAST

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Randall HOFFBECK, COMMISSIONER-DESIGNEE, DEPARTMENT OF REVENUE, explained that the majority of the "Revenue Forecast" presentation would be presented by Dr. John Tichotsky, the Chief Economist for the Department of Revenue (DOR) and the head of the department's economic research group responsible for the revenue forecasting in the Revenue Sources book. He referred to slide 3:

Methods: What Do We Forecast at DOR?

- We directly forecast Petroleum Revenue
- the largest component, accounting for 88% of state unrestricted revenue in FY 2014
- "Petroleum Revenue" includes severance taxes, royalties, corporate income tax, and all other revenue from oil companies
- We directly forecast Non-petroleum Revenue
- We use someone else's forecast for Investment Revenue
- We use the Federal Revenue authorized for spending as the forecast
- It is typically 20%-30% more than actually gets spent.
- DOR compiles all different revenue streams and compiles them in the annual Revenue Sources Book

Commissioner Hoffbeck turned to slide 4:

"Oil Revenue Forecasting,"

Three Factors for Production Tax Revenue Forecast

REVENUE = (Net value \* Tax Rate) - Credits taken against liability

Net value = (Price\*Production) - Costs

1. Price
2. Production
3. Costs
  1. Capital expenditures
  2. Operating expenditures
  3. Transportation cost

Commissioner Hoffbeck noted that the three factors provided structure for understanding the forecast.

Commissioner Hoffbeck discussed slide 5:

"Fall 2014 Highlights"

- Input changes relative to the 2014 Spring Forecast
- Oil price levels have been reduced sharply in the near-term.
- Oil production has been increased for all years.

- Correspondingly, unrestricted revenues have been revised downward.
- Revenue impacts largely due to changes in oil price assumptions.
- Lease expenditure (or investment) in the oil fields maintained high levels which has increased expected production

Commissioner Hoffbeck explained that the slide summarized the differences between the fall and spring forecast.

Vice-Chair Micciche asked whether Commissioner Hoffbeck felt "comfortable" with the more conservative approach employed in the current revenue forecast.

Commissioner Hoffbeck replied that he was comfortable with the conservative methodology used in the current forecasting. He noted that oil prices had further declined since the fall forecast was published.

Vice-Chair Micciche wondered whether the department included analysis of political and other investment climate forces when constructing the revenue forecast.

JOHN TICHOTSKY, CHIEF ECONOMIST, TAX DIVISION, DEPARTMENT OF REVENUE, answered that the department had access to a broad range of analysts due to its relationship with the Permanent Fund Corporation and the yearly price forecasting session. The department maintained contact with the analysts and relied on their expertise to "keep a pulse" on the political and structural (supply and demand) issues affecting the markets. The department strove to stay informed as the predictive analysis developed. The department analyzed ranges of prices with the eventual goal of attempting to predict revenue. The current tax structure did not impact revenue as greatly with low oil prices as it did with higher prices.

Commissioner Hoffbeck noted an error in slide placement and clarified that slide 7 will be addressed after slide 11.

Mr. Tichotsky explained slide 8, "Production History with Adjusted Expected Investment Case." The graph depicted an overview of production history heading into a decline period from the high production period of the 1980's. He drew attention to the bulk of the production coming from Prudhoe Bay, which would continue to dominate production in the future. In addition, new smaller fields coming online

contributed to increased production of over 500 thousand barrels per day (bbl. /d).

Mr. Tichotsky cited slide 9, "ANS Production Comparison," which illustrated the contrast between the 2014 spring forecast and the 2014 fall forecast. He relayed that the department meticulously scrutinized any projections of new production included in the oil companies production plans before inclusion in the forecast.

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Senator Dunleavy asked whether models existed that considered the "dramatic" and "precipitous" decline in price, how it impacted production, and if a "lag time" occurred between price change and production. He wondered whether low oil prices spurred a decline in production and high oil prices prompted increased production.

Mr. Tichotsky stated that production was related to investment; Alaska was currently in a "strong" investment period. He noted that investment lead to periods of future production. He continued that the "timing between investment and prices were not connected." Oil companies' production plans were made "irrespective" of price fluctuations because plans were made in the long-term.

Vice-Chair Micciche referenced slide 8, and noted the predicted decline in oil production beginning in mid-2017. He asked what the probability of declining oil production was beyond 2017.

Mr. Tichotsky cautioned that the decline represented "statistical uncertainty" since the forecast was difficult to predict over longer periods of time. Production forecasts were most reliable up to two years into the future.

Vice-Chair Micciche surmised that if the current decline "flattened out" in 2017, it would indicate that the decline prediction would also even out.

Mr. Tichotsky agreed and concurred that as more definitive information was available in the future the information would be reflected in the forecast model. The department forecasted a specific price for budget purposes but as the model was projected over time the prediction was more of an

"image" of the future. He reiterated that the forecasting data was much less reliable over longer periods of time.

Senator Hoffman asked that when forecasting "long-term production outputs" how much consideration was given to the current price of oil and market conditions and if the department thought that the industry would "pull back" production with sustained low oil prices.

Mr. Tichotsky answered that during the price forecast session in October, oil prices were anticipated to decline but not as low as what occurred. He maintained that economists understood commodity market volatility; long periods of price stability worried economists. Stability was indicative of a supply and demand equilibrium that was historically unusual. He was certain that if prices continued to decline energy demand would increase, supply curtailed and the equilibrium changed. The uncertainty was the timeline of when that would occur. The department would update and revise the information in the spring forecast as conditions changed and information was received. He speculated that some price recovery was on the horizon at some point in the future.

Senator Hoffman wondered whether the department considered Oil Producing and Exporting Countries (OPEC) pronouncements of future projections when forecasting.

Mr. Tichotsky replied with uncertainty.

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Co-Chair MacKinnon asked whether the President's announcement regarding "taking areas of the Alaska National Wildlife Refuge (ANWR)" affected the revenue forecast.

Mr. Tichotsky replied in the affirmative. He detailed that the department took into account federal policy, international markets, and anything that would affect supply and demand when developing the forecast.

Co-Chair MacKinnon asked whether the ANWR pronouncement could be quantified so the legislature could send the federal government a bill for lost revenue.

Commissioner Hoffbeck interjected that the current forecast did not include oil from the ANWR areas because projects

were not slated in areas of the reserve. He thought that the policy did have a "major impact" on new options for additional revenue moving forward in a climate of low revenue.

Co-Chair MacKinnon asked whether any of the "ANWR reserves were banked on any of the producers books." She informed the committee that producers banked reserves were factored into a producer's credit worthiness. She wondered whether producers had holdings on banked reserves in ANWR and what the repercussions were on the United States economy and the state of Alaska.

Commissioner Hoffbeck noted that he was not aware of information available to DOR to determine whether any ANWR holdings were "banked on producer's books."

Co-Chair MacKinnon related that she would inquire with the state's producers for an answer.

Co-Chair Kelly referred to an article titled, "OPEC Meets Adman Smith" he read decades ago and summarized that the laws of supply and demand prevailed over curtailed production. He believed that in the current situation demand would increase as the price lowered but the scenario would take a much longer period of time because currently continuing to increase production did not make sense under the low price environment. He wondered whether OPEC's continued high production in the climate of low oil prices affected prices in the long-term as opposed to producing less in the a period of high oil prices.

Mr. Tichotsky replied that much "complexity" existed in the markets. He predicted that as a "general rule," extremely low prices in the near future would create a more volatile market.

Co-Chair Kelly asked what natural forces in economics would affect an increase in the price of oil in a scenario where one producer continued to increase production in a low price market.

Mr. Tichotsky answered that cheaper commodity prices created more demand.

Co-Chair Kelly confirmed his understanding and clarified that currently, OPEC seemed committed to increased

production regardless of the low price of oil, which was counter to traditional market forces.

Mr. Tichotsky responded that Saudi Arabia was the "swing producer" in OPEC because the country had the capacity to boost production anytime. However; low oil prices created instability in oil producing nations. He exemplified the current situation in Russia. He explained that Russia's currency was devalued and "issues with production" ensued. He underlined that complex issues made predicting the price of oil arduous.

Co-Chair Kelly concurred with Mr. Tichotsky's statements and reiterated his belief that OPEC will produce more oil to generate more revenue.

Mr. Tichotsky characterized his assumption as a reasonable explanation, but cautioned not to underestimate the "great uncertainty" of the market that could cause prices to lower or raise. He surmised that "uncertainty will probably breed volatility."

Senator Dunleavy contended that the future price of oil was unknown and impossible to predict. He believed that basing the budget on revenue forecasts was akin to basing the budget on "winnings in Las Vegas." The world market forces were changing and unpredictable and that the state needed to base the budget on very low oil prices and very low production estimates to create stability in state budgeting.

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Co-Chair Kelly asked if Mr. Tichotsky could comment on Senator Micciche's belief that Saudi Arabia was attempting to "break North Dakota" with below \$40/bbl. price of oil and that the price would not rebound until the scenario occurred.

Mr. Tichotsky replied that the scenario was not unlikely, but reminded the committee that Alaskan oil did not influence price. Alaska typically received anywhere from \$2 billion to \$5 billion in revenues from oil each year regardless of price and thought that it was a reasonable expectation.

Co-Chair MacKinnon pointed out that with regard to the President's recent comments on new oil development, the

state received \$35 million in offshore oil in 2014 (cited on page 94 of the Revenue Sources Book) and was projected to increase. She requested that DOR "run some numbers based on what the federal government had proposed" and send the government a bill.

Vice-Chair Micciche felt that the effect of speculation on oil prices had radically decreased in the last year to 18 months. He asked whether the trend might continue.

Mr. Tichotsky opined that speculation was an important "part of the process that created forward thinking and expectations". He agreed that there was less speculation, but felt as prices or uncertainty increased speculation would also increase.

Mr. Tichotsky pointed to the word "offshore" on page 94, of the Revenue Sources book. He clarified that "offshore" referred to the territorial waters of Alaska or the three to six mile revenue sharing zone. The state did not have any sovereign or property rights beyond the 6 mile zone.

Mr. Tichotsky turned to slide 10:

#### ANS OIL PRODUCTION FORECAST

- Volumes from Developed Reserves (Currently Producing):

- Oil from wells that are in production and following typical reservoir engineering optimization without major investment.

- These volumes are from projects already in place and thus remain unadjusted for risk.

- Volumes from Undeveloped Reserves and additional/accelerated Developed Reserves:

- Oil from projects that will add incremental oil to existing fields or will bring new fields into production.

- Must have senior management approval and be allocated funds in the company's budget.

- These volumes are risk-adjusted for commercial uncertainty.

- Volumes from Contingent Resources:

- Oil from projects that are likely to occur in the future, but have not met the requirements of the previous category.
  - Oil reserves must be known and recovery is technically possible with current technology.
  - These volumes are more strongly risk-adjusted due to the commercial uncertainty and other risks.
- DR + UDR + CR = Unrisked Investment Case

Mr. Tichotsky referred to slide 12, "North Slope Production Forecast," that graphed the volumes of the reserves according to its classification. He reported that volumes from developed reserves were forecast with a high degree of certainty. The reserves from undeveloped reserves and contingent sources were forecast with "relative certainty and included in the production forecast. He elaborated that the "upside potential volume" from undeveloped reserves reported in a company's production plan offered the department much less certainty and was not included in the production forecast.

Mr. Tichotsky continued to slide 12, "Production Forecast," which contained a graph of forecasted production from 2015 through 2024. He indicated that the revenue forecast was based on a specific price in 2015 and 2016. The department historically "over forecasted" future production volumes. Previously, the departments "risking methodology" included the "unrisked investment case" which contributed to over forecasting future production. The reasons DOR over forecasted the unrisked investment case was twofold. One reason pertained to timing; projects were in progress, but the commencement of production was unknown. The other reason was that the predicted amount of production from the project was overestimated. However, the unrisked investment case line on the graph illustrated a "very realistic potential of oil that could come online, given the right investment climate." He added that the "low investment case" included on the graph portrayed production forecasted relying on currently producing reserves and no new investment.

Senator Dunleavy queried whether the state was currently "in a low investment scenario."

Mr. Tichotsky believed that it was too early to know. He opined that Alaska could market itself as a safe investment

in a low price climate. Because the lead time to production was long, and volumes were large by the time production commenced prices would be higher. He defined his scenario as "compelling."

Mr. Tichotsky continued that the current production forecast portrayed the "range of possibilities" and provided "goalposts" for future market scenarios.

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Senator Dunleavy asked whether the department contacted with a production engineer and wondered what happened to the individual if the projections were "wildly off the mark."

Mr. Tichotsky responded that recent one and two year predictions were accurate. He pointed out that the difficulty was with definitive forecasts over a ten year horizon. He felt that the ideal long-term prediction included a range of production volumes. Forecasting beyond a two-year horizon was problematic. He voiced that DOR was satisfied with its short-term forecasting.

Senator Dunleavy assumed that a DOR expert did not anticipate the current steep decline in oil prices.

Mr. Tichotsky reiterated that the production forecast was based on the information provided by the oil companies; their production plans and investments and believed the current forecast was satisfactory.

Mr. Tichotsky identified slide 7:

DEPT. OF REVENUE INVESTMENT CASES

•Unrisked Investment Case:

- This is a technical forecast provided by a DOR consulting petroleum engineering service.
- It is based upon the expectations and best estimates of oil companies.
- It includes forecasts from the production from developed, undeveloped oil reserves and contingent resources
- Adjusted Expected Investment Case:

- This is the official revenue forecast.
- Unrisked investment case adjusted for risks and uncertainties.
- It is used for forecasting revenue beyond two years.
- All developed reserves remain un-risked, but less certain projects are weighted over time.

•Low Investment Case:

- This includes forecasts strictly from projects and wells that are already developed. This is risk weighted only at the technical level.
- If no new projects came to fruition, this is what we would expect the future to look like.

Mr. Tichotsky examined slide 14, "Alaska North Slope Crude West Coast Price." He articulated that the graph depicted the inaccuracy of the forecasted mid-term average price of over \$100. The price hovered at \$47. However, prices were typically volatile and the current low was not as steep as a drop that occurred as recently as 2009.

Co-Chair MacKinnon referred to slide 14, and wondered what the notated "95 percent confidence level" meant.

Mr. Tichotsky related that the confidence level was not contained in the slide and referred to chapter 4, page 29 of the Revenue Sources Book.

Vice-Chair Micciche clarified that the inclusion of the confidence level reference on the slide was a mistake and did not refer to the data on slide 14.

Mr. Tichotsky affirmed but further clarified that in the Revenue Sources Book the reference to the confidence level related to the actual price relative to the mean. He continued to slide 15, "Alaska North Slope Crude West Coast and West Texas Intermediate Prices," which graphed the price relationship between Alaska North Slope Crude (ANS) and West Texas Intermediate (WTI). He observed that the volatility in the price of oil was more of the norm rather than the stable price environment of the last few years.

Co-Chair MacKinnon asked why the price of Brent oil was not included in the comparison on slide 15.

Mr. Tichotsky responded that Alaska North Slope crude (ANS) was traded on the West Coast market. He elucidated that

historically, ANS accounted for a large share of the crude oil refined in California and Washington. ANS crude was currently more like Brent crude which traded on the global market by water tanker. West Texas Intermediate represented U.S. sourced (U.S. midlands) crude at depressed prices because the oil was suppressed from global markets. He elaborated that the amount of crude had significantly decreased and was substituted with crude from various countries, i.e., Ecuador or Russia. Currently, ANS was part of a global market called "water born crudes." The West Texas Intermediate market represented the U.S. midlands, which was "bottlenecked" and not able to get its oil to the global markets resulting in lower prices. Traditionally, the state "benchmarked" off of the price of the WTI but since entering the global water born market, "... the state no longer took the WTI benchmark at a coefficient and imputed" the price of ANS based off of WTI.

Co-Chair McKinnon asked that if Brent oil was graphed on the chart would the price be similar to ANS.

Mr. Tichotsky answered that in general the two crude markers were very similar.

Co-Chair MacKinnon wondered why the graph depicted WTI instead of Brent oil.

Mr. Tichotsky specified that the WTI benchmark was familiar and regularly reported in the news media. The department would provide a graph that included the Brent oil benchmark.

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Co-Chair MacKinnon wondered whether DOR changed its modeling.

Mr. Tichotsky replied that until 5 years ago DOR forecasted WTI prices and converted them to ANS using a coefficient. However, the practice was halted when the WTI benchmark became "disaligned" with ANS. He furthered that Brent oil, being a European marker, was not an appropriate benchmark either. The department forecasted the ANS price exclusively.

Senator Bishop commented on slide 15. He shared that the bottleneck on WTI was being mitigated by an "export

pipeline at Cushing" [Wyoming] to Port Arthur [Texas]. In addition, he noted significant west coast capital investments expanding railroad lines to the Cherry Point terminal [near Blaine, Washington]. He felt the transportation changes, in addition to Bakken oil [North Dakota] was exerting pressure on ANS prices.

Mr. Tichotsky responded that the opening up of Cushing was raising the price of WTI up to the global price without affecting the global price. He commented that transporting crude was costly, inefficient and limited to rail capacity. Tanker and pipeline transport of crude oil was more efficient. Railed Bakken oil was not competing with ANS; global water born crudes were. He communicated that Alaskan crude also had the option of being exported to other markets. He hypothesized that if the Cherry Point refinery price dropped too low, the proper incentives would fall into place for the option to sell to Asian markets existed. He cautioned that the issues were complex and "not as simple as it seemed at face value."

Vice-Chair Micciche asked whether there "was any value to Alaska" supporting import tariffs on exported oil coming into the west coast market." He mentioned that tariffs were applied to Alaskan oil exported to other countries.

Mr. Tichotsky responded that tariff "mechanisms can produce monetary value in the short term. He believed that over time markets set the "most efficient" price and the state would fare better to "develop to the market price" rather than impose tariffs.

Mr. Tichotsky directed attention to slide 16;

"Key Oil Price Drivers,"

- Supply & Demand
- There are two main factors to monitor.
- Global spare capacity, since it is both a reflection of supply and demand. In other words, the Organization of Petroleum Exporting Countries (OPEC) spare capacity (flipping a switch) is key.
- Cost of developing new oil supply.
- Current Events
- Weak global demand
- Saudi trades market share for lower prices

Co-Chair MacKinnon asked Commissioner Hoffbeck whether he believed that The President's response to the Keystone Pipeline Project would affect ANS supply and demand.

Commissioner Hoffbeck replied that he did not believe it would affect ANS supply, but that moving the product more efficiently would affect demand. He felt that the President's actions of keeping the pipeline "bottled up" actually benefited the ANS price.

Co-Chair MacKinnon further queried whether "what the President was doing was helping keep prices depressed for America."

Mr. Tichotsky stated that when attempting to forecast price the most useful tool was to understand the potential for high and low price extremes and other complex factors. It was impossible to pinpoint the global oil price on one particular factor.

Co-Chair MacKinnon referred to the Keystone Oil Pipeline, and wondered whether completion would affect "Alaska's viability for production" or "create less incentive in Alaska." She judged that the Keystone Pipeline would not affect ANS. She believed that ANS was a "resource for all of America." She stated that, "Saudi Arabia was controlling the market right now" and wondered whether Keystone affected Alaska.

Mr. Tichotsky responded that the Keystone Pipeline "was not directly related to the west coast market." He delineated that the Keystone Pipeline affected the WTI price by exporting North American midland crude to the market. He delineated that Alaska production did not control the price and was sold into the west coast market, which was not affected by the Keystone Pipeline. He noted that Ecuadorian and East Siberian crude competed more directly with ANS.

Co-Chair Kelly handed the gavel over to Co-Chair MacKinnon.

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Mr. Tichotsky referred to slide 17:

"Price Forecast Methodology"

Price Forecasting Session

- Held a day long oil price forecasting session on October 7, 2014.
- Speakers provided insight into oil markets, probability and analysis, modeling, and financial aspects of commodity markets.
- 37 participants from state government, academia and the private sector.
- DOR, DNR, DOL, OMB, University, Legislative Finance and outside participants.
- Participants were asked to forecast P10, median, and P90 real ANS prices for the West Coast.
- Real prices were converted to nominal using a 2.25% inflation assumption.
- Official forecast is based on probabilistic outcomes from Price Forecast Session and DOR price model.

Mr. Tichotsky noted that representatives from the oil industry did not participate in the forecasting session due to anti-trust issues. He detailed that the department sought a "P10" probability (probability of 10 percent) in forecasting the low price and a "P90" probability when establishing the price for ANS and West Coast Crude.

Senator Dunleavy wondered who participated in the oil forecasting session since representatives from the oil industry did not attend.

Mr. Tichotsky replied that the participants represented experts and analysts who studied the oil industry, experts from DOR, and analysts from other departments that had developed expertise in oil and gas markets.

Senator Dunleavy wondered what the actual composition of the participants were.

Mr. Tichotsky replied that the group was comprised of Alaskan's who had the expertise, interest, and

qualifications to analyze the global markets and possessed a strong knowledge of markets or the energy industry. The day was spent listening to the experts. He stated that the method was called a "modified Delphi process."

Senator Dunleavy asked how the individuals were selected.

Mr. Tichotsky responded that anyone with appropriate knowledge or expertise of the energy industry from state government, the private sector, or the university, may participate. Journalists were prohibited from attending the forecasting session.

Vice-Chair Micciche believed that commodity markets typically had little effect from inflation. He wondered why the department utilized a 2.25 percent inflation assumption.

Mr. Tichotsky reminded the committee that oil is a U.S. dollar dominated market. He pointed out that when analyzing the "future nominal price of oil" an assumption on inflation is mandatory and not unreasonable to factor in. The department consistently utilized the inflation rate provided by its contracted investment company, Callan Associates. He indicated that the inflation assumption was "especially critical in how it affected the price forecast in the outer years." A forecasted price of \$137/bbl. in 2025 amounted to \$100 in real dollars because inflation caught up to the price over time. He reiterated that DOR believed that the long-term price of oil would eventually recover to approximately \$90bbl. to \$100bbl. in real dollars.

Mr. Tichotsky referred to slide 18:

"Fall 2014 ANS Revenue Forecast Prices"

Official forecast is one value within a range of possible outcomes.

- Probabilities as of early December 2014
- FY 2015 & FY 2016 are from an internal DOR probabilistic pricing model.
- FY 2017 and beyond are from the Fall 2014 price forecast session held on October 7, 2014.

Mr. Tichotsky elaborated that the department used a "probabilistic pricing model" that factored in the

"reversion to the mean;" "the likelihood that the price of oil will revert to the current price of oil." Another factor of the model analyzed "the chaos in the system," and whether the current price of oil is a "jump event." He defined a jump event as something out of the norm. He judged that the current price of \$50/bbl. of oil was a jump event.

Mr. Tichotsky examined slide 19, "'What if the oil price is ...'" for the last half of FY 2015." He related that what mattered was the average price of oil over a fiscal year. The slide depicted the actual and estimated monthly price of oil over FY 2015. He noted that prices were much higher from July until October of 2014. If the price of oil continued in the \$50/bbl. range through June of 2015 the lowest price for the fiscal year would be \$68/bbl. The average forecasted price in December 2014 for FY 2015 was \$77/bbl.

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Vice-Chair Micciche clarified that the nominal inflation adjustment in the forecasted price "accounted for the eventual purchasing power of the U.S. dollar versus the value of the commodity."

Mr. Tichotsky responded that the inflation adjustment represented the potential rate of real inflation to the U.S. economy. He informed the committee that the department issued a revenue forecast in nominal dollars and the legislature budgeted in nominal dollars.

Senator Hoffman stated that the state's bond rating was downgraded as the price of oil dropped below \$50/bbl. He asked whether the state's bond rating will rebound or be further downgraded through 2025.

Commissioner Hoffbeck reported that the state's bond rating was not downgraded. Moody's [bond rating agency] placed the state on a "negative watch" but the state retained a Triple A bond rating. The bond rating could be affected by how the state reacted to the fiscal environment when budgeting regarding: the size of government, continued savings, and generating new sources of revenue.

Senator Hoffman wondered which factors were most important to the rating agencies.

Commissioner Hoffbeck responded that the rating agencies were most focused on the state expanding its revenue base.

Senator Olson asked whether Commissioner Hoffbeck was advocating for a state income tax and if the administration would be in favor of one.

Commissioner Hoffbeck replied that he was not advocating for a state income tax and did not believe that the state's policies should be dictated by rating agencies. He added that Alaska was the most financially solid state in the country.

Senator Olson asked whether the bond rating would change significantly if the state instituted a state income tax.

Commissioner Hoffbeck answered in the negative.

Senator Bishop commented that he felt it was very important for the state to maintain its Triple A bond rating.

Co-Chair MacKinnon wondered how a potential bond downgrade would impact the state and whether the administration was analyzing a bond downgrade scenario.

Commissioner Hoffbeck responded that DOR and the governor was scheduled to meet with the rating agencies: Moody's, Standard and Poor's, and Fitch on February 2 and February 3, 2015. He noted that the current oil markets do not affect the price of borrowing because debt was inexpensive, but that might not be the case in five or six years. He maintained that the state needed to protect its Triple A bond rating.

Co-Chair MacKinnon wondered what experts the new administration retained in order to be prepared for meeting with the bond rating agencies. She suggested that inexperience within the governor's transition team when conversing with the rating agencies coupled with the precipitous decline in oil prices possibly contributed to the bond rating downgrade discussion.

Commissioner Hoffbeck replied that he believed the price of oil was the biggest driver of Moody's negative watch announcement. He had confidence in the team assembled to meet with the rating agencies. Every member had prior

experience presenting to the rating agencies. He felt that the team was solid and the discussion would be robust.

Mr. Tichotsky interjected that he had worked as a credit rating analyst with Fitch, and had experience with the North Slope Borough. He thought that the team had expertise on both the treasury and the tax side of the credit rating issue. He surmised that forecasting revenue was useful not only for budgeting purposes, but for the credit agencies to understand how the state predicted its future revenue.

Co-Chair Kelly returned to the room.

Mr. Tichotsky referred to slide 20, "Historical ANS West Coast FY OIL PRICE BANDS: ANNUAL AVERAGE AND OFFICIAL FY2014 FORECAST" and articulated that the slide depicted the actual price of oil averaged over a year, as well as the highest and lowest "spot prices" from 2010 through 2014. He remarked that in 2013 and 2014 the price of oil remained the same, and was an almost statistically impossible occurrence. He observed that the forecasted price (ranging from 2015 through 2025) depicted within a range of high and low possibilities represented the department's preferred method of forecasting the price of oil. He understood the need for a specific number.

In response to a question by Senator Hoffman, Mr. Tichotsky restated that slide 20 represented actual prices from 2010 through 2014.

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Mr. Tichotsky referred to slide 22, titled, "General Fund Unrestricted Oil Revenues." The chart depicted the total revenue broken down by revenue type with actual 2014 and 2015 prices and the forecasted price for 2016. He conveyed that the net royalty was a "very important component to revenue" and remained "relatively" stable with low oil prices. He noted that the non-petroleum revenue (other sources of economic activity) was approximately \$500 million.

Commissioner Hoffbeck added that production taxes were emphasized when discussing the value of Alaskan oil but additionally, the Net Royalty component generated substantial revenue.

Vice-Chair Micciche queried what assumptions the department was making with regard to oil and gas property taxes.

Commissioner Hoffbeck replied that the value was tied to the asset itself and not to the value of oil and was relatively stable. He qualified that property taxes were a cost-based model, and declined slightly over time due to physical deterioration; calculated by replacement costs minus depreciation.

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Co-Chair MacKinnon referred to the proposed natural gas pipeline and the property tax valuation in relation to municipalities. She remarked that some local communities were "sensitive" to the valuation. As the valuation increased the state received less and the municipalities received more. She related that the previous administration engaged in negotiations with municipalities to find a resolution to the expensive property tax litigation brought to the state by communities. She requested clarification on how the current administration planned to address the issue.

Commissioner Hoffbeck replied that legally, he could only speak to the issue in generalities and reported that there were two separate issues. One issue related to the litigation regarding the existing trans-Alaska pipeline and the other issue questioned how to move forward on the gasline. Mediation over the trans-Alaska pipeline litigation was scheduled to meet in February. The state, municipalities, and the pipeline owners would attempt to reach a long-term resolution on the value of a trans-Alaska pipeline and the associated taxes.

Co-Chair MacKinnon queried whether the commissioner recused himself from the litigation since he had litigated in the past on behalf of municipalities and was strongly in favor of the municipalities' position.

Commissioner Hoffbeck clarified that in 2006 he was the primary witness for the state in his role as the state assessor. In a subsequent trial, he was the expert witness

for the municipalities. He reasoned that "he should be able to come up with the same answer on either side of the table if he was really being honest about what" he did. He stated that his testimony was not dramatically different for both trials. He continued that he was the Finance Director for the North Slope Borough and was a consultant for the borough and the City of Valdez during property tax litigation. He made a request to the attorney general's office to review the issue and decide whether he should recuse himself.

Co-Chair MacKinnon asked whether the attorney general designee would make the decision in light of his involvement in the issue on behalf of the municipalities.

Commissioner Hoffbeck replied in the negative and added that another attorney was assigned to the issue.

Commissioner Hoffbeck continued that in relation to the gasline he met with the municipal advisory group to discuss "alternate ways of valuing the pipeline to make it more stable and responsive to the economics of the project." He noted that another meeting was scheduled to specifically discuss the AKLNG project.

Co-Chair MacKinnon asked whether the meeting was a "confidential meeting," and if he could share the items under discussion.

Commissioner Hoffbeck answered that the group favored discussing the PILT (payment in lieu of taxes) proposal.

Vice-Chair Micciche wondered if the negotiations with municipalities over PILT were successful whether there was "potential" that the PILT model might be used on the trans-Alaska pipeline negotiations in the future.

Commissioner Hoffbeck stated that it was a possibility, but municipalities were resistant to "tie the gasline issues into existing assets and that it would be a difficult discussion."

Vice-Chair Micciche thought that the issue divided Alaskans for many years and that the PILT model was worthy of consideration to resolve differences in the future.

Senator Hoffman asked about slide 22, "General Fund Unrestricted Oil Revenues," and wondered whether the actual revenues depicted were based on audits. He requested an update on the department's progress of "audited taxes."

Commissioner Hoffbeck reported that the audit review process began as soon as DOR received a return and that DOR was approximately five and one half years behind in a six year statute of limitations on several audits. The backlog was largely created due to the implementation of a new tax management system and took a vast amount of staff time. He related that he had spoken with the Tax Division director who assured the commissioner that the department would not miss any audit deadlines and would catch-up within the next few years.

Mr. Tichotsky referred to slide 23, titled, "General Fund Unrestricted Revenues Non-Petroleum." The chart depicted the total non-petroleum revenue broken down by revenue type with actual 2014 and 2015 prices and the forecasted price for 2016.

Co-Chair MacKinnon asked about the drop in investment returns income between the actual reported amounts of \$130 million in 2014 to a forecasted \$30 million in 2015. She wondered whether the figure represented the expected draw on the states reserve accounts to balance the budget and if the states rate of return on investments was predicted to be lower than last year.

Mr. Tichotsky explained that the forecast for investment returns was based on the average returns predicted by Callan. Investment returns were "volatile" and average predictions were not reliable in the short-term.

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Commissioner Hoffbeck interjected that he agreed with Co-Chair MacKinnon's assumptions. The reserve draw and the fact that currently, there was very little return on short-term investment factored into the lower forecast. He indicated that the major returns from the Permanent Fund were not reflected in the forecast.

Co-Chair MacKinnon asked if DOR was currently attempting to "move fixed assets into cash to meet the projected \$3.4 billion revenue shortfall." She reminded the committee that

the \$3.4 billion shortfall was only for the remainder of FY 2015.

Commissioner Hoffbeck answered in the affirmative.

Co-Chair MacKinnon believed that the future budget [FY 2016] was also projected to have a \$3.4 billion shortfall.

Commissioner Hoffbeck replied in the affirmative.

Co-Chair MacKinnon asked how the administration was prepared to meet the shortfall without proposing additional revenue sources.

Commissioner Hoffbeck referenced a presentation by Pat Pitney, Director, Office of Management and Budget that demonstrated the shortfall could be met for "a couple" of years from the state's savings accounts. Additional revenue was needed in the future.

Co-Chair MacKinnon referred to slide 23 and queried whether DOR was preparing for a cash draw. She thought that as the state spent down its savings the state could not sell its investments without taking "incredible losses." She wondered how the department was strategizing on how to draw on "more fixed" assets to meet the projected \$3.4 billion shortfall from savings. She believed that at current oil prices the shortfall might amount to approximately \$7 billion.

Commissioner Hoffbeck voiced that the assets were moved to liquid assets as needed in a timely and programmatic way looking into the future. He expounded that very little of the assets were invested in longer term investments in recognition of its future need so no loss was incurred but by moving the assets into more liquid assets the amount of returns were "dramatically reduced" as short-term investments.

Co-Chair MacKinnon announced the "urgency" of the topic at hand. She requested an accounting of the state's cash flow and where the department was drawing the reserves from.

Commissioner Hoffbeck agreed to provide the committee with the information.

Senator Hoffman referred to a presentation by the Director of the Legislative Finance Division (LFD) that urged discussions regarding generating additional revenues in order to pass enacting legislation in the short-term. He asked whether the department engaged in discussions about how to generate potential revenue.

Commissioner Hoffbeck answered in the affirmative, and shared that the governor was willing to engage in the discussion.

Mr. Tichotsky turned to slide 24, titled, "Total Revenue Forecast - FY 2015 and FY 2016." The chart reported the 2014 actual and FY 2015 and FY 2016 forecasted total revenue and revenue broken down by revenue type. He shared that in FY 2014 the state generated the second highest overall total state revenues. He offered that the state was well positioned in terms of wealth relative to other states.

Mr. Tichotsky referred to slide 25, "FY 2016 General Fund Unrestricted Revenue, With Price Sensitivity," and observed that the graph demonstrated that in a lower price environment the decline revenue curve tended to flatten out and did not decline as greatly as revenues increased over \$80/bbl. He cited the charts on page 83 of the Revenue Source Book and recommended that the committee refer to the charts when inquiring what the state's revenue would be at a particular price and production combination.

Mr. Tichotsky moved to slide 27, "Comparison - Fall 2014 vs. Spring 2014 Forecasts. He noted that the charts highlighted the amount the forecasted figures had been adjusted from the spring 2014 to the fall 2015 forecasts. The forecasted price changed approximately 27 percent (declined) for the current period and production numbers increased [2.7 percent], which did not alter the effect of low prices; a decrease of half of the projected revenue in the current fiscal year. The slide depicted a similar scenario in FY 2016.

In response to a question by, Co-Chair MacKinnon Mr. Tichotsky restated that production estimates increased in FY 2016.

Mr. Tichotsky identified slide 28, "Contributors of Change in FY 2015 Revenue Forecast." He remarked that one

contributor of change in the revenue forecast was production.

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Vice-Chair Micciche referred to the departments projected revenue of \$2.8 billion based on \$66.03/bbl. in FY 2016 (\$2.2 billion in petroleum revenues and \$5.7 billion in non-petroleum revenues). He noted that the range of prices forecasted was a low of approximately \$40/bbl. to a high of \$85/bbl. and wondered how DOR responded when the price of oil was in the bottom of the range.

Mr. Tichotsky responded that in terms of revenue forecasting the difference was \$1.6 billion to \$1.8 billion in revenue per year as opposed to \$2.5 billion at \$80/bbl. The revenue difference in the low ranges was not as great until prices rose to the higher end of the spectrum.

Mr. Tichotsky referred to slide 29, "Contributors of Change in FY 2016 Revenue Forecast," and explained that the chart depicted a considerably lower price than the forecasted spring price and a production increase of 30 thousand barrels per day.

Mr. Tichotsky moved to slide 31, "North Slope Operating Expenditure Forecast Change," and detailed that the graph depicted an increase in operating expenditure based on the increase in investments over the previous spring forecast. He reverted attention to slide 30, "North Slope Capital Expenditure Forecast change," and indicated that the department was "overly optimistic" when forecasting the timing of receiving capital expenditures. The expenditures were anticipated to be greater than expected in spring 2014.

Commissioner Hoffbeck explained slide 32, "Net Tax Credits Versus Production Tax," noting that the data had created some controversy. He discussed that the light green bar on the bar graph depicted production tax before any credits. The darker green bar portrayed production tax after credits used against tax liability. He communicated that not all credits were considered costs. The difference between the two bars indicated the cost of credits per barrel. He observed that the 20 percent per barrel capital credits under Alaska's Clear and Equitable Share (ACES) and its replacement in SB 21 (SB 21 Oil and Gas Production Tax,

June 2013) were essential parts of the tax system, and were accounted for before revenues. The differences between the light green and dark green bar also represented the per barrel allowances that were considered in the tax rate for the companies that were actually producing and had a tax liability. The dark green bar denoted approximately \$500 million in FY 2015, which was the amount of tax the producers were paying this fiscal year. The red bar (the production tax net of refundable credits) which dipped below the zero line in negative numbers, represented credits that encouraged production namely, exploration and new field development. The activity did not immediately create a revenue stream and qualified as refundable credits. He emphasized that the producers were paying production taxes but the negative total (production tax net of refundable credits) indicated by the red bar [in FY 2016] represented the state's investment in the future to bring more production online. He judged that the issue was not a "systemic problem" with the credits but indicated a cash flow problem due to low oil prices. He surmised that credits that spur investment in the future at times when revenue was low were "painful" but remained crucial investments for the future.

Co-Chair MacKinnon referenced an editorial written by Governor Walker titled, "The Hard Truth about Alaska's Oil Revenue." She perceived that the editorial attributed the problem to the "big three" oil producers in the state [BP, ConocoPhillips, and Exxon]. She clarified that an array of oil producers paying taxes operated in the state and that the three largest producers paid net positive taxes to the state. She elaborated that the negative net number was generated by producers who had zero tax liability. Under the state's new tax regime a small producer's zero tax liability could be purchased by the state. The negative number represented credits to smaller producers to "incentivize production." She asked the commissioner whether he agreed with her assessment.

Commissioner Hoffbeck concurred with her statements.

Co-Chair MacKinnon continued that oil taxes accounted for 88 percent of Alaska's revenues. She referred to the "Indirect Expenditure Report" sanctioned by the legislature in 2014 and compiled by the Legislative Finance Division with the help of DOR. She noted that the report showed substantial reductions in [non-petroleum] revenue

authorized by the legislature in collaboration with the tax paying entities and were established as far back as 1969. She asked the commissioner to name the top five to ten tax credits in order to determine those particular credits value to the state.

Commissioner Hoffbeck was unable to provide the information without review but agreed that the state's tax credits needed to be re-examined to ensure they were achieving the original goals. He would provide the information at a later date.

Co-Chair MacKinnon noted that other types of tax credits in other "revenue streams" did not generate revenues and exemplified the Film Tax credit. She stated her support for the film industry in Alaska and noted the benefit the credit provided those employed in the industry. However, she believed that tax credits and the resulting ceded revenue needed to be re-examined in the face of multi-billion dollar revenue shortfalls. She suggested that the legislature develop a method for DOR to assign value to tax credits and determine whether a particular tax credit would generate future revenue for the state.

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Commissioner Hoffbeck responded that one element embedded in the film tax credit was a pre-credit review and approval process, which was missing from other tax credits. He specified that one criteria considered was whether the credit was in the best economic interest of the state and believed that criteria should apply to every tax credit.

Vice-Chair Micciche believed that SB 21 was specifically designed to induce "improvements" in the long-term. He assumed that the credits predicted in the department's oil production forecast included "the volume from undeveloped resources and additional accelerated developed reserves." He asked whether the credits reflected the category of undeveloped resources that had a high probability of producing a net positive outcome for the state.

Mr. Tichotsky replied in the affirmative. He explained that the forecast examined the net investment effect on production. He restated that the greater the investment the greater the "production signal" the investment sends.

Co-Chair MacKinnon pointed out that the Cook Inlet tax credits had zero liability, and that the Southcentral region directly benefitted from the credits. She delineated that the credits incentivized development as a solution to the "brown outs" the area had been experiencing. The majority of the refundable credits were associated with South-Central and the Cook Inlet region of Alaska.

Commissioner Hoffbeck indicated that the refundable credits were actually split fifty-fifty between Cook Inlet and the North Slope. He pointed out that significant development was presently occurring on the North Slope. The credits "incentivized" and enhanced the oil and gas industry in Cook Inlet.

Vice-Chair Micciche stated that North Slope production generated revenue for the state and Cook Inlet production served Southcentral Alaska's energy needs and reflected "two very different production environments." He wondered whether the administration shared his view.

Commissioner Hoffbeck replied that the Cook Inlet credits were intended to create a stable gas supply for Southcentral Alaska and that the purpose of credits for the North Slope was to generate revenue for the state. He added that the Tesoro Refinery in Southcentral also benefitted from the incentive credits.

Senator Dunleavy inquired whether the administration was considering revising the tax regime instituted in SB 21 in the near-term.

Commissioner Hoffbeck responded in the negative. He believed that the new tax system needed time to develop to determine whether it was producing the intended results.

Co-Chair Kelly did not agree with the administrations initial response to the issue of oil tax credits. He believed that false information was disseminated in the press around the issue of oil tax credits and that it was unfortunate that the citizens of Alaska had to "mistakenly" make decisions about oil industry taxes and production based on falsehoods. He referred to the editorial piece by Governor Walker, and felt that it aligned with the "nontruths" circulated about the credits and "hit" the legislature "hard." He referred to press reporting that he believed misrepresented the facts regarding SB 21. He

maintained that SB 21 rectified a previous tax system that wrote "huge checks to the oil industry." He found it "difficult to navigate" the situation while misinformation was being circulated and believed that in regards to his editorial the governor was misinformed. He was encouraged that the administration had no intention to revisit SB 21 and felt that the tax overhaul already had a positive effect on production while sending a message of "stability" to the industry. He concluded that the legislature had worked arduously on the issue of tax credits and believed that the Governor was acting responsibly with a restrained approach to SB 21.

Co-Chair MacKinnon clarified that the Cook Inlet loss carry forward credits expired January 1, 2016.

Mr. Tichotsky referred to slide 33, "Fall 2014 Total Revenue Forecast," and observed that the graph demonstrated the historic variability of the state's revenue sources (non-petroleum, petroleum, federal, and investments) but on average more stability was predicted in the future.

Mr. Tichotsky referred to slide 34, "Unrestricted Revenue Forecast 2015-2023," and noted that the chart depicted the department's belief that oil prices were expected to recover over the longer-term and that production was expected to increase in the short to mid-term. The production decline beginning in 2019 was due to uncertainty by forecasting that far into the future. Deductible lease expenditures were anticipated to increase due to the additional production which also affected the state's revenue. Revenues in the \$2.5 billion range were expected in the short-term. The graph included the production tax value per taxable barrel.

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Vice-Chair Micciche agreed with the departments forecasting methodology but expressed concern that the forecasted price of \$66.03/bbl. was 42 percent above the current price of oil.

Mr. Tichotsky replied that the revenue forecast "is what it is" and that "perfect knowledge" was not available. He voiced that the revenue forecast provided a "multi-use tool" for budgeting, planning, and the bond rating

agencies. He felt that "overall" the revenue forecast served the users well.

Senator Dunleavy noted the forecasted "significant production decline" and asked for clarity.

Mr. Tichotsky reiterated that the decline represented the uncertainty in forecasting production into the longer-term.

Senator Bishop referred to the Cook Inlet credits, and related that the credits had "eliminated a lot of fear in Southcentral Alaska" and that similar credits could benefit energy needs in other parts of the state.

In response to a question by Senator Hoffman, Mr. Tichotsky replied that the asterisk on slide 34 next to general fund unrestricted revenues was there inadvertently.

In response to a question by Co-Chair MacKinnon, Mr. Tichotsky replied that the footnote on slide 33 that read, "GFUR did not reflect true investment revenue forecast" was also not relevant.

Co-Chair MacKinnon referred to the red line projecting federal revenues of \$3.1 billion on slide 33, and wondered whether the figure included federal monies from "the increase with Medicaid."

Mr. Tichotsky replied in the negative. He elaborated that typically \$3.1 billion of federal revenue was allocated but approximately 20 percent to 30 percent less (approximately \$2.4 billion) was actually spent.

Vice-Chair Micciche believed that Commissioner Hoffbeck was "extremely fair on the positive net effects of SB 21." He calculated that the net positive to the state from the new production tax of 35 percent base tax and sliding scale at current prices was well over \$200 million as opposed to the previous tax regime. He wondered whether DOR had done any calculations regarding the differences in revenue between the previous [ACES] and new tax systems.

Commissioner Hoffbeck replied that he had not performed any recent calculations but agreed that "a substantial uplift" had occurred with low oil prices because of the "minimum tax floor."

Co-Chair Kelly asked whether SB 21 "tended" to raise more revenue with low oil prices than ACES.

Commissioner Hoffbeck responded in the affirmative and furthered that when the minimum tax threshold was reached, SB 21 raised "substantially more" revenue.

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ADJOURNMENT

[11:42:05 AM](#)

The meeting was adjourned at 11:42 a.m.