Alaska Oil and Gas Association

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AOGA Testimony on House Bill 247
House Resources Committee
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Good Afternoon Co-Chairs Nageak and Talerico, and members of the Committee. For the record, my name is Kara Moriarty and I'm the President/CEO of the Alaska Oil and Gas Association, commonly referred to as "AOGA".

AOGA is a professional trade association whose mission is to foster the long-term viability of the oil and gas industry in Alaska for the benefit of all Alaskans. Thank you for the opportunity to testify today on House Bill 247, Governor Walker's oil and gas tax policy proposal.

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AOGA represents the majority of oil and gas producers, explorers, refiners, transporters and marketers in Alaska. Our current members include: Alyeska Pipeline Service Company, BlueCrest Energy, BP, Caelus Energy, Chevron, ExxonMobil, Hilcorp, PetroStar, Shell, and Tesoro. Although I am here on behalf of a varied and diverse group of companies, my testimony today represents the thoughts and sentiments of each and every member. On matters related to tax, AOGA requires unanimous consent on testimony.

Before I address the bill before you, I believe it is prudent to discuss the current state of the oil and gas industry in Alaska. In order for each of you to make an informed decision, it is important to understand and appreciate the industry from a context broader than mere tax revenue.

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The state revenue depicted on this table represents the total state revenue generated in fiscal year 2015, restricted and unrestricted state revenue. The unrestricted portion of the $2.3 billion was $1.7 billion, representing 75% of the state's total unrestricted revenues.

In addition, the industry paid $447 million in property taxes to local governments. Again, for greater context, the mining industry generates $83.7 million in state revenue and pays $18 million in taxes to local governments.

It would be imprudent to discuss the oil and gas industry's contributions to Alaska without mentioning jobs. Based on data from the most recent McDowell Group report on jobs and wages in the industry and data in the 2015 Department of Revenue Sources Book (RSB), the oil and gas industry is, without question, a main driver in fueling Alaska's total economy.

When you combine jobs from direct industry employers like AOGA members, plus the jobs provided from indirect industry employers such as the multitude of Alaska based contractors, plus the induced jobs created by those employees spending money in their communities, there are 51,000 private sector Alaskan jobs created by the oil and gas industry according to the McDowell Group's estimates. The McDowell Group also modeled the number of state employees and other jobs created in Alaska's economy through state spending, acknowledging that the overwhelming majority of that spending is attributable to the oil and gas industry. McDowell Group found that an additional 60,000 public sector jobs would not exist without the industry's fiscal contributions. All told, the McDowell Group concluded that 111,000 jobs generating $6.45 billion in wages result from the oil and gas industry's presence in Alaska. By comparison, the mining industry generates about 8,700 jobs in Alaska.

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To put it in more simple terms, more than 1/3 of Alaska's jobs are tied to the oil and gas industry. For every direct job the industry provides, 20 additional jobs are created throughout Alaska's economy. The McDowell Group found that no other industry comes close to that magnitude of multiplier.

Finally, you have undoubtedly read headlines regarding the industry being forced to lay-off direct employees in this current, low price environment. It is not just oil industry families that are dealing with the adverse effects of downsizing, contractions in the industry are felt across Alaska, as every dollar earned by an oil and gas employee generates $8 additional dollars in wages throughout the state.

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It is easy for the cynical to tell anecdotal stories about getting on an airplane next to a worker who lives out of state coming or going from the North Slope. Although the industry for a variety of reasons cannot dictate where an individual must live, companies consistently strive to hire as many eligible Alaskans as possible. The statewide average for all resident hire, across all industries is about 80% Alaskan hire. Many AOGA member companies actually have a higher rate of resident hire than the statewide average. For example, Caelus Energy has more than 85% Alaska hire and over 400 contractors working on the Slope this year. Alyeska has a 94% Alaska hire rate, with 20% of their employees being of Alaska Native heritage. 100% of BlueCrest operations staff are Alaska residents, while 70% of the construction workers at their Cosmopolitan project are state residents. Petro Star boasts 97% Alaska hire.

In 2014, BP spent $2.2 billion in Alaska, with 72% of that spend with Alaska companies; they currently have a 79% Alaska hire rate. 89% of Hilcorp's workforce are Alaskans. In addition, industry supports scholarships and training programs to increase the resident hire. For example, Alyeska alone spends $2 million to hire, train and develop Alaska Native employees.

Would the industry like to hire more Alaskans? Of course they would. It makes good business sense to hire Alaskans, as it is both more efficient and economical to do so.

What does not make good business sense is the provision in Section 27 of the bill to limit the repurchase of refundable credits to just a percentage of the certificate equal to that company's percentage of Alaska resident hire in the previous calendar year, including Alaska hire by the company's contractor work force.

Basing the repurchase of tax credits on a company's local hire percentage would make it difficult, if not impossible, for operators to plan and evaluate investments because their contractors' and subcontractors' Alaska hire percentages are outside the operator's control. This uncertainty will, in turn, discourage potential new investment here.

In addition, a resident-hire limitation on the amount of an otherwise well-earned tax credit certificate that can be cashed out also raises significant issues under the U.S. Constitution, and an earlier Alaska-hire preference attached to the construction of the Trans Alaska Pipeline System was struck down by the U.S. Supreme Court. The inevitable legal battle would drag out in court, and the unanswered question would cloud Alaska's tax system with uncertainty until there was a ruling. We note that the U.S. Supreme Court recently heard oral arguments involving an Alaskan issue, the Sturgeon case, it has taken nine years for that case to wind its way through the legal system to reach the highest court. Does Alaska want to create further uncertainty over local hire?

Finally, if it is good policy to put local hire conditions on how the oil and gas industry is taxed, one might expect similar proposals for other industries operating in Alaska. But the Administration isn't proposing anything like that, even though some industries employ much higher rates of non-Alaskans than ours.

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As I already indicated, Alaska's oil and gas industry is a major contributor to state government, both in terms of revenue generated for state spending as well as the jobs created by the industry. You can see from this table that, since statehood, oil and gas has been the source for 85% of the state's unrestricted revenue, totaling $141 billion dollars. This figure has not been adjusted for inflation, so in the total in today's dollars would be far greater.

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As you discuss a change in Alaska's oil and gas tax policy, this slide is a reminder that in the last decade there have already been 5 major changes in tax policy. As the President of Hilcorp stated last week, "I started in the oil business right straight out of school, during the real boom in the 70's/early 80's in Midland, Texas. I'm not aware of fiscal system ever changing in the State of Texas since I've been working in the oil and gas industry. I've been in Alaska four years, and we've debated it 3 or 4 times." He went onto to say, "More than anything, changing rules and taxes every few years is a sure way to scare investment away."

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Of course, the last major change in tax policy occurred three years ago with the passage of SB 21, followed by the referendum to repeal the new law in August 2014. Voters decided the state's current fiscal policy was good for Alaska, and we would agree that Alaska has proved to be competitive, has attracted new jobs and investment, and will ultimately result in more production to the state.

Since April 2013, when the bill passed the legislature, industry has announced more than $5 billion in additional spending across the state. That increased spending could not have happened at a better time, as the investments made in the last 18-24 months are helping the industry sustain itself in this low price environment.

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But what has the increased investment meant in terms of production? As you can see from this chart, using data from the Department of Revenue, production on the North Slope has stabilized and was basically flat from 2014 to 2015, which is particularly significant when considering an historical trend of 5-6% annual decrease.

The state's own forecast shows the power of a competitive fiscal system. The blue line is historical production in Alaska for the last decade, the black line is the forecast from December 2013, and the red line is the forecast from just this past December.

If you look at the chart to the right, and look out a few years to the year 2020, and compare this year's forecast to the forecast released in the Fall of 2013, after SB 21 had passed but had not yet been enacted. After approximately two years under this tax system, you will see the Department of Revenue is forecasting 50,000 barrels per day more than what they were forecasting in 2013. To provide further context, the price forecast in the Fall 2015 forecast is $50/barrel less for 2020 than it was in the 2013 forecast. Even with the much lower price forecast, the production forecast is still 50,000 barrels per day more.

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There has been a lot of conversation about "new oil" or oil that qualifies for the gross value reduction or “GVR”. The purpose of the GVR was to lower the effective tax rate on new production as a way to incentivize new production. Some have recently asserted that all new oil after 2002 will pay zero taxes if prices are under $70 per barrel. I will discuss government take on all oil, including GVR, later in the presentation, but I would like to point out, that the DOR is forecasting that GVR will average about 8% of our overall production for the next 15 years. So while bringing on new fields and new oil is important to Alaska’s future, our legacy fields will continue to provide the lion’s share of production for years to come.

Slide 11

Looking to Cook Inlet, you will see a tremendous oil production success story. The Division of Oil and Gas Director Corri Feige mentioned these statistics during her presentation last week. You can see there has been an increase of over 100% since 2009. The investments made to increase Cook Inlet production have made a significant impression on the local economy. Additionally, our member company Tesoro refines every barrel of oil possible that travels the short distance to their refinery. A December 2015 Econ One study for the Senate Finance Committee reported that Alaska refineries supply the majority of the State’s demand in the Southcentral and Interior regions. When oil production was lower in Cook Inlet the Tesoro refinery was importing oil to refine from as far away as Africa, just to meet these in state needs. Econ One also went on to say “We estimate that the total value added to Alaska’s economy by the two refiners currently in operation (Tesoro and PetroStar) is approximately $153 million per year. The [refining] industry provided $23.2 million in revenue annually to the State in the form of revenue in kind (RIK) purchases over and above the revenue in value (RIV) alternative and $9.3 million in property and income taxes.” Having a local source of supply for the refinery is good for value added manufacturing in

Alaska.

Slide 12

It is impossible to have this conversation without acknowledging the ominous and unprecedented drop in oil prices. Prices today are not only the lowest we've seen in a decade, but when adjusted for inflation, they are the lowest since the mid-1980's. In less than two years, the industry has experienced a 70% drop in oil prices. You are well aware of the impact this has had on the State of Alaska's revenues. You have historically received 85-90% of your revenue from oil. As significant as that is, it's important to recognize that the industry receives 100% of its revenue based on the market prices for what it produces. As my friends in other industries will tell you, we are price takers, we are not price makers.

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Every industry operating in Alaska fully understands that Alaska is an expensive and logistically challenging place to do business. I imagine that concept was expressed by the mining industry last week, and it is particularly true for the oil and gas industry.

The following chart demonstrates that while oil and gas development costs grew 90% since 2000, inflation grew only 40% during the same period. In other words, over the past fifteen years, costs have surged more than two times the rate of inflation. This is yet another compelling factor and financial stressor on industry in Alaska, which compounds the difficult decisions these companies are making to cut costs and increase efficiencies while safely and reliably producing oil and gas.

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Invariably, companies are forced to operate despite the current oil price environment; this can result in projects being delayed and deferred. Perhaps most painfully, it also results in Alaskan jobs being lost. This chart shows the relationship between the low price on slide 11 and the high costs on slide 12. It looks eerily similar to the charts you as policy makers are reviewing in terms of the state's revenue and expenses.

The oil and gas industry is cash flow negative, as least as much as the state sees itself as being.

Slide 15

As I alluded to before, the high cost environment in Alaska is even more difficult to navigate during this unprecedented low price environment. According to the Department of Revenue's Fall Sources Book, the estimated average cost of producing a barrel of oil on the North Slope – before a company pays even one penny of tax – is $52/barrel. To reiterate, companies spend $52 to produce each barrel before they pay any corporate income tax, property tax, or production tax in Alaska. One need not be an economist or Rhodes scholar to understand that, in a $30 a barrel world with $52 costs, oil companies are in an untenable position in Alaska.

Yet despite this, here we are, testifying about legislation to add additional costs to the industry by raising the production tax. It is not surprising that Department of Oil and Gas Director Feige testified last week that companies are gravely concerned about any substantive changes to tax policy. "Changes in taxes generally are lumped into the bucket… of cost. At a time when prices are low, that sets off some alarm bells."

Intuitively, it seems like poor long-term policy to choose to increase the costs to the industry at a time when companies spending is already out of balance with their revenues by over $20/barrel before they pay the existing taxes. If additional taxes are levied on the industry, forcing them to be even more out of balance, you can be sure that the industry would have to make more severe cuts in expenditures that are needed to maintain and grown the state’s production.

The Department of Revenue Tax Director suggested to me a few weeks ago that if industry were to *simply* eliminate all capital expenditures, the industry would be able to “break even” at these prices. This astonishing suggestion discounts the significant role that capital investment plays for maintenance and the integrity of industry operations. Absent continued capital spending, the State can say good-bye to the currently forecasted additional 50,000 barrels per day in 2020. As misguided as that line of thought might be, it does highlight the fundamental question at the core of this discussion. How badly are you willing to mortgage Alaska’s future for nominal and short-term gains today?

It will be very challenging for the industry to reduce operating expenses, without further reductions in the workforce.

Any increase in this environment will have a negative impact on the industry and on the state’s future.

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As you weigh yet another change in tax policy, there are policy questions that need to be answered:

- What effect will the policy have on overall oil and gas production in the state?
- Will the policy make Alaska more competitive or less on a global scale?
- Will the policy provide stability to the industry and the state of Alaska?
- Will the policy provide predictability to companies looking to make huge investment decisions?

The Department of Revenue has frequently said that industry will be testifying to the impact of their proposed changes, and I have no doubt each company will do that, but I encourage you to ask each individual company over the next several days their view of these questions.

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The Administration's proposal represents the sixth major tax change in the last 11 years. Prior changes came from unprecedented high oil prices, or endeavored to incentivize development in the state and make Alaska more competitive.

However, the motivation behind this current proposal is not to improve the fiscal system for the industry or create incentives for further development and increased production. Rather, it is purely driven by the state's desire for more money, now. As Director Alper said on February 12th, "It is a tax increase. I don't think we are attempting to disguise that."

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Raising taxes when prices go up, and then raising them again when prices go down, undercuts stability and predictability. The Administration acknowledges the industry is suffering tough economic times; in fact, according to their testimony last week, if prices average around $40/barrel for 2016, the industry will suffer more than $1 billion "loss" in the state of Alaska. If the state keeps the current structure and does nothing, spending a $1 billion more than industry is taking in will have a negative impact on Alaska's economy, considering the industry is the largest private economic driver in the state.

Yet it is clearly the intention of the state to raise taxes on an industry with negative cash flow- and not by small margins. To add another half-billion impact to the industry with the passage of HB 247 will only accelerate cutbacks by the industry, which will affect the number of Alaskans working, the amount of cash that circulates through the economy, and ultimately, the future health and growth of the industry.

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Under Governor Hammond, Alaska first established an equitable policy of one-third government take for the state, one-third for the federal government, and the last third for industry. During the ACES regime, government take climbed to a higher level, which, in turn, led directly to SB 21 in an effort to normalize total government take over a broad range of prices.

As Janak Mayer from enalytica explained last week, with the slide that Rep. Josephson will hang on his door, government take is about 62% in a price range from $60-150, including government take on new oil, or gross revenue reduction oil.

Contrary to Director Alper's testimony two weeks ago, HB 247 increases government take. In fact, Mr. Mayer demonstrated and explained "that the cumulative impact of the proposed changes would be to shift up government take in lower oil prices. In times like today, the effective government take exceeds 100%.

Rep. Josephson summarized it well by saying, "Industry suffering so much – that we (the State) are getting all the money."

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Two weeks ago, AOGA submitted specific comments for each section of the bill that causes the industry concern two weeks ago, and in the interest of time, I will not belabor each and every point. However, I do want to comment on a few of the substantial concerns we have with the bill.

The governor's proposal would increase the minimum gross tax from 4% to 5%. Although a one percentage point increase might not sound significant to some, it reality, it represents at least a 25% increase for those companies who already pay the 4% minimum tax.

Additionally, the Governor's proposal would forbid companies from using any earned or available tax credits to reduce the minimum tax below the new 5% floor. It is likely that there will be companies, large and small, that have earned "new oil" tax credits or exploration, drilling or tax loss credits from prior year investments, while also operating in a loss position due to low oil prices. For those companies, using those tax credits is the only way they can also continue to invest in the state. The proposal would delay, or possibly deny, vital economic recovery at the very time companies need it the most.

In other words, raising the minimum tax affects everyone, and the proposed increase is large enough to cause substantial negative impacts on all producers at today's oil prices. It is poor tax policy to engage in nothing more than a flagrant money grab at a time when the State should be encouraging industry to continue making vital investments.

For smaller companies or newcomers to the state who have yet to make a profit in Alaska, they don't pay the 4% minimum tax, so under the governor's proposal, they would go from paying zero in production tax because they don't make a profit, to immediately being hit with a 5% gross tax, a punitive tax increase described by Director Alper as an "infinite increase."

Additionally, the proposal would change the way the minimum tax is determined and would prevent a producer from taking the actual tax credits available for a month to the extent they are greater than the initially estimated amount. Both of these incremental changes amount to a fundamental change in how the tax is calculated and will result in a tax increase.

Another major concern relates to the change in the net operating loss (NOL) tax credits. The Administration has testified that they are preserving the NOL credit, but we contend that under the current proposal the NOL credits become virtually useless.

NOL tax credits are utilized both on the North Slope and Cook Inlet and were established to help level the playing field for new companies trying to get a foothold in Alaska and allow all companies making critical investment to truly understand the economics under which those investments were made. Under SB 21, NOLs provide an even level of government support for capital investments on the North Slope.

HB 247 would prevent the use of NOL tax credits to reduce the minimum tax. This change is analogous to the federal government not allowing a company's losses to be applied against its corporate income tax. Additionally, the proposal imposes a ten-year limit for a company to apply unused NOL credits. Again, the proposed changes in HB 247, essentially eliminate the value of the NOL tax credit. Without question, changing the value of the NOL will have a tremendous impact on companies and effectively discourage future investment.

There are several other major changes proposed to credits, both for the North Slope and Cook Inlet. Setting arbitrary limits of $25 million per company, when even the "smallest" of projects range in the $500 million - $1billion range, is unreasonable and will be a strong disincentive for future investment. Eliminating or discouraging cash rebates for companies that may not yet have production or profits, strongly disadvantages new companies, especially considering that they invested in good faith based on the tax policy in place when the investments were committed. For the State to basically say, after the fact, that it is not going to fund its share of the new developments, as originally promised, is just wrong and potentially puts some of these new companies out of business.

Eliminating two important credits for Cook Inlet and "middle earth" is also dangerous as the Cook Inlet drilling tax credits were unequivocally the driver for several key investments in the region that have already led to increased production and jobs. The state has benefitted from several new, smaller companies into the state, making new discoveries that would positively increase the State's future revenues from royalties and taxes on that new production. These credits are not a "cost". They are an investment by the state with a good return. Companies have already entered into contracts and made large financial commitments for spending over at least the next year. Abruptly terminating those credits after they have made substantial good faith investments and commitments over the next year is bad faith on the state's part and will chill these types of investments in the future.

And, we fundamentally disagree that Cook Inlet has gas in search of a market as has been asserted by the Administration. DOR, DNR and enalytica have all testified that additional investments are necessary to meet the increasing demand of Alaska's residents. Without continued investment, gas production will rapidly decline. Any decline will inevitably result in higher utility rates for consumers and increase the likelihood of gas shortages.

The proposed revisions in Section 39 of HB 247 define "outstanding liability to the state" broadly as "an amount of tax, interest, penalty, fee, rental, royalty, or other charge for which the state has issued a demand for payment that has not been paid when due and, if contested, has not been finally resolved against the state." Thus, the State could deny or delay tax credit payments for virtually any outstanding and alleged liability, regardless of whether it is pending adjudication. If a taxpayer had an existing dispute with a state agency unrelated to taxes, it could be deemed an outstanding liability to the state and the tax credit used to satisfy that liability; or if an audit was pending, the tax credit could be delayed until the conclusion of the audit.

This revision, absent further clarification or modification, would provide the State with the power to arbitrarily deny or delay any tax credit, or to apply them against unresolved and unrelated disputes, including those utilized by in-state refiners. This could have a major impact on both refineries. According to a recent report by Econ One for the Department of Natural Resources: “Alaska’s refineries are relatively small in size and technologically simple. [This] puts Alaska’s refiners at a disadvantage relative to larger, more efficient refineries…[which] becomes greater when refinery utilization outside the state drops, meaning that refiners have spare production capacity. Refiners of Alaska’s size and complexity are generally the first to close or idle units in this environment.”

It is extraordinary then that in this price environment and the challenges it presents to our instate refineries, Petro Star and their parent company Arctic Slope Regional Corporation are investing over $20 million on an asphalt expansion in North Pole, scheduled to come online this summer.

Creating increased uncertainty with this provision causes understandable concern to my members.

Although there are plenty more aspects of this proposal that warrants further discussion, I will conclude by addressing the proposed increase in the interest rate. AOGA supports the current rate and believes it is reasonable, particularly considering the lengthy statute of limitations that provides the Department of Revenue with six years to audit a company’s production tax return. As Director Alper stated on February 12 in front of this committee, “when there is a change in an oil and gas tax return, it is almost always in the State’s favor. We’re looking for more money.”

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Stated succinctly and candidly, HB 247 fails to encourage increased production, fails to make Alaska more competitive for future investment, and fails to provide stability and predictability. This will, without question, result in lower long term production and revenues to the state. On one hand the Administration has said that it “is not predicting new or lesser activity through the enactment of this bill.” On the other hand, the Administration has also stated that “It’s reasonable to say that corporate decisions might be made differently if a limitation was put on that (tax credits).”

Enalytica agrees, stating that “limiting refundable credits would increase capital needs.” In this price environment, it will be incredibly challenging to find funding for those increased capital needs. Enalytica went on to say, “for projects currently under development, a July effective date would have major adverse impacts.”

HB 247 makes a series of incremental changes that could be characterized by investors as “quite scary.” And as Mr. Mayer explained last week, “incrementally taking more slivers without fundamental changes to the system – which can be more concerning than fundamental changes – because fundamental changes can be accepted if stable, but this creates ‘oh dear’, when environment is tough, folks are going to come back year after year to get another slice.”

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Raising taxes on companies that are reporting losses or are in negative cash flow positions is neither a prudent nor feasible long-term solution, and is certainly not sound tax policy. While we appreciate the need to close the state’s fiscal gap, AOGA would advise against taking even more from the oil and gas industry when it is more important for the state to encourage these companies to continue to make critical investments in our collective future. To cripple the oil industry is a misguided attempt to address short-term concerns that will actually result in greater long-term harm to the state’s economy.

Compounding the negative impact of the highly burdensome changes in Governor Walker’s latest oil and gas tax policy proposal is the provision that all but one of these changes would become effective on July 1, 2016, while one is retroactive to January 1, 2016. It is now February, and companies' operational plans for the full calendar year have already begun to be implemented. Contracts for the entire year have already been entered into, work has commenced, and financial commitments have been made by the companies – all based on the existing tax structure. Any sudden reduction in the tax credits and/or increase in the taxes on such short notice would therefore be, in effect, a retroactive tax change. This would result in a long-term serious impact to Alaska's oil and industry, and have an intensely negative impact on the state's reputation throughout the global banking and financial community.

Whether or not the Governor's proposal is enacted, the oil and gas industry will still be the largest annual contributor to state government by far.

The oil and gas industry will contribute 7.5 times more than the Governor's proposed income tax, 50 times more than the proposed revenue from mining, and 37 times more than from commercial fishing.

When will it be time for the State to realize that, despite the rhetoric and misconceptions, the industry is not immune from financial hardship? Increasing taxes on the industry that is the largest contributor to state government during a time when that industry is suffering major financial loss will result in long-term negative repercussions to the state's overall economy. Forcing the industry to reduce investments through excessive tax increases in today's economic downturn will lead to a reduction of industry jobs, a reduction of oil and gas production, and a certain reduction in future revenues to the State, all of which will only serve to exacerbate the revenue crisis the state currently faces. This is not a sound tax policy. This is not in the State's best interest.

In the spirit of "Let's pull together", and in order to make it through the current economic downturn, we cannot emphasize enough that imposing significant tax increases and eliminating access to critical incentives does nothing to increase production. It creates more harm to Alaska's largest industry and the state's economy as a whole.

The industry is not before you today asking for a tax decrease or for relief while we struggle though extraordinarily low prices. We do ask, however, that you consider that the industry has supported 85% of Alaska's revenue since statehood, and at this trying time, you do no harm to the long-term viability of the oil and gas industry in Alaska, for the benefit of all Alaskans.