

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

February 21, 2018

3:30 p.m.

MEMBERS PRESENT

Senator Cathy Giessel, Chair
Senator John Coghill, Vice Chair
Senator Natasha von Imhof
Senator Bert Stedman
Senator Kevin Meyer
Senator Bill Wielechowski
Senator Click Bishop

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

SENATE BILL NO. 176

"An Act establishing the Alaska Tax Credit Certificate Bond Corporation; relating to purchases of tax credit certificates; relating to overriding royalty interest agreements; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 176

SHORT TITLE: TAX CREDIT CERT. BOND CORP; ROYALTIES

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

02/05/18	(S)	READ THE FIRST TIME - REFERRALS
02/05/18	(S)	RES, FIN
02/21/18	(S)	RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

SHELDON FISHER, Commissioner-designee
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: Presented SB 176.

KEN ALPER, Director
Tax Division
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: Provided comments on and sectional analysis of SB 176.

DEVEN MITCHELL, State Investment Officer
Department of Revenue (DOR)
Juneau, Alaska

POSITION STATEMENT: Commented on SB 176.

ACTION NARRATIVE

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CHAIR CATHY GIESSEL called the Senate Resources Standing Committee meeting to order at 3:30 p.m. Present at the call to order were Senators Bishop, Stedman, Coghill, Meyer, Von Imhof, and Chair Giessel.

SB 176-TAX CREDIT CERT. BOND CORP; ROYALTIES

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CHAIR GIESSEL announced consideration of SB 176, sponsored by the Administration through the Rules Committee, and managed by the Department of Revenue (DOR). She said Alaska's oil and gas tax credit system, which included cashable reimbursement for investments was reformed in 2016 and again in 2017 with the passage of House Bill 247 and House Bill 111 that ended the cash reimbursement provisions.

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SENATOR WIELECHOWSKI joined the committee.

CHAIR GIESSEL said however, the state still has unpaid obligations. In response to those funding obligations and recognizing Alaska's need to reduce its reputation for risk to the world's financial sector, the Department of Revenue (DOR) has proposed a solution. She welcomed Commissioner Sheldon Fisher and Ken Alper, Director, Tax Division, to the table.

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SHELDON FISHER, Commissioner-designee, Department of Revenue, Anchorage, Alaska, introduced himself and said he would talk about the proposal in SB 176 to address the existing and outstanding oil and gas tax credits.

KEN ALPER, Director, Tax Division, Department of Revenue, Anchorage, Alaska, introduced himself.

COMMISSIONER FISHER said they would first discuss overarching goals and objectives for this proposal, go into the history, and then go into the details and provide a granular analysis. At the end Mr. Alper would provide a sectional analysis. He would prefer questions to be asked as they come up.

COMMISSIONER FISHER said when the governor asked him to be DOR commissioner, he identified these tax credits as an issue he wanted resolved. It has formed an important part of the governor's economic stimulus package.

As many know, the state has lost about 9,200 jobs between 2015 and 2017 and the oil and gas industry is down almost 31 percent. The Institute of Social and Economic Research (ISER) at the University of Alaska is expecting the year-over-year losses for 2018 will be another .7 percent. They did not view this reduction, which is less than prior years, indicates a recovery in activity but rather that the state's financial challenges are starting to be absorbed. They are still looking for some recovery.

He said this proposal allows for up to \$600 million or maybe a little bit more that could be an economic stimulus for the oil and gas sector of the economy. It also addresses the uncertainty about how the credits will be funded that has created limitations in the small companies' - the ones impacted by these credits - ability to raise capital and to continue to invest in the fields that they have discovered.

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COMMISSIONER FISHER said he didn't know how many jobs this might create but he called their attention to an Institute of Social and Economic Research (ISER) presentation last year on government spending where they estimated that for every \$100 million of government spending around 460 to 900 jobs are created. When a stimulus is put into an economy, the whole economy is stimulated with downstream jobs like support services, retail locations, and restaurants. So, a large overarching goal of the \$600 million is to provide additional stimulus into the economy.

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He said SB 176 tries to balance a number of competing interests in addressing the state's fiscal problem. The governor proposes a \$477 million budget deficit and his budget assumes this bill will pass. If it doesn't pass, another \$180 million will need to be appropriated to cover the statutory minimum. So, this bill actually helps minimize the deficit in FY19. Some argue that this money should be spent on higher priorities, but their first priority is job creation. And because this proposal actually preserves money, those dollars can be spent on other priorities or to limit the amount of the deficit.

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SENATOR VON IMHOF said a good chunk of this money would pay off bank debt and asked how that can create jobs.

COMMISSIONER FISHER replied that she was right, but one of the dimensions of this bill is that credit holders will be able to reduce the discount rate the state will charge them by committing to reinvest in Alaska. He explained that the state has learned that right now the capital markets are largely frozen to these companies, because they are not performing on their current obligations. As this money comes to the companies and their balance sheets are cleaned up, he is confident they would be able to access additional capital.

SENATOR VON IMHOF said that would be the two-step approach that they hope will happen. On his point that the deficit will increase by \$180 million without this program, her view is that assumes every entity that has an outstanding oil and gas tax credit will participate in this program. But what if everyone doesn't participate?

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COMMISSIONER FISHER replied that today's numbers are based on the assumption that essentially everyone participates. Within the last week they shared with the companies the DOR calculation of their credits and the discount they would receive under the various options under this program. Every affected party wants to participate.

SENATOR WIELECHOWSKI said the large overarching goal of this bill is to provide stimulus into the economy and asked if he evaluated infusing \$800 million into the economy in a different way, like paying everyone their full Permanent Fund Dividend (PFD) check.

COMMISSIONER FISHER answered that they did look at other options, and the Governor's economic stimulus package also includes a capital budget. Although he wasn't prepared to discuss that today, he could say that it was for deferred maintenance with an associated fair amount of value.

He hopes the committee is persuaded that this is almost a unique opportunity. The reason is because while the state is using its bonding capacity to pay these credits off, the discount that the credit holders will take on their credits will pay the interest on that debt. So, it's almost free money to be able to accelerate the payment into the current time-period because the cost of borrowing will be borne by the credit holders. He is not aware of any other option that has that mechanism built into it as a potential.

SENATOR WIELECHOWSKI said then that he assumes that they hadn't done any other analysis of the simulative effect of infusing \$800 million into the economy like paying a full PFD check.

COMMISSIONER FISHER said others have done that, and the department could bring that forward. He was not trying to avoid that question, but it's a separate question. The legislature could choose to appropriate a full dividend, and it wouldn't either positively or negatively the merits and wisdom of this program. Because of the nature of the structure, the credit holders themselves are covering the interest on the debt and the described relationship features are present regardless of what the legislature decides to do with the PFD.

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CHAIR GIESSEL asked if the unpaid credits are considered debt by the rating agencies and if they are negatively reflecting on the state's standing.

COMMISSIONER FISHER answered they are part of the payment obligations that the state has and that the credit rating agents look at as they consider its debts in considering debt capacity.

SENATOR WIELECHOWSKI asked if security is being offered for these bonds.

COMMISSIONER FISHER answered that these bonds would be subject to appropriation bonds. So, the creditability of the State of Alaska would be offered. In many respects, credit agencies would think about this as one form of an obligation for a different form of an obligation. In other words, the state's balance

sheet, called the Comprehensive Annual Financial Report (CAFR), already includes these credit obligations and those will be converted into a bond instrument.

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SENATOR WIELECHOWSKI asked if this is classified as a revenue bond or a general obligation (GO) bond.

COMMISSIONER FISHER replied it is a "subject to appropriation bond."

SENATOR STEDMAN said that "subject to appropriation" is why they are sitting here today, because these credits were subject to appropriations and not an open-ended call on the treasury. That language wasn't in the statute. However, these credits accumulated under the thinking that it was an open-ended appropriation.

SENATOR STEDMAN said one could look at the budget in two ways. One of the ways is that governors have to present a balanced budget. So, if the state is running a deficit, they have to come up with some revenues to make it equal before handing it to the legislature. But the deficit from owing the credits is the same today as it was a month ago, and he doesn't see it as increasing the deficit by doing something to decrease it.

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COMMISSIONER FISHER agreed on his first point that these credits were subject to appropriation, but he differed in thinking that the state bears some responsibility for creating the expectation that the credits would be paid annually as they occurred.

He said the Governor is trying to create a balance between a variety of competing interests and the balance comes in by saying to the credit holders if you want to receive your cash up front you have to be willing to accept a discount. That discount reflects the time/value of money and actually helps them and the state in a number of ways.

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To Senator Stedman's second point on the deficit, the statutory minimum published in the Revenue Sources Book for FY19 is \$206 million. The payment that is contemplated under this scheme for FY 19 would be \$25 million. That is why he says there would be a \$180 million difference, and his point is that the Governor's budget would have to be increased by \$180 million to account for it.

COMMISSIONER FISHER said he hoped to satisfy their concerns, but central to this proposal is a desire to produce a savings to the state budget in the near term (shifting payments into other periods) but also an overall smoothing of spending into periods when the state expects to have more revenue to pay them.

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COMMISSIONER FISHER said the second thing they are trying to balance is support for the small producers, because the major producers don't enjoy a benefit from the tax credits or the credit program. One of the strategic interests the state had when it created the credits in the first place was to try inducing small producers to come to Alaska, because of the view that it would increase competition, particularly on the North Slope, and generate more development of the state's resources. As a result of changes that have happened, many of these companies are in default and unable to access capital. Part of what SB 176 will do is clean that slate and allow them to get back to work.

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Finally, Commissioner Fisher said, this is an issue of the state's credibility: on the right-hand side of slide 3 was a cartoon figure of a moose holding a wad of cash, a document that was used by the state to try to attract producers to come to Alaska. The sentences under it said: "For the entire lifecycle of your project, the State of Alaska is there for you. We do not just talk big, we follow through big - with cash! Here is what you can expect when you come to Alaska:" and then it listed the attributes of the program.

People were trying to get the word out, and statements like this combined with a practice of paying the credits on a current basis induced people - very sophisticated organizations - to invest in Alaska. He thinks as a matter of ethics and honor that these credits should be addressed.

COMMISSIONER FISHER related that the administration reached out to a number stakeholders in developing this bill and one was a bank that has historically lent into this space. The first comment the individual made was that the bank was not lending to Alaska. When asked why, he answered that the outstanding debt is not performing; any new debt has to go to the same credit committee that knows it's not performing. So, they have closed Alaska off to future lending. They understand how Alaska got to

this point and view the bill as a mature and sophisticated response to resolving the credit issue.

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SENATOR WIELECHOWSKI said the commissioner acknowledged that these are very sophisticated investors and he assumed that they read the law before investing tens of millions of dollars or more. The law says it's subject to appropriation and then subject to payment by the director: both are totally discretionary. The state has actually paid every penny it is statutorily obligated to pay.

COMMISSIONER FISHER responded that he is exactly right. This program does not contemplate the state's perspective to be that it is worse off than the statutory formula. This program invites credit holders to accept a discount, so that the net present value of their payments and the state's obligations under this bond are actually neutral or modestly improved. His point is that this is viewed as a mature and sophisticated response is that it allows the credit issue to be cleaned-up and it allows the small producers to go back to work. It really doesn't cost the state anything, because the small producers themselves are accepting a discount and that is paying for the cost of financing the bond program.

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SENATOR STEDMAN remarked that his conversation with some of the bankers is that they missed the appropriation risk in their underwriting, but here the state is with a one-billion-dollar mess in its lap that needs to be cleaned up; the banks will tighten up underwriting going forward. There is enough finger pointing to go around both sides of the table.

COMMISSIONER FISHER agreed with that perspective, but his only point is that the administration is trying to balance all interests in a way that is fair and reasonable, and he hopes to persuade the legislature and Alaskans that this is a prudent approach.

COMMISSIONER FISHER turned the discussion over to Ken Alper to talk about the history and the background of the state's tax credits.

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MR. ALPER said slide 4 provides a thumbnail history of the tax credit background to walk through the intent perspective of some of the tax credits that got added over time and built upon each

other. The first was an exploration tax credit that was started in 2003, and that was still during the era of a gross based tax; it had no cash payback element. It was only used to offset taxes and was intended to bring new exploration, primarily on the North Slope.

In 2006, transferable and cashable tax credits came with in the Petroleum Production Tax (PPT) bill, along with the transition to the net profits-based tax. New credits specifically targeted capital expenditures (the state wanted people to spend money in pursuit of oil) and operating loss credits, which in some ways was the mirror-image of a net profits tax. A profitable company that spends incremental money is reducing their profits and therefore reducing their tax basis; a company spending without production is losing money: so, that credit was a percentage of their spend roughly equivalent to what their tax rate would have been, and as a result, a similar economic benefit of losses equal to the benefit of spending to a profitable company. This incentivized new field developers all of a sudden not just explorers. Embedded within that was the idea of a repurchase where the state would not just give you a credit that you could use or sell to another producing oil company but would actually buy them back within certain constraints that originally went up to \$25 million/company/year.

A year later, the Alaska's Clear and Equitable Share (ACES) bill revisited some of the assumptions in the PPT bill; one was that the limitation was creating some market problems. Anecdotally, the prices being offered for credits by the major producers was lower than some felt comfortable with at the time and they started looking at substantial surpluses. The cap was deleted as to how much could be spent per company and instead a cap was put on the appropriation. A statutory formula and a specific fund was created to establish and hold the tax credit repurchase money known as the ".028 Fund" for AS 43.55.028. It established that some percentage of production tax revenue should be set aside into the fund for the repurchasing purposes.

MR. ALPER stated that formula was routinely ignored for nine years. Between FY07 and FY15 the budgets that were passed were appropriated the full amount, and there never was any intent to limit what the state spent. It was completely governed by what the companies were asking for. It wasn't until FY 2016 that those caps first started to come into play, and maybe by 2013/14 people had forgotten that there was a statutory formula cap at all. But there they were!

In 2010, the Cook Inlet Recovery Act was a different incentive targeted at the looming gas supply shortages for utility gas in South Central Alaska - Anchorage, Kenai, and MatSu. It was a very large credit tied to drilling-specific costs, but because Cook Inlet already had a very minimal tax regime, there was never was never an expectation of substantial revenue coming from the oil and gas production there. Those credits were never expected to generate new revenue the way the North Slope taxes were expected to lead to new production and royalty for the state. This credit was truly for preservation of a livable lifestyle in South Central Alaska, which relies on gas for heat and electric. That in some ways created a portfolio of credits that was out of scale with the formula in the statutory appropriation, because no one contemplated all the Cook Inlet credits when the formulas were put in statute.

In 2013 the legislature passed SB 21, a North Slope-only tax reform bill that was primarily a tax cut. It eliminated the capital expenditure credit and replaced it with the per barrel credit, which was tied to the price of oil and the amount of production that a company might have. That made a fundamental change in how credits were used on the North Slope, but all the credits under SB 21 remained cashable just as they were under ACES with the exception of that per barrel credit, which could not be cashed out or carried forward or used generally below the minimum tax level.

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More recently, in 2016/17, HB 247 reduced and eliminated the credits for Cook Inlet - the state sort of declaring victory in its war on the gas supply shortage. It also put some limitations on the new oil benefits that were part of SB 21. Finally, HB 111 wound down the program completely to where the state would no longer issue cashable tax credits. They eliminated the net operating loss credit, the single largest-used credit and replaced it with a new system of carried-forward lease expenditures that companies will be able to use once the underlying leases were brought into production. It was a substantial change for the explorers and developers, although it didn't materially affect the tax status of the incumbent major producers.

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What have these tax credits done? They have helped heat Alaskans' homes. Hilcorp took over aging Cook Inlet assets and put a lot of money into their restoration, increasing production and squeezing more productivity out of what some people were

beginning to write off. Now suddenly, there is no longer a supply anxiety in Cook Inlet.

New companies came into Alaska looking for gas: Bluecrest and Furie being the most prominent examples. (Mr. Alper said he gets a little bit of leeway regarding confidentially, as these companies had outed themselves as users of the tax credit program, and he could talk more about specifics in a public forum.)

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On the North Slope, the state has created the potential for substantial new production: new oil and jobs. Pikka is Armstrong and Repsol's field with a new partner called Oil Search, Ltd. The Nuna field, which is an expansion to Oooguruk, is a Caelus field originally developed by Pioneer. All those things feed into the Governor's stimulus goals for jobs and additional revenue - although the production tax from a new oil field in its early years of production is relatively low in large part because of the gross value reduction. However, they are paying royalties from day one and that is a substantial revenue stream for the state. The production tax benefits of the gross value reduction go away after three to seven years, and then the tax will start to increase to the state. All that revenue funds government services.

SENATOR STEDMAN commented that some legislators have sat here for a decade or so and struggled with trying to rejuvenate Cook Inlet to prevent brown outs in the Railbelt area, but one of the things they rarely mention is the impact of the Regulatory Commission of Alaska (RCA) and deregulation of pricing. As they attempted to stimulate Cook Inlet, and quite frankly overstimulated it, the RCA allowed the price to flow more. Once that kicked in, there was more gas in Cook Inlet than they know what to do with. Looking at this in hindsight, about every two years they were here at the Resources Committee to try to stimulate Cook Inlet with everything they could think of.

MR. ALPER said it's not part of their pitch, but he is inclined to agree with the Senator on some of the history.

SENATOR STEDMAN asked if they go forward with the bond package, would all the participants in it remain confidential.

MR. ALPER replied not necessarily. Part of HB 247 is an annual report to the legislature of how much a specific company received in cash from the state in the previous calendar year.

The first report was issued last March and they will have a similar report in a month or so with the 2017 totals. As expected, that number will be around \$77 million, most of it going out in August/September. If all this money is spent in 2018 to finance credits, the state interprets the law to say that the state would put that in the subsequent years' annual report.

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MR. ALPER said slides 6 and 7 summarize the state's total purchases to date: actual cash out the door is \$3.6 billion. Of that, some has gone to companies that aren't yet in production and may never be in production (for example: failed exploration and companies that have left Alaska). But 16 companies have received credits who now have new production of about 175 million barrels of oil equivalent, much of it gas, through the end of CY16. That is the best comprehensive data they have, and production is split evenly between North Slope and the non-North Slope (the new North Slope fields that came on in the last 8 or 10 years fall in this category and the new gas wells are the worked-over gas wells that he noted in the last couple of slides).

Slide 7 is about where the state is now, which is holding \$806 million in credits, about \$500 million of that North Slope and about \$300 million non-North Slope. Among that \$800 million, are \$60 million of "conditional certificates." These are exploration requests that have not been fully reviewed and vetted and issued. Per the changes made in HB 111 last year, the DOR issues a certificate at the time of application for the purposes of getting them in the queue. These have to be finalized and may have some small dollar adjustments before being bought under some program.

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MR. ALPER said in the next 10 years they expect another 106 million barrels from fields currently producing and another 23 million from the fields not yet producing; adding that to the 86 million that already happened, they see 215 million barrels of oil on the North Slope coming directly from the tax credit program.

In Cook Inlet, (there is no Middle Earth production in the forecast), all the current oil and gas production has benefited from these credits. There is no question about it. Roughly speaking, the ongoing production to meet the needs in the Railbelt is 90 billion cubic feet per year, which works out to

15 million barrels of oil equivalent. Additionally, the oil from the Cook Inlet has increased in the last several years and now works out to about 5 million barrels per year. That number could go up; Bluecrest might talk about some of their upside, for example. But that 5 million plus the 15 million oil equivalent of the gas is about 20 million times the 10-plus years in the forecast added to what we already have, for about 300 million barrels of oil equivalent incentivized from oil and gas tax credits in Cook Inlet. The sum-total is over 500 million barrels.

SENATOR STEDMAN wanted to know the non-North Slope total credits and total severance and royalties and when the severance and royalties will equal the credit expenditures.

MR. ALPER said he would do his best to get the answer for him, but the answer for Cook Inlet is probably many years. On the North Slope, he imagined a payout in a more reasonable period of time, because the taxes in the Cook Inlet just simply won't support the credit expenditure. The royalties, however, will, but it will take longer.

COMMISSIONER FISHER continued on to slide 8 that gets into the real proposal. It indicates the estimated statutory payment for FY19-FY25. The statutory minimum is a formula based on the production taxes that the state levies and the threshold is \$60/barrel. If it is at \$60/barrel or higher, then the statutory minimum is 10 percent of production taxes and if it's less than \$60 then it's 15 percent. It's important to say these figures will be updated in the spring forecast that will be issued in mid-March. The schedule has caused, in some cases, a cessation of activities by small producers as they have struggled to maintain financial viability.

SENATOR WIELECHOWSKI noted that the FY19 estimated statutory payment is \$206 million and the statute, AS 43.55.028(b)(1), says that the money appropriated to the fund including any appropriation of the percentage...is based on revenue of taxes levied under AS 43.55.011, which is the oil and gas production tax formula. But the revenue forecast for oil and gas production tax in FY19 is \$338.8 million. When he multiplies that by 15 percent, he gets \$50,700,000, not \$206 million. That figure is actually high, because it includes the Hazardous Spill Response Fund. It's probably closer to \$48 million. So, it looks like that number is overstated by \$158 million.

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MR. ALPER responded that the math he was about to describe is not new methodology; it has been used for the last three years (for as long as it has been relevant, because the legislature paid them in full before then). Section .028(b)(1) says the percentage of the revenue from .011, and that has been interpreted to mean the actual tax calculation, which is 35 percent of production tax value prior to the application of any credits. Thirty-five percent of production tax value in FY19 is in the neighborhood of \$1.3 billion, and about \$1 billion worth of primarily per-barrel credits will be offset against that, which results in the approximately \$300 million in revenue that is in the Revenue Sources Book. It's that \$1.3 billion times the 15 percent, and the 15 percent is used because the forecast oil price is \$57/barrel, which is less than \$60/barrel. That is where the forecast gets the \$206 million.

SENATOR WIELECHOWSKI said that is not how he recollected the legislation was passed. The state could theoretically get into a situation where 100 percent was engulfed in paying out taxes and that was never the intent (recalling previous testimony from the administration). It was never the intent to allow two-thirds of the state's production tax revenue to go to paying tax credits.

MR. ALPER said it would come up again as they go through the sectional analysis, and the portion of the bill that describes the mechanism for calculating the anticipated cash flow to producers, and therefore how the buyout amount is calculated, presumes the same calculation that get them to the \$206 million. It repeats the language in a way that clarifies what Senator Wielechowski is pointing out: it's before the application of any credits. If the method he is suggesting were used in the bill, and the payout was in the neighborhood of \$50 million per year, it would take 16 years to get through \$800 million and they would start seeing very reduced and probably unacceptable buyout amounts to companies because of the compounded discount rates over 16 years. There is some imperfect clarity in that section of the language, which was corrected for the purposes of this program in the new sections added by the bill.

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COMMISSIONER FISHER reiterated what Mr. Alper said, which is that this is not a change to the way the administration has calculated this and has published in the Revenue Sources Book for a number of years. The appropriations that have been submitted by the administration and approved by the legislature have been based on this formula; the debate has been following this formula. In his mind, this is another opportunity for the

state to either help or harm its reputation if the result of this process is that in the very year where these credits are a meaningful amount, the state chooses to reinterpret that and reduce it again. It sends a signal to the industry that whenever it's in the state's interest it will reinterpret the law to favor itself. It is dangerous to do that.

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COMMISSIONER FISHER went to the slide 9 hypotheticals: if you assume a credit holder has \$100 million in credits that are payable over a four-year period in equal amounts of \$25 million, the program offers two alternatives to that credit holder. The lower discount rate is estimated to be 5.1 percent; that represents the state's cost of borrowing and has two components: the DOR has estimated, based on current market conditions, that it would cost about 3.6 percent to borrow the money (interest on the bonds plus the cost of issuance), and 1.5 percent has been added as a cushion to come up with an estimated state cost of borrowing of 5.1 percent. The 10 percent number is somewhat arbitrary: it is roughly a mid-point between the state cost of borrowing and their estimate for the weighted average cost of capital for the credit holders. The 10-percent discount rate is the base rate under the bill. So, if a credit holder does nothing, the DOR's offer to them would be discounted at 10 percent.

To qualify for the lower discount rate of 5.1 percent, the credit holder must give the state one of four additional benefits: first, they have to agree to give the state an overriding royalty interest, they have to commit to reinvest this money in Alaska within a 24-month period, or if they have seismic data that has been the subject of the credits they have to agree to an early waiver of the 10-year term of confidentiality for it. Finally, there are two credit programs that are modest in size and a little different than most of what they have talked about: one is capital investments in refineries and the other is gas storage credits associated with the Interior Energy Project (IEP); those would qualify for the lower rate by definition. He provided two examples of payment options on slide 9.

COMMISSIONER FISHER said someone might ask why a credit holder would accept \$87 million for \$100-million worth of credits, and the answer is: they need the money now. And even though 10 percent is materially above the state's cost of capital, but the department believes it is less than a credit holder's cost of capital. This means if they can't secure this financing at a

lower cost elsewhere, that would make them more inclined to accept the discount. When the state pays them \$87 million, it would turn to the financial markets and borrow the \$87 million. He explained that the present value of payments to the bond holder and the payments under the debt would be roughly the same. In fact, under the 10 percent discount, the state is a little bit better off; under the 5 percent discount the payments between the those two are neutral. Of course, the state has received some other benefit: the overriding royalty interest which would be intended to have an equivalent value to the roughly \$6 million difference between the 10 percent discount and the 5.1 percent discount rate in this example. Under either scenario, the state would be covering its costs through the discount rate that the credit holder would accept.

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Slide 10 walks through how the mechanism would work. Before issuing bonds, the state would secure a commitment from the credit holder to participate in the program. That requires the department to estimate what proceeds would be available to them under the various scenarios and then credit holder would have to make an irrevocable commitment to participate.

COMMISSIONER FISHER said the reason the irrevocable commitment to participate is important is before going to market and issuing the bonds, he wants a precise number for the debt. Once the commitment is received the state would issue bonds. Of the current outstanding \$806 million in credits, the department estimates \$100 million worth will likely be purchased by the majors to offset other tax liabilities that they have, leaving about \$706 million to be addressed in the first issuance of this program. That would result in a bond issuance in the range of \$618 million to \$660 million, depending on the discount rate that is applied.

COMMISSIONER FISHER said the state could be in the bond market by August or September with this program, assuming this bill passes by May. In the future, additional issuances will made as additional credits become due, and estimate in the neighborhood of \$200 million over the next three successive years.

SENATOR VON IMHOF asked what the irrevocable commitment means and when it has to happen.

COMMISSIONER FISHER replied the department would give the credit holders notice and a period of time for closing of about two weeks before issuing the bonds. "Irrevocable" means at that

point they are bound to accept that offer from the state, so it can rely on it for the bond issuance.

SENATOR VON IMHOF asked if they were talking about issuing bonds in late July.

COMMISSIONER FISHER answered late July or early August.

MR. ALPER said the lower discount rate is an estimate for today's purposes. The exact rate will not be known until the bonds are sold, but commitments will be made based on the DOR's best estimate two weeks before. To the extent there is any interest rate risk, it's whatever happens in that two-week period.

SENATOR VON IMHOF remarked that she hoped the state wouldn't go under water in that two-week period.

COMMISSIONER FISHER replied that they are confident that the 1.5 percent cushion built into the offerings would cover any interest rate movement between the commitment and issuance.

SENATOR VON IMHOF said okay.

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SENATOR WIELECHOWSKI asked "how it can be constitutional to do this?" Article 9, Section 8 says no state debt shall be contracted unless authorized by law for capital improvements or for housing loans for veterans and it is ratified by a majority of the voters.

Section 11 has exceptions, but those say the restrictions on contracting the debt of Section 8 do not apply to debt incurred through the issuance of revenue bonds by a public enterprise or public corporation of the state or political subdivision when the only security is the revenues of the enterprise or corporation.

He said the commissioner had testified that this is not a revenue bond, that no security is offered, and that no revenue will be generated by an enterprise or corporation. "This clearly violates the constitutional prohibition on bonding," Senator Wielechowski said.

COMMISSIONER FISHER invited the DOR State Investment Officer to comment on this issue.

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DEVEN MITCHELL, State Investment Officer, Depart of Revenue (DOR), said Senator Wielechowski is right that this wouldn't be a constitutional debt like general obligation debt. He has heard lawyers refer to it as "lower case "d" debt." It would be similar to an Alaska Housing Finance Corporation (AHFC) obligation: they are creating a public corporation that would enter into a contractual arrangement with the state and that arrangement would formulate a commitment of the state to pay, and that commitment to pay would be pledged to third parties that would purchase the state's bonds - similar to the financing of the Goose Creek Correctional Facility, which was a revenue bond of the MatSu Borough that didn't pledge anything except for the state's commitment to pay through a lease the state entered into with the borough.

The commitment to pay is subject to an appropriation commitment; it's a pledge to third parties; it's the basis of the rating on those bonds and the basis of the investors' risk in waiting.

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SENATOR WIELECHOWSKI said he asked the Division of Legislative Legal for an opinion, but he hadn't received it yet. It just seems like a really questionable way of circumventing the constitutional prohibition against bonds. You could theoretically say we have a \$2.5 billion deficit and we're just going to issue a bond that is subject to legislative appropriations, which is exactly what the constitutional founders wanted to prohibit.

MR. MITCHELL responded that, as Senator Wielechowski pointed out earlier, the state has a variety of public corporations that have that power. The Alaska Pension Obligation Bond Corporation, for instance, has the ability to issue \$5-billion worth of state funded debt that is on the books right now.

SENATOR WIELECHOWSKI said that is because AGDC and AHFC have potential revenue. Pension obligation bonds sought to get revenue by investing the money at an 8 percent rate of return.

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COMMISSIONER FISHER said this is an important conversation and the department feels comfortable with its position. The bond counsel still has to issue an opinion and he is happy to engage in a debate. He suggested tabling the issue and coming back to it after a section analysis.

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SENATOR BISHOP said taking an overriding royalty position in return for these discounts was mentioned earlier. Correct?

COMMISSIONER FISHER answered yes.

SENATOR BISHOP said, "Well, there's your linkage."

COMMISSIONER FISHER responded it could be, depending on what percentage of credit holders use that function.

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COMMISSIONER FISHER said slide 12 was about details of the bond; it would be a 10-year term; the all-in cost would be a little over 3.6 percent. It has been modelled using two years of interest only, three years of growing increased debt service, and five years of a flat amortization at the end - for the initial debt. Successive years would be interest-only paid "with a bullet at the end."

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Slide 13 models the numerics of the statutory payment schedules and the amount of payments annually. Comparing the statutory minimum amount to the aggregate, one sees a couple things: first, in every period between now and FY25, the amount of payments would be less but obviously go longer. The large amounts are not paid out in the next couple of years, which has a number of helpful features. First, it allows the state a little more time to deal with its current fiscal challenges, giving the legislature a chance to see where the state's funding will come from, and the costs are shifted into periods where the state could be expected to have revenue to cover them. In addition, the present value of these two streams - the statutory payment and the aggregate stream - are either favorable or neutral to the state, because of the discount options.

SENATOR STEDMAN said the schedule could be crafted in a lot of ways and that he liked the idea that the department is trying to deal with "this billion-dollar mess," but he personally didn't like the interest-only aspect. He was concerned also about shifting this problem down the road to the next governor and the governor after that. The state could bite the bullet over the next two or three years and make the payment schedule shorter and get it over with. Everyone knows the money is going to come out of the Permanent Fund to run the state in the next couple of years. "We created this mess, we should clean it up, and leave

the budget to the next legislature in the best position possible."

SENATOR VON IMHOF wanted to build on what Senator Stedman just said and asked if there is a way to do a hybrid of the proposal: the discount makes sense and going out in the bond market makes sense, too, but having more aggressive payments. The totals indicate the state will pay a couple hundred million more by eeking this out over the extra five or six years. She understands that by delaying the payment and doing interest-only helps the current cash flow, but she thinks if there is a way to model the payments in five or six years, they could just be done with it.

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COMMISSIONER FISHER said he could certainly model any of those scenarios. In the interests of simplicity, he pointed them to the third column from the right on slide 14 that is titled "Current Total Payments to Revenue." That column includes the payments to revenue under state debt obligations, state supported debt service (for things like lease/purchase of the Atwood Building or supporting the Goose Creek Facility through a lease commitment, school reimbursement programs, statutory payments under PERS and TRS, as well as these credits). So, starting in FY19, those add up to 35 percent of revenues and it declines down to 20 percent of revenues out to FY27. Out of that 35 percent in FY19, 10 percent of that is these credits, and under this financing program, that would become 1.3 percent. So, the state is actually in a period (between now and 2024) where 35 to 31 percent of revenue is consumed by these other expenses that don't fund daily state government operations; they go to commitments the state has made. This program has the ability of smoothing out the overall payments, and while it does that by shifting them into the future, it creates a flatter schedule that may be more appropriate. However, he said this is clearly a decision for the legislature to address.

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Slide 15 was a recap of the proposal which is an economic stimulus: they expect most of the credit holders will reinvestment in Alaska; it supports small producers and unfreezes some of their projects; and it reestablishes Alaska's reputation. The commissioner added that as these entities reinvest and continue to pursue their projects, production is expected sooner than otherwise projected, which results in future royalties, jobs and other benefits. It moves the cost

into periods where the cost and cash flow will be better matched.

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CHAIR GIESSEL called the meeting back to order and invited Mr. Alper to provide a sectional analysis of SB 176.

MR. ALPER said the bill is conceptually three different things; it creates a bond corporation, makes certain amendments to tax credit statutes, and creates the mechanism to buy them back. Another section deals with the idea of overriding royalties, DNR statutes, at the end of the bill.

Section 1 exempts the overriding royalty interest as well as the bond corporation from the Procurement Code. This language is in a lot of bills.

Section 2 is many pages long and creates a new chapter AS 37.18, which establishes the Alaska Tax Credit Certificate Bond Corporation within the DOR. This new entity parallels almost all the language that created the Pension Obligation Bond Corporation in previous legislation. He emphasized that these subsections and components were not made up on the fly; there was precedent for all of it.

MR. ALPER continued explained that they are creating a corporation, so it needs a board of directors, which is three department commissioners, including the DOR commissioner. They are authorized to issue bonds of up to \$1 billion and then have a reserve fund, the vehicle through which the money that goes to pay the interest on the bonds passes through, as well as the money that passes through to the companies from the credits are bought. It authorizes the corporation to set the terms of the bonds and has a sunset date.

Should the legislature move around some of the assumptions about the bond, the payback schedule, what's interest only and what's not, presuming that the discount rate stays the same, Mr. Alper said that will not change any of the offers to buy credits from the companies. The present value of all the variations should be about the same. The part where they are valuing the credits is not going to be impacted by putting in either a five-year or a ten-year schedule. It's just a matter of the future state cash

flow in having to pay down on the principal and interest payments on those bonds.

MR. ALPER said the proposed corporation must adopt a resolution to approve the bonds (AS 37.18.060) and certain enforcement rights to the bond holders. The bonds may not be issued unless the discount rate is at least 1.5 percent greater than the total interest cost. This gives the state protection that it won't lose money through arbitrage or anything else. The Pension Obligation Bond Corporation has a similar provision. The amount the state expects to earn should be greater than the amount it will pay. Bonds are legal instruments.

He didn't like the language: "This chapter shall be liberally construed to carry out its purposes," which is legal language to say that we understand what we are supposed to do with this and we are going to do it. The corporation may adopt regulations as necessary and the definitions.

MR. ALPER said he was not the most qualified person to talk about the details, but someone from Treasury would be happy to talk in greater detail about section 2 if needed.

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He said sections 3, 4, and 5 are all parallel construction amending the three existing tax credits in the corporate income tax statutes (AS 43.20.): the Kenai Gas Storage credit program, the LNG storage credit for the Interior Gas Utility, and the refinery infrastructure credit. All are written so that they can be paid out of the .028 Fund. Those are amended and conformed to say the credits can be bought using the proceeds of this bond program.

SENATOR WIELECHOWSKI asked if this corporation will actually have an office and people working in it or is it just sort of a "dummy pass-through corporation" to avoid the constitutional prohibition on GO bonds.

MR. ALPER answered there would be no staff or office; this is a subsidiary of the existing Treasury Division that has a lot of bonding programs. The fiscal note has \$2,500 which is basically an annual registration charge associated with having this bond out there. He wouldn't characterize it as circumventing the constitution.

SENATOR STEDMAN asked him to clarify the comment about how some of the other credits are tied into this bond package.

MR. ALPER said those three corporate income tax credits are not in AS 43.55 and a small amendment was needed to say they could also be paid out of this bond proceeds mechanism, which isn't directly passing through the .028 Fund.

SENATOR STEDMAN said this is a bigger target than just the credit balance.

MR. ALPER answered no; those specific income tax credits are already in the universe they are talking about. The \$806 million includes any refinery credits, and when they talk about the \$200 million of credits yet to come even though the program has sunset, they are talking about the last half year or so of cashable credits that were earned before the sunset in HB 111 as well as the last couple of years of the refinery credit, which sunset in 2019, and the Interior Gas Utility credit, which sunsets in 2020. Those are already presumed to be eligible under the program, but their enabling statutes need to be amended to make sure they are eligible to get the bond cash.

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He said sections 6 and 7 are the parts of the Tax Credit Fund, itself, that talks about how cash is used. Specifically, the money is used to purchase tax credits that comes from direct legislative appropriations; the money from the bond proceeds can also be used to purchase tax credits. It's conforming language.

Section 7 references a provision that was added by HB 247, the so-called "Haircut," that puts a \$70 million cap on how much a given company can get in a year, and says of that \$70 million, the second \$35 million, if the company wants it, will have to take a reduction in value. This program is being exempted from that Haircut. He clarified that obviously if there is a company with a large number of credits, they would expect they would be getting more than \$70 million and want to make sure that that cap language does not apply to the bond program. It just applies to the traditional tax credit appropriations.

Section 8 is a definitions section. The important definitions are: "money disbursed by the commissioner," which means the bond money and "total interest cost" is a fiduciary term meaning the cost of the interest plus the financing and creation cost (management costs of doing the bond issuance). The rate in the final bond will be the total interest cost plus 1.5 percent.

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Section 9 has to do with another section added into HB 247 that says if a company has an obligation to the state through unpaid royalties or fines, in addition to taxes the state could offset their tax credits to pay these state obligations to a state agency. This authority has always existed and is being extended to include this new program.

Section 10 is the guts of the bill; the new changes and several new subsections create the authority to go through the purchase mechanisms for this bonding program. It creates new .028(k) (l) (m) and (n):

.028(k): how a company makes the irrevocable commitment of credits to the program. It also says they have to offer all their certificates or none at all. It also says if they choose not to participate in the first round by the cutoff date, July 1, 2018, those credits are not eligible for the second round of financing.

MR. ALPER explained that the department tried to be as flexible as possible but got a little restrictive here because their modeling indicated the possibility of gaming the system. Someone could choose to not participate hoping that a bunch of other people do; clear the decks, get rid of all the credits in line in front of them; and improve their position if they chose to participate in a second round of financing.

.028(l) creates the expectation of cash flow for the companies. It creates new definitions of "assumed pro-ration methodology" and "assumed appropriation." In other words, it references the statutory appropriation, and given how many credits a particular company has and what year they came in, and therefore where they fit in the rank order of the credits in the pro-ration among all the other credits from that year, when they would expect to get their money. It empowers the department to figure out what the cash flow would be. Then it will be discounted at the rate to find in subsequent section (m).

He said the department gave the companies a preliminary analysis of what their expected appropriations would be and what their discount would be so that they could participate in this conversation during the session.

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.028(m) says the discount rate in which a present value will be established to pay a company off is 10 percent unless one of the four criteria are met:

1. one of the corporate income tax credits
2. the overriding royalty interest
3. the commitment to reinvest all the proceeds within the state within 24 months. This requires the commissioner to sign off on this being an acceptable commitment on them being able to get a higher buyout.
4. the waiver of the 10-year confidentiality period for those companies holding the seismic credits.

MR. ALPER explained that .028(m) doesn't "hard code" the 5.1 percent. It says total interest cost plus 1.5 percent, which gets determined closer to the date of issuing the bonds.

.028(n) says once the credit is bought at something less than face value, the remnant amount (the 13 percent not being bought) retains no value. It expires by selling the rest to the state at a discount.

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Section 11 is about overriding royalty interests. It authorizes the commissioner of DNR to negotiate these. If a company chooses to offer a royalty interest, which would be a share of the value (not an ownership interest in oil); it's a financial quasi-royalty often used in industry when someone sells a lease to another company, they might retain an overriding royalty interest. For example, an offer is made. There is a method by which DNR values it, risks it, and considers the likelihood of it playing out and becoming real production. In the context of Commissioner Fisher's slide with \$87 million scenario or the \$93 million scenario, that royalty has to have a present value to the state of at least \$6 million to warrant giving the incremental cash to the company for it.

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Section 12 is regular regulatory language authorizing both departments to write regulations.

Section 13 allows those regulations to be retroactive to the effective date should it take longer than that to write them.

There is an immediate effective date on the bill. It isn't usually in their bills, but the commissioner mentioned wanting

to go to the market in August and it would take 90 days to get all the pieces ready to be able to do that. So, they would like to have the statutory authority to be preparing for it at the end of the legislative session.

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CHAIR GIESSEL thanked the presenters for explaining the bill. She held SB 176 committee and said she looked forward to getting the answers to the committee's questions.

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CHAIR GIESSEL adjourned the Senate Resources Standing Committee meeting at 5:05 p.m.