

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

April 12, 2016

9:00 a.m.

MEMBERS PRESENT

Senator Cathy Giessel, Chair
Senator Mia Costello, Vice Chair
Senator John Coghill
Senator Bert Stedman
Senator Peter Micciche
Senator Bill Stoltze
Senator Bill Wielechowski

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

SENATE BILL NO. 130

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

certain well expenditures; repealing the calculation for certain lease gas production tax credits for certain losses and expenditures; relating to limitations for expenditures applicable before January 1, 2011; making conforming amendments; and nontransferable oil and gas production tax credits based on oil production and the providing for an effective date." alternative tax credit for oil and gas exploration; relating to purchase of tax credit

- MOVED CSSB 130(RES) OUT OF COMMITTEE

PREVIOUS COMMITTEE ACTION

BILL: SB 130

SHORT TITLE: TAX;CREDITS;INTEREST;REFUNDS;O & G

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/19/16	(S)	READ THE FIRST TIME - REFERRALS
01/19/16	(S)	RES, FIN
04/04/16	(S)	RES AT 3:30 PM BUTROVICH 205
04/04/16	(S)	Heard & Held
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04/11/16	(S)	MINUTE(RES)
04/12/16	(S)	RES AT 9:00 AM BELTZ 105 (TSBldg)

WITNESS REGISTER

KARA MORIARTY, President and CEO
Alaska Oil and Gas Conservation Association (AOGCC)
Anchorage, Alaska

POSITION STATEMENT: Shared four policy questions in evaluating the sixth tax change in CSSB 130 to the industry in 11 years.

REBECCA LOGAN, General Manager
Alaska Support Industry Alliance
Anchorage, Alaska

POSITION STATEMENT: Opposed SB 130.

SCOTT DAVIS
Alaska Support Industry Alliance
Kenai, Alaska

POSITION STATEMENT: Warned against any further tax burden on the industry relative to SB 130.

KATI CAPOZZI, Communications and Project Manager
Resource Development Council (RDC)
Anchorage, Alaska

POSITION STATEMENT: Opposed CSSB 130(RES).

DOUGLAS SMITH, CEO
Little Red Services
Houston, Texas

POSITION STATEMENT: Related how his company was laying off employees and idling equipment.

BOB HAJDUKOVICH, CEO
Raven Alaska
Anchorage, Alaska

POSITION STATEMENT: Related the impact to his company when Caelus Energy stopped work on the North Slope.

JANAK MAYER, Chairman & Chief Technologist
analytica
Legislative Consultant
Washington, D.C.

POSITION STATEMENT: Provided an impact analysis for CSSB 130 dividing his "high-level" summary into the North Slope versus Cook Inlet and other parts of the state.

CORRI FEIGE, Director
Division of Oil and Gas
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: Provided her general observations about impacts to activity levels related to CSSB 130, as well as how it affects data capture for the NDR.

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

POSITION STATEMENT: Apologized for not being able to stay and offered Mr. Alper to comment on the various versions of SB 130.

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

POSITION STATEMENT: Provided a comparison of the different versions of SB 130.

ACTION NARRATIVE

[9:00:34 AM](#)

CHAIR CATHY GIESSEL called the Senate Resources Standing Committee meeting to order at 9:00 a.m. Present at the call to order were Senators Costello, Coghill, and Chair Giessel.

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

[9:00:46 AM](#)

CHAIR GIESSEL announced consideration of SB 130. She said the purpose of the meeting today is to take public comment on CSSB 130(RES), [version 29-GS2609\W], that was introduced last night. She thanked the administration, Department of Revenue (DOR), and Tax Division Director Alper, for taking the data from all the permutations of the tax credit rebate bills and putting them into a single chart. This CS is a departure from an approach that has been taken before.

[9:02:24 AM](#)

SENATOR STEDMAN joined the meeting.

[9:02:33 AM](#)

KARA MORIARTY, President and CEO, Alaska Oil and Gas Conservation Association (AOGCC), Anchorage, Alaska, said she would share four policy questions as they evaluate the sixth tax change in 11 years in the new CS. She does have the unanimous consent of her diverse group of members to offer these initial thoughts, and from their view, none of the questions have a positive answer.

Will this increase production? Frankly the answer is no, Ms. Moriarty said. This is a significant threat to Cook Inlet production. Dramatically and adversely changing the tax system in the Cook Inlet as proposed in the CS will decrease production of oil and gas in the Inlet. For the North Slope, there will also be a negative impact, especially on smaller fields. Alaska needs every company to be successful, because the state needs increased production from every field and region. This CS will not add more production.

Will this make Alaska more competitive? Many of the proposals that were included in the Governor's bill remain in the Committee Substitute and make it very difficult to attract new investment and companies to Alaska, Ms. Moriarty stated.

[9:04:47 AM](#)

Will it provide predictability? The only thing that seems to be predictable, even with this CS, is that the state will constantly change tax policies regardless of oil price, and regardless of the economic condition of the industry. Ms. Moriarty stated that we hear that everyone has to pay something to solve the state's fiscal crisis. We would ask, what other industry is being asked to pay, or in our case, pay more when the state has clearly demonstrated that industry is losing money?

How will this CS affect Alaska families, businesses and jobs? If you passed this CS in its current form, Ms. Moriarty said, there would be less investment by companies, which will result in less production and job loss. She added that they had heard the passionate pleas from Alaskans who have already suffered from the current economic situation on Saturday. Alaska families, businesses and jobs will continue to be affected in a negative way. How will this CS affect Alaska families, businesses and jobs?

Lastly, will this CS provide stability? Ms. Moriarty said they recognize that many of legislators are looking for ways to fill the state's budget gap and see increasing taxes on the oil industry as part of the solution to create a stable environment for Alaska. But her job is to tell them how the industry will react to those changing policies. Again, she needs more time to evaluate the CS, but for now it is bad for Alaska. It is destined to make the economic situation for the industry even worse, and when the industry suffers, the state suffers too.

[9:06:22 AM](#)

SENATOR COSTELLO thanked her for providing her testimony and asked if the plan is to do a full review of the CS and then submit comments in writing.

MS. MORIARTY answered yes, and they will be listening to testimony from the legislative consultant and department this afternoon.

[9:06:57 AM](#)

SENATOR STEDMAN asked if they opposed a zero severance tax in Cook Inlet going forward.

MS. MORIARTY answered that Cook Inlet doesn't pay a production tax now, and they knew the state would be evaluating that in 2022, but they do receive tax credits to help with the high-cost environment and to encourage investment. If the credits are removed without paying a production tax, that in effect is a tax increase. It changes the companies' economics whether there is a no production tax or not.

SENATOR STEDMAN said he would clarify the question since the CS is still being digested. Everyone wants a stable tax environment. After the credits are phased out in 2019 he asked if AOGA has a position on the zero severance tax structure.

MS. MORIARTY replied that this would take effect on January 1, 2018, so the companies have about 18 months before the dramatic step down in the credits in 2017 and then they completely go away. Especially in this price environment, that will not lead to any increased investment, and drilling will be cut back. Hopefully the legislature's consultant will look at a range of prices, because that is really key in this discussion. Incentivizing investment was the whole point of the credits, because the Cook Inlet Basin has always been a challenging economic environment.

MS. MORIARTY said she talked with both of her Cook Inlet companies this morning and under this proposal even with no production tax if prices stay the same there will be less capital expenditures.

[9:09:54 AM](#)

SENATOR STEDMAN said no one knows what the price will be in FY18 or FY25, and maybe the policy set today will last only through the next winter or the winter of 2030. It depends on how stable the component parts are. If the bill is passed and enacted, in

2025 Cook Inlet wouldn't have a production tax. He didn't know what the price would be, but it could be \$80. He hoped this was an opportunity to have that conversation with her members and maybe get more feedback, because not having a severance tax is a huge policy change for the state.

MS. MORIARTY responded that there has been little to no production tax in Cook Inlet even during the ELF regime, and it was designed that way because the Cook Inlet fields are much smaller and the platforms don't produce as much, but it doesn't mean the state wasn't benefiting. The state has actually been collecting more money from Cook Inlet royalties even without a production tax. So now, they are now focused on how to increase production whether there is a production tax or not.

[9:12:14 AM](#)

REBECCA LOGAN, General Manager, Alaska Support Industry Alliance, Anchorage, Alaska, said the Alliance started this legislative session with two legislative priorities: increase production and pass a sustainable budget. She was disappointed to be here today recognizing that neither of those things will happen. She opposed SB 130. She knew when the \$4.6 billion budget came out on March 15 they would get to a point where they would have to come to the oil industry, because they didn't do their job on the budget.

Their position on this bill has always been to oppose any changes to the current tax structure. During the last weeks her members have very passionately talked about the thousands of people they have laid off. However, they didn't know how many workers the state had laid off and thought it was maybe 75.

[9:13:55 AM](#)

SENATOR STEDMAN commented that it could be argued in any legislative session that they hadn't done their job; it depends on which side of the political aisle you are on or the argument at the time, or if you are rural, or urban, or whatever. But the legislature is made up of a cross section of 60 different people from across the state with different backgrounds. His impression is that very few members and staff members in the building recognized that 4 percent floor was not a hard floor and that credits would swing into it. However, all of the professional folks in the industry understood that. Also, the members were rather surprised at the impact of NOL loss stacking and how it works in conjunction with the floor. And industry has yet to come forward with a discussion on that. But it hasn't been until the last couple of weeks that a lot of people in the

building even realized that such an issue existed. He guessed that one of the pitfalls of rushing any tax legislation through is a lack of understanding of different price environments the state would be facing and it leads to substantial instability. He personally thought that was the root of the issue they are facing.

MS. LOGAN said legislators are elected to make policy calls, and being given the information whether it was surprising or not, they are now in a situation of low oil prices. Everyone in the this building wants to increase production, so the policy call they face with the current tax structure is what to do at low oil prices to not damage the industry. The question is, "Are you going to put more taxes on an industry that is hemorrhaging?"

SCOTT DAVIS, Alaska Support Industry Alliance, business owner, Kenai, Alaska, said the Cook Inlet Recovery Act has positively impacted his community over the last 10 years. They went from brown outs and not enough gas and shutting down the fertilizer and LNG plants to talking about reopening Agrium and exporting LNG. In the last two years, they have watched just from the price of oil the decrease in activity in their community that has negatively impacted all businesses there, including his. He warned against putting any further tax burden on the industry.

He said oil and gas production started on the Kenai Peninsula in the 50s, so they are well used to these market ups and downs. They also heard about the positive effect of a favorable tax structure in listening to the Kenai/Soldotna Chamber of Commerce. Enstar now has a contract to have enough gas to get through the next few years, but it's still in the ground. It still needs investment to be produced.

[9:19:12 AM](#)

KATI CAPOZZI, Communications and Project Manager, Resource Development Council (RDC), Anchorage, Alaska, opposed CSSB 130(RES). She said RDC is a statewide trade association comprised of individuals and companies from Alaska's oil, gas, mining, forest productions, fisheries and tourism industries. They believe the best approach to expand the economy and generate new revenues for the state is to produce more oil, attract more tourists, harvest more fish, and mine more minerals.

She said regarding CSSB 130, raising taxes on companies that are reporting record losses and are in a negative cash flow is not sound fiscal policy. It will not increase production down the

TAPS, nor encourage development of new mines; it won't attract more tourists, and it won't boost investment in the fishing industry.

Higher taxes in this low price commodity environment will likely deter investment that means lower state revenues and a weaker private sector over the long run. Changing the tax structure now will make a bad situation worse.

MS. CAPOZZI said there is good news: several news outlets recently announced an increase in year-over-year oil production during the past 12 months. This is the first increase in throughput since 2002, which is more proof of the current tax regime working. Next year's production needs to be even higher than this year's. The current tax policy brought new exploration, jobs and continued investment to the state and stabilized North Slope production and somewhat shielded Alaska from massive cutbacks that have occurred elsewhere.

She said this bill moves Alaska in the wrong direction. It is the sixth major tax change in 11 years. RDC members are not asking for a tax decrease during this time of low commodity prices, but they do request that as the state considers changes to tax policy, it does no harm to its largest industry.

[9:22:08 AM](#)

SENATOR STEDMAN said it might be beneficial to have DOR do the analysis to see if there has been an increase in oil production and if it helps deal with the "minimum tax trap" the state is in. When he has done that analysis, he found it doesn't help at all. It puts more production down the pipe, but it doesn't help the broader issue that the state is facing financially.

[9:23:37 AM](#)

CHAIR GIESSEL said she would be happy to pose that question although she was puzzled by it, since less production means more engineering issues to solve.

SENATOR STEDMAN clarified that he is not suggesting that declining production benefits the pipe, but from the state's financial perspective what the financial implication is within the tax system of moving barrels of production up. Clearly having additional production is better than no marginal increase, but they need to understand the sensitivity the tax structure is built around. He wouldn't expect to see any benefit from an increase in production from purely a tax position.

CHAIR GIESSEL rephrased the question: if we see increased production of 50,000 barrels a day, what are the implications to the state at different prices: at \$60 and \$80.

SENATOR STEDMAN said he was thinking more of this price range and looking at the trigger on the minimum tax.

CHAIR GIESSEL said that her goal is a longer term vision.

DOUGLAS SMITH, CEO, Little Red Services, Houston, Texas, said they had laid off 35 employees for almost \$4 million in annual payroll and they have idled a number of pieces of equipment. This is the trend in the overall industry and the Anchorage community hadn't seen the full impact of the economics yet. You can't pull this much payroll out of the state and not see significant trickle-down economic impacts. Taking additional taxes by hardening the floor or other proposed changes to the industry will cause an impact.

The longer term implications are that once equipment is idled and employees are laid off, capacity is lost and as oil prices recover, there will be a significant delay in response to the changing market conditions. He urged them to be thoughtful and to think long term. See what can be done to get through the next 12 - 24 months and see if prices do recover and get out of this bind without making any significant changes to the current tax policy. If the new producers who made investments based on the 20 percent reduction at the wellhead are now limited to five years, those long term investment plans are no longer valid. They can control tax and regulatory policies, but they can't control the price of the commodity. Changing tax policy could be seen as a negative to any kind of approach to a gas project.

[9:32:08 AM](#)

BOB HAJDUKOVICH, CEO, Ravn Alaska, Anchorage, Alaska, said they had \$1 million worth of fly-in work to support Caelus Energy operations and were recently impacted when Caelus stopped work on the North Slope. They really need that stable tax policy to be able to move forward.

They also take a global view that businesses like theirs that serve over 100 communities throughout the state with their 75 aircraft are benefited by the exploration and development phases of industry while the state clearly benefits from volume flowing through the pipe. Anything the state can do to keep the exploration and development going is critical now.

CHAIR GIESSEL, finding no further comments, closed public testimony on SB 130 and recessed the meeting until 3:30.

[9:35:25 AM](#)

Recessed from 9:35 a.m. to 3:30 p.m.

[3:30:35 PM](#)

CHAIR GIESSEL called the Senate Resources Committee meeting back to order at 3:30 p.m. Senators Costello, Coghill, Stedman and Chair Giessel were present. Senators Wielechowski, Micciche and Stoltze arrived shortly after. The Chair invited Mr. Mayer to provide an analysis of the Committee Substitute (CS) for SB 130.

JANAK MAYER, Chairman & Chief Technologist, enalytica, Legislative Consultant, Washington, D.C., said he would conduct an impact analysis for CSSB 130 dividing the "high-level" summary into the North Slope versus Cook Inlet and other parts of the state.

[3:35:06 PM](#)

He said for the North Slope, the CS continues the NOL credits' ability to reduce taxes below the 4 percent floor (slide 2) and changes the tax assessment to an annual basis (rather than the approach taken by the original bill to move part of that to a monthly basis).

For "new oil," the ability of NOL \$5/bbl and small producer credits to reduce taxes below the 4 percent gross floor and the annual basis of tax assessment continue. However, key changes are made: removal of the impact of the Gross Value Reduction (GVR) in calculating the NOL to ensure 35 percent support for North Slope spending. At the moment, interaction of these things can create substantially more than 35 percent support for spending on the North Slope in certain circumstances. It also proposes an \$85 million per company cap on refundable credits to protect the state from the major liability that could come from major new developments. It also proposes a five-year time limit on the GVR, which enalytica has concerns about.

[3:37:21 PM](#)

The Cook Inlet provisions reduce all Cook Inlet credits starting January 1, 2017 (slide 3): the well lease expenditure (WLE) credit to 20 percent, qualified capital expenditure (QCE) credit to 10 percent, and the net operating loss (NOL) credit to 15 percent. And then from January 1, 2018 onward, sunsets all credits and exempts Cook Inlet from production tax.

The Middle Earth provisions grandfather existing .025 frontier basin credits until 2022 and phases down the WLE, QCE and NOL credits, but doesn't eliminate them.

General provisions that apply to both the North Slope and Cook Inlet:

- 7 percent quarterly compounded interest on delinquent taxes, but only for three years
- Tighter language for existing liabilities to state from oil and gas production withheld from refundable tax credits
- Alaska hire is linked to credit refund priority, not amount
- Surety bond (\$250K) to protect local creditors

[3:38:23 PM](#)

There is a big difference between Cook Inlet and the North Slope credits (slide 4) Mr. Mayer explained. The majority of refundable credits go to Cook Inlet producers. However, Cook Inlet production generates limited direct revenue for the state. The credits on the North Slope are more limited, but also are a far smaller fraction of total value generated.

[3:39:25 PM](#)

The CS maintains the status quo in terms of not changing either the minimum tax rate or to further harden the floor (the original bill said the NOL could not be used to further reduce tax liability below the 4 percent gross floor). The effective tax rate under ACES could fall to zero, he explained, because capital credits were applied after the gross floor. SB 21, instead, had a similarly progressive tax rate, although slightly lower, the difference being that just below 10 percent effective tax rate legacy production would shift over from the net tax system to the gross tax system, which is highly regressive.

[3:42:02 PM](#)

At ease for technical teleconference difficulties.

[3:45:00 PM](#)

CHAIR GIESSEL called the meeting back to order at 3:45 p.m.

[3:46:14 PM](#)

MR. MAYER said the biggest change for legacy (North Slope) production was proposed in the original bill and is the question of hardening of the floor and a gentle raising of it (slide 5). One credit, the NOL, for legacy production can take one down below the 4 percent gross floor. The CS maintains the status quo in allowing the incumbent legacy producer's tax rate to go below the 4 percent gross floor.

MR. MAYER proceeded to walk through the rationale in thinking about the tradeoffs and why from a policy perspective this might be a sensible call to make. He talked before about the effective tax rates under previous fiscal regimes - under SB 21 and under the proposed bill. The left chart showed a highly progressive tax system under ACES where the tax rate could also come down substantially below what was thought of as the base tax rate of 25 percent, and as prices come down the effective tax rate keeps coming down to zero. The reason that happens is 20 percent capital credits under ACES that act as a progressive component in the system, thus reducing that tax rate down further.

Initially there was also a 4 percent gross floor under the ACES system, but in reality that 20 percent capital credit could bring one below that floor, because it was calculated after the net minimum calculation was done. The impact was that while that 4 percent gross floor existed under statute, in reality it wasn't binding. The choice made under SB 21 was to substantially harden that by saying the dollar-per-barrel credit couldn't take one down below that 4 percent gross floor. So, what one sees from the chart is that production tax under SB 21 or CSSB 130 essentially maintains the status quo. But a sharp inflection point happens where the tax switches over from the net to the gross tax and then suddenly the tax rate rises very steadily. That happens because gross tax is highly regressive and so as prices continue to fall, the gross tax takes up steadily more and more of the net value, until it takes up all of the net value at around \$50, because there is very little net value remaining.

So, in order to think about what happens below those prices, one needs a different way of looking at the data, Mr. Mayer explained. That is on the chart on the right-hand side. Instead of an effective production tax rate, it simply looks at the actual amount of tax paid per taxable barrel produced. One sees the red line of SB 21/CSSB 130 again falling sharply until the point of just below \$80/barrel where the switch from net to gross tax happens with a sudden inflection at which point the production tax per taxable barrel falls at a much shallower rate. Then in the mid-\$40s is where, because there is no longer any profit and in fact companies are actually taking a loss, the eligible flat NOL credit brings the tax paid per taxable barrel down further and down to zero.

Obviously a key change that would have been made by the original bill is both the raising of the floor but also the hardening of

it, meaning the NOL credit can't be taken to reduce against the floor. In thinking about the tradeoffs here, Mr. Mayer said, there are a few things that are important to think about. One is that, by definition, in an environment where a major producer is eligible for a NOL tax credit, it is a company that is already making a cash loss. The question is a substantial one as to whether it is desirable in those circumstances to continue to levy an infinite tax rate against that producer versus allowing the tax steadily to fall away, bearing in mind that companies are still paying large amounts in royalty, and paying well over 100 percent government take on their overall production.

[3:52:29 PM](#)

Secondly, and a bigger point even beyond the raising of taxes in the most difficult environment, it's not clear that the benefit of that hardening is worth the cost in terms of impact to the companies' potential future investments, when you consider that really this is about needing state revenue from the future for the present rather than actually increasing total revenue. That is to say if a company is accruing a net operating loss credit, simply saying that that credit cannot be taken against the floor, means that credit is accrued and its value continues over time. In other words that just means that the credit the company needs to take as a deduction is against future revenue rather than taking it at the moment against their current revenue. For the state it means taking a little bit more in revenue at the moment but correspondingly be taking less in revenue in the future. Those are the real questions to ask about that dynamic.

This also means that as prices rise, those credits still need to be paid out. That creates an environment where prices have risen substantially, but state revenue hasn't accordingly, because it is now effectively paying back that revenue it took from the future to the present, because all the credits built up in the system. The question is about whether the cost of that kind of move is actually worth the benefits.

[3:54:53 PM](#)

SENATOR MICCICHE said that hardening the floor seems like the best decision for the state at this time and it is not intuitive, and asked if companies have the ability to apply their tax liability right now or later.

MR. MAYER answered that ultimately those deductions can be carried forward under Alaska's system. In that sense all the 4 percent gross floor does is to say you have these expenses and you can no longer deduct them this year against your income,

because that would take you below the floor. By doing that, the state is simply pushing those expenses into future years.

[3:58:19 PM](#)

He said one of the other changes proposed under the original bill, though not adopted in the CS, is the question of annual versus monthly tax calculations. Director Alper has talked about this as "migrating credits," but analytica thinks it is much clearer to think about this as annual versus monthly calculations and slide 6 shows how that works. Keeping annual calculation avoids a tax hike. He explained how the gross minimum tax may apply to some months, while the annual calculation remains net profit-based. In his 2014 example, enforcing a monthly gross minimum would have netted the state an additional \$100 million.

[4:00:33 PM](#)

MR. MAYER said some key things in the bill are substantial changes and need addressing; other changes seem to be more "salami slice" revenue-raising tactics that from an investor's perspective, are actually quite chilling, because it's not clear where the incremental raises stop and how there can be any certainty that this really is a solid and unchanging tax system.

[4:01:08 PM](#)

CHAIR GIESSEL explained for clarity, that he articulated on slide 5 that the CS does not harden the floor. It maintains SB 21. And he just said on slide 6 that the CS does not go to monthly tax calculations and maintains the present annual calculation.

MR. MAYER said that was correct.

[4:01:47 PM](#)

He said slide 7 looks at how the changes impact new North Slope development. To do that they looked at a reasonably accurate model of sample North Slope investment (not any particular investment): cumulative CAPEX and DRILEX of \$1.3 billion and average annual OPEX of \$15 billion to produce a total of around 20 million barrels of oil at a peak production rate of 20,000 barrels a day drilled over eight years. This process builds up a realistic cash flow of recent investments.

MR. MAYER explained the first thing was timing of cash flows that include: CAPEX, drilling costs, OPEX, and government take. For the first couple of years in the project the impact of the credits is negative. One sees three years of initial up front

capital spending of close to \$100 million on drilling pads and pipelines facilities before drilling actually begins and several years of ongoing drilling long after production has actually started. This means because there is substantial ongoing spending through those years you can see the government take gets substantially bigger after seven or eight years of production once drilling finally stops. That is where the bulk of government take, but through the net profit tax, actually occurs. Taxes up until that point where sustained drilling is no longer happening are relatively a much smaller piece of the picture. That timing of cash flows is crucial in understanding one of the changes in the CS, which is the question of limiting the timing application of the GVR. Leading to slide 8.

[4:04:53 PM](#)

He explained that the CS places a five-year time limit on the GVR (slide 8), and that can have a major impact on the value of a project such as this one or any North Slope projects that are the status quo of this model (20 percent GVR). The X axis looks at different possible lengths in years of a limit on the currently non-time limited GVR. The Y axis looks at percent of the current value of the project measured in terms of net present value (NPV) over time of all the cash flows and what percent would be taken away by placing some sort of limit in years on the GVR. One sees quite intuitively that as the length of that limit increases, the amount of value that is taken away by having that limit decreases. So, in all these cases, for instance, by the time a 15-year limit on the GVR is reached, it has very little impact on overall project economics. One could do that very easily and not be saying to current producers who have made sanctioned decisions based on GVR economics that a major substantive change is being made.

As the limit in time periods in years get shorter, that impact on the net present value of a project gets much greater and is greatest at low prices, because a project like this is essentially marginal at \$50/barrel oil. So, if one were to eliminate the GVR that is the same as saying there is a zero year limit on the GVR, that actually wipes out all the value of the project at that price. Assuming the \$50 level applies for the entire lifespan of this project, a five-year limit wipes out more than half of the total value of that project. At higher prices, the impact is less, but it is still substantial. For instance, at \$100/barrel they are still talking about 20 percent of the net present value taken off a project by a five-year limit. Whereas a 10-year or greater limit has much reduced impact on the project. The key reason why it's so great at those

short time limits versus the later ones is because the project has substantial drilling costs in the first five years (and isn't paying production tax), and that 5 to 10-year window is actually where a lot of the production tax liability occurs, and therefore, where a lot of the value to the company in a GVR exists. So, Mr. Mayer cautioned against a short limit, because it would have "quite disruptive impacts" in terms of the value of these projects to investors that have already made these decisions.

[4:08:39 PM](#)

SENATOR WIELECHOWSKI asked if he had the NPV for a project at these various prices.

MR. MAYER answered that he could go back to some of his calculations and get those for him. At \$60/barrel for this project under the status quo they are talking about \$50 million net present value (NPV) going up to over \$1 billion north of \$135/barrel.

SENATOR WIELECHOWSKI asked if he used an NPV of \$10.

MR. MAYER answered yes.

SENATOR WIELECHOWSKI asked if he had those numbers broken down at \$60, \$70, \$80, \$90, and \$100/barrel and if the NPV was before the GVR or for the total project value.

MR. MAYER answered this has been a status quo project assuming a 20 percent GVR. So, just over \$55 at \$60/barrel, \$184 at \$70/barrel, \$310 at \$80/barrel, \$556 at \$100/barrel, and just under \$800 at \$120/barrel.

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Slide 9 graphed hardening the floor for new oil subject to the GVR. Mr. Mayer wanted to show total government take over a project life-cycle, both for status quo and under the CS versus under the original bill. The different components are royalty, oil tax, production tax, and state and federal corporate income tax. In almost all cases except when one gets to very low prices, those add up to the black dashed line, which is government take, and that is below the sum of the bars at low oil prices. The production tax is effectively negative at those prices. If one assumes that oil prices for the entire life cycle of this project were \$40, \$50, or \$60/barrel, that means a certain amount is being paid upfront either through the tax system or through reimbursed NOL credits and at the tail-end of

this project, revenues occur through profit-based production tax. At the lowest prices, the value of the credits is greater than the value of the taxes. Once one reaches above \$60 or \$70/barrel world, the value of the subsequent taxes is substantially greater than the value of the credits and gets greater as prices rise.

But even though production taxes are effectively negative to the state below \$50/barrel, Mr. Mayer said, one has to remember that the impact of the other components of this fiscal regime, in particular the substantial and regressive royalty, is such that one can see the design of the status quo system is to give overall government take for new projects between 60 and 55 percent neutral over a very broad price range. But at the lowest prices that government take still starts to rise and gets up to just under 100 percent at \$40/barrel and gets even higher at lower prices. That simply is the effect of the royalty.

So, hardening the floor in terms of what can be deducted against those credits reduces (in the world of the original bill) the stakes to a negative production tax position. In those cases it also means you are simply getting to that regressive portion of the curve driven by the royalty sooner and harder; it's no longer quite as flat and neutral across the broader range of prices as might otherwise be the case. So, at \$40/barrel government takes goes to 130-140 percent.

For new production the aim was to have an overall neutral regime, taking into account the effect both of the production tax and the royalty, and all these components across a wide range of prices. Understand that in terms of not making that change, one is simply saying this is still a regressive system and government take still gets up to 100 percent at current prices, and "we just don't want to take that even further."

[4:14:55 PM](#)

SENATOR WIELECHOWSKI asked if any other states have an even more regressive tax structure at current prices.

MR. MAYER answered there are many; the vast majority of states in the U.S. are a gross tax system. In that sense, places like North Dakota do not look like they were investment environments at current prices in many regards. There is also a balancing act to be performed. Alaska is unique in the U.S., in this context, in having a net profits system. It's a system that could potentially be neutral or progressive and take substantially more of the value at higher prices. One can be

better protected on the down side through the royalty, through parts of the gross minimum tax, than one might be with a pure net profits tax. And one can take more through a net profit tax than one would through a regressive system of royalties and gross severance taxes, but you can't try to do both: be Norway and North Dakota.

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Slide 10 deals with what, for the administration, is a genuine issue that the CS addresses, as the original bill did, the question of the ability of an NOL credit to actually be worth more than 35 percent of an actual loss, because of its interaction with the GVR. The table on slide 10 shows how the calculations work. The core thing to realize is that under SB 21, the status quo, what would otherwise be \$6 dollars in production tax value is assessed as negative \$6/barrel, and at \$40/barrel it is a loss of twice as big as that. Mr. Mayer explained that the reason it is twice as big is "the fiction of reduced revenue that is created to allow a lower tax rate without ring-fencing costs."

MR. MAYER explained that because the statute has the NOL calculated on that inflated loss instead of the 35 percent net credit against an actual NOL, his example has 70 percent support for government spending. The difference comes when the NOL credit is calculated including the effect of the GVR or not and this comes particularly prominent at low oil prices. The difference can be up to \$10 million for his example project, in particular, between the years 8 and 10 when the project is actually making a profit. The difference between those two things is credits are being paid out - the project is actually in positive cash flow status - but once the GVR is assessed, it appears as though it's making a loss. So, the effect of the CS is to say this doesn't seem like what was intended under SB 21 and addresses that.

CHAIR GIESSEL said she thought she saw a typographical error. Looking at the chart of numbers on the left hand side he has SB 21 GVR and the next column says HB 247.

MR. MAYER apologized for the error and said those should be the original SB 130 as well as CSSB 130.

He continued that slide 11 concerned the refund limits. The key thing to understand is that any sort of binding refund-ability limit tighter than the amounts actually being claimed by companies has an impact in terms of the amount of capital those

companies need to build a project and on rates of return they receive. The chart on the left looks at cumulative cash flow over time for a \$1.3 billion project, but it probably only takes \$300-\$400 million to build. This is due to a combination of things: one being that many of drilling costs are incurred after the start of production. So, all that the project needs is to get to a point where the cumulative cash flow is at its lowest level and from that point forward, this project is self-sustaining. So, the difference between the two lines in the graph was the question of how much of the NOL tax credit can be refunded. To the extent that it is paid out by the treasury means that substantially less capital is required by these companies to build a project.

So, if a company goes into a project like this looking at the letter of law as it stands now thinking it can be built for \$350 million, the original bill has a \$25 million limit, assuming this project is being built by a company with no other projects claiming an NOL credit, that probably increases the amount of capital required to somewhere over \$400 million.

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Several companies one can think of now have other projects in their portfolios that are also in NOL territory still. For a company like that the impact could be in many cases actually close to \$500-550 million of total capital required to build this project. So, the key here is the impact on projects that have already been sanctioned and are currently under way, where if one were to place a strict limit particularly as the original bill did, in the middle of this year, they are essentially saying to these companies you thought you needed \$350 million and you now need 50 percent more than that, and also by the way your internal rate of return (IRR) has gone substantially down (chart on the right of slide 11). They have to tell that to their financiers, and that will not be an easy conversation.

On the other hand, Mr. Mayer explained, protecting the state against potential credit outlays is a valid action. And the question remains what a near Kuparuk-sized new development could look like and that could mean more than \$2 billion in credits over the three or four years of development before the start of production. It still is a hard argument to ask for more money.

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MR. MAYER said the question is if \$85 million could work for companies that have already started their projects or whether that starts to seriously challenge their current capital plans.

If it does, the question becomes is the difference between \$85 million and of \$100 million worth the impact of that investment or not. It makes a lot of sense as a limit in terms of trying to protect the state against the environment where there are multiple hundreds of millions of dollars a year to a single company for a major new development on the scale that hasn't been seen recently.

[4:25:02 PM](#)

Slide 12 considered Cook Inlet changes and their impacts. There are currently three credits in Cook Inlet: the 25 percent NOL credit for carried-forward annual loss, stackable with either, the 20 percent QCE credit for all qualified capital lease expenditures, or the 40 percent WLE credit for well-related capital lease expenditures.

MR. MAYER said the 25 percent NOL credits for Cook Inlet are very different than the operating loss credits on the North Slope, because there is no corresponding production tax on oil and only a very small production tax on gas in Cook Inlet. In addition, that can be stacked with either a 20 percent qualified capital spending credit or suspending well-related, intangible, drilling costs up to 40 percent credit, and if one is eligible for the NOL credit with minimal to no taxes.

Under the CS those numbers would be roughly halved down to 15, 10, and 20 percent respectively in 2017 and sunset from 2018 onwards and there would be no production tax in Cook Inlet from 2018 onwards. There would be a shift to a low government-take, free market approach that says we're not going to look to this as a source of tax revenue and it is not the place for the very substantial subsidies that have occurred so far.

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MR. MAYER said the high level impacts of those things, particularly for ongoing drilling in mature fields and new projects where very substantial additional demand over and above what exists in Cook Inlet at the moment, could still work in the Cook Inlet with no credits at all. The one crucial question where no taxes can be seen as an attractive regime is if it is generally seen by players in the market as durable. So far, one of the key rolls of the credits, particularly in recent years, is to say people don't really know what the future of this regime looks like from 2017, and from 2018 onwards things start to look blurry, but at least there are credits. So the payback times are very short. For a regime with no credits but also no taxes that can be a very good regime, but it needs to be seen as

lasting for the next decade and well beyond. If that isn't the case, the conclusions around attractiveness start to look very different.

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SENATOR STEDMAN said the "free market approach" was "kind of a twist," because a free market lacks a lot of government intervention and he didn't see how a zero tax definition could be a free market approach.

MR. MAYER responded, "All of these things are relative." The current approach in Cook Inlet is one of very strong state intervention through a high level of subsidy of investment.

In terms of achieving the state's aims there, there are a number of tools it can use. One is the fiscal lever which the state leans most heavily on at the moment; another is the question of prices which are high and fairly regulated at the moment, and the third is the question of effective market regulation to try to create a more competitive market (probably the most neglected).

The approach of the CS says from 2018 onwards the consent decree goes away, no major spending, no major subsidy, but also this isn't going to be a major source of tax revenue. In that sense, it's a fiscal system that looks not unlike large parts of the federal offshore, which also has a low fixed royalty which doles revenues to the state that are seen as highly attractive fiscal regimes, because they have a low level of overall government take.

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SENATOR WIELECHOWSKI said Cook Inlet had low taxes for years at very low prices of \$1 to \$3 and very little subsidies, and a huge amount of gas, but in the late 90s the situation changed. Then the state started doing more subsidies in the form of tax credits while the tax remained at zero. He asked if Mr. Mayer had ever done an analysis to figure out what really impacted Cook Inlet: the prices, which are among the highest in the country, or the subsidies?

MR. MAYER answered analytica had looked at the available historical data last week and presented more detailed versions of that to other committees, but broadly speaking, they concluded a lot of things were happening at the same time in Cook Inlet over the last 5 to 10 years. On one hand, there was the natural evolution of the basis; one or two established

players focused on the area back in the day and now after many years of steady decline, no longer a material basin for them and for whom an exit at some point was going to be natural. Relative to the Lower 48 there were some of the lowest gas prices in the country at the time when the Henry Hub was at an all-time high, very different than at the moment. He thought the natural cycle of both bringing in new companies that were interested in rejuvenating the basin combined with a move to higher pricing was always going to have some substantial effect. And a lot of the effect they have seen has to do with those two things.

Now clearly at the time there was a great deal of concern about where the situation was headed and throwing credits into the mix substantially accelerated that transition. It made it much easier to bring in the companies that eventually came to achieve a lot of that turnaround. It is very difficult to pick apart how much of that was due to the credits and how much was due to the fundamental changes going on in the basin. One has to conclude it's about all these things in combination, and when one looks purely at the economics for things like ongoing drilling in the mature fields, it's hard to see that, particularly at these prices in Cook Inlet, that it is not a desirable activity to continue even without credits.

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MR. MAYER said slide 13 presented three models of hypothetical projects based on assumptions around real things they have seen in the last couple of years in the Cook Inlet. The first scenario was a market constrained one: a completely new development - though not additional drilling in mature fields - but for the sorts of things seen recently like new resources trying to be brought to market with old gas projects. The reason they are looking particularly at gas projects is that they want to understand what is involved in achieving security of gas supply in Cook Inlet on an ongoing basis if the idea is to have that degree of support

He said the big challenge for a project like this is to say this is really a project that is sized to produce much more gas - over 100 mmcf/day - and so one is spending hundreds of millions of dollars on facilities, pipeline, platforms, and all the rest (and one has seen these sorts of amounts of cash to produce in a facility with that sort of capacity in at least one place in the Cook Inlet). But in facing a fundamentally constrained market, that means there is only a very small wedge of incremental demand that can be supplied, and the economics of a project like that look enormously challenged. And they look enormously

challenged even with the very generous 45 to 65 percent support credits that have existed in the Cook Inlet so far. The project in this model drills only a handful of wells over the course of a decade starting off producing about 18 mmcf/day of gas, getting up to maybe 40 mmcf/day well into the next decade. Having made that big upfront investment makes the economics very strained.

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MR. MAYER explained that the status quo for a project like this in Cook Inlet on slide 14 means that because of the big amount of cash the state is providing, if they look at net present values across a wide range of prices from \$5 to \$10/mcf, the state is net negative in all of those environments. The company is maybe just positive sort of above \$7/mcf and there are rates of return (ROR) that might be just bearable, but don't look very attractive, and one sees the lowest of government takes of anywhere in the world in around the 40 percent range.

Under SB 130 in its original form that change is substantially where there is only the 25 percent NOL credit and none of the qualified capital or well lease expenditure credits. There is substantially higher government take, a situation where the state may be net negative, but at least at higher prices is possibly net positive. So, the overall risk equation between the company and the state seems a little better balanced, though of course, the project is that much further challenged in terms of ROR and whether it is actually a favorable project to produce at these prices.

MR. MAYER explained that the cost assumptions he is using are based on projects they have seen recently in the area, though undertaken at a time when worldwide competition for resources meant the costs were very high, and those costs are coming down to a point that it might be feasible to start to think about undertaking a project like this in a way that these figures don't accurately capture. What they see at the moment is that under the cost structure that has existed until now, projects like this are very challenged even with the credits. What the credits meant was that the state was in a strongly negative position and they made something like this maybe just bearable to do.

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Slide 15 showed the results if instead there were an unconstrained demand environment, a very different situation from what exists in Cook Inlet today, but one that has a

substantial export customer, for instance, or another major source of demand that doesn't exist at the moment. The economics of a project like this would look very different, and fundamentally it's this rather than anything else that determines whether a project like this can really work. This project has exactly the same initial facilities capital investment, but an optimal drilling program that instead of drilling just four wells over the course of a decade, drills around three wells a year for the first three years and then a lower level of drilling every year after to maintain the plateau. In the case of around 140 mmcf/day of gas the cash flows look much more like what one might expect from this sort of gas project and much healthier economics as a result.

The graph on slide 16 represented a status quo company, an SB 130 NOL only company and a CSSB 130 no credits company. In the first company, the federal government and the state are all in positive territory, although the state is by far the worse off of the three, because of the very low level of government take (50 percent) and quite attractive ROR. The relative position of the state under SB 130 or the CS improves substantially and the position of the company deteriorates substantially, but in terms of internal ROR even in an environment with no credits it seems possible, particularly if one could reduce some of the costs, that projects like this could go ahead if they just had access to the end gas market that they need. Constrained demand is overwhelmingly the problem for a project like this and not the credits, particularly if some of the producers that might be capable of additional projects like this at the moment can get their existing investments to a point of self-sustainability on a cash flow front.

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MR. MAYER said slide 17 looks at the question of ongoing drilling in mature fields assuming similar drilling costs to the first constrained example and similarly drilling for the four wells over the period of a decade. There is less well productivity, because they are drilling in mature fields, but looking at what the cash flow economics look like. The big difference here is that no big facilities need to be built to enable the work to occur.

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Slide 18 has two columns, because the original SB 130 and the CS fundamentally look the same: under the original bill the only credit was the NOL credit and companies that have mature existing fields producing are by and large not eligible for that

and so the impact looks the same on them as the governor's original bill did. One sees very high internal ROR for investments in mature fields under the status quo with a high level of state support. If one thought this was a stable regime that would continue well into the future, with no production tax and no credits, it still looks very attractive in terms of undertaking this work on an ongoing basis provided one genuinely believes that it is a stable regime that isn't going to change in the future.

MR. MAYER said that concluded his analysis.

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SENATOR WIELECHOWSKI asked him to put together a chart that has the investment metrics: government take and internal investor ROR, for the GVR.

MR. MAYER replied that he would.

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CORRI FEIGE, Director, Division of Oil and Gas, Department of Natural Resources (DNR), Anchorage, Alaska, said she would make some general observations about impacts to activity levels she could perceive through the CS as well as look at data capture to the NDR. She said the CS takes a step forward in trying to find a reasonable balance between the state outlay against trying to maintain a healthy investment climate, which will support continued exploration and development activities in the state.

MS. FEIGE said that DNR deals with this type of legislation in two ways: first and most directly is through the data that is captured by DNR through the existing credit program and exploration incentive credits, and secondly would be simply through activity level and the pace at which oil and gas exploration and development work is taking place in the state. To look first at credit data with the roll back and the phase out of all of the - especially in Cook Inlet - credits (NOL, QCE, WLE) and the coinciding sunset of the exploration incentive credits, would roll up into a net impact to DNR of just simply not having as much data available that would go public.

She said she had spoken at length previously about the seismic data and some of the expanded downhole data sets that become available for public distribution through some of the incentive credit programs. All of that being said, the division would still be able to capture all the data it needs to continue doing its job. Well data would be able to be made public in a

continuing fashion as it is done now through the Alaska Oil and Gas Conservation Commission (AOGCC).

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On the topic of activity levels around the state, she said Cook Inlet with the phase out of the credits and reduction of the other credits to zero and the removal of all production taxes is an interesting thing to contemplate. She agreed with analytica that in the long term a significant downturn would not be seen, but in the near term, especially with those projects that are currently in active drilling and development phases - most notably BlueCrest at the Cosmo development and Furie at the Kitchen Lights Unit - they would see a time period over the next couple of years where those companies work very diligently to do as much as they can while the other Cook Inlet credits still exist. Then there would be a retooling period with their financing. Those kinds of changes clearly would be material to their financing moving forward. Both of those companies are working now at securing their finance for the next two to three of their activities. She would expect to hear from them about amendments to the pace of that activity through their plans of operation and development for those specific units.

Over the long haul, Ms. Feige said, that zero production tax really does try to balance Cook Inlet against the North Slope in terms of state outlay and recognizes that Cook Inlet is a different market. It is the source of energy for the majority of the population in Alaska.

Looking at other areas of the state - Middle Earth, for example - with the reduction in support level that the CS provides, she would expect to see a slowdown in activity levels. Although exploration success in the activities they will see in the next year could be a game changer. With that comes the ability to find capital and find additional partners. She didn't think the slowdown would be catastrophic.

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She said she was glad analytica took the time to walk through the phase out of the GVR over five years, because DNR would "absolutely concur" that the five years even out to 10 years would be too short. Fifteen would have nearly no impact to the value of the project, and that is important especially in terms of keeping ongoing very large developments coming down the pipe on the North Slope moving ahead.

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MS. FEIGE said DNR has concerns with the type of bonding in section 44 of the new CS being placed in a bill like this. DNR bonds regularly for impacts from activities that are associated with the oil and gas exploration and development work, but for the state to step in and tie up capital in what may or may not be an accurate number at the \$250,000, raises some questions. They wonder about the mechanics of how that program might work. In some discussions around the table and with bankruptcy attorneys the take away was there were probably better vehicles through workman liens and other means that small party contractors could protect themselves more effectively. The state could build stronger protections through expanding statutory liens rather than through a bond program associated with tax credit refunds.

SENATOR WIELECHOWSKI asked if DNR supports removal of hardening the floor.

MS. FEIGE replied they didn't discuss that specifically; they paid more attention to what DNR's interaction with this type of legislation is. They very much applaud the balance the CS attempts to take.

SENATOR WIELECHOWSKI asked if she speaks for the Walker administration and if DNR supports the CS as it stands.

MS. FEIGE answered that she can only speak for herself, personally, and not Commissioner Rutherford and she felt the CS is taking a step in the right direction.

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SENATOR MICCICHE asked if the change is from people who are borrowing on a guarantee of state credit to folks that require a lot more access to capital or other sources of security and how the removal of credits wouldn't result in a downturn during that vulnerable stage of exploration and development.

MS. FEIGE replied that she anticipates a retooling period and that as the credits phase themselves to zero, they will probably see a flurry of activities while they still exist. In that two-year period they would see a lot of activity on the financing front, knowing that as they move forward there will be a zero tax regime on the backside. She sees a slowdown in activity while the retooling takes place, and that would impact the smaller companies more and those that have less depth of capital, but she also thought that smaller companies would join forces to pool capital on good looking prospects.

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SENATOR WIELECHOWSKI asked if she expected the amount the state has to pay out in credits in the next few years to increase in Cook Inlet.

MS. FEIGE answered if companies are actively drilling, it stands to reason that they will do as much in the two remaining years as they possibly could. However, with the levels at which the credits are stepping down, essentially being halved over the next couple of years, the net outcome given what is drill-ready today, in Cook Inlet would be about a draw, if not a little less in their projection.

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SENATOR WIELECHOWSKI asked if she supported removal of the confidentiality provisions.

MS. FEIGE replied that DNR does not deal with those confidentiality provisions and she has no position on that.

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RANDALL HOFFBECK, Commissioner, Department of Revenue (DOR), Anchorage, Alaska, said he had to get to another meeting and that Mr. Alper would provide a comparison of the tax credit bills.

KEN ALPER, Director, Tax Division* Department of Revenue (DOR), Anchorage, Alaska, said he had a side-by-side comparison and a granular fiscal note table with different line item components. He also would provide the current version of the companion bill that is in the other body. Mr. Alper said he saw this bill last night and today he embarked upon a modeling exercise to come up with fiscal note numbers. Frankly, he expected the totals to be larger than what was in the bottom line number. The FY18 impact is about \$55 million and perhaps \$80 million in FY19.

MR. ALPER said it was an effort to keep the four bill versions straight and in many ways the most straight forward comparison is the House Resources CS that had two major changes to current law: the ramp down to a lesser extent of the Cook Inlet tax credits as well as resolving the GVR net operating loss (NOL) interaction that Mr. Mayer talked about on the North Slope.

Going forward from that point the Senate Resources CS has a more aggressive Cook Inlet credit reduction with the taxes and credits all going to zero in 2018. Then "the graduation" of the

new oil to become old oil after five years of production. The fiscal note (line 6) has it showing up as incremental revenue beginning in FY21 when the first of the fields that are currently enjoying the GVR on the North Slope will start to pay taxes effectively at the full rate. Compared to the Resources version that has the stepped down Cook Inlet credits, the full removal of Cook Inlet credits doesn't actually show up in the fiscal note until FY20. It seems counterintuitive, but there is a natural time lag between company spending and the state spending.

He explained that the repeal of all these credits that are based effectively on companies spending money or showing an operating loss in calendar year 2018 doesn't really get applied for to the state until that company files its 2018 taxes for which the true up payment is due in late March of 2019. By the time his staff reviews those applications - it is about 120 day turnaround - and issues credit certificates it would be July 2019. They get refunded within several weeks of that point. Once they are in July 2019, it's really an FY20 expenditure for the great bulk of the credits that might be earned by spending money in calendar year 2018.

Unfortunately, Mr. Alper said, the side-by-side document on the screen was provided based on an earlier version of the bill. He used the metric on the bottom for the fiscal impact in FY19 and FY18 whereas the CS really kicks in in FY20. So there is a dramatically larger impact in the FY 20/21 columns compared to the House Resources version.

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Starting from there the main changes from the House Finance version is the hardened floor. They did the 2 percent hardening of the floor against many credits including the NOL. That change alone is worth about \$100 million in incremental revenue that is to a certain extent just a delay. When you increase the minimum tax payments without allowing the NOLs to be used against them means you are increasing the NOL carry forward, which aren't being reduced by offsetting a tax. Instead they carry forward to a future year where they will be offsetting a tax.

MR. ALPER explained that the idea of a carried forward NOL for nonrefundable NOLs from major producers is a relatively new phenomenon. It was not part of their prior analysis and it was not seen in material amounts until they had already produced the spring revenue forecast in the later part of March, about three weeks ago. It is a new thing and they are endeavoring to keep it

as a tracked number on all the comparison analysis with this bill, because every one of them in addition to affecting the state's revenue is also affecting the state's future liability for the carry forward credits. It is an important metric.

MR. ALPER also adjusted a statement by Mr. Mayer when he said that the hardening of the floor moves all of that liability to the future; he would say it moves most of it to the future. Some of the incremental revenue from hardening the minimum tax was related to the new oil that currently gets the GVR, and that \$5/barrel credit can be used to reduce taxes below the minimum tax to zero. Bringing that oil under the minimum tax is true revenue and not deferred revenue through future NOLs. These are the great bulk of the dollar containing provisions of the CS before them.

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Some of the secondary provisions that are important are the 7 percent interest rate for three years and then no interest beyond that. He has watched that language evolve as the bill has been in various committees and he appreciates the concern about audit delays which the department is working on correcting. By next year it should be better. He also understood the desire to ramp down interest in some way, and that makes sense after a fixed period of time. The House Finance version reverts to simple interest after a number of years and this version reverts to no interest.

He wanted to clarify that there might be a concern because of the way the effective dates work. Right now there are very low interest rates. There is a 3 percent rate in current statute and as this bill kicks in, there is some concern that that 3 percent interest will drop down to zero on the three-year old audits immediately and there won't be any period of the higher interest. However, that could be fixed through transition language.

[5:08:20 PM](#)

He raised another question regarding inconsistencies in the presentation and what he saw in the actual bill and the draft version of the side-by-side the chair put on the table last night. The extension of the Middle Earth exploration credits references the year 2022 and that is the year in which the Middle Earth traditional exploration credit has already been extended to through prior legislative action. Whereas those credits are sunseting in the rest of the state: Cook Inlet and the North Slope this July. What is in the physical language of

the bill is an extension of the frontier basin super credit, the 80 percent credit, and that is not a long term extension. It is a very limited extension of a well that is in progress that has been spudded by July 1 of this year. The way the bill is written, section 25 says the rest of that well can be completed and still enjoy the full 80 percent credit, but there is no language extending the frontier basin-specific credits to 2022 right now and he wanted to make sure that was the intent.

CHAIR GIESSEL responded that the intent was there would be no new entrants into that tax credit.

MR. ALPER said it is a major policy decision to go to zero tax long term in Cook Inlet, and the degree to which industry will treat that as a durable tax has an impact on the degree to which it's going to be valuable in encouraging and incentivizing behavior.

He said they should be aware that the state has revenue from Cook Inlet built into its forecast. It's not large, but it is an increasing number. If the oil tax, which is tied to the economic limit factor (ELF) is zero, but the gas tax is \$.17 for around 100 bcf/year with the utility demand in Anchorage being in the 80-90 bcf range and some small amount still exported, that tax represents about \$17 million in revenue. However, the state doesn't get that much, because most of that production is currently eligible to receive the small producer credit.

MR. ALPER said they should be aware that, because of the slow sunset of the small producer credit beginning in a year or so, Cook Inlet gas revenue will be seen under current law, at a number ramping up towards about \$17 million, as the small producer credit falls away and then finally, in 2022, he estimates \$100-125 million in oil and gas production tax revenue from Cook Inlet. That number is probably unrealistically high, because it refers to the underlying tax regime (the 35 percent net tax without any per barrel or per mcf credits). Were there to be a tax system that worked its way through a future legislature, it would probably come in somewhere between zero and \$125 million, but in analyzing this bill long term, he had to take that \$125 million off the board in the distant out-years because of the zero tax.

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Another possible unforeseen circumstance tied to the Cook Inlet gas cap is the language in AS 43.55.011(o), the so-called gas used in state (GUIS) tax cap, which is at the same rate. That is

being repealed along with the Cook Inlet caps. That will impact certain gas that is sold commercially on the North Slope (gas sold to TAPS for pump stations and operations and gas that is used within the utility systems in Barrow, which has utility gas). The gas that is actually used in field is tax free and that is a specific exemption in statute, not a problem, but the gas that is sold will likely have some sort of tax impact that he was not able to model in the time allowed. That is in the fiscal note indeterminate line.

MR. ALPER said the North Slope gas tax system is not fully developed. SB 21 was written around oil and the 35 percent rate is the rate on everything that goes to a 13 percent gross tax on gas in 2022, a provision in SB 138 (the AKLNG bill), but they might need to contemplate what the treatment of that gas used in state might be between now and 2022.

[5:13:28 PM](#)

SENATOR WIELECHOWSKI asked if the Governor supports this version.

MR. ALPER said he wouldn't guess; Governor Walker's official position is that he supports the original version of the bill as he introduced it.

CHAIR GIESSEL stated that at 5:30 yesterday she and other Senate leadership met with the Governor and presented the bill to him.

[5:14:49 PM](#)

SENATOR WIELECHOWSKI asked if it's fair to observe that by removing the hardening of the floor and the fact that there are no significant credits being taken by the "big three," that the major producers on the North Slope are "left virtually unscathed" by this version of the legislation.

MR. ALPER responded that he tried to break out the impact of the bill at various segments in previous presentations. The major producers for the most part are out of Cook Inlet now. So, obviously the Cook Inlet changes are relatively insignificant to them. The North Slope changes are tied primarily to new oil (the GVR and the NOL issue) and now the sunset of the GVR. So, it is fair to say that the legacy producers and the currently producing major fields are not substantially impacted by any of the changes in the bill as it stands in this CS.

[5:15:51 PM](#)

SENATOR STOLTZE asked what Mr. Alper would advise the governor: this bill, HB 247 or no bill.

MR. ALPER replied that he hadn't thought that question through. He knows the Governor wants a bill and sees the need for credit reform. Either of the bills is an improvement over the status quo, both in the fact that it helps the state's fiscal picture, although to a far smaller degree than he originally proposed, as well as several of the technical issues and concerns with how SB 21 was performing due to the unforeseen circumstance of low prices. Those have been surviving in all the various versions of the bill and it would be unfortunate if those were lost outright, which would happen if there was no bill.

He said the biggest "X factor" that has entered the conversation since the bill was introduced is the idea of rolling forward of the major producers' NOLs. The department is still digesting the meaning of it and is not comfortable knowing about the \$677 million in future liability when effectively the state will not be receiving taxes, even after the price of oil goes up. They just don't know how to handle that at this point.

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SENATOR COSTELLO said the fiscal note says it does not include the revenue impacts from potential changes in investment, and she was curious if that means that the opportunity costs have not been considered in his presentation.

MR. ALPER answered to a certain extent that is disclaimer language, but she is correct. He is saying whatever he thought was going to happen - this company was going to spend this many dollars on this project - and that being built into their various forecasts, this is how the bill impacts their treatment of money related to those projects. If someone decides to do something that they were otherwise not going to do or the reverse, that is not captured in the analysis before them.

SENATOR COSTELLO asked if he anticipates being able to capture that.

MR. ALPER replied that that economic analysis is beyond their skills; companies might choose to do different things. Once the bill reaches its final stage, every company has to go through its own internal analysis. Sometimes those analyses are driven by straight up and down economics and sometimes there are other factors that he couldn't forecast.

[5:20:10 PM](#)

SENATOR WIELECHOWSKI asked if the tax and credit numbers for FY17/18 will change substantially with passage of this bill.

MR. ALPER answered because the bill doesn't touch upon the minimum tax issues, up until FY22 there is not a material amount on the revenue side. The small amounts of revenue that are tied to the minimum tax that is reduced by operating losses nearly to zero remains the story going forward. Should the price of oil be what is in the spring forecast, the state would not get more than \$15-20 million in production tax a year for several years. The credit spend is going to go down primarily because of the Cook Inlet reductions. While it's unfortunate that \$404 million happened in FY15, the state is seeing both the ramping down of company behavior and a couple of companies leaving the inlet.

He explained that the FY15 spend was really tied to money spent in 2013. To a certain extent they are closing the barn door after the horse has left. Should companies do the investments they have said they may do - the BlueCrest and Furies in Cook Inlet are the most obvious ones - the status quo analysis would see a much larger credit number. If someone spends an extra half billion dollars that's going to result in a 50 percent state credit support, that's \$250 million in credits. Until that sanction it doesn't show up in their forecast. The further they get into the future the status quo looks smaller even though they know it is really going to get bigger as it gets closer to the present. So, there is a tendency to "low-ball" the fiscal impact of a bill like this.

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SENATOR WIELECHOWSKI said most of the effective dates are set at July 1, 2016, and the testimony the commissioner gave several meetings ago was that there was a concern that if you kept the credits going until next January companies would act rationally and go out and try to spend as much as they can to take advantage of the credits. He asked if that effective date applies to Cook Inlet in the original bill, because the bill now is pushing out the credits until 2017, and he said they will impact the state through 2020. He didn't completely understand that, but he also wanted to know if he worries about a flurry of activity in Cook Inlet, although Director Feige said she didn't expect much impact on the tax credits. He didn't see how that is possible. He asked Mr. Alper his take on that situation.

MR. ALPER replied that the fiscal note for the earlier version had a very large savings in FY17, in part due to the July 1

effective date. When they looked a little deeper into that they realized to a certain extent because those large numbers were tied to the \$25 million repurchase cap that is in the so-called .028 fund, it's not about earning credits. There was a little bit of internal confusion, because a lot of the very large credits that have already been earned in calendar year 15 were falling off the table by not being paid in FY17. It was never their intent to not pay those. The Governor's original bill had a \$900 million fund capitalization fiscal note attached to it. It might still be attached to this bill. The idea was to make sure there is adequate money to spend before obligation of what is on the table now. So, the intent of the original bill was to say we're not going to earn credits and pay them based on having been earned after the effective date. That is a big difference when it comes down to 2015, which was a very large spending year and is behind us now.

He believed what Director Feige was saying is that dramatically reducing the credits beginning in January 2017 won't drive that much activity compared to the 50 percent that is being provided now. It's almost impossible for people to add more work between now and the end of this calendar year, because their work plans are already pinned down. There might be a little bit of an increase next year, but the fiscal impact of that at the reduced 25 percent level of total support would be less on the state than current law, which if we got twice as much work at half the credit level would be a net zero. No real impact is felt until the 2018 spend, and based on earlier testimony that doesn't actually affect the budget until 2020.

[5:26:46 PM](#)

CHAIR GIESSEL thanked Mr. Alper for his testimony and noted her office had received no amendments.

SENATOR COSTELLO moved to report CSSB 130 (RES), version 29-GS2609\W, from committee with individual recommendations and attached fiscal note. There were no objections and it was so ordered.

CHAIR GIESSEL said oil and gas has changed the State of Alaska. Five of the committee members out of the seven were actually born in Alaska and know the positive impact the oil and gas industry has had on the state. These tax credits are an example of partnership; they are also a way of incentivizing activity just like going to a store and having a coupon for a product. Often using those coupons establishes faithful loyal customers who keep coming back and buying the product: the same idea with

the state's tax credits. Their goal was to establish loyal customers that would continue to work here, and the state has reaped tens of billions of dollars in revenue that has built roads, schools and all kinds of infrastructure. But this precipitous drop in oil prices is devastating, not just to companies but to the state, too. Probably the most hurtful thing is that jobs are being lost. She said it is hard for her to offer a bill like this knowing what it will do to this resource development. Still she is was hopeful and encouraged everyone that there is a future here. The state has "massive resources" that have not yet been developed. This will turn around and it's important to have discipline, patience, and a long-term vision.

[5:31:33 PM](#)

SENATOR MICCICHE said he appreciated the work the chair and the committee had done on this legislation and he would see it in the Finance Committee. If members had concerns he invited them to feel free to discuss them with him.

[CSSB 130(RES) was reported from committee.]

[5:32:06 PM](#)

CHAIR GIESSEL adjourned the Senate Resources Committee meeting at 5:35 p.m.