

SENATE FINANCE COMMITTEE
January 16, 2019
9:05 a.m.

9:05:54 AM

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:05 a.m.

MEMBERS PRESENT

Senator Natasha von Imhof, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Click Bishop
Senator Lyman Hoffman
Senator Peter Micciche
Senator Donny Olson
Senator Mike Shower
Senator Bill Wielechowski
Senator David Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Senator Cathy Giessel; Senator Mia Costello; Senator Chris Birch; Senator Shelley Hughes; David Teal, Legislative Finance Director; Senator Lora Reinbold; Representative Ben Carpenter; 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; Doniece Gott, Committee Assistant to the Senate Finance Committee, Legislative Finance Division.

SUMMARY

PRESENTATION: COMMITTEE ORGANIZATION/INTRODUCTION OF MEMBERS and STAFF

PRESENTATION: DEPARTMENT OF REVENUE, REVENUE FORECAST

^PRESENTATION: COMMITTEE ORGANIZATION/INTRODUCTION OF MEMBERS and STAFF

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Co-Chair Stedman noted that the committee table had been extended to accommodate the larger size of the committee. He reminded members and those in the gallery to silence cell phones. He introduced the committee members.

Co-Chair Stedman explained that the committee had been increased [from seven to nine members] due to the complexity of budget issues facing the state. He commented on the geographic diversity of the committee members. He relayed that subcommittee work would be assigned to members over the following several days. He acknowledged Senate President Cathy Giessel, Senator Mia Costello, Senator Chris Birch, and Senator Shelley Hughes in the audience.

[9:08:40 AM](#)

Co-Chair Stedman introduced his staff.

Co-Chair von Imhof introduced her staff.

Senator Bishop introduced his staff.

Senator Wilson introduced his staff.

Senator Olson introduced his staff.

Senator Micciche introduced his staff.

Senator Hoffman introduced himself and his staff.

Senator Shower introduced his staff.

Senator Wielechowski introduced his staff.

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Co-Chair Stedman discussed the function of the committee and the hiring of staff. He reported that finance information would be available to all members and their staff regardless of party affiliation. He introduced the committee support staff.

DONIECE GOTT, COMMITTEE ASSISTANT TO THE SENATE FINANCE COMMITTEE, LEGISLATIVE FINANCE DIVISION, introduced herself and staff.

Co-Chair Stedman discussed committee decorum and reminded the committee that the passing of notes to members must be done through the committee page.

9:16:10 AM

Co-Chair Stedman discussed the role of the Legislative Finance Division (LFD).

DAVID TEAL, LEGISLATIVE FINANCE DIRECTOR, introduced himself and discussed the role of LFD. He reminded the committee that the division was nonpartisan. The LFD analysts in the room introduced themselves.

9:18:33 AM

Co-Chair Stedman continued to discuss committee decorum. He informed the committee that he would be sending a letter to members to relay information about committee functions. He would endeavor to give time to each member with a question during meetings, while conserving the time of the committee. He strove to keep topics moving without lengthy debate that did not work towards resolution. He did not support delay tactics or political maneuvering. He wanted to ensure that all members had the same information and received answers to questions. He used the example of information distributed by LFD.

Co-Chair Stedman highlighted that each member had a live microphone and asked that everyone speak clearly. He asked that members not eat at the committee table. He suggested it was possible to pass a note to the chairman if a member needed to leave the room for any length of time.

9:22:17 AM

Co-Chair Stedman continued to discuss committee decorum and asked that members refrain from reading newspapers or magazines at the table. He asked that members be respectful of public testimony. He requested that members leave cell phones in their offices.

Co-Chair Stedman reported that the Department of Natural Resources presentation had been rescheduled for the following day due to weather delays.

^PRESENTATION: DEPARTMENT OF REVENUE, REVENUE FORECAST

9:24:47 AM

BRUCE TANGEMAN, COMMISSIONER, DEPARTMENT OF REVENUE, discussed the presentation "Fall 2018 Revenue Forecast" (copy on file). He thought it was appropriate that the first committee discussion of the year was pertaining to revenue. He remarked Governor Michael Dunleavy was pursuing a different approach to the budget that would match expenditures to revenues.

Commissioner Tangeman referenced the Revenue Sources Book, a non-partisan document that showed the state's revenue streams. He noted that oil revenue was one of the largest drivers, several other revenue sources were detailed in the book. He highlighted that Chapter 3 of the book was informational and included a different focus each year; the chapter in the current publication included a timeline showing 60 years of revenue from 1959 to 2018. Other chapters included petroleum revenue, non-petroleum revenue, federal revenue, investment revenue, credits, state endowment funds, and public entities. He added that the book was available online.

Co-Chair Stedman asked that the presenter avoid using acronyms so those listening from home could understand what was being discussed.

Commissioner Tangeman continued discussing the Revenue Sources Book. He reported that the book had been produced for many years. He noted that he had knowledgeable staff with him that could expand on committee questions.

9:28:16 AM

Commissioner Tangeman began with a revenue forecast table on slide 3, "REVENUE FORECAST: 2018 to 2020 Totals." He drew attention to unrestricted general fund (UGF) listed at the top of the table. He noted that historically [in FY 18] oil revenue had been \$1.9 billion; the forecast was \$2.2 billion for FY 19 and \$1.7 billion for FY 20. He noted that the oil price was the primary driver. He spoke to the

fluctuations in oil price over the years and recent months. The year to date price was currently over \$70 per barrel, but the department was officially forecasting a FY 19 year end price of slightly over \$67 per barrel. The FY 20 forecast was \$64 per barrel. He noted the previous administration had originally anticipated oil prices of \$75 per barrel, but due to large fluctuations in price in October through December [2018], the new administration believed it was more appropriate to reduce the forecast, especially through November.

Commissioner Tangeman pointed to investment earnings under the UGF category, which had not been shown in the past. With the passage of SB 26 [Permanent Fund legislation passed in 2018] including the percent of market value (POMV) draw from the Permanent Fund Earnings Reserve Account (ERA), the department was now showing the calculated amount of investment earnings for FY 19 and FY 20. The calculation was currently 5.25 percent based on the ending balance of the last five years. Investment earnings was forecast at approximately \$2.7 billion for FY 19 and \$3 billion for FY 20. The slide also showed designated general funds (DGF) including non-oil revenue and investment earnings, which he noted were fairly stable.

Commissioner Tangeman stated that other than unrestricted oil revenue, which consisted of production tax, property tax, corporate income tax, the department also showed excise taxes (such as tobacco, marijuana, and motor fuel taxes), royalties, and federal revenues (which were fairly consistent with DOR forecasts for FY 19 and FY 20).

[9:31:56 AM](#)

Commissioner Tangeman moved to a table on slide 4 titled "Unrestricted Petroleum Revenue Forecast: 2018 to 2020." He highlighted petroleum property tax, petroleum corporate income tax, and petroleum production tax. The variation in petroleum corporate income tax in FY 18 through FY 20 was a result of very low oil prices from several years back, which drove taxpayers into net operating loss positions. The tax revenue had stabilized with oil prices of \$67 per barrel [in FY 19] and [the projected FY 20 price of] \$64 per barrel, which would increase corporate income tax revenue.

Commissioner Tangeman continued to discuss slide 4, and pointed out the reduction in production tax, primarily due to oil price. He noted that [Department of Natural Resources] Commissioner Corri Feige would be walking through the production forecast as well. He noted excitement over numerous oil plays (e.g. Pikka and Willow) under discussion. He explained that the point of the production forecast was to risk forecasts into the future - DOR was hopeful but did not want to depend on the fields starting on a certain date with a certain production and price. The further out the plays were, the more risk the state applied in its forecast. He noted that Commissioner Feige could provide further detail. The royalties section of the table included mineral bonuses and rents, which were fairly stable; oil and gas royalties (12.5 or 16.5 percent received by the state); and interest.

[9:34:14 AM](#)

ED KING, CHIEF ECONOMIST, OFFICE OF MANAGEMENT AND BUDGET, reviewed a graph pertaining to oil market movement in relation to DOR price forecasting for FY 18 (slide 6). He explained that the slide showed a story of what had occurred over the last twelve months. In January 2018, prices had been fairly stable around \$65 to \$70 per barrel. He noted that the blue line represented Brent crude prices and the white line represented West Texas Intermediate (WTI) prices. The graph showed the differential between the two market prices. He detailed that the differential had been fairly stable over the past year, but there had been substantial volatility.

Mr. King referenced a decision made by President Trump in May 2018 to exit the Iran nuclear deal and to impose sanctions on Iran. He expounded that at the time the markets had been trying to figure out how supplies taken off the market would be introduced into the market to satisfy global demand. Consequently, Saudi Arabia and Oil Producing and Exporting Countries (OPEC) had decided to increase production; however, before production was increased the market started to react to the 1 million to 1.5 million barrels that would come off the market, which had resulted in an increase in price. He expounded that in late summer/early fall [of 2018] oil prices had exceeded \$80 per barrel, which coincided with the time DOR had collected data for its forecast projection. He noted that between January and October, the average price of oil was

in excess of \$70 to \$75 per barrel, while the price was over \$80 per barrel when the forecast had been compiled. Immediately after the forecast had been compiled, the waivers on the Iran sanctions had flooded the market with production the market had anticipated coming off, which had resulted a slide in the oil price. Oil prices had dropped from \$85 per barrel in early October to \$50 in the beginning of January [2019]. He believed that with the recent events there may have been an idea that the \$64 price looking forward to FY 20 was optimistic. He reported that oil prices were currently about \$60.50 per barrel. He noted the general idea was that oil prices should be around that price, which put into context the price forecast into FY 20.

[9:37:57 AM](#)

Mr. King moved to slide 7 titled "PRICE FORECAST: Impact of Spare Capacity: Short Term." The slide showed a chart titled "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 detailed that when supply was above demand, prices fell, and when demand was above supply, prices rise. The chart showed that in the past month supply had been in excess of demand, which had put downward pressure on prices. The expectation [of the EIA] was it would take about six to nine months for the supply glut to clear and that prices would be suppressed during that time. Almost immediately after the information in the chart was released, OPEC decided to cut back on fair production; therefore, the blue line [representing world production] shifted down. The shift had resulted in a near balance between supply and demand, indicating that prices should be relatively stable.

Mr. King continued that the current \$60 to \$61 price felt like what prices should be. He added that there were risks, especially in the next couple of months with refineries turning over to summer production. The change would result in some inventory builds that may put downward pressure on price. Additionally, there was concern about the accuracy of the demand price; therefore, people were watching closely watching earnings reports as they were coming out in the current week. He communicated that expectations had been met thus far and the risk had not yet come to fruition. He believed there should be stability over the

next three to six months and moving forward prices should be in the \$65 range.

[9:39:48 AM](#)

Co-Chair von Imhof pointed to slide 7 and remarked that the green bars showed the magnitude of the difference in supply and demand. She remarked on political pressures that impacted oil price via supply and demand. She noted the slide 8 showed the vast difference in opinions from the world's best analysts. She commended Mr. King for arriving at the \$64 per barrel oil price, which she thought sounded reasonable. She wondered about the department's sources for global supply - she thought it would be the most accurate.

Mr. King pointed out that the graph on slide 7 was updated every month by the EIA and the current information had been released the previous day. He detailed that the market's projection had changed drastically in the past month in response to OPEC coming back on production. He asserted that it was an impossible task to predict the future. He explained that everything occurring in the marketplace was unpredictable. The best that could be done was to understand the nature and range of things that were predictable and things that were not.

Co-Chair Stedman remarked that the legislature expected commissioners to try to do the impossible task.

[9:42:19 AM](#)

Mr. King turned to slide 8, "PRICE FORECAST: Differences in Analyst Forecasts," demonstrating what analysts looked at when considering what oil prices may do in the future. He asserted that many of the demand factors, whether a person had a bullish or bearish opinion, hinged on what they believed would happen in Asia. He explained that an increase in personal wealth in Asia, bringing the ability to travel and own a car, increased the demand for oil products. He elaborated that anyone who believed oil prices would be high also believed there would be sustained and significant growth in Asia. Whereas, individuals who were more bearish about oil prices tended to believe sustained growth projections in Asia were over optimistic.

Mr. King discussed supply on slide 8. The big factors were what was taking place with U.S. midcontinent shale

producers and what the marginal costs of bringing oil into production were. He elaborated that other factors impacting supply were typically geopolitical. The Canadian aspect on the chart related to heavy oil that was typically mined and turned into oil through a heating process (the process was expensive and required a high oil price). Another factor were the needs requirements for Russia, Brazil, Venezuela, Iran, Iraq, and other Middle Eastern countries with access to supply, to meet their own budgets and optimize their resources. Everyone looking at supply considered the cost of supply, how and when supply would be brought online, and what geopolitical factors could disrupt bringing the supply online. Overall, supply and demand depended on how much Asia would grow and how much it would cost to bring production online. There were currently many more known supplies in the world than there was need to bring them online. It was not a question of whether new prospects would be discovered to bring online, but a question of the cost it took to bring production to development.

[9:44:50 AM](#)

Mr. King moved to slide 9 titled "Brent Forecasts Comparison as of 12/4/2018." The slide showed a line graph entitled "Real Oil Prices and Forecasts," depicting how financial analysts trading in oil markets and the New York Mercantile Exchange (NYMEX) were pricing options to purchase oil at a later date. The red line showed the NYMEX price (the price traders were trading at) and the blue line showed what analysts were projecting the future to look like. He elaborated that the green line showed the EIA projection for oil prices and the black dotted line showed the outcome of the DOR preliminary forecast from October [2018]. He noted that NYMEX and analysts had used the DOR's October projection in the Revenue Sources Book as a reference in December. He reported that when the new administration had come into office, the first thing it looked at was whether the projected price made sense in light of new information garnered since October.

Mr. King explained that the new administration had decided to discard the October price forecast session and revert back to the [2018] spring forecast with an update of FY 19 actuals that were available.

Commissioner Tangeman added it had been very important for DOR to go back to the most recent analysis to arrive at an

oil price to consider. He thought it was important to consider that the numbers had been contemplated and stress-tested. He thought that the most reasonable option was to use the spring price forecast due to the volatility between September and December [2018]. He remarked that the forecast happened to be in the \$64 range and showed all of the volatility seen over several months. He clarified that the department was not faulting the work done [in October 2018], but wanted to use a more stable environment. The department believed the spring forecast numbers were the most appropriate to use for the current and future fiscal years.

[9:47:34 AM](#)

Senator Micciche asked whether the latent or reserve oil supply was more significant than ever in terms of future oil prices. He referenced earlier discussion about stability and asked for verification that a significant amount of production could be brought online more easily than in the past.

Mr. King agreed with Senator Micciche's assessment. He expounded that wells associated with shale production in Texas and North Dakota could be drilled and fracked in a matter of weeks and could bring vast production online quickly. He elaborated that when disruption occurred in the market that started forcing prices up due to an imbalance, those producers had access to capital and were able to crank out production quickly. He explained it put a ceiling on how high prices could rise. He detailed that prices may exceed \$80 to \$100 per barrel for a week or possibly a few months, but if there was capital ready to be deployed there were resources ready to be produced, which would put pressure back down.

Mr. King believed the idea there could be sustained oil prices in the \$100 range was unrealistic. He acknowledged that things could change rapidly, but it was not the case based on present information. He continued that when prices had been depressed, many fracking operations had run out of capital due to bankruptcies, which had enabled prices to increase before new investors came in and reconsolidation occurred. He detailed that consolidation had taken place and the access to capital was available; therefore, the ability to see high oil prices was relatively low.

[9:49:51 AM](#)

Commissioner Tangeman added that back in 2011/2012 when North Dakota shale plays had been coming online, they had not understood what the tails on the wells looked like. He detailed that operators had believed the breakeven point would be \$70 per barrel; however, presently the breakeven point was in the \$30 range. He relayed that the state had learned a significant amount about what competition looked like around the world and in the Lower 48 where they could react quickly to oil prices. He explained it was something the North Slope did not have the ability to do.

Mr. King pointed out that the constraints/collars on the impact of shale production worked in the other direction as well. He elaborated that the specific wells declined so quickly that they required continual investment; if the oil price fell too far the investments dried up, which allowed the price to rise again. Theoretically, there was a much narrower band where prices should be more stable between the \$50 and \$70 range, and if the price went too high or low, the market would react relatively quickly.

[9:51:08 AM](#)

Co-Chair Stedman referenced slide 11 and asked the presenters to discuss why Alaska was insulated from specific West Coast basins and why it followed Brent closer than WTI.

Mr. King asked to briefly speak to slide 10 titled "Brent Forecasts Comparison as of 1/3/2019." The slide included a chart titled "Real Oil Prices and Forecasts," which used the fall [2018] forecast. He detailed that the black dotted line represented the DOR forecast showing the \$64 rising with inflation that had been published. The blue line represented the analyst forecast as of the preceding week and the red line showed the NYMEX trading price the preceding week as well. Since then, prices had already started ticking up. He concluded that the published price seemed to be a reasonable estimation of what would happen, based current information.

Mr. King displayed slide 11, "EIA Cases from 2018 Annual Energy Outlook," which showed a chart entitled "Real Oil Prices and Forecasts." He noted the information was slightly outdated as it was published earlier in 2018. The

orange dotted line represented the EIA reference case for the long-term forecast; the red dotted line was EIA's extreme high; and the yellow line was EIA's extreme low. He explained that EIA analyzed where the options market was trading and looked at what the strike price was on prices that were on the high and low ends of the spectrum to build a confidence range. The data was informed by what the market participants suggest the range of possible outcomes looking forward would look like. He remarked that the chart showed that the market really did not know - prices could be \$30 per barrel or \$100 per barrel. He reported it was necessary to pick a number somewhere in the middle, which was more likely to be the case.

Mr. King continued to discuss slide 11, noting that even one year in the future could show a great deal of volatility - there were numerous geopolitical factors and other factors that played in (e.g. natural disasters, terrorist attacks, and other) that could happen in a hurry. The price that was most reflective of ANS was the Brent price because Alaska Brent oil was shipped through a pipeline to Valdez and shipped primarily to Anacortes, Washington or Los Angeles, California. He continued that because there were no pipelines that crossed the Rocky Mountains, the only other place those refineries were getting oil from were other waterborne sources (e.g. oil tankers from Saudi Arabia, Russia, South America).

Mr. King explained that ANS traded at parity or slightly below other waterborne crude oils, which was what the Brent marker represented. The WTI marker represented what was taking place in the rest of the U.S. - it was the Texas-based crude marker where Texas, North Dakota, and Gulf of Mexico oil was traded. He furthered that because there was so little infrastructure that could move oil around midcontinent (the shale revolution about 10 years back brought Texas and North Dakota production much higher than infrastructure could support), the price had been suppressed for the past decade. He elaborated that WTI had been selling at a discount to Brent over the past 12 or so years. Once the infrastructure got worked out, which would take numerous years, the oil was expected to find its way to refineries in need of oil or onto tankers in the Gulf of Mexico if the U.S. was in an export situation. He would expect the WTI and Brent differential would close and possibly revert back to where it had been before 2006/2007 where WTI had sold at a premium to Brent. Regardless of

what was taking place in the WTI markets, Alaska cared about what was taking place on the West Coast (i.e. Brent). The state did not expect midcontinental infrastructure taking place to impact prices in Alaska as much as it would impact prices in Texas.

[9:56:27 AM](#)

Mr. King discussed slide 12, "Market Activity Around RSB Publication." He noted that the slide illustrated how quickly the markets had changed in the current calendar year. He elaborated that the stock market and commodities market took a beating between October and January and market sentiment had followed what had been occurring in the marketplace. He continued that as recently as 1.5 weeks earlier the market sentiment was depressed, which called into question how high oil prices would be able to go and what should be expected. He countered the sentiment that the current forecast may be too high and asserted the forecast was just about right based on current information.

[9:57:34 AM](#)

Commissioner Tangeman addressed the fall 2018 cost forecast beginning with an overview on slide 14. He noted that Co-Chair Stedman had requested a brief overview. The state had a net tax system where operating and capital costs were deductible. He asked a colleague to provide detail beginning on slide 14.

DAN STICKEL, CHIEF ECONOMIST, ECONOMIC RESEARCH GROUP, TAX DIVISION, DEPARTMENT OF REVENUE, showed slide 14, "Lease Expenditures - Overview." He explained that lease expenditures were important for two reasons: 1) they provided an important indicator of company activity and the investment into future oil and gas production expected to take place; and 2) they were an integral part of the production tax revenue calculation. The slide addressed some of the nuances of the production tax calculation and how lease expenditures were involved.

Mr. Stickel reported that capital and operating expenditures were all allowed to be immediately deducted in the production tax calculation (a net profit tax). He explained there was no depreciation of the capital or operating expenditures like there was for certain other tax types. In the case of a net operating loss, a company was

allowed to carry forward any expenditures not deducted immediately on its tax calculation. The production tax also had a minimum tax (4 percent of gross value). He detailed that at oil prices between \$40 and \$60, companies would pay at the gross minimum tax and would not receive a benefit for lease expenditures.

10:00:16 AM

Mr. Stickel turned to slide 15, "COST FORECAST: North Slope Capital Lease Expenditures," which showed a line graph. He noted that in preparing the cost forecast, operators provided DOR with a tax return with a five-year projection of capital and operating costs for each of their fields. The department also met with operators in the fall and held production forecast meetings. Additionally, the department reviewed expenditures reported on tax returns and public information. There was substantial information, documentation, and analysis that went into preparing the cost forecasts. He relayed that slide 15 and slide 16 focused on the North Slope lease expenditures, which was the primary driver of state revenues.

Mr. Stickel considered FY 18 North Slope capital expenditures of approximately \$1.7 billion, which were expected to increase over the next several years. Companies had communicated to DOR their anticipation of spending a bit more on capital expenditures pertaining to legacy fields, primarily in response to some of the new opportunities that had been discovered and also in response to the rebound in prices. Companies had cut back significantly when prices had been lower a couple of years back - some of the activity on existing fields was starting to come back online.

Mr. Stickel reported the department was expecting an increase in spending on new developments in the early 2020s. He noted there were some exciting and significant new production opportunities (the committee would hear about the following day) including Pikka and Willow, which were a couple of the largest in the group. The department's forecast showed a bit of a reduction in capital spending beginning in the mid-2020s. The department had not yet identified in its production forecast the next set of new developments. He elaborated that if some other ongoing exploration took place and they began to see more developments coming into production forecast, the

department would anticipate some capital expenditures associated with some additional new fields later in the mid to late 2020s.

Mr. Stickel compared the fall and previous spring forecast. He noted that there had been a shift in the timing of some of the new developments in consultation with the operators and how some of the developments would come into play. He relayed that a greater proportion of the oil in the production forecast was from new developments in the fall forecast versus the spring forecast. There was a higher overall capital expenditure in the forecast going into the outyears as a result of needing to have the investment to bring the production online.

[10:03:56 AM](#)

Co-Chair von Imhof referenced slide 15 and remarked it was encouraging to see new investment in Alaska. She highlighted cross-collaboration between agencies as a result of the new administration. She had recently seen an article from the Department of Labor and Workforce Development (DLWD) indicating the recession may be on its tail end and there were new jobs on the horizon. She assumed there had been conversations between DOR and DLWD because she suspected an increase in investment would yield new jobs. She referenced 6,000 to 8,000 jobs in the oil and gas and mining sector that were lost in 2015 and 2016. She thought it would be nice to know what potential opportunities there would be on the horizon.

Co-Chair von Imhof looked at the second bullet point on slide 14 and noted there had been minimum tax paid for several months to one year in 2016/2017. She considered efforts made by companies to become more efficient and lowering their costs and asked at what price they had a sense of when the minimum tax may kick in. She recalled hearing the range \$45 to \$47 the previous year. She used prices of \$52 and \$42 as examples and wondered at what price the tax would take effect.

Mr. Stickel stated that the minimum tax would apply at any price. He detailed that company breakevens were being seen at prices in the low \$40 range. He explained that the cross-over point between the minimum tax and the net tax was the point at which the 35 percent net profits tax less allowable credits began to exceed the 4 percent gross

minimum tax. The crossover point was somewhere in the \$60 to \$65 per barrel range.

Co-Chair Stedman noted that the forthcoming presentation would address a more detailed look at an income statement format and how the structure worked with changing prices and volumes. He explained they could identify the trigger marks - where they had been the last two or three years and where they were in the current year and going forward. He relayed it would be the next step of the presentation in more detail, dealing with credits and other potential impacts and how the legislature wanted to deal with potential bonds.

[10:07:05 AM](#)

Co-Chair Stedman referenced slide 15 and Mr. Stickel's discussion about legacy fields. He asked Mr. Stickel to define legacy fields for the public and explain the need to bifurcate fields. He looked at the FY 20 forecast and observed that expenditures were shown as approximately \$2.5 billion. He thought it appeared about \$500 million to \$600 million of the amount was nondeductible. He asked for an explanation of why there would be deductible versus nondeductible capital expenditures. He asked if there were any future implications that nondeductible capital expenditures would have against the treasury.

Mr. Stickel answered DOR's analysis of oil production considered three field categories. Legacy fields had been in operation for several years (e.g. Prudhoe Bay, Kuparuk, Endicott, and Alpine). There was an additional category of producing fields (that had come online in the past several years) eligible for gross value reduction (GVR), a provision of the production tax code (e.g. Point Thomson and GMT). The third category was comprised of fields expected to come online over the next several years. He explained that the fields would initially qualify for GVR - a temporary tax benefit for new fields and would eventually graduate into the legacy field category.

Mr. Stickel answered that deductible versus nondeductible lease expenditures were terms of art. The department broke out lease expenditures that could be applied against an immediate tax liability, which included spending by major producers. The department also broke out other lease expenditures that were not immediately applicable against a

tax liability - primarily spending by new developers developing new fields. The immediately deductible tax expenditures impacted state tax revenue immediately, while expenditures that were not immediately deductible could be carried forward and could affect the state's tax revenue in the future.

Co-Chair Stedman noted that the net system required the state to allow deductibility. Allowing expenditures to be carried forward was a standard procedure just like on an income tax where a loss could be carried forward.

10:10:14 AM

Co-Chair Stedman referenced a previous chart that began with 2018 and remarked it would be helpful for the chart to go back a couple of decades to show actual expenditures alongside the forecast showing capital and lease expenditures. He suggested asking DLWD to add in the labor component because of its significant size. He believed it would show a large spike from around 8,500 or 9,000 up to 16,000 and back down to the current number. He asked the department to provide the information to the committee.

Senator Wielechowski asked about lease expenditures on slides 15 and 16. He asked whether oil companies were able to deduct expenditures they incurred on federal lands where the state received no royalties. If so, he asked for a breakdown of the information.

Mr. Stickel did not have the information on hand. He noted the production tax applied on federal lands within the state, meaning a company could deduct expenditures and save the National Petroleum Reserve-Alaska (NPRA) the same as it would on state land for production tax purposes.

Senator Wielechowski asked for a breakdown of the amount. He used NPRA as an example and understood that development would cost billions of dollars in the next several years. He asked how much a company could deduct annually on federal land such as NPRA if \$1 billion was spent.

Mr. Stickel responded that if \$1 billion was spent in NPRA, the company would be able to deduct the \$1 billion against its net profits tax calculation, assuming it had revenue to offset the amount.

Co-Chair Stedman remarked that the committee would be holding separate discussions on the various components related to how expenditures were handled. He noted there was different revenue under different land ownerships, meaning not all oil was equal, as had been presented at the table in the past. He hoped that the presentation by DNR the following day would help.

10:13:09 AM

Mr. Stickel considered slide 16, "COST FORECAST: North Slope Operating Lease Expenditures." He explained that major producers of legacy fields had reduced their operating expenditures over the last several years in response to lower prices. The department had seen information and had heard from companies that operating expenditures on legacy fields were expected to be fairly flat over the next several years. The department anticipated some increase in operating expenditures in several years as new fields started to come online. The major change from the spring to the fall forecast had been in fine tuning some of DOR's assumptions about the operating costs of new developments.

Mr. Stickel pointed to the orange line representing the spring forecast, which showed a large increase in operating expenditures in the FY 23 timeframe. The increase was still included in the fall forecast but was less significant. He explained that companies developing new fields had done substantial work optimizing the developments - they were expecting the new developments would be operated in a less costly way than some of the existing developments of the past.

Co-Chair Stedman referenced earlier testimony by Mr. Stickel that DOR met with companies once a year to receive their expenditure forecast. He asked for verification that the information was integrated into the department's report.

Mr. Stickel replied that DOR required companies to submit lease expenditure forecast information twice a year. The department had a more formal set of meetings with operators in the fall as it produced the fall forecast and a follow up in the spring as it produced the spring forecast. The department met with operators in the October timeframe to

develop the fall forecast and would touch base with them again in February as DOR prepared its spring forecast.

[10:15:27 AM](#)

Mr. Stickel looked at slide 17, "COST FORECAST: North Slope Transportation Costs." He detailed that transportation costs were deducted in the net profits calculation and in arriving at the gross value, which was the basis of the gross minimum tax for production tax and royalty payments to the state. The department was forecasting that transportation cost would drop of about \$1 per barrel from FY 18 (when netback costs averaged \$9.52 per barrel) to FY 19 (when netback costs averaged \$8.53 per barrel). The primary reason for the decrease in transportation cost was a settlement of a methodology for calculating the tariffs of the Trans-Alaska Pipeline System (TAPS). The new methodology resulted in a lower tariff calculation going forward. Beyond 2019 there was moderate increases in netback costs, primarily to inflation.

Co-Chair Stedman asked the department to include historical information for the data on slide 17 in addition to the information he requested earlier.

Mr. Stickel agreed.

[10:16:59 AM](#)

Senator Micciche asked for an explanation of the relationship on the GVR and lease expenditure between the minimum tax at the crossover point and above the crossover point. He asked if there was a proportional difference on the net to the state.

Mr. Stickel asked if Senator Micciche was asking about GVR versus non-GVR oil as it related to the crossover point.

Senator Micciche replied he was interested in both. He asked if the benefit was the same for the GVR and lease expenditures when a minimum tax was reached versus north of the crossover point.

Co-Chair Stedman asked for a definition of GVR. He reminded the public that the legislature got a consolidated snapshot of the industry over 12 months which averaged all producers. He explained that the view was an aggregate of

monthly reporting by multiple companies. He elaborated that the legislature did not receive a clear snapshot. He furthered that some companies may be profitable under a tax regime, while others may be losing money or breaking even.

Mr. Stickel replied there was a great deal of complexity to the issue.

Co-Chair Stedman asked for a snapshot and thought there would be ample opportunity to go into greater detail. He asked Mr. Stickel to highlight that the Revenue Sources Book now contained a separate line showing expenditures related to GVR fields.

Mr. Stickel explained that the GVR was a provision enacted in SB 21 in 2013, which allowed for beneficial tax treatment for new fields. A new field qualified for the GVR for the first seven years of production or for three years of production if oil prices exceeded \$70 per barrel. There was a graduation from GVR eligible to the legacy tax rate where the GVR benefits no longer applied. The GVR provided two benefits to the field. First, 20 percent of the gross value was excluded from calculating production tax value, part of the net profits tax calculation.

[10:20:34 AM](#)

Mr. Stickel explained the second GVR benefit for fields. There was different per taxable barrel credit applied in calculating the net profits tax instead of a zero to \$8 per barrel sliding scale credit for legacy production (the GVR-eligible production got a flat \$5 per barrel credit and in certain cases the credit could be used to take a company below the minimum tax, which was a distinction between the sliding scale credit for legacy production and the \$5 per barrel credit for GVR-eligible production). The general calculation was net profits tax minus credits (35 percent of net profits, which included the 20 percent GVR allowance) - the amount was compared to the 4 percent gross minimum tax and the higher amount was paid. He elaborated that whether a company received a material benefit from the GVR depended on the company's economics (its portfolio projects) and the current oil price.

Co-Chair Stedman asked Mr. Stickel to give a general idea of the dollar amounts being referenced.

Mr. Stickel stated that DOR was projecting a total impact of the per taxable barrel credit of about \$1.2 billion in FY 20.

Co-Chair Stedman clarified he was interested in the GVR reduction amounts. Mr. Stickel estimated that the 20 percent GVR reduction estimated for FY 20 excluded about \$108 million from production tax value.

Co-Chair Stedman asked for the total for the current year. Mr. Stickel replied that DOR was predicting the exclusion would be about \$134 million.

Co-Chair Stedman asked about the \$5 per barrel credit. Mr. Stickel answered that he did not have the breakout of the \$5 per barrel GVR credit versus the sliding scale on hand. He offered to follow up with the information.

[10:23:16 AM](#)

Senator Wielechowski asked if there could be a negative tax rate on a GVR field. Mr. Stickel responded that the tax was calculated on a company basis, and a company as a whole could not have a negative tax rate.

Senator Bishop commented that the state had one of the top most complicated tax regimes worldwide.

Co-Chair Stedman agreed. He cautioned against drawing any conclusions on the gross dollar figures. He spoke to the necessity of looking at the entire picture. He acknowledged that the magnitude of dollars was large. He noted the information would be put into context with the entire process later on. He added that the figures were \$50 million to \$100 million or more, which was significant.

[10:24:40 AM](#)

Commissioner Tangeman reviewed slide 19, "Outstanding Tax Credits," which showed a bar graph entitled "Ending balance of credits available for repurchase, assuming historical interpretation of statutory formula for FY 2020+." He discussed cashable credits, which were credits earned by companies without a tax liability. Over the past couple of years, cashable credits had been eliminated. He reported that even two years back the slide would have shown an increasing liability into the future. The state had ended

most cashable credits for purchase; therefore, the liability was a finite amount. Slide 19 showed payoff plan for credits owed by the state. Historically the credits were paid off as they were earned and turned in. The previous administration "a more minimum amount, due to oil prices" in the \$30 range, had been paid.

Commissioner Tangeman continued discussing slide 19 and relayed that the state's liability had been just under \$800 million in FY 19. The past spring the legislature had appropriated \$100 million for the credits, which had been in conjunction with a tax credit bond. He explained it had been anticipated that the state would be able to bond to pay off the liability balance. He expounded that the bond issue had been delayed and was currently in the court system. He explained that the slide cut the \$100 million (appropriated by the legislature) loose beginning in December, which brought the liability down to under \$700 million. The gray bar showed the value - reflective of DOR's historical interpretation of what a minimum amount would be. He remarked that the figures were subject to appropriation. He believed the data reflected that the state could wipe the liability from its books in the next couple of years.

[10:27:34 AM](#)

Co-Chair Stedman asked if the state did not issue the bonds, but made the statutory payout for FY 20, it meant there would be three to four more years of payments before the state was finished [paying off the liability].

Commissioner Tangeman answered that the final amount was projected to be paid in FY 20, meaning the total would be five years. The forecast showed the amount would be about \$175 million per year.

Co-Chair Stedman stated that there would be a forthcoming discussion on issuing bonds versus paying the liability off over time.

Commissioner Tangeman shared his intent to provide a brief overview on the topic later in the presentation. He acknowledged the complexity of the discussion and expressed the department's willingness to have a more detailed discussion in the future.

[10:28:39 AM](#)

Commissioner Tangeman showed slide 20, "Update on Tax Credit Bonding (HB 331)":

- Corporation established last year in House Bill 331 (HB 331).
- Purpose:
 - "to finance under AS 43.55.028
 - (1) the purchase of
 - (A) transferable tax credit certificates issued under AS 43.55.023;
 - (B) production tax credit certificates issued under AS 43.55.025; and
 - (2) the payment of refunds and payments claimed under AS 43.20.046, 43.20.047, or 43.20.053."
- Authorized to issue up to \$1,000,000,000 in subject-to-appropriation bonds.
- FY 2019, \$27 million appropriated for debt service on any bonds issued by the Corporation. Bond proceeds to be appropriated from Corporation to Commissioner of Revenue for purchases.

Commissioner Tangeman noted the \$27 million was part of the \$100 million appropriated by the legislature.

[10:29:17 AM](#)

Commissioner Tangeman showed slide 21, "Update on Tax Credit Bonding (HB 331)":

- The Corporation has not issued any bonds due to litigation.
- Complaint alleged that the subject-to-appropriation bonds authorized in HB 331 violated provisions of the Alaska Constitution on state debt and financing. In June, the State filed a motion to dismiss the complaint.
- The Superior Court granted the State's motion to dismiss on January 2, 2019.
- The State has moved for entry of final judgment. Once the final judgment is entered, the Plaintiff will

have 30 days to file an appeal to the Alaska Supreme Court.

Commissioner Tangeman elaborated that if an appeal was filed, the case could stretch out for 12 to 18 months. He explained that the state would be back in the same fiscal situation it had been in the previous year. He thought the concept of bonding was sound, but the state was currently in a "hurry up and wait mode."

10:30:04 AM

Commissioner Tangeman turned to slide 23, "Changes to 10-Year Unrestricted Revenue Outlook." He pointed to the top section of the slide and noted that during the fall price forecast session, oil prices had been in the \$80 range. The department had decided to use the spring 2018 forecast for the 10-year forecast. The change had impacted FY 19 and outyears were similar to FY 19. The middle section of the table showed UGF revenue excluding the Permanent Fund transfer. He noted it was something that required discussion. The bottom section of the slide showed UGF revenue (fall 2018 versus spring 2018). He considered the fall forecast and pointed out a slight increase in FY 19, stable revenue in FY 20 and FY 21, and slight declines going forward. He added that the bottom section included the Permanent Fund transfer. The very bottom line beginning with \$3.2 billion reflected the (5.25 percent of the total ending balance of the last five years) calculation from SB 26 [Permanent Fund legislation passed in 2018].

10:31:50 AM

Commissioner Tangeman showed slide 24, "Oil & Gas Production (OGP) Tax Audit Status Report." He reported the issue had been substantial for DOR and taxpayers. The state had gone through various tax iterations over the past decade, which has slowed things down from an audit standpoint. He stated the issue was difficult for the state and taxpayers when working to understand the different tax structures. Fortunately, the tax regime had been fairly stable since 2014. He believed the bottom line was there was a light at the end of the tunnel. He remarked on the complexity of the issue, but explained DOR and taxpayers understood how to calculate, which would enable audits to catch up over the next couple of years. Statutorily DOR had six years to audit a tax return and he anticipated

completing audits within three years in the next couple of years.

Commissioner Tangeman reviewed slide 25, "OGP Tax Audit Update":

- Thorough audits completed through 2012
 - Previously reviewed all sections of a taxpayer's return
 - Some sections were 100% audited
 - Time consuming, but deemed to be necessary with new tax and new staff
 - Scope was wide and materiality was low - it was a learning process
- Stable tax law provides time to get caught up, plan, and develop better procedures.
- Tax system in place provides better transparency and organization of data.

[10:33:25 AM](#)

COLLEEN GLOVER, DIRECTOR, TAX DIVISION, DEPARTMENT OF REVENUE, turned to slide 26, "OGP Audit Improvement Plan." She reported there was good news going forward and the state had gotten through the worst from the audit perspective. She elaborated that difficult audits had been concluded. She explained there had been some years with two different tax policies in a calendar year, which made things more complicated. The department had stable employees and was getting ready to finalize all the 2013 audits at the end of the quarter. The department planned to get on track and have a three-year cycle for audits. She detailed DOR had been working with taxpayers and soliciting feedback on how to improve.

Ms. Glover explained that the two-way relationship between the department and taxpayers factored in perspectives from both sides. She highlighted DOR had developed an audit improvement plan that had been communicated to taxpayers in regard to oil and gas taxpayers. The plan looked at data sharing and considered taxpayer confidentiality agreements. She noted that many operators had cost information that went to multiple taxpayers. The interpretation of statute and regulations, which could be ambiguous, was also a focus for the division. Work included looking at areas where regulations could be cleaned up for clarity, which would result in fewer audit assessments, appeals, and litigation.

Ms. Glover discussed that the Tax Revenue Management System (TRMS) implemented in 2014/2015 meant the 2014 tax returns were in a computerized system, which had not been the case in the past. The system provided consistency to returns and data. She concluded the new system would result in efficiencies within the oil and gas audit group.

10:36:39 AM

Senator Micciche relayed the legislature had received a letter regarding audits for 2011 and several other years. The letter had shown the audits had resulted in a positive assessment of \$275 million to the state. He asked if there was any difference in the 2012 audits that were now complete. He stated that a positive assessment was nice, but he was concerned about a scenario where the state would owe money.

Commissioner Tangeman replied that one of the requests for the current presentation was to provide back tax assessed values. The department had the letters prepared and would distribute them to members' offices.

Ms. Glover believed the letters had been distributed to committee members. She referenced a packet of documents that included a letter as well as information on oil and gas production tax audits for 2011 and 2012 tax years (copy on file).

Co-Chair Stedman remarked that the committee had received the documents immediately before the meeting started, which made it difficult for members to prepare. He reported that members would read the letters and the committee would provide a list of questions to DOR. He communicated the committee would likely have a separate presentation on credits due to the complexity of the issue. He was interested in information going forward about where net losses were generated versus where revenue was generated.

Ms. Glover noted that the packet included a 2012 assessment that was similar to the 2011 audit assessment of about \$270 million. The packet included detailed tables showing actual taxes paid for 2018. She highlighted that taxes paid in 2018 were significantly higher than those in 2017, which was reflected in the revenue forecast.

Senator Micciche asked about the probability of the state owing money after the completion of an assessment of the 2013 audits. He surmised the probability was low.

Ms. Glover answered she did not have the information but would follow up. She clarified the 2013 audits were not yet complete.

[10:39:19 AM](#)

Commissioner Tangeman concluded the presentation with slide 27, "UGF Relative to Price per Barrel (without POMV), FY 2020." The slide showed a graph depicting the crossover point and provided a scale showing the effect on UGF revenue as ANS prices increased. He thought the slide was a good visual representation of how the price change impacted the state's bottom line.

Co-Chair Stedman asked for verification that the probability of prices reaching \$130 per barrel was close to zero. Commissioner Tangeman agreed.

Co-Chair Stedman asked to have the slide redone with a price range between \$40 and \$80 per barrel. He also requested information showing the trigger point on the minimum tax. He stated it would be helpful for people to remember the state had a gross tax and net tax running at the same time, with one dominating the other.

Commissioner Tangeman agreed to provide the information.

Co-Chair Stedman thanked the testifiers for the presentation. The committee was looking forward to the department's operating budget presentation. He remarked the committee was anticipating substantial changes in the governor's proposed budget. He wanted to see the commissioner testify before the committee and encouraged him to bring any needed support staff.

Co-Chair Stedman discussed the agenda for the following day.

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ADJOURNMENT

[10:43:01 AM](#)

The meeting was adjourned at 10:42 a.m.