

SENATE FINANCE COMMITTEE
April 18, 2016
3:36 p.m.

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CALL TO ORDER

Co-Chair MacKinnon called the Senate Finance Committee meeting to order at 3:36 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

Senator Pete Kelly, Co-Chair

ALSO PRESENT

Janak Mayer, Chairman and Chief Technologist, enalytica;
Laura Cramer, Staff, Senator Anna Mackinnon; Craig
Richards, Attorney General, Department of Law; Randall
Hoffbeck, Commissioner, Department of Revenue; Angela
Rodell, Executive Director, Alaska Permanent Fund
Corporation.

PRESENT VIA TELECONFERENCE

Nikos Tsafos, President and Chief Analyst, enalytica.

SUMMARY

SB 128 PERM. FUND:DEPOSITS;DIVIDEND;EARNINGS

SB 128 was HEARD and HELD in committee for
further consideration.

SB 130 TAX;CREDITS;INTEREST;REFUNDS;O & G

SB 130 was HEARD and HELD in committee for further consideration.

#sb130

SENATE BILL NO. 130

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

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JANAK MAYER, CHAIRMAN AND CHIEF TECHNOLOGIST, ENALYTICA, introduced himself.

NIKOS TSAFOS, PRESIDENT AND CHIEF ANALYST, ENALYTICA (via teleconference), discussed the presentation titled "CS SB 130: Key Issues and Assessment" (copy on file), beginning with slide 25, "CI Overview and Changes: Activity":

Activity has responded in recent years

Exploration drilling in Cook Inlet has gone through several cycles since 1950s

Recent exploration activity (post 2010) on par with previous exploration peaks

Development drilling has been more stable over the years

Recent growth placing three-year rolling average among highest in state's history

Mr. Tsafos highlighted slide 26, "Cook Inlet Oil and Gas Production: Basic facts":

Oil: Peak in 1970 at 226 mb/d; trough in 2009 at 7.5 mb/d; upturn post 2010 (+10.5 mb/d)

Gross Gas: Peak in 1990 at 853 mmcf/d; big drops in 1994-1998 and 2005-2013; stable in 2014-15

Net Gas: Peak in 1996; 1990s plateau from blowdown at Swanson River; fall post 2005, then stable

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Mr. Tsafos discussed slide 27, "CI Overview and Changes: Scorecard":

the Cook inlet oil and gas market: A scorecard

What has happened to oil and gas production and activity in the Cook Inlet in recent years?

Oil production has risen from 7.5 mb/d in 2009 to almost 18 mb/d

Gas production has stabilized after years of steadier decline

How has the gas market adjusted in recent years?

Cook Inlet has undergone major transition in supply, demand, prices, competition and expectations

Some of these changes are typical in mature basins—others are unique to Cook Inlet

What's the outlook and how sensitive is the outlook to changes in oil/gas fiscal system?

DNR: 1,183 bcf in remaining 2P reserves; 1,600 bcf w/ Cosmopolitan and Kitchen Lights (ballpark)

Continued drilling at old fields plus Cosmopolitan and Kitchen Lights: current market well supplied

At current (gas) price levels, brownfield investment should be profitable under stricter fiscal regime

Credits more important for developing new resources, especially with demand constraints

Currently much uncertainty over future regime - setting a stable, sustainable system is paramount

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Vice-Chair Micciche felt it would be nice to determine the potential demand based on all of the different factors. Mr. Tsafos responded that there were multiple strategies to attract investment.

Co-Chair MacKinnon announced that there would be further meetings related to the oil and gas tax structure.

Mr. Mayer continued to discuss slide 27.

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Mr. Mayer looked at slide 28, "Project 1: Market constrained (assumptions)":

Large upfront investment but constrained gas market
Limited ability to sell gas: can only drill a well every few years

Mr. Mayer discussed slide 29, "CI Overview and Changes: Project 1; Project 1, Market Constrained Results." He stated that the slide represented three separate scenarios: Status Quo; CS SB 130(RES), CS HB 247(FIN).

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Senator Dunleavy wondered if there would be a decline in demand for credit without any changes. Mr. Mayer replied in the affirmative.

Senator Dunleavy felt that idle rigs would decrease the credits. Mr. Mayer agreed.

Senator Dunleavy remarked that the environment may not be attractive for a capital constrained company to move a rig to the North Slope in a small market. Mr. Mayer agreed.

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Mr. Mayer highlighted slide 30, "CI Overview and Changes: Project 2":

Project 2: Market un-constrained (assumptions)

Large upfront investment but un-constrained gas market

Continued drilling lead to a plateau of 130 mmcf/d

Scenario would require a step change in existing supply-demand dynamics in Cook Inlet

Mr. Mayer addressed slide 31, "CI Overview and Changes: Project 2; Project 2: Un-constrained Results."

Mr. Mayer highlighted slide 32, "CI Overview and Changes: Project 3":

Project 3: Drilling in existing field (assumptions)

Drilling expenditures at existing production—smaller upfront investment

No market constrains assumed

This is a point-forward analysis—it ignores sunk, entry or acquisition costs

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Mr. Mayer discussed slide 33, "CI Overview and Changes: Project 3; Project 3: Drilling Existing Field Results."

Vice-Chair Micciche looked at slide 31, which demonstrated that the elimination of the production tax had no effect. The only difference in the reduction of the internal rate of return and the increase in the revenue to the state was the level of the reduction of credits between the two bills. Mr. Mayer replied in the affirmative.

Vice-Chair Micciche shared that he had further questions that he would address later.

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Co-Chair MacKinnon stated that the purpose of the presentations were meant to set an examination of how the credits were utilized in the state.

Mr. Mayer encouraged the committee to see that the credits in Cook Inlet were about incentivizing activities that were less affordable than in the past. The North Slope could remain, but the net operating loss credit was about timing of tax flows rather than the total amount.

Senator Dunleavy remarked that the Cook Inlet dealt with mostly gas. He wondered if there could be increased oil production in Cook Inlet. Mr. Mayer replied that it

depended on the oil price, rather than the credit environment.

Senator Dunleavy shared that transportation and production costs were lower in Cook Inlet than the North Slope. He remarked that he would ask a similar question the following day. Mr. Mayer agreed.

Co-Chair MacKinnon wondered whether the credit market would see Alaska in a more stable environment, should the state use the savings to have an annuity payment or a fixed draw. Mr. Mayer replied that it was always good to have assets to smooth the volatility that comes with depending on commodity prices.

Co-Chair MacKinnon felt that it would be a positive step to change the current structure. Mr. Mayer agreed.

SB 130 was HEARD and HELD in committee for further consideration.

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#sb128

SENATE BILL NO. 128

"An Act relating to the Alaska permanent fund; relating to appropriations to the dividend fund; relating to income of the Alaska permanent fund; relating to the earnings reserve account; relating to the Alaska permanent fund dividend; making conforming amendments; and providing for an effective date."

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Vice-Chair Micciche MOVED to ADOPT the committee substitute for SB 128, Work Draft 29-GS2859\S (Wallace/Martin, 4/17/16). Co-Chair MacKinnon OBJECTED for DISCUSSION.

LAURA CRAMER, STAFF, SENATOR ANNA MACKINNON, explained the committee substitute. She discussed the changes from the original bill, outlined in the Sectional Analysis (copy on file):

Section 2: Language requiring the Alaska Permanent Fund Corporation to adopt regulations similar to the State's procurement code

Section 3: Adds the Alaska Permanent Fund Corporation to the list of those state agencies that are exempt from the State's procurement code

Section 5: Transfers the management and investment of the Constitutional Budget Reserve from the Department of Revenue to the Alaska Permanent Fund Corporation

Section 6: Requires the Alaska Permanent Fund Corporation to prepare an annual report on the balance and returns of the Constitutional Budget Reserve fund

Section 9: (b) Defines the Percent of Market Value payout as 5.25 percent of the average year-end market value of the Permanent Fund and Earnings Reserve Account for the first five of the most recently completed six fiscal years. The payout may not exceed the year-end balance of the earnings reserve account for the fiscal year just ended

(c) Reserves 20 percent of the POMV payout for dividends. The remaining 80 percent of the payout is subject to a dollar for dollar reduction as oil and gas revenue rises above \$1.2 billion (adjusted for inflation).

Oil and gas Unrestricted General Fund revenue excluding the amount to be paid as 20 percent of the prior year royalties to the dividend

\$1,200,000 revenue limit adjusted for inflation

Section 10: AS 37.13.145 is the Disposition of Income of the Permanent Fund statute

- (a) Unchanged - Establishes the ERA and identifies the ERA as holding earnings of the Permanent Fund and ERA
- (b) Repealed in this bill - dividends based on statutory net income
- (c) Repealed in this bill - inflation proofing

- (d) Repealed in this bill - segregation of Amerada Hess
- (e) Added in this section - each year the legislature may appropriate to the General Fund the amount available for distribution from the Earnings Reserve Account under the POMV in Sec. 10 (b) and the limit calculation Sec. 10 (c)
- (f) Inflation proofing mechanism

Senator Hoffman wondered if Ms. Cramer meant \$1.2 billion. Ms. Cramer replied in the affirmative.

Section 12: Conforming language relating to procurement

Section 18: Repeals language relating to the subaccount of the Constitutional Budget Reserve, the former dividend calculation, inflation proofing calculation, and Amerada Hess language

Co-Chair MacKinnon WITHDREW the OBJECTION. There being NO further OBJECTION, the proposed committee substitute was adopted.

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Mr. Teal looked at the document, "Cash Flow Under SB 128/HB 245" (copy on file):

Sec 7

Reduces royalties dedicated to the permanent fund from new oil fields (post 1980) from 50 percent to the constitutional minimum of 25 percent. That increases general fund revenue by about \$50m annually depending on the price of oil.

Sec 8

Deletes the definition of income available for distribution. That formula was based on earnings during the preceding 5 years.

Sec 9

(b) Replaces the earnings-based "available for distribution" formula in section 8 with a POMV calculation. The nominal payout to the general fund is 5.25 percent, but the effective payout will be about 4.8 percent (in the long-term) if the permanent fund corporation's projections regarding real earnings of 5 percent and inflation of 2.25 percent are realized. The effective payout is lower than the nominal 5.25 percent payout because the payout is based on the average balance during the past 6 years.

(c) Ensures that 20 percent of the payout goes to dividends. Under the Spring forecast, that will be about \$500 to \$600 million annually. The remaining 80 percent of the payout is subject to a dollar for dollar reduction as oil revenue rises above \$1.2 billion (adjusted for inflation). The impact of the payout limit is:

1. Zero when oil is below about \$75/bbl. (\$75 oil generates about \$1.2 billion in production taxes and royalties (after reserving 20 percent of royalties for dividends

2. The payout is reduced by a dollar for every dollar of oil revenue (less the 20 percent portion of royalties that goes to dividends) between \$1.2 billion and about \$3.1 billion. The reduction occurs at oil prices between about \$75/bbl and \$100/bbl as shown in the graph below.

3. When oil prices are above about \$100/bbl, the POMV payout is reduced to zero and additional oil revenue is spendable. General fund revenue available to spend will be lower (relative to revenue without a limit) by about \$2 billion.

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Mr. Teal discussed the charts on page 2 of the document.

Senator Dunleavy remarked that the revenue limit focused only on the Permanent Fund, not taxes. Mr. Teal agreed.

Senator Dunleavy noted that there was nothing in the bill that would prevent the legislature from increasing taxes. Mr. Teal agreed.

Vice-Chair looked at the Sectional Analysis, and queried the changes in Sections 5 and 6.

Co-Chair MacKinnon announced Ms. Rodell could address those sections.

Vice-Chair Micciche remarked that there was a value in the difference in the earnings. Mr. Teal deferred to Ms. Rodell.

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Co-Chair MacKinnon looked at page one of the analysis, and wondered if the dividend was capped, or was the dividend guaranteed at \$1000 and tie it directly with the volatility of oil with the opportunity for interest earnings. Mr. Teal replied that the dividend guaranteed at \$1000 and tie it directly with the volatility of oil with the opportunity for interest earnings. He stated that the calculations showed a consistent \$1000 dividend. The dividend would be less volatile than the current dividend calculation.

Co-Chair MacKinnon remarked that the modeled projections represented the spring forecast. Mr. Teal replied in the affirmative.

Co-Chair MacKinnon queried the highest price per barrel in the spring forecast model. Mr. Teal replied that he thought it was close to \$60 per barrel at the end of the forecast period.

Co-Chair MacKinnon shared that Alaska currently at \$40 per barrel.

Vice-Chair Micciche wondered if the revenue should be in statute. Mr. Teal replied that it may seem like revenue was limited to \$200, but the limited revenue at \$130 was just under 7. He stated that beyond \$100, there was a \$2 billion revenue limit at every price.

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Vice-Chair Micciche remarked that it was a dangerous revenue limit, with no control in the bill. Mr. Teal understood that the inflation proofing transfer would be subject to appropriation. He stressed that the entire earnings reserve was subject to appropriation. He remarked that regardless of the balance, the legislature could appropriate the fund for any purpose. He stated that one could not bind or restrict future legislators their ability to spend the earnings reserve account.

Senator Dunleavy queried the oil production for the following year. Mr. Teal replied that he did not know.

Senator Dunleavy queried oil production in one year. Mr. Teal responded that he did not know.

Co-Chair MacKinnon stressed that the committee was attempting to create a revenue stream that had a different volatility than oil

Senator Bishop wanted to know what the revenue would look like in 2030.

Senator Dunleavy wondered how long Mr. Teal had been working for the Legislative Finance Division. Mr. Teal replied that he had been there for approximately 20 years.

Senator Dunleavy wondered whether the state could ever control its spending. Mr. Teal felt that the state had controlled its spending, because there was savings available to sustain the budget so far.

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CRAIG RICHARDS, ATTORNEY GENERAL, DEPARTMENT OF LAW, stated that the administration was supportive of the current committee substitute.

RANDALL HOFFBECK, COMMISSIONER, DEPARTMENT OF REVENUE, agreed with General Richards.

Senator Hoffman understood that the administration would look at the proposal in a favorable manner. He remarked that some legislators were concerned with the dividend level. He understood the utilization of the fund, and the guarantee of \$1000 for three years. He expressed concern with putting that formula in statute. He suggested a

formula of guaranteeing \$1000, and then adjusting the dividend for inflation over the following four to five years. He stressed that the fund was the peoples' money.

Co-Chair MacKinnon remarked that there was a three-year review period to address some of those specific issues.

Senator Bishop echoed Senator Hoffman's comments.

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Senator Dunleavy stressed that there was a concern about the ceasing the focus on reducing the budget. He shared that the proposal did not include any taxes. He queried efforts by the administration to reduce spending. He wondered if the public should expect any vetoes on expenditures in order to reduce the budget. Commissioner Hoffbeck responded that he could not speak to what may or may not be vetoed by the government. He remarked that a \$70 per barrel oil price, there was not a limitation in the plan. He stressed that there would always be pressure to fill the budget gap. The governor had a revenue package to fill some of that gap. He stated that this model did not reduce the downward pressure to balance the budget.

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Co-Chair MacKinnon looked at "Document B" (copy on file). She remarked that there were four "health checks" on the fiscal model. She noted that the upward left hand portion outlined spending. She stated that it showed where the money would be withdrawn, based on the spring forecast. She noted that the right hand corner showed dividends to Alaskans. She stated that the model worked under the current downward price forecast. She noted that Alaskans had seen very different volatility recently. The right hand corner showed the health of the Permanent Fund and the corpus itself. She remarked that under the scenario, there were 36 years before the budget reserves were extinguished. She stressed that the corpus of the Permanent Fund should continue to grow, but noted that a 5.25 percent draw may fare less well than a 5 percent draw. She remarked that the scenario showed a target cut for the current year of \$250 million. She shared the efforts of the legislature to fix the crisis. She wondered if the proposal provided revenue diversity of approximately \$2.5 to \$2.5 billion. She

stressed that there would still be a budget gap. Commissioner Hoffbeck replied in the affirmative.

Co-Chair MacKinnon stressed that her constituents were not interested in taxes, and other Alaskans were interested in taxes. She shared that the proposed calculation included tax credit reform.

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Senator Hoffman remarked that the gap was not completely filled, and the capital budget was fixed at \$185 million. He felt that number over the long-term was unrealistic.

Co-Chair MacKinnon looked at the "Cash Flow Analysis", and stated that the UGF pay out limit allowed for additional dollars that could be diverted to the CBR or a capital account for deferred maintenance.

Vice-Chair Micciche remarked that Alaska was a sovereign with most of its income from the sale of oil in the global market. He felt that, with normal corpus growth, the state could be sustainable without taxing Alaskans. He queried the actions that would result in a fully sustainable budget. Commissioner Hoffbeck replied that there must be additional revenue to maintain a sustainable budget. He stressed that the current climate may be a reflection of a structural change in oil price, because of the technology changes that have allowed a tremendous amount of oil be brought online. He stated that a \$60 to \$70 per barrel price point did not allow enough money in oil and gas to sustain a budget.

Vice-Chair Micciche noted that there would be a 4.62 percent draw from the Permanent Fund. He queried a vision of what would occur when revenue exceeded responsible spending. General Richards replied that the fundamental difference between the revenue limit versus the original drafting of the Permanent Fund Protection Act, was that the act would have "sliced off the spikes." The original bill would have maintained the flat spending level from the three cash flows across all price ranges.

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Vice-Chair Micciche queried a time limit for the meeting. Co-Chair MacKinnon responded that there was one more presenter and three members in line for questions.

Vice-Chair Micciche queried another mechanism that would be largely statutory, where the legislature did not relent their control. General Richards remarked that the language stated that "the Legislature may inflation proof."

Senator Olson remarked that noted that most people were concerned with the dividend calculation, which was somewhat different than the Permanent Fund Protection Act. He queried a plan that would "ride the market." Commissioner Hoffbeck replied that the governor's plan "rode the market", and would give more of a dividend reflecting the income available. He stated that funding would keep the dividend in the \$1000 range.

Senator Olson queried the effect on the bond rating in the short-term between the governor's proposal versus the committee substitute. Commissioner Hoffbeck replied that either plans would be received in a relatively similar fashion. He remarked that it was important for the bond rating agencies to see that Permanent Fund was an available source of revenue to secure the bonds.

Co-Chair MacKinnon thanked Commissioner Hoffbeck and General Richards for their collaborative approach to the formulation of the legislation.

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Vice-Chair Micciche wondered if the legislature could create a regular draw to help with liquidity. Commissioner Hoffbeck the bill had a provision to remove Section C for the five year requirement, which allowed for a prudent investor for the CBR.

Co-Chair MacKinnon queried setting a spending limit. General Richards replied that he did not have an official position. He shared that in the initial stages of the Permanent Fund Protection Fund, there was an examination of a number of different ways to address the volatility issue, including a more broadly defined revenue or spending limit. He stated that it was difficult to create an effective spending limit.

Senator Bishop commented that the bill seemed to provide a spending limit.

Co-Chair MacKinnon shared that Alaskans were interested in government spending more than any other time, especially when facing a reduction in their dividend.

Senator Dunleavy wondered whether the administration would continue to pursue the tax concept, should this proposal move forward. General Richards replied that he had not heard anything other than the governor's original plan. He did not want to speak for the governor outside of the Permanent Fund.

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ANGELA RODELL, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION, shared that the goal of the committee substitute was to understand the mechanics of the intent. She appreciated the flexibility to work with DOR on cash management, so there would only be a requirement to make a withdrawal when necessary. She appreciated the addition of the procurement language, which would help to pursue investments in a timely manner.

Senator Bishop wondered if there was a discount for the money managers. Ms. Rodell replied that it depends on the investment. She stated that the internal managed items, such as fixed income and real estate were set fees. She remarked that the fees would be lower for the CBR, because the size of the asset did not matter. She stated that externally managed accounts often had attached fee schedules, so those had thresholds for the management fees.

Ms. Rodell stated that she did not have any closing comments, but remarked that she was ready to do the work requested by the committee.

Co-Chair MacKinnon recalled a year when the Retirement and Management Board investment performance was better than the Permanent Fund performance. Ms. Rodell replied in the affirmative.

Co-Chair MacKinnon queried value in the diversification of who would invest the money, rather than one group. She queried anything that the legislature might consider to avoid duplication of services. She remarked that the

Permanent Fund Corporation was prestigious. Ms. Rodell responded that the commissioner of DOR was had fiduciary responsibility for all of the state's financial assets. She felt that there were benefits of both diversification as long as there was continuity. She felt that diversification was most helpful in asset allocation, as opposed to an individual running a particular portfolio.

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Senator Olson wondered if Ms. Rodell had an optimistic perspective on the bill. Ms. Rodell replied that it was the intent to examine three years of earnings. She encouraged the committee to expand that intent to examine more areas of the reserve.

Co-Chair MacKinnon shared that she had observed presentations by the governor to the Permanent Fund Board ideas for use of the assets. She had seen the models and the actuaries that supported the board. She wondered whether the board would be able to examine the committee substitute. Ms. Rodell replied that the next board meeting was scheduled for May 24 and 25. She hoped that the legislative process would be complete before that time. She shared that the board felt it was important to respect their roles as trustees to manage the funds of the corpus. She stated that the legislature had the authority to determine how the fund was used.

Co-Chair MacKinnon thanked the day's presenters.

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Co-Chair MacKinnon announced that there would be a meeting the following day.

Vice-Chair Micciche remarked that there was room to reduce the size of government, but stressed that there would be a point when once could no longer make any more reductions.

SB 128 was HEARD and HELD in committee for further consideration.

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ADJOURNMENT

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The meeting was adjourned at 5:42 p.m.