

HOUSE FINANCE COMMITTEE
February 25, 2019
1:32 p.m.

[1:32:24 PM](#)

CALL TO ORDER

Co-Chair Foster called the House Finance Committee meeting to order at 1:32 p.m.

MEMBERS PRESENT

Representative Neal Foster, Co-Chair
Representative Tammie Wilson, Co-Chair
Representative Jennifer Johnston, Vice-Chair
Representative Dan Ortiz, Vice-Chair
Representative Ben Carpenter
Representative Andy Josephson
Representative Gary Knopp
Representative Bart LeBon
Representative Kelly Merrick
Representative Colleen Sullivan-Leonard
Representative Cathy Tilton

MEMBERS ABSENT

None

ALSO PRESENT

Bruce Tangeman, Commissioner, Department of Revenue; Ed King, Chief Economist, Office of Management and Budget; Dan Stickel, Chief Economist, Economic Research Group, Tax Division, Department of Revenue; Colleen Glover, Director, Tax Division, Department of Revenue.

SUMMARY

PRESENTATION: FALL 2018 REVENUE FORECAST

Co-Chair Foster reviewed the meeting agenda.

^PRESENTATION: FALL 2018 REVENUE FORECAST

[1:33:26 PM](#)

BRUCE TANGEMAN, COMMISSIONER, DEPARTMENT OF REVENUE, provided information about the department's Revenue Sources Book. He spoke of his stellar staff that produced the publication. He introduced a PowerPoint presentation titled "Fall 2018 Revenue Forecast," dated February 25, 2019.

Commissioner Tangeman relayed that the new administration was presenting revenues and budgets differently. The administration was matching revenues to expenditures rather than addressing the components in two separate discussions. The governor asked the department to get the revenue numbers together first, then he was going to match his budget to the revenues. Commissioner Tangeman would be walking through the report stopping to point out very pertinent pages as he went along. It was a document that had been generated for many years and was extremely useful.

Commissioner Tangeman explained that Chapter 3 of the Revenue Sources Book tackled a different issue each year. The current year's Chapter 3 discussed 60 years of revenue history. He recommended to members to read Chapter 3 from reports of previous years, as they were very informative and interesting to read.

Commissioner Tangeman began with slide 3 which provided a one page look at the entire revenue picture and could be found on page 6 of the Revenue Sources Book. The top section was the unrestricted general fund (UGF) revenue. The chart showed FY 18 actuals and the forecast for FY 19 and FY 20. The largest change under UGF revenues was investment earnings reflecting a percent of market value (POMV) draw as a result of the passage of SB 26 [Legislation passed in 2018 establishing a POMV draw]. He highlighted that for FY 20 about \$2.9 billion of the \$3.0 billion was the earnings reserve account (ERA) draw.

Commissioner Tangeman continued to the designated general fund (DGF) section broken down into oil revenue, non-oil revenue, and investment earnings. Unrestricted general fund revenue in the top section encompassed production revenue, property tax, corporate income tax, and royalties. Other restricted revenue was included such as excise tax, fish tax, charitable gaming, marijuana tax, and motor fuel tax.

Commissioner Tangeman continued to the next section down, other restricted revenue. It was a portion of royalty

revenues, a portion of the Public School Trust fund and others. He indicated greater detail could be found in the Revenue Sources Book. The bottom section of the chart was federal revenue including oil revenue and federal receipts.

1:38:05 PM

Vice-Chair Ortiz referred to slide 3 and queried the reason for a drop in oil revenue between FY 19 and FY 20. Commissioner Tangeman replied that it primarily had to do with the price of oil. The forecast was about \$68 per barrel in FY 19 and \$64 per barrel in FY 20. Currently, the price was averaging just under \$70 per barrel. The price of oil was currently outpacing the department's forecast slightly. Since mid-January the price of oil climbed to more than \$60 per barrel. The price of oil was \$68 on the previous Friday. He hoped the price would increase.

Commissioner Tangeman turned to slide 4 that showed the top part of slide 3 in greater detail. He pointed to the section on taxes which showed petroleum property tax, petroleum corporate income tax, and production tax. Royalties encompassed mineral bonuses and rents, oil and gas royalties, and interest. Oil and gas royalties on state lands in Prudhoe Bay made up the largest portion of the royalties category.

Vice-Chair Johnston asked if the amount of property taxes was before the passage of any new legislation. Commissioner Tangeman replied in the affirmative.

Commissioner Tangeman turned to slide 6 related to the Fall 2018 price forecast. He asked Ed King to join him at the table to walk through some informative slides.

ED KING, CHIEF ECONOMIST, OFFICE OF MANAGEMENT AND BUDGET, addressed slide 6 regarding the oil price forecast. The slide showed where prices had been over the previous year and the direction prices were headed over the budget cycle and beyond. There had been a significant amount of volatility in the past year. Over the summer prices had been over \$70 per barrel. At one point the price broke the \$80 mark reaching \$85 per barrel in October 2018.

Mr. King elaborated that much of what was occurring at the time was geopolitical uncertainty, mostly around Iran. He relayed that there was a requirement for about a million

barrels of oil being produced by Iran to come off the market. The market reacted to the requirement by trying to encourage more oil to come to the market by increasing the price. The price moved up through the summer and into the fall. The effort was successful, as new oil came into the market. For instance, Saudi Arabia increased its production and mid-continent producers of shale oil increased their production. The market got blind-sided with the waivers issued for Iranian oil, allowing the oil to stay on the market after the market had just reacted to the need to bring more oil to it. He pointed out that from October through December there was about a 40 percent drop in the price of oil because of there being too much oil on the market at the time.

Mr. King continued that in December Oil Producing and Exporting Countries (OPEC) started to cut back on production, as did Russia. The market started to stabilize and presently oil prices closed at \$65 per barrel at the end of the day. Oil prices were back in the range of what the department thought was reasonable. He suggested the volatility of oil prices would continue through 2019. There were several geopolitical questions that remained unanswered including whether Iranian waivers got approved. There were several tensions and sanctions occurring with the regime change in Venezuela. There were many questions about what would happen next. He would not be surprised if oil prices shot up again. However, it would not be prudent for the state to count on such an event to happen.

Vice-Chair Ortiz asked about the red marks on the graph on slide 6. Mr. King answered the red arrows pointed out specific points in time. He noted that the blue line represented the Brent oil price and the white line represented the West Texas Intermediate (WTI) oil price.

Mr. King continued to slide 7: "World Liquid Fuels Production and Consumption Balance," which depicted the supply and demand balance [from 2013 to 2019 by the Energy Information Agency (EIA)]. He explained that the EIA was an agency of the federal government which tracked oil price movement and supply and demand balances. The entity published the chart every month in its short-term forecast. The chart was a December publication. He presently had the one from January. It showed that the balance had collapsed. He explained that the yellow line represented the timeframe in December showing that the world's production was

outpacing consumption. It indicated there would be downward pressure on price, as there was too much oil on the market.

Mr. King continued that the green bars represented the fact that there was very little room for oil prices to rise. Since then, OPEC cut back on its production which moved the two lines together. He suggested that there was currently balance. He conveyed that in looking at the January 19 version of the table the green bars collapsed to nearly zero. The expectation was that there would be some stability in prices.

[1:45:19 PM](#)

Mr. King turned to slide 8: "PRICE FORECAST: Differences in Analyst Forecasts," which demonstrated what analysts looked at when considering what oil prices might do in the future. It was very important for analysts to take into account the supply and demand balance, especially when looking beyond a month or two. He suggested that even if there was a price disruption that drove prices up or down in the near-term, it was important to consider the larger picture for the price forecast looking forward. Everyone was paying attention to the demand from Asia and how economic growth in Asian countries with large population centers was doing. He elaborated that if they had more disposable income, they would use more oil products including plastics and transportation fuels. It would increase the demand for petroleum. China, India, and Africa were being watched as the large population centers continued to develop.

Mr. King discussed supply. He noted that the cost to get oil out of the ground and to market, and the location of the supply were always considerations. Currently there were enough discoveries of resources to meet decades-worth of anticipated consumption. He elaborated that having the resource was not the concern so much as the cost to extract it and get it to market at a price that competed with the next best alternative. People were thinking about what the next best alternative might be such as battery technology. He noted the cost of actual development was also important. He suggested that as producers were finding ways to push down on the cost of production, it limited the ability for prices to get too high. The advancement of technologies such as horizontal drilling and fracking was pushing down on the cost of production, therefore, the opportunity for prices to rise was very limited.

Mr. King moved to slide 9: "Brent Forecasts Comparison as of 12/4/2018: Real Oil Prices and Forecasts." The slide showed a graph comparing the price forecast done in October 2019 and released to the public on December 4, 2019 - the morning of the new administration taking over. At the time of the forecasting session in October oil prices were up near \$85 per barrel. The participants of the forecasting session were optimistic. However, comparing the October forecast to the actual prices in December made it apparent that the administration needed to make an adjustment. He pointed to the dotted line which showed the price forecast session results.

Mr. King moved to slide 10: "Brent Forecasts Comparison as of 1/3/2019: Real Oil Prices and Forecasts" where the dotted line showed what was published in the Revenue Sources Book. He reported that the forecast was significantly lower to reflect the new information the state received.

Commissioner Tangeman elaborated on the reason the forecast number had been changed by the Department of Revenue (DOR). He noted the price volatility in the fourth quarter of 2018. The department decided it was important to use a more reasonable price based on the volatility that had occurred and the price correction. It was important to have a more reasonable forecast for the new administration to be able to build its budget and for the legislative budget process. Choosing the price forecast required a significant amount of work. The department went back to the spring forecast and made changes from there. The forecast lined up with prices in the \$64 per barrel range up to about \$74 per barrel over the following 10 years. He wanted to share the department's process on why the current forecast was in front of legislators and where it came from.

[1:51:11 PM](#)

Mr. King displayed slide 11: "EIA Cases from 2018 Annual Energy Outlook," which showed the Energy Information Administration's (EIA) long-term price outlook. Essentially, the chart conveyed the uncertainty of the future. The Energy Information Administration looked at the futures market and the options price for oil (futures contracts) trying to price the range of contracts to generate the high and low cases. The chart showed what

range of possible future prices in the market place people were willing to bet money on. In looking out to the following year people had purchased options at more than \$100 per barrel and other people were buying below the \$30 mark. The market did not know for certain what would happen. He suggested that the department could not build a budget based on such a large range. The department had to choose a number based on the EIA's reference case.

Mr. King elaborated that the EIA reference case represented a central tendency of expected prices. He drew attention to the dotted black line which represented DOR's forecast. The department's forecast was slightly lower than the EIA's forecast. He noted that the EIA's long-term forecast was from 2018 but was not published until January 2019. It was about a year old. There was a new EIA outlook available and the department was happy to provide it to legislators.

Mr. King indicated that the next few slides provided further details of how the market had adjusted to volatility through the previous summer and fall. Some people looked at activity and saw reasons to be bearish or bullish. The department needed to be prepared that oil prices could be much higher or lower than the department was forecasting. The department would use a number that provided at least some confidence in meeting or beating the forecast.

[1:54:22 PM](#)

Co-Chair Wilson spoke about needing to live within the state's means. She asked what would happen if the forecast was too high. She wondered where the administration would find the money needed to fund the budget at its current level.

Commissioner Tangeman answered that it was a risk that was always present. The department felt it was being conservative. The Constitutional Budget Reserve (CBR) was the shock absorber that was in place. The department would not know whether it would be short until well into the fiscal year. He was aware the governor was not interested in overdrawing the ERA. He reiterated that the CBR would be the natural shock absorber if the forecast was off.

Co-Chair Wilson suggested that the forecast was not only based on price but, also, on the number of barrels per day.

She queried about projects coming online in the next fiscal year.

Commissioner Tangeman replied that Department of Natural Resources would address the issue in greater detail later in the week. He mentioned that there were several projects that were included in the department's forecast including assessing the risk of projects the further out they were to production. There were several things assimilated into the production forecast. Although the department was optimistic about projects coming online as planned, it assigned risk based on the potential price of oil and other factors. Ultimately, the department took a conservative approach.

Co-Chair Wilson wondered how many times the price had been higher than projected in the previous 10 years.

Commissioner Tangeman replied that the department had produced graphs with the information. He offered to provide the detail.

Vice-Chair Ortiz referred to slide 12: " Market Activity Around RSB Publication" and asked how accurate the average Brent Crude forecast had been historically.

[1:58:34 PM](#)

Mr. King replied that several of the forecasters were in investment banks or trading in the oil markets. There was a tendency for people that made money buying contracts that increased in value to be overly optimistic. Whereas, with the New York Mercantile Exchange (NYMEX) in futures trading, the numbers tended to come in low. He directed attention back to slide 10 which showed analysts' forecasts that tended to be more bullish. The New York Mercantile Exchange future prices tended to reflect some sort of risk and the numbers tended to be lower. The department's forecast tried to land between the two bounds.

Vice-Chair Ortiz thought Mr. King was saying that the average Brent Forecast had historically been above reality consistently year-after-year.

Mr. King answered they tended to be high or more optimistic about the future than other people because they were in the market and made money selling related products. He thought if a person were to go back and look at the forecasts, they

tended to be higher than other people. He could not be more specific because from 2006 to 2012 oil prices were ramping up. He suggested that when the department or other forecasters were trying to make a forecast of what would happen next, the information they had was rooted in the current price environment. In an environment where prices were rising, most people forecasted low because actual prices ended up being high. The analysts in such an environment ended up being more accurate. However, in a price environment where prices were declining the opposite would be true. In looking at just the previous 10 years, the forecast might be more accurate. That might not be the case over a longer period of time.

Vice-Chair Ortiz referenced Mr. King's testimony that the department's projections on the decline of oil revenue from 2019 to 2020 reflected a drop in price to \$64 rather than a price of \$68 per barrel. He asked if he was correct.

Commissioner Tangeman answered that the forecast was \$68 for FY 19 and \$64 for FY 20.

Vice-Chair Ortiz asked, in relationship to the Brent forecast, whether the department's projection of \$64 compared to Brent's of \$70 came from the desire to be as conservative as possible.

Mr. King did not think the department was intentionally trying to be low. Rather, it was trying to take into account all of the available information. The department looked at the NYMEX curves and what EIA was doing. The Energy Information Association's forecast was also \$64. The department would not make money from selling the product. The state did not have the same motivation that analysts might.

[2:02:27 PM](#)

Vice-Chair Ortiz was not questioning the need to be conservative. He asked about the difference in annual revenue between an oil price of \$70 per barrel versus an oil price of \$64 per barrel.

Mr. King answered it would be somewhere in the \$500 million range.

Vice-Chair Ortiz asked for verification that the \$70 oil price projection was fairly accurate over the prior 10 years.

Mr. King answered that the department's goal was to provide a number the state could budget to. If the actual price ended up being in the \$70 range, it would be great. It actually happened in FY 19 where the state budgeted based on an oil price of \$64 per barrel. It appeared oil prices would end up closer to \$68 by the end of the year. As a result, part of the anticipated CBR draw would not have to be made. The higher the price of oil was pushed, the more likely the price would end up below it. It was better to beat the oil price forecast. It was not the department's intention to beat the price, rather, it's goal was to come as close as possible to the actual price with the best information possible. Based on all of the information the department had, it thought it was prudent to budget to a price of \$64 per barrel.

[2:05:13 PM](#)

Representative Josephson noted the presenters had touched briefly on production. He believed there were about four or five reasons why, even with an uptick in production, West of the Natural Petroleum Reserve-Alaska was not likely to be the lifeline the state had hoped it would be. He noted that new oil enjoyed a 10 percent reduction in value for 10 years through gross value reduction. The production areas were not on state land. Therefore, the state did not receive a royalty share. A portion of a royalty share was transferred to municipalities. He noted the expense of reaching the areas and that the carry forwards would have to be gone through to reach the profitable years. He thought there would be profitable tax years, but they would not be helpful in the short-term. The producers specified that the returns would materialize in the future. He referenced the drop in legacy field production and speculated that new production would cover the loss of legacy fields. Although new production was great for the economy and jobs, it was not a panacea for the treasury. He asked if he was accurate.

Commissioner Tangeman answered that Representative Josephson's statements were all accurate. The department presentation would look at several slides pertaining to costs. The tax system was a net system. He agreed with the

statement about the cost to develop oil. The state had experienced a good run in Prudhoe Bay. It was an elephant field that was in a good location. As the search for oil went further East and West from Prudhoe Bay it was much more expensive to develop. He mentioned two discoveries that were each estimated to produce 100 thousand barrels of oil. Things were optimistic. However, the state needed companies that knew how to develop oil and who could bring their capital to the state for development. He thought as the department stepped through the actual calculation under the state's net tax system, it would show that the fields were very expensive to invest in and develop. Until the fields are developed it was just oil in the ground. He stated the information was good news, but it was only news until oil made it into the pipeline.

Commissioner Tangeman thought the representative's assessment of the declining legacy fields was very accurate. He expounded that the department anticipated a decline of production of 5 percent total over the following 10 years. Recently, the department had seen a 6 to 7 percent decline annually. It was the natural decline of Prudhoe Bay without new oil to fill the tranche that the state was losing. He thought the state was now seeing a combination in its forecast of a decline in Prudhoe Bay and an increase new production from fields coming online holding the state even. He noted the challenge of staying even with production. He mentioned the cost of several billion per year to bring new oil online.

[2:09:43 PM](#)

Representative Josephson asked how long it had been since the Alaska North Slope (ANS) price was more closely aligned with the Brent price than with the WTI price.

Mr. King answered that the ANS oil price had always tracked Brent. He furthered that prior to 2006 when the oil in the mid-continent started to take off, distressing the price of oil, the differential inverted between WTI and Brent. Prior to 2006, WTI and Brent traded very closely. There was a \$1 to \$2 differential to account for the difference in transportation costs. Alaska North Slope oil was between them. They were currently inverted because of distress. He continued that ANS traded about equal to Brent overall. However, more often ANS was under by about \$0.50. Currently, ANS was over that amount.

Commissioner Tangeman would be having Dan Stickel to the testifier table to discuss the cost forecast. He noted that the Senate Finance Committee had asked the department to include the information in the presentation. It was a 101 overview. The state had a very complex tax structure in place. He continued that with being a net tax structure there were deductible items as well. He opined that it was important to understand how the forecast expenditures (operating, capital, and transportation expenditures) would affect the revenue stream.

2:12:16 PM

DAN STICKEL, CHIEF ECONOMIST, ECONOMIC RESEARCH GROUP, TAX DIVISION, DEPARTMENT OF REVENUE, spoke to slide 14 titled "Lease Expenditures - Overview." He relayed that lease expenditures were important for two reasons. They were an integral part of the tax calculation. The state had a net-based production tax. Lease expenditures were also an indication of company investment in the state. Investment lead to future production and economic activity. He relayed there were a few notes on the slide about how lease expenditures related to the production tax. He reported that all upstream costs and transportation costs incurred by a producer were deducted in determining the net profit or production tax value, for the tax. He continued that any losses could be carried forward into future years and applied against a future year's tax liability. One unique aspect of Alaska's production tax was that all capital costs were immediately deductible. The state did not require a company to depreciate capital costs, they could take an immediate deduction. In calculating the production tax a company would compare their net tax, which was a 35 percent net tax rate, minus allowable credits. They would compare it to a gross minimum tax of 4 percent. He continued to explain that the lease expenditures would impact their tax liability when the company was paying the net tax. In general, for the state's major operators, the cross over point was in the \$60 to \$65 per barrel range. At current levels and above most of the companies would be paying on the net tax. Therefore, changes in lease expenditures would directly impact their tax liability. He suggested that at lower prices changes in lease expenditures were still important, but they would not have an immediate and direct impact on tax liability.

Mr. Stickel advanced to slide 15 titled "Cost Forecast: North Slope Capital Lease Expenditures." He indicated that slide 15 and slide 16 showed the state's fall forecast for North Slope lease expenditures compared to the prior spring forecast. He indicated that to prepare the state's cost forecast the department had submissions provided by the operators of the producing units. They submitted a 5-year projection of their lease expenditures. The department also had discussions with the operators and looked at various public information about activity in the field. The Department of Revenue also consulted with the Department of Natural Resources (DNR) to make sure the lease expenditure forecast was in line with the production forecast that they issued.

Mr. Stickel continued to discuss Slide 15 which showed the state's capital expenditures forecast for the North Slope. He reported that in FY 18 North Slope capital expenditures were approximately \$1.7 billion. The state was expecting the amount to increase over the next several years. The state was seeing an increase in spending at the legacy fields, as the existing producers were ramping up spending slightly in response to higher prices. He highlighted FY 19 and FY 20. The other major increases in FY 20, FY 21, and FY 22 were the addition of several new fields to the revenue forecast including the Willow, Pikka, and Greater Moose's Tooth units. He reported that, beginning in FY 19, the state was looking at approximately \$1.5 billion of annual capital expenditures for the legacy fields. Everything beyond that amount was spending on new developments. In comparing the spring forecast to the fall forecast the only change was shifting out the time for new developments. He continued that in the out years in the mid '20s and beyond the department added more spending on new developments which was in line with the production forecast.

[2:16:26 PM](#)

Mr. Stickel moved to slide 16, which was a similar slide looking at the operating cost forecast. He reported that in FY 18 the North Slope operating expenditures were about \$2.6 billion. The department was expecting spending at the existing fields to be fairly flat over the forecast time horizon. The producers had done a significant amount of work to bring down costs and to make the fields work at current prices. The department felt that most efficiencies

had been realized to-date. There was a slight increase in the operating cost forecast in the out years as some of the new developments came on. He highlighted the reduction in FY 23 in the forecast compared to what the spring forecast indicated. It represented a new understanding of the anticipated cost of the new developments. The companies were working diligently to operate the new developments in a more efficient manner to keep the ongoing costs lower than they had been historically.

Mr. Stickel turned to slide 17 which looked at per barrel transportation costs for moving oil from the North Slope to market. It included the Trans-Alaska Pipeline, feeder pipelines, and marine transportation costs. He reported that for FY 18 the average transportation cost per barrel was \$9.52. The department was forecasting \$8.53 per barrel for FY 19 - about \$1 per barrel lower in FY 19 than in FY 18. The change had to do with the settlement of a methodology for calculating the Trans-Alaska Pipeline tariff between the Federal Energy Regulatory Commission, the producers, and the state. The change resulted in a lower Trans-Alaska Pipeline System (TAPS) tariff in the forecast beginning in FY 19. Beyond that time, the overall transportation costs were growing roughly with inflation.

Co-Chair Wilson asked about the forecast time periods. She asked when the spring forecast would come out.

Mr. Stickel replied that the department issued two official forecasts every year - once in the fall in December and once in March or early April. They both included a full forecast for the following 10 years of revenue and the different variables having to do with revenue. For the current year the target release was in mid-March, but the final date had not yet been determined. He elaborated that in terms of the work that went into the forecast and modeling, the major forecast was the fall forecast. The department spent the summer working on models and produced the Revenue Sources Book each year. The spring forecast was a new forecast but was largely an update in terms of how the modeling and background work went.

Co-Chair Wilson asked which amounts should be used for the budget. Mr. Stickel answered that typically the spring forecast was the revenue number that tied into the budget. Co-Chair Wilson would hope for a good one.

[2:20:50 PM](#)

Vice-Chair Ortiz pointed to slide 14 that included a lease expenditure overview. He asked what the effective tax rate was that oil companies paid. Mr. Stickel answered that the information would be forthcoming. Commissioner Tangeman added that he had signed the memorandum that morning and the response would be given to the committee soon.

Vice-Chair Ortiz asked for verification there would be a definitive tax rate provided. Commissioner Tangeman answered there was no definitive rate because producers paid different amounts but incite would be provided as to how the rate was calculated.

Vice-Chair Ortiz asked if a definitive tax range would be provided in order to assist him in responding to his constituents' queries.

Mr. Stickel answered that the department had compiled a chart which showed the effective tax rate for a legacy field based on production tax value. It was a range of prices and would help the representative to answer questions from the representative's constituents.

Representative Josephson suggested that in the oil price range of \$60 to \$80 per barrel the per barrel credit was at its most generous point of \$8. He wondered if he was correct in saying that the credit was at the most generous point on the scale. Mr. Stickel answered that the statement was fairly accurate.

Representative Josephson understood that when the industry was not making as much as it would otherwise, the purpose of the credit was to incentivize production. However, there was a question regarding fields in production and whether they would be producing otherwise. Essentially, the per barrel credit brought down the effective rate from 35 percent to some other figure. He asked if he was correct. Mr. Stickel answered in the affirmative.

Co-Chair Foster believed the memorandum would be passed out to members shortly.

[2:25:00 PM](#)

Commissioner Tangeman indicated that next section that would be discussed was the credits forecast and would begin with the outstanding tax credit liability, otherwise known as the cashable credits. He turned to slide 19: "Outstanding Tax Credits." He clarified he was speaking of tax credits not applicable to the big three legacy field producers. The credits he would be discussing were credits offered to bring new entrance to the North Slope. The debate had been about bringing more competition to Alaska to invest in oil production.

Commissioner Tangeman continued that in going back to other oil tax systems there had been several different incentives and tax credits available for folks to invest. Those incentives were brought to an end in the previous 2 years. Currently, instead of an increasing liability, the state was showing the tail end of the plan to pay off the tax credits. He reemphasized that the information was based on current statute. The department had a supplemental request to add more money to the FY 19 budget payoff. He suggested that the payment for FY 20 looked fairly accurate and was approximately \$175 million. The chart reflected the state being able to pay off its tax liability by FY 24 if it was only appropriating \$175 million for the following several years.

COLLEEN GLOVER, DIRECTOR, TAX DIVISION, DEPARTMENT OF REVENUE, introduced herself.

Representative Josephson understood that when money was flowing into the state treasury the idea was to create some parity between producers and non-producers with the cash credit program. The concern with suspending the cash tax credits was that parity was eliminated. He suggested there was some evidence that the small producers were continuing to participate notwithstanding they would not receive the benefit. He asked if the department could confirm that there were investors that wanted to come to Alaska. He also wondered if the department expected the 3 major producers to fill the void in some way and to start investing in fields they might not have otherwise invested in because of the absence of other producers. He asked the commissioner to comment.

Commissioner Tangeman answered that the producers were investing. The state was forecasting an increase in capital expenditures in fields other than in Prudhoe Bay. He

mentioned Hilcorp investing in the state. He was uncertain if the company's decision was based on cashable credits. He thought it might have been an incentive. Companies such as Repsol also invested. He did not believe a tax credit was a stand-alone incentive drawing them to the state. However, it was part of a suite that made Alaska competitive and a more interesting place to invest. He commented that Hilcorp was becoming the fourth major producer. There would likely be other producers anchored in Alaska for the long-term as other units, such as Pikka and Willow, came online. He reiterated that the cash credits were gauged more at the smaller investment companies. He agreed that when prices were higher, the state was paying the credits at a more aggressive rate. Payments were being made at a lower rate due to oil prices. He would discuss the bonding issue in the following couple of slides.

[2:30:13 PM](#)

Commissioner Tangeman advanced to slide 20, "Update on Tax Credit Bonding (HB 331)." He reported that HB 331 [Legislation passed in 2018 establishing the Alaska Tax Credit Certificate Bond Corporation] was passed in the previous year. He explained that with oil taxes being low the state was unable to pay off tax credits as aggressively as in the past. The prior administration came up with the concept of bonding for the tax credit liability to pay off the debt service over the following 8 to 10 years. The issue was currently caught up in the legal system. The state received a favorable ruling in the Superior Court but anticipated it would go to the Supreme Court. Resolution on the issue would likely be delayed for another 12 months. The previous administration was anticipating and hoping that the state would be able to bond in the summer and fall to take care of the liability. However, it did not work that way. There was about \$100 million appropriated for the FY 19 budget as a backstop amount in case the bond issue did not come to fruition. When the new administration took over, it decided to make the \$100 million payment.

Representative Sullivan-Leonard asked for an example of how the tax credits had helped smaller companies to invest in Alaska and how the state's failure to pay the credits might have presented challenges for the companies.

Commissioner Tangeman responded that the first of the issues occurred when the state was having rolling brown

outs in Anchorage due to the Cook Inlet issue. He believed it was the impetus for the tax credit program which turned out to be successful. He did not think there was a resource issue but rather an issue with gas production in the Cook Inlet. He also mentioned the challenge of getting companies to the inlet to explore for more gas to widen the reach. The tax credit program proved to be very successful in the Cook Inlet.

Commissioner Tangeman continued that when the tax credit system extended to the North Slope, the state found that not every company's balance sheet allowed for investment in Alaska to the extent needed. Alaska was a very expensive place to invest. He noted that when prices spiked in 2012 and 2013 the state discovered the need to compete - for several decades it had been the biggest play, but other options had presented themselves in the U.S. including shale plays in North Dakota. He suggested that at a certain oil price there were several options that became fiscally feasible. For instance, in North Dakota in 2001 and 2012, the shale plays were new, and fracking had been around for a while. Companies knew what the peak production had been, and it happened right away. They were not certain what the tails looked like on the individual wells. They also thought the breakeven point might be around \$60 to \$70 but were now seeing it could be around \$35 per barrel.

Commissioner Tangeman spoke to the need to be competitive. When prices had gone down there had been limited resources and the state had to decide how it was going to deploy its assets. Unfortunately, some companies had gotten caught up in the issue and probably went bankrupt while some were hanging on waiting for the tax credits. He reiterated that Alaska was very expensive and not everyone could do business in the state.

[2:36:00 PM](#)

Commissioner Tangeman reported that the bonds were currently tied up in litigation. The state received a favorable ruling in the Superior Court. The case would go to the Supreme court which would take at least 12 months to resolve. The state had set aside \$170 million in the budget for the case.

Commissioner Tangeman turned to slide 23 that included three different tables. The top table was ANS oil price for

Fall 2018 versus the Spring 2018 forecast. The only difference was in FY 19 where the state forecasted around \$64 per barrel. The middle table included UGF revenue 10-year forecast excluding the Permanent Fund transfer - the POMV transfer. He reported a slight reduction in the out years which was more in line with the state risking potential production that would be coming online. He suggested if targets were met, the negative numbers would go positive. However, the department accounted for risk in case they were delayed or did not come online as anticipated. The bottom section included UGF revenue with the POMV draw - it reflected the additional revenue that was brought to the table through the POMV. There was not an aggressive slope to the line. The number went from about \$2.9 billion in FY 20 to about \$3.3 billion in FY 28. The amounts were based on a 5.25 percent POMV draw dropping to a 5 percent draw.

Representative Josephson asked about the 5.25 percent or 5.0 percent POMV draw from the ERA which showed a sustainable number. He asked how the administration intended to fund the FY 16, FY 17, and FY 18 dividends that had not been fully funded.

Commissioner Tangeman answered the dividends would be funded from the ERA. The budget did not include the back payments of Permanent Fund Dividends. The payments would come from the ERA in the form of an additional draw. The department viewed the money as funding that would have been drawn from the ERA to fund FY 16, FY 17, and FY 18. Since the money remained in the ERA, the state experienced a 10 or 12 percent return. There was an upside to the fact that a large portion that was not paid out earned a substantial return. He specified that because it was a 3-year issue, the department recommended a 3-year solution.

Vice-Chair Ortiz spoke to the same issue of paying off back dividends to residents. He clarified that the back payments would be based on an added draw of 5.25 percent which would have some impact on the amount of revenue the state would receive from future draws. He surmised that the investment money would no longer be in the fund earning returns. He asked if estimates included the idea that the money would no longer be a part of the investment portfolio.

[2:41:11 PM](#)

Commissioner Tangeman answered in the negative. The data was based on the current laws in place. The data was based on the year-end balance for the Alaska Permanent Fund Corporation (APFC) and estimates going forward. It was not taking into account any other proposals.

Vice-Chair Ortiz asked what the impact would be on revenue from future draws if the draws occurred.

Commissioner Tangeman answered that once the bills were before the legislature there would be a robust discussion in the modeling of the impacts to the ERA. He indicated that the corporation was projecting earnings of \$4.1 billion in the coming year. The percent of market value would be about \$2.9 billion. The back pay in FY 19 was about \$600 million. He reported that the net earnings would still be about \$600 million. The department could look more closely at the impact on future revenues once the bills were before the legislature.

[2:42:34 PM](#)

Ms. Glover would be providing an update on the oil and gas production tax audits. She began on slide 25: "OGP Tax Audit Update." The department had completed the 2012 audits and was nearly completed with the 2013 audits. The department was working through much of the backlog and the complications it had with audits because of the changes in tax regimes from year-to-year. She reported there had been staff turnover and new software to contend with. The department currently had an online system, the Tax Revenue Management System (TRMS). The department had a sophisticated, proprietary software system it used for tax returns. The majority of the returns were currently electronic and provided for better data to be used. The department was looking forward to getting into the 2014 audit year to see the efficiencies.

Ms. Glover turned to slide 26: "OGP Audit Improvement Plan." The department intended to be completed with the 2013 audits by the end of the first quarter of the current year. The audit team planned to take a short break to step back in order to plan for the future. There was an audit improvement plan the department had been working on internally and had been reaching out to tax payers to develop a comprehensive plan dealing with how to be more efficient, streamlined, and communicative, and how to

incorporate more stringent audit practices. The department was looking at risk-paced audits, and issue-based audits instead of auditing 100 percent of the tax payer returns.

Ms. Glover reported that the department was also reaching out to other industry associations for feedback in benchmark audit practices. The department was planning to have defined audit plans going into 2014 using a more traditional audit format that would include an opening meeting with the tax payer, a defined scope of an audit, protocols in hand, and agreements regarding data sharing. She explained that sometimes the department did not get the data it needed in a timely manner, but sometimes that was due to the department making a last-minute request. The department wanted to be more collaborative with tax payers. She also mentioned streamlining the TRMS. Once the department got through the 2014 audit cycle, it would have a much better idea of how it would work using the information in the system and using standardized templates. The department was committed to being in a 3-year cycle by 2022.

Vice-Chair Johnston surmised all of the things Ms. Glover reported were dependent on whether the legislature kept the tax regime consistent. Ms. Glover replied that through 2018 audits, the tax structure was the same. Vice-Chair Johnston commented that in order to maintain a 3-year cycle, the state would need to maintain a consistent tax regime. She asked if she was correct. Ms. Glover replied in the affirmative.

Commissioner Tangeman turned to the last slide of the presentation, slide 27: UGF Relative to Price per Barrel (without POMV), FY 2020." He indicated the slide showed the price sensitivity of ANS and what revenue could be expected without the POMV. He noted that the Legislative Finance Division also had a price sensitivity chart that was informative.

Co-Chair Foster noted that the committee had received a letter [letter from Commissioner Tangeman to the committee to provide responses to committee questions on indirect expenditure report presentation on February 8, 2019, dated February 25, 2019, (copy on file)].

[2:47:25 PM](#)

Representative Sullivan-Leonard asked for the final quarter balance for the ERA. She thought it was about \$19 billion.

Commissioner Tangeman did not know the exact amount. He was aware of the balance on December 31, 2018 which was \$16.6 billion. Recently the number was in the mid \$17 billion range. He commented that it reflected the market changes. He reported that the total Permanent Fund balance dropped to \$0.4 billion. However, the balance of the ERA had not changed significantly. Presently the total Permanent Fund balance was over \$65 billion.

Representative Sullivan-Leonard requested to hear from Mr. King on the numbers.

Mr. King replied that on the APFC website, the ERA balance would be about \$13.5 billion. He suggested that the amount was slightly misleading because the Permanent Fund was booked as a liability (the \$2.9 billion draw that was coming as the POMV during FY 20). In looking at the numbers he advised caution in the interpretation. He explained that the \$13.5 billion was the amount of money available in the fund in addition to the money that was already obligated to the budgets for FY 19 and FY 20 which included the dividend payments and the general fund uses.

Representative Sullivan-Leonard asked Mr. King for the totals. Mr. King responded that in looking at the cash balance of the account presently, it would be about \$19.5 billion. However, it included all of the money that was obligated to be transferred to the principle account or to the general fund. The available balance was about \$13.5 billion.

Vice-Chair Ortiz asked about the potential effects of making the Permanent Fund Dividend (PFD) back payments. He suggested it would have an impact on the earnings potential of the fund and for the POMV draw. He wanted Mr. King to comment on any other potential impacts.

Mr. King replied that the more assets the state had under management, the more earnings it would generate. If the money that was not paid out in PFDs over the previous 3 years that remained in the fund, the fund would generate a larger amount of revenue.

Vice-Chair Ortiz asked how much more revenue would be generated if the draws were not made.

Mr. King answered that 6.5 percent of \$2 billion would be approximately \$130 million per year in additional earnings. The question was whether the earnings belonged to the state or the people. The governor was trying to address the question.

Representative LeBon appreciated the department's conservative approach to projections. He asked about the industry standards on a POMV, endowment, or a permanent fund draw rate.

Mr. King answered that looking at an endowment fund such as a university, the typical draw rate was somewhere around 4 percent to 5 percent. One of the reasons for the percentage rate was because if the funds deteriorated, there was not really an opportunity to make up the funds. The Permanent Fund had a protection mechanism in the principle account. By putting the account in a protected account and only drawing on the earnings, it was an alternative way of managing an endowment fund. The protection existed regardless of whether a POMV was used. The state was in an odd situation currently where the state was using a POMV to restrict the draws on the earnings that were kept in the holding account rather than a POMV on the total fund as a mechanism for maintaining the principle protection. It was slightly different from a typical endowment fund. It was the case that the 5 percent POMV currently in place was intended to protect the fund. Given the projection of returns the corporation was currently using, it was the upper limit of what the projection would allow. If the state tried to draw more than 5 percent, it would put more stress on the fund and require a higher return to maintain the fund balance.

[2:53:40 PM](#)

Representative LeBon commented that paying out money for past dividends in future years was not a wise choice if looking at the fund long-term. He wondered if a wiser choice would be to roll those dollars into the principle balance. He asked if the administration had considered his suggestion.

Commissioner Tangeman answered it was a policy decision. The governor strongly felt the citizens of the state were entitled to the funds in FY 16, FY 17, and FY 18. His goal was to make the issue right. Since the funds would be drawn out over the course of 3 years, it would not be doing any significant damage.

Mr. King added that there was a difference between trying to grow and protect the fund versus the intended use of the fund. If the intent of the fund was to do what the statute required, which was to pay out dividends, then it was not really a question of the most prudent fiscal choice. Rather, it was about whether it was the morally right thing to do. It was not a question of maximizing the fund's value, but about following the current statutes. If the goal was to maximize the fund's growth, it would be financially prudent to cut the budget further to avoid taking any of the POMV. If the goal was to grow the fund as large as possible, then the aim should be no draws from the ERA. It was a balance between the current generation following the current law and how much to grow the account for future generations and how much the current generation should sacrifice in order to protect future generations.

Representative LeBon surmised it would be a compromised position to focus on the formula as outlined in SB 26 and not to treat the pay back dollar amounts as a payout to the following 3 years if taking the most conservative approach to a POMV on an endowment.

Mr. King answered that if a person perceived the \$2.4 billion sitting in the fund as state money, it should be protected. If the money was viewed as the public's money sitting in a state account, it should be dispersed.

Vice-Chair Johnston stated that inflation proofing was also in statute. She asked if the department had done modeling in terms of the ERA and the stress factor of inflation-proofing the principle and the highs and lows of the availability of funds and the POMV draw.

Mr. King replied that the inflation proofing formula required the principle balance to be protected from being eroded by inflation. He reminded members that it was not the entire account that was inflation protected, it was the principle account. He conveyed that when looking at the 6.55 percent projection on the total accounting return that

the fund was projecting - the \$4.1 billion the commissioner had discussed - the \$2.9 billion draw plus inflation proofing ate up the earnings. There were not enough additional earnings to inflation proof the current balance of the ERA. He indicated that because of the way the current formula worked, the total projection that the Permanent Fund was using was not sufficient to meet all of the statutory requirements. As a result, a little bit of the money would be swept over to the principle account as long as the inflation proofing statute was being used. In following all of the current laws including the statutory PFD, inflation proofing, and the draw, the ERA would be maxed out in terms of what it could do.

[2:59:05 PM](#)

Co-Chair Wilson returned to slide 23. She did not recall significant discussion occurring when SB 26 passed regarding following the statutory formula of the dividend. She thought it was the responsibility of the legislature to follow both statutes. However, it was important to consider the negative effects on the numbers listed on the slide. She suggested that a 5.25 percent draw with the current amount in the ERA would be very different than if the legislature used \$1 billion or \$2 billion out of the ERA in the following 2 years.

Commissioner Tangeman agreed that the debate on SB 26 was not about how the amount would be split. The focus was on the amount that could be withdrawn. The statute on the calculation of the dividend was not changed and was the law Governor Dunleavy thought should be followed. He believed it also lent for the discussion the governor was focusing on: revenues matching expenditures. Regardless of the amount drawn from the ERA for the POMV and how it would be split, the governor felt strongly in following the law for the dividend calculation and controlling state spending. A full dividend payout would equate to \$1.9 billion leaving \$1 billion for government. The governor had turned the discussion around by starting with revenues and building a budget up to those revenues. He thought the discussion shined the light on the fact the state currently had limited revenue streams. The governor's focus was to balance the budget with a full dividend in place.

Co-Chair Wilson agreed that the state should have been balancing its budget a long time ago. She emphasized that

the more the legislature touched the ERA, whether through back pay or not balancing the budget, the more it would impact government services and the dividend in the future. She wanted to better understand the impacts.

Commissioner Tangeman asked if she was asking about the impacts of doing the back payments in conjunction with the POMV draws.

Co-Chair Wilson suggested that there were two issues she was trying to better understand. She referred back to slide 23 which showed how much funding the state would have in the following few years using a 5.25 percent draw for another year then dropping to 5.0 percent. The legislature did not have a discussion about how SB 26 worked with a full dividend because it was cut. She believed the dividend was about having it for future years, not just the next few years. She was trying to better understand the impacts of the numbers on the slide with additional draws.

Co-Chair Wilson reiterated comments by Mr. King about a necessary 6.5 percent return on investment. She noted the stock market was not doing well at present. She asked if there was a way to see what the ERA would look like in the next year if more money was taken out of the ERA in the current year. She wanted everyone to understand how all of the figures on slide 23 worked based on decisions that still needed to be made.

Mr. King commented that because of the way the POMV formula worked on a 5 year averaging basis, the full ramifications of the draw were not felt in the first year. They were spread out over time. He indicated that, with the 3-year draw to pay back the prior year dividends, it was spread out even further. The hit the state would be taking would likely not be felt until 2028. The difference was about \$100 million per year. He would show the graphs. He asked if the chairman wanted to see them as part of the PFD pay back bill or something separate.

[3:04:52 PM](#)

Co-Chair Wilson wanted to see it now. She asked listeners not to send her letters on the back pay bill yet, as she had not made her mind up. She thought it was important to take into consideration the time the state was in. She liked Mr. King's comment about a draw maybe not impacting

the state in the coming year but would ultimately impact the state in future years. The information would be useful in considering several bills.

Co-Chair Foster was fine with having the current conversation. However, he noted that the department would be presenting on a bill and supplying the numbers being requested.

Vice-Chair Ortiz asked if the chair intended to have the department address the memorandum. Co-Chair Foster wanted to finish questions on the presentation first.

Representative Josephson mentioned the administration's allegiance to the PFD formula. He asked about the reduction to the school grants and whether there was a piece of legislation changing the school foundation formula or simply moving the figure from about \$5000 to \$4000 per student as an average. Commissioner Tangeman thought the Office of Management and Budget should answer Representative Josephson's question. Representative Josephson was curious how the administration reconciled its fidelity to one formula and whether it would be equally loyal to the other formula.

Vice-Chair Johnston asked if the department could include how inflation proofing would be affected in its modeling.

[3:07:57 PM](#)

Mr. King remarked on the memorandum and the shape of the curve. He thought it was important to remember that in Alaska's oil tax system it actually had two oil systems - effectively a 4 percent gross tax and effectively a 35 percent net tax that had some credits that brought the rate down. The graphic showed that at prices below about \$65 per barrel, only the gross tax was in effect accounting for the shape of the curve. It was as though the actual effective gross tax rate was 4 percent until the net tax system kicked in.

Commissioner Tangeman offered to read the memorandum to the committee. Since the committee had time to review it, he thought members might have some specific questions.

Vice-Chair Ortiz referenced a graph at the bottom of page 1 of the memorandum related to the effective production tax

rate. He suggested that, based on the current oil price and the prices in the forecast, the effective tax rate would be 8 percent to 9 percent. He asked if he was correct. Mr. Stickel replied in the affirmative. It represented in aggregate for legacy fields - the production tax only component of the share of production tax value. He continued that at the FY 20 price of \$64 per barrel the effective tax rate would be 8 percent.

Vice-Chair Ortiz clarified that Mr. Stickel had stated 8 percent. Mr. Stickel replied in the affirmative.

Vice-Chair Ortiz asked how competitive the rate was compared to other tax regimes worldwide. Mr. Stickel was not prepared to address the question at present.

Mr. King answered that Alaska's tax system was based on the federal requirements through federal law and the mining act. He suggested that because of the way Alaska owned its natural resources and leased its mineral interests, it applied a tax. Other states did not own the mineral leases, they only applied a tax. Alaska was more like a Central American country than Texas or North Dakota. He explained that the norm in the world was to have a production sharing agreement in place. It would assign risk to the governing interest. Certain countries had higher effective tax rates because it compensated them for taking additional risks. Whereas, Texas and North Dakota had a lower tax rate but did not account for the fact that companies were paying other tax rates. He advised that when looking at the 8 percent or 9 percent tax rate in the current price environment it was important to remember there were other ways the state was generating revenue. He explained that SB 21 [Legislation passed in 2013 regarding oil and gas production tax] was designed so that the 12.5 percent or 16.67 percent royalty rate in combination with the net rate was relatively stable at about 60 percent to 65 percent of total take. In total, the state took more than most other regimes especially relative to the risks taken by the state.

[3:12:49 PM](#)

Representative Knopp believed it was important to note the graph included production tax rates. He clarified that Mr. King had stated that when the taxes were combined Alaska was on par with other states.

Mr. King answered that he was hesitant to say that Alaska was on par with other states due to the difference in the regimes. If the question was whether Alaska was getting its fair share and looking at the numbers, most people would say it looked relatively fair. It was not the case that companies were running away with the bank. If the state were to increase the tax rate, it would put additional stress on the economics to continue to produce.

Representative Josephson clarified that Mr. King used the number of 65 percent as the total state take but thought he meant between the federal and state governments. Mr. King confirmed Representative Josephson was correct. He meant the total amount of the producer's share.

Representative Josephson asked for additional clarification about the number. Mr. King answered that the sliding scale barrel credit was intended to create some level of progressivity that offset the regressive nature of the royalty. He suggested that when there was a 12.5 percent gross, it was a higher share of the net when oil prices were low. The intent of SB 21 was to create an almost level total non-producer share across all price ranges. In the current price environment, there was a similar share presently - as if the prices were \$90 to \$100 per barrel. He continued that the pie would get bigger but would be distributed consistently.

Representative Josephson agreed that when prices fell in 2014 there had been discussion about the total take for the state including its royalty share. It reflected something the state owned, but it still needed help getting to the resource. He thought it remained a reflection of the state's entitlement by virtue of statehood. He suggested tax was a different policy altogether. He asked Mr. King if he agreed.

Mr. King thought it was important to remember that the oil owned by the state was leased to producers through DNR. The royalty that was kept for the state was to compensate the state for its ownership share. The taxes and the other ways the state collected revenue from the companies were not to compensate the state for its ownership share. The tax system was not intended to capture value from the state's ownership share. It was the contract the state entered into when it leased out its resources.

Co-Chair Foster thanked the presenters. He reviewed the schedule for the following day.

Co-Chair Wilson noted that they had asked OMB for the matrix that it used to create the budget. She wanted to see the information prior to the Thursday meeting. Co-Chair Foster agreed.

#

ADJOURNMENT

3:18:10 PM

The meeting was adjourned at 3:18 p.m.