SENATE FINANCE COMMITTEE
April 27, 2017
9:07 a.m.

9:07:17 AM

CALL TO ORDER

Co-Chair MacKinnon called the Senate Finance Committee meeting to order at 9:07 a.m.

MEMBERS PRESENT

Senator Anna MacKinnon, Co-Chair
Senator Click Bishop, Vice-Chair
Senator Shelley Hughes
Senator Peter Micciche
Senator Donny Olson
Senator Natasha von Imhof

MEMBERS ABSENT

Senator Lyman Hoffman, Co-Chair

ALSO PRESENT

Senator Cathy Giessel; Senator Bert Stedman; Senator Mia Costello.

PRESENT VIA TELECONFERENCE

Rich Ruggiero, Castle Gap Advisors, Houston, TX; Roger Marks, Legislative Consultant, Legislative Budget and Audit Committee.

SUMMARY

CSHB 111(FIN)(efd fld)
OIL and GAS PRODUCTION TAX;PAYMENTS;CREDITS

CSHB 111(FIN)(efd fld) was HEARD and HELD in committee for further consideration.

#hb111
CS FOR HOUSE BILL NO. 111(FIN)(efd fld)

"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; relating to carried-forward lease expenditures based on losses and limiting those lease expenditures to an amount equal to the gross value at the point of production of oil and gas produced from the lease or property where the lease expenditure was incurred; relating to information concerning tax credits, lease expenditures, and oil and gas taxes; relating to the disclosure of that information to the public; relating to an adjustment in the gross value at the point of production; and relating to a legislative working group."

9:08:48 AM

RICH RUGGIERO, CASTLE GAP ADVISORS, HOUSTON, TX (via teleconference), discussed the presentation, "Petroleum Fiscal Design HB 111" (copy on file).

Co-Chair MacKinnon handed the gavel to Vice-Chair Bishop.

Mr. Ruggiero addressed slide 4, "How Are Explorer/Producer Costs Recovered?":

- Net Operating Losses (NOLs) are created in any year where the sum of the costs exceed the amount of revenue available for recovery of those costs
- For gross based fiscal systems (like most of the lower 48), there is generally no allowance for costs recovery, as the tax is based on the gross revenue back to the well, lease or unit boundary
  - There are some allowable deductible costs between the sale point in the market and the well, lease or unit boundary
  - LNG shipping and long distance pipeline transportation are examples
- Net based systems in use around the globe have many different mechanisms for cost recovery
  - “Cost Oil” in Production Sharing Agreements (PSAs)
  - Cost deductions, ranging from a limited percentage up to 100 percent of available revenue
  - Recovered as per a schedule, much like the depreciation of capital

- And others

Vice-Chair Bishop handed the gavel to Co-Chair MacKinnon.

Mr. Ruggiero addressed slide 5, "What is the Value of 'Recovery'?":

- Looking at the same project, but run against the fiscal systems in several different regimes, the internal rate of return (IRR) and net present value (NPV) to the producer (and thus the net present cost to the government) varies greatly
  - Project IRR and NPV are key aspects of investment decision making
- These variations are the result of several different methods of accounting for the costs or NOLs
  - Which costs incurred are eligible for recovery?
  - How much time does it take to recover them?
  - Is there any interest or uplift provided?
  - Is there one or multiple tax rates (i.e. can the effective tax rate differ from when the NOL is created to when the NOL is recovered)?
  - Is the recovery of costs against the petroleum tax ultimately deductible against corporate income tax?
- The combination of all of the above will inform the producers as to the attractiveness of the fiscal regime

9:14:16 AM

Mr. Ruggiero looked at slide 6, "Retaining Value for NOLs i.e. Cost Recovery":

- Current Alaska structure provides for 100 percent of cost recovery "value" through the concept of the cashable credit
- Removal of the cashable credit option then creates a challenge as to how to preserve the full "value" of cost recovery
  - Switch to carry forward of net operating losses (CF NOLs)
- Applying CF NOLs to possible future North Slope projects surfaced issues related to the interaction

with per barrel credits and gross minimum taxes resulting in producers possibly not getting full value for their costs and NOLs
- Defined this inefficiency as “Wasted NOLs”

Mr. Ruggiero highlighted slide 7, "Basic Alaska Structure":

- Start with the GVPP or Gross Value at the Point of Production
  - Subtract Current Costs
  - Subtract CF NOLs
  - Subtract appropriate GVR if eligible
- This results in the PTV or Production Tax Value
  - Cannot be less than $0
  - Calculate preliminary petroleum tax at 35 percent of PTV
  - Subtract eligible per barrel credits
- This results in the “net” petroleum tax due
  - Cannot be less than $0
- Calculate the “gross” minimum tax
  - 4 percent of the GVPP at prices above $25
- Tax due is the greater of the “net” or “gross” amount

Mr. Ruggiero addressed slide 8, "Basic Alaska Structure":

- Start with the GVPP or Gross Value at the Point of Production
  - Subtract Current Costs
  - Subtract CF NOLs
  - Subtract appropriate GVR if eligible
- This results in the PTV or Production Tax Value
  - Can not be less than $0
  - Calculate preliminary petroleum tax at 35 percent of PTV
  - Subtract eligible per barrel credits
- This results in the “net” petroleum tax due
  - Can not be less than $0
- Calculate the “gross” minimum tax
  - 4 percent of the GVPP at prices above $25
- Tax due is the greater of the “net” or “gross” amount

Mr. Ruggiero looked at slide 9, "Simple Single Barrel Example":

- First, lets look at the calculations before the introduction of CF NOLs
- For NON-GVR
  - Net tax is 4.25
  - Gross minimum tax is 2.60
  - Tax Paid is the greater of so 4.25
- For GVR
  - Net tax 2.70
  - Gross tax 2.08
  - Tax Paid 2.70

Mr. Ruggiero looked at slide 10, "Simple Single Barrel Example – Add in CF NOLS":

- Assume 50 in available CF NOLs
- For NON-GVR
  - Use 35 CF NOL to take the PTV to 0
  - Net tax is 0
  - Gross minimum tax is 2.60
  - Tax Paid is the greater of so 2.60
- FOR GVR
  - Use 22 CF NOL to take the PTV to 0
  - Net 0
  - Gross – N/A as per barrel credits pierce the floor

9:21:16 AM

Mr. Ruggiero looked at slide 11, "Simple Single Barrel Example – Optimize CF NOLS":

- Assume 50 in CF NOLs
- Use only the amount of CF NOL to optimize use of per barrel credits and min floor
- For NON-GVR
  - Only need to use 4.7 and not 35
  - 30.3 NOL wasted, or 86 percent wasted
- FOR GVR
  - Only need to use 1.77 versus 22

- 20.2 NOL wasted or 92 percent wasted

Senator Olson looked at slide 10, and wondered whether all the net operating losses (NOLs) must be used to bring the production tax values (PTVs) to zero. Mr. Ruggiero replied that the current legislation stated that the producers were obligated to take all available and carryforward costs and apply them until the PTV became zero. The remainder became a carryforward loss for the following year.

Senator Olson surmised that one did not need to use all the NOLs to get to zero. Mr. Ruggiero responded that the current bill would allow to choose the number of NOLs to equalize the net and gross taxes.

9:25:34 AM

Mr. Ruggiero addressed slide 12, "What is the Takeaway?":

- Because of the interaction of the various mechanisms within the fiscal structure, no one item should be viewed stand alone and care should be taken to make sure the level and degree of inter-dependency is understood.
- So long as Alaska keeps some form of GVR, per barrel credits and hard floors related to gross minimum taxes, the impact of CF NOLs will range from slightly less to much less than what one would expect.
- Changing other mechanisms, such as increasing the minimum tax or reducing per barrel credits, will alter the value to the producer and the impact to the state for CF NOLs.
- For 100 percent used and useful NOLs the proffered language in the SRES CS will allow producers to only use NOLs when useful to reduce taxes.

Mr. Ruggiero looked at slide 14, "Time Can Have More Impact than Tax Rate":

- Modeled a hypothetical field for purposes of only showing the effect of timing on producer economics
- All model runs are based on the same data
  - Producer investment of 100
  - Total revenue of 400

- 100 cost recovery
- 300 of profit split between producer and government
- In each of case 1 to 3 the total cash to the producer and to the government is identical, only the timing changes
- Depending on how cost recovery is handled, the results range from a very doable and profitable project to a project that would not get developed

Mr. Ruggiero looked at slide 15, "4 Timing Scenarios of Same Total Dollars":

- Immediate Recovery 100 percent Useful – i.e. money back right after investing IRR = 27 percent, NPV = 46, CF=120
- Accelerated Recovery 100 percent Useful – i.e. all available revenue for cost recovery before profit splits IRR = 20 percent, NPV = 27, CF=120
- Delayed Recovery 100 percent Useful – e.g. cost recovery through depreciation of an asset IRR = 14 percent, NPV = 14, CF=120
- Only 50 percent Useful Recovery – i.e. As suggested by the other body IRR = 6 percent, NPV = -12, CF=100

*CF = undiscounted cash flow

9:32:26 AM

Mr. Ruggiero highlighted slide 16, "Uplift Compensates for Timing Differences":

- Many regimes offer some form of “uplift” or interest on carry forward losses to allow the producer to recover some of the time value loss as well
- We could fill several days of testimony on what is the right or fair rate of uplift
  – Companies, depending on size, will argue long run returns in the 12 percent to 20+ percent and would need an equivalent uplift to be kept whole
  – Governments tend to view the world as long run 4 percent to 6 percent return and view anything higher as a “giveaway”

– Settling somewhere in the 'middle' means both sides give a bit

- 10 percent annual uplift falls nicely in between expected return rates

Mr. Ruggiero addressed slide 17, "Impact of Interest Rate on Time Value of Money":

- The yellow highlighted cells basically show, at the interest rates listed across the top, how long it takes to double your money

Mr. Ruggiero looked at slide 18, "Uplift – For How Long?":

- Many aspects of the fiscal regime and the particular project will suggest what is the right length of time for providing uplift
- This is a self-correcting mechanism
  - Those that can use the NOLs quickly are not disadvantaged and thus need little uplift
  - For whatever circumstances lead to prolonged recovery, uplift is a means of keeping whole
- Legacy producers with sizeable current production are advantaged
- New players may, depending on price forecasts, take decades to recover their costs

9:39:53 AM

Mr. Ruggiero highlighted slide 19, "Quick Modeling Runs - Observations":

- Life-cycle Model plus Legacy on 6 percent decline
  - $10 TandS, $30 costs for Legacy
  - Used 500,000 bpd as legacy production
- With a hard floor at 4 percent
  - At prices above $50/bbl there is sufficient taxable value from the legacy production to be able to immediately deduct the new project capital costs
  - Economically, this is nearly the same as cashable credits

– Relative to a producer with no legacy production, this adds 3.5 percent to 4 percent to the project return (IRR) and doubles the discounted net present value

■With no hard floor

– The absence of a gross minimum hard floor provides very small improvement to project IRR and net present value for new development

9:42:19 AM

Mr. Ruggiero looked at slide 20, "Legacy Operator, Legacy + New Oil Field (GVR eligible), No Wasted NOLs, No Hard Floor":

■Assumptions:

– 7 years pre-production investment
– GVR benefits are realized for 3 years only (does not reflect current statute)

9:49:16 AM

Senator Micciche wondered whether the numbers were severance only. Mr. Ruggiero replied in the negative. The state tax included royalty.

Mr. Ruggiero highlighted slide 21, "Legacy Operator, Legacy + New Oil (GVR eligible), No Wasted NOLs, With a Hard Floor":

■Assumptions:

– 7 years pre-production investment
– GVR benefits are realized for 3 years only (does not reflect current statute)

Mr. Ruggiero looked at the column under "$55", and remarked that that the NOLs would not be recovered until year 37.

Mr. Ruggiero looked at slide 22, "New Operator, New Oil (GVR Strict 3 years), No Wasted NOLs, No Hard Floor":

■Assumptions:

– 7 years pre-production investment
– GVR benefits are realized for 3 years only (does not reflect current statute)

- With no hard floor, no tax is paid during minimum tax period

9:54:37 AM

Mr. Ruggiero referred to slide 23, "New Operator, New Oil (GVR Strict 3 years), No Wasted NOLs, With a Hard Floor":

- Assumptions:
  - 7 years pre-production investment
  - GVR benefits are realized for 3 years only (does not reflect current statute)

Senator von Imhof surmised that there was a "trade-off" between the state receiving more money in the short-term with a hard floor, but prolonging the NOL's final recovery year. Mr. Ruggiero agreed.

Senator von Imhof stated that the slide assumed a $5 per barrel credit, which did not pierce the floor. She asked for more information regarding that assertion. Mr. Ruggiero replied that the $5 per barrel was only applied to the first three years. He stated that starting in year four of production, it would move to the sliding per barrel credit that would not be allowed to pierce the floor.

Senator von Imhof noted that it did not reflect current statute. Mr. Ruggiero agreed. The slide was an analysis.

Mr. Ruggiero furthered that it was based on a request. The intent was to see the impact of the NOL recovery.

9:58:10 AM

Mr. Ruggiero highlighted slide 24, "New Operator, New Oil (GVR eligible), No Wasted NOLs, With a Hard Floor and 10 percent Uplift":

- Assumptions:
  - 10 percent Uplift
  - 7 years pre-production investment
  - GVR benefits are realized for 3 years only (does not reflect current statute)

Mr. Ruggiero addressed slide 26, "Alaska Competitiveness Under Senate Resources CSHB111":

- For legacy players
  - See this as positive as defines the priority use of the various deductions
  - Allows quick recovery of costs and NOLs
  - Allows credits to be recovered from corporate income taxes
- For new players
  - Uplift helps, but expected timing of new mega projects would suggest longer than 7 years are needed for uplift
  - Initiation of 1 barrel of oil production terminates accrual of uplift. This immediate termination could cost a new player needed uplift on billions in spending; would suggest that a sizeable threshold, such as 5000 barrel per day, be set as to when uplift ceases to be payable
  - Is the uplift particular to annual packages and each gets its own 7 year window, or are NOLs to be treated as one package regardless of year of creation and given the same 7 year window for uplift?
- Recommend that the window apply separately to each annual package amount
- NOLs to be used on a first in first out basis

10:06:00 AM
AT EASE

10:10:07 AM
RECONVENED

10:10:40 AM

ROGER MARKS, LEGISLATIVE CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE (via teleconference), discussed the PowerPoint, "Senate CS for CS HB 111 (Ver C-P); Some Observations" (copy on file).

Mr. Marks looked at slide 2, "Summary":

Reduces state credit exposure without compromising competitiveness of overall fiscal system

Some economic observations regarding the interaction of loss recovery, the per barrel credit, and the gross minimum floor under the CS follow

Two lingering issues

Mr. Marks addressed slide 3, "Preface":

The production tax is a net tax with a 35 percent rate
There is a floor on that net tax equal to 4 percent of gross value
    The per barrel credit and loss recovery perform distinct functions:
    The per barrel credits provide tax relief to partially offset the high burden of royalties at low prices
        It reflects this year's business
        If not used they are lost forever, and the royalty offset role is eviscerated
    Loss recovery provides for the deduction of costs in computing net value that could not be deducted in prior years
        It reflects prior years' business
Since they are distinct issues, using them both is not redundant

Mr. Marks looked at slide 4, "The Royalty Problem (Using GVR Oil)":

ANS Price $50
Transp ($10)
Gross $40
Upstream Costs ($35)
Net Value $5
1/8 Royalty ($5)
Producer income before prod tax ($0)
Govt take before prod tax 100 percent

Senator Micciche queried the reason for using $35 for upstream costs. Mr. Marks replied that his numbers added $10 to the Revenue Sources Book.

10:17:31 AM

Mr. Marks addressed slide 5, "CS Summary of Credits and the Floor":

• Losses
– Currently (both Non-GVR and GVR Oil):
• Can use losses to bring tax below floor
– CS: (both Non-GVR and GVR Oil):
• Cannot use losses to bring tax below floor*
• Per Barrel Credit
– Currently:
• Non-GVR Oil: Cannot use credit to bring tax below floor
• GVR Oil: Can use credit to bring tax below floor
– CS: No change
* If non-GVR and GVR losses were treated differently it would be necessary to allocate losses between them, which would be very difficult

Mr. Marks looked at slide 6, "Observation 1: “Hardening” the Floor"

• Under current law taxpayers can use carried forward loss credits to bring taxes below the gross minimum floor
• Under the CS taxpayers can only use carried forward losses to bring the tax down to the floor

Mr. Marks addressed slide 7, "Hardening the Floor Against Losses: Loss Recovery on Non-GVR Oil":

• No loss recovery unless prices above about $65/bbl
– Losses on production not generated until prices below about $35/bbl
– Losses on development of other non-GVR oil would have offsetting income at all but very low prices
– Loss recovery on non-GVR oil does not appear to be a significant problem

10:22:49 AM

Mr. Marks highlighted slide 8, "Hardening the Floor Against Losses: GVR Oil Tax Calculation at Current Prices":

ANS Price $50
Transp ($10)
Gross ($40)
Gross minimum at 4 percent $1.60
Per barrel credit ($5.00)
Tax $0.00

Mr. Marks addressed slide 9, "Hardening the Floor Against Losses: Loss Recovery on GVR Oil":

- Most new development would be GVR oil
- Companies with substantial existing production and income could offset GVR losses
- GVR production from companies without existing production
- Since per barrel credits cannot be carried forward, and because of their value, taxpayers would use per barrel credit first
- Accordingly, taxpayers might only use losses when prices were high enough such that use of per barrel credit and losses exceeded floor
- At about $85/bbl, net tax exceeds gross minimum
- Accordingly, these losses may not be recovered until after GVR status lapses (after 3 or 7 years) and per barrel credit can no longer take tax below minimum. At that point taxpayers may start recovering losses.

10:27:51 AM

Mr. Marks looked at slide 10, "Uplift on Cost Recovery":

- Provides net present value boost to companies who have to wait to have production/offsetting income
- Currently CS limits only to companies without production
  - Companies with only limited production/offsetting income may not be in a much different situation
- The issue of early GVR cost recovery only at high prices applies here
  - Similarly, may only be invoked after GVR status lapses (after 3 or 7 years of production)

Mr. Marks addressed slide 11, "Sequencing Under the CS: Two Possibilities Non-GVR Oil Assuming a $5 Loss Carried Forward":

ANS Price	$55	$55
Transp Cost	($10)	($10)
Gross Value*	$45	$45
Upstream Costs	($25)	($25)
Loss	($5)	($0)
PTV	$15	$20
Tax before p/bbl credit at 35 percent	$5.25	$7

Per barrel credit ($3.45) ($5.20)
Tax $1.80 $1.80
*Gross minimum (at 4 percent) $1.80 $1.80

10:34:21 AM

Mr. Marks looked at slide 12, "Unresolved Issue 1: The Order of Deducting Losses vs. Per Barrel Credits":

• Recognizing:
– Per barrel credits lapse if not used
– Unused losses carry forward if not used
• The CS does not specify which is used first in calculating the tax
• Given the hard floor for non-GVR oil:
– It will probably be to the taxpayer's benefit to use the per barrel credits in getting the tax down to the floor, and carrying unused losses forward
– Would be consistent with utilizing functional intent of the per barrel credits and loss recovery inherent in the statute

Mr. Marks addressed slide 13, "Questions":

• Should the statute specify the sequence?
– Do 100 percent of available losses have to be used first?
– Do 100 percent of available per barrel credits have to be used first?
– Can taxpayer mix?
• Should statute specify the sequence? Should statute leave it up the taxpayer? Should statute leave it up to the Department?

Mr. Marks displayed slide 14, "Unresolved Issue 2: What Does it Mean to Use a Credit to Bring Taxes Below the Floor?"

• Under the CS, for GVR oil, losses cannot bring taxes below the floor, but the per barrel credit can
• Suppose:
– Tax before credits: $10
– Minimum tax: $7
– Per barrel credits: $5
– Losses: $4

Mr. Marks discussed slide 15, "Taxpayer Options Pursuant to DOR Interpretation in Similar Situations:

If you use both credits, they are both the cause of getting below the minimum
Tax before credits: $10
Use $3 in losses to bring tax down to minimum, but
not use any per barrel credits to reduce tax further
($3), TAX $7
Tax before credits $10
Use $5 in per barrel credits, but not use any losses to reduce tax further
($5), TAX $5

Mr. Marks highlighted slide 16, "Taxpayer Options Pursuant to DOR Interpretation in Similar Situations: If you use both credits, they are both the cause of getting below the minimum":

- Start out with $10 in tax before credits or losses
- Use $3 in losses to bring tax down to $7 minimum
- Then use $5 in per barrel credits to bring tax down to $2

Mr. Marks addressed slide 17, "Analogy":

- Suppose you have $100 in your checking account
- You write two $100 checks
- Did both checks, or the second check, cause you to be overdrawn?

10:40:45 AM

Mr. Marks looked at slide 18, "At Stake":

- Recognizing the distinct function of each credit
  - The per barrel credit is not loss recovery
  - Loss recovery is not the per barrel credit

Senator von Imhof stressed that it was important not to misinterpret the NOL use, because there could be confusion in the NOL carryforward. Mr. Marks agreed. He supported less ambiguity in statute.

Co-Chair MacKinnon discussed the following day's agenda.

CSHB 111(FIN)(efd fld) was HEARD and HELD in committee for further consideration.

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ADJOURNMENT

10:45:11 AM

The meeting was adjourned at 10:45 a.m.