

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

January 26, 2018

1:03 p.m.

MEMBERS PRESENT

Representative Andy Josephson, Co-Chair
Representative Geran Tarr, Co-Chair
Representative Harriet Drummond
Representative Justin Parish
Representative Chris Birch
Representative DeLena Johnson
Representative George Rauscher
Representative David Talerico

MEMBERS ABSENT

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

COMMITTEE CALENDAR

HOUSE BILL NO. 288

"An Act relating to the minimum tax imposed on oil and gas produced from leases or properties that include land north of 68 degrees North latitude; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 288

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(S): REPRESENTATIVE(S) TARR

| | | |
|----------|-----|---------------------------------|
| 01/16/18 | (H) | READ THE FIRST TIME - REFERRALS |
| 01/16/18 | (H) | RES, FIN |
| 01/22/18 | (H) | RES AT 1:00 PM BARNES 124 |
| 01/22/18 | (H) | Heard & Held |
| 01/22/18 | (H) | MINUTE(RES) |
| 01/26/18 | (H) | RES AT 1:00 PM BARNES 124 |

WITNESS REGISTER

KEN ALPER, Director
Tax Division

Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Provided a PowerPoint presentation entitled, "Analysis of HB 288 Increase to Gross Minimum Tax" dated 1/16/18.

ACTION NARRATIVE

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CO-CHAIR GERAN TARR called the House Resources Standing Committee meeting to order at 1:03 p.m. Representatives Tarr, Parish, Birch, Johnson, Rauscher, Talerico, Drummond, and Josephson were present at the call to order.

HB 288-OIL AND GAS PRODUCTION TAX

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CO-CHAIR TARR announced that the only order of business would be HOUSE BILL NO. 288, "An Act relating to the minimum tax imposed on oil and gas produced from leases or properties that include land north of 68 degrees North latitude; and providing for an effective date."

CO-CHAIR TARR provided the following information related to the previous hearing of HB 288 on 1/22/18: a corrected slide entitled, "Other Possible Considerations," and a new slide entitled, "Taxable Barrels Plus Royalty Barrels Value."

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KEN ALPER, Director, Tax Division, Department of Revenue, provided a PowerPoint presentation entitled, "Analysis of HB 288 Increase to Gross Minimum Tax" dated 1/16/18. He informed the committee the definitions of Alaska's four major oil and gas revenue sources are as follows (slide 2):

- property tax: ad valorem tax on the value of oil and gas property, pipelines, equipment, and facilities, most of which is shared with local government where the assets are located and which garners approximately \$100 million per year
- royalty: landowner's share of taxes, generally 12.5 percent, and one quarter of which must go to the corpus of the Alaska Permanent Fund

- production tax: profits-based tax that garners most conflict and is based on various complicated calculations
- corporate income tax: collected on remaining profits after production tax for oil and gas taxpayers at a typical effective rate of 7 percent

MR. ALPER continued to slide 3, which illustrated the state's oil and gas revenue from fiscal years 2012-2017 (FY 12-17) and the average price of Alaska North Slope oil for the same time period. He pointed out although the average price of oil was the same in 2013 and 2014, a lower production tax rate caused a reduction in the tax revenue. All four revenue sources have declined, with the most reduction to production tax revenue, which is based on profits.

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REPRESENTATIVE PARISH asked for a further explanation of corporate income tax.

MR. ALPER explained corporate income tax is based on estimated taxes which are tied to previous years; therefore, in 2015 companies paid large estimates based on past profits thus at the end of the year the state refunded overpaid taxes. Also, in error, some revenue from corporate taxes was not deposited to the Constitutional Budget Reserve Fund (CBRF), and corrections were made, resulting in a negative tax flow in FY 16 and FY 17.

REPRESENTATIVE RAUSCHER noted slide 3 does not include the amount of the deposits to CBRF and asked for the amount not included.

MR. ALPER said generally deposits to CBRF are payments on audits and range from \$100 million to \$125 million; however, in FY 17, the amount was almost \$400 million due to [tax] settlements.

REPRESENTATIVE TALERICO surmised the difference in revenue between FY 13 and FY 14 - shown on slide 3 - was due to a decline in production.

MR. ALPER advised the decline was due to less production, an increase in spending by the companies, and on 1/1/14 the tax system converted from Alaska's Clear and Equitable Share (ACES) [passed in the Twenty-Fifth Alaska State Legislature] to Senate Bill 21 (the More Alaska Production Act) [passed in the Twenty-Eighth Alaska State Legislature], which assesses a lower tax rate and thereby reduced revenue.

MR. ALPER reviewed previous tax credit reforms within House Bill 247 [passed in the Twenty-Ninth Alaska State Legislature] as follows: phased out Cook Inlet tax credits; reduced Middle Earth [land in Alaska south of 68 degrees north latitude and outside of Cook Inlet] tax credits; extended the Cook Inlet gas tax cap and added a \$1 per barrel of oil tax that garners approximately \$5 million per year from production in Cook Inlet; added sunset provision to Gross Value Reduction (GVR) for new North Slope oil production; annual cap on per-company, per-year cash credit payments; resident hire priority; limited transparency with an annual report to reveal companies that receive cash for credits; interest rate change for better reporting; technical cleanup and repeal of obsolete language for clarity; regulation package proposed and adopted effective 1/1/17.

REPRESENTATIVE PARISH returned attention to slide 3 and asked Mr. Alper to explain the decrease in royalty from 2012 to 2017.

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MR. ALPER advised royalty revenue is a function of gross value, not of net value; gross value is the market price of oil minus the cost of getting it to market, which is around \$10. When the price of oil dropped from \$110 per barrel to \$40 per barrel, companies' profits dropped by 90 percent, but the gross value of oil only dropped by two-thirds, thus slide 3 illustrates the reduction in the wellhead value of the oil.

REPRESENTATIVE PARISH inquired as to when DOR expects recovery in the value of the royalty.

MR. ALPER said the official forecast indicates a small recovery in production tax revenue and royalties in FY 18 and FY 19 - an additional \$200 million to \$300 million - if there is an increase in the price of oil to approximately \$60 per barrel.

REPRESENTATIVE PARISH turned attention to slide 4 and asked about the impact of the 80-90 percent credits granted prior to the passage of House Bill 247.

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MR. ALPER clarified operating loss credits were intended to be 35-45 percent of a loss, which was valid when a company was spending for a future field not yet in production, and was

designed to align with the marginal tax rate paid by producers [that are bringing in profits]. Although not intentional, under certain circumstances, when a company was in production, but was operating at a loss due to low prices, its new oil production was eligible for gross value reduction and that lowered the rate; for example, instead of \$10 million loss getting a 35 percent credit of \$3.5 million, the gross value reduction turned the loss into a \$30 million paper loss, resulting in a tax credit of \$10.5 million. Mr. Alper stated this effect of previous legislation was inadvertent and was corrected prospectively in House Bill 247.

REPRESENTATIVE PARISH further asked whether the credits were to be assessed against future taxes.

MR. ALPER said the credits were cashable certificates and posited this was not wise public policy.

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MR. ALPER reviewed previous tax credit reforms within House Bill 111 [passed in the Thirtieth Alaska State Legislature] as follows: ends most cashable tax credits for losses or other activities; repealed net operating loss (NOL) or carried-forward annual loss credit statute; replaced NOL credits with new system of carried-forward lease expenditures. The new system is based on the idea of cost recovery after production begins, and established a ringfence to prevent certain losses, and maximized taxpayer flexibility on use; if unused, lease expenditures lose value after ten years to protect against "downlift" (slide 5).

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REPRESENTATIVE RAUSCHER asked when the division expects to see changes resulting from House Bill 111.

MR. ALPER said the effective date of House Bill 111 was [1/1/18] and none of the new credits will be claimed prior to the taxes that are filed in March 2019; therefore, a company losing money during construction in 2018, and beginning production in 2019, will start using credits in 2019 and gave he an example. Mr. Alper continued with the features of House Bill 111: aligned tax interest rates to a compromised level; credits can now be carried back in time and used against a prior year tax liability or can be sold, limited by [payments owed to] CBRF after an audit assessment, and he gave an example of funds owed after settlement of tariff rate litigation; conditional exploration

credits granted at time of application to ensure a company's place in the queue; seismic work in Middle Earth no longer eligible after 2017; exploration credits in Middle Earth can be used to offset corporate income tax; delayed repeal of the tax credit fund after all credits are purchased; established legislative working group to work on continuing oil tax issues such as incentives for future development (slide 6).

REPRESENTATIVE PARISH inquired as to the value of the cashable tax credits that may be sold.

MR. ALPER was unable to estimate because sales of tax credits are free market transactions. Furthermore, since the state stopped paying the tax credits, they are now on the secondary market, but the market is limited, and the price is low. Provisions in House Bill 111 seek to open the secondary market and major purchases of tax credits may take place. He estimated there are approximately \$800 million worth of tax credits in the hands of industry awaiting purchase; however, bids may be low.

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REPRESENTATIVE BIRCH questioned whether discounting tax credits is common practice in other tax regimes.

MR. ALPER advised Alaska's [entire] concept of cash for tax credits is extraordinarily rare in the world; faced with limited funds and pressure from industry, the state seeks an amicable way to remove the credits from the state's liabilities. Although current legislation has limited the burden of this liability, \$900 million in outstanding credits is certain; the goal of forthcoming legislation is to offer discounts equal to the state's cost of the interest it would pay in order to sell bonds and pay the tax credit liability.

CO-CHAIR TARR asked for clarification on the amount of the total outstanding tax credits.

MR. ALPER explained the biggest component of the tax credits will be 2017 operating loss credits; House Bill 111 provides that one-half of 2017 eligible operating loss credits are eligible for cash and one-half are no longer eligible. Thus, there are upcoming partial operating loss credits that could be sold or used to offset taxes; also expected are credits claimed by the Interior Gas Utility, refinery credits, and a few other entities.

CO-CHAIR TARR referred to the forthcoming legislation and asked whether the state would pay full value for the tax credits [by issuing bonds].

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MR. ALPER cautioned the forthcoming legislation is being drafted and is very complex. He remarked:

Imagine ... your company is holding \$100 million worth of tax, tax credits. If you look at the formula ... [DOR] can calculate what your share of that appropriation would be for the next five years. Let's say you stand to make \$30 million in FY 19, [\$30 million] in FY 20, [\$20 million] in FY 21 and [\$20 million] in FY 22, ... what we would do is take that cash flow and discount it at that discount rate ... so [DOR] would back that out to a present value at the discount rate and offer a lump sum payment to buy all of the tax credits at that lump sum.

MR. ALPER concluded the company would receive less than face value and the state would gain some value to use to pay the interest on the money it borrowed to pay the credits.

REPRESENTATIVE PARISH surmised the foregoing solution would protect industry and asked for the amount of the current interest that is due on the outstanding tax credits.

MR. ALPER advised tax credit obligations do not bear interest but are subject to appropriation and can be sold or used against tax liability.

REPRESENTATIVE PARISH questioned how, without knowledge of the market value, the state can ensure it will fulfil its responsibility to its citizens.

MR. ALPER suggested the forthcoming legislation is a better way to deal with the tax credit problem than the status quo. Further, to benefit the state and industry, the issue needs to be resolved without having to appropriate hundreds of millions of dollars the state does not have. He returned attention to the presentation and stressed oil and gas tax legislation is often complex; however, HB 288 seeks to accomplish one goal which is to raise the minimum tax - known as the floor - from 4 percent to 7 percent when the average price of oil for the year is greater than \$25 per barrel (slide 7). He explained how the

minimum tax works: the production tax is based on a calculation of net profits known as production tax value (PTV) [as illustrated on slide 8]. He pointed out produced oil has at least two owners: landowners who earn royalty and the producer who profits, and only the taxable share factors in the calculation of PTV. Mr. Alper explained gross value at the point of production (GVPP) is market price less the cost of transportation. From GVPP is subtracted lease expenditures - the costs of operating the field, and capital costs - and the remainder is PTV. The final calculation uses the higher of either PTV multiplied by a 35 percent tax rate minus the per barrel credit, or GVPP multiplied by a 4 percent minimum tax rate. [HB 288] would raise the minimum tax rate from 4 percent to 7 percent. Slide 9 was a chart of tax increases based on a range of oil prices.

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CO-CHAIR TARR, as an aside, pointed out differences between slide 9 and information presented at the hearing of HB 288 on 1/22/18.

MR. ALPER said companies reacted to lower oil prices not only by doing less but by cutting costs, which lowered the breakeven price on a barrel of oil. In fact, as shown on slide 9, industry efficiencies have lowered the costs on transportation and lease expenditures on an average barrel of legacy oil from approximately \$50 to approximately \$37. Using \$60 as an example, he further explained the calculation to determine PTV and the subsequent tax calculation that is based on PTV: PTV is taxed at 35 percent, and after subtracting an \$8 per barrel credit, the production tax is \$0.17; however, when a minimum tax of 4 percent is assessed, the tax at \$60 per barrel oil would be \$2.01. Mr. Alper concluded at lower prices industry pays the minimum tax and at around \$65 per barrel and above, industry pays the net tax. Also shown on slide 9 was the effect of proposed HB 288, which is to raise the minimum tax to 7 percent, which at \$60 per barrel oil would be \$3.51. Another aspect of increasing the minimum from 4 percent to 7 percent is that the industry will pay a gross tax until oil prices reach approximately \$72 per barrel. Further, the impact of the bill is a function of price and he provided the increases in taxes derived from 170 million taxable barrels at a range of oil prices (slide 9). He pointed out the effect of HB 288 to increase tax revenue stops when oil prices reach \$80 per barrel and above.

MR. ALPER, in response to Representative Rauscher's question as to the effect [of HB 288 on production tax today], said there would be an increase of \$0.54 per taxable barrel at \$70 per barrel oil. In further response to Representative Rauscher, he said the \$91 million shown on slide 9 is not current revenue, but additional revenue from production tax at an oil price of \$70.

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REPRESENTATIVE BIRCH observed royalty tax share is included in total revenue on slide 3 and opined a true illustration of oil and gas revenue to the state would include its 12.5 percent royalty share at the different prices shown on slide 9.

MR. ALPER said there is no royalty share on a taxable barrel of oil; further, DOR has not analyzed the effect of the bill on the total state take from all the aggregated tax revenue and he offered to do so.

REPRESENTATIVE BIRCH said he was interested in the offered information. He opined anything that attracts investment to increase production and generate royalty at 12.5 percent is a large and significant component. He stressed the importance of inviting investment and encouraging production which will have more of an impact on state revenues [than would HB 288].

CO-CHAIR TARR observed slide 9 indicates the impact of changing the percentage [of tax revenue] regardless of what happens to [levels of] production.

REPRESENTATIVE BIRCH advised at \$40 [per barrel of oil], 12.5 percent of 170 million barrels would result in \$850 million in royalty, which increases to \$1.5 billion at [\$70 per barrel]. He restated royalty share is a significant amount of revenue and deserving of the legislature's focus.

MR. ALPER recalled royalty collected in 2012 was \$2.9 billion when oil price was \$110 per barrel. He reminded the committee three-quarters of royalty is available for the state to spend and one-quarter is deposited to the Alaska Permanent Fund.

REPRESENTATIVE PARISH asked how the forecast revenue shown on slide 9 would change with GVR oil.

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MR. ALPER said line 2, identified by GVPP, would be reduced by 20 percent thus at \$60 oil, PTV would be \$13 instead of [\$23.35]. Further, the minimum tax does not apply to GVR eligible oil; in fact, the tax on GVR eligible oil does not apply until the price of oil approaches \$70 per barrel. He directed attention to slide 10, which was a graph of forecast FY 20 production tax revenue at net, a 4 percent minimum, and a 7 percent minimum as proposed in HB 288. Mr. Alper, speaking from his experience as the director of the Tax Division, informed the committee auditors at the tax division have a difficult task and he described several features of Alaska's complex oil and gas tax law. However, [should HB 288 become law] at almost all circumstances, industry would pay a zero tax on GVR eligible oil and 7 percent tax on legacy oil. He urged for a simple solution: eliminate other taxes and instigate a 7 percent gross tax.

CO-CHAIR TARR pointed out the increase brought by HB 288 would primarily affect legacy oil.

MR. ALPER restated the actual effect of HB 288, for the most part, is that industry would pay a 7 percent gross tax. He turned attention to slide 12 and said further issues for consideration are related to oil profitability at different prices, such as:

- current 4 percent minimum tax is applicable at \$25 per barrel oil as is the proposed increase to 7 percent
- the average breakeven point was reduced to \$37 for FY 19 as a result of industry cutting cost
- a producer may survive a tax increase when oil prices are \$70 per barrel but not when oil prices are \$30 per barrel thus the price at which the minimum tax applies may need to change
- the \$25 per barrel price was set in 2006
- raising the minimum tax would increase the breakeven price of a typical field by about \$1 per barrel
- oil profitability estimates are up dramatically since last spring: increased production and reduced spending, production tax forecast increased \$40 million, tax credit increased \$150 million

MR. ALPER continued to slide 13 and restated oil profitability estimates are up from earlier forecasts due to additional production and reduced spending, which has added \$2.1 billion in industry divisible profits; however, the production tax share of

\$2.1 billion is \$40 million and the statutory tax credit appropriation increased by \$150 million.

REPRESENTATIVE TALERICO asked whether DOR has an amended Revenue Forecast Fall 2017.

MR. ALPER said a Revenue Forecast: Preliminary Fall 2017 [10/25/17] was issued for the [Thirtieth Alaska State Legislature Fourth Special Session 10/23/17-11/21/17]. He acknowledged there were minor changes from the preliminary forecast to the Revenue Forecast Revenue Sources Book (RSB) Fall 2017 [12/31/17], but the big changes were from Revenue Forecast: Spring 2017 [4/14/17]. In further response to Representative Talerico, he agreed there was a change in the production tax, not from the tax calculation, but due to one-time events.

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REPRESENTATIVE PARISH returned attention to slide 13 and asked when industry made the investments that resulted in increased production of \$1 billion.

MR. ALPER advised industry has been continually making investments since the '70s and has made considerable efforts to slow production decline and to increase volume.

CO-CHAIR JOSEPHSON asked whether an increase in oil price is factored into the increased production value of \$1 billion (slide 13).

MR. ALPER said no. The spring forecast indicated \$60 oil price thus the value is based on a lower price assumption and dramatically larger volumes. In further response to Co-Chair Josephson, he clarified the increase in oil price over the last 12-18 months is not reflected. He explained:

What [DOR is] illustrating to do this was the estimated aggregated profit that's subject to the 35 percent tax because that's the calculation that feeds into the tax credit statutory formula. That number has been adjusted upward by \$2.1 billion and almost none of it - in fact it's a negative impact - is related to the price because the spring forecast was based on \$60 oil and the fall forecast on ... \$56 oil. ... The reduction in company spending of \$1.1 billion is dramatic ... and that's nothing that the state did per se, [the industry] simply spent a billion dollars

less than they thought they were going to and by the nature of a profits tax, what you don't spend ends up getting added to your profits.

CO-CHAIR JOSEPHSON asked for the amount of federal income tax assessed on the industry.

MR. ALPER said the federal income tax rate until 12/31/17 was 35 percent of profits after deductions, including state taxes; as of 1/1/18, the federal income tax rate is 21 percent.

CO-CHAIR JOSEPHSON said at an oil price of \$70 per barrel, HB 288 would generate approximately \$200 million more to the state, but questioned whether the increase is fair and affordable by industry. He said he was unsure how to value \$2.1 billion in divisible profits.

MR. ALPER said "... I'm not quite sure how to answer that and the, the key is going back to the slide I had a couple of minutes ago: this all changes dramatically if the price goes back down to [\$50 or \$40], or something like that."

REPRESENTATIVE PARISH returned attention to slide 13 and asked for an estimate on how much of the \$1.1 billion in reduced spending is reduced investment.

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MR. ALPER observed the price dynamics of the oil industry are complex; during periods of high demand subcontractors received premium prices for services but as the demand subsided, subcontractors also reduced their costs, "so how much of it is getting the same amount of work done for less money and how much of it is doing less work, it's some combination of the two and I don't know that I could answer definitively." Slide 14 referred to the period of time from 1977 to April 2006, when the Alaska oil and gas tax system was a gross tax and was tied to a value similar to GVPP known as the economic limit factor (ELF) [enabling legislation passed in the Tenth Alaska State Legislature and modified in 2005], which was subject to a multiplier that varied from field to field. Mr. Alper said the formula to determine the tax was "exotic" and based on the profitability of each field. Over time, the tax rate declined - because average production declined in individual fields - from nearly 12 percent in 1995 to 6.7 percent in 2006. He pointed out in those years Alaska's oil tax revenue was garnered from a gross tax system, and for the last three years, the existing tax

system has functioned as a gross tax of 4 percent of North Slope production.

REPRESENTATIVE DRUMMOND asked whether the tax rate changed each year.

MR. ALPER clarified there was no change in the tax rate, except in 1989 one of the factors in the calculation was modified. He further explained the ELF system used a formula with exponents tied to factors related to production from each field to set a tax rate; although tax revenue was trending down, there were increases between 2004-2006 due to a one-time time event. In further response to Representative Drummond he explained trend downward was due to the decline in the average production per well which is lowered as new wells are drilled in each field, even if the level of production is maintained.

REPRESENTATIVE PARISH inquired as to industry profits during the period of time a gross tax system was in effect.

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MR. ALPER said industry profits depended on the price of oil and other factors; during that time period DOR did not have access to industry cost data because the tax was based on gross income. He opined the oil industry made larger profits when the price of oil was higher, regardless of the state tax rate. Mr. Alper acknowledged the issue of tax stability is a valid concern by industry and slide 15 listed the seven changes that have been made to Alaska's production tax within thirteen years; industry will testify that it is hard to invest when taxes are unknown. In 2005, by executive order, former Governor Frank Murkowski aggregated the Prudhoe Bay satellite fields for ELF calculations, and the net effect was a \$150 million tax increase to the state. Subsequent litigation was resolved in December 2016, when the Alaska Supreme Court upheld the former governor's action. Mr. Alper described the other changes that were made by the legislature and noted the high revenue collected in 2008-2012 has somewhat sustained the state budget. Tax regime changes were as follows (slide 15):

1. 2005: Prudhoe Bay satellite fields aggregated
2. 2006: Petroleum Production Tax (PPT) [passed in the Twenty-Fourth Alaska State Legislature] taxed net profits
3. 2007: ACES corrected revenue shortfalls and instituted an aggressive progressivity measure

4. 2010: Cook Inlet Recovery Act "CIRA" [passed in the Twenty-Sixth Alaska State Legislature] increased natural gas supply from Cook Inlet to Southcentral and the Interior
5. 2013: Senate Bill 21 eliminated the progressivity measure, replaced capital credit with per barrel credit, and lowered tax for new oil by GVR provisions
6. 2016: House Bill 247 tax credit reform
7. 2017: House Bill 111 tax credit reform

MR. ALPER turned attention to how a minimum tax change impacts new fields under development or to be developed. With the current tax regime, a company can carry forward its spending to develop a new field and reduce its future taxes once oil is produced. Provisions within House Bill 111 allow a company to only use carry-forward [expenses] sufficient to reduce its taxes down to the minimum tax, with the exception of the time period affected by GVR, when taxes can be zero; however, after the GVR time period of three to seven years, a company cannot reduce its taxes below the minimum tax. For example, if a company spent billions to develop a major new oilfield, after production begins, the company would pay the minimum tax no matter the price of oil because the past spending will reduce its taxes. Thus, raising the minimum tax from 4 percent to 7 percent would impact field economics and thereby impact decisions on whether to invest in new fields. In addition, if the higher minimum tax causes a company to take too long to use its lease expenditures, it would not be able to recapture 100 percent of its investment in the field due to downlift (slide 16).

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REPRESENTATIVE RAUSCHER expressed concern about the current recession in Alaska and projects that have been lost, noting new fields may not come into production before the tax credits apply. He questioned whether HB 288 creates risk at a time the state seeks investment and production.

MR. ALPER said he would not express an opinion on risk and his intent is to present facts and figures; however, there is concern about how minimum tax changes affect a new field. Although not a major change, the bill would change industry rates of return by a fraction of a percent, which would impact some companies.

REPRESENTATIVE TALERICO surmised a loss of value occurs when a project is being developed over seven or eight years and [the

tax rate is reduced] by GVR, after production begins the project's lease expenditures begin to lose value.

MR. ALPER said yes and posed the example of a company that invests \$1 billion before first production; subsequently after production and making profits, the company would want to use \$200 million per year over five years to get the tax rate down to the minimum tax. By raising the minimum tax from 4 percent to 7 percent, the company may only need to use \$100 million per year to get to the minimum, and the lease expenditures may reach maturity at ten years and lose value, before the company has used them.

CO-CHAIR TARR remarked:

... for purposes of that ten-year calculation, for Department of Revenue purposes for that "day one," it's when you go into production, so it's a full ten years once the ... project is into production that those, you know, that each of those ten years you can use your losses against any taxes and then it would be in the following year where the downlift would start.

MR. ALPER clarified the timeline is ten years from the date the cost was incurred; in fact, if the money was spent in the five years before first production, the "year one" expenditures are already five years old, and by year six of production, will begin to lose value if not used.

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CO-CHAIR JOSEPHSON expressed his understanding the ten-year or seven-year period of downlift does not commence until the time of production and asked for further clarification. He recognized Mr. Alper's concerns that a higher minimum tax may reduce economic viability for a new explorer and that the bill may create an inability to recapture the cost of development because of downlift; however, he returned attention to [slide 7 of a PowerPoint presentation entitled, "House Bill 288, Fairness in Oil Taxes," undated, that was provided during the hearing of HB 288 on 1/22/18] and pointed out at \$60 per barrel oil PTV is approximately \$20 and the gross tax is approximately \$2. In addition, PTV is further reduced by state and federal income taxes. He acknowledged royalty paid to the state is not reflected, and royalty is directly related to levels of production, but industry take is approximately \$18 with \$2 to the state as production tax.

MR. ALPER returned attention to slide 9, which illustrated updated estimates of production tax, and pointed out state and federal income tax will be based on approximately \$21, although at an oil price of \$40 per barrel, PTV is \$3.35, which would leave only \$2 after the payment of production tax; in fact, the payment of "a 12 percent gross royalty might actually turn that company negative."

REPRESENTATIVE BIRCH said slide 17 summarized his concerns regarding HB 288. He referred to potential developments in the Arctic National Wildlife Refuge (ANWR) and the National Petroleum Reserve-Alaska (NPR-A) and restated that a minimum tax increase could reduce the viability of future projects and stressed the veracity of the two other bullet points on slide 17. He cautioned the statements on the slide are masterful understatements of the impact of a 75 percent tax increase, particularly at a time the state needs to encourage the investment and exploration that are essential for new production.

MR. ALPER said the most important point on slide 17 is to understand the tax. He suggested at an oil price of \$100 per barrel, one would believe Alaska's tax system is reasonably high; in fact, at high oil prices, the state garners the minimum tax from new fields because the system has replaced credits with "carry forwards" during the early years. He remarked:

... so, it's no longer ... just a low-price conversation. So yes, it's a 75 percent increase, it's a 75 [percent] increase above a sort of synthetically low tax because we're allowing them to buy it down to the minimum tax through the recapture. There are regimes around the world, frankly, that allow companies to pay zero during their cost recovery period. ... Alaska chose not to go that way, we chose to insist on the minimum tax, we're now discussing what should that minimum tax be.

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REPRESENTATIVE PARISH pointed out the language of the bill calls for an increase from 1 percent to 2 percent although, from the information presented on slide 17, it can be said the increase to the effective tax rate is 101 percent; he urged for plain language in the explanation of the bill.

MR. ALPER stated his testimony represents various points of view on the bill, and from industry's point of view the tax rate is a 75 percent increase to production tax, which is approximately one-quarter of industry's obligation to the state; he advised both are legitimate views and urged the committee to understand both definitions.

REPRESENTATIVE PARISH returned attention to slide 14, noting the average gross tax ranged from approximately 12 percent [in 1995] to approximately 7 percent [in 2006]. He questioned why a 7 percent gross tax was "intolerably low" in 2006, but an [effective tax rate of 7 percent] is "impossibly high" in 2018.

CO-CHAIR TARR passed the gavel to Co-Chair Josephson.

MR. ALPER recalled the 4 percent minimum was in statute for eight years without application until the price of oil dropped; however, in the fall of 2014, the minimum tax became applicable. Proposed changes to the minimum tax on oil and gas production tax is one of many issues that arose out of the state's fiscal crisis.

REPRESENTATIVE TALERICO stated his understanding that at 4 percent, each percentage point added is 25 percent, which is shown very appropriately [on slide 17].

CO-CHAIR JOSEPHSON passed the gavel back to Co-Chair Tarr.

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REPRESENTATIVE DRUMMOND asked what Mr. Alper meant by a synthetically low tax.

MR. ALPER explained a company producing oil in a high price environment would pay a high tax on its profits; however, in order to credit the company for the billions of dollars it spent prior to production, the tax system will allow the company to use the amount of its investment to reduce its taxes to the minimum tax. He said, "In the context of just that one year, it is an artificially low tax you're paying - it's reasonable because we are paying you back in some way for that past investment and we are doing it at a later date than we would have under the previous law ... the compensation you're getting for no longer having [cashable tax credits paid] is that reduced tax rate during your early years of production."

CO-CHAIR TARR said from the state's perspective, taxes that are reduced to a 7 percent minimum protects the state's interest.

MR. ALPER turned to HB 288's impact specifically on new fields and directed attention to the bill's fiscal note [identifier: HB288-DOR-TAX-1-20-18] that estimates increased revenues of approximately \$230,000,000. This estimate is calculated on expected oil prices and expected current legacy production; however, the fiscal note does not incorporate [slides 16-18] which are related to new fields. For example, if a new field begins production in FY 24-FY 25, the producer will pay the minimum tax - the minimum tax is proposed by HB 288 to increase - and increases to the minimum would change the producer's cash flow and may change decision-making. Continuing with issues for new fields, slide 18 illustrated a life cycle analysis for a hypothetical new field. The model proposed lifetime production of 750 million barrels - from a project that required \$10 billion in capital costs - and 120,000 barrels per day peak production was used to show the effect of the proposed increased minimum tax. Over the life of the model field, at \$60 per barrel oil, production tax would be increased by \$375 million and at \$80 per barrel oil production tax would be increased by less than \$200 million. He cautioned that the internal rate of return is an important consideration to investors: the internal rate of return would erode by one- to two-tenths of 1 percent over the life of the project. Further, the breakeven price would increase by \$1 per barrel, which the company would use to determine a go, or a no-go decision.

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CO-CHAIR TARR suggested the committee review the information presented on slide 18 as it would relate to smaller near-term development; she pointed out the difficulty of assessing [the impact of revenues from] a development that will not see production in ten or twelve years on state finances with a near-term problem.

MR. ALPER added that [the impact of the bill] on a near-term field also differs in that most of the development was accomplished during the previous tax system, which provided cash credits; near-term fields would not be as affected by downturn when production begins. However, later projects would be affected by the time limit on lease expenditures. In further response to Co-Chair Tarr, he confirmed because of the change brought about by House Bill 111, spending post-1/1/18 is affected.

CO-CHAIR TARR advised the committee must consider the factor of the various timelines of projects.

REPRESENTATIVE BIRCH asked whether the governor supports the proposed legislation.

MR. ALPER said the governor has not taken a position on the bill and it is not expected that he will do so.

CO-CHAIR JOSEPHSON returned attention to new exploration and asked whether the governor's forthcoming legislation, which proposes to sell bonds to pay owed cash credits, would satisfy DOR's concerns about carry-forward losses [that are delayed by an increase to the] minimum tax.

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MR. ALPER explained the carry-forward statutes are clear but appropriations to pay the credits are uncertain and that affects the economic status of the industry. The goal of the forthcoming legislation is to eliminate the industry's uncertainty by taking away the risk that the state will not pay in a timely manner.

[HB 288 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 2:58 p.m.