ALASKA STATE LEGISLATURE
JOINT MEETING
SENATE RESOURCES STANDING COMMITTEE
SENATE FINANCE COMMITTEE
April 15, 2017
9:00 a.m.

9:00:47 AM

CALL TO ORDER

Chair Giessel called the Senate Finance Committee meeting to order at 9:00 a.m.

SENATE FINANCE COMMITTEE MEMBERS PRESENT

Co-Chair Anna MacKinnon
Co-Chair Lyman Hoffman
Vice-Chair Click Bishop
Senator Peter Micciche
Senator Donald Olson
Senator Shelley Hughes
Senator Natasha von Imhof

SENATE FINANCE COMMITTEE MEMBERS ABSENT

none

SENATE RESOURCE COMMITTEE MEMBERS PRESENT

Chair Cathy Giessel
Vice-Chair John Coghill
Senator Natasha von Imhof
Senator Bert Stedman
Senator Shelley Hughes
Senator Kevin Meyer
Senator Bill Wielechowski

SENATE RESOURCE COMMITTEE MEMBERS ABSENT

none

ALSO PRESENT

Roger Marks, Legislative Consultant, Legislative Budget and Audit Committee; Senator Gary Stevens, Senator Mia Costello, Representative Chris Birch.

SUMMARY

HB 111 OIL & GAS PRODUCTION TAX;PAYMENTS;CREDITS

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

PRESENTATION: MR. ROGER MARKS, CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE

#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."

9:00:47 AM

^PRESENTATION: MR. ROGER MARKS, CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE

9:01:50 AM

Chair Giessel relayed that HB 111 was heard for the first time in the Senate Resources Committee the previous day. She informed that the joint committee would have two meetings to hear testimony from legislative consultants.

ROGER MARKS, LEGISLATIVE CONSULTANT, LEGISLATIVE BUDGET AND AUDIT COMMITTEE, introduced himself and noted that he was on contract with the Legislative Budget and Audit Committee. He discussed the presentation, "Evaluation of HB 111," (copy on file).

Mr. Marks showed slide 2, "Roger Marks -Background":

•Since 2008: Private consulting practice in Anchorage specializing in petroleum economics and taxation

–Clients include: State of Alaska Legislature, federal government, local municipalities, University of Alaska, oil and gas explorer/producers, pipeline companies, commercial/investment banks, private equity firms

•1983-2008: Senior petroleum economist with State of Alaska Department of Revenue Tax Division

–Statutory and regulatory design
–Economic and commercial valuation of exploration, development, production, transportation, refining, marketing, taxation
–Analysis of international competitiveness
–North Slope gas commercialization

Mr. Marks discussed his work pertaining to oil production tax policy and associated legislation.

9:04:38 AM

Mr. Marks displayed slide 3, "North Slope Oil Price ($/bbl) - The Alignment of Misery," which showed a line graph depicting a drop in oil prices starting at the end of 2014. He wanted to discuss that the state's budget woes from lower oil taxes were matched by the taxpayers having less money to pay the taxes. He additionally wanted to explore the issue of how the misery of low oil prices was allocated between the state and taxpayers under current statute and the proposed HB 111.

Mr. Marks turned to slide 4, "Two Themes":

1. The alignment of misery:
   -The state’s budget woes from lower oil taxes are matched by the taxpayers’ having less income to pay them

2. How is the misery of low prices allocated between State and taxpayers under SB 21 and HB 111?

Mr. Marks remarked that for his evaluation of HB 111, he would generally present the approach he took in practicing economics and in practicing tax administration when he worked for the department. He thought the method would help enlighten multiple perspectives and the impacts to all parties.

Mr. Marks showed slide 5, " Fair Share: Understanding Impacts to All Parties":

- State
  - –Development of resources for maximum benefit of its people
- Taxpayers
  - –Investor demands
  - –Competitive opportunities
  - –Cash flow constraints

Mr. Marks relayed that as he considered the information, he believed that maximizing the long-term benefit of resource development in the state was competitiveness. In his career he had actively participated in efforts to both increase and decrease taxes when it appeared that what Alaska was receiving was out of line with international competitive norms.

9:07:07 AM

Mr. Marks discussed slide 6, "Current North Slope Income Legacy Fields (Old Oil)":

- ANS Market Price ($/bbl) $55
- Less Transportation ($10)
- GROSS Revenue $45
- Less Upstream costs ($23) *
- DIVISIBLE Income $22
- Less State Taxes & Royalties ($11)
- Less Federal Income Tax ($4)
- PRODUCER after-tax net income $7

* DOR average estimate based on reported and audited costs. Including transportation, Alaska about $5-$15/bbl higher than average Lower 48 costs. Newer oil upwards of $10-$20/bbl more expensive.

Mr. Marks informed he would be focusing on the North Slope and some basic numbers for his presentation. He characterized the slide as a basic income statement for

current North Slope activity for legacy fields. He pointed out that he would be discussing gross value (market price plus transportation cost); which was sometimes called "wellhead value" and was the basis for royalties and taxation.

Mr. Marks continued to discuss slide 6, noting that when considering gross revenue less upstream costs, it resulted in divisible income. Divisible income was available to be divided between the government and investors before taxes. Divisible income could also be called production tax value (PTV). He specified that a break-even price was approximately $40 under the assumptions on the slide.

Mr. Marks spoke to slide 7, " Economic Barometer on Fair Share: “Government Take”":

> Defined: Percentage of divisible income that goes to government
>
> Allows:
> Look at tax on its own terms
> Systematic comparison to other similar jurisdictions
> Compare proposal to status quo
> Looks at all taxes / royalties

Mr. Marks explained that 'Government Take' was a cash flow snapshot of who received what funds. He stated that for an investor or taxpayer, the total amount paid for production tax and royalties was most important, as opposed to how much was paid for each. He stated that government take was not a perfect tool. He referred to comments by fellow consultant Rich Ruggiero that suggested that sometimes timing of revenue was more important than the quantity of revenue. He thought that timing issues had more of a role in rate-of-return type fiscal systems that were in play in production sharing contracts. Alaska was a cash-flow type tax system, and he wanted to compare the state to other such systems. Government take provided a tool for analyzing tax.

9:11:54 AM

Mr. Marks spoke to slide 8, which showed a bar graph entitled "Government Take at $55/bbl Market Price." He explained that when government take was used as an analysis tool, there were areas of judgement that needed to be

exercised. It was important to consider the peer group, or what states Alaska would be compared to. He had looked at places that had investment opportunities where the physical terms were established in a similar context as Alaska; and additionally, places where the geological and cost contexts were similar. On the slide, the peer group of tax and royalty regimes were basic Western industrialized democracies. In the group, the taxes were governed by statutes and regulations established by democratically elected legislators.

Mr. Marks continued discussing the bar graph on slide 8, explaining that he had put a threshold of 400,000 barrels per day. He asserted that another area in which to compare regimes was cost. He explained that every jurisdiction on the slide had cost variability, as did Alaska. He had access to a number of informational databases and the graph depicted a good estimate of the average cost for production under development in peer group of regimes.

Mr. Marks continued to discuss slide 8, indicating that the regimes being compared were across the bottom axis of the graph, and the government take on the left-hand column. The graph assumed an oil price $55 per barrel (bbl). He stated that of the five United States regimes represented; all of them had royalties, and three had production taxes based on gross revenue. Of the five international regimes; three had royalties, one had a production tax. All the ten regimes on the graph had corporate income taxes.

9:14:41 AM

Co-Chair Giessel stated that Alaska was commonly compared to Norway, and wondered if the country had a royalty tax.

Mr. Marks answered in the negative. He furthered that the country had a combination of two different taxes that basically functioned like an income tax, at about 78 percent of net income. He characterized the structure as a neutral system - whether oil prices were high or low, the tax was roughly 78 percent and neither progressive nor regressive. He added that oil taxes in the United Kingdom were similarly structured.

Senator Meyer asked where Alaska fit within the group.

Mr. Marks stated he would address Alaska's position in the group later in the presentation.

Senator Wielechowski thought that Alaska was in the 60 percent range, but was unsure if it signified that the state took 60 percent of $55/bbl. He referred to a presentation by the Department of Natural Resources from the previous day, which had shown that at $60/bbl the state received $2.03, which was an effective tax rate of a couple percentage points. He asked if the number was accurate and thought the oil companies got transportation costs, lease expenditure costs, and profit.

Mr. Marks looked at slide 10, "Government Take SB 21 (Legacy Fields)," which showed a line graph that demonstrated how Alaska fit in to the peer group. At $55/bbl, the government take was 67 percent of the divisible income. He stated that later in the presentation he would discuss the production tax amount.

9:17:31 AM

Senator Micciche asked to go back to slide 6. He referred to the $22 in divisible income indicated on the slide, and thought the government take of $15 would equate to 60 percent.

Mr. Marks confirmed that 15 percent divided by 22 percent would be the government take.

Senator Micciche asked to go back to slide 8. He pondered the 68 percent, and wondered if there was an equivalent comparison with the peer group list on the slide.

Mr. Marks stated that given that government take was looking at the percentage of divisible income that went to government, the comparison was looking at the same metric.

Senator Stedman referred to slide 8, and asked for discussion on how the private royalties were handled in Texas and North Dakota. He asked for more information on the regime in North Dakota, which was frequently used as an example for comparison. He noted that the state of North Dakota did not own sub-surface rights.

Mr. Marks affirmed that the states of Texas and North Dakota both had a number of different royalty rates

depending on the ownership structure of the land. He explained that to be conservative he was using a royalty rate of 19 percent for North Dakota, and a royalty rate of 25 percent for Texas.

Senator Stedman thought the amounts sounded reasonable. He expressed interest in discussing the calculations further with Mr. Marks after the meeting. He expressed a desire to recognize the minimum tax range within the $55/bbl range.

9:20:34 AM

Senator Stedman asked to review slide 6. He thought there was several ways to view the information, including by changing the order of information and view production tax value. He wondered if Mr. Marks could elaborate on the matter.

Mr. Marks stated that divisible income was much like production tax value, and the government take being examined was exactly the split of divisible income (or production tax value) between the government and the investor.

Senator Stedman thought that royalties would come out first. He thought the point of the list was to demonstrate production tax value, and acknowledged the list could be presented in many ways.

Mr. Marks stated that in calculating taxes and royalties, the portion of production was paid, and taxes were paid on the non-royalty portion. The spreadsheet showed the financial impact of both royalty and production tax. He thought one could do a slightly different split to calculate what happened after deduction of royalty. He believed it was important in looking at total government take, in terms of analyzing the real outcome of the tax.

9:23:06 AM

Senator Stedman agreed that it was important to look at all components, but reiterated that he wanted his colleagues to look at the total value rather than merely per barrel numbers. He commented that a previous discussion included the total production tax value moving about $1.3 billion. He thought it was possible to forget the magnitude of what was being discussed.

Mr. Marks returned to slide 8, which showed the government take at $55/bbl.

Mr. Marks turned to slide 9, "Government Take Competitive Boundary," which showed a line graph with one descending blue line. All prices between $40/bbl and $100/bbl were examined for an average government take among the ten regimes, which created the blue line on the graph entitled "Competitive Boundary." There was high take at low prices, and lower take at high prices. There was a general regressive pattern, because most of the jurisdictions were on a gross taxation basis. He stated he would talk more in detail about the reasoning behind the shape of the line. He explicated that generally if the government take fell above the line, it was not competitive; and if government take fell below the line, it was competitive. He stated that he would present the competitive boundary when he showed the impacts of the current tax and the proposed tax.

9:25:11 AM

Mr. Marks went back to slide 10, which had a line graph showed how SB 21 [Oil and gas tax reform legislation that passed in 2013] lined up with the competitive boundary. He noted that when SB 21 had been designed, its goal was to get a government take of between 60 and 65 percent at high oil prices. Since that time, competitive jurisdictions had dropped taxes in response to low prices. In the peer group; United Kingdom, Norway, and Alberta had done so. He pointed out the difference between Alaska and the competitive boundary as shown on the graph. He noted that every one percent difference in government take represented about $30 million.

Co-Chair Giessel asked if Mr. Marks could elaborate on the gap between lines on the left-hand side of the graph below $60/bbl. She wondered why Alaska was so different than the competitive boundary.

Mr. Marks stated that most of the jurisdictions were taxing on gross, and most of them had a royalty based on gross. The graph showed the percent of the net value (not gross value) that went to government. When taxing on percent of gross, it was a much larger percent of net, because net was so low. The reason Alaska was so much higher was not due to the tax system, but rather the fact that the state's costs

were so much higher. He compared Alaska's $10/bbl transportation cost compared to most Lower-48 production with $3/bbl. The extra cost of doing business on the North Slope raised the tax from $5 to $10 more than the average Lower-48 cost. The higher costs resulted in how the graph manifested at the low end.

9:28:03 AM

Senator Stedman asked if it was possible to get a breakdown of slide 10 with major components including minimum tax, royalty, income tax, and property tax. He also requested Mr. Marks to help the committee understand how tax credits were used in the calculations.

Mr. Marks agreed to provide additional information through the Legislative Budget and Audit Committee.

Mr. Marks showed slide 11, "Calculation of SB 21 Tax":

> Higher of
> –Net calculation
> OR
> –Gross Minimum Tax (market price less transportation): 4% of gross*
> Can use loss carryforward credits to bring tax below gross minimum
>
> * Legacy fields are on gross minimum tax until about $65/bbl

Mr. Marks explained that net income signified gross value after subtracting the upstream costs. He explained that the gross was the market price less transportation.

Mr. Marks turned to slide 12, "Basic Net Calculation for North Slope Legacy Fields (Old Oil)":

> Net calculation:
> 35% X Net Value
> less sliding scale per barrel produced credit

Mr. Marks reiterated that net value was divisible income or the production tax value.

9:30:46 AM

Mr. Marks turned to slide 13, "Sliding Scale Credit Per Barrel Produced Calculation: Legacy Fields":

•Gross value less than $80/bbl: $8/bbl
•$80-$90/bbl: $7/bbl
•$90-$100/bbl: $6/bbl
•$100-$110/bbl: $5/bbl
•$110-$120/bbl:$4/bbl
•$120-$130/bbl:$3/bbl
•$130-$140/bbl: $2/bbl
•$140-$150/bbl: $1/bbl
•Over $150/bbl: $0/bbl•For old oil cannot use credit to bring tax below gross minimum tax

Mr. Marks discussed how the net calculation was done. As prices went up, the per-barrel credit went down. Under the current statute for the legacy fields, the per-barrel credit could not be used to bring tax below the gross minimum. Carry-forward losses could be used to bring tax below the gross minimum.

Mr. Marks turned to slide 14, "The $45/bbl Gross Pie ($55/bbl market price)," which showed a pie chart. He mused about the purpose of a per-barrel credit. He stated he would discuss gross taxation. He addressed the pie chart on the slide. Of the $45/bbl gross amount, $23 was upstream costs, and $22 was divisible income. Royalty was based on gross value, so half of a royalty payment to the state was for costs. With gross as the basis, half the royalty would be a payment on cost; which was the reason that at low prices, the government take was so high.

Mr. Marks spoke to slide 15, "The $45/bbl Gross Pie ($55/bbl market price)." The slide showed the same pie chart as the previous slide, broken down into who received the divisible income. He commented on the breakdown between the state, the federal government, and producers.

9:33:07 AM

Mr. Marks referred to slide 16, " January 2016: The $20/bbl Gross Pie($30/bbl market price)":

Costs	$23/bbl (115%)
State	$4/bbl (20%)
Feds	-$2/bbl (-10%)
Producers	-$5/bbl (-25%)

•Taxpayers pay 16% of $20, plus property tax, while they are $3 in the hole

•Government take is off the charts (Slide 10)

Mr. Marks discussed why the information on slide 16 was not interpreted into a pie chart. He indicated that Excel could not process the numbers for a chart when the costs exceeded the amount of the whole. He noted that in January 2016, there was $20 in gross revenue and $23 in cost. Producers started out $3 in the hole, and paid royalty and property tax. If producers had prior loss carry-forwards, it could be used to bring tax below the 4 percent of gross. If not, the producers would be paying 16 percent of the $20 gross.

Mr. Marks turned back to slide 10 to illustrate the graph in an even lower price scenario, where the government take would be off the charts.

Senator Stedman wanted more information on how tax credits affected the share calculation. He asked if it was common around the world that the industry took business risk (and low-price risk), and most sovereigns structured business relationships to have a constant revenue source.

Mr. Marks answered in the affirmative. He stated that most fiscal systems around the world were regressive; and took a high government take at the low end, and a low government take at the high end. In Alaska the industry took a high end at the low-price scenario, and a high end at the high price scenario. He relayed that he would be discussing the rationale for the system. In most regressive systems the taxpayer took the low side risk, but received a bigger share of the upside as a trade-off. He informed that he would be concluding his presentation by explaining how the typical regressive system did not happen in Alaska.

9:37:41 AM

Mr. Marks turned to slide 17, "Disadvantage of Taxes & Royalties Based on Gross (vs. Net)":

•Ever increasing gross/net value divide
•Net more reflective of actual economics
•Under gross a field with $20/bbl costs is taxed the same as a field with $50/bbl costs

- •A net system automatically adjusts
- •Some other jurisdictions do tax on gross
  - –Alaska’s high costs exacerbate the problem
- •At prices under $65/bbl Alaska essentially operating on a gross system

Mr. Marks commented that Alaska had a gross system through 2006, and had changed due to declining production. Under a gross system companies could not deduct upstream costs. As the North Slope was extending to more and more expensive fields, there was an ever-increasing gap between gross value and net value, and taxing on growth was distorting the economics. He stated that taxing on the net profit was much more reflective of the actual economics. He used the example of Kuparuk River Unit which had a number of fields with much different production costs. Under a gross system, all fields paid the same amount in tax because the upstream costs were not being deducted.

Mr. Marks restated that most other jurisdictions taxed on gross value, but Alaska's high costs exacerbated the problem. With a "higher-of" system in which gross and net were being compared, legacy fields switched from gross to net at about $65/bbl. Until prices reached $65/bbl, Alaska operated under a gross system.

Mr. Marks showed slide 18, "Govt Take With and Without Per Barrel Credit - SB 21 Legacy Fields," which showed a line graph. As prices went higher, cost was a smaller slice of the gross amount, and royalty based on growth became less of a problem. As prices increased, the tax rate was lowered. The goal in 2013 was to get a government take between 60 percent and 65 percent to be competitive.

Mr. Marks explained that the blue and green lines on the graph represented SB 21 and the competitive boundary, respectively. He highlighted the red line, which showed what the government take would be without a sliding scale credit. The effect made a huge difference in making the tax competitive and off-setting the negative aspects of taxing on gross at low prices.

Mr. Marks displayed slide 19, "Summary: Sliding Scale Per Barrel Produced Credit":

- •Adjustment of effective tax rate to offset high royalty at low prices

•Economically should not be considered a credit or called a credit
•An important feature

9:41:50 AM

Senator Wielechowski asked to return to slide 18. He asked if Mr. Marks was suggesting that the state should lower its tax rate.

Mr. Marks reiterated that the red line on the graph on slide 18 showed what the government take would be if Alaska did not have the sliding scale per-barrel royalty. The slide had illustrated that the point of putting the feature in SB 21 was to bring the government take down competitive international norms.

Senator Wielechowski reiterated his question as to whether the state should be lowering its tax rate.

Mr. Marks referred to the blue line, which showed the current system under SB 21. He noted that at prices above $50/bbl, the state was fairly competitive. Prices below $50/bbl yielded a higher government take because of the state's higher costs.

Senator Wielechowski referred to the revenue forecast, and numbers provided by DNR. He pondered that if the government take was 100 percent at $40/bbl, it was 100 percent of virtually nothing. According to the Department of Revenue, Alaska received $1.23/bbl out of an oil price of $40/bbl, which was an effective tax rate of 3 or 4 percent. He considered that between a price of $40/bbl and $55/bbl, the state got virtually nothing because any funds were paid back in tax credits. He offered that the estate had tax credit liabilities of hundreds of millions of dollars.

Senator Wielechowski compared Alaska's tax scenario to the State of North Dakota, where he had seen 25 percent to 30 percent royalty rates for private land owners. He thought if one examined the raw numbers of monetized oil running through the pipeline; North Dakota was at an effective tax rate of 35 percent to 40 percent, which equated to between $3 billion and $4 billion. He asked Mr. Marks if the state should adopt the tax and royalty structure of North Dakota, and wondered how much more the state would get with the change.

Mr. Marks turned back to the bar graph on slide 8, and acknowledged that North Dakota had a healthy government take given the assumptions used on the slide. He was happy to look at Alaska under North Dakota's system if requested. He stated that he would discuss the tax credit situation as he furthered his presentation. He acknowledged that Alaska's tax credit situation was a problem given the state's cash flow issue. He did not disagree with Senator Wielechowski that the affordability of oil credits at current oil prices for Alaska was a significant issue.

Co-Chair Giessel referred to the low profit per barrel number that DOR had presented, and asked if it included only the severance tax or other things such as royalty, corporate income tax, etc.

Mr. Marks understood that the DNR numbers were only considering the production tax.

9:46:44 AM

Senator Stedman referred to North Dakota, and recalled the state had a royalty rate of 20 percent or higher. He thought Alaska's net system had an advantage relative to the gross systems; and thought the state should balance its high-cost environment and be able to compete against North Dakota's structure. He asked Mr. Marks if he could tie in the relationship between the 35 percent base tax and the per-barrel deduction to get the effective tax rate down. He mentioned net operating loss (NOL) and carry-forwards, which he wanted to be included in the ongoing discussion.

Co-Chair Giessel suspected the matter would be addressed in the several hours of testimony that would follow.

Senator von Imhof thought it was important to look at the combined nature of all the different mechanisms that SB 21 encompassed. She referred to testimony the previous day that suggested considering the mechanisms separately could have unintended consequences. She referred to slide 18, and thought the red line reminded her that HB 111 removed the $8 per barrel credit. She thought it seemed that the state may be uncompetitive at any oil price. She found it interesting that Alaska took a 100 percent minimum tax at prices of $40/bbl or below. She thought North Dakota might also be examining the tax regime practices of Alaska.

9:50:10 AM

Mr. Marks looked at slide 20, "Tax Rate Vocabulary":

- •Statutory Rate:
  - –Nominal rate in tax code applied to some base that may be increased or decreased by other factors
- •Effective Rate:
  - –Tax as percentage of pre-tax income (divisible income)
- •Marginal Rate:
  - –How much additional tax is when price goes up $1
- •Can look at the production tax in isolation or all taxes and royalties as a whole
- •Investor economics depend on the total payments to government without regard to specific sources

Mr. Marks had been asked to present tax rate vocabulary; and explain the difference between statutory rates, effective rates, and marginal rates. He discussed differences in statutory tax rates. He thought it was not possible to go far in discussing the statutory tax rate in isolation without referring to everything it applied to. He thought the effective rate was a much more useful concept. He reiterated that investors cared most about the total tax that would be paid, rather than the amount of the components.

Mr. Marks discussed slide 21, "Effective and Marginal Prod Tax and Total Tax/Roy Rates - SB 21," which showed a line graph. He explained that the bottom two lines were the effective and marginal production tax rates under SB 21. He pointed out the top two lines were total tax royalty. He recalled that Ken Alper (Tax Division Director for the Department of Revenue) had shown a similar graph the previous day; but used numbers from the average North Slope cost instead of a legacy field.

Mr. Marks continued discussing slide 21, addressing the bottom line representing marginal severance tax rate. He discussed how the marginal rate varied with price. He looked at the line depicting the total tax royalty effective rate. He commented that the Alaska marginal tax rate was higher than the worldwide competitive norm.

9:54:36 AM

Senator Micciche referred back to slide 8. He thought it was clear that more dollars went into the GF than in the past tax regime. He asked how many of the tax regimes on the slide would be at 100 percent of government take at the oil price of $40/bbl.

Mr. Marks preferred to contemplate the question further before offering an answer.

Senator Micciche thought the number would be next to zero, considering that most were on a gross tax basis. He referred to slide 6, and thought most of the regimes were based on the economics of drawing investment. He asked how many successful oil producing regimes were based on the philosophy of wanting more money.

Mr. Marks thought most regimes were similarly based on trying to get as much profit as possible while keeping a competitive environment. He thought the dynamics were a bit skewed because of the high percentage of income the state gathered from oil, where most other regimes had a more balanced and diverse source of income.

9:57:08 AM

Vice-Chair Bishop referred to slide 21, which was modelled on legacy fields. He thought Mr. Marks had commented that Ken Alper had modelled after the aggregate of North Slope fields.

Mr. Marks referred to the Revenue Source Book. He conveyed that 90 percent of production was from legacy fields. He stated he would discuss new oil.

Senator Stedman thought there were distortions embedded in the system. He referred to the current structure of a 35 percent tax rate, and thought the state could have just as well set a 45 percent or 55 percent tax rate and increased the per-barrel deduction. He thought the committee should try and get as many of the distortions out of the system.

Mr. Marks commented that focusing on the statutory rate was a limited exercise without considering how it interacted with the whole. He thought solely focusing on the statutory rate could not go far in understanding the tax.

9:59:44 AM

Senator Wielechowski asked to return to slide 8, and recalled that the royalty rate in Texas was 25 percent for private land owners.

Mr. Marks relayed that there was a variety of royalty rates in Texas. The high end was 25 percent, which he used for the analysis in order to be conservative.

Senator Wielechowski asked about the gross tax in Texas.

Mr. Marks answered in the affirmative.

Senator Wielechowski had a hard time comprehending that the government take in Texas was the same as that in Alaska. He wondered about corporate income tax and sales tax in Texas.

Mr. Marks stated that the combined state and federal rate was 36 percent in Texas.

Senator Wielechowski suggested that if there was $10 billion of oil going down the pipeline, royalties and taxes would add up to $3.6 billion in Texas. In Alaska, the state would only get $1.5 billion in royalties and taxes for $9 million worth of oil in the pipeline.

Mr. Marks stated that the big difference was that in Texas it was not necessary to spend $10 per barrel to get oil to market, which made a huge difference in the value of the oil.

Senator Wielechowski stated that there was tremendous value to the fact that Alaska had a net profit system. He thought it was not possible to compare Texas and Alaska fairly, since Alaska had a net system and Texas was able to write off all its costs.

Mr. Marks stated that the $10 per barrel cost made an enormous difference in the value of the oil in terms of low oil prices.

10:02:57 AM
AT EASE

10:04:26 AM

RECONVENED

Senator Wielechowski clarified that the transportation costs were incurred in large part to Aleyeska pipeline, which was owned by the oil companies. So in large part, the $10 per barrel was staying in the same company.

Mr. Marks emphasized that nearly all tax tariff was a repayment of actual costs incurred. He relayed that most of the Trans-Alaska Pipeline System (TAPS) had been recovered through depreciation, and there was a small amount of undepreciated costs on which a profit was made.

Mr. Marks displayed slide 22, "New Oil":

- Defined
  - –Units created after 2002
  - –Fields in older units created after 2011
  - –Extensions of existing fields
  - –About 5%-10% of total oil
- Can cost $10-$20/bbl more than legacy fields
- Differential tax provisions
  - –Gross reduced by 20% in calculating production tax value
- (Reduced by 30% for high royalty fields)
  - –Per barrel credit set at $5/bbl at all prices
  - –Can use per barrel credits and loss carryforward credits to bring tax below gross minimum tax

Mr. Marks explained that sometimes new oil was referred to as "GVR oil," since there was a gross value reduction to the oil. He explained that unlike legacy oil, it was possible to have a per barrel credit for new oil.

10:07:10 AM

Mr. Marks showed slide 23, "Govt Take for New (GVR) Oil - SB 21," which showed a line graph. He pointed out that starting on the left-hand side, the blue line representing Alaska government take was very high. He explained that it was possible for companies to use loss carry-forwards as well as a per-barrel credit to bring taxes down to zero. The graph showed high government take that occurred when there was zero tax. He explicated that even with no tax, companies were paying $33 in upstream costs, $10 in transportation, property tax, and a royalty based on gross. He calculated that a tax would kick in at an oil price of

about $75/bbl. The break-even price under the assumptions on the slide was about $55/bbl.

Mr. Marks turned to slide 24, "Govt Take for New (GVR) Oil - SB 21 - Focus on $55 - $75." He reiterated that at $55/bbl price, the government take would be 80 percent; and at $75/bbl price (when oil companies began paying tax), there was a competitive boundary. He understood the department's concern about companies not paying taxes on "new oil." He thought the economics for new oil, even without taxes, was very daunting.

Co-Chair Giessel reminded that the legislature had put a timespan on new oil the previous session. The limit was 7 years, or 3 years if the price of oil reached $70/bbl.

Mr. Marks discussed slide 25, "Major Economic Provisions of HB 111 - North Slope":

- Floor hardened to gross minimum tax
- No per barrel credits for legacy fields
- Base rate on net reduced from 35% to 25%
- Progressivity after ptv exceeds $60
- Fields are ring-fenced for exploration/development
- Elimination of refundable credits
- After 7 years losses carried forward lose 10%

Mr. Marks stated that he would focus on the North Slope. He stated that the first four points on the slide were four major economic parameters, and he would later explain how the items affected government take. He informed that he would discuss other provisions in the bill such as ring fencing, elimination of refundable credits, and reducing the value of loss carry-forward credits after 7 years.

10:10:53 AM

Mr. Marks showed slide 26, "Ring Fencing / Refundable Credits":

- PPT was set up in 2006 to ring fence a company's operations North Slope-wide
  - –A company with production could offset its exploration / development costs
  - –This provided a very significant net present value benefit

- Refundable credits were originally designed to put explorers/developers on an even basis with producers
  - A company with no offsetting income could realize the tax value of expenditures in the same timely manner
- By ring fencing exploration / development separately and eliminating the refundable credits, the net present value of exploration / development costs are significantly diminished to everyone
- The state's cash affordability of refundable credits is an issue
- The way most of the rest of the world does it:
  - Company operations are ring-fenced jurisdiction-wide
  - Explorers/developers carry their losses forward without refundable credits until they have offsetting income

Mr. Marks explained that ring fencing and refundable credits were related. He explained that ring fencing signified (in tax parlance) the size of the entity that was being examined for tax calculations. He gave the example of the United States, which was ring fenced for corporate income taxes; one could offset income in one state through losses in another. Oil fields and geographic areas could be ring fenced.

Mr. Marks relayed that ConocoPhillips was developing the Willow field under the ring fencing provision. Under the status quo, the company could offset the cost for Willow with income from Prudhoe Bay; but could not under the provisions of HB 111. He thought the committee would be hearing from Conoco Phillips in the following days. He encouraged the committee to ask the company what the legislation would do to the rate of return and viability of the Willow project. He suspected the bill would have a significant impact.

10:13:26 AM

Mr. Marks continued to discuss slide 26, noting that in 2007 refundable credits were established to put non-producers and producers on an even basis. Without refundable credits, an exploring company with no offsetting income would have to wait for production to deduct costs.

Mr. Marks explained that previously, all parties were on the same basis for the positive value of the economics; and HB 111 would put all parties on the same basis in terms of the negative value of the economics (not being able to monetize the losses in a timely manner). He thought it was difficult to determine the state's cash affordability of refundable credits.

Senator Hughes thought that slide 26 indicated that the combination of ring fencing and refundable credits would deter exploration and development and thereby reduce future production and revenue.

Mr. Marks thought that the scenario would reduce the net present value for investors. He thought that some viable projects would not be so without ring fencing and refundable credits. He thought there were situations in which refundable credits could be given and result in either successful exploration or not.

10:17:37 AM

Mr. Marks turned to slide 27, "Reduction of Carried Forward Losses After 7 Years":

- If losses are incurred and not deducted:
  - –Production tax value artificially elevated
  - –Application of the nominal tax rate will result in an artificially elevated tax
- Punishes taxpayers for delays not of their doing

Mr. Marks explained that a provision of HB 111 was a 10 percent annual decline of loss carry-forwards after 7 years. He thought there had been a representation that part of the provision was intended to provide incentive for earlier development. He had observed that there were many reasons that projects did not move forward that were unrelated to the investor. He thought the state should not send the message for companies to work with haste (in order to avoid losing value of tax deductions) due to the fragile arctic environment.

Senator Meyer asked if it was safe to say that some delays were due to permitting or negotiations with the North Slope Borough, both of which were not within the producer's control.

Mr. Marks answered in the affirmative, pointing out that one of Conoco Phillips fields was delayed for years over the issue of building a bridge in a certain area versus building a pipeline underneath the ground. Negotiations between the company and regulators had taken a lot of time.

Senator Stedman thought the federal government allowed for the carry-forward of losses for 20 years. He mused about the appropriate amount of time to allow for carry-forward, and referred to problems in the Arctic with delays of implementation. He thought letting carry-forward of losses run for the long term it was problematic for accounting. He asked for Mr. Marks to comment on the subject.

Mr. Marks commented that not only did the federal government allow for 20 years of loss carry-forwards, but losses could also be carried back for two years to get additional net present value. He thought that if it was not possible to deduct costs, ultimately the tax rate applied would be to an artificially high income base. He opined that he would not place any time limitation on carrying losses forward. He suggested that no one was more motivated to get projects moving than the investors themselves.

10:21:40 AM

Vice-Chair Bishop spoke to the last bullet on the slide, and reminded that litigation was a new component to consider. He referred to a mine nearby that took over twenty years of litigation before production. He thought there was merit in extending the seven-year time period for loss carry-forwards.

Vice-Chair Coghill referred to variability of commodity prices. He thought it was important to consider that a long-term investment in Alaska had to go through economic, litigation, and commodity price cycles. He echoed the words of Vice-Chair Bishop.

Mr. Marks showed slide 28, "Hardening the Floor":

- Losing costs
  - Suppose gross value is $21/bbl
  - Suppose upstream costs are $25/bbl
  - So there is a $4/bbl loss
    - There are two parts to the $25/bbl cost:

–Part that took income down to zero ($21/bbl)
–The other part that took income below zero ($4/bbl). This is the loss.
–When paying on the gross minimum tax, by hardening the floor, and carrying the losses forward, only those latter costs get recovered. The former never do.

•January 2016 Situation (Slide 16):
–With the hard floor, taxpayers would have been $3 in the hole, then paid royalties and property tax, and then paid production tax.

10:24:20 AM

Senator Stedman referred to extensive dialogue over the previous years regarding hardening the floor. He thought there was $80 million worth of $5 credits that would go below the floor in 2017; and suggested it would change the investment dynamics of companies it applied to. He thought if the floor was hardened it was important to consider how to not negatively distort the economics of projects.

Mr. Marks stated that he would present a slide that would explicitly demonstrate the effects of hardening the floor, particularly regarding the economics of legacy fields.

Mr. Marks looked at slide 29, "Section 21: Gross Value May Not Be Less Than Zero":

•High pipeline costs are not a trivial occurrence
–Pt Thomson, Smith Bay, etc.
•In circumstances of high pipeline costs and low prices gross value could be less than zero
•Production tax value (ptv) is gross value less upstream costs
•Losses are negative production tax value
•If gross value has a floor of zero, those costs that brought ptv below zero are never recovered

Mr. Marks relayed that the tariff for the Point Thomson pipeline was between $15/bbl and $20/bbl. The cost was so high due to the settlement between the operators and the state, in which the state had insisted that the operators build a pipeline that could transport 70,000 barrels per day. He thought much of the capacity of the pipe was empty

and still being paid for. He mentioned very high pipeline costs as the Western North Slope was developed.

10:27:44 AM

Senator Stedman asked if the state ring fenced Point Thomson, if it would disallow the producer to take losses from other areas where there was a gain. He asked about hypothetical distortion of economics by different ring fencing configurations.

Mr. Marks informed that after the initial development of Point Thomson, the project was probably not losing money. Ring fencing could affect the economics of large-scale development. Under the existing code, he thought the Smith Bay project would get refundable credits, which would be a huge amount of money. He discussed offsetting of costs in the absence of ring fencing, and thought Smith Bay would probably be ring fenced.

10:30:45 AM

Mr. Marks turned to slide 30, "Government Take: Legacy Fields." He stated that for the rest of the presentation he would show government take graphs, comparing SB 21 and HB 111. He explained that the four basic elements working dynamically in the graphs were the hardening of the floor, the repealing of the per-barrel credits, the drop in the tax rate (from 35 percent to 25 percent), and progressivity at higher prices.

Mr. Marks showed slide 31, "Government Take - SB 21 vs. HB 111 - Legacy Fields," which showed a graph which illustrated the government take for legacy fields. The bottom line showed the competitiveness boundary, and the top line showed HB 111. He wanted to focus on the range of prices between $50/bbl and $70/bbl, where the was a huge gap between SB 21 and HB 111.

10:32:06 AM

Mr. Marks showed slide 32, ""Government Take - SB 21 vs. HB 111 - Legacy Fields - Focus on $50 - $70." He stated that under SB 21, the change-over from gross to net happened at $65/bbl. Under HB 111, the switch from gross to net happened at $40/bbl. He noted that the difference between the graph and the previous graph was entirely attributable

to getting rid of the per-barrel credit. He discussed the importance of the per-barrel credit in tempering the tax to be within international norms. At $55/bbl, the difference between the two bills (for legacy fields) was 8 percentage points and in government take (about $1.60/bbl).

Senator Wielechowski referred to the lower green line representing the competitive boundary, and was distressed to hear the state was not competitive. He referred to Security and Exchange Commission (SEC) filings from Concoco Phillips; and reported that in 2014 in Alaska Conoco made $2.04 billion, and lost $22 million in the Lower 48. He discussed company earnings and losses. He considered the net income of the company, and thought Alaska was the most profitable place in the world where it did business.

10:35:08 AM
AT EASE

10:35:13 AM
RECONVENED

Co-Chair Giessel asked if Senator Wielechowski would provide other committee members with a copy of the documents he was referencing.

Mr. Marks replied to Senator Wielechowski's comments and thought that SB 21 showed that the state was competitive. He compared the SB 21 graph line to the international competitive line on the graph on slide 32. He thought it was important to understand the difference between ConocoPhillips' operations in Alaska versus the Lower 48 and the rest of the world.

Mr. Marks discussed different compositions between gas and oil in the state versus elsewhere. He stated that the economics between oil and gas were very significant. He asserted that natural gas markets in the Lower 48 had been poor, as had oil. He noted that companies did not separately report oil and gas income, but there were shared costs. He discussed financial statement reporting, and the difference between oil and gas on a British Thermal Unit (BTU) basis. He did not think it was possible to compare per-barrel numbers between different geographic areas that had different compositions of oil and gas.

10:37:22 AM

Senator Stedman commented on the complexity of the topic and asked Mr. Marks to elaborate on the difference between a net tax system and a gross tax system, as well as how the proposed bill would affect the system under various oil price contingencies.

Mr. Marks turned back to slide 11, which explained the calculation of tax under SB 21. He stated that there was a "higher of" calculation between a net calculation and a gross calculation. Under SB 21 the crossover point was $65/bbl (using cost assumptions with legacy fields); at which point the net calculation became higher, and a net system was in effect.

Mr. Marks showed slide 25, which explained major economic provisions of HB 111. He explained that under HB 111 the dynamic shifted; the per-barrel credit was eliminated, and the base rate was reduced. The crossover point was then changed from $65/bbl to $40/bbl.

Senator Stedman suggested that the current year was under a gross tax structure. He wondered if the bill was adopted, if the crossover point would be moved, and change the tax structure to a net tax system as well as create a substantial change in tax that was due.

Mr. Marks referred to slide 32, and answered in the affirmative.

10:40:33 AM

Mr. Marks read slide 33, "Government Take: New (GVR) Oil."

Mr. Marks showed slide 34 through slide 37, "Government Take: New (GVR) Oil - SB 21 vs. HB 111," which each showed a line graph. He indicated that he would break the graph down in to three different graphs in order to see what happened with different oil prices between $45/bbl and $55/bbl and above.

Mr. Marks shared that with oil at $45/bbl, government take went from 230 percent to 260 percent. He thought the numbers were daunting, given the cost of new oil. He stated that the difference between SB 21 and HB 111 was about 30 percentage points in government take, which was worth about 60 cents per barrel at $45/bbl. He also noted that under

both curves the lines were significantly over the international competitive boundary.

Mr. Marks explained that new oil was allowed to bring tax down to zero with a per-barrel credit. The government take under SB 21 was a high take with no tax. When examining the graph from an oil price of $45/bbl to $55/bbl, the difference between SB 21 and HB 111 was about 6 percentage points, worth about 75 cents per barrel. Under HB 111, the government take was about 23 percentage points above the international competitive boundary.

Mr. Marks continued, and examined the effects of oil priced between $55/bbl and $65/bbl. There was a 5 percent difference between SB 21 and HB 111, which equated to approximately 90 cents per barrel. He furthered that under HB 111, the government take was about 17 percentage points above the international competitive boundary.

Mr. Marks looked at higher oil prices between $65/bbl and $150/bbl; at this threshold he thought SB 21 and HB 111 were not too dissimilar. He detailed that up until about $105/bbl, progressivity kicked in.

Mr. Marks turned to slide 38, "Observations on Gross & Net Taxation":

- Gross value is higher than net value
- Gross tax rates will generally be lower than net tax rates
- At low prices net value will be small and gross taxes will generally be higher than net taxes
- As prices increase, and costs become an increasingly smaller share of gross value, net taxes will generally be higher than gross taxes

Mr. Marks commented that gross tax system taxed on a higher base and a lower tax rate.

10:44:38 AM

Mr. Marks showed slide 39, "Conclusion":

- -Notwithstanding the havoc low prices have played with the state budget
- -How is the misery of low prices allocated between State and taxpayer?

-Generally there is a basic risk/reward symmetry in the world between how investors and governments share downside risk and upside potential (Slide 30)
-Alaska appears at odds with the general pattern

Mr. Marks went back to slide 31 to illustrate how there were regressive systems in the world that taxed on gross; in which the investor bore most of the downside risk, but got most of the upside potential. He explained that there were progressive systems in the world that taxed on net; in which the government and producers shared the downside risk and upside potential. He qualified that most systems in the world were gross systems, which explained the downward slope of the competitive boundary line on the graph. He reiterated that regressive systems were high take at low prices, and low take at high prices. He shared that Alaska was the only place in the world where as oil prices went up, the system was flipped from gross tax to net tax.

Mr. Marks continued discussing slide 39. He thought SB 21 was slightly at odds with the general pattern of global tax systems. He considered that HB 111 was noticeably more at odds with the pattern, especially considering the price range that was expected in the forthcoming years.

Co-Chair Giessel discussed the agenda and topics for the afternoon joint meeting.

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ADJOURNMENT
10:47:35 AM

The meeting was adjourned at 10:47 a.m.