

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 27, 2017

7:01 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 George Rauscher
Representative David Talerico

MEMBERS ABSENT

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

COMMITTEE CALENDAR

WORK SESSION WITH RICH RUGGIERO, OIL & GAS CONSULTANT,
LEGISLATIVE BUDGET & AUDIT COMMITTEE

- HEARD

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
02/24/17	(H)	Heard & Held
02/24/17	(H)	MINUTE(RES)
02/27/17	(H)	RES AT 1:00 PM BARNES 124
02/27/17	(H)	RES AT 7:00 PM CAPITOL 106

WITNESS REGISTER

RICHARD RUGGIERO, Consultant
 Legislative Audit and Budget Committee
 Alaska State Legislature; Managing Partner
 Castle Gap Advisors
 Castle Gap Energy Partners
 Houston, Texas

POSITION STATEMENT: Discussed net operating loss and credits and presented a model showing a range of prices with Alaska's current tax bill applied to them.

ACTION NARRATIVE

7:01:13 PM

CO-CHAIR GERAN TARR called the House Resources Standing Committee meeting to order at 7:01 p.m. Representatives Rauscher, Drummond, Talerico, Westlake, Josephson, and Tarr were present at the call to order. Representatives Johnson, Parish and Birch arrived as the meeting was in progress.

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

[7:01:36 PM](#)

CO-CHAIR TARR announced that the only order of business would be a Work Session with Rich Ruggiero, Oil & Gas Consultant to the Legislative Budget and Audit Committee, pertaining to 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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RICHARD RUGGIERO, Managing Partner, Castle Gap Advisors, Castle Gap Energy Partners, said he would discuss the relationship of credits - net operating losses (NOLs) taken as credits and carry forwards - and the consequence of giving credits at one rate and taxing the income at a different rate. He said he would also show a model of a range of prices applied to Alaska's current tax bill versus the "bracketed net" he said he discussed during the 1:00 p.m. House Resources Standing Committee meeting.

MR. RUGGIERO, from his laptop computer, projected an image he called a dashboard, which he explained is a simple way to calculate the effects of doing things in different ways. He pointed to a graph showing the current tax system, the "producer take" percentage, the effective tax rate, and the bracketed net system. He noted some deviation between a total net system bracketed with no gross revenue reduction (GVR) or per barrel credits versus Alaska's current system, which has GVR and per barrel credits based on certain prices. He talked about the percent of producer take, the percent of effective tax, and the Alaska North Slope (ANS) West Coast market price for oil. Mr. Ruggiero said this model allows for testing certain things. He highlighted an "uptick," which occurs where the minimum tax takes over - assuming a hard floor. He said if he were to set the minimum tax at zero, then at certain prices there would be a loss.

MR. RUGGIERO said to determine the cost he put in two different multipliers. He continued as follows:

In an interesting circumstance, your tariff could go down from the plus or minus \$10 per barrel it's at, quite conservatively, if you had a couple major new finds. The tariff is ... fixed cost plus a small

variable component, and it's divided by the number of barrels going through to recover that. So, it's the cost recovery, plus whatever the return on the capital employed as a component of the tariff, divided by barrels. So, if you doubled the number of barrels, you might actually see that cost go down. But you might see operating costs on a per barrel basis go up, as you have general inflation and things get more difficult and you have fewer barrels per well that you're putting out. So, I just built this to where we could look at multipliers going separately on those two and actually going in opposite directions.

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REPRESENTATIVE BIRCH asked for clarification regarding the current effective rate.

MR. RUGGIERO said the rate is about 8 percent.

REPRESENTATIVE BIRCH surmised the bracketed and [effective] rates track closely.

MR. RUGGIERO confirmed that is correct. He pointed to a second bracket showing 20 percent and showed how if he changed that to 15 percent, "it can actually bring things down." He said it is possible to play with the size of each bracket step and the rate in each bracket and to "decide how you want to match things up." He talked about a scenario in which inflation doubles cost, the effective tax goes to "100-plus percent," and the minimum tax is "eating up everything there is to be had." He said in this scenario, the bracketed system "stays in the same shape, but it keeps moving to the right as the cost structure goes up, because it's based on the [production tax value] (PTV)." Deviation then occurs between the bracketed system and the current system, because the current system bases the credits on an absolute price in the market. He demonstrated how he could change the numbers to "inch one curve closer to the other one and match it up." He said there would never be an exact match over a wide range of scenarios, but the two could come close. He continued:

The beauty of something like this is this is it. It's just like doing your income tax at home: You've got your liable deductions; you figure out what your adjusted ... net income is ...; and you go to the tables and you figure out your tax. You don't have to count barrels; you don't have to worry about monthly;

you don't have worry about a whole lot of things; this would just be done -- you know, trued up at the end of the year based off of the averages and your average PTV and the rest.

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CO-CHAIR TARR summarized Mr. Ruggiero was showing the committee that through the manipulation of the numbers, the bracketed and current systems can mirror each other more or less closely.

MR. RUGGIERO responded that is correct. He indicated that it is a matter of playing with nuances and deciding whether the objective is to have all the credits "and everything else built in" to the current system to be at the low end or high end of the profit range and how to "pull these two together to make them work." He shared that when he was developing the [dashboard], he was surprised at how closely through the six-bracket system he developed he could match [Alaska's various oil tax credit systems], such as Senate Bill 21 [passed in the Twenty-Eighth Alaska State Legislature] and House Bill 247 [passed in the Twenty-Ninth Alaska State Legislature], with the step net system.

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REPRESENTATIVE PARISH said he is leery of "bracket systems" because, at a certain point, "spending one additional dollar on ... widgets on the Slope would result in a shift in potentially millions of dollars of liability or debt to the state." He asked Mr. Ruggiero if he could allay his concern.

MR. RUGGIERO said under continuous progressivity, such as with Alaska's Clear and Equitable Share (ACES) [passed in the Twenty-Fifth Alaska State Legislature], although the change in the absolute tax may have been, for example, from 72 [percent] to 71.6 [percent], the marginal change might have been 95 percent. He said that was the nature of continuous progressivity. He continued as follows:

Under the bracketed system, if I'm in the 35 percent bracket, I'm in a range of PTV, let's say from 50 to 60 dollars a barrel; if I change that PTV by \$1 a barrel, it stays at that same percentage rate that's in that bracket; it doesn't impact all the tax that's paid on working up to that bracket that they're in. So, ... an example that I had this afternoon, you pay

that maximum of \$2 on the first bracket. And so, whether you're up here adding or subtracting a dollar, you're still paying \$2 on that first bracket; paying \$4 on the second bracket; you're paying et cetera for PTV. So, you don't get that type of drastic change that you're talking about with the ... bracketed system.

7:16:00 PM

REPRESENTATIVE BIRCH questioned why, if the bracketed net tax closely approximates what Alaska has currently, the state would want to change.

MR. RUGGIERO said he is offering an alternative system wherein the state does not have to track the per barrel credits, does not to have the GVR, and does not have "special Cook Inlet versus North Slope versus Middle Earth." All that could be dealt with under one system, he explained.

REPRESENTATIVE BIRCH said the state is currently operating under Senate Bill 21. He asked Mr. Ruggiero to confirm that his proposal closely approximates Alaska's present structure, in terms of the current effective rate and producer share.

MR. RUGGIERO responded that what he is showing the committee represents "how it would apply to, let's say, the North Slope where you have ample production, ample revenues, and the cost structure." He continued as follows:

I have not delved into... But if there was a decision to go this way, you would then need to test it against specific Cook Inlet fields. I believe ..., intuitively, that it will work for the low dollar PTV Cook Inlet fields, if you have a very low base-rate tax to start. So, instead of starting at 35, as I said, you could start at a 5, you could start at 10, and then that would still leave the tax rate on Cook Inlet things very low, and only tax ... higher when you got into higher profitability fields and operations.

REPRESENTATIVE BIRCH explained that Senate Bill 21 is doing as intended, so he questioned why the state would "throw it out" and "start over again." Notwithstanding that, he indicated a willingness to listen.

MR. RUGGIERO said he finds it interesting to see what has transpired ten years since ACES. He said one of the goals was durability. He noted that the cost structure had almost tripled in those ten years, and if it doubles or triples further, then "all of a sudden your credits that are based on oil price - the \$8 becomes meaningless, because costs will have overtaken it." The impact will not be as intended when it was low profit per barrel to the operators. He said the net system that sets a tax for the first \$10 per barrel profit remains the same tax whether that \$10 occurs at \$100, \$150, or \$200 a barrel. He explained that was his reasoning for putting his idea out as an alternative going forward that could take away many of the moving parts and create a simple system that mirrors personal or corporate income tax.

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CO-CHAIR TARR offered her understanding that Mr. Ruggiero had said that Alaska's current system, attached to fixed prices, could deteriorate in value over time because of inflation and capital and operating cost increases "versus doing it off the profit," which she alluded would mean recognizing the circumstances under which the companies under a net system would have a profit and "being more sensitive to that than the fixed price that may not have the same impact."

MR. RUGGIERO responded, "Exactly."

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CO-CHAIR TARR noted that the committee had been shown calculations based on the cost multiplier of 100 percent. She said, "One particular new find is very far away and ... would likely have pretty high development costs." She suggested that 200 percent may not even be high enough, and she would like to see the multiplier set at double that.

MR. RUGGIERO illustrated the curve at double the current cost structure. He indicated that a facility far from the North Slope that required a separate facility and pipelines could have a considerably higher cost structure. As the zero profit point moves further to the right in the curve, he said, the impact starts to show wherever the effective tax is swinging upward, which in this example start at about \$95. He said that is when the 4 percent minimum tax, as a hard floor, "starts kicking in and moving up." In response to Co-Chair Tarr regarding the tariff multiplier, he stated that if there is [an oil discovery]

big enough to warrant development and production, and if the tariff is taken down to 75 percent of what it is, then "it didn't change the shape too much; it scooted some things to the left." He said the point at which there would be zero profit would occur at a lower price. He added, "But you could get a lowering of the tariff for most of the players in the state overall if we got a lot more production coming through." In an example where the tariff is calculated up 50 percent to accommodate two pipelines, he said that "it is keeping the same general shape." He said [the bracketed net system] can be changed by manipulating the brackets and the percent tax applicable in each bracket. He added, "So, I can take it down, I can bring it up, relative to where your current set of tax structures has their effective rate in the producer share."

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REPRESENTATIVE PARISH remarked that last year "we saw what happened when we were unprepared or exposed at exceptionally low ... prices." He asked Mr. Ruggiero to see what things would look like at \$40 per barrel.

MR. RUGGIERO offered a conceptual response that if he were to reset everything to 100 percent on the cost and then added in "45/40, 35/30," then the gross minimum would take over to where there would eventually be a loss and "100 percent of everything they're making goes to the state." He said it would look like what the committee was seeing in the visual example, but with the "X" axis shifted with different numbers on it.

MR. RUGGIERO, in response to a follow-up question from Representative Parish, indicated that the example he had shown was simulating a set of costs against a market price, and that may be for one player or two. He said the beauty of the net system is that each entity with a different profitability would move along the curve with a different effective tax rate.

REPRESENTATIVE PARISH expressed his excitement in anticipating modifications to federal corporate income tax.

MR. RUGGIERO responded that he did build in the possibility for modeling a significant change, and he asked if there is a particular number Representative Parish would like him to "throw in and look at."

REPRESENTATIVE PARISH queried, "If a corporation were able to pay the same rate as ... the President of the United States, what would that do to ... the overall picture?"

MR. RUGGIERO offered to pick a number for Representative Parish. He plugged in 20 percent to his calculations and noted that that changed the curve such that if there is no further increase from the state, the state curve stayed the same, but the producer share moved up because of the reduction in the federal corporate income tax.

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CO-CHAIR JOSEPHSON said the crossover point is at about \$82 right now. He stated his assumption that the crossover point moves to the left if "the GVR and per barrel are left."

MR. RUGGIERO answered that the crossover point is not representative of anything; "it's actually two separate thoughts just plotted on the same plot." He said those two thoughts are the producer take and the non-producer - or government - take. He said, "When their take goes to absolute zero because they're at a loss, but they're still paying some tax, yours goes to 100 percent of whatever there is being paid." He added that that is just a feature of a hard floor minimum tax.

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REPRESENTATIVE BIRCH offered his understanding that bracketed tax is not mentioned in HB 111, and he asked how Mr. Ruggiero's dashboard calculations relate to the proposed legislation.

MR. RUGGIERO responded that he understood there to be concern regarding HB 111 in the following areas: cashable credits and what the state's fair share would be at a low or no profits rate for the operators. He said the consequence of operating credits at one rate and being taxed at an effective rate far below that creates "a bit of a very positive bump for the operator," which he indicated may not have been intended. He said he is looking at the whole package and looking for the justification in taking the NOL credit percentage from 35 to 15. He said he is considering whether the 35 percent is [the problem] or something else. He said he studied the overall structure and the changes proposed under HB 111 and recommended looking "a bit broader" and holistically. He said the co-chairs gave him the green light to figure out what he would do and why he would recommend it, which is what he is talking about now. He summarized that

although his work does not go directly to HB 111, as written, he believes that it goes to the intent of what the committee is trying to do with HB 111, which is to make structural fixes. He opined that "you can't make simple structural fixes; you have to look at it a bit more holistically."

REPRESENTATIVE BIRCH explained that he is trying to determine whether the committee is building on what it has or starting off with something new.

MR. RUGGIERO suggested that he is offering information as an additional tool of which the committee may not have been previously aware.

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CO-CHAIR TARR said that the issue of setting a fixed price came up when considering changes to credits, and the idea there could be unintended consequences led to the decision that "this would be worthy of comparison." She said ACES did not anticipate high prices and Senate Bill 21 did not anticipate low prices. She confirmed for Representative Birch that the information being provided by Mr. Ruggiero is not in HB 111 but is in response to the legislature's quest for a system that incentivizes oil producers to continue doing business in Alaska.

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REPRESENTATIVE RAUSCHER asked for confirmation that HB 111 is "our starting point."

CO-CHAIR TARR answered, "Yes." She remarked on the numerous amendments that had been made to Senate Bill 21 as an example that [HB 111] is a framework from which the committee will determine the final outcome.

REPRESENTATIVE RAUSCHER asked what the goal of HB 111 is.

CO-CHAIR TARR directed attention to page 7 of Mr. Ruggiero's presentation during the 1 p.m. meeting on the same day. As shown on page 7, she read that the goals are to: keep oil flowing through the Trans-Alaska Pipeline System (TAPS) as long as possible; encourage exploration and development of new fields; encourage new operators; understand and capture upside value from existing fields; and create a durable petroleum taxation system. She said she imagines that there will be more points for consideration going forward.

REPRESENTATIVE RAUSCHER said it sounds like with all the changes being discussed the result will be House Bill 247 once more. In response to Co-Chair Tarr, he restated that following Senate Bill 21 and House Bill 247, "we're just going to end up there again, it seems like."

CO-CHAIR JOSEPHSON said House Bill 247 is Alaska law. He said there was a version that passed the House, but not the Senate, in early June [2016]; it largely reformed tax credits in Cook Inlet. He added, "And largely did not do anything, although a couple things on the North Slope." He offered his understanding that House Bill 247 left up to a \$70 million annual tax credit, "depending on whether there was a haircut." He continued as follows:

... That was the cashable part that was at our discretion, but a company could accrue hundreds of millions of dollars, and they could have partners also accruing hundreds of millions of dollars, and we're participating in that at a 35 percent share, and these totaled, in FY 17, \$775 million. That's more than half of what we paid to educate K-12. So, the committee chairs want to look at that sort of outlay, ... with a new body, and really consider, is that the policy -- Even though it was rejected by the Senate in part, we want to ask them again: Do you continue to want to have an outlay of \$500-\$600 million a year with a \$3 billion deficit? I want to see if the answer's still yes.

CO-CHAIR JOSEPHSON concluded that is part of [the reason for HB 111], but there are other elements to the bill.

REPRESENTATIVE RAUSCHER reiterated that he thinks the result will end up being something that already exists, but he said he may be wrong.

[7:40:10 PM](#)

CO-CHAIR TARR related the idea of durability and said it remains a goal of hers to determine a system that works with all price fluctuations. She recalled that Mr. Ruggiero had said that linking a per barrel credit to a certain price does not necessarily reflect the cost to the company; therefore, linking [credits] to companies' profits may be a better way to go, because the system would not be [affected by] the volatility of

price. She indicated this is in alignment with the comments that have been heard by the companies regarding profitability and what keeps them competitive. She concluded, "And that was why this particular idea ... was of interest to me personally to explore and sort of ... put some numbers in there that would help illustrate it." She asked Representative Rauscher if her explanation had helped.

REPRESENTATIVE RAUSCHER answered yes.

7:42:49 PM

REPRESENTATIVE PARISH asked if the system being illustrated by Mr. Ruggiero would cause any problems in terms of transparency.

MR. RUGGIERO responded that in a net system, it is necessary to have access to costs and to that on which the money is being spent. He said he is not sure to what degree information is being shared currently, but information would need to be shared to the extent that the state could be comfortable that "good, prudent operators spent at the level that it needed to be spent."

REPRESENTATIVE PARISH asked if Mr. Ruggiero had another graphic showing final impact in dollars to the state.

MR. RUGGIERO responded:

I altered the size of three brackets and two percentages, and you'll see that on the plot, I was able to take the net bracketed from about a 75 percent correlation to almost a 98 percent correlation to your current tax law. So, if you've got a fiscal note from the DOR that says you should be receiving this much tax at this sort of price, then if you'd set up your net system as I've got it ... configured right now, your numbers would be the same; there should not be any difference.

7:45:11 PM

REPRESENTATIVE JOHNSON asked Co-Chair Josephson to restate the amount of cash credits the state is currently paying.

CO-CHAIR JOSEPHSON offered his understanding that the amount is \$40 million, but "that's because of the veto." He said what "the independents" expected from the state and what the state

expected to deliver would have been approximately \$775 million in FY 17. He said it was about \$575 million, but \$200 million carried over because of an FY 16 veto.

[7:46:08 PM](#)

REPRESENTATIVE BIRCH asked if, with a current effective rate of 100 percent, there is any characterization of what the State of Alaska makes irrespective of the tax structure.

MR. RUGGIERO answered that in his model, the 100 percent indicates that the minimum tax is "consuming every dollar profit that they've got." He added, "And probably then some on top of it; I just capped it at 100."

REPRESENTATIVE BIRCH remarked that some people want to set aside royalty share, which he emphasized is a significant component of what the State of Alaska derives as an owner of the asset. He said he wants to ensure that "we roll that into whatever sort of assessment we're making." He emphasized that production is the key element to consider for any plans made. The tax, he said, is "over and above that." He said he was trying to interpret how Mr. Ruggiero reached the 100 percent amount.

MR. RUGGIERO, regarding the option he had put forward, explained that the royalty is the same for the current system as it would be if the state were to adopt the net bracketed system.

REPRESENTATIVE BIRCH suggested that may not be the case if the tax system is such that it discourages investment and, thus, drives down production.

MR. RUGGIERO replied:

If you believe, as I think you stated, that the current system is attracting investment and is bringing more barrels into the pipe, since what I put up here as an alternative taxes it exactly the same way, then it should be just as effective at doing those things you would like to see happen.

[7:48:32 PM](#)

CO-CHAIR TARR talked about the distinction between producer and non-producer and that the royalty of [oil and gas] found on private land goes to the private landholder - not the state. She indicated that some of Mr. Ruggiero's figures may have been

requested as a way to sort out "apples to apples" comparison. She mentioned that the State of Alaska is competing with other states for investment dollars.

CO-CHAIR TARR noted that HB 111, as currently written, proposed to raise the minimum tax from 4 to 5 percent, and she asked Mr. Ruggiero if he would display that increase for the committee.

MR. RUGGIERO said going to 5 percent shows as a slight uptick at the lower end of the price spectrum, because a gross tax is a regressive tax and is "very penal when there isn't much profit in the system to share." He indicated that the low end, to which he referred, is the point at which companies would be struggling a little bit, because the profitability is not quite what they would be expecting.

CO-CHAIR TARR next asked Mr. Ruggiero to show an example of something more dramatic, such as a change to 10 percent, and she observed that that would change the producer share. She reviewed some of the examples that Mr. Ruggiero had shown earlier and asked him to repeat the example where the cost multiplier is set at 200 percent, which reflects 100 percent of the producer share going to the State of Alaska. She said this clearly reflects how the different costs of development influence "how this all really works."

MR. RUGGIERO pointed out that when doubling the costs and looking several years into the future, he adjusted the brackets, which resulted in "the two curves lying on top of each other." Going back to 100 percent results in "more separation between the curves." He said the calculation can be set up to start off with some deviation today and increased deviation over time. He said it is possible to determine where the effective tax should be the same and how much deviation to have on either side of that timeframe in order to have some durability - "some length of time where this will work and be reasonable compared to what you have now."

CO-CHAIR TARR said she has learned that although different systems have different incentives, when the whole package is put together, it is desirable to consider the effective tax rate. She offered her understanding that Mr. Ruggiero had shown a "low bracket for low prices" and that at a 5 percent tax, it is not until profit increases that the percent tax increases.

MR. RUGGIERO confirmed that is correct.

CO-CHAIR TARR invited Mr. Ruggiero to show the last scenario.

7:54:42 PM

MR. RUGGIERO displayed a representational model showing a hypothetical [oil] field with the following characteristics: four years of spending at a cost of \$600 million, followed by 20 years of production. He said the purpose of the model is to look at three options to handle NOLs. He said every regime allows the producers that spend their money to recover it. When producers are spending and don't have the income to offset their costs, the question then is what mechanism to use so that the producer will recover those costs. He said the State of Alaska has established a mechanism wherein the producers can take their NOL and, at a given percentage, turn it into a cashable credit. He said "the majority" of systems carry forward the loss or the cost, and the money is recovered from future production. He said he is aware of "just a couple" that "will convert it to a credit, then carry that credit forward to be deducted from future tax liability."

MR. RUGGIERO said that because HB 111 proposes to change the percentage at which the NOLs would be converted to tax credits, he looked at what the impact would be of "these three different ways of looking at it." He said his model reflects the rate at which NOLs are converted to tax credits, what the effective rate is at the time those tax credits are used, and what benefit one system has over another. Regarding losses carried over into the future, he said there is a time value of money that plays a key role into the economics and decision making as to whether or not to invest in a project.

MR. RUGGIERO showed two bar charts: the top one showed the producer internal rate of return on the project and the effective tax rate. With an effective tax rate of 35 percent and an NOL that was converted to tax credits at 35 percent, there is no difference between carrying forward credits and carrying forward an NOL - it is the same return on the project. Conversely, with the ability to "cash at 35 percent" there is "a considerable uplift." He said that is because cash allows the recovery of the value of the loss or credit in the year in which it is incurred, which lessens the investment in the first four years. He indicated that getting the credit four years sooner than it would have been obtained by subtracting it from producing operations is indicative of the time value of money.

MR. RUGGIERO then showed information on the chart and said, "Today you're plus or minus, based on your per barrel credits, the average cost that you have, and the price of the oil; you're in the range of the 10 percent effective tax." He said having a credit created and with an NOL occurring and "converting it at 35 percent to a credit," then applying that credit "in a world where the effective tax that they're paying is 10 percent," results in "a tremendous bump in the [internal rate of return](IRR) of the project by doing that." He added, "And they ... actually get a commensurate bump in the net present value of the project overall, as well." He said that the parameters of the net present value improve depending on the rate at which the credits are created and what the effective tax rate is. He offered an example.

[8:01:24 PM](#)

REPRESENTATIVE BIRCH asked if the credits had been "rolled in there."

MR. RUGGIERO answered yes. In response to a follow-up question from Representative Birch, he said his hypothetical project example was created to allow the committee to choose at which rate losses are converted to credits and what effective tax is in place when the credits are used. He indicated that doing this shows the value for the cost to the operator and to the state of "creating them in ... one environment at one rate and using them in a different environment at a different rate." He specified three examples: one represents the project being able to take its investments during its four-year development period and converting it to cash; the second represents taking the NOL and converting it at a given rate to a tax credit, not being able to cash it, but using that tax credit once the field goes into production and "using those credits against the tax bill that they would otherwise have"; and the third represents taking the NOL and carrying it forward to be deducted against future taxable income before the tax is calculated and assessed. He explained that when a credit is given at 35 percent of a loss but is then applied against a 10, 12, or even 15 percent effective tax, that is a considerable incentive that the state has given.

[8:04:12 PM](#)

The committee took an at ease from 8:04 p.m. to 8:08 p.m.

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CO-CHAIR TARR reviewed that there had been discussion of producer internal rate of return, and she mentioned the Alaska Liquefied Natural Gas Project (AKLNG) and the possible desire of partners to get a 15 percent rate of return, while the state might consider a lower internal rate of return. She offered a recap of the three examples Mr. Ruggiero had just given prior to the at-ease.

MR. RUGGIERO offered clarification regarding the differences he had previously stated related to an NOL created and given the 35 percent cash and a carry forward credit of 35 percent that is used at "an effective 15 world" with a gain from roughly a 14 percent IRR project to an 18 percent IRR project. The latter, he said, would give a considerable increase, which at a project of this [hypothetical] size would be worth a couple hundred million dollars of net present value at 10 percent discounting. He said that is a benefit he would assume all operators, quite sophisticated in their modelling, would notice. He said, "And I believe that's why you may get some comments that it's very important to keep these credits at 35 percent. And the credits at 35 percent, with your current tax regime, means that there's this little boost to each of the projects that is out there that could be achieved."

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CO-CHAIR TARR asked Mr. Ruggiero if he could talk about "uplift."

MR. RUGGIERO recommended not to turn anything into tax credits, but rather to carry forward NOLs and only use the NOLs where there is production to use them against. He said, "I do not see why the state needs to pay for things up front ... and get their money back later." He said nearly all regimes in the world carry forward their costs until those costs are recovered. However, he said if an NOL is carried forward for six or seven years, it loses value as compared to a project where the NOL can be recovered in one or two years. He stated his belief that Alaska is in "the plus zone," because it allows capital to be deducted as fast as it can be recovered. He said many regimes limit capital recovery through depreciation schedules or caps on the amount of costs that can be recovered in a given year, much like corporate taxes. He said given the size and cost of projects in Alaska and the number of years it may take to get from development to production, there can be a loss in value in a project if it takes too long. One way to compensate for that

lost time value is to offer some form of uplift, which can be annual, such as NOLs carried until they can be used, or a lump sum uplift on all capital.

MR. RUGGIERO showed a model that allows an uplift to be calculated. He entered a figure of 10 percent and continued as follows:

What you'll notice is we start bringing the NOL at the different conditions of what it's created at - the effective tax - bring them closer to the line of the cashable option that you have.

MR. RUGGIERO said just like with the aforementioned brackets and tax, it is possible to play with the amount of uplift that the state may want to give going forward. He showed a table with a certain number of years and different annual uplift rates. He indicated numbers that show "the multiplier from the original loss if it's carried that long in time at that interest rate." For example, he said, "If I was to carry something seven years at 12 percent, it would have a multiplier of 2.2. So, for every \$100 of loss, seven years in the future I could be deducting \$221." He explained that the reason he chose that example is that there are a number of production-sharing contracts in the world where the government gave a one-time uplift of approximately 120 percent. He said he questioned that the first few times he saw it, but was given the explanation that "if you take a 12 percent uplift for about seven years, that's the uplift that you get." He said the reason the government did that is to give 2.2 times whatever was spent on allowable capital expenditures, with an incentive if the producer can get the field [in production] faster than seven years. Conversely, if the producer takes longer than seven years to get the field in production and is responsible for that timing, then the government only gave "the uplift for the seven years after that; any time value loss you suffer."

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MR. RUGGIERO, in response to Co-Chair Tarr, crunched some numbers to illustrate the differences between taking a tax credit versus carrying forward an NOL. He emphasized there would be a significant impact when creating credits at one rate that is drastically higher than the effective tax rate, when [tax credits] are carried forward.

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CO-CHAIR JOSEPHSON, regarding the uplift schedule and a rate of 10 percent, expressed concern about the nonspecific time it would take to work through an NOL and about "leaving something unanswered."

MR. RUGGIERO responded as follows:

I'm looking at option A or B. A is: I've turned these NOLs into credits and I pay somebody for them now, so I'm cash out of pocket. If I had that cash, I would look to something like my PFD return, the state could be making -- I'm just going to be using a round [number] plus or minus 8 percent; that's long-run equity market 8 percent. So, that's your alternative. So, if you're paying a 10 percent uplift, what you're basically paying is a couple points above what your long-run return should be on your investments. So, you're paying slightly more than what you're getting by keeping that money in your fund and investing it.

As far as the companies go - and this depends on which company you're talking about; some have much higher expectations than others - but if you look long run, over the same long-run period of the equities market, you might see that there's an average gain of 12-14 percent by the companies. That's the alternative for their money. So, if they're only getting 10 percent, they're giving up 2-4 points.

So, you just have to pick something like 10 percent, which is somewhere in the middle between long-run their [emphasis on "their"] return for ... upstream oil companies and long-run your [emphasis on "your"] return for your equity investments in your fund, and so, you're both giving a little bit, but you're meeting in the middle ground. And so, you're really not giving up that much, even though the number looks big when it gets into the future, you've kept your cash in other investments and allowed it to grow.

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CO-CHAIR TARR remarked that Alaska has its mining taxation system set up in this manner, wherein companies are given time in the first few years to recapture their losses from exploration and development costs. She said cashable credits

have been a challenge that has resulted in a \$900 million obligation the state has to figure out how to pay. Some independent and new entrant companies have given the state feedback that they will not be able to continue in Alaska if the state does away with cashable credits. She said the state is looking for options that are competitive with other regimes, and offering the uplift would resolve the problem of the time value of money.

MR. RUGGIERO recollected that an industry representative, within the last week, had talked about how an incumbent [producer] could "write it off right away, so it's worth a lot more" whereas [the newer producer] has to wait resulting in diminished value over time. He said, "This is where the uplift helps them." There would still be some diminishing relative to the cost of capital, but not that much; therefore, [uplift] keeps incumbents and new players "somewhat on the same level playing field." He said true balance will never exist, but it is possible to get to a place where the state is "not in any way, choosing winners and choosing losers."

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CO-CHAIR JOSEPHSON surmised that "an independent" faced with the uplift idea would be more comfortable with "the annual chart" Mr. Ruggiero had shown rather than "an expectation of a large 110 percent," as Mr. Ruggiero mentioned had occurred, perhaps in Europe. He said he did not know if there could be "a takings issue," but suggested "a future legislature could look at that as something to avoid." He clarified he wanted to know if "politics could get in the way of one's security about their uplift."

MR. RUGGIERO responded that politics always gets in the way of oil companies. He recognized that the legislature cannot bind a future legislature, which is why many projects are being built contractually rather than through legislation.

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REPRESENTATIVE PARISH asked if "this sort of NOL" would be transferable.

MR. RUGGIERO answered that all the rules would have to be considered to avoid unintended consequences. He noted that in the United Kingdom (UK), there was something he nicknamed as "the no thin slicing rule." He explained that there were

operators who had gone through exploration and had considerable losses. It was during a time when the UK had a plus or minus 70 percent windfall profits tax. He said the largest field in the UK was paying "a ton of windfall profits." He continued as follows:

So, what they found is a sliver of that field might have been worth \$300 to them; ... to the person that had losses, that ... same sliver might be worth a thousand dollars, because he can immediately take it, and even though it was tax paying, it would be non-taxpaying for him, because he had all these accumulated losses. And so, you started getting these thin slices being sold out of this field for the sole purpose of these people being able to use their losses. So, then it became a bit of a rule about no thin slicing in these fields.

We did discuss that in '07 when we were here helping advise on ACES, which is a little bit of the background into the cashable credits, in that to both prevent those with a strong position from bidding down the price if they bought them, but being able to use them at full price and not getting in to sort of this thin slicing of field equity and the rest. ... So, that way "gaming" of the system didn't occur. Things were put in place to make sure that people get value that they thought they were going to get.

Now, as you move forward and there's NOLs, my position would be ..., depending on what incentives you're giving for new players to come and visit, you can then decide whether or not you wanted to turn those into cash. And I think as my presentation today said, if they're totally done and they're leaving the state and they paid all their contractors, you might consider that part of your incentives is to pay some cash for those losses that they had at some conversion rate. But otherwise they get held and they get carried forward until they have got production to use those NOLs against.

REPRESENTATIVE PARISH expressed interest in learning the best way for companies to achieve maximum benefits for their shareholders.

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MR. RUGGIERO, in response to Co-Chair Tarr, stated that the 10 percent uplift equalizes the NPV of the project and brought the IRRs closer together between the options. Changing the NOL conversion rate or effective rate would give different results. He said there are multiple moving parts. Depending on how the parts are set, there can be the appearance of parity with an NOL carry forward system and parity with a cashing credit system. He added, "And the beauty of the second one is the state isn't out a lot of money." He said hopefully if parameters are set up, then "the operator becomes a bit indifferent."

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CO-CHAIR TARR reiterated the desire to offer incentives that bring "the new entrants" and independents to come to Alaska to do exploration work. She indicated that a message has been that if "the cashables" go away, then that would be a problem. She concluded, "So, this is ... [a] potential way to sort of overcome [a problem] ... not doing cash and making it more attractive."

MR. RUGGIERO noted that he had created a model of an S curve: when the project rate of return is at the bottom, it means there is a very low tax and low growth; at a 16-18 percent rate of return, the tax gets steep in the example; it would level out at whatever the regime decided would be the maximum tax rate. He explained the S curve is a way of showing that more is given at the low end but taken back at the high end when everyone has lots of profit to share.

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CO-CHAIR TARR announced that HB 111 was held over.

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ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 8:39 p.m.