

SENATE FINANCE COMMITTEE

May 13, 2016

9:34 a.m.

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CALL TO ORDER

Co-Chair MacKinnon called the Senate Finance Committee meeting to order at 9:34 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 Donny Olson

MEMBERS ABSENT

Senator Lyman Hoffman

ALSO PRESENT

Randall Hoffbeck, Commissioner, Department of Revenue; Ken Alper, Director, Tax Division, Department of Revenue.

PRESENT VIA TELECONFERENCE

SUMMARY

PRESENTATION: OIL and GAS TAX CREDITS

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RANDALL HOFFBECK, COMMISSIONER, DEPARTMENT OF REVENUE, emphasized the importance of a committee process that was working, and believed that HB 247 had changed dramatically. He felt that some of the changes improved the bill. He acknowledged the long-term impacts of carry forward credits that several versions of the bill had addressed. He stressed that the House Rules Committee version of the bill advanced the legislation but needed additional work to

garner the governor's support. He spoke to the spring forecast, and the concern over whether it adequately addressed the issues associated with industry expenditure reductions. He relayed that the Department of Revenue (DOR) examined the data through March and found the information accurate. He noted that the department used information provided by the industry. On the capital expenditure side, the department forecasted less than the actual spend.

Commissioner Hoffbeck continued his opening remarks, noting that the revenue figures were low. The forecasted price was less than \$40 bbl. and the actual price was \$45 bbl. He reported that if the prices remained at the level the average price for FY 16 would be \$42 to \$43 bbl. He noted that every dollar above the forecasted amount equated to roughly \$25 million in revenue. He remarked that "the critical issue" at the \$45 price point was that the issues associated with carry forward credits were eliminated. He explained that industry operated at a profit at \$45 bbl. under the state's tax structure, and was not eligible for carry forward loss credits. He supported fixing the carry forward issue in legislation even though the price of oil was predicted to move within a range of \$35 to \$65/bbl. in the current fiscal year. He relayed the administration's position that production tax was a severance tax and not an income tax. He explicated that the state maintained a specific oil and gas income tax where losses could be carried forward. A production tax or severance tax was a "charge based on severing a non-renewable resource from the state." He shared that "the administration was firm in its position" that the tax rate should not drop below zero. The state should not pay an entity to produce its resources. The governor said he would accept a 4 percent floor that allowed losses to decrease the floor to zero in a given year but the losses could not be carried forward to produce a negative tax. He relayed that the administration would judge the bill accordingly.

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Senator Dunleavy asked whether the administration believed the majority of the tax credit issue was centered on Cook Inlet. Commissioner Hoffbeck replied in the affirmative except for the net operating loss credit (NOL) that applied to both areas. Senator Dunleavy wanted to make sure the public understood that the tax credit issues were focused on Cook Inlet. He thought it appeared as if the legislature

was focused solely on the North Slope, when in fact much of the tax credit issue was from production in Cook Inlet. Commissioner Hoffbeck responded in the affirmative.

Vice-Chair Micciche thought Senator Dunleavy had asked a good question, and referred to SB 21 (Oil And Gas Production Tax) [Chapter 10 SLA 13 - 05/21/2013]. He believed that some individuals "rhetorically" connected SB 21 with the state's "cashable credit exposures." He reported that HB 280 (Natural Gas: Storage/ Tax Credits) [Chapter 16 SLA 10 - 05/12/2010] known as the Cook Inlet Recovery Act created the credit issue and not SB 21. He asked for a response. Commissioner Hoffbeck discussed legacy issues. He answered that the majority of the "cash flow credit" issues that concerned the administration stemmed from most of the previous tax regimes. He listed the previous tax systems as: the Cook Inlet Recovery Act, Alaska's Clear and Equitable Share (ACES), Petroleum Production Tax (PPT), and the Economic Limit Factor (ELF). Vice-Chair Micciche thought it was important for the public to understand the issue. He understood that SB 21 repealed the 20 percent Capital Expenditure (Capex) credit enacted with ACES, which he characterized as "detrimental" to the state. He offered that 2013 was the record year for tax credits under ACES when the state paid approximately \$918 million due to capex credits. He wondered whether Commissioner Hoffbeck wanted to comment on the topic. He noted that the ultimate goal was to address the "\$4.1 billion" budget deficit which drove reconsideration of the tax credit system. Commissioner Hoffbeck deferred to Mr. Ken Alper, Director, Tax Division, Department of Revenue, for the answer.

Co-Chair Kelly referred to Vice-Chair Micciche's comment that the state's current tax credit liability amounted to \$700 million. He clarified that the amount was actually \$500 million due to the governor's veto of \$200 million last year, which he considered a "false reduction." He believed accuracy was important when discussing the credit numbers. He noted that the repayment of the \$200 million was pending and still owed by the state.

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KEN ALPER, DIRECTOR, TAX DIVISION, DEPARTMENT OF REVENUE, addressed previous comments. He stated that the tax credit liability for cash, based on the forecast for FY 17 was

\$775 million and included the \$200 million referenced by Senator Kelly that carried over from FY 16. The FY 16 forecast was \$700 million and fully funded by the legislature. He confirmed that the governor vetoed \$200 million. He related that the peak year for "repurchases" would be FY 17, if the full amount of \$775 million was fully funded. In relation to Senator Micciche's remarks, he recounted that FY 14 was the peak year for credits against liability of over \$900 million. He added that the figure represented a "hybrid" due to the cross-over between ACES and SB 21. The fiscal year included the last year of the 20 percent capex credits under ACES and the first year of per barrel credit under SB 21. He added that between the cashable credits and credits against liability the state paid over \$1.5 billion in total credit liability in FY 2014.

Vice-Chair Micciche stated that he was referring to FY 13, and offered that the reason he had used \$775 million figure was to try to maintain accuracy due to the "way the press covered this issue." He stated that the highest year of credits was due to the ACES capex credit and was not related to the current situation. He believed the ACES capex credit was over generous.

Co-Chair Kelly concurred with Vice-Chair Micciche and announced that some of the "stacked" tax credits were expiring or eliminated. He stated that if the press was creating a "boogeyman" of credits he wanted to use the accurate amounts. He voiced that the credits were approximately \$500 million dollars. He was reminded of the "mantra" stated by some that the state was paying out more than collecting in production tax. He remarked that no one discussed the collection of oil royalty, property, and income tax as well. He referenced Commissioner Hoffbeck's remarks regarding severing a non-renewable resource from the state, and commented that he ignored the fact that the oil was paid for in royalty.

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Senator Dunleavy remembered that Commissioner Hoffbeck testified that the administration had no intention of revisiting SB 21. Commissioner Hoffbeck answered in the affirmative. Senator Dunleavy referred to the forecast and wondered if the department was collecting data to determine

whether a decrease in activity would result in a decreased use of credits.

Mr. Alper responded in the affirmative and explained that the credit forecasts were "tied" to the information the industry provided regarding its projected work. The out year forecasts were typically low due to the industry's uncertainty of work in the future. The department's forecast was "fairly accurate" and the lease expenditures were tracking very closely with the FY 16 forecast. He indicated that if the lease expenditures were on track for FY 16 the credits expectation was closely matched for FY 18 due to the one and one half to two year lag between when the money was spent and the requests for reimbursement.

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Co-Chair MacKinnon relayed that she reviewed the "Indirect Expenditure Report" dated January, 2015 [published by the Legislative Finance Division] and viewed the data regarding the credits and the expiration dates from the Division of Oil and Gas. She asked whether the state "blanket credited the industry with every federal credit available" that a company can use against taxes. Mr. Alper clarified that Co-Chair MacKinnon was referencing corporate income tax and asking whether the state internalized the federal tax code into the state's corporate tax code. He stated that the income from companies that were applied to "the apportionment formula and applied to Alaska by a certain percentage was also internalizing" the federal tax credits. He did not consider himself an expert on corporate income tax and offered to provide more details. Co-Chair MacKinnon asked whether Mr. Alper could provide the committee with information on the implications on how much money or lack of money the state received under the corporate tax. Mr. Alper agreed.

Mr. Alper discussed the presentation "Oil and Gas Tax Credit Reform - CSHB 247(RLS)\C" (copy on file). He commented that although the bill had changed the committee was familiar with the range of options and issues in HB 247. He noted that each slide addressed a specific issue and how the governor proposed to address the issue and how

the House Rules Committee version dealt with the issue. He drew the committee's attention to an additional document titled, "Comparison of Provisions of HB 247 - Oil and Gas Tax Credits" (copy on file) which provided a comparison of provisions of various versions of the bill including the proposed Seaton-Wilson compromise, which the committee might discuss in the future but was not included in the PowerPoint.

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Mr. Alper discussed slide 2:

Major Provisions in Rules Committee Substitute:

Exploration Credits

- Governor's bill
 - o Allows existing credits to sunset on 7/1/16
 - o Keeps "middle earth" extension to 1/1/22
 - o Repeals older dormant DNR exploration credits
- Rules CS
 - o Also keeps the change made in several earlier versions to extend the "Frontier Basin" credit to protect ongoing AHTNA investment
 - o Extends this language six months due to additional delay in acquiring a rig

Mr. Alper commented that the Frontier Basin credit was related to Middle Earth credits and extended the credit another 6 months.

Co-Chair MacKinnon asked for clarification about the bullet "keeps "middle earth" extension to 1/1/22," and wondered whether the credit already expired but the governor's bill extended it. Mr. Alper clarified that the credit was passed in 2003 that contained an original sunset date of 5 years and was extended by previous legislatures two more times. The last extension applied statewide and expired July 1, 2016. He furthered that an amendment embedded within SB 21 extended the credit exclusively to Middle Earth until 2022.

Senator Bishop asked whether he was referring specifically to the "023025 credit." Mr. Alper specified that the credit was the "025A" [43.55.025(a)] credit; the primary exploration credit. He added that the Frontier Basin credit

was also contained in 025 (a) subsection 6 and was the 80 percent credit that sunset in July, 2016 that was extended in the current version of the bill.

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Co-Chair MacKinnon cited the term "super credit," in relation to the Frontier Basin credit and wondered what the credit was and why the credit was maintained by the governor when "in all other instances" he wanted to eliminate or reduce credits. Mr. Alper answered that the term "super credit" was first used in relation to the Cook Inlet Jack-up Rig credit when the Cook Inlet Recovery Act and SB 309 (Oil & Gas Tax Credits/ Payments) [Chapter 15 SLA 10 - 05/10/2010] was adopted. He detailed that the Jack-up Rig credit provided 100 percent support for the first well drilled with a deep water jack-up rig in Cook Inlet. The "extra" incentive credit was referred to as a super credit because the scope was beyond what the state had previously offered. The Frontier Basin bill in 2012 [HB 276 (Oil/Gas Prod.TaxCredits/Rates/Value) [Withdrawn by Sponsor 04/15/2012] was ultimately folded into a larger tax incentive bill [SB 23 (Tax/Credit: Film/Oil & Gas/Gas Stor./Corp) Chapter 51 SLA 12 05/30/2012] and "emulated" the jack-up rig provision in an attempt to finish work in targeted areas in the basin. He qualified that the super credit was rarely used and was not much better than utilizing the 40 percent exploration credit stacked with the net operating loss credit. The super credits were not stackable and the jack-up rig credit required payback. He related that the AHTNA Corporation was utilizing the jack-up rig credit in the Glenallen area while attempting to find a gas supply for local utility needs. The project was permitted and was "in the works" for several years but due to circumstances beyond the corporations control work was slowed. The previous committees decided the extension request was reasonable at a cost to the state of \$1 million to \$2 million.

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Co-Chair MacKinnon referred to the Cook Inlet Jack-Up Rig credit that was successfully used to find gas. She wondered whether the state expected to receive the 50 percent payback over ten years and if it was included in the forecast. Mr. Alper replied that the jack-up rig credit was not actually used in Cook Inlet. The companies employed the exploration credit or the Well Lease Expenditure (WLE)

credit stacked with the NOL credit and received 65 percent state support. The 100 percent jack-up rig credit required 50 percent payback, a higher information hurdle, and a more limited expenditure barrier and was avoided.

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Mr. Alper addressed slide 3:

Major Provisions in Rules Committee Substitute:

Cook Inlet (and Middle Earth) Credits

- Governor's bill
 - Eliminated 20% QCE and 40% WLE, kept 25% NOL
 - Kept 2022 "tax cap" sunset
- Rules CS
 - NOL kept at 25% in 2017 but only if producing by 1/1
 - QCE repealed 1/1/17
 - WLE reduced to 20% for 2017-18 and repealed in 2019
 - Keeps 2022 tax cap sunset but "working group" section explicitly calls for new tax system to take effect in 2019

Mr. Alper stated that the Cook Inlet credit system was really the old ACES system. He explained that the 2022 "tax cap" sunset was replicated from the PPT era maximum taxes that applied to Cook Inlet. He added that the expectation was that a future legislature would resolve the Cook Inlet tax issue. He described the House Rules CS as being a slower ramp-down to what the governor had wanted.

Mr. Alper looked at slide 4:

Major Provisions in Rules Committee Substitute:

North Slope Credits, Limits, Carry-Forwards

- Governor's bill
 - Kept 35% NOL rate (not current administration policy)
 - Capped repurchase at \$25 million / company / year, large company exclusion, 10 year sunset
- Rules CS

- o 35% NOL for 2017-19 transition period, only for small producers and pre-production developers
- o Capped at \$75 million / company / year
- o After 2020 all companies must "carry forward" lease expenditures to use against future revenue
- o Effectively keeps the 35% tax value for carry-forward

Mr. Alper informed the committee that based on the spring forecast exposing the "potential extent of major producer operating losses" the governor wanted to eliminate or reduce NOL credits. He delineated that the original version disqualified a large company with more than \$10 billion in annual revenue from receiving cash credits and required that the NOL credits were carried forward to future years for use against its taxes. He believed the House Rules CS took a different path that had not been seen before. He indicated that "small producers" were defined as companies producing less than 15 thousand barrels per day. The NOL loss had traditionally been used by companies that did not have revenue due to the pre-production development stage and was reverting back to that specific use. He stated that after 2020 the NOL credit was eliminated. He revealed that converting the NOL credit into a carry forward credit created "dissonance" between the incumbent producer and a new producer several years away from production. The incumbent producer was able to use the carry forward expenditure against revenue when the price of oil increased but new developers not in production had to hold the carry forward lease expenditures for future years. He shared the concern that the "playing field leveling" effect was lost by not offering credit support.

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Vice-Chair Micciche stated that he used different terminology, and thought the playing field was leveled. He opined that the credits prior to the change were advantageous to smaller companies and the current provisions provided a level playing field for all companies. He asked whether Mr. Alper agreed. Mr. Alper answered that in the past when the prices were high, "it truly was a level playing field to have cash credits because the major producers were offsetting their expenses and paying fewer taxes by spending money." He furthered

that when the price dropped, the playing field was tipped in favor of independent producers who were receiving cash for their credits and the major producers were required to carry their losses forward. He felt that the new provision was a "rebalancer" but once the prices increased the advantage went to the producers since they receive revenue offset by lease expenditures.

Co-Chair Kelly referred to the 35 percent NOL credit that expired in ten years. He asked whether the companies that had credits when the expiration date matured would write the losses off, or if the losses were still eligible for repayment. Mr. Alper asked whether Co-Chair Kelly was referring to the governor's original proposal. Co-Chair Kelly replied in the affirmative. Mr. Alper responded in the affirmative. He clarified that the idea was considered a "first in first out" situation and on the tenth year the company would lose the credits. Co-Chair Kelly asked whether the provision was eliminated. Mr. Alper responded in the affirmative and stated that the House Rules Committee version eliminated the sunset and the carry forwards were unlimited. Co-Chair Kelly asked whether the administration wanted the provision reinserted in the bill. Mr. Alper replied that the administration's preference was to eliminate operating losses for the major producers' carry forward and allow use of the losses in a single year to limit reducing the tax to zero.

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Commissioner Hoffbeck affirmed Mr. Alper's statements. He indicated that credits could be used in an individual year to zero out taxes but that any excess credits above that would be lost. Co-Chair Kelly asked whether the provision would be in place within ten years. Commissioner Hoffbeck replied that it would be effective immediately.

Vice-Chair Micciche noted that Mr. Alper had referred to things beyond the control of the state, and the definition of a level playing field, price, and whether or not a company was producing. He was concerned that the state had spent hundreds of millions on companies that never produced oil and even left the state. He felt the scenario left a "significant exposure" for the state. He believed the current system was inequitable. He asked for Mr. Alper's comments. Mr. Alper voiced that it was reasonable to say the policy of the state in previous years was to encourage

new players especially on the North Slope. The open-ended refundable credits were designed to give advantages to developing companies that had not yet generated revenue similar to the advantages producing companies received. He believed abuse occurred and the state absorbed some losses that were unrecoverable. He thought the danger was that the state had already substantially invested in new producers and new discoveries and did not want to "pull the rug out" under companies that were farther along in development with the help of the state "subsidy" while trying to reduce the state's exposure.

Co-Chair Kelly asked whether most of the excess losses occurred under ACES and not under SB 21. Mr. Alper responded that the abuse occurred under a mix of tax systems due to the longevity of the system that was in place. He recounted that under ACES the NOL credit was 25 percent and the capex credit was 20 percent. The state was paying for 45 percent of North Slope companies' expenditures for ongoing development work up through 2013. Subsequently, under SB 21 the NOL credit was raised to 45 percent for 2 years through the end of 2015. He delineated that the increase was designed as a "hold harmless" to conciliate producers. All of the current credits due were based on the 45 percent NOL. The credits were reduced on January, 2016. He indicated that two circumstances were unique to the gross value reduction (GVR) and new oil benefit in SB 21; a company was able to artificially inflate the size of an NOL credit resulting in a benefit larger than 45 percent. He believed that the result was not intentional but the administration was attempting to reduce the benefit through HB 247.

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Co-Chair Kelly thought Mr. Alper had mostly described credits from the previous tax regime (ACES). He wondered how large the NOL credit grew under the GVR. Mr. Alper replied that if a company had a cash flow loss, the NOL would be a percentage of the loss. He expounded that the GVR was a "subtraction mechanism" where losses were subtracted from revenue and taxes were paid on a smaller figure. The loss to the state was in the \$25 to \$50 million per year range. Co-Chair Kelly mentioned that some of the tax credits that were losses to the state were also from PPT and ELF and "far fewer were related" to SB 21. Mr. Alper clarified that the NOL credit was part of the oil tax

regime since PPT. The idea of reimbursing the companies for a percentage of lost revenue was a "consistent feature" since the inception of a net profits tax.

Mr. Alper presented slide 5,

Major Provisions in Rules Committee Substitute:

Minimum Tax Changes

- Governor's bill
 - o Increased "floor" to 5%
 - o "Hardened" minimum tax against NOLs, \$5 per-barrel credit for new (GVR) oil, small producer, and exploration credits
- Rules CS
 - o Keeps current 4% floor and doesn't harden against additional credits
 - o Because NOLs end (2017 for majors, 2020 for others), floor indirectly hardened because no NOLs to use
 - o Revenue impact delayed to 2020 because pre-effective date NOLs can still be used to go below floor

Mr. Alper explained that currently the tax floor was harder under SB 21 than under ACES. Under ACES, the 20 percent capex credit was able to reduce taxes to zero and was eliminated. The equivalent large credit was the per barrel credit and was limited by the floor. The department discovered that if a company had a loss in year one it could be utilized in year two to reduce taxes below the floor. The governor's original proposal hardened the floor against the carry forward scenario as well as the other credits listed on the slide.

Co-Chair MacKinnon asked whether the education credits could be stacked against the floor. Mr. Alper stated that the education credit could be used against multiple taxes and the governor excluded the tax under the 5 percent hard floor. The House Rules version eliminated the governor's hardening proposals. The bill indirectly hardened the floor by eliminating the NOL credit. With the removal of the NOL, a major producer may carry forward the current year's expenditure's into the next year to reduce their tax liability but only up to the 4 percent floor. He summarized that "it was an indirect hardening of the floor for the major legacy producers."

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Commissioner Hoffbeck interjected that with a 35 percent net operating loss a producer could reduce its tax liability to zero from the 4 percent floor. Under the current version, a company was able to carry forward its expenditures and write-off 35 percent of the marginal tax rate but was prohibited from use until the amount was above the minimum tax, which was at the price of \$75 bbl. He stated that maintaining a 4 percent tax floor was a benefit to the state. The provision deferred the liability to a point of time in the future when oil prices increased.

Senator Bishop thought that the provision "partially eliminated double dipping." Mr. Alper was unsure about the concept of double dipping. Senator Bishop thought the governor's version did not allow for the 35 percent carry forward forcing the expenditure in the same year. The current version allowed a carry forward and a liability owed sometime in the future. Mr. Alper clarified that the governor's proposal disallowed NOL use to reduce liability below the floor but allowed the credits to roll forward until the price of oil was higher. The House Rules Committee Substitute (CS) had allowed for future deduction of expenditures and could lower a company's taxes to the floor. He specified that the provision was "a back door way" of accomplishing the same thing by "subtracting expenditures instead of preventing the subtraction of credits."

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Co-Chair Kelly was under the impression the floor was lower than 4 or 5 percent. Commissioner Hoffbeck assured him that the floor was no lower than 4 percent depending on the version of the bill. Mr. Alper stated there was a distinct "inflection point" of \$80 bbl. where the hard floor "kicked in." He qualified that currently the point was set at \$75 bbl. due to the decrease in industry spending. Co-Chair Kelly asserted that industry's lower spending was a result of revenue losses which resulted in the reduced spending that lessened its liability to the state. He believed his perspective was a "general over-arching discussion that we disagree on and that is okay." Mr. Alper clarified that the expenditure assumptions were down and the department had included the lower numbers in the forecast.

Co-Chair MacKinnon asked whether the current statute had the floor set at 4 percent. Mr. Alper answered that the floor was 4 percent if the price of oil was above \$25 bbl. and step laddered down to 3 percent between a price of \$20 bbl. and \$25 bbl. and 2 percent between \$17.50 and \$20. bbl. In addition, certain credits reduced liabilities below the floor. Under SB 21, the "per taxable credit" could not be utilized below the floor.

Co-Chair MacKinnon asked about previous statements that the governor was not going to change SB 21 and wondered whether the governor's proposal increased taxes. Commissioner Hoffbeck affirmed that the 4 to 5 percent hardened floor proposal increased taxes and was one area the bill attempted to change SB 21. He communicated that the floor provision was not intended as a direct attack on SB 21 but as an alteration to the tax regime in general. He related that the governor decided against including provisions such as "maturing of new oil" because he wanted to avoid changing SB 21.

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Co-Chair Kelly asked Commissioner Hoffbeck if he knew how much the total dollar amount of the 4 or 5 percent hard floor was. Commissioner Hoffbeck voiced that the difference was approximately \$50 million.

Mr. Alper clarified that \$50 million represented the amount of increase to the floor. The amount varied with the price of oil; i.e., at \$75 bbl. the amount was \$75 million and at \$40 bbl. the amount totaled under \$50 million. He added that one percent of magnitude equated to roughly \$50 million. The other portion of revenue derived from hardening the floor changed between the fall and the spring, which grew to \$150 million from \$50 million because the amount of operating losses earned by the major producers increased dramatically, but the floor was hardened and the state was able to "scoop back more revenue" through a lower price of oil in the original bill.

Co-Chair Kelly asked whether the total amount of revenue at a 4 percent hardened floor was "about \$150 million." Mr. Alper explained that roughly 160 million taxable barrels of oil were produced on the North Slope each year. If the well head value was \$40 bbl. multiplied by 160 million equated to \$6.4 billion multiplied by 4 percent the total was \$250

million that amounted to the base number notwithstanding the extent that some amount was lost or added back, which represented the "cap."

Senator Dunleavy thought the idea behind SB 21 was to curtail the decline of oil production in order to increase the state's revenue. He wondered whether the administration had shared the philosophy, and if the administration shared concerns that changes to the current tax credit structure for the North Slope would interfere with the goal of increased production. The issue was the "crux" of his concern. He wanted more production resulting in more revenue. Commissioner Hoffbeck thought that "any money that was taken off the table would have an impact." He thought the issue was whether the impact was in "relative proportion to the amount of money" removed from the system. He expressed concern that the level of credit support was unsustainable. The administration wanted to establish a sustainable credit system at the level the state treasury could meet its credit obligations. He expressed a greater concern over projects in process that relied on the credit support to date and needed the additional credits to complete the project. He wanted to avoid credits for "speculative" projects and eliminate credits that never benefitted the state. He acknowledged that "pulling back on the credits would have some impact" but felt that it was a "necessary step." He revealed that the administration was concerned that some projects were becoming credit-dependent and would never benefit the state.

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Senator Dunleavy wondered whether Commissioner Hoffbeck was aware that developing a new oil field was a long-term process, up to ten or fifteen years. He believed the state needed to maintain "rolling exploration and production" to preserve oil production levels and he thought any interruption at present could impact the state in 10, 15, or 20 years. He wondered whether the department had calculated the impact in the future. He was concerned about the long-term consequences to the state. Commissioner Hoffbeck reported that the administration held "active discussions with developers and producers" when drafting the bill in an attempt to accommodate their issues if possible. He communicated that the bigger driver to the success of oil development was the price of oil rather than tax credits. He thought it would take a "price recovery" to

bring more fields "online" at a "balance point." He disagreed that the state could afford a credit program that could "force" the fields into development at a low oil price environment. He recommended patience and stated that no matter what the state did to incentivize production the industry was shuttering rigs and slowing development until oil prices recovered.

Co-Chair Kelly referred to remarks by the commissioner that some of the credits would never payoff on some projects. He restated that oil brought other income besides production tax. He asked whether the projects actually cost the state a net loss of money or was not profitable relative to a production tax. He asked the commissioner to define "payoff." Commissioner Hoffbeck reported that the department examined projects utilizing credits against just the production tax and all unrestricted and restricted revenues. He discovered that the credit support versus the size of some project's field development had a negative net present value to the state. He added that the size of the field was a factor.

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Mr. Alper spoke to royalties. He referred to the National Petroleum Reserve Alaska (NPR) and the Greater Moose Tooth fields and relayed that the areas were federal leases with federal royalties and the state received only 50 percent of the royalties. He stated that the state received only 27 percent of any near off shore oil development and no royalties on fields like CD5 owned by Arctic Slope Regional Corporation (ASRC) that was on private land. He expounded that there "was currently no filter inside the credit programs." He believed it was important to ensure the state gained revenue "on the back end" of credits that provided large amounts of state support. Co-Chair Kelly asked whether the situation was widespread or restricted. Mr. Alper deduced that the problem was small but growing.

Senator Olson held that the state could encourage production. He mentioned looking at the situation from "a more global perspective," and wondered whether other tax regimes were successful in increasing production by "manipulating" its tax system. He was concerned that the state would appear unstable by changing its tax system so often. Commissioner Hoffbeck expected that analytica [Energy Consultants contracted by the legislature] had

analyzed the question more than DOR had. He reported that oil companies were "laying down rigs" all over the world in the current low price environment. He deduced that at a stable \$50 bbl. price point some rigs would come back into production but the price needed to increase before new investment began again. Senator Olson asked whether the commissioner was "optimistic." Commissioner Hoffbeck thought prices would recover slowly.

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Senator Dunleavy pondered that the cost to do business on the North Slope was more expensive than in the Lower 48. Commissioner Hoffbeck agreed. He wondered whether tax policy mattered with regard to retaining some investment through the period of low prices and in avoiding a situation where industry "rethinks its investment" and left the state due to changing tax policy. Commissioner Hoffbeck believed that stable tax policy was important. He maintained that the current system was not stable because it was unaffordable for the state. He asserted that "a change had to be made" after recognizing that "the amount of money made was not commensurate with the outlay." He stated that "credits were not price sensitive." The credits went up as the price of oil dropped. He remarked that until the state implemented a "stable regime" long-term stability was unattainable.

Co-Chair Kelly declared that "words mattered," and referred to Commissioner Hoffbeck's comment that the treasury could not sustain the current tax policy. He thought that many legislator's would "disagree" with the concept. He deemed that if the Cook Inlet credits were removed from the debate the disagreement would increase. He stated that "60 percent of the credit problem" was rooted in Cook Inlet. He did not believe that the treasury could not support the system. He referred to a slide from a previous presentation (while recognizing that the numbers were not current) and recalled that \$7.4 billion was invested in credits and gained the state \$61 billion in revenue. He felt that \$7.4 billion was acceptable and the notion that the figure was "too high was debatable." He determined that "most people would buy into an investment like that." He understood that the state was no longer able to afford the equivalent level of investment but that the concept was "the same" and the credits had "attracted companies to the North Slope." He believed that the idea that the state would "run out of money" paying for

credits under the current tax system was "not a true statement."

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Commissioner Hoffbeck contended that the majority of the large amount of revenue generated "was at a point in time the state had very little exposure" to credits. He stated that "the credit exposure had grown over the last few years" during a period of low revenue. He questioned the "correlation." Co-Chair Kelly asserted that the \$7.4 billion was the departments figure. Commissioner Hoffbeck agreed but offered that the over \$60 billion in revenue was attributed to past tax regimes. Co-Chair Kelly agreed but felt that the "principle" behind the credits remained that "credits stacked up against revenue was a pretty good investment" and was less so in the current environment.

Senator Bishop wanted to confirm Commissioner Hoffbeck's statement that credits were not price sensitive. Commissioner Hoffbeck confirmed his statement.

Vice-Chair Micciche voiced that "production for the sake of production had very little value" for the states "bottom-line." He stated that the problem was "net negative production across a broad spectrum of pricing." He added that Kuparuk and Prudhoe Bay were developed in the absence of credits. The development was based on "price and geology." He referred to a statement by the commissioner regarding the high price of producing oil on the North Slope. He believed that the costs were variable depending on each oil field. He referred to some non-conventional exploration in the Lower 48 that was more costly than production on the North Slope. He thought the issue was an "appropriate" discussion to engage in and felt that some issues needed to be reexamined. He wanted to proceed with "accurate numbers," and wanted to "understand the exposure to the state." He discussed the spring forecast and requested an "update." He asked whether the department had run numbers under new assumptions due to the higher price than forecasted. He thought there were adjustments that had to be made, and wondered whether the department could provide updated figures. Mr. Alper cited the commissioner's statement that the state gained roughly \$25 to \$30 million for every additional dollar above the forecasted price. He indicated that for FY 16 the price was approximately \$2 or \$3 higher than the forecasted price. In FY 17, the

forecasted price was \$39 bbl. He offered to send the committee a report updated for the spring that showed general fund unrestricted revenue forecasted over the next ten years based on the price of oil. He indicated that he carried around a stack of fiscal notes reflecting the different versions of the bill. He furthered that each fiscal note had two subtotals; one was revenue and the other figure was savings to the state. He attempted to provide accurate figures through the various and multiple version of the bill. He offered to provide a comparison of all of the version's fiscal notes for review.

10:53:37 AM

Vice-Chair Micciche announced his goal as "willing to compromise." He wanted to purge the discussion from rhetorical language, and use real numbers in order to help Alaskans understand the issue. He wanted information regarding the state's exposure related to price and value that would result in a "forward looking" process that fostered healthy production in the future. He wanted to have an honest discussion with Alaskans and "make good decisions using those facts" and thought DOR was helpful in providing the information. Mr. Alper concurred that "honest facts and figures" were important. He stated that the bill was not able to change the state's credit liability in FY 17 of \$775 million. The bill could affect the state's exposure for FY 18 and beyond.

Co-Chair MacKinnon believed that the administration "compounded the problem" by vetoing \$200 million appropriated the previous year for the credit liability. She thought the "conversation had become convoluted" when the \$775 million figure was quoted that "should be closer to \$500 million to \$600 million." She shared her frustration over the veto and related that the legislature had met the obligation. She believed that the veto had negative consequences for many companies. She recounted discussions with the Office of Management and Budget (OMB) director, Pat Pitney, regarding the negative effects for the state and industry and believed the veto compounded the problems. She held that the governor vetoed the money with good intentions. She voiced that the legislature attempted to point out the consequences of the veto with the administration. She asserted that the \$775 million figure "exasperated the conversation" and "compounded the frustration" regarding the credit figures. She referred to

a variety of media outlets shaping the conversation based on its perspective of the situation. She spoke about "the baggage" the legislature had to carry in regards to the administrative decision and past legislative decisions concerning the tax structure and decades old credits. She thought the issue was creating instability in the industry. She maintained that the money diverted from the one-time expense versus investing in long-term production would impact the state. She agreed with Vice-Chair Micciche's comments that the state should not support incentives resulting in negative impacts for the state. She believed that the governor and the media were pointing to the net negative credits and not reporting that the legislature was prepared to provide "corrective reforms." She alluded to NOL credits on slide 5. She cited an announcement by BP regarding decreased production in FY 17 by 40 thousand bbl. She asked for clarification regarding whether the decrease would happen in FY 17. She asked whether the department knew the amount of net operating losses based on the lower production.

[11:00:14 AM](#)

Mr. Alper answered that the BP rig laydown was reflected in the spending and production forecast. He thought that the decrease would happen over two years but would speed up the decline curve. He conveyed that the carry forward NOL was forecasted at \$357 million in FY 17. Every dollar shift in the price of oil would alter the total by \$65 million. He added that at the breakeven price of \$46 bbl., the NOLs were zero.

Co-Chair MacKinnon asked whether the legislature should change major policy that supported long-term investment and revenue to the citizens of the state versus proposing alternative tax policy to stabilize a "particular moment in time." She noted that legislation proposing taxes on other industries was stalled. She referred to the oil and gas tax issue labeled as the "log jam" in regards to concluding the legislative session. Mr. Alper noted that the administration shared the committee's frustration regarding lack of movement on the governor's fiscal package. He concurred that the matter was something of a logjam. He noted that the other six revenue bills only added up to \$150 million and did not balance the budget. He thought the oil tax issue had a substantially larger impact on the state and could help balance the budget. He voiced that the

"NOLs could be gigantic or non-existent," but the state needed to protect itself for the time when the price of oil recovered and the state gained revenue. The administration worried that the carry forwards would "eat tomorrow's revenue" when the price of oil recovered and the bill attempted to address the situation.

Co-Chair MacKinnon emphasized the point because the administration wanted to eliminate credits that provided the state \$61 billion from 2007 to 2015. Mr. Alper stated that the great bulk of oil production that payed taxes was from "wells drilled long ago" regardless of policies of past legislatures. He commented that to the extent that SB 21 did not anticipate low oil prices, ACES had not accounted for high oil prices. He thought that the \$7 billion in production tax revenue and the \$9 billion in oil and gas revenue windfall in a single year was well outside anyone's forecast and provided the savings to help the state through the current fiscal crisis. He referred to a slide that illustrated that the state spent \$38 in credits for every dollar of new oil and felt that was "unfair" on the high side and the figures of \$7 billion in credits producing \$60 billion in revenue was "unfair" on the low side and the real answer lied somewhere in between.

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Co-Chair Kelly was disturbed by Mr. Alper's comment that carry-forward losses would detract from future revenue when prices recovered. He asserted that the state wanted to increase production even when the price was low. He did not want to discourage companies from producing in a low price environment so when the prices recovered there "was a whole bunch of money." He concurred that initially the state would receive less but revenues would increase in the future. Commissioner Hoffbeck thought that that the governor's plan focused on the sustained "reality" of the low price environment of \$35 to \$60 bbl. price range for the long-term future. He believed that some of the adjustments were necessary because some of the credits did not work within the price point range.

Co-Chair MacKinnon asked whether the commissioner understood why she was concerned over the veto and the public's perception of the oil tax credit issue that compounded the problem by not paying all of the credits when due. She remarked that the administration was asking

the legislature to adopt something that might reduce a revenue shortfall in the future but also reduce production. Commissioner Hoffbeck recognized the situation she described. He shared Mr. Alper's remarks to the House Rules Committee that the \$775 million was an "anomaly" and was a high water mark" and credits in that amount were not anticipated to happen again. He communicated that the administration wanted to correct an unforeseen issue in SB 21 created by prolonged low oil prices.

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Senator Bishop referred to six different proposals on oil tax policy in the legislation, and wondered when enough was enough. He believed the issue related to stability, and wondered who could guarantee that tax policy was not going to be readjusted again in another six months for something unforeseen. He thought that if the state "did not have the guts" to ride out the tough times with the current tax policy, the state should not enter into a 30 year natural gas project at 25 percent ownership with its own inherent cyclical commodity prices.

Senator Dunleavy thought that the present conversation was getting confusing. He felt that Commissioner Hoffbeck had spoken in a way that would provide newspaper headlines. He referred to the commissioner's comments that stated the majority of the credit issues concerned Cook Inlet and previous tax regimes and that the governor was not altering SB 21, yet he had just spoke of fixing an anomaly in SB 21. He believed that the commissioner was "muddling" the conversation. He strongly suggested dealing with the Cook Inlet credits in a separate bill. He thought that multiple issues were being discussed and getting "balled up."

[11:13:56 AM](#)

Commissioner Hoffbeck responded that the issue of dealing with carry-forward had developed during the session with the spring forecast and that the governor's original bill did not deal with the carry forward issue. He added that the governor initially did not intend to adjust SB 21. Senator Dunleavy commented that the issue should be a "numbers issue" for the state.

[11:14:59 AM](#)

AT EASE

[11:21:33 AM](#)

RECONVENED

Mr. Alper continued to discuss slide 5, recounting the subject of NOLs. He clarified that after the effective date of the House Rules CS, the NOLs changed to the lease expenditure construct. The carry forward NOLs would be utilized against minimum tax payments until they were depleted. Therefore; the revenue impact from the hard floor was not apparent until 2020.

Co-Chair MacKinnon asked whether the provision was intentional. Mr. Alper answered that the NOLs as a carry forwards were current law and through the creation of the new system with an effective date of 2017 the result was "how the system absorbed those things that would already be existing."

Co-Chair Kelly asked whether Mr. Alper could reiterate his last comment. Mr. Alper restated that under current law companies earned NOL credits and major producers had to carry the NOLs forward, utilize them against future taxes and reduce liability below the floor. He explained that on January 1, 2017 the House Rules CS abolished NOL credits per say. The costs that generated the credit was the element that carried forward instead of a credit. The costs could not be reduced below the floor but were calculated into future taxes. Before the effective date of the bill, it would take two years before any impact on revenue from the change would be realized.

[11:24:15 AM](#)

Mr. Alper turned to slide 6, "Major Provisions in Rules Committee Substitute":

New Oil "GVR" Provisions

- Governor's bill
 - No changes
- Rules CS
 - 10-year "graduation" of GVR oil to become legacy oil
 - (Note- concept of "graduation" started with House Finance CS; various versions in the 5-7 year range)

Mr. Alper relayed the concept that new oil should not be new oil forever. The CS provided sunsets for the various benefits for new oil such as; reduced taxation through the subtraction mechanism from the GVR, the per barrel credit, and the ability to reduce tax liability below the floor. The CS included a 10 year graduated sunset period.

[11:25:43 AM](#)

AT EASE

[11:26:29 AM](#)

RECONVENED

Mr. Alper discussed slide 7, "Major Provisions in Rules Committee Substitute":

6. Misc and Technical Provisions

- a) Gov: GVR can't be used to increase the size of an NOL
Rules: Kept as written
- b) Gov: Municipal Utility Lease Expenditure pro-ration
Rules: Kept as written
- c) Gov: Transparency, can release amount of credits received and the work done to earn them
Rules: Limited to refunded credits, and dollar total only
- d) Gov: Interest Rate increase from 3% over Federal Reserve, simple to 7% over Fed, compounding
Rules: Increase to 5% over Fed, compounding

Mr. Alper repeated that the GVR limit produced a \$25 to \$50 million impact in revenue generation. He explained the Municipal Utility Lease Expenditure as the non-taxable activity of a municipal utility that owns its own gas field, burned the gas in its own turbine but was permitted to sell any excess to a third party; which was considered a taxable sale. Currently, the utility was allowed to subtract 100 percent of its lease expenditures even if it only sold 10 percent of its gas; the provision offered a pro-ration fix. In addition, he noted that the House Rules CS permitted a limited release of information containing the company's name and the dollar amount of cashable credits received.

[11:29:09 AM](#)

AT EASE

11:29:23 AM

RECONVENED

Mr. Alper continued to discuss slide 7. He stated that because the House Rules CS eliminated the cashable credits in three years the transparency provision vanished upon expiration. He reminded the committee that the delinquency tax rate was reduced in SB 21 from 11 percent compounded interest to 3 percent simple interest for all taxes. He revealed that the 3 percent with simple interest instead of compounded was an error in the bill. The Rules CS instituted a rate of 5 percent over the federal rate. The department favored the provision which currently totaled 6 percent with compounded interest. He elaborated that when an audit revealed additional taxes were owed it resulted in lost opportunity costs for the state. The state had to cover in savings what it did not receive in taxes and viewed the 6 percent interest as payback for the company's shortfall.

Mr. Alper spoke to slide 8, "Major Provisions in Rules Committee Substitute":

6. Misc and Technical Provisions (con't)

- a) Gov: Alaska Hire tied to percentage of credit that can be refunded
Rules: Alaska Hire as prioritization for repurchase given limited funds
- b) Gov: Credits can be used to offset other delinquent obligations to the state such as royalties
Rules: Credits can be held back, but if contested must get company's consent to use to pay obligation
- c) Gov: No bonding or other formal means to protect local vendors from bankruptcy
Rules: \$250k surety bond with local vendor priority

Mr. Alper communicated that the House Rules CS allowed the companies that met the 80 percent Alaska-hire threshold to receive the highest priority in ranking for credit repayments in a situation of limited funds by the state. He noted that the House Rules CS maintained the credit offset for delinquent obligations under the restrictions that the non-oil related obligation was reversed and must be relevant to the company's oil and gas business.

Mr. Alper continued to discuss slide 8. He relayed the administration's support for the surety bond provision to protect local vendors.

[11:35:43 AM](#)

Mr. Alper reviewed slide 9, "Summary of Fiscal Impact," which gave a summary analysis of the different bill versions in chart form. The versions included were the governor's original HB 247, the Senate Resources [CS SB 130 RES] version and the House Rules CS. He observed that the governor's bill contained more "aggressive" effective dates, especially related to hardening the floor versus the other versions that offered more delayed and gradual implementation. He noted the House Rules CS impact of \$175 million by FY 2020 that represented the hardening of the floor, "ramp down" of the Cook Inlet credits, and the caps on credit repurchasing. He thought that one "weakness" of the governor's bill was the very large NOL carry-forward, and described it as borrowing money from the future. He characterized hardening the floor without restructuring the NOL credits as accepting more revenue now but paying it back in the future. He emphasized that by softening the floor hardening the carry forwards were decreased. However, the CS still projected \$685 million in FY 20 in lost revenue to the state from the NOL carry forwards.

[11:37:51 AM](#)

AT EASE

[11:38:05 AM](#)

RECONVENED

Vice-Chair Micciche commented on "borrowing from the future" and thought it was important to also note the NOL carry forward of \$508 million predicted in the Senate Resources version and the over \$1.2 billion in the governor's bill in FY 20. Mr. Alper concurred, and qualified that the amount reflected his previous statement regarding the hardening of the floor provisions in the governor's bill.

Co-Chair MacKinnon pointed to the document provided by the department titled, "Comparison of Provisions of HB 247 - Oil and Gas Tax Credits" (copy on file).

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ADJOURNMENT

11:39:12 AM

The meeting was adjourned at 11:39 a.m.