

**ALASKA STATE LEGISLATURE  
JOINT MEETING  
HOUSE RESOURCES STANDING COMMITTEE  
SENATE RESOURCES STANDING COMMITTEE**

Kenai, Alaska  
June 17, 2015  
8:59 a.m.

**MEMBERS PRESENT**

HOUSE RESOURCES

Representative Benjamin Nageak, Co-Chair  
Representative David Talerico, Co-Chair  
Representative Bob Herron  
Representative Kurt Olson  
Representative Paul Seaton

SENATE RESOURCES

Senator Cathy Giessel, Chair  
Senator Peter Micciche  
Senator Bill Stoltze  
Senator Bill Wielechowski  
Senator John Coghill

**MEMBERS ABSENT**

HOUSE RESOURCES

Representative Mike Hawker, Vice Chair  
Representative Craig Johnson  
Representative Andy Josephson  
Representative Geran Tarr

SENATE RESOURCES

Senator Mia Costello, Vice Chair  
Senator Bert Stedman

**OTHER LEGISLATORS PRESENT**

Senator Lesil McGuire  
Senator Anna MacKinnon  
Representative Mike Chenault  
Representative Guttenberg - via teleconference

**COMMITTEE CALENDAR**

OVERVIEW OF ALASKA'S OIL AND GAS TAX CREDIT REGIME

- HEARD

**PREVIOUS COMMITTEE ACTION**

No previous action to record

**WITNESS REGISTER**

RANDALL HOFFBECK, Commissioner  
Department of Revenue (DOR)  
Juneau, Alaska

**POSITION STATEMENT:** Testified on Alaska's oil and gas tax credits.

KEN ALPER, Director  
Tax Division  
Department of Revenue (DOR)  
Juneau, Alaska

**POSITION STATEMENT:** Presented an overview of Alaska's oil and gas tax credits.

JANAK MAYER, Chair and Chief Technologist  
analytica  
Washington, D.C.

**POSITION STATEMENT:** Reported on oil and gas production tax credits at low oil prices.

NIKOS TSAFOS, President and Chief Analyst  
analytica  
Washington, D.C.

**POSITION STATEMENT:** Reported on oil and gas production tax credits at low oil prices.

PATRICK FOLEY, Senior Vice President  
Caelus Energy Alaska  
Anchorage, Alaska

**POSITION STATEMENT:** Presented an overview of Caelus Energy Alaska operations.

BENJAMIN JOHNSON, President and CEO  
BlueCrest Energy  
Fort Worth, TX

**POSITION STATEMENT:** Presented an overview of BlueCrest Energy operations in Alaska.

JOHN BARNES, Senior Vice President  
Hilcorp Exploration & Production, Alaska  
Houston, TX

**POSITION STATEMENT:** Presented an overview of Hilcorp operations in Alaska.

JASON BRUNE, Senior Director  
Land and Resources  
Cook Inlet Region, Incorporated (CIRI)  
Anchorage, Alaska

**POSITION STATEMENT:** Spoke in favor of oil and gas tax credits.

#### **ACTION NARRATIVE**

[8:59:59 AM](#)

**CHAIR CATHY GIESSEL** called the joint meeting of the House and Senate Resources Standing Committees to order at 8:59 a.m. Representatives Nageak, Herron, Seaton, Olson, and Talerico, and Senators Stoltze, Micciche, Coghill, Wielechowski, and Giessel were present at the call to order. Also in attendance were Senators Lesil McGuire and Anna MacKinnon and Representative Mike Chenault. Representative Guttenberg listened via teleconference.

[9:01:55 AM](#)

CHAIR GIESSEL recognized staff and thanked the Kenai Chamber and Visitor Center for the use of their building. She announced that the only order of business would be an overview of Alaska's oil and gas tax credit regime.

#### **Overview of Alaska's Oil and Gas Tax Credit Regime**

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CHAIR GIESSEL said there is misunderstanding on this topic, and she wants to make things clear to legislators and the public.

[9:04:12 AM](#)

RANDALL HOFFBECK, Commissioner, Department of Revenue (DOR), said there is a growing interest in tax credits, particularly with regard to Alaska's budget situation, "and that became even more clear in Fairbanks, where a lot of people identified credits as an issue," but they did not really understand them very well. People need to understand the tax credits a lot better than they do right now, he stated. The credits are probably the most complex part of the oil and gas tax structure.

[9:07:08 AM](#)

SENATOR STOLZE asked about the administration's position and if it would have been advantageous to the state to withhold reimbursement of tax credits. He asked the consequences of not funding the credits. That question will be the core of this discussion, he stated.

[9:08:42 AM](#)

COMMISSIONER HOFFBECK said the administration did not want to get into an oil and gas tax debate this year because there were bigger issues to deal with. Philosophically, the credits are an integral part of the financing of [oil and gas] projects, and the administration would not have unilaterally tried to reduce the credits because of the impact it would have had on the companies that are relying on them. Going forward, the administration will engage in the dialog in light of Alaska's budget situation, but to just cut oil and gas tax credits at this time would not have been appropriate, he explained.

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KEN ALPER, Director, Tax Division, Department of Revenue (DOR), said there are many different oil and gas tax credits coming from several pieces of legislation; some are layered over each other and some are stacked. He showed an update of the magnitude of Alaska's tax credit system and said there are about \$1.5 billion worth of credits received by industry in one of two ways. There are credits using tax liability, which means the taxpayer will not pay the tax; these are used primarily by major producers that owe taxes. There are also refundable credits that are repurchased, primarily used by smaller companies that do not have profits and therefore no tax liability, and "the state is writing them a check, essentially, in repurchasing their credits."

CHAIR GIESSEL asked if the state writes the check or if the credit is sold to another company.

[9:12:17 AM](#)

MR. ALPER said the state purchases tax credits subject to money being available through appropriations. There is also an open market to sell them to a third party who could then use them against its own tax liability. He gave the example of Alaska's film tax credit, which cannot be repurchased but can be sold on the open market, and other Alaska corporate taxpayers have been buying them to use against their own tax liability. That ability exists for oil and gas tax credits, but because of Alaska's historic open-ended repurchase policy, "almost all of the credits have gone by that route in the last five or six years."

CHAIR GIESSEL said Mr. Alper's charts are available online.

[9:13:46 AM](#)

MR. ALPER said the modern credit era began in 2007 when Alaska started a net profit tax regime with the PPT [Petroleum Production Tax], and about \$7.4 billion worth of oil and gas tax credits have been used since. The largest portion is \$4.3 billion used against tax liability primarily by the major producers. The second largest figure is \$2.2 billion in refunded credits on the North Slope, and it is used by new producers and startup companies that do not have enough tax liability against which to take the credits, and the state will be repurchasing their credits. The non-North Slope group, primarily Cook Inlet and "Middle Earth," used less than \$0.1 billion against tax liability. The number is misleading as there is not much tax liability in Cook Inlet because of the underlying tax caps and other statutory limitations, but "about \$0.8 billion have been refunded in Cook Inlet, and that number has been increasing rapidly in the last several years because of some statutory changes made in 2010." Another \$0.74 billion in taxes were not paid because of the Cook Inlet tax cap. "Middle Earth" is a term used for every place in Alaska south of 68 degrees latitude and outside of the Cook Inlet basin.

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MR. ALPER said the first "modern era" tax credit is called the "alternative credit for exploration." "Alternative" because there were some credits from the 1980s that are not now used. Originally, the alternative credit was 20 to 40 percent,

depending on the type and location of the work. Created in 2003 when the state was still under ELF [Economic Limit Factor tax scheme], most of the credits required some kind of qualification from DNR [Department of Natural Resources]. There was no repurchase mechanism and the credits were intended to be held until the company had a future tax liability or until sold to a third party, he explained. On slide 8 he showed several new credits from the PPT, which is when tax credits "really took off," he said. The most important PPT credit was a 20 percent carry-forward annual loss credit or "net operating loss credit." The loss credits intended to balance the playing field between the active producers and the newcomers.

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MR. ALPER explained that the state reimbursed smaller players at the same percentage as the major players. The other significant PPT credit was the qualified capital expense (capex): "the 20 percent capex credit that became a very prominent part of our tax regime." The small producer credit gave an additional credit of up to \$12 million, an "off-the-top cut," to cover higher marginal expenses of smaller operations. The "clawback" credit was created to benefit companies who had already invested in projects previous to the creation of the credits. The PPT was the beginning of the state buy-back, he said, where "we put in a repurchase mechanism, capped it at \$25 million per company per year, and limited it just to smaller companies producing less than 50,000 barrels per day." He turned to the next slide covering ACES [Alaska's Clear and Equitable Share tax scheme], which passed only a year after the PPT. There was an increase in the base rate in ACES, the carry-forward annual loss credit increased to 25 percent, the transitional expenditure and claw-back credit were removed, and the \$25 million per company cap was eliminated. The legislature created the tax credit fund, which the state uses for repurchasing credits. It is open-ended, because the secondary market for credits is soft (50 to 70 cents on the dollar), so the state decided that as long as it had the funds, it would purchase the credits at full value. In 2010, there were several oil and gas bills, and one gave a credit for the Cook Inlet gas storage facility and increased a number of Cook Inlet production credits, including creating a 40 percent well-lease expenditure credit. Another bill, by Senator McGuire, created a larger credit for jack-up rig drilling in Cook Inlet.

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MR. ALPER said slide 10 lists some secondary provisions of House Bill 280, the Cook Inlet Recovery Act, which have added to the credit burden in the last several years. The original law was to allow the use of credits gained in Cook Inlet to be applied to Cook Inlet. There used to be a requirement to reinvest the cashed out credits in a new project, and there used to be a recapture provision. He explained that because of the Cook Inlet tax cap, a company would first have to use its credit to buy down tax liability from what it would have been without the cap and then only be cashed out on the remaining portion. But, now, producers are cashed out at the full value of the credit. The legislation has led to a dramatic increase in Cook Inlet reimbursable tax credits. In 2012, the Frontier area credit was created, comparable to the jack-up rig credit, for some of the first wells drilled in some target basins, and an LNG (liquefied natural gas) storage facility credit was created, primarily for the Interior gas project.

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MR. ALPER said that in 2013, Senate Bill 21 changed tax credits primarily on the North Slope. It eliminated the 20 percent capital credit and replaced it with a production-based credit of zero to eight dollars a barrel for "legacy" oil, depending on the price of oil, and a \$5 per barrel credit for "new" oil, unrelated to oil price. There was an increase in the loss carry-forward credit to 35 percent, because the base tax rate in SB 21 is also 35 percent; however, there was a two-year temporary increase to 45 percent for 2014 and 2015, because the projects under construction at that moment were receiving 45 percent from the state (the 20 percent capital credit and the 25 percent loss carry-forward credit). A value-added credit for service providers was also added. In 2014, the refinery credit was added, which is a capital improvement credit targeted at in-state refineries to try to keep them competitive.

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SENATOR MACKINNON asked whether the infrastructure credit has been used.

MR. ALPER said it is targeted at corporate income tax and took effect in 2014, so the state will not see it until the fall.

REPRESENTATIVE HERRON asked about the loss carry-forward credit and if the state should let it expire.

MR. ALPER said it is not scheduled to expire. His opinion is that the credit is a playing field leveler between the newcomers and the incumbent producers, and he would not like to remove it.

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MR. ALPER said that when a company applies for a credit and qualifies, it will get a certificate of the dollar amount. The owner can sell it or save it until it has tax liability. Also, the state can repurchase the credit if there is money in the fund, subject to appropriations. The recent budget included \$700 million for repurchases in 2016. If the fund were limited, there are regulations on how to prioritize the repurchases, which is first in, first out. The state has no discretion to choose to repurchase one credit over the other.

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SENATOR MACKINNON asked whether that is under statute or regulation.

MR. ALPER said the repurchase comes from the fund, and without an appropriation, there would be no money.

SENATOR MACKINNON said there have been discussions about prioritization. She asked whether Alaska is getting what it wants "when we specifically pay out cash." Sometimes a credit is against production and sometimes it is for exploration, she said. It is a balancing act to get the small producers to compete. When credits are paid on a first-come, first-served basis, the larger companies can [benefit by] acting more quickly, so she asked if the administration is going to make regulatory changes to prioritize what Alaska wants.

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COMMISSIONER HOFFBECK said that will be part of the discussion with the legislature and the companies. He wants to look at options that will not impact oil and gas operations but will be sensitive to Alaska's limitation of funds. The first-in, first-out system is not viable. One idea was to do a prescreening, preapproval process, he said, and companies would know that their spots are preserved and their credit has value. He said the administration is looking at a lot of different options. When revenues were flush, it worked well. The administration will come forward with proposals, he stated.

SENATOR MACKINNON said the North Slope producers have been contributing 80 to 90 percent of Alaska's revenue, but some explorers are wildcatting, and Alaska is underwriting that activity. She said "those companies are going bankrupt and they are selling their credits ...." She said it will be part of the discussion.

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SENATOR MCGUIRE asked about low interest loans instead of credits.

MR. ALPER said the wildcatters are borrowing money at a very high interest rate, and the state ends up buying all of their risk. "We're just at the very beginning of what would be a long path." Instead of buying down their risk, partnering with industry in some way might put the money into the project instead of into the financing company.

SENATOR MCGUIRE spoke of lowering lending rates or deferring interest for these companies.

MR. ALPER said anything along those lines would require a robust piece of legislation.

COMMISSIONER HOFFBECK said that idea has been floated to some of the smaller companies, but free money is always more desirable than a low interest loan, but it's "an option that has some traction."

SENATOR MICCICHE cautioned the state from trying to pick winners and losers. He asked if the state does due diligence on the wildcatters on their financial health or abilities to perform. "We've been stung a little bit," but Alaska wants new players, and they should have a foundation, he expressed.

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COMMISSIONER HOFFBECK said there are specific requirements for qualifying for the credits, and as long as a company qualifies, a certificate is issued. But that has been a point of discussion on whether [credits should be issued] based on whether it is a good project or not.

SENATOR MICCICHE said a clear set of expectations will keep the state from picking winners and losers. Basic qualifications on

knowledge, backing, and experience will provide a greater probability for production.

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MR. ALPER said slide 14 shows the estimate in the operating budget and the actual amount that was repurchased. For the year that is about to end, it will come close to \$625 million and the budget estimated \$450 million. The prior five years, "we have overshot the estimate by \$560 million." He said it is a very front-loaded process. Most of the requests come in March, and there is a statutory 120-day turnaround. It takes several weeks to process the checks, so by the end of August "you'll see \$475 million out the door out of FY16's money."

SENATOR WIELECHOWSKI asked about how much the statute requires the state to reimburse.

MR. ALPER said there is statutory guidance on supplying the reimbursement fund with 10 percent of the production tax revenue. For Fiscal Year 2016, it would be about \$91 million, but the legislature has the ability to fund it at whatever level it desires. If the legislature had been endowing that fund [with the 10 percent] instead of "simply spending to the request," he calculated that the fund would have built up and then gone down to about zero now, which is the same place it is now. In the budget passed last week, the decision was made to write it open-ended for at least one more year at \$700 million.

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MR. ALPER said that not every company is eligible to get their credit repurchased. Those that produce more than 50,000 barrels per day are not able to, but they can sell them or hold and use them when they have a tax liability. The credits can be sold to any company that pays a corporate income tax in Alaska, not just the oil companies. He turned to slide 16. In 2015, the Tax Division made efforts to compile historic summary information and make it available. Three such reports are provided to the committee today and include a table of what credits were in place in what year; historic and forecasted credits by category and region; and the impact of the Cook Inlet tax cap. He said DOR never releases company-specific credit information due to confidentiality.

MR. ALPER turned to page 17 and said the "023 credits" are by far the biggest category of credits and should be split into two

major sub-categories. There is a fundamental difference between the loss credits, 023b, "and then the spending-type credits, the capital credit, 023a, and the well-use expenditure credits for Cook Inlet and Middle Earth, 0231." He said the per-taxable-barrel credit, the SB 21 production credit for the North Slope starting in FY14, has unusual data points. The number was lower in 2014 due to higher oil prices. In 2015 and 2016 it is smaller because of the limit of the 4 percent gross minimum tax. The company pays the 35 percent net tax and then applies its per-barrel credit only until it gets down to the minimum tax, 4 percent. At that point, they lose the rest of the per-barrel credit. He said, "For our own internal accounting," there is a credit of \$590 million in FY2016, and that is half of what is actually earned. In FY2017, the price of oil is forecast to be \$86.00, but "it doesn't increase the revenue that much; you don't see Alaska's oil and gas production tax revenues start increasing dramatically now until the price of oil hits about \$90 per barrel."

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MR. ALPER said that it is not realistic to call all \$7.4 billion worth of credits as a cost. Some of them truly are integral parts of the tax regime and are offsets to what would otherwise be very high tax rate. He believes that the tax rate itself would have been lower if not for those credits, and in some cases, it creates a differential incentive to reinvest a higher percentage of a company's profits back in Alaska. In SB 21, "the credit is an offset to the tax and it's designed to create a progressive element: a little bit lower tax rate at lower prices, a higher tax rate at higher prices." It is difficult to consider them a credit as an inducement to doing the work, he said. Most of the credits against liability fall into that category. The credits that are refunded are to encourage certain behavior like getting new companies to drill, explore, and go to new areas, and those credits are truly credits.

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REPRESENTATIVE SEATON asked about the credit being progressive.

MR. ALPER said the lower the price of oil goes, the lower the effective tax rate. If the price per barrel goes up to \$160, Alaska would collect a full 35 percent tax, and now it is 4 percent of the gross. The decision was made to go from the \$5 per barrel production credit to a sliding scale, and his understanding is that it was to add an element of progressivity.

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SENATOR MCGUIRE said slide 18 is important, and she encouraged Mr. Alper to show it to new lawmakers. The credits in SB 21 were meant to encourage certain behavior, and the legislature could have required a lower tax rate instead. This discussion was often left out of debates, she said.

MR. ALPER said Governor Parnell's original version of SB 21 had a 25 percent flat tax, which became 35.5 percent. At the expected price range of around \$100 per barrel, there was no net change from 25 to 35.5 percent, he stated. The number of credits were zero at that price of oil, but in the amended version, it was \$750 million in more tax and \$750 million in more credits, "so is it fair to consider that credit when the net effect to the state was essentially zero?" He said he agrees with Senator McGuire. Moving to slide 20, he said that there is a myth that many of the credits will soon expire. That is not correct, except for a relatively small portion of the credits. These include the 20 percent qualified capital expenditure credit for the North Slope (they will still be available for Cook Inlet). Additionally, most of Alaska's exploration credits are due to end, per statute, on July 1, 2016, and those are the standard 30 and 40 percent North Slope and Cook Inlet credits and the jack-up rig credits. The only exception is that the non-Cook Inlet and non-North Slope exploration credit will exist for another five years. "But, realistically, the exploration tax credits have not been a big dollar item recently; it's been about \$25 million, and even after they sunset, many of those same expenditures will be eligible for other credits, like the net operating loss or the Cook Inlet capital expenditure credit."

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MR. ALPER said there is a temporary oddity with the exploration credit on the North Slope. The net operating loss credit has been temporarily increased and the exploration credit remains in place, so there are circumstances in the North Slope where the state is paying 85 percent of exploration expenditures for the big companies. It will remain in place for two years. The third credit that is winding down is the small producer credit, and it is not a reimbursable credit—it can only be used by companies with actual production and profit to offset their taxes by up to \$12 million per year. Last year, ten companies used it, and they can use it for a total of ten years, but new applicants are not allowed to sign up for it, he said. A similar statute to the

small producer credit is in the PPT, was never used, and will sunset as well.

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MR. ALPER stated that the second myth is credit reimbursements are rapidly declining. The DOR projections only include known projects, so any new project will add credit reimbursements. The forecasting is very conservative; if the production is in the forecast, then the underlying credits will be there. Slide 24 shows an example. Repsol, a major producer announced a large discovery on the North Slope, and that is good news for Alaska—but what does it mean in practical terms? If that company decided to spend \$1 billion in 2016 on a new oil field, it means the next year there will be a \$350 million operating loss credit and several years before any actual oil revenue. "So, we have to take the forecasted credits with a grain of salt," he said. If Alaska is successful in encouraging new development, it will see more credits to go along with it. Whether it is a large or small field, there will be a 35 percent tax credit.

COMMISSIONER HOFFBECK said the slide does not represent what Repsol actually plans to do; it is just an example. He then noted that the other large credit impact in the near and midterm future is AK LNG [Alaska Liquefied Natural Gas Project], and if it goes ahead, in addition to the project costs itself (about \$50 billion), there is another \$5 billion of upstream spending. He spoke of consultant enalytica estimating a short-term production tax impact of a little less than \$2 billion. The companies making the investment will be saving almost \$2 billion on their taxes. That cost will show up against the revenue side, but it is not yet built into the DOR forecast, he explained.

[10:00:44 AM](#)

SENATOR STOLTZE asked if there is another myth that Alaska does not have to pay for these credits. Director Alper worked with the Democratic minority in the legislature and maybe perpetuated that myth, he stated.

COMMISSIONER HOFFBECK said it is a myth that the director was working with the Democratic minority and perpetuating that idea. Mr. Alper was asked for an analysis, and the department tries to accommodate requests from all legislators.

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COMMISSIONER HOFFBECK pointed out that the credits have been earned under the current regime and they will either be paid as a reimbursable credit or against tax liability. "We could not have avoided those payments."

SENATOR STOLTZE said then that would be another myth.

COMMISSIONER HOFFBECK told him he could call it a myth.

REPRESENTATIVE SEATON spoke of AK LNG and the proposal to take both royalty and production tax as gas in-kind, and "25 percent is the nominal range, and yet it seems on this project they are providing 35 percent of the upstream costs in the project for 25 percent of the value in both royalty and production tax." He asked if it is a 35 percent production tax credit, "and we're both including both royalty and production tax and we get 10 percent less than that investment percentage; is the administration looking at that, at all, or is that a problem for the equity of the state versus the rest of the people in the project?"

[10:04:12 AM](#)

MR. ALPER said that is an interesting observation. It is true that the state will be paying, indirectly, 35 percent of the upstream cost and will be getting 25 percent of the downstream value. He said he does not believe the administration is specifically looking at that, but part of the rationale of former DNR Commissioner Joe Balash wanting the original 25 percent [indecipherable] from the first version of SB 21 "was in creating some sort of balance for that; that the state's participation would match the state's ownership share, but we are creating a bit of a situation where we're paying more on the upstream than receiving on the midstream."

SENATOR MACKINNON spoke of the benefits of a pipeline, and she asked whether the state considered, with the knowledge that it is going into a potential \$45-\$55 billion project and with the current tax credit structure, that Alaska's tax credit is a portion of its purchase price to buy into the shares.

[10:06:02 AM](#)

COMMISSIONER HOFFBECK said, "We have talked about buying in on some of these." The ability to use the Alaska's past credits as any kind of down payment would be a part of a significant debate, but he is unaware of the state doing anything more than

due diligence on whether it is a good idea to buy in or not. He said he does not believe there has been any negotiation on how those credits would have played in.

SENATOR MACKINNON said she hoped that he keeps the finance and resource committees apprised. She spoke of a court challenge and going backwards. "But going forward," she continued, "we can negotiate with our partners, and we're providing 20-35 percent of the funds to create the infrastructure, so it looks like we should be able to get some kind of a benefit ...." She asked if the state did not pay the owed tax credits, as was suggested by some members of the public ... would there be an interest penalty. Mr. Alper noted that [paying the credits] was subject to annual appropriations, but she asked if there was flexibility. She asked about an interest clause, and if the legislature changed the tax structure, would interest counter balance that change.

[10:08:16 AM](#)

COMMISSIONER HOFFBECK answered that if credit reimbursement funds were short-funded, it would be a deferral of payment, and it would not remove the obligation. It would be more of a cash flow issue to pay it later, and there would not be an incremental cost to the state for waiting a year, so it would be a financial benefit to the state to wait, but "there's an issue of honor and good faith and all that that comes along with that." There is no statutory interest for deferring payment of credit; it is all subject to appropriations, he clarified.

SENATOR MACKINNON said, "And, then, in a lawsuit, we think that we would win based on the tightness of our contracts if we forced, through lack of payment, a small explorer to go bankrupt because they couldn't meet those high interest payments, which, at least, that's what I have been told, they're doing with our cash payout credits to keep their companies functioning." She asked if Alaska would be held harmless in a lawsuit if there was an income tax credit that the state could not pay.

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COMMISSIONER HOFFBECK said the statutory obligation to the explorer is to issue a certificate, and the state has always met those obligations. The statute also requires the DOR to draft regulations to cover the circumstances of the state being unable to repurchase the credits.

SENATOR MACKINNON asked if the secondary market is available or has it been cut off since allowing repurchasing by the state.

MR. ALPER said there is no secondary market. There was nothing formally created, the statute just allows for a transfer. The tax credit certificates are sometimes assigned to finance companies before they are even issued, he noted.

[10:10:35 AM](#)

REPRESENTATIVE OLSON said Alaska had six years under ACES and there was a shortage of auditors.

MR. ALPER said the statute of limitations on production tax audits is six years, and it was extended from three years with the passage of ACES. He said it is one of his missions as director to accelerate that process, and "we will get the 2009s out before you convene in January." The slowness is due to some major changes in the DOR in the last few years, including the drafting of very complicated regulations related to upstream costs that never had to be addressed before. He said the department has been implementing major new software, which just rolled out in January and is enabling the DOR to do much of its work online. It has been a huge success, but building it and testing it took a year or more.

REPRESENTATIVE OLSON asked about the accuracy of the estimates for the ACES credits.

MR. ALPER said the ACES credits are based on what was claimed, and there are always adjustments with tax returns and are all subject to appeal. It is a small amount. He said he was working late reading the 2008 production tax audits, and he noted that the state made almost \$7 billion in that year. "It was a walk down memory lane for me to experience what it was like to be rolling in money," he said, and it will be about 95 percent less next year. The extent that the [estimates] are not correct will not materially move the bottom line.

[10:13:44 AM](#)

SENATOR MICCICHE said this discussion is timely. Mr. Alper's selection of myths to be clarified is handpicked and rather limited. He said he has put out his own list of myths. "If we're going to expand myths and facts, I'll ask you a couple questions." The most common myth by the Alaska public is that

Senate Bill 21 has earned less [in tax income]. He said it would be a helpful item to add to the list.

COMMISSIONER HOFFBECK said the truth of the numbers is that, in the current \$60 per barrel oil price regime, SB 21 has earned more money than ACES would have because of floor. The myths were the two that he asked Mr. Alper to address, because people have been focusing on the [untruth] of credit impacts declining.

SENATOR MICCICHE said his constituents have a knowledge gap and it is encouraged by some people. He said he thinks that the total package of earnings for the state is an extremely important discussion. The tax regime should be a living document, and people should understand the impacts and benefits from the various changes.

COMMISSIONER HOFFBECK said the discussion of the "total take" is important, but he is hoping to get away from the debate between SB 21 and ACES. The people voted for SB 21 and it is a law, so the question is how to make it work better.

SENATOR MICCICHE said he does not think [the commissioner's] intentions are diabolical. He said "we" forget that Alaskans are not exposed to any of the terminology, so the legislature needs to communicate at a level that everyone can understand, and that is missing. He suggested a focus group, perhaps. He wants the public to understand the changes and why the legislature is making them.

[10:19:17 AM](#)

MR. ALPER said the main reason for the deficit is the low price of oil. Because the state is in a net profit tax regime, the taxes go down a lot faster than the price of oil. That is a simple fact, and a 100 percent tax could not fix the situation.

[10:20:17 AM](#)

SENATOR WIELECHOWSKI said that during the legislative debate nobody was arguing for keeping ACES. He and others wanted to overturn SB 21 and replace it with something different. Two of the key proposed items dealt with the gross minimum tax and fixing the credits, "all of which are problems that we're facing right now to the point where we are paying out \$642 million more in FY15 and FY16 in tax credits than we would receive in production taxes." He asked if the state ever before paid out more in tax credits than it received in production tax.

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MR. ALPER said Alaska is not losing money on the overall oil tax regime, when including royalties, corporate income tax, and the like. Alaska is not paying anyone to take Alaska oil, with the possible exception of Cook Inlet. The production tax as a stand-alone regime – the taxes and the credits offset from those taxes – has a negative cash flow for FY 2015 and FY2016—that is fact, he said. That is the way the law is written. The credits are fixed, and they are tied to spending, but the taxes are tied to profit. Prior to 2007, Alaska oil taxes were based on gross, so it was impossible to have a negative tax or cash flow on oil. But for the first time, it is true that what Senator Wielechowski said is correct. He added that he hopes it is a temporary situation “that we’re going to work past as the price of oil recovers.”

SENATOR WIELECHOWSKI said that paying more out in tax credits than Alaska receives in production taxes is not a good thing for the state; if fact, “I would envision that there’s probably not another state in the country or a country in the world that pays out more in tax credits than it receives in production taxes.” There is a member on this committee who is not present who has done some analysis of North Dakota and found that North Dakota has very limited credits, if any. Alaska has large credits. He asked about comparing the Alaska tax structure with the tax structure in North Dakota.

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COMMISSIONER HOFFBECK said there is a current analysis by the Oil and Gas Competitiveness Review Board that includes North Dakota and other places on how other tax regimes compare with Alaska’s. Some of those comparisons may be difficult.

MR. ALPER said because Alaska has a net profits tax and every other state uses gross, there is an inherent crossover point. Generally, a net tax will be higher at higher oil prices, and so North Dakota probably has higher tax revenue at current prices. If the price of oil goes above \$100, there will be a point at which Alaska will make more on oil taxes. The question is of catching more during low prices or during high prices, and that is the decision the legislature makes when making oil tax policy.

SENATOR MICCICHE said, "We're still working to confuse Alaskans on the comprehensive valuation of our oil tax system." He said he is ready to move on, but asked if it were true that "if the Yes-on-1 folks were successful, it would have cost the people of Alaska approximately \$400 million in FY2015 and approximately \$550 million in FY 2016 ... if they would have been successful."

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MR. ALPER noted that the numbers Senator Micciche quoted are from the fall forecast, and there were some revisions. He said SB 21 taxes are coming in largely because of the 4 percent minimum tax, and had ACES remained in place by the referendum, the taxes could have been driven to zero, because Alaska would have been taking in \$300 million less.

REPRESENTATIVE NAGEAK said Alaska has benefitted greatly from the activities of the industry. He said Alaska has learned what works and what doesn't work. The previous way of doing things has provide benefit in the sense of operating on both sides of the equation, the taxers and the taxpayers. He said, "We've lived together for so long that we have learned to work together on issues that come when things happen." He recalled the problems with the fisheries when the Endicott [oil field] was built, and the industry did a study to learn more about "those fish and everything else," and [the study concluded] that the people of the North Slope were right. So the industry made breaches in the Endicott causeway, and it has worked, he said. That is just an example of how they work together. When the tax equation was changed, "I think it helped the local municipalities by increasing revenues in a lot of cases to counter losses from before." He said he looks forward to updates from the industry, not only here, but up in the North Slope. "When it comes to talking about the benefits and non-benefits of the previous tax structure, it's a whole lot different than it was before."

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REPRESENTATIVE SEATON said he appreciated the historical presentation, and he recalled that during the PPT hearings, consultants said to never give tax credits of over 20 percent, because credits based on investment will be out of sync with revenues and could put the state at an extreme risk. It seems like that is the situation Alaska has found itself in, he noted. He asked about the Cook Inlet situation. He is glad that there are investors there, but there is a zero production tax for oil

in Cook Inlet, and there are production tax credits that cannot be recovered through any production unless royalties are reduced. If there is a 25 percent net operating loss carry forward plus a 40 percent lease expenditure, "we're talking about investing 65 percent into an operation that in the future will have production with zero production tax return to us," he said. "Are we really saying that we are offsetting that expenditure that we are making – that 65 percent of the cost – with royalty?" He said that it does not seem like Alaska has any other source of funds from that production other than royalty to make that expenditure, and it has not been talked about that way, but it seems like that is where we are. For Alaskans, he asked, is the legislature looking at how the credits in Cook Inlet add up.

[10:32:30 AM](#)

MR. ALPER said he does not like combining the royalty and production tax conversation, because they have different functions. One is Alaska's sovereign right to tax, and the other is a landowner's right, and Alaska only gets royalty on Cook Inlet production that is on state land. He said the rationale behind the tax cap was the potential for Cook Inlet gas shortages. The legislature, in 2005, when the PPT was being introduced, was worried that a tax would be an undue hardship on the companies exploring and producing gas that supplied the utilities in Southcentral Alaska. "It is zero" because it locked in the ELF multipliers and rates. So, for all the old fields in production, it was zero, and it varies from gas field to gas field, but the average gas tax in Cook Inlet is 17.7 cents, and that tax regime has a sunset in 2022. He said the analysis Representative Seaton spoke of is true with a project under development: a 40 percent credit plus the 20 percent net operating loss. He explained that it is usually "between the 20 and the 40; some fraction of their spending falls under the one credit and some under capital, so we're paying 55 percent, let's say, for an explorer in Cook Inlet." The phenomenon that the tax cap brings in is that even an active producer who does not have a net operating loss is still eligible to receive those well-drilling credits. So, he said, there are circumstances where a company could be producing and not paying taxes because of the cap, or paying a very low rate, and still be eligible to receive large credits for well drilling and capital expenditures.

[10:34:03 AM](#)

COMMISSIONER HOFFBECK said there has been a fairly substantial increase in property taxes within Cook Inlet because of the new development; although, it does not offset the credits.

REPRESENTATIVE SEATON expressed his concern that the chart on the historic and forecasted tax credits shows that total tax credits are going up \$95 million from 2015 to 2016, and \$490 million from 2016 to 2017. He said he does not need to discuss which tax regime is better, he just wants to make sure, as Alaska goes forward, "we look at a regime that works for us at high and low oil prices – that they self-adjust and the state is not put into a financial hardship in any regime." This meeting today is really important to get these issues on the table, and, he said, Alaskans do not need to talk about the past, but the state must get control of its fiscal situation, and get something that works for Alaska.

[10:36:47 AM](#)

SENATOR COGHILL said the investment that the legislature is making by providing credits is to have fuel during the winter. He felt that the credits worked, but he asked if they have lived their useful time. On the North Slope, he was interested in production capacity, so there were incentives for exploration. Under the tax scheme that evolved, it was putting Alaska's money into new production, not contemplating that the price would drop to what it did, he said. It has been a highly volatile international market, and consultants say we are probably not even a noticeable sliver. "So we have to be competitive in that world," he stated. The tax credit was to invest in production, he reiterated. The question in his mind is if Alaska is getting what it asked for. It should not be about being short on cash, but whether it gets to the production that Alaska wants. If not, "then maybe we are wasting our time." He said the legislature decided to incentivize certain behavior but also share the risk, but is it getting the value?" he asked.

[10:39:24 AM](#)

SENATOR WIELECHOWSKI asked about the interplay between Cook Inlet and the North Slope for a company that operates in both.

MR. APLER answered that there is not a material difference for smaller companies, because credits are essentially cashable. For a large company with operations in both areas, it could cash out its credits, he explained. From the ACES legislation, a lot of those credits would have been lost from Cook Inlet, because

there was only so much tax liability and it had to be held onto until there was future tax liability. House Bill 280 enabled those credits to migrate to the North Slope and be used against that tax liability.

SENATOR WIELECHOWSKI asked if there was a significant amount used in that manner.

MR. ALPER said he has only seen "anecdotal information" in a memo from a prior commissioner to a senator that said it was \$50-\$100 million annually, but that is speculative.

[10:40:46 AM](#)

SENATOR MCGUIRE said she would like to remind people how integrated Senate Bill 21 was with regard to credits. Senate Bills 309 and 280 were for Cook Inlet. She suggested that when incentives are successful, people to want to "take more." She asked people to think through how the legislature accomplished what it wanted. The Senate Resources Standing Committee held hearings where the mayor of Anchorage was contemplating importing LNG from Indonesia and experiencing rolling blackouts. She said the committee used data from the old field to employ two tax regimes that have been successful, and she urged caution in taking more, because that is power cost equalization for Southcentral residents. It is a center of commerce, and taking more [revenue] means killing the golden goose. She said she will be protective of Cook Inlet tax credits that are in place. Something is coming back in property taxes that were not coming in to the general fund before, because "those fields were dead."

CHAIR GIESSEL said there is an interior energy plan to draw gas from Cook Inlet as well.

[10:43:44 AM](#)

MR. ALPER spoke of credit projections and said the department talks to companies and gets their reports and attempts to figure out what is going to happen, and the "net result of this whole conversation is if it's enough of a real expenditure to show up in the production forecast, it's enough of a real expenditure to have the credits show up in the credit forecast." Alternatively, regarding explorers, if a project is planned and announced, then the cost of the reimbursements will be in the analysis, but many other things are not yet in there. It is necessary to understand that the more successful Alaska is in attracting new oil and gas

development, the more, under current law, the state will be paying for credits two to five years down the road.

CHAIR GIESSEL thanked him for the extremely valuable presentation. She introduced, *enalytica*, legislative consultant.

[10:45:54 AM](#)

JANAK MAYER, Chair and Chief Technologist, *enalytica*, said it was his fourth year advising the legislature on oil and gas taxation.

NIKOS TSAFOS, President and Chief Analyst, *enalytica*, said the price of oil is what is really driving this topic. The price has rebounded somewhat from its low of \$41 per barrel. He turned to slide 3 and said the graph shows the boom in U.S. production over the past five years, where 5.5 million barrels a day have been added. As a comparison, he noted that Alaska's peak oil production was about 2 million barrels per day. When the U.S. starting adding production, there was a decrease in global oil due to the civil war in Libya. About the time that Libya stabilized, sanctions were placed on Iran, which decreased the amount of oil entering the market. Then, in 2014, the growth of the U.S. production started translating almost 100 percent on the additional supply of the global market. Prices started dropping last summer, because production started to really grow and expectations for demand turned.

[10:52:40 AM](#)

MR. TSAFOS said that every month the International Energy Agency provides a forecast of oil demand, and the agency predicted a drop in demand, which helped drive down the price of oil. The forecast is starting to come up, and growth in supply is not as dramatic, he said. He added that he does not want to discuss OPEC [Organization of the Petroleum Exporting Countries] and what it did, but basically what OPEC realized is in this new world, there wasn't really much that it could do, and so there was no point in trying to defend a price that was "out of sync with the fundamentals." People read that OPEC is saying that the crazy Americans are producing all of this oil out of nowhere, "but it's so scattered," he said. There are about 70 companies operating across the Lower 48, "and it's really hard to figure out what's going on." Part of OPEC's strategy is to let the price move according to the market, such as: "Let the market tell us at what price American producers go bankrupt, rather than ... trying to figure it out from Saudi Arabia." He showed, on

slide 4, a chart with the rig count in the major shale areas in the U.S., and it shows that, depending on the play, there may be a peak of 200 rigs to 600 rigs. The charts showing oil production at a low level depict mostly gas plays, he explained. The point is that low prices are creating a response in activity; the rig counts are crashing. People are scaling back, but the bottom chart shows that production is not crashing, and that is because not all wells are equal. In North America, a large cut in the rigs may have only a minor cut in production. Ignore the news articles about big declines [in the oil industry], because what really matters is production, not the rig count, he stated.

[10:57:17 AM](#)

MR. MAYER said North Slope crude went from \$107 per barrel to \$67 per barrel in two years. Slide 5 shows state revenues and credits, and he said that revenues from petroleum sources went from \$5.7 billion to \$2.1 billion this year. If the only revenue was royalty, the decline would be linear, but net value falls much more sharply than oil prices, because costs are essentially fixed. A 37 percent decline in oil price gave Alaska a 63 percent decline in total revenue. In 2014, royalty was about 30 percent of the revenue and production tax contributed 45 percent, and in 2015, royalty makes up 45 percent of the revenue, and production tax contributes only 17 percent. "In terms of credits that are paid out and [the] production tax number you see there in the green, and net of credits and deductions that have gone through the tax system, not including things like the dollar-per-barrel credits, which simply ... act to reduce a taxpayer's liability, looking solely at credits that are actually paid out or potentially paid out by the treasury to companies that don't have liability, those are pretty similar between last year and this year," he said, referring to slide 5. It was \$593 million in 2014 and \$625 million in 2015. "The big difference is that's a much bigger picture of the revenue total for this financial year than the previous one, and that's true if one compares it to the overall revenue pie, particularly true if you compare it specifically to production tax."

[11:01:54 AM](#)

MR. MAYER said, regarding other credits that are not explicitly shown in the previous slide, there are the credits that are paid to companies that have a tax liability, and they are the largest number of credits overall. This year there was \$363 million in tax liability, but \$570 million in credits. Last year had a much

happier revenue picture with \$2.6 billion in production tax versus \$888 million in credits. These credits are a fundamental part of the design of the system, he stated. He spoke of credits increasing as oil prices decline, and the basic function is to reduce the rate of tax at lower prices. He said that it is a progressive system, and it functions much like the ACES progressivity scheme, although ACES started with a lower 25 percent tax rate and increased with the price of rising profits and prices. He noted that there were problems with marginal rates in ACES. That was changed by setting a higher maximum tax rate, 35 percent, but that is too high at low oil prices, and "so we'll find a way to bend that tax rate down at lower prices, and that's exactly what these credit do." But the question is if it is a reasonable system.

MR. MAYER asked whether the system is denying money Alaska should be earning from its oil—leaving aside the question of credits that are paid out directly to companies, which he will discuss later. He said one way of looking at the question is by doing simple math, but he cautioned the use of simplified numbers. Comparing other resource owners like North Dakota and Norway must be done on a like-to-like basis, he stated. He said this is a crude, aggregated look at a single year, and every company's finances are lumped together [slide 7]. The chart does not account for spending heavily now to create future production—it is just one point in time. This average barrel price does not really exist, but it is a useful way to look at the tax in the current environment, he explained. If oil were \$107.60 per barrel, the gross value would be \$98.20 at the point of production. He then subtracted \$59.40 in production costs and \$13.80 in royalty and property taxes, generating a net value of \$45.60. He then applied a production tax of 35 percent with a \$6.00 per barrel credit, as well as state and federal corporate income tax, and he ended up with a producer value of \$19.20 per barrel.

MR. MAYER [moved to slide 8] and showed a similar calculation with oil at \$67.50 per barrel, and royalties fall, but not as much as the net components. Property tax stays the same, and production tax falls, because the net has fallen from \$45 down to \$10 [per barrel]. The producer ends up with \$2.40 per barrel. He noted that the graph shows royalties going from 27 percent of the net price to 70 percent. Royalties are regressive, and if prices go down far enough, they will take up everything, he stated. Alaska has a progressive credit system that is supposed to reduce the effective rate of the tax as oil prices fall, and to a certain point it does, but when the 4 percent minimum kicks

in, the \$2.30 in production tax cannot fall any lower. Because of the substantial fixed royalty, at \$107 per barrel, the government takes 68 percent, and at \$68 per barrel, the government take is 88 percent. When looking at the amount of money there is to go around, the tax system is taking almost everything there is to take, he stated.

[11:16:02 AM](#)

SENATOR MICCICHE referred to a paper by Roger Marks, April 25, which was based on a lower price but summarized Mr. Mayer's comments. He said he is seeing that people confuse Alaskans by comparing production costs with the Lower 48. Because of the effects of royalty and taxes, the lower the value of oil, the more the government takes.

MR. MAYER said that is what he said. Those are levied on the gross barrel.

REPRESENTATIVE SEATON asked about corporate income tax.

MR. MAYER said his recollection is 35 percent federal tax and about 6.5 percent state tax.

[11:17:48 AM](#)

MR. MAYER moved to slides 9 and 10, comparing tax rates in ACES to those in SB 21. At the low prices, SB 21 brings in more money for one reason alone: the gross minimum tax. Under ACES, 20 percent capital credits were applied after [the minimum], so the credits could have taken [the production tax] down to zero. "At some point, it takes you down to that floor and it can't take you down any further, so once you hit 4.5 percent of the gross, your tax rate not only can't decrease, but it starts to increase." So, under SB 21, the state gets \$2.30 in production tax, and under ACES it would have had a negative value; however, large companies cannot have less than zero in production tax, but they can carry amount forward against future liability, he explained.

MR. MAYER moved to slide 11. Regarding the impacts of negative revenue of \$625 million from credits paid [to the oil industry] by Alaska, "most of these things are as they were previously." He said Alaska has taken the 20 percent capital credits and replaced them with the sliding per-barrel credits, and "those all simply affect credits that are paid against the liability, not the cash that is actually paid back to producers who don't

have a liability," which is the biggest source of concern here. [The \$625 million] includes the net operating loss credits given to a company that is spending a lot of capital on new developments and does not have much or any revenue to compensate. These credits of 45 percent are "a substantial portion of this piece." Cook Inlet activities also contribute a substantial portion of the \$625 million. He said SB 21 made changes "that do reduce a few small pieces." The alternative credit for exploration, the Frontier basin credit, and the small producer credit were not changed by SB 21, he said, and they sunset in 2016 and 2017. If a company was able to collect the credits before they sunset, it can continue to claim them for nine years afterwards, he noted, but overtime, the sunsets will save \$113 million out of the \$625. Senate Bill 21 also temporarily increased some of the credits with transitional arrangements to protect small producers. It got rid of the 20 percent capital credits, and it increased the loss credit to 35 percent to go with the increase of the base tax rate from 25 percent to 35 percent. He said that the transitional arrangements raise the credit for the small producer to 45 percent through to January, 2016. There will be some decrease in credits paid out after that time, he added.

[11:25:28 AM](#)

SENATOR MICCICHE asked about production tax for FY 2015 and about "the footprint of the producer paying tax versus not paying tax." The legislature has had empathy for small producers and encouraging them with generous tax credits. He asked which producers are paying a net-positive in production taxes.

MR. MAYER said that no company producing 50,000 [or more] barrels per day can receive a credit paid out by the treasury, [except] producers that do not have a tax liability. The [substantial producers] with tax liability "and possibly some additional smaller producers that also have a tax liability collectively contribute that \$362 million to the treasury in production tax as well as all these other elements of the total revenue pie," which is about 90 percent of the state's total unrestricted revenue. "Separate to that, there are small producers that don't have a tax liability that do claim credits, and those credits are paid out to them." These are separate companies "and quite separate revenue streams." The companies that are paid for the credits have relatively little or no production, he said. These companies may have only a small amount of production and, relative to that production, high amounts of spending in future production such that the credits

they are entitled to exceed any liability that they would have, and the net balance is negative. He added that the largest portion of this is the net operating loss credits, currently 45 percent from any net operating loss. He said the effect is exactly the same for large producers and small producers as both can spend \$1 billion and decrease a tax liability by \$350 million. It is an important equalizer between the large and small producers, particularly in the North Slope. Cook Inlet is different, he explained, but for the North Slope, the bulk of that is effectively achieving the same deal for those small producers that do not pay tax as the deal the big producers get. He explained that if a big producer invests in future production, the state pays 35 percent of those costs, because it will take 35 percent of the revenues "down the track."

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SENATOR MICCICHE asked if the risk balance for larger producers is healthy or if they are victims of low oil prices. He asked if the balance may be "off" for smaller producers and if they evaluate whether future potential production is worth "being somewhat out of balance."

MR. MAYER said Alaska has a slightly lower tax than North Dakota, because North Dakota gets less revenue at higher oil prices. Any fiscal system is a balance between risk and reward. He said ACES was a balance that had the state take more risk on the downside but take in more on the upside, and SB 21 did the opposite. A large producer is better equipped to weather the volatility, he said, and may be willing to spend the money now.

[11:33:26 AM](#)

REPRESENTATIVE SEATON noted that the 35 percent federal tax is actually 23 percent, and the most recent average of [Alaska's] corporate income tax is slightly over 4, not 6.6 percent. That money is left in the producers' hands, he said. He asked about calculation using those more accurate figures.

MR. MAYER said he would not like to use his methodology to benchmark government take, because that would require a lifetime analysis of assets. He said he would not want to use these "headline" figures "and say this is emphatically the level of government take we're at, because I don't have the knowledge or information to do that." The aim of his exercise is more about the differentials between "what things are like" at \$100 and \$66 per barrel. Companies in the hole do not pay the effective rate

of 35 percent, but oil companies frequently pay very high rates, so using the 35 percent figure is probably not that far from the truth, he offered. He added that actual figures will not make a dramatic impact on the overall picture.

REPRESENTATIVE SEATON said that the producer value of \$2.40 [per barrel] is significantly different if the tax is less. That would show a lot of value as if it were government take, but the producer keeps it. He said he is not challenging the analysis, but he questions the retained value versus the state's value.

[11:36:59 AM](#)

MR. MAYER said the final slide is important regarding credits that are refunded by the treasury. He noted that the credits "go to very different companies than the large companies that provide a vast majority of the tax revenue." Geographically, the \$625 million is split about evenly between the North Slope and Cook Inlet, and Cook Inlet does not contribute any more than about 5 percent of total petroleum tax revenue. This exercise is stacking credits that come from current investments into future production against current revenues, so there is a time "mismatch," he stated. The North Slope picture looks a lot less "out of whack," he said, as the credits that are refunded are the 35 percent reinvestments into future production tax revenue. In most cases, Cook Inlet production tax on oil is "effectively zero," and royalty is reduced. By any measure, there is a substantial subsidy for the Cook Inlet petroleum industry. He noted that there was a fear of rolling brown outs in Anchorage and a need to turn Cook Inlet basin around, which has been done, but these credits that are paid out directly to petroleum companies may not be sustainable with [Alaska's] current budget constraints. The chart paints a strong picture of where that conversation might start, he offered.

[11:40:20 AM](#)

CHAIR GIESSEL announced that the committee would hear from several Cook Inlet producers.

PATRICK FOLEY, Senior Vice President, Caelus Energy Alaska, said Caelus recently purchased all of the assets of Pioneer [Natural Resources Co.]. He said his goal is to dispel myths, to remind the committee of Caelus activities, and to put a face on "your co-investor." It is finances from the state that helps many of Caelus's projects, he said. Since 2002, his company spent \$2 billion in Alaska, and it is one of the companies that gets the

tax credits. He said the company was named after the Roman God of the sky, and "we have a large North Slope business; we're exclusively focused on the North Slope." Caelus has conventional loans and very large private investments from the Apollo Global firm. It operates the Oooguruk field with a 70 percent working interest, producing about 15,000 barrels a day, he stated. Pioneer/Caelus has been in Alaska since 2002 and has yet to make a profit. He said the company's 2015 capital budget is about \$220 million for Oooguruk and Nuna, which had gravel installed last year and has a commitment for first oil in the fourth quarter of 2017. He added that Nuna has "something north of 100 million barrels." The big oil companies "have all the good stuff," and Caelus has to deal with tight, crummy reservoirs on the North Slope, but they can be successful with the right technology. He said his company is the leading fracker in the state. These are very expensive wells, he said, and they are about 6,000-foot laterals with very large frack programs where the company pumps somewhere between 3 and 4 million pounds of proppant in each. He said it is difficult because the company operates out in the ocean, drilling all year round but fracking only in the winter from a fabricated ice pad. He said last winter's drilling season was very successful, and the company brought all its wells on line. He said Caelus did a capacity test to determine "how much oil we could make through our system, through our existing wells, and we peaked at 22,500 barrels, which is phenomenal." When drilling a well, "we pre-produce a water injector ... then pretty shortly we actually convert them to water injection," so rates drop from 20,000 barrels a day to more like 11,000 barrels, he explained.

[11:46:30 AM](#)

MR. FOLEY said the credit program is instrumental in helping Alaska "grow the pie." Caelus paid \$18 million to purchase leases to the east of Prudhoe Bay and immediately shot a high resolution seismic 3D program. The company shot a 3D program on Oooguruk, so there are two seismic programs that it spent \$30 million on, and it installed gravel and a road, and it will come back and install facilities and begin to drill development wells. In the first phase of Torok, there will be 30 development wells and something close to 20,000 barrels a day, he said. He said he is excited to announce another project near Smith Bay that NordAq had put together. It is a legitimate billion-plus barrel recoverable reserve resource in the shallow waters of Smith Bay, he said, and it was a complicated transaction. NordAq had difficulty with its financial backing, and the only way this deal could go forward was by solving all of the problems. He

said he was locked in a room with NordAq, business people, engineers, CIRI [Cook Inlet Region, Incorporated], attorneys, Doyon, and Cruz Construction to find a way to make a deal to allow the two wells to be drilled this winter. He noted that he hopes to close the deal tomorrow. Caelus will be the operator and have 75 percent interest, he added. The state of Alaska did not have a seat at the table, but without state tax credits Caelus would not be doing this. He said he appreciates the budget problems and hopes the state finds a solution without getting rid of his credits.

[11:50:24 AM](#)

MR. FOLEY said slide 7 demonstrates the amount of money Alaska pays out in credits, which is less than its revenue. He said Pioneer started in 2002 during ELF and committed to a project. The tax regime changed to the PPT and then to ACES. He said has worked in other states and other countries, and he has never seen a less stable fiscal system than in Alaska, and for an investor, stable is more important than favorable. His industry does a good job of following the rules and making investment decisions, but the legislature makes the rules. "Thankfully, I've had an opportunity to have a seat at the table and at least participate in how some of those rules are drafted," he noted, but he asked to be able to experience the fiscal terms that were expected when making a commitment. He said there is almost a sense of fear that the state might have to pay out a really big amount, and "isn't that a great thing?" When the state pays, it is a result of the investments made, and he cannot imagine anything better than paying out very large credits, because that means that very large investments were made.

MR. FOLEY said the next slide shows the difference between a 023 credit, which is a loss carry forward credit, and a 025 credit, which he calls an EIC or exploration incentive credit. For the EIC credits, there is a "very active" application process, and the state decides if the project is worthy. He said NordAq went through that exercise and has preapproval for the EIC credits. When the industry makes an investment, part of the rules is that it would earn a credit certificate, and it needs absolute reliance that the state will pay for the certificate. Having uncertainty would chill investments, he added. Referring to an earlier question of state purchases eroding the third party market, he said his business sold its credits early on for a modest cash discount to a big producer. "Then the state had a program to be able to buy credits directly, and that's all we've

ever participated in," he stated. He said he heard that the purchasing market is very thin with high discounts.

[11:55:52 AM](#)

MR. FOLEY said the oil industry is magical because of the job multiplier effect; every industry job creates 20 indirect jobs. He turned to slide 10 showing all of the [petroleum industry] activity in 2015 when oil was \$100 per barrel, and now, none of these companies have their foot on the brake, because they have confidence that oil prices will recover. It is not important what oil prices are now, but what they are going to be in the future, and as the legislature contemplates changes to the credit system, he asked for members to keep that in mind. Please keep in mind the relationship between the tax rate and the credits, because they go hand-in-hand, he said. Alaska made a bargain to help investors with credits upfront in exchange for higher taxes when they make a profit. There are tremendous resources on the North Slope, and the credit system motivates explorers and appraisers. Caelus is the kind of company Alaska would like to have, he opined.

[11:59:27 AM](#)

CHAIR GIESSEL congratulated Mr. Foley regarding its partnership with NordAq, and she introduced the next speaker.

[11:59:44 AM](#)

BENJAMIN JOHNSON, President and CEO, BlueCrest Energy, said BlueCrest is a small independent oil company, and he would like to explain the process for deciding to come to Alaska. The company is privately-held, but all executive managers are from major oil companies. One board director was a chief operating officer of ConocoPhillips, and the Alaska vice president was the operations manager for Prudhoe Bay. Mr. Johnson was an executive with ARCO and grew up in Kenai, working his way through college on the Cook Inlet platforms. He noted that he also worked on the North Slope and in the Gulf of Mexico. BlueCrest looked all over the U.S. and what made the company look at Alaska was the tax credits and the opportunity, he said. He added that BlueCrest is not trying to find the next biggest deal, and it has only one property to develop: the Cosmopolitan Project. There are 30 people working in Alaska for BlueCrest, and there will be about 250 people later this year. He noted that there are no production taxes on oil in Cook Inlet, but the royalties alone, over the initial 10 years and based on \$65 per barrel oil, will

be \$300 million, and that is not counting any property taxes, income taxes, or future production taxes. There will be about \$20 million in property taxes in the next 10 years, he added. This year, his company plans to spend about \$80 million, and next year about \$120 million. He said capital is limited for smaller companies, and the cost of money for BlueCrest is very expensive.

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MR. JOHNSON said BlueCrest has spent \$144 million to date and has received \$21 million in tax credits. The company does not have any third-party debt – it is using shareholder money – but to go forward it will need to borrow money. BlueCrest will be closing on a \$30 million loan facility from AIDEA [Alaska Industrial Development and Export Authority]. He turned to page 3 of his handout, and said “this is what we saw when we bought it from Pioneer.” BlueCrest bought Cosmopolitan in 2012, and Pioneer took those funds and put them into the Permian Basin and made a lot of money. The people of BlueCrest saw potential, he said. There was an initial well drilled in 1967 that found some oil, but no one had ever seen “the upper part of the main part of the heart of the structure.” In 2013, he said, BlueCrest drilled one vertical well offshore and found what he had hoped: a lot of gas and more oil. The field is located about three miles offshore of Anchor Point, but it will be reached by drilling onshore with a large rig that is under construction. There will be no oil production in the water, and he anticipates that they will be on production with the first well by April of 2016. At some point, BlueCrest will begin drilling water injection wells to keep the pressure up in the reservoirs. Through 2019, its total projected spending is \$690 million. The gas they discovered is another story, he said. It is a good example of how Alaska's credit program motivated the company “to get to the right place.” It has found a lot of gas, but it is too shallow to reach from onshore, so the plan is to put two very small gas production platforms offshore. Capital was limited, and the company had been focused on oil, so they have been working with WesPac Midstream, a company that came to Alaska to deliver gas to Cook Inlet. He said the two companies are now talking, and WesPac will pay 100 percent of the development costs and receive all of the gas, until later when BlueCrest will work its way back into an 80 percent ownership in the gas. He said WesPac is willing to commit this gas for Alaskans. He does not want the gas to go away if Alaskans need it. The gas production will start in 2016 and be ready in 2018, at a time when there may be a shortfall of gas in Cook Inlet.

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MR. JOHNSON said Cook Inlet is a prolific basin, but there has been very little discovery—the last large discoveries were made in the 1960s. Access is easier than the North Slope, but much more difficult than the Lower 48. The offshore exploration well BlueCrest drilled in 2013 was 7,400 feet deep and cost \$45 million, and a similar well in the Gulf of Mexico would cost \$8 million, he said. The company's onshore wells will have a 5,000 foot horizontal opening and will cost \$30 million, and in the Lower 48 it would cost about \$9 million. In general, there is enormous potential in the state, and the major oil companies have done a great job of developing the enormous projects – no one else could do that. But, well-run, independent companies will have a big part in Alaska's future, he opined. BlueCrest is well-suited for exploration and development of small projects and has strong technical abilities, efficiency, flexibility, and innovativeness. He reiterated the limited capital for small companies. He turned to slide 9, and he opined that most of the new Alaska discoveries will be small. "I don't know how many more Prudhoe Bays we'll have," he stated. Looking at the typical evolution of basins around the world, they are started by majors who do the costly projects, and then the independents move in and "reinvent the resources." He spoke of the Permian Basin, as an example. It is estimated to have a fourth of all U.S. oil reserves, and in the 1970s to the 1990s, the majors produced the fields and then sold them to independents. It was too mature for the big players. In the 1970s, it was producing 2 million barrels a day and declined in 2005 to 850,000 barrels a day. Then the independents came in, and they got the rate back up to 1.3 million barrels per day. Alaska has to compete with other areas, and the credits were why BlueCrest chose to come here.

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MR. JOHNSON said he views the credits as offsetting the high costs of working in Alaska. Without them, he could not have convinced investors to buy into his company, and if credits stop, it would not continue full development as planned, he stated. His company is not producing anything now, but it is receiving credits. If the credit program stays the same, Cosmopolitan will receive about \$190 million in state credits within the next four years. The state royalties will be \$600 million, and that is a 200 percent return on Alaska's investment. Additionally, Alaskans will have access to the gas and oil, he noted.

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SENATOR MICCICHE said this is the natural gas of the retirement homes and households of Cook Inlet, Alaska. It has become normal that the service providers in Cook Inlet have a premium because of the proximity to the North Slope, "and I'm not sure the costs are justified." He encouraged independent producers to bring down those costs.

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MR. JOHNSON said he agrees. His company bought a drilling rig, which locks in prices for the next four years—it cuts over \$50 million out of its drilling budget.

SENATOR MACKINNON asked about the cost of capital.

MR. JOHNSON said it is very expensive; money for preproduction has a 10 to 20 percent interest rate. After production it gets much more reasonable, but exploration is high risk and there is no certainty of a discovery. But on the development side, which is what his company is doing, money is still expensive. The objective is to quickly get into production and then refinance.

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JOHN BARNES, Senior Vice President, Hilcorp Exploration & Production, Alaska, said he has been with Hilcorp Exploration & Production for about three years, and the company has been a big player in Cook Inlet. Showing slide 2, he stated that Hilcorp is incredibly cost-conscious. Operating costs in Alaska are too high, he noted, and Hilcorp has to be innovative and cost effective to be competitive with its Lower 48 business. Allegedly, costs are higher in Alaska, "but we won't accept that." He said that, right now, Cook Inlet's cost structure is competitive with Hilcorp's Lower 48 work. The company has recently moved on to the North Slope, and its goal is to get the North Slope cost structure in line with Cook Inlet's — that's how you deal with low-cost environments, he stated. Low prices force companies to wake up to operating costs, and Hilcorp talked to its contractors, who deserve to make their return, because they are in this as well, he stated. He said Hilcorp tries to save operating expenses and put that money into new wells. He added that by capturing adjacent opportunities, a company leverages its infrastructure, and that is what everybody does, because it dilutes fixed costs against more barrels. He

said his 2014 investment in Cook Inlet was about \$374 million. There are a lot of old, broken wells in Cook Inlet, and Hilcorp acquires assets from major companies, "and then we go in and we work really, really hard to get production up." If you want more production, spend more money, he added. In 2015, Hilcorp will spend about \$340 million, which includes its business on the North Slope. It closed on three properties from BP in November. He said the acquisitions in Cook Inlet and the North Slope total about \$1 billion each, and "that's just to get a seat at the table."

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MR. BARNES said the oil and gas business needs optimists, because pessimists will not drill. In 2011, he was the only employee, and at the end of 2013, there were 360 employees, and 97 percent were Alaska residents. The Alaskans are now 88 percent of Hilcorp employees, but the intent is to hire Alaska residents. Additionally, in Cook Inlet, Hilcorp has 1,500 contractors, off and on. When Hilcorp took over in 2012, it acquired Marathon, "so we moved more gas that winter," but in the summer, Hilcorp needed more markets and export options. He said it is important to find ways to create market. Competition is good so people will be competing in trying to move gas from Cook Inlet to Fairbanks and other Interior areas. It is rewarding to see the market plays at work to solve energy questions, he stated. Things were not booming when Hilcorp took over, but Hilcorp increased production from 6,000 barrels per day to over 12,000. After Hilcorp closed on North Slope acquisitions, it has gone from zero barrels to 60,000 barrels per day in December of last year, he stated. The key is the mindset to just go out and do the work.

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MR. BARNES said 20,000 barrels per day on the North Slope does not look interesting, but the company has held flat compared to the decline. He said Hilcorp is commissioning a smaller automated service workover rig to change wells out "without using these buildings that they move around on the Slope called 'drilling rigs'." He said production went down a couple of times because of normal summer activity, but he is incredibly optimistic about the North Slope. He showed a chart of Hilcorp's royalties, which went from \$28 million per year to \$56 million. It is important to have a long view on investments; the state encourages investment and payout will be longer than what is happening just this year. If production goes up, the value of

assets go up, and property tax payments increase, he explained, so the state and industry have the same goal of increasing production. He showed his last slide. The green bars represent cumulative Hilcorp investments since January 2012. Previous operators were not investing enough to hold production flat, and Hilcorp produced 20 million more barrels than previous operators would have. The state has to decide if it wants a tax structure that asks "why can't production go up?"

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SENATOR STOLZE said there is a little facility in his district that is 170 megawatts, "and I guess we're relying on about 7 million cubic feet a year." He said he thinks they are paying "about seven now," with an escalator. He asked about the policy of Southcentral and Railbelt energy reliability and tax credits. He said the district has the facility and is depending on it, and "I think that number is only going to go up on consumption."

MR. BARNES said the tax credit structure is part of an overall analysis of the cost to do business, and it is working. The Cook Inlet tax credits are working, because production is going up and people are looking at exciting new opportunities. Competition will be good for providing gas and drilling new fields, and more players bring in more contractors, which ought to drive prices down, he said. It is the free market system at work, and people will not look for the gas without good contractors and tax structures.

SENATOR STOLZE said the decision was made to build that big multi-megawatt, so there is no choice.

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MR. BARNES said the Permian basin keeps on giving. Cook Inlet is not, but it has a lot of opportunities. No one knows what is out there, but are people optimistic or pessimistic?

CHAIR GIESSEL said Hilcorp has been exciting to watch.

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JASON BRUNE, Senior Director, Land and Resources, Cook Inlet Region, Incorporated (CIRI), said CIRI has a long history of participating in the oil and gas business as a lessor and a royalty owner. It has contributed to finding and developing the 28 producing oil and gas fields in the Kenai Peninsula and

offshore of Cook Inlet, he said. It is a lessor to a number of operating companies, including Hilcorp, Cook Inlet Energy, NordAq, and Aurora Gas, and CIRI has an exploration agreement with Apache, one of the largest independent oil and gas corporations. The agreement covers a large portion of CIRI's acreage, and the ultimate goal is to yield a better understanding of the land through seismic acquisitions and identifying promising drilling opportunities. He said CIRI also holds a minority interest in Alaska Storage Holding LLC, also known as Cook Inlet Natural Gas Storage Alaska (CINGSA). It is Alaska's first underground gas storage facility and is in Kenai.

MR. BRUNE said he is constantly being approached by new companies because of CIRI's large land base and interest in development. In September, 2013, CIRI topped \$1 billion in total dividends payed to its 82,000 Alaska Native shareholders. He said 70 percent of profits from natural resource development is shared with the ANCSA [Alaska Native Claims Settlement Act] regional corporations and all of Alaska's village corporations. The impacts can be felt from Homer to Healy and from Fairbanks to Chugiak, he said. Oil and gas development in Cook Inlet led to statehood with the discovery of oil in Swanson River. In 1971, the Cook Inlet basin was producing over 230,000 barrels a day, and it was flush with natural gas. When oil was discovered in Prudhoe Bay, interest moved out of Cook Inlet, and oil production declined to less than 9,000 barrels per day, and there were rolling brownout drills. In 2010, the legislature passed the Cook Inlet Recovery Act, which expanded tax credits and incentives. As large companies moved on, smaller companies came in, he said, upgrading platforms and drilling new wells. Since 2010, 75 new oil wells were drilled, and Cook Inlet saw its fourth annual increase in production. There is now adequate supplies of gas to meet local demand, and there is storage capacity, he stated. During the same time, CIRI saw production on its land increase, and so it gets larger royalty income and the state gets more in tax revenue. This can be attributed to the incentives and tax credits, he opined.

MR. BRUNE reported that he spoke with companies in Texas that once invested in Alaska but had left, and they said Alaska's previously high tax regime was a major factor for leaving. Each company expressed enthusiasm for the new tax regime and its endorsement by Alaska voters, he stated. Other issues were a lack of infrastructure, small supply chain, fewer contractors, limited drilling seasons, increased permit timelines, and the antidevelopment community. That drives costs up, and the companies have a responsibility to their shareholders. While in

Texas, he said he attended the Nape conference with 20,000 attendees; "anyone and everyone who's involved in the oil and gas business was there." The mood was somber because of the price of oil. He had a booth and those whom he talked with were intrigued at the allure of 1.5 million acres of opportunity on CIRI land. Many companies talked about the high costs that exist in Alaska, and when he showed them the Alaska tax credits and the tax ceilings in Cook Inlet, it demonstrated that the state wants to be a partner with the industry and encourage new investments and new players.

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MR. BRUNE said the incentives are not handouts, they are investments that pay back in royalties, production tax, property tax, and corporate income tax. The tax credits cannot be used to offset CIRI royalties, he explained. These returns will be measured over generations and not in fiscal year budgets; additionally, there will be year-round high-paying jobs, local property and sales taxes, and economic opportunities for Alaska Natives statewide. Continuing these tax credits is imperative for Cook Inlet, he opined. Ending these credits would be unwise. He was on the losing end of an investment decision, and "we should continue to send a message that we want new investments, we want new players, and as a state we want to be partners." People at the conference wanted more information and he sent them to the State of Alaska booth, which was encouraging companies to come to Alaska, and those efforts should be commended, he said. While working with the state with renewed oil and gas tax incentives, he said, Cook Inlet production will continue to trend upward and will lead to more revenue, more jobs, and enhanced opportunities for CIRI shareholders.

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CHAIR GIESSEL thanked everyone for their participation and attendance.

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#### **ADJOURNMENT**

There being no further business before the committee, the Joint House and Senate Resources meeting was adjourned at 12:53 p.m.