ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE
February 24, 2017
1:01 p.m.

MEMBERS PRESENT

Representative Andy Josephson, Co-Chair
Representative Geran Tarr, Co-Chair
Representative Dean Westlake, Vice Chair
Representative Harriet Drummond
Representative Justin Parish
Representative Chris Birch
Representative DeLena Johnson
Representative David Talerico

MEMBERS ABSENT

Representative George Rauscher
Representative Mike Chenault (alternate)
Representative Chris Tuck (alternate)

COMMITTEE CALENDAR

HOUSE BILL NO. 111
"An Act relating to the oil and gas production tax, tax payments, and credits; relating to interest applicable to delinquent oil and gas production tax; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 111
SHORT TITLE: OIL & GAS PRODUCTION TAX;PAYMENTS;CREDITS
SPONSOR(s): RESOURCES

02/08/17	(H)	READ THE FIRST TIME - REFERRALS
02/08/17	(H)	RES, FIN
02/08/17	(H)	TALERICO OBJECTED TO INTRODUCTION
02/08/17	(H)	INTRODUCTION RULED IN ORDER
02/08/17	(H)	SUSTAINED RULING OF CHAIR Y23 N15 E2
02/08/17	(H)	RES AT 1:00 PM BARNES 124
02/08/17	(H)	Heard & Held
02/08/17	(H)	MINUTE(RES)
02/13/17	(H)	RES AT 1:00 PM BARNES 124

02/13/17	(H)	Heard & Held
02/13/17	(H)	MINUTE(RES)
02/17/17	(H)	RES AT 1:00 PM BARNES 124
02/17/17	(H)	Heard & Held
02/17/17	(H)	MINUTE(RES)
02/20/17	(H)	RES AT 1:00 PM BARNES 124
02/20/17	(H)	Heard & Held
02/20/17	(H)	MINUTE(RES)
02/22/17	(H)	RES AT 1:00 PM BARNES 124
02/22/17	(H)	Heard & Held
02/22/17	(H)	MINUTE(RES)
02/22/17	(H)	RES AT 6:30 PM BARNES 124
02/22/17	(H)	Heard & Held
02/22/17	(H)	MINUTE(RES)
02/24/17	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

SCOTT JEPSEN, Vice President
External Affairs and Transportation
ConocoPhillips Alaska, Inc.
Anchorage, Alaska
POSITION STATEMENT: During the hearing of HB 111, provided a PowerPoint presentation entitled, "House Resources Committee," dated 2/24/17, testified in opposition, and answered questions.

PAUL RUSCH, Vice President
Finance
ConocoPhillips Alaska, Inc.
Anchorage, Alaska
POSITION STATEMENT: During the hearing of HB 111, participated in the PowerPoint presentation by ConocoPhillips Alaska, Inc., testified in opposition, and answered questions.

DAN SECKERS, Tax Counsel
ExxonMobil Corporation
Anchorage, Alaska
POSITION STATEMENT: During the hearing of HB 111, testified in opposition and answered questions.

PAT GALVIN, Chief Commercial Officer/General Counsel
Great Bear Petroleum
Anchorage, Alaska
POSITION STATEMENT: During the hearing of HB 111, provided a PowerPoint presentation entitled, "HB 111," dated 2/24/17, testified in opposition, and answered questions.

ACTION NARRATIVE

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CO-CHAIR GERAN TARR called the House Resources Standing Committee meeting to order at 1:01 p.m. Representatives Tarr, Parish, Drummond, Johnson, Westlake, and Josephson were present at the call to order. Representatives Talerico and Birch arrived as the meeting was in progress.

HB 111-OIL & GAS PRODUCTION TAX;PAYMENTS;CREDITS

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CO-CHAIR TARR announced that the only order of business would be HOUSE BILL NO. 111, "An Act relating to the oil and gas production tax, tax payments, and credits; relating to interest applicable to delinquent oil and gas production tax; and providing for an effective date."

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SCOTT JEPSEN, Vice President, External Affairs and Transportation, ConocoPhillips Alaska, Inc., provided a PowerPoint presentation entitled, "House Resources Committee," dated 2/24/17. Mr. Jepsen informed the committee HB 111 is a tax increase that increases the cost of doing business in Alaska for ConocoPhillips Alaska, Inc. (ConocoPhillips); because ConocoPhillips does not get cashable credits, and has not accrued net operating losses (NOLs), the impacts to ConocoPhillips are the increases to the base tax structure such as the increase in severance tax, the change in the per barrel credits, the interest change, and the theoretical migrating tax credits [slide 2]. Slide 3 was a graph that illustrated the tax increase brought by HB 111 at Alaska North Slope (ANS) West Coast oil prices from $30 to $120 per barrel. He noted at lower prices, there is an increase of 25 percent at a time when investors are typically losing money, and at higher prices, the per barrel credit declines from $8 to $5, which increases the tax rate in the "mid-price range." Mr. Jepsen pointed out one of the key tenets of Senate Bill 21 [passed in the Twenty-Eighth Alaska State Legislature] was to level the tax rate over a broad range of prices, which is undone by the proposed legislation. He referred to his previous testimony [on 2/1/17] that under all oil prices the state currently has the largest share of revenue. Using data from the 2016 Revenue Sources Book (RSB), Tax Division, Department of Revenue (DOR), he said when investors are profitable, the state takes 41-46 percent of net revenue, and when the investment is negative, the cash flow goes to the state. Referring to previous testimony by the Tax Division, DOR, related to a hypothetical field under Senate Bill 21, total state take is about 46 percent, and under HB 111 is about 50 percent. Although the state is always getting the most revenue of all parties, HB 111 is a tax increase that increases the cost of doing business in Alaska, which decreases investment, decreases production, hurts state revenue, and costs jobs. Turning to Alaska's competition for investment, Mr. Jepsen directed attention to slide 4, which illustrated the opportunities for investment that ConocoPhillips has in its portfolio related to the cost of supply, and a map indicated the location of emerging and in-production unconventional plays in Canada and the Lower 48. A graph showed the cost of supply and the potential resource development at a certain cost. Although specific opportunities were not identified, Mr. Jepsen said in Alaska the cost of supply is in the $40-$50 per barrel range, which is the top-end. ConocoPhillips has made an effort to reduce costs in Alaska in order to remain competitive with other investment opportunities. In fact, ConocoPhillips has reduced its cost of supply at its CD5 [drill site] investment from $60 to about $40. Reducing costs of supply in Alaska is an intense focus for the company, and the state can help by maintaining a stable tax policy. He stressed that a key factor in investment decisions is total cost of supply, including the cost of royalty, severance tax, income tax, capital expenditure (CAPEX), and operating expenditures (OPEX), thus debate on tax policy should not focus on one element of cost, but how an increase to severance tax in Alaska, which is already a high-cost environment, "drive[s] us further and further out of the money in terms of being able to drive investments to the state." He clarified that the information on slide 4 was representative of opportunities for the industry as a whole, not only for ConocoPhillips.

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MR. JEPSEN continued to explain that although profit is "on the margin," ConocoPhillips continues to invest in Alaska because Alaska oilfields have rates of lower decline and there is exploration potential at reasonable oil prices. However, increased cost will move Alaska out of competition for continued investment, and as a partner with the industry, the state needs to maintain a stable tax environment with a reasonable fiscal framework.

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PAUL RUSCH, Vice President, Finance, ConocoPhillips Alaska, Inc., addressed migrating tax credits. In 2014, DOR identified companies that were moving per barrel credits to certain months to reduce their tax obligations. ConocoPhillips believes tax law is clear that production tax is an annual tax with monthly estimated installment payments, and for the calculation of the final annual tax liability, in 2014, companies utilized the amount of annual per barrel credits to determine their full year tax obligation. He said the changes proposed in HB 111 appear to be a simple change to fix what DOR perceives as a problem; however, ConocoPhillips is concerned the change is a move from an annual tax to a monthly tax, which increases complexity and "opens the door to even further changes in that direction." Mr. Rusch cautioned the state and industry are already challenged to complete audits on the current annual tax in a timely manner [slide 5].

CO-CHAIR TARR observed oil prices can be higher and lower in different months, and when prices are higher, the state does not have the opportunity to take advantage of higher prices, which is necessary in order for the state to maintain credits and incentives during periods of lower prices.

MR. RUSCH restated that this is an annual tax, and the state will capitalize on the higher prices in any month when the annual tax is recalculated at the end of the year.

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REPRESENTATIVE BIRCH observed the most significant share of state revenue is royalty, and asked whether royalty is paid on a monthly or daily basis.

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MR. RUSCH explained ConocoPhillips makes monthly installment payments of production tax, with a "true up" at the end of the year. Mr. Rusch and Mr. Jepsen affirmed that royalty is paid on a monthly basis as well. Mr. Rusch returned to the presentation, and recalled DOR testified that applying interest for a three-year period may encourage taxpayers to delay the audit settlement process. However, the timeline to complete and finalize an audit - and the settlement process - is controlled mostly by the state, and not the taxpayer. Slide 6 was a chart that highlighted the status of tax audits for ConocoPhillips from 2006 through 2011, and 2006 was the only tax audit finalized. The tax audit for the remaining years are still open; for example, in 2007, the final tax return was filed in March 2008, followed by six years taken by DOR to complete the audit and issuance of the audit in 2014. Also in 2014, the audit was appealed within sixty days, DOR released an informal decision mid-2016, a formal appeal was made within thirty days, and the audit is now in the Office of Administrative Hearings, Department of Administration. He concluded there is limited ability for the taxpayer to influence the timeline. In addition, the lengthy schedule for audits leads to assessments in which the interest component is greater than the underlying tax assessment, which he characterized as not good for either side. House Bill 247 [passed in the Twenty-Ninth Alaska State Legislature] recognized that a high interest rate applied during an extended audit period is inappropriate, and the three-year limitation put in place by House Bill 247 was intended to address the long audit process by also doubling the interest rate, with the expectation that there would be a reduction in the audit periods.

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CO-CHAIR JOSEPHSON acknowledged extended state audits are matters of frequent discussion. He pointed out slide 6 shows the 2007 return is in a hearing, thus there is a dispute. He recalled other hard fought oil tax and oil revenue issues, and opined there would be no incentive for industry to reach a settlement after three years.

MR. RUSCH said ConocoPhillips' decision to appeal an assessment is not based on the interest rate but on the underlying issue; in fact, ConocoPhillips' incentive is to reach certainty on taxes.

CO-CHAIR JOSEPHSON expressed his surprise that the company would consider the cost of interest irrelevant.

MR. RUSCH said ConocoPhillips does not make its decision on whether to appeal an item based on the interest rate.

MR. JEPSEN added that if that were the case, ConocoPhillips would have settled the 2006 audit in 2010; however, sometimes the courts uphold ConocoPhillips' positions. He pointed out Alaska's Clear and Equitable Share (ACES), [passed in the Twenty-Fifth Alaska State Legislature] regulations were not finalized until 2010, thus the regulations were unknown and remain without precedent.

REPRESENTATIVE PARISH observed members of the oil and gas industry have underpaid billions of dollars in taxes, and asked how to avoid a similar situation in the future. In response to Mr. Jepsen, he clarified his reference was to the Trans-Alaska Pipeline System (TAPS) tariff settlement in the state's favor.

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MR. JEPSEN cautioned the present court decision may not prevail. It is assumed TAPS will have a long life and variables include: increasing costs, increasing state take, low oil prices, older fields, and mature fields. The assumption by the court may not be what actually happens.

CO-CHAIR TARR has heard suggestions that the state's tax system is too complicated to administer, which is validated by slide 6. In 2006, moving to a net profits system raised questions related to deductions and led to only one tax audit for ConocoPhillips completed in ten years. She asked whether the presenters agree there is a reason to simplify the tax system, so the state can better administer the severance tax program.

MR. JEPSEN cautioned against starting with a new tax system but urged for the state to make the existing system work; for example, the federal government has a net tax system and audits three to five years of tax returns in one year.

MR. RUSCH urged for the state to reach resolutions on the outstanding audits in order to establish precedent and find common issues; in addition, audits should focus on consistency, protocol, and the materiality of issues, as other fiscal regimes do.

CO-CHAIR TARR requested additional information in this regard.

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MR. JEPSEN summarized HB 111 is a significant tax increase for ConocoPhillips in base tax structure. The bill moves Alaska in the wrong direction and increases the cost of supply at a time when the state has a lot of competition. The changes to the per barrel credits do not represent a reasonable government share, and changes to the interest time period add to costs. Another element of HB 111 is hardening the floor, which is another tax increase. ConocoPhillips does not get NOLs, but is interested in gross value reduction (GVR) oil because its new projects may qualify for GVR. Furthermore, Senate Bill 21 is a key component in increased investment, more jobs, production, and revenue to the state. Mr. Jepsen stressed that tax policy matters to industry and increased cost of supply to the industry will impact investment.

REPRESENTATIVE BIRCH agreed Senate Bill 21 is working. He asked how the per barrel tax credit reduction affects rates. The HB 111 fiscal note indicates by 2025, the state will realize a net gain of an additional $300 million in revenue, and he questioned how tax credits play a role in the tax scenario.

MR. JEPSEN said ConocoPhillips generates revenue for the state; in 2016, ConocoPhillips' net income was about $230 million and the company paid the state about $500 million in royalty, severance tax, property tax, and income tax, thus the state has positive oil tax revenue, and can choose where to spend that revenue. Regarding the per barrel credit, the 35 percent tax rate on the net was implemented as part of a combination of per barrel credits and base tax rate. When the per barrel credits are eliminated, the tax rate is increased by a substantial amount. He restated that these factors are in place to level the regressive nature of the tax rate at low oil prices.

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REPRESENTATIVE PARISH noted ConocoPhillips is concerned about the increase in the minimum tax rate from 4 percent to 5 percent and to hardening the floor. He asked what percent production tax rate ConocoPhillips currently pays.

MR. JEPSEN said approximately 4 percent, on average for last year.

CO-CHAIR TARR remarked:

> Talking about the per barrel credit ... the way that is applied ... it's transportation cost deductions, and then lease expenditure deductions, and then the production tax value, then the tax at 35 percent, and then the per barrel credit is added on, and so even though ... the tax calculation is already done, and then you add the per barrel credit to that, you include the per barrel credit in your base tax rate calculation.

MR. JEPSEN responded:

> ... I think the actual way you do it is: take your revenue, gross revenue, less transportation, less OPEX, less CAPEX, less the per barrel credit, calculate ... the 35 percent times that revenue ....

CO-CHAIR TARR said, "It's the opposite way."

MR. RAUCH stated Co-Chair Tarr's calculation was correct. The tax credits are a reduction in the tax amount as opposed to a tax deduction which would come before. The overall rate, from a calculation of the net tax, is a function of the 35 percent tax rate and the impact of the per barrel credit. Previous testimony from DOR has stated that if per barrel credits were not part of the current tax law, the 35 percent tax rate would be lower.

CO-CHAIR TARR suggested if the state were going to make changes to the per barrel credit, ConocoPhillips' response might be different if there were also adjustments to the base tax rate.

MR. RUSCH said yes.

CO-CHAIR TARR observed that HB 111 does not deal with the GVR issue and is hardening the floor against NOLs; however, ConocoPhillips does not receive NOLs.

MR. JEPSEN remarked:

> It's a matter of materiality. We would hope that by extension, we wouldn't continue to move down that direction.

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REPRESENTATIVE BIRCH has heard in West Texas wells can be drilled in 14 days that would take significantly longer in Alaska. He cautioned that as oil prices go up there will be a point where there will be increased production in the Lower 48 and Alaska will still have competition from the Lower 48.

MR. JEPSEN restated that Alaska production comes at higher cost and thus it is harder to attract investment from a limited capital environment; in addition, also working against Alaska is timing, as there are a limited number of rigs available at any time. Alaska has been slower to "come down," because it has been a good place to invest under the current tax system, although prices have stayed low for a long time.

REPRESENTATIVE BIRCH said, "Tax stability helps."

CO-CHAIR TARR recalled at the time the legislature discussed Senate Bill 21, the focus was on an oil price range of between $60 and $100 per barrel, and thus the tax system that was created does not work well in the new lower price environment. She inquired as to whether those who have testified that Senate Bill 21 is working had a better idea of its impacts at lower prices, as the legislature did not model or design the tax system for lower prices.

MR. JEPSEN expressed his belief that low prices were contemplated because Senate Bill 21 contains provisions that continue to "ratchet down" the tax at increments of $25 or $15; in fact, that was the purpose of the provision that below a certain level the industry would pay a minimum tax. He said all parties recognized that low oil prices are not good for the industry and the state would have lower revenue. Mr. Jepsen opined the state does not need a different system because it still has a modicum of revenue, and it is not possible to tax the industry to get the state out of a budget deficit. He cautioned that creating a system "anymore imbalanced than it is right now, you run the risk of losing investment."

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DAN SECKERS, Tax Counsel, ExxonMobil Corporation, said the legislature is once again increasing taxes on the oil industry in troubling economic times. The proposed legislation will not only increase industry taxes and change tax policy, but will undermine investor confidence and weaken Alaska's overall investment climate. In order to meet the state's long-term goals, tax policy must provide confidence that changes in the state's tax policy will not adversely affect investments already made. Mr. Seckers said HB 111 is purported to establish a durable tax policy; however, the aspects of durability and certainty lose their value if their cost is too high. Senate Bill 21 is working as intended, and has been good for Alaska's economy, jobs, and state revenue, and for Alaska's global competitiveness. He expressed ExxonMobil Corporation's support for previous industry testimony that HB 111 is a significant tax increase; in fact, many provisions of HB 111 have been carried over from debate last year on House Bill 247, and the changes within HB 111 will not improve the investment climate, will not lead to jobs, more oil and gas in TAPS, or help the economy. From a tax policy perspective, Section 2 is a 25 percent tax increase for some companies and an infinite tax increase for others, and is not a long-term solution for any fiscal problem. Section 3 would prevent companies from realizing the true economics of their investment by preventing the use of all critical tax credits - not just sliding scale credits - and is an immediate and significant tax increase. Section 3 also prevents companies from utilizing available earned credits from one month against their total liability for the year, referred to as migrating credits. He restated the provision is not justified because it applies to all credits, and requires companies to file "perfect monthly estimates." Mr. Seckers characterized this provision as "very troubling ... and would change the substance of the law and migrate the tax more to a monthly tax than the annual tax in which it currently is."

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MR. SECKERS continued to Section 5, which would reduce the amount of NOL deductions or tax credits a company can claim. He stressed that no company wants to lose money, and Alaska's tax structure is modeled closely after a net-based tax system and allowing the matching of revenues and expenses is the cornerstone of a net tax system, and allows the recovery of critical investment. The elimination of 60 percent of NOLs will change how investments are viewed and is a tax increase, and he gave an example. He questioned whether the state wishes to have a policy that will indefinitely delay or jeopardize projects. He said, "So from a practical point of view and a tax point of view, this provision would penalize companies that make important decisions, those in the past and those in the future." Mr. Seckers said Section 7 is not a tax credit reform provision because sliding scale tax credits are in current policy to mitigate the increase in the base rate from 25 percent to 35 percent, and were carefully designed to allow recovery and include an element of progressivity. Furthermore, Section 7 targets legacy fields, which are the backbone of Alaska's oil industry and provide almost 93 percent of oil revenue. Finally, he explained Section 10 adversely affects fields that are located a distance from existing infrastructure - and thereby are more expensive to develop - by not allowing companies to consolidate all production for tax purposes, so that a company with a loss on one field can consolidate with others and "make the project economic." However, Section 10 would "ring fence" the field, and the costs of developing certain fields will be lost. The result would make marginal and remote fields harder to get funding.

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MR. SECKERS concluded that raising taxes at this time will force all companies to reexamine short- and long-term investments, and is inconsistent with the state's vison of promoting oil and gas development. He recalled previous tax increases occurred when oil prices rose; however, enacting HB 111 indicates Alaska will raise taxes when prices go up or when the industry is losing money, despite the benefits brought to the state by the oil industry. He cautioned that if Alaska raises its costs, ExxonMobil Corporation will reexamine its investments and will take appropriate action, and restated that Senate Bill 21 is clearly working and has led to increased production and more jobs. However, increasing taxes on companies that are losing money will not lead to more jobs, production, or benefits to the economy.

CO-CHAIR TARR returned attention to past changes in Alaska's tax policy, and recalled some of the changes were specific to Cook Inlet and did not affect ExxonMobil Corporation. She inquired as to whether all of the tax changes are "problematic" for ExxonMobil Corporation.

MR. SECKERS said yes.

CO-CHAIR JOSEPHSON questioned why the state, as a sovereign, is not entitled to "a 4 percent, hard floor [tax] in all circumstances, for the severing of a state resource?"

MR. SECKERS opined the key issue is whether the policy change will hurt or help industry, especially smaller companies that need credit recovery to reduce the minimum tax. He pointed out in addition to severance tax, companies pay royalty, property taxes, and income taxes.

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CO-CHAIR JOSEPHSON remarked:

> ... the 35 percent tax rate ... [has] never been operative since, since its advent ... it's come close, maybe, but ... why the NOL should be at 35 percent if it's to be paired with a 35 percent tax rate that, that doesn't happen? Shouldn't it, if there was meant

> to be some reciprocity or, or parity there, and one could question why .... Basically I'm asking about the effective tax rate that is really being paid, and whether ... the NOL shouldn't better mirror that effective tax rate.

MR. SECKERS explained most regimes don't have tax credits for losses, they are carried as losses, and are tied to the statutory tax rate. [In Alaska] the effective tax rate is an arbitrary judgement made by the state. Alaska chose to make the NOL a tax loss credit because its tax system had a progressivity surcharge under ACES. However, if ACES had not been implemented, NOLs would be treated as they are in all of the other net-based regimes in the world: carried forward as losses. He continued:

> And if that were the case then the losses unique to that taxpayer and that's beneficial to that taxpayer when they earn money and when they made a profit against their tax rate, whatever it may be. Whereas, the disconnect that's created in Alaska is because you've created it as a credit. And there's only one way to put that, and that is through some tax rate. And the best one would be the statutory rate because that's the only fair rate that's on the books that's applied to all taxpayers equally.

CO-CHAIR TARR reminded the committee that witnesses have referred to testimony by DOR provided at the committee meeting on 1/30/17, slide 24 [of a PowerPoint presentation entitled, "Alaska's Oil and Gas Taxation - Status Report, dated 1/30/17], which indicated the effective tax rate is at 35 percent when the price of oil is about $140 per barrel, when combined with credits. She said, "You saw the reduction to 15 percent because that was more where ... the effective tax rate would be at the more normal prices ...."

REPRESENTATIVE JOHNSON read from previous testimony by Mr. Ruggiero of Castle Gap Advisors provided at the hearing on 2/20/17 [slide 5 of a PowerPoint presentation entitled, "Developing Petroleum Fiscal Policy," dated 2/20/17] as follows:

> Working from a common understanding ... will help everyone better understand the input that will be received from various respondents putting forth ... self-serving opinions.

REPRESENTATIVE JOHNSON continued [from slide 10] as follows:

> Operators routinely deploy these top three detractor themes: instability ... negatively impacts new developments and investments; competitions, other regimes will be more attractive in comparison; and jobs, jobs are at risk due to potential lower activity.

REPRESENTATIVE JOHNSON said these seem like valid concerns, but they were characterized by the presenter as self-serving statements, and she asked whether ExxonMobil Corporation would consider the foregoing as valid business concerns when making its evaluations.

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MR. SECKERS opined the aforementioned are not themes but are facts; ExxonMobil Corporation and other companies look at a wide range of variables, including the stability of a regime over a long period of time, such as whether the tax in Alaska next year is known or unknown, which adds uncertainty and unpredictability to the investment decision. He assured the committee these are valid concerns in the business world, and the level of uncertainty will be compared to that of other regimes. Mr. Seckers gave several examples of the business decision-making process.

REPRESENTATIVE PARISH asked what rate ExxonMobil Corporation paid in severance tax last year.

MR. SECKERS said ExxonMobil Corporation's taxpayer information is confidential, and it paid the amount it was required to pay by law. Furthermore, ExxonMobil Corporation does not file fraudulent tax returns, and its returns are prepared by accountants, reviewed by lawyers, and are finally reviewed and audited by managers who complete a checks-and-balances process.

REPRESENTATIVE PARISH inquired as to what Mr. Seckers would attribute the major settlements that have been paid by the oil industry to the state.

MR. SECKERS acknowledged any two reasonable people can disagree on the interpretation of law. ExxonMobil Corporation will defend its position and will also honor settlement decisions made by the court. Regarding production tax settlements, he said challenges are brought when necessary, although he pointed out that the percentage of taxes in dispute is small relative to the amount of taxes paid.

CO-CHAIR TARR referred to the court case that required development at Point Thomson and that is believed to have caused ExxonMobil Corporation to earn net operating losses, which "the state is sort of paying for." She has heard criticism that the "duties to produce" concept, which was litigated in order to force development at Point Thomson, should not result in ExxonMobil Corporation earning losses.

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MR. SECKERS declined to address Point Thomson litigation. He said Point Thomson is a very challenged resource; however, the state will benefit whenever the Point Thomson field is developed, and the treatment under the law would have been the same. Although ExxonMobil Corporation is the operator, it has partners in the development, and penalizing a certain development because it "took longer" is poor tax policy.

REPRESENTATIVE JOHNSON asked how Alaska compares with other governments as far as stability and tax changes.

MR. SECKERS advised Alaska is close to the top of regimes that repeatedly reexamine their tax systems; in fact, research that has been previously provided to the committee showed that in 2016, regimes were lowering taxes to keep investment and to prevent companies from relocating. Alaska is "going in the other direction," and he expressed his understanding that in this price environment, most regimes want to spur investment, and thereby retain jobs, royalty, property taxes, and benefits.

CO-CHAIR TARR observed utilizing NOLs are generally a function of a corporate income tax provision, but in Alaska also applies to severance tax. She asked whether other regimes offer NOL deductions as a credit, and also as a function of the severance tax calculation, rather than corporate income tax.

MR. SECKERS was not aware of any region or taxing jurisdiction that offers NOLs as a credit. He offered that this provision was intended to "capture the high end of prices every month, so that's why it was put in as a credit." For example, if there is a loss, under the progressivity of ACES, the production tax value upon which the progressivity is based would come down. As a credit, it didn't, thus Alaska got the highest tax rate possible. Furthermore, he said he has not seen a tax loss carry-forward applied to production tax, and as far as he knows, Alaska has a unique system.

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CO-CHAIR TARR acknowledged Alaska has marginal, economically challenged, and remote fields that need to be developed; the state seeks to support challenged fields without assuming undue risk. She asked how the state would assess such fields.

MR. SECKERS cautioned against ring fencing fields. Oilfields are consolidated for tax filing purposes, and separating challenged fields invites complexity and puts additional burdens on challenged resources. In order to incentivize challenged resources at less cost to the state, he suggested continuing the gross revenue exclusions, which apply once a field is producing. Remote fields need to be developed, and he questioned whether the state seeks to limit the geographic search for oil and gas to close to existing fields. The gross revenue exclusions help remote fields, although challenged fields may not yield the highest amount of severance tax; however, there would be revenue from property tax, income tax, jobs, and royalty. He urged for the committee to look at tax policy in its entirety.

CO-CHAIR TARR inquired as to an approval process to better scrutinize challenged fields and developments.

MR. SECKERS said Norway and others have advanced approval processes; however, this raises concerns about information disclosed to competitors, perhaps in violation of federal anti-trust law, and the unwanted sharing of proprietary information.

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PAT GALVIN, Chief Commercial Officer/General Counsel, Great Bear Petroleum, provided a PowerPoint presentation entitled, "House Resources HB 111," dated 2/24/17. Mr. Galvin informed the committee Great Bear Petroleum is an exploration company that seeks to become a production company, and after extensive investment in its exploration phase, hopes to move into production through discovery or acquisition. As such, the provisions of the tax code affect his company in a different way. He suggested there may be other ways to address the objectives of HB 111 such as how the state will afford to pay the tax credits, and how to balance state revenue with attracting new investment [slide 1]. To address the tax credit payments, he provided a DOR graph from last year and stated most of the Cook Inlet credits were eliminated by House Bill [247]. Further, exploration incentive credits (EICs) have expired, thus the state's cash outlay looks significantly different now [slides 2-4]. In addition, DOR information related to the size of individual payments to companies - in relation to the overall payment - has changed in that very large payments now have a cap to limit how much will be available to each company per year. For example, $3 billion was paid over a nine-year period: one taxpayer received a payment greater than $200 million in a single year, five times one company received payments between $100 million and $200 million in a single year; eleven times one company received payments between $50 million and $100 million in a single year. Mr. Galvin pointed out between $1.3 billion and $2.3 billion were paid out in large payments that are no longer going to be made, but payments now will be made over a period of years and the drain on the state's budget is no longer the same problem [slides 5 and 6]. Therefore, most of the tax credits have been eliminated, and the state's annual cash exposure has been largely mitigated. He said the remaining NOL tax credits are intended to level the playing field between new companies coming into the state and existing incumbents who are able to get a tax benefit for their expenditures immediately. The reason for this policy still exists, and is just as strong today as before [slides 7 and 8]. He stressed the need for credits to provide benefits to new entrants remains, and many provisions in HB 111 are detrimental solely to new entrants in the state. He opined the changes made by [House Bill 247], "tilted the scale towards the incumbents, this will further tilt it in favor of the incumbents even more." Detrimental provisions in HB 111 include: lowering NOL credit rate to 15 percent; eliminating the "refundability" of NOL tax credits; not having a production threshold for a minimum tax floor affects small producers disproportionately [slide 9].

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MR. GALVIN turned attention to how the tax program affects investments by incumbents versus investments by new companies. For example, an incumbent with a $1 billion investment in a new project is able to immediately deduct its investment against current revenue. Further, the per barrel exclusion affects the 35 percent tax rate; in fact, the effective tax rate will differ for each taxpayer, understanding that DOR projections of tax rates at a certain price are "a gross simplification of basically aggregating every taxpayer and showing you if they were all either all similarly situated or it was all one taxpayer, this is what they'd be paying." In reality, each taxpayer is in a very different position in regard to their effective tax rate. For this presentation, Mr. Galvin used a 25 percent effective tax rate, which he characterized as a reasonable approximation; however, there is no single number. In the example, a 25 percent tax rate taxpayer would immediately save $250 million on their tax payment, so the project cost is $750 million, not $1 billion [slides 10 and 11]. Mr. Galvin compared this situation to a new company that spends $1 billion, and which under HB 111, earns a 15 percent tax credit that is not refundable. The new company will not receive its tax credit until it begins production, then the minimum tax will limit its ability to use its NOL, and thus will not receive economic value for its expenditures for many years. He stressed an exploration production company works in an expensive environment and not receiving the credit for three to seven years reduces the value of the credit to one-third [slide 12]. Currently, the new company would receive a $350 million credit, paid at $35 million per year - subject to appropriation - and thus nearly equivalent to what is received by an incumbent at an equal level of investment [slide 13]. Mr. Galvin said the difference also has implications for project development if two taxpayers in different situations are joint partners. He gave an example of 50/50 partners with investments of $1 billion each, but due to unequal tax treatment have poor project alignment. Solely because of the tax system, the new company would have spent $865 million for the same interest the incumbent acquired at a cost of $735 million, which would delay and complicate the project [slides 14 and 15]. He suggested a more balanced approach - which in the aforementioned example - the incumbent gets immediate tax savings of $250 million and the new company gets a cash rebate from the state of $250 million, and there would be project alignment because the two companies would not have to negotiate additional terms [slide 16].

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MR. GALVIN continued to other issues raised by HB 111, such as the "hard floor, and what that does for small producers." He restated that every taxpayer is in a different situation; a small producer is going to be expending money on exploration and new development, thus a system that does not recognize their costs creates a disincentive to production. For example, companies start with the first phase of limited production and progress to higher levels of production. The bill may encourage producers to forgo the first phase, because a modest amount of production creates the hard floor and denies credits that would otherwise be generated [slides 18 and 19]. The small producer credit is a credit available to companies with production up to 50,000 barrels of oil per day; however, the qualification period has ended, and companies that previously qualified were promised this benefit for a period of 10 years, and based their investment decisions upon the benefit. Although - from the state's perspective - eliminating the small producer credit is not significant, the change will "potentially devastate a number of companies in terms of their expectations on the projects that they're pursuing." He restated the importance of a balance between the revenue to the state and the impact to taxpayers [slides 19 and 20]. Mr. Galvin observed during the past 10-15 years, the tax debate has transitioned from a focus on exploration to a focus primarily on production; however, in order to have future production, he cautioned that there must be exploration for new discoveries, or there will be certain decline [slides 21 and 22]. He provided a chart from 2007 that illustrated balancing revenue with investment climate, transparency with economic flexibility, and incumbents with new entrants, are all universal, ongoing, and significant factors [slide 23]. His past experience with oil tax debate began at the time between the Petroleum Production Tax (PPT) [passed in the Twenty-Fourth Alaska State Legislature] and subsequent changes to oil tax policy. The administration at that time focused on a return to a gross tax, thus consultants and the administration's economic team were tasked to identify a gross tax that would benefit the state. However, it was found that a combination of a gross tax and various credits would not achieve the state's desired revenue without risking projects that were underway, therefore, the state retained a net tax [slide 24]. He said he was troubled that there are those who mistakenly believe a gross tax is a simple solution that eliminates any risk, gains state revenue at any price, and protects new projects. Mr. Galvin closed as follows: a problem of tax credits does not exist; don't put new companies at a disadvantage; balance revenue and investment across all taxpayers [slide 25].

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REPRESENTATIVE BIRCH appreciated [slides 3-5] that segregated North Slope and non-North Slope credits. Turning to the financial viability of projects, he recalled DOR "referenced about a 10 percent discount or hurdle rate, in their ... analysis, and if I recall, the Department of Natural Resources, like with Caelus, I think they were in the 15 to 20 percent." He asked for a reliable discount rate for comparison purposes.

MR. GALVIN expressed his belief the DNR analysis of 17.5 percent for Caelus is more accurate in terms of "what actual E&P companies experience and what we would use in terms of our own analysis ...."

REPRESENTATIVE BIRCH agreed "a 15 to 20 percent range that DNR is using is probably a more valid range."

MR. GALVIN clarified that the discount rate assigned by DOR is representative of what the state's appropriate discount rate should be for forgone revenue; however, for the company, the higher rate is appropriate because of the nature of the cost of capital and associated risk.

REPRESENTATIVE BIRCH recalled there was discussion in 2013 that the tax credits were proposed with the intention to draw new and small companies to Alaska for oil exploration and research. He asked whether the tax credits were effective.

MR. GALVIN said, "It was effective in perhaps more than the state intended in some instances."

[HB 111 was held over.]

CO-CHAIR TARR discussed the time allowed for industry and public testimony on the bill.

REPRESENTATIVE BIRCH encouraged the co-chairs to balance the presentation of various issues with expert testimony from the appropriate state departments.

3:09:11 PM

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 3:09 p.m.