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# Oil and Gas Tax Credit Reform
## HB247

Presentation to House Resources Committee

February 3, 2016

# *Bill Title*

"An Act relating to confidential information status and public record status of information in the possession of the Department of Revenue; relating to interest applicable to delinquent tax; relating to disclosure of oil and gas production tax credit information; relating to refunds for the gas storage facility tax credit, the liquefied natural gas storage facility tax credit, and the qualified in-state oil refinery infrastructure expenditures tax credit; relating to the minimum tax calculation for monthly installment payments of estimated tax; relating to interest on monthly installment payments on estimated tax; relating to limitations for the application of tax credits; relating to oil and gas production tax credits for certain losses and expenditures; relating to limitations for nontransferable oil and gas production tax credits based on oil production and the alternative ta credit for oil and gas exploration; relating to purchase of tax credit certificates from the oil and gas tax credit fund; relating to a minimum for gross value at the point of production; relating to lease expenditures and tax credits for municipal entities; adding a definition of "qualified capital expenditures"; adding a definition for "outstanding liability to the state"; repealing oil and gas exploration incentive credits; repealing the limitation on the application of credits against tax liability for lease expenditures incurred before January 1, 2011; repealing provisions related to the monthly installment payment for estimated tax for oil and gas produced before January 1, 2014; repealing the oil and gas production tax credit for qualified capital expenditures and certain well expenditures; repealing the calculation for certain lease expenditures applicable before January 1, 2011; making conforming amendments, and providing for an effective date." *(273 words)*

## *Suggested Informal Short Title*

An Act reforming oil and gas tax credits and strengthening the minimum oil and gas production tax.

# *Work Done Since Last Session*

- Governor's line-item veto capped FY16 spending at $500 million
- Temporary liquidity crisis; many meetings with industry and others to help reassure lenders
- Multiple presentations with history, current practice, and possible changes
  - Joint Resources in Kenai, June 17
  - Three "regional" presentations to Senate Working Group September through November
  - All presentations on BASIS; we're prepared to go through similar information for the committee
- Development of reform legislation including plan for transition from current system

# *History of Oil and Gas Production Tax Credits*

- First “modern” Oil and Gas credit was the Alternative Credit for Exploration (AS 43.55.025) passed in 2003 while Alaska still had the “Economic Limit Factor” (ELF) Gross Tax
- Several credits added in 2006 with passage of the “Petroleum Production Tax” (PPT) and switch to net profits-based taxation. Included Cook Inlet tax caps as well as the first “state repurchase” provisions
- Credits substantially modified with passage of “Alaska’s Clear and Equitable Share” (ACES) in 2007; state repurchase made more open-ended
- Cook Inlet Recovery Act and related legislation in 2010
- Frontier Basin credits added in 2012
- SB 21 passed in 2013, dramatically changed North Slope credits, replacing “spending” with “production” focus

# *History of Oil and Gas Production Tax Credits*

- Credits initially added to encourage certain desired behaviors, tied to anxiety over declining production and a need for new investment
- Later credits were added as core components / offsets of the net profits system
- At times credits were layered on top of each other, creating unanticipated circumstances
- Credits can either be used against tax liability, or cashed out (“repurchased”) by the state
- Per AS 43.55.028(e)(4), a company producing over 50,000 bbl / day can not have their credits repurchased by the state

# History of Oil and Gas Production Tax Credits

## Major Credits Available (current law):

- **.023(b) Net Operating Loss (25-45%)**
  This is the main refundable credit on the North Slope and the largest statewide credit. "<u>Stackable</u>"
- **.024(i&j) Per-Taxable Barrel ($0 to $8)**
  Only on North Slope
  Only can be used against tax liability
- **.023(a&l) Capital and Well Expend (20-40%)**
  Only outside North Slope, usually refunded
- **.025(var) Exploration Credit (30-40%)**
  Expires 7/16 in North Slope and Cook Inlet
  Extended in Interior / Frontier Areas until 2022
- **.024(c) Small Producer Credit (up to $12 mil)**
  Closed to new applicants in 5/16

# *History of Oil and Gas Production Tax Credits*

**FY 2007 thru 2015, $7.4 Billion in Credits**

**North Slope**

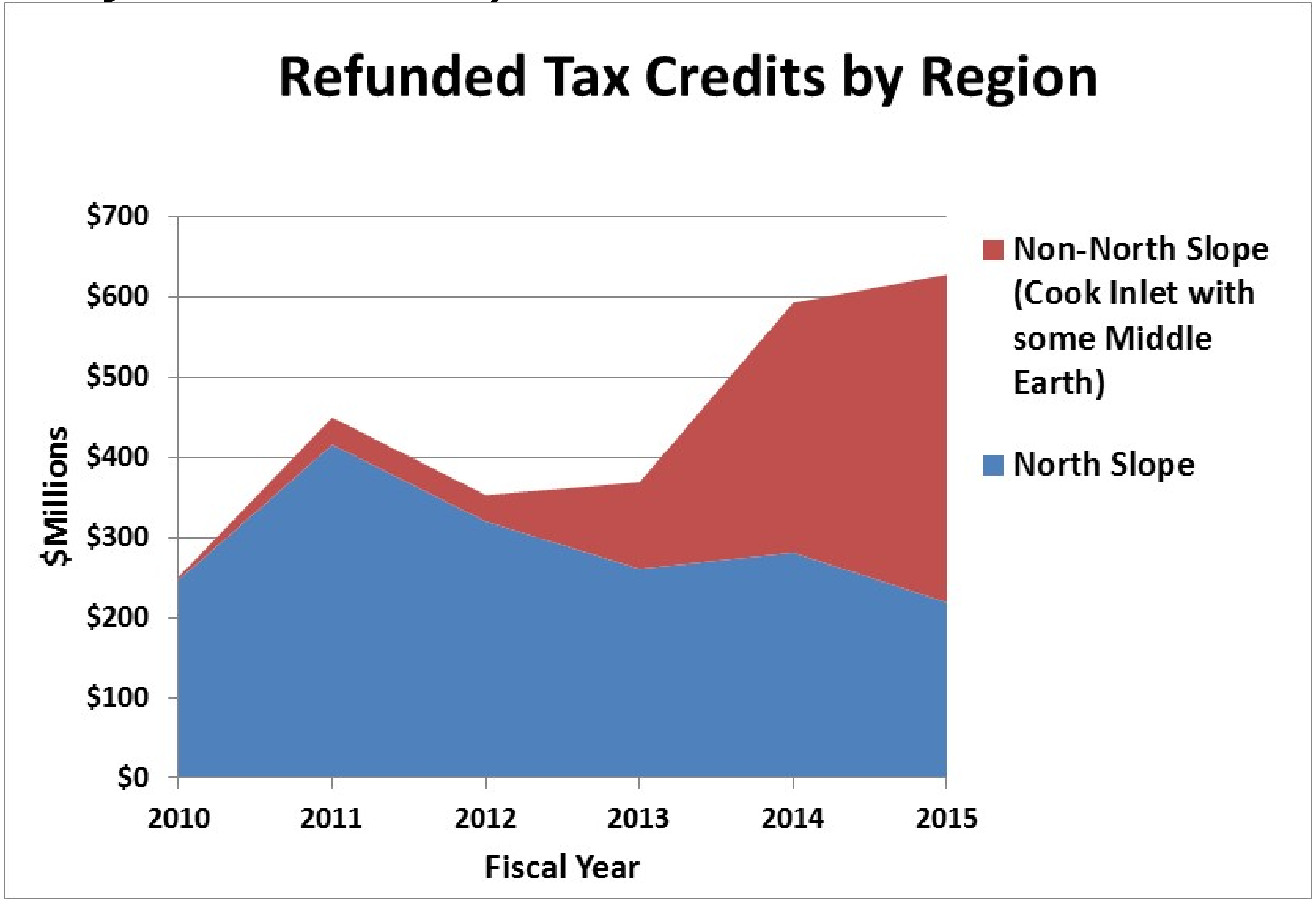
- $4.3 billion credits against tax liability
  - Major producers; mostly 20% capital credit in ACES and per-taxable-barrel credit in SB21
- $2.1 billion refunded credits
  - New producers and explorers developing new fields

**Non-North Slope** (Cook Inlet & Middle Earth)

- $100 million credits against tax liability
  - Another $500 to $800 million Cook Inlet tax reductions (through 2013) due to the tax cap still tied to ELF
- $900 million refunded credits (most since 2013)

# History of Oil and Gas Production Tax Credits

- Tremendous growth in non-North Slope (almost entirely Cook Inlet) refunded credits since FY10



# History of Oil and Gas Production Tax Credits

**Of the $3 billion in state-refunded credits through the end of FY15:**

- $1.45 billion went to six North Slope projects that now <u>have</u> production
- $650 million went to 13 North Slope projects that <u>do not have</u> any production. Some of these are abandoned, and some are in process
- $450 million went to six non-North Slope projects that <u>have</u> production
- $450 million went to eight non-North Slope projects that <u>do not have</u> any production

# *History of Oil and Gas Production Tax Credits*

**Of the $500 million in authorized credit repurchases for FY16:**

- About $472 million has already been paid
  - About $200 million from North Slope and $272 million from Cook Inlet / Interior
  - 58% non-North Slope, similar to FY15 data
- Nearly all are 2014 NOL's and Cook Inlet Drilling
- Still expect $700 million total demand, but
  - Most of the applications DOR has in-hand don't need to be issued until next July

# *History of Minimum Production Tax "Floor"*

- During gross tax era, there was a minimum "cents per barrel" tax. In 2005 it was 60 to 80 cents adjusted for API gravity
- AS 43.55.011(f) added as part of "PPT" bill to ensure a minimum level of revenue as part of compromise with transition to Net Profits tax
- Sliding scale from zero to 4% of Gross Value, based on the price of oil. For all prices above $25 is 4%
- Under PPT and ACES, the floor could be "pierced" by many credits including the primary 20% capital expenditure credit

# *History of Minimum Production Tax "Floor"*

- Under SB21, strengthened for "legacy" oil meaning the North Slope per-taxable-barrel credit cannot reduce taxes below the "floor"
- Several other current credits can reduce payments below the "floor"
  - Net Operating Loss; Small Producer Credit; Various Exploration Credits; Per-Taxable-Barrel credit for "new" oil eligible for the Gross Value Reduction (GVR)
- Provision was never broadly triggered until the fall 2014 price collapse
- Most North Slope production taxes throughout 2015 were at the "minimum tax" level

# *Major Bill Themes*

1. Reduce the state's annual cash outlay;
2. Protect Net Operating Loss credits as a playing field leveler between legacy producers and newcomers;
3. Limit repurchases;
4. Strengthen the minimum tax;
5. Be more open and transparent;
6. Honor and pay credits earned to date and through any transition period.

# Recommendations of Senate Working Group

1. Gradual implementation
   - ✓ $1 billion transition fund for existing and future liability
2. Consider Timeline / Sector Impacts
   - ✓ Maintains future cash support for Operating Loss credits
3. Protect local venders at bankruptcy
   - Not addressed in this bill but this is an important and timely issue

# *Recommendations of Senate Working Group*

4. Protect Minimum Tax "Floor"
   - ✓ Prevents credits from reducing payments below the minimum; increases rate to 5%
5. Protect Frontier Basin Tax Breaks
   - ✓ Continuation of exploration credits in these areas maintains state support at up to 65%
6. Enhance Reporting Requirements
   - ✓ Limited confidentiality waiver so Alaskans know what their money is being spent on

# Exploration Credits

- On 7/1/16, the “Jack up Rig” and “Frontier Basin” credits expire
- Also, regular .025(a) credits expire for North Slope and Cook Inlet
  - .025(a) credits remain for “Middle Earth” until 2022
- **Administration policy is to let them expire.**
- Preemptively repeal other exploration credit programs that are not currently being used, in AS 38.05.180(i) and AS 41.90.
- Add .025 DNR data requirements to .023(b)

# Cook Inlet Drilling Credits

- **Repeal AS 43.55.023(a) and .023(l)**
  - SB21 repealed the "spending based" credits for the North Slope
  - Prevent profitable companies who pay zero taxes from receiving state credit payments
  - Need for a broader Cook Inlet tax reform before 2022
- **Reduce general Cook Inlet cash support for development to the 25% .023(b) credit**

# Repurchase Limits

- Expand current .028(e)(4) restriction saying companies who produce greater than 50,000 BOE / day can't have credit certificates repurchased, and must hold them to use against future production
  - **Any company with global annual revenue greater than $10 billion / year**
  - Restore PPT-era cap of $25 million / company / year
  - Percentage of repurchase tied to percentage of Alaska resident hire
  - **Carried-forward loss credits expire after 10 years**

## Remove Exceptions / Loopholes

- Provisions that artificially inflate net operating losses
  - **Can't use GVR (new oil value reduction) to increase the size of a Net Operating Loss** (has led to credits greater than 100% of loss)
  - If a municipal entity owns production and sells only a portion of that production to an outside party, only the pro-rata share of expenses can be deducted against revenue

# Strengthen Minimum Tax

- **Can't use an operating loss credit,** small producer credit, or exploration credits **to reduce payments below the 4% floor**
  - We see these in the forecast coming out for rest of FY16, as one or more major producers will show a net operating loss for 2015
  - This one provision is retroactive to 1/1/16
- Extend 4% floor to GVR-eligible "new" oil
- Prevent per-taxable-barrel credits earned in one month from being used against another month's taxes at true-up
- **Increase from 4% (at prices above $25) to 5%**

# Other Provisions

- Interest Rate Reform
  - Eliminate error in SB21 that prevents compound interest on underpayments and assessments
  - **Increase interest rate to state's "opportunity cost," seven percent above Fed Discount Rate**
- Confidentiality Waiver
  - Name of company and how much they received in state repurchased credits
- Transportation Costs can't reduce Gross Value below zero
- Credit certificates must first be used to satisfy any obligation to the state

# *Bill Impact: Example Scenarios*

**North Slope Major Producer**

- Higher oil prices: no change
- Prices below ~$85: currently paying 4% minimum tax; must pay increase to 5%
- Extended period of very low prices: cannot use Net Operating Loss credit to reduce payments below the "floor"

# *Bill Impact: Example Scenarios*

**North Slope New or Smaller Producer**

- Higher oil prices: no change
- Prices below ~$85: must pay minimum tax. Currently per-barrel credit can reduce taxes to zero
- If company has an operating loss, the Gross Value Reduction cannot be used to increase the size of the loss to earn a larger NOL credit

# *Bill Impact: Example Scenarios*

**North Slope New Project Developer**

- Net Operating Loss Credits continue to be earned at the 35% level – no change
- Large Multinational Companies: must hold their credit certificates to be used against future tax liability
- Smaller Companies: limited by $25 million / company / year cap. Must carry forward all credits in excess of this

# *Bill Impact: Example Scenarios*

**Cook Inlet Existing Producer**

- Currently pays low to zero taxes due to Cook Inlet tax caps, yet is eligible for 20%-40% credit repurchase for Capital and Well Lease Expenditure credits
- Repeal of these credits means producers without an operating loss do not earn refundable credits. Tax caps remain through the end of 2021

# *Bill Impact: Example Scenarios*

## Cook Inlet New Field Developer

- Currently receives a 25% Net Operating Loss credit stacked with either the 20% Capital or 40% Well credit. State typically refunds 50-60% of costs
- With repeal of Capital and Well credits, will continue to receive 25% Net Operating Loss credit

- Large Multinational Companies: must hold their credit certificates to be used against future tax liability
- Smaller Companies: limited by $25 million / company / year cap. Must carry forward all credits in excess of this

# *Bill Impact: Example Scenarios*

## **Interior / Frontier Area Explorer**

- Currently receiving 65% state credits for exploration; 50-60% for development
- With repeal of Capital and Well credits, development projects will only receive the 25% Net Operating Loss credit
- However, exploration credits have been extended through 2022, meaning qualified expenditures continue to receive 65%

# Revenue Impact

## FY17 Impact Est. $500 Million / year

- Elimination of about $200 million / year in certificates
  - Mostly from repeal of .023(a) and (l) as well as elimination of so-called loopholes
- Deferral of payment on another $200 million / year in certificates that would have to be held for use against future tax liability
  - Based on various new repurchase limits
- Additional revenue of about $100 million
  - Strengthening minimum tax plus increase to 5%
  - Interest rate reform

# Revenue Impact

**In subsequent years, the estimated budget savings per the DOR Fiscal Note is reduced**

- This is largely tied to a decline in estimated tax credits in DOR’s official revenue forecast
- Our credit forecast only includes “known” projects and is typically revised upwards from year to year
- Credit projections use the same conservative methodology as DOR’s production forecast
- Most “new” projects would add to the amount of projected credits

# *Implementation Cost*

## Transition

- Bill is being written with an effective date of 7/1/16 for nearly all changes
- "Honoring Existing Credits" means:
  - Roughly $200 million FY2016 "overhang"
  - Estimated $425 million credits based on spending in CY2015, which will largely be paid in early FY2017
  - Credits earned in first half of CY2016 prior to the effective date
  - Total equals about $1 billion which will be paid via an appropriation to the .028 Tax Credit Fund

# Implementation Cost

- The changes anticipated in this bill will require somewhat substantial reprogramming of the Tax Revenue Management System (TRMS) and Revenue Online (ROL) which allows a taxpayer to file a return online and update the current tax return forms
- We have requested an estimate from the software developer, and currently assume a one-time cost of about $1.5 million to accomplish this
- We do not anticipate any additional costs to administer the tax program
- There will also be a need for substantial amendments to existing regulations to fully implement the changes

# Closing the Budget Gap

| | (Millions) |
|---|---|
| **FY16 Budget** | **$ 5,200** |

**FY17 Baseline Revenue (after proposed legislation)**

| | |
|---|---|
| AK Permanent Fund Protection Act (annual draw) | $ 3,300 |
| Revenue from existing taxes and fees | $ 850 |
| Earnings on Savings | $ 135 |
| | **$ 4,285** |

**FY17 Spending Reductions**

| | |
|---|---|
| Continue Cuts | $ 140 |
| ***Reform O&G Tax Credits*** | ***$ 400*** |
| Net Priority Investments | ($ 40) |
| | **$ 500** |

# *Closing the Budget Gap*

| **New Revenue Components (estimated)** | **(Millions)** |
|---|---|
| Mining (starting in FY 2018) | $ 6 |
| Fishing | $ 18 |
| Tourism | $ 15 |
| Motor Fuel | $ 49 |
| Alcohol | $ 40 |
| Tobacco | $ 29 |
| ***Oil and Gas (strengthening minimum tax)*** | ***$ 100*** |
| Income Tax (half in FY17; first full year is FY18) | $ 200 |
| | **$ 457** |
| | |
| **Total with reductions and new revenue** | **$ 5,242** |

# *Sectional Analysis*

**Sec. 1-5.** Conforming language related to the repeal of AS 41.09 in Sec. 40 of the bill. The repeal is a currently unused exploration incentive credit program.

**Sec. 6.** Conforming language related to changes to reporting requirements and confidentiality rules in Sec. 8 of the bill.

**Sec. 7.** Changes the interest rate for delinquent taxes from 3 percent above the Federal Reserve Discount Rate to 7 percent above. This would currently result in an interest rate of about 8%; about halfway between the current 4% and the 11% that was in place before the passage of SB21 in 2013.

If the state were to begin using earnings from our major savings account, the Permanent Fund, to fund government operations, there would be an “opportunity cost” that comes from unpaid taxes. Our interest rate on these unpaid taxes should reflect the expected rate of earnings on our savings.

# *Sectional Analysis (continued)*

**Sec. 8.** Provides an exception to the general taxpayer confidentiality statutes, so that the name of each company claiming credits, the amount they claim, and a general description of their activities can be made public.

**Sec. 9-11.** Amends the Gas Storage Facility, LNG Facility, and In-State Refinery Tax Credits so that these cannot be paid if the taxpayer has any outstanding liability to the state. Currently this is restricted to only a tax liability.

**Sec. 12.** Increases the minimum tax rate in AS 43.55.011(f) to 5% at all oil prices. Currently it is 4% at any oil price above $25 per barrel, stepping down at lower prices. The minimum tax applies only to production from the North Slope.

**Sec. 13.** Changes the description of monthly installment payments in AS 43.55.020(a), to conform with the higher minimum tax rate in Sec. 12. *(long technical section)*

# Sectional Analysis (continued)

**Sec. 14-16.** Conforming language related to the repeal of AS 43.55.020(a)(1) and (2) in Sec. 40 of the bill. The repeal is obsolete installment payment language related to production prior to 2014.

**Sec. 17.** Strengthens the minimum tax in two distinct ways:

(b) Prevents several credits that currently can be used to reduce payments below the 4% level from being used for this purpose. Those credits would be carried-forward until the taxpayer had sufficient tax liability against which to use them.

(c) Prevents the circumstance in which per-taxable-barrel credits that could not be used in the month in which they were earned, because of the limitations of the minimum tax, could be claimed at annual tax true-up. This effectively turns the per-taxable-barrel credit into a monthly rather than an annual calculation. Currently if there is substantial price volatility within a year it could result in large tax refunds.

# *Sectional Analysis (continued)*

**Sec. 18.** Modifies the carried-forward annual loss credit in AS 43.55.023(b) so that, for “new” oil production eligible to receive the Gross Value Reduction (GVR), the GVR cannot be used to increase the size of an annual loss. Thus, if a company has oil production but is operating at a loss, their loss credit is limited to the actual size of the loss. Currently there are circumstances in which a company could receive credit refunds for amounts in excess of 100% of their loss.

**Sec. 19.** Amends AS 43.55.023 so that credits in that section cannot reduce tax liability below the minimum tax, rather than zero as in current statute. Also establishes a sunset when certain credits must be carried forward instead of being cashed out; in these circumstances the credits can only be carried forward for 10 years.

# Sectional Analysis (continued)

**Sec. 20.** Establishes a sunset in which credit certificates can only be held for 10 years before they expire.

**Sec. 21.** Conforming language related to the repeal of AS 43.55.023(a) in Sec. 40 of the bill. The repeal is the "qualified capital expenditure" credit outside of the North Slope.

**Sec. 22.** New language adding the notice and data sharing requirements that are currently part of the alternative credit for exploration, and applying them to other credits. This will enable DNR to continue to receive seismic and downhole information after the sunset of the exploration credits.

**Sec. 23.** Amends AS 43.55.024 so that the small producer credit cannot be used to reduce tax liability below the minimum tax. Although this credit will be closed to new recipients in May of 2016, some companies will continue to receive this benefit until approximately 2024.

# *Sectional Analysis (continued)*

**Sec. 24.** Amends AS 43.55.024 so that the $5 per-taxable-barrel credit received by GVR-eligible North Slope oil production cannot reduce tax liability below the minimum tax. Currently this can be reduced to zero; only the sliding-scale credit for non-GVR oil is limited by the minimum tax.

**Sec. 25.** Amends AS 43.55.025 so that exploration credits cannot reduce tax liability below the minimum tax.

**Sec. 26.** Amends AS 43.55.028(e) to add limitations on which companies can receive refunded tax credits versus which must hold their certificates and use them against tax liability:

(2) Companies with any liability to the state are ineligible to receive payment for their tax credit certificates. Currently this is restricted to only a tax liability.

(5) Limits cash repurchase to only companies whose gross revenues in the previous year were less than $10 billion.

(6) Limits annual per-company repurchase to $25 million.

# Sectional Analysis (continued)

**Sec. 27.** Adds a new limitation to a company's ability to receive a cash repurchase of their tax credits. The state can only repurchase that percentage of a certificate that equals that company's percentage of Alaska resident hire in the previous calendar year.

**Sec. 28-30.** Conforming language related to the repeal of AS 43.55.023(a) and / or (l) in Sec. 40 of the bill. The repeal is the "qualified capital expenditure" and "well lease expenditure" credits outside of the North Slope.

**Sec. 31.** New section specifying that the Gross Value at the Point of Production, defined as sales price less eligible transportation costs, may not be less than zero

**Sec. 32.** Conforming language related to the repeal of AS 43.55.165(j) and (k) in Sec. 40 of the bill. The repeal is the "standard deduction" limitation on lease expenditure inflation that expired in 2010.

# *Sectional Analysis (continued)*

**Sec. 33-36.** Conforming language related to the repeal of AS 43.55.023(a) in Sec. 40 of the bill. The repeal is the “qualified capital expenditure” credit outside of the North Slope.

**Sec. 37.** In the case where a municipal entity has an interest in oil and gas production, and sells only a portion of that production to an outside party, their ability to deduct lease expenditures and claim credits is limited in proportion to their taxable production.

**Sec. 38.** Adds a definition for “qualified capital expenditure” to the general definitions section of AS 43.55. This replicates the definition that was in AS 43.55.023 which is repealed because the .023 “qualified capital expenditure” credit is also being repealed in Sec. 40. Most of the conforming sections that currently reference AS 43.55.023(a) use this definition.

# Sectional Analysis (continued)

**Sec. 39.** Adds a definition for “outstanding liability to the state.” This conforms with the changes made in Sections 9, 10, 11, and part (2) of 26.

**Sec. 40.** Repeals multiple sections. All of these have been specifically referenced elsewhere in this analysis or are technical repeals that conform with other repealed statutes.

**Sec. 41.** Applicability section with multiple sub-parts. In general, ensures that the changes only apply to production after the effective date. Also provides that applications that come in later for credits related to expenditures before the effective date are protected under the former program. Clarifies the timing related to the new 10-year sunset for carried-forward annual loss credits.

# Sectional Analysis (continued)

**Sec. 42-43.** Transition language enabling DOR and DNR to draft regulations to implement the changes in this Act, and establishing that regulations may be retroactive to the effective date if they are finalized after the effective date.

**Sec. 44.** Section 17 is retroactive to January 1, 2016. This is the key floor-hardening provision preventing certain credits from being used against the minimum tax, and is related to the specific concern that one or more major producers could have an operating loss in 2015 and use the carried-forward credit to reduce 2016 tax payments below the minimum tax to zero.

This is the only provision of the bill for which we are seeking this retroactivity.

**Sec. 45.** Immediate effective date for the transition and regulatory language.

**Sec. 46.** Effective date of July 1, 2016 for the rest of the Act.

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# Thank You!

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