

SENATE FINANCE COMMITTEE

May 4, 2017

9:09 a.m.

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CALL TO ORDER

Co-Chair MacKinnon called the Senate Finance Committee meeting to order at 9:09 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
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

None

ALSO PRESENT

Ken Alper, Director, Tax Division, Department of Revenue;
Dan Stickel, Chief Economist, Economic Research Group, Tax
Division, Department of Revenue; Senator Cathy Giessel;
Senator Bert Stedman; Senator Pete Kelly.

SUMMARY

HB 111 OIL & GAS PRODUCTION TAX;PAYMENTS;CREDITS

HB 111 was HEARD and HELD in committee for
further consideration.

PRESENTATION: DEPARTMENT OF REVENUE ANALYSIS OF HB 111

#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."

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^PRESENTATION: DEPARTMENT OF REVENUE ANALYSIS OF HB 111

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Co-Chair MacKinnon requested that the presentation start on slide 10.

KEN ALPER, DIRECTOR, TAX DIVISION, DEPARTMENT OF REVENUE, introduced himself. He apologized for the absence of Commissioner Randall Hoffbeck, and indicated that Chief Economist Dan Stickel could speak to the fiscal notes. He continued that in addition to tax credit history, the first 9 slides of the presentation continued information on the current balance of credits owed. He would refer to the slides if necessary during the presentation.

Mr. Alper discussed the presentation "SCS CSHB 111(RES)\C - Oil and Gas Production Tax Credits - Analysis of the Bill" (copy on file). He referenced slide 7, informing that it contained a table (that had been disseminated via memo the previous week), that showed new information required by HB 247 [oil and gas tax policy legislation passed in 2016] and listed what companies had received in cash credits in 2016.

Mr. Alper showed slide 10, "Specific Provisions of Senate Resources Bill." He considered the effects of Senate Resources Committee Substitute for HB 111.

Mr. Alper referenced slide 11, "Elimination of Cash Credits-North Slope NOL":

Eliminates the "Carried Forward Annual Loss" (NOL) credit by repealing AS 43.55.023(b)

- Instead of losses turning into cashable credits, the excess expenditures are carried forward to be used in a future year to offset revenue
 - When used, only enough is used to reduce liability to the equivalent of the minimum tax. The rest carry forward
 - Issue of interaction with GVR / multiplier effect
 - Value that's carried forward receives an "uplift" or interest of 10% compounding for up to 7 years (only for companies without production)
 - 10% compound interest for 7 years roughly doubles value
 - Would like clarification on when the uplift begins
- * red text indicates technical concerns being addressed

Mr. Alper indicated that the red text on the slides denoted technical concerns, which had been previously discussed by himself and Co-Chair MacKinnon and staff. He understood that the concerns were being resolved by the committee and did not materially impact the dollar value of the bill. He stressed the importance of working through the technical language of the bill so that the committee's will could be carried forward with the bill.

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Mr. Alper continued discussing slide 11. He detailed that the North Slope "Carried Forward Annual Loss" [or, net operating loss] (NOL) credit was a 36 percent credit, the Middle Earth NOL was a 15 percent credit in the current year, and the Cook Inlet NOL was at 15 percent but would be gone the following year. The major point of the NOL was a loss carry-forward to use against future taxes.

Mr. Alper referred to remarks pertaining to carry-forwards losing value, and indicated that the only amount used was that which was required to bring the value down to pay the minimum tax. He indicated that previous versions of the bill would have brought the value down to zero, and then still the minimum tax would be required. He thought the current bill was clearly written to say that one could carry forward to only the minimum tax level.

Mr. Alper highlighted a technical issue of the repeal of a section of the bill that included the NOL credit. Within the bill section, there was language that fixed a problem within the integration of the NOL and the gross value reduction (GVR). He explained that the GVR could be subtracted from a producer's loss, thereby increasing the size of a tax credit and creating an opportunity for tax credits in excess of 100 percent of a loss. He thought the issue was an error from the original language of SB 21 [oil and gas tax legislation that passed in 2013].

Mr. Alper discussed uplift, which he described as an interest payment from the state to the company in possession of the losses, generally used to compensate the company for the time-value of money. He used an example of a company that had \$1 million in losses it was able to use two years later, while earning 10 percent compounding interest per year on the losses. The uplift would be used to offset future taxes. He mentioned the "rule of 72," which would almost double the value of a carry-forward.

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Co-Chair MacKinnon asked if there was a different percentage to consider that would keep a company whole versus doubling the value of the carry-forward.

Mr. Alper thought the question of "whole" was very subjective, and that there were many potential metrics to use. He thought the time-value of money could be viewed as interest or inflation value, or viewed as the cost of capital.

Co-Chair MacKinnon asked if the administration had the definition of what "whole" was, when the state previously promised to pay tax credits but was not currently doing so. She wondered if there was a percentage that the administration was supportive of, in aid of describing "whole."

Mr. Alper answered in the negative, and stated that the administration recognized the industry hardship created as a result of not paying tax credits. He stated that the administration would like to find a complete solution to be able to pay off the tax credits in the current year. He thought there were technical questions that could be discussed at a later time; such as the effective tax rate.

He discussed the effective tax rate of SB 21, which was substantially lower than the 35 percent calculated rate. The carry-forwards were already valued at 35 percent, which he thought could be considered as a built-in uplift. He opined that there was probably not a need for additional interest because of the difference between the value of the carry-forwards against taxes versus the actual effective tax rate paid by the companies.

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Senator von Imhof referred to the technical issues highlighted in red on the slide. She asked (if hypothetically there was no uplift) how the NOL would be utilized with the GVR. She wondered how it might preserve an NOL going forward if a GVR was taken first.

Mr. Alper explained that the issues were not related. He used the example of a company that lost \$20 million the previous year, but had production from a new field that had a gross value of \$100 million. He explained that a GVR functioned when 20 percent of the gross was subtracted from the net; which was a provision that was added in SB 21 in order to lower taxes. With \$100 million in profits, a company would only pay taxes on \$70 million to \$80 million. For tax calculation purposes, the company's loss would be \$40 million, which was comprised of the \$20 million loss and an additional subtracted 20 percent. He summarized that 35 percent of the \$40 million loss would be \$14 million, and the company's credit became 70 percent of the loss instead of 35 percent. He explained that the inadvertent outcome had not been contemplated when oil was at higher prices, and no one had questioned what would happen when a producer was losing money. He stated that there had been a technical fix the previous session.

Mr. Alper continued to speak to Senator von Imhof's question. He believed the way the bill was written satisfied the previous committee chair's intent that carry-forward credits were not wasted. He shared that under the House version of the bill, a company with \$100 million in profit could use \$100 million in carry-forwards to bring the net to zero, and still pay the minimum tax. After changes to the Senate version of HB 111, the carry-forwards would not be used faster than what it would take to get a company to the minimum tax floor.

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Mr. Alper showed slide 12, "Elimination of Cash Credits-Middle Earth":

Middle Earth credits were generally cut in half by HB247

- Currently has a 15% NOL. This can be stacked with either a 10% Qualified Capital Expenditure, a 20% Well Lease Expenditure, or (through 2021) a 40% Exploration credit.
- Bill deletes the NOL outright, so state support decreases from 25%-55% to 10%-40%
- Remaining QCE (023(a)) and WLE (023(1)) credits continue to be earned and turned into certificates, as do (through 2021) exploration credits
- Due to time language and fund repeal, these certificates would no longer be cashable and could only be either held to use against liability or sold (transferred)
- No uplift or carry forward, which are limited to North Slope losses

Mr. Alper explained that Middle Earth credits were not the primary focus of the bill, but were affected by some changes being made. The bill would delete the Middle Earth NOL credit completely. A company doing work in Middle Earth (areas not in Cook Inlet or the North Slope) would get any one of the three credits on the slide, but not in addition to the 15 percent NOL credit. He qualified that overall state support was decreasing.

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Mr. Alper discussed slide 13, "Elimination of Cash Credits-Credit Fund":

Eliminate the tax credit fund by repealing most of AS 43.55.028

- This has much broader impact than simply eliminating the NOL credit
 - o New Middle Earth credits are no longer cashable
 - o Credits still outstanding after 1/1/18 would require specific appropriation to DOR for any repurchase

- o The "corporate income tax" credits (LNG Storage, Refinery) remain cashable by specific appropriation until they sunset
 - o Repeals per-company "cap" language from HB247
- One lesson of the 2006-2007 period was that running a cashable credit program without a fund is cumbersome

Mr. Alper explained that the tax credit fund was the method by which the legislature appropriated money which the Department of Revenue (DOR) used to pay off tax credits. He informed that there needed to be a method to ensure the remaining cashable credits were cashed, which would require specific appropriation, and was how it was originally done. He discussed the history of payment for cash credits. Section 6 of the bill created a new mechanism by which the legislature could directly appropriate money to purchase "corporate income tax" credits until the sunset in the following three or four years.

Mr. Alper discussed the last bullet on the slide, which referred to the \$70 million per-company cap; and the split by which the first \$35 million was at full value, beyond which the company would have to take 75 cents on the dollar. He understood the desire to repeal the tax credit fund, but recommended that the repeal be delayed a couple of years to clear the books.

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Co-Chair MacKinnon asked if the administration had a position on the tax credits for the refinery and liquid natural gas (LNG) storage facilities.

Mr. Alper answered in the negative, and did not personally have a position on the matter. He thought the credits were an important tool that were put in place for a reason. He observed that the LNG storage facility had credits that were continuously pushed back a year. The project had been somewhat delayed, and the state was hopeful that the Interior Gas Utility would buy the large tank to earn the credit. The credit was modelled on the credit used in the Kenai to build the successful Cook Inlet Natural Gas Storage Alaska (CINGSA) gas storage facility. He hoped for a similar successful project to help with utility prices in the Interior.

Mr. Alper discussed the refinery credit, which was short-term and used by companies. He thought the downside to the state was somewhat capped; since there was a limit on the number of users, time frame, and dollar amount. He thought it was an aspect of the system that the state should see to fruition and hope for positive results. He used the example of PetroStar's asphalt facility, which was a tangible example of the refinery credit. It was argued that the facility made road-building in the state cheaper, and the tax credit system was responsible in part.

Co-Chair MacKinnon asked if the administration was picking winners and losers with the tax credits.

Mr. Alper stated that the statutes were written fairly broadly, and any refinery would be eligible for the credit. He stated that there had been legislation in 2012 pertaining to the Interior Gas Utility LNG storage facility, but had affected other utilities.

Co-Chair MacKinnon asked if it was fair to say that the administration prioritized the refinery credit, the LNG credit, and the storage facility credit because it was not making a suggestion that they were repealed.

Mr. Alper stated that the administration had not made a suggestion to repeal any particular credit. He thought the particular credits were somewhat encumbered within the existing system because of the calendar. The NOL credits earned by most companies were (for the most part) issued in the month of July because of statutory language. He noted that credits against the corporate income tax tended not to get claimed until October, when corporate income tax was claimed. If the state was short on cash, those credits missed out on the funds because of the first-in first-out regulatory language. He furthered that because companies were not currently eligible to get tax credit certificates, they were left in a sort of limbo. He recounted working with a taxpayer on the issue earlier in the year. If the credits were going to remain, he suggested making them certifiable, so the credits could be treated more equally with other credits. He did not think the administration was showing favoritism, but rather he was pointing out an existing inequality in the system.

Co-Chair MacKinnon believed that the administration had been on the record as not supporting cashable credits.

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Vice-Chair Bishop suggested that the gas storage credit (the CINGSA credit) was limited to one project.

Mr. Alper concurred.

Vice-Chair Bishop asked if the credit could go away.

Ms. Alper stated that there had been an internal conversation with Senate staff on the matter during debate on HB 247. He elaborated that there was a "claw-back" provision that stated if the project went out of business within a certain number of years, there was an obligation to pay back a certain portion of the credit. He thought it would be wise to keep the credit on the books until it was past the provision deadline. He thought that other than the provision it was possible to repeal the credit.

Vice-Chair Bishop asked about the LNG storage facility credit, and whether it was for one storage tank project.

Mr. Alper recalled that the credit was broadened from being targeted from specifically at the Interior Gas Utility. He thought it was broadened but there was an expectation that it was for the company that got there first. He thought there was an expectation that it would be used by the Fairbanks utility.

Senator Micciche asked about a project in Glenallen. He thought that sometimes credits were used to encourage the economics of a project that was unlikely to ever be uneconomical. He thought Mr. Alper had asserted that the storage facility credit was for one project, but had also mentioned another possible project in Glenallen.

Mr. Alper relayed that the matter had been debated in the House Resources Committee in 2012 when the legislation that created the credit was being considered. He recalled that the legislator representing the Glenallen area had wanted to broaden the language so the Glenallen project would also be eligible to receive the credit. He had recalled that the credit was available for more than one project, and appreciated Vice-Chair Bishop's clarification. He restated that the credit was only for a single project, but either potential project could receive it. The Fairbanks project

was much farther along and therefore far more likely to claim the credit. He added that realistically the size of the credits (\$15 million) was more suited to the size of tank that a Fairbanks utility would get versus the smaller tanks that a small-town utility would need.

Co-Chair MacKinnon asked if it was fair that the gas storage being discussed was closed to new project entrants, and projects had to begin operations before 2016 to qualify for the CINGSA credit.

Mr. Alper answered in the affirmative, and stated that CINGSA was perceived to be a successful project. He thought the project had done great things for reasonable availability in the Cook Inlet. He continued that Cook Inlet was the only area that used native natural gas, so it was the only place that could plausibly use an underground storage facility. The intent of the credit (part of the Cook Inlet Recovery Act in 2010) was to create the seasonal stability. He did not think there was a broader intent to include other locations, because it was not needed elsewhere. The law had been written tightly so as to preclude unintended uses. He thought if it was the legislature's desire to make more credits for underground gas storage, there could be additional dialogue; however, he could not envision a need for it anywhere in the state.

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Vice-Chair Bishop thought the CINGSA storage facility was interesting, as more gas was found when drilling was done for the tanks.

Senator Micciche thought many people had claimed ownership of the gas. He recalled Mr. Alper had stated CINGSA was related to Cook Inlet, and wanted to clarify that all of the natural gas being used in the state (including the LNG being used in the Interior energy project) came from Cook Inlet and took advantage of the CINGA supply benefits.

Mr. Alper concurred, and stated that because the gas originated in Cook Inlet, it would naturally be stored there. He explained that an underground gas storage facility was for the most part an empty gas field that was being reinjected. He restated Vice-Chair Bishop's reference to the gas that was found during the CINGSA project, and

the open question as to who owned the gas. He stated that the administration did not have a position on the matter.

Co-Chair MacKinnon stated that an LNG credit referred to in the Revenue Resource Book was available to anywhere in the state, and thought the legislature could consider a repeal. The credit stipulated operations must begin before 2020.

Mr. Alper stated that the Cook Inlet underground gas storage facility was a successful project that satisfied the mission for which it was created.

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Mr. Alper turned to slide 14, "Expanded Ability to Use Credits- Explorers":

Exploration credits can be used to offset Corporate Income Taxes in addition to Production Tax

- Limited to company-earned credits and the company's own taxes. Although not explicit in language, intent is to not have credits be transferable to other CIT taxpayers
- As written, potentially impacts about \$200 million in current and pending applications, plus any new Middle Earth exploration credits earned through 2021
- Most explorers are not Alaska CIT taxpayers, so this change would not be a material issue for them
- Provides for separate specific appropriations to purchase remaining Corporate Income Tax (gas storage and refinery) credits before they sunset

Mr. Alper relayed that the provisions listed on the slide were added in part to compensate for the limited availability of cash, to the governor's vetoes, and the expectation that there might no longer be funding available. He indicated that there was a lot of highlighted red areas of text on the slide, as there had been some uncertainty when initially reading the bill. After spending time with Co-Chair MacKinnon's office, the administration was relieved to understand the intent of the bill.

Mr. Alper continued discussing the points on slide 14. He used an example of an explorer that had a credit with no access to cash or payment of production tax. If the company was a corporate income tax payer, it could use the exploration credit to offset its own corporate income tax.

He noted that the exploration credits had already sunset in the North Slope and in Cook Inlet; and the issue pertained to Middle Earth.

Mr. Alper elaborated that many of the explorers doing the work in the Middle Earth area were regional Native corporations such as Doyon and Ahtna, which were C corporations that could be corporate income taxpayers by meeting certain definitions. He continued that the corporations could use exploration credits to offset liability. He thought it was not entirely clear (but was somewhat clear by omission in the bill) that the credits were not transferrable. It was not possible to sell the exploration credits to another company to use against corporate income tax. He thought there had been initial concern that the credits could spread to outside the oil and gas industry.

Mr. Alper continued discussing corporate income tax. He thought that as it was written, the language would also apply to the roughly \$200 million in existing and pending applications or certificates for exploration credits, mostly from the North Slope and Cook Inlet. The existing certificates would not be usable against corporate income tax. He expected to see a clarification in the next version of the bill. He thought many of the smaller companies in question were not corporate income taxpayers, so there was a limited scope to the change being proposed. He thought the real impact would be to provide an alternative mechanism for the regional Native corporations in the Interior to be able to monetize their own exploration credits.

Mr. Alper pointed out that the section addressed on slide 14 provided for a separate appropriation (after elimination of the tax credit fund) to pay off the remaining corporate income tax credits before the sunset in 2023.

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Co-Chair MacKinnon referred to the second bullet on the slide, which referred to a potential impact to about \$200 million in current and pending applications. She asked if the new fiscal note reflected an updated understanding of the intention of the Senate Resource Committee in the Committee Substitute (CS).

Mr. Alper stated that the \$200 million was inclusive of \$150 million in pending applications, and \$50 million that was already in company hands. He stated that the baseline assumption was assuming the demand for the credits was paid in the first year. He referred to the Revenue Sources Book, which showed over \$1 billion in expected credit purchases in FY 18, in which the \$200 million was included. Some of the obligation would be pushed in to the future, but none of the assumptions of the bill would be changed.

Co-Chair MacKinnon asked for clarification that the fiscal note did not contain the \$200 million of potential impact.

Mr. Alper answered in the negative.

Senator von Imhof considered the second and third bullets on the slide. She asked if the credit would every be used because most companies did not pay corporate income tax.

Mr. Alper responded that the companies that would own the \$200 million in current and pending tax credit applications were generally either not corporate income taxpayers, or had certificates that were assigned to third parties (such as a bank). He stated that the administration did not model based on any assumption that there would be changes to the circumstances around the \$200 million listed on the slide.

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Co-Chair MacKinnon thought there had been misunderstanding that suggested that Alaska Native corporations did not pay corporate income tax. She referred to emails she had received. She asked Mr. Alper to elucidate what entities paid corporate income tax, who did not, and why.

Mr. Alper pointed out that corporate income tax was not his area of expertise. He stated that corporate income tax was very similar to federal corporate income tax. He discussed the difference between "C" corporations and "S" corporations, and informed that C corporations were shareholder-based, and the earnings were retained by the entity. The earnings of an S corporation passed through to the owners, and therefore it did not have to pay income tax in Alaska. He qualified that S corporations had to have less than 100 shareholders. He noted that Alaska's regional Native corporations were traditional C corporations. If the corporations were profitable and had a tax liability, they

paid taxes. He pointed out that he could reveal if a certain corporation paid taxes, because it would reveal if that entity was profitable, which would constitute a violation of taxpayer confidentiality.

Co-Chair MacKinnon summarized that the succinct answer was that Alaska Native corporations were C corporations, and did pay income tax at the appropriate calculation just like every other corporate tax payer.

Mr. Alper concurred, and offered to send a sector report for the member's information.

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Vice-Chair Bishop asked about the shareholder limitations for S corporations.

Mr. ALper felt he was venturing to the limit of his expertise on the matter. He believed that to qualify as an S corporation, a company had to have fewer than 100 shareholders.

Co-Chair MacKinnon referred to the aforementioned \$200 million in current and pending applications, and asked what portion was available for cash credits that were being discussed.

Mr. Alper stated that all of the credits were existing, and were based on work that was done before the effective date of any legislation being considered, and would thereby fall into the preexisting system. He thought it was important to know that there was \$477 million in credits that were in company hands on January 1, 2017; and the credits were the next set that would be paid. Whatever the legislature appropriated in the current year, it would be paid to credits on a pro rata share basis. If \$200 million was appropriated, everyone would get paid about 15 cents on the dollar. The next \$477 million that was appropriated (whether it took one year or five years) would go to the credit-holders. He detailed that within the total, about \$50 million was for exploration credits. The other \$150 million was part of the set of credits that were pending and under review, and would be issued in 2017 and would be cashable before the effective date of the bill.

Co-Chair MacKinnon thought the description sounded like bankruptcy court.

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Mr. Alper showed slide 15, "Expanded Ability to Use Credits-Past Liability":

Allows credits to be used to offset older tax liabilities

- Language appears three times, in Sec. 7 (use of 023 credits), 9 (use of transferred certificates), and 13 (transferred exploration certificates)
- Most older / amended liabilities result from an audit or other "administrative proceeding;" these taxes are generally paid to the CBRF so if credits can be used to offset it means less deposits into the CBRF
- This is the only context in which a credit or similar benefit is allowed to offset penalties or interest (as opposed to the tax)
- Could be used to offset conservation surcharges (AS 43.55.200-300) or private royalty tax (AS 43.55.011(i))
- Purchased 023 credits can currently offset only 20% of a current year tax liability. When used against past years, this is superseded, allowing use all the way to the minimum tax floor

Mr. Alper stated that the slide showed a new provision of the bill which allowed for a company to purchase others' tax credits certificates to offset a tax liability that came from a period of time earlier than the credit itself. It was not currently allowed in statute, and DOR had put out an advisory bulletin in late 2016 (advisory bulletin 16-01) that had asserted the prohibition. He explained that the concept of "administrative proceeding" was language from Article 9, Section 17 of the Alaska Constitution, and stated that any revenue resulting from an administrative proceeding relating to resources would get deposited in the Constitutional Budget Reserve (CBR). He added that the initial funding that created the CBR came from large royalty lawsuits the state settled with the industry in the 1980s.

Mr. Alper continued to speak to slide 15. He discussed audit assessments, and relayed that the department had just completed an older round of audits with \$193 million worth

of total assessments. He informed that potentially, the money could be paid with purchased tax credits. He thought the legal status was somewhat unclear, and referenced case law (Hickel vs. Halford, 1994). It was unclear whether the administrative proceeding was triggered when the tax was paid or assessed. It was possible for companies to divert money from the CBR by purchasing tax credits to offset old taxes.

Mr. Alper discussed the policy choice around the allowability of using credits to pay interest and penalties. He informed that the way the bill was currently written, purchased credits could also be used backward in time to offset penalties and interest in addition to the additional tax found to be due through the administrative proceeding.

Mr. Alper highlighted the fourth bullet in red, which he did not think had been the intent of the previous committee. He detailed that the conservation surcharge was a nickel-per-barrel tax that went towards the spill clean-up and recovery program. He thought there would be a forthcoming version of the bill that would address the technical concern highlighted in the fourth bullet.

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Mr. Alper spoke to slide 16, "Changes to Minimum Tax":

- With NOL credits converted to carry-forwards, those carry-forwards cannot be used to reduce taxes below the minimum tax. Hardens floor at very low prices
- Most credits can be used below the minimum tax to zero per existing statutes, but are limited if the taxpayer is also using .024(j) (sliding scale per barrel) credits
- Senate Resources HB111 specifically exempts those other credits that are currently not cashable (GVR per-barrel credit in .024(i) and small producer credit in .024(c)) to be used below the minimum tax, to zero. This supersedes direction in advisory bulletin 2017-01
- Other credits are still limited by the advisory bulletin, although exploration credits used against corporate income tax can also reduce liability to zero

Mr. Alper recounted that the issue of hardness of the minimum floor had been hotly debated the previous year. He

qualified that "hard" meant what could be done to reduce a tax payment below the minimum tax, and in what way was a taxpayer held to pay the minimum tax. He referred to a DOR advisory bulletin (2017-01) with regulatory language pertaining to an interaction with sliding scale per-barrel credits. He discussed the specific floor hardening within the bill, which was only truly relevant at prices below about \$40/per barrel (bbl). He explained that the provision would protect a certain amount of revenue to the state at lower oil prices. He added that most credits could currently be used below the floor, with the exception of when the credits were interacting with sliding scale per barrel credits.

Mr. Alper continued, noting a couple of exemptions in the bill that specified certain credits not be hardened to the floor. The exemptions resulted in small negative numbers on the fiscal note, which were reflective of a reduction in revenue from certain provisions in the bill.

Mr. Alper discussed slide 17, "Other Exploration Credit Changes":

- Exploration credits sunset on 7/1/16 for both North Slope and Cook Inlet. Credit had been previously extended for the rest of the state "middle earth" through 1/1/22
- New timetable to issue exploration credits to 120 days after receipt of application and data. This is not tied to a specific tax filing deadline, which is the way the 120 day deadline in the .023 credits is written
- Require clarification that the required data is submitted to DNR. Also, they typically take well more than 120 days to process especially seismic data. Unclear intent in this circumstance

Mr. Alper referred to frustration that DOR had not turned around exploration credits quickly enough. He explained that most other actions had a fixed timetable, so it was almost inevitable to exploration credits would lag without a timetable. He detailed that there was some issue as to how the new timetable for exploration credits proposed in the bill would interact with the required provision of some data to the Department of Natural Resources. He thought that conceptually the addition of a timetable to the exploration credits was not problematic to the department,

but did not want to put undue burdens on DOR or DNR to rush the processing of a sizable data set.

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Senator von Imhof referred to the third bullet, which was in red. She thought the 120-day limit was specifically for seismic credits.

Mr. Alper stated that there was a lot of technical language in the bill, and thought that if the intent of the bill was only to put the timetable on the seismic credits, he had not been fully aware. He stated that there were other exploration drilling activities taking place in Middle Earth. If the intent was for the timetable to not apply to the other activities, he was happy for the clarification.

Co-Chair MacKinnon stated that there may be a 120-day timetable consideration on another credit as well.

Mr. Alper asked Co-Chair MacKinnon if it was the intent for the timetable to apply to drilling exploration credits.

Co-Chair MacKinnon stated that the language would come out in a new committee substitute (CS).

Mr. Alper apologized for his lack of understanding of the nuances of the current version bill.

Co-Chair MacKinnon clarified that the committee expected Mr. Alper to speak to the current version of the bill, and the current version only had a timetable for seismic data exploration credits.

Mr. Alper moved to slide 18, "Use of Carry Forwards":

Senate Resources version of HB111 provides a partial or limited "Ringfence" of uplifted value

- The actual carried forward loss can be used to offset any taxable production tax income, at any time
 - So the value could potentially be used without the project in question being brought into production
- Use of the interest portion, or uplift, has additional limitations
 - Company must have North Slope production

- o Company must have some lease interest in the property where the expenses were originally incurred
- o Commercial production must have begun on the lease or property where the expenditure was incurred

Mr. Alper discussed a hypothetical situation in which a company that had backlog of a lot of loss carry-forwards, and then struggled with a failing project. He thought there could be a scenario under which the producer sold the project, but in essence was selling the carry-forward losses that another company could use to offset its own legacy production from existing fields; thereby costing the state a lot of potential tax revenue. He thought there was a partial solution in the bill. He had put the word "production" in red on the second bullet, as there was some a technical consideration as to the definition of "production." He thought there might be a forthcoming change to align the definitions.

Mr. Alper continued discussing slide 18, and pondered the issue of whether there was a limitation on the use of carry-forwards. The applicable sections of the bill addressed how the limitation was different between the principal and the interest, as well as how much surety was the state getting that any field would actually be brought into production before the state gave it value. He referenced Section 21 and Section 22 in the bill.

[10:05:38 AM](#)

Co-Chair MacKinnon had heard Mr. Alper refer to 'uplift' as interest, and understood it was one way to define keeping an entity's value whole. She referenced inflation, and wondered about an accurate definition of uplift.

Mr. Alper stated that uplift was an excess of inflation, and DOR's modelling for all economic forecasting assumed a baseline inflation rate of about 2.25 percent per year. The uplift provided in HB 111 was 10 percent per year. He understood that the uplift provision was in order to compensate the companies for the time-value of money (expected investment returns, opportunity cost, or weighted average cost of capital). He informed that most companies spending money on large oil field were borrowing funds, and would be compensated by uplift for the cost of carrying

forward the debt into a future year. Currently the bill provided for 10 percent for up to seven years, and there were many different inflation rates to consider.

Co-Chair MacKinnon observed that Mr. Alper had stated that instead of the 10 percent stipulated in the bill, the administration considered 2.25 percent to be inflation-proofing.

Mr. Alper agreed.

[10:07:53 AM](#)

Mr. Alper explained slide 19, "Interest Rate Changes":

- Removes zero interest provisions that were added in HB247, and restores oil and gas production to the SB21 rate (3% + fed) although with compound interest, and makes this change for all taxes
- Current federal discount rate is 1.5%; interest rate is 8.5% compounding (4.5% simple for other taxes). Senate Resources HB111 would make it 4.5% compounding for all
 - o We testified in 2016 that interest rate should at least match the expected Permanent Fund rate of return, which is the state's opportunity cost for unpaid taxes
 - o That is currently about 7%, or roughly 5.5% + fed

Mr. Alper informed that the slide had nothing to do with uplift, but rather with the interest rate paid by taxpayers to the state tax division when there was delinquent tax found by an audit. He thought it was important to know that the provision dealt with a two-way interest rate. If a company overpaid, it would be paid back with interest. If the audit was challenged and the company won against the state, the state would pay back the funds with the same rate of interest.

Mr. Alper recalled that Alaska used to have a very high 11 percent compounding interest rate related to delinquent taxes. He believed that SB 21 bill language had inadvertently removed the compounding provision in a late amendment, resulting in a 4.5 percent simple interest. With the passage of HB 247 in the previous legislative session, the oil and gas production tax was carved out from all of the underlying interest language, and specified an interest

rate of 7 percent. The interest rate would remain for three years and then revert to zero. He understood the intent was the extended timeframe on completion of audits. If there was an appeal or long court proceeding, there would be no interest in the outlying years.

Mr. Alper stated that the bill would get rid of the 3-year interest sunset. The bill would also re-align all the taxes so that the oil and gas production tax would not have a separate interest regime from all other taxes. He shared that the administration believed that the interest rate on delinquent taxes should roughly reflect the state's opportunity cost, since the state was most likely going to be using invested savings to fund ongoing government operations. Conceptually the administration approved of the structure of aligning all the taxes and getting rid of the sunset.

[10:11:56 AM](#)

Senator von Imhof asked if Mr. Alper was suggesting all industries in Alaska should be at the same tax rate for interest on delinquent taxes.

Mr. Alper stated that it had been so until 2016, and only since the passage of HB 247 was oil and gas separated from other taxes.

Senator von Imhof asked if Mr. Alper could repeat what other industries were paying for interest on delinquent income taxes.

Mr. Alper shared that other industries were paying simple interest at the "SB 21 rate," which was 3 percent plus the fed, to equal about 4.5 percent. He stated that all industries, with the exception of the oil and gas production tax, were paying 4.5 percent non-compounded interest.

Senator von Imhof asked if the administration felt that all industries should be paying 7 percent.

Mr. Alper stated that before SB 21 (through 2013), all industries were paying 11 percent, and then the tax was cut to 4.5 percent. He thought the right amount was somewhere in the middle, probably at 7 percent.

Co-Chair MacKinnon challenged Mr. Alper on the concept of opportunity cost. She asked if he could convey the rate of return on the CBR. She asserted that he had conflated drawing from the savings accounts with opportunity costs; while the savings accounts were not drawing what the Permanent Fund was. She thought it was an unfair comparison.

Mr. Alper stated that Co-Chair MacKinnon was correct in the assertion that the CBR had been the primary draw on the state's savings as it balanced the budget during shortfalls for the past few years. Previously a portion of the CBR had been invested similarly to the Permanent Fund, and the weighted average returns were closer to 5 percent.

DAN STICKEL, CHIEF ECONOMIST, ECONOMIC RESEARCH GROUP, TAX DIVISION, DEPARTMENT OF REVENUE, stated that as of fall 2016, the long-term expected rate of return for the CBR was 2.89 percent.

Co-Chair MacKinnon emphasized that the Permanent Fund corpus was protected by the constitution of the state, which was very different than opportunity cost for rates of return on any other asset the state had. She did not disagree that interest could be somewhere in the realm that Mr. Alper had suggested. She thought that Mr. Alper was leaving state residents with an exceptionally high expectation. She thought any such increase should be applied to all industry taxpayers.

Mr. Alper agreed that the same interest rate should apply to all taxpayers. He did not see a broader public purpose in carving out one tax type from others. He thought the conversation was illustrative of what the state was being paid for delinquent taxes versus what it was paying as the rate of uplift; and thought the case could be made to align the two. He stated that the way the bill was written, the state was getting 4.5 percent interest on delinquent taxes, but was paying 10 percent.

Co-Chair MacKinnon thought Mr. Alper had made a fair assertion.

[10:16:33 AM](#)

Mr. Alper read slide 20, "Fiscal Analysis." He asked if committee members had any questions concerning the previous sections of the presentation.

Co-Chair MacKinnon clarified that there were different fiscal notes, and the committee was considering the bill that left the Senate Resources Committee. She informed that the Tax Division of DOR had issued an advisory opinion that circumvented state statute and inserted regulation that defined how to move forward; which was a subject of ongoing discussion and affected the composition of the fiscal notes.

Mr. Alper referred to the passage of SB 21, and the subsequent regulatory process. He referred to an amendment that hardened the floor to the sliding scale per-barrel credit. The sliding-scale credit could not be used to reduce taxes below the minimum tax. He described the creation of the amendment as a "late-night process" and asserted that the intent had been to get the minimum tax from the production no matter what. He questioned whether the regulation reflected the broader intent of the legislation. He stated that there were different interpretations by different sections of DOR as to how the floor was hardened.

Mr. Alper continued discussing the DOR advisory opinion, relaying that the department had needed to resolve an internal difference of understanding between the auditors and economists. He explained that DOR had wanted to publish the advisory opinion in time for payment of 2016 taxes. The advisory opinion iterated that the floor was somewhat harder than previously understood. If a company was using a sliding-scale credit, it could not go below the floor. A company that might earn a small amount of per-barrel credits could forego all of them and use other credits to go below the floor.

Mr. Alper continued to discuss the effects of the advisory opinion. In summary, the credits could not be used below the floor in the baseline assumptions. When considering the fiscal note, the specific credits that could go below the floor looked like negative numbers. He thought that from the producers' point of view it should be a net neutral. Considering the interpretation of the law and regulation, the opinion constituted a reduction in revenue.

10:21:48 AM

Co-Chair MacKinnon discussed different interpretations of the sliding scale credit, and Mr. Alper's reference to a late-night amendment. She made the point that the committee would model against two different scenarios because taxpayers were interpreting the regulations differently. She asserted that the committee wanted to understand the ramifications from a taxpayer perspective. She thought taxpayers had an opportunity to sue to the state through an appeals process.

Co-Chair MacKinnon recalled a conversation with Mr. Alper in committee in which he may have previously misstated how the sliding scale credits could be used. She wanted to clarify that in addition to a complex tax structure, the committee was contemplating two perspectives. She thought it would be difficult to understand for those not in the room. She hoped that the committee understood her comments.

Co-Chair MacKinnon asserted that the committee had asked DOR for figures that had not been provided. The committee was waiting for data pertaining to the two interpretations of the sliding scale credits.

Mr. Alper stated that DOR had received clarification the previous day regarding the alternative scenario analysis that the committee had requested. He relayed that Mr. Stickel had worked late the previous day and early in the morning to provide information. He thought he could provide the requested information by the following day.

Mr. Alper asserted that the advisory opinion was not a new interpretation of policy, and considered a difference of opinion between the auditors and economists at DOR. He emphasized that the "audit masters" had written the regulations, and had achieved only partial success in communicating them in 2013. He articulated that the advisory bulletin was a plain reading of the regulations. The regulations had gone through the public review process, and did not change from the draft to the final.

Co-Chair MacKinnon asked if it was fair to say that taxpayers may have been treated differently.

Mr. Alper thought it was fair to say that taxpayers may have understood the rules differently.

10:26:58 AM

AT EASE

10:28:05 AM

RECONVENED

Senator Micciche stated that only in Alaska was a \$55 million shift characterized as a "nuance." He asked when Mr. Alper had become aware of the inconsistency in how the taxpayers were evaluating the regulation.

Mr. Alper stated that the \$55 million he cited was for an earlier version of the fiscal note, and there was no negative \$55 million in the current note. He furthered that DOR had made an adjustment based on an understanding related to an overhanging current operating loss. He clarified that he personally became aware of the inconsistency the previous fall when the special session was over, and he was able to re-engage with some deeper policy issues. He detailed that it had taken time to understand the issue, vet it internally, talk with the commissioner, and decide on a course of action.

Mr. Alper continued addressing Senator Micciche's question. He recalled that when he learned of the inconsistency, the fall forecast was issued with the assumption of the softer floor. He continued that DOR had anticipated \$100 million of exploration credits to be purchased and used against tax liability in FY 18, which had not been possible due to the tighter strictures of the advisory bulletin. He informed that the main reason for the delay of the spring forecast was that DOR needed to re-do all the assumptions. He summarized that the department was aware of the inconsistency in the fall, had brought it up in committee in late January, and had published the advisory bulletin and revised the spring forecast in March and April.

Senator Micciche wondered if DOR had given any advice, and if it had understood the order of the usage of the credits in every case. He was wondering if there would be forthcoming court cases.

Mr. Alper stated that the department tried to avoid giving tax advice. The department had been asked if it had concerns with people purchasing credits, and the department had answered in the negative. He referred to a "20 percent

rule" referenced on an earlier slide, under which a company could use purchased 023 credits to offset 20 percent of its taxes. Additionally, purchased 025 credits could offset 100 percent of taxes; which was why the department had presumed there would be a focus on 025 credits. The department had built the \$100 million liability into the system. To his knowledge, none of the credits were sold with the expectation of being used, and then were not usable. He thought the topic was an awkward circumstance if the issue would end up in court someday.

Co-Chair MacKinnon did not want DOR's team to be working till the early hours of the morning to produce a product that may or may not be accurate. She asked for a realistic time frame for production of the requested alternate scenarios. Co-Chair MacKinnon discussed the requested data.

[10:33:58 AM](#)

Mr. Alper mentioned Co-Chair MacKinnon's reference to post-advisory-bulletin information. He stated that there were two things to consider: the underlying change between the fall and spring forecast, and the addition of the advisory bulletin into the underlying assumptions and analysis. He believed that DOR had provided a revised version of the HB 111 (version L) fiscal note. He clarified that the House Finance Committee had used more of a pre-advisory-bulletin analysis. He asked if Co-Chair MacKinnon was requesting that DOR do an analysis of the House Resources CS.

Co-Chair MacKinnon answered in the affirmative. She understood that there were significant changes to the bill in the House Finance Committee, and wanted to compare the final product with the changes that were made in the House Resources Committee.

Mr. Alper noted that one feature of the current fiscal note was a breakdown in the carry-forwards to see the value of the uplift as a separate line item. He stated that the House Resources Committee version of the bill was the only other version that had some version of uplift. He stated that DOR would provide the same additional granularity in analyzing the House Finance version of the bill as well.

Senator Micciche had reviewed both fiscal notes. He referenced a \$45 million shift, and wondered about the evaluation of the House version of the bill.

Mr. Alper stated that DOR had recognized that the status-quo carry-forwards had included a certain amount of loss. He questioned when companies would use the carry-forwards and how. He detailed that under the Senate Resources version of the bill there had been a distortion in how the carry-forwards were viewed. He discussed changes to the fiscal note; and stated that the net impact across ten years was the same, but the numbers had shifted between years.

10:37:26 AM

Vice-Chair Bishop echoed the comments of Co-Chair MacKinnon regarding taking time to do quality work. He thought the Co-Chair had expressed consideration for the well-being of DOR employees.

Co-Chair MacKinnon concurred, and was aware that the DOR team was working exceptionally long hours. She wanted to ensure that the quality of the work remained consistently high as it had been in the past.

Mr. Alper stated that the economic research group (within the tax division) was an essential asset to the state. The group had many different functions but was a front-line responder during legislative session. He expressed gratitude for the group's skill and diligence.

Senator von Imhof spoke to slide 22, in which the last bullet referred to approximately \$460 million in accrued uplift. She thought the point was illustrative of what could potentially accrue over time. She pondered allowing the GVR to be taken early on. She asked if it would make sense to model the cost to the state if the GVR credits could be taken first, with no uplift; versus allowing a ten percent uplift.

Mr. Alper did not fully understand Senator von Imhof's question.

10:39:55 AM

AT EASE

10:47:10 AM

RECONVENED

Co-Chair MacKinnon explained that members should forward any questions pertaining to the CS to her office. She referenced a table from page four of the fiscal note, which had been enlarged for easier viewing. She relayed that the committee would hear the remainder of the presentation the following day.

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ADJOURNMENT

10:48:21 AM

The meeting was adjourned at 10:48 a.m.