Alaska Oil and Gas Association

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AOGA Testimony on Committee Substitute House Bill 247

House Finance Committee

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Good Afternoon, Co-Chairs Thompson and Neuman, 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 Committee Substitute (CS) for House Bill 247, Governor Walker's oil and gas tax proposal.

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.

There is no denying it – as legislators you have a tremendous challenge in these economic times. And whether you want to believe it or not, the reality is, the oil and gas industry is facing similar challenges. Loss of revenue. Cutting budgets. Laying people off.

Even in the face of these low prices, industry recognizes the value of investment and jobs to Alaska and we are doing our part to sustain what we can in this tough environment – weather the storms and continue operating at a loss in the interest of longer term sustainability. Do not make it harder for us to sustain Alaska's economy and jobs by adding additional costs and more economic hardship.

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Alaska's oil and gas industry fuels our state's economy. No other industry comes even close.

- 1/3 of all jobs in Alaska are attributed to the oil and gas industry. Over 110,000 jobs.
- For every direct job created by the companies exploring, producing, transporting, and refining oil and gas in Alaska – 20 more private and public sector jobs are created.
- For every dollar in wage created by industry, $8 additional dollars in wages are created.
- And, even though oil and gas revenue constitute 66% of the state's unrestricted revenue due to low prices, for FY2017, 2/3 of the state's revenue will be from one industry.
- In addition to state revenue, last year, the industry paid $447 million in property taxes to local governments.
- What other industry or individual Alaskans are currently contributing 2/3 or have contributed so much to the state's budget and local governments? None. No one comes close. Our detractors may not like it, but the fact is, the oil and gas industry has been part of the solution and is currently contributing a significant share to the state's budget.

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The industry and the state have a long standing, mutually beneficial partnership, but we are businesses who respond to the policies you make. So, as you deliberate changing oil taxes, again, please ask yourself these four questions:

1) Will this policy change create more production in Alaska?
2) Will this policy change make Alaska more or less competitive on a global scale?
3) Will this policy provide stability to the state of Alaska and to the industry?
4) Will this policy provide predictability?

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The House Resources Committee spent over 40 hours hearing testimony from the Administration, legislative expert consultants, and industry on the Governor's proposal. As a result, the Resources Committee realized the detrimental effects of many of the original provisions of HB 247, including the $25 million cap on refundable credits, the zeroing out of tax credits in the Cook Inlet and middle earth, and the increase and hardening of the floor for minimum tax. While this improved the CS, the CS nevertheless is concerning to industry, in part, as it would represent the 6th major change in tax policy in 11 years.

Two weeks ago, I was on the phone with Jamy Rosenfield, the Senior Vice President of IHS – a global consulting firm and co-founder of CERA with world renowned and best-selling author, Dr. Daniel Yergin. We were discussing the global downturn and the economic challenges facing the oil and gas industry across the globe. When I told him that the state of Alaska was considering a tax increase and elimination of key incentives, his response was shock and disbelief. He was shocked that a state so dependent on the industry would actually consider increasing taxes in this price environment.

As your legislative consultant has said, and will likely testify to later today, he is not aware of any other region that has considered so many tax changes in the past decade.

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Objectives like stability and predictability can be subjective, I understand that. However, production is production. We either have it or we don't. It won't matter if prices go back up to \$60 or \$80 or \$100 per barrel if production goes back to the decline rates of the past.

So – what has happened to production in the current fiscal system? If the state's forecast holds for the next three months, FY16 will see the first increase in production since 2002. But – you cannot just look at production today. It's also important to look forward and consider what the impact of today's investments will have on future production. The black line is historical production in Alaska for the last decade, the red line is the forecast from December 2013, after we started the current fiscal regime, and the blue line is the forecast from just last week.

If you look at the chart to the right, to the year 2020, and compare this year's forecast to the forecast released in the Fall of 2013 you will notice that after just over two years in our current system, the Department of Revenue is forecasting over 50,000 barrels per day more than what they were forecasting in 2013. To provide further context, the Spring price forecast is \$50/barrel less for 2020 than it was in the 2013 forecast. Think about that: Even with the much lower price forecast, the production forecast is still over 50,000 barrels per day more four years from now.

There has been a lot of conversation about "new oil" or oil that qualifies for the gross value reduction or "GVR". The very purpose of the GVR was to lower the effective tax rate on new oil as a way to incentivize more production. It was designed for the new oil to pay a bit less in tax as an incentive, and it's working, but it's important to point out that according to DOR's own estimates, the lion's share of our future production will continue to come from the legacy fields that do not qualify for this additional incentive. Industry will be paying current tax rates on 91-92% of the future production for at least the next 15 years.

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The industry, just like the State of Alaska, is experiencing the repercussions of an unprecedented drop in oil prices. Prices today are the lowest we've seen in more than a decade. 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. The State has historically received 85-90% of its 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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Invariably, companies are forced to operate despite the current oil price environment, and in doing so, the oil and gas industry is currently cash flow negative, meaning, we are not collecting enough revenue each day (represented by the green line which represents oil price) to pay our bills (represented by the blue line).

When businesses do not have enough cash flow to pay their expenses, it results in cut backs. The oil and gas industry is no different. We have seen a dramatic increase in project delays, deferrals, and rigs going idle. Most painfully, Alaskans have lost jobs, and not just 40 or 50 of them. Individual companies can give you their specific job loss numbers, but from June 2015 to June 2016, there will be over 1,000 fewer direct employees of the oil and gas industry. This number does not include the multiplier effect.

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To add insult to injury, Alaska has been and continues to be, a high cost environment. High costs make it even more difficult to navigate during this unprecedented low price environment. According to the Department of Revenue's Spring Sources Book, (page 10 specifically), the estimated average cost of producing a barrel of oil on the North Slope and getting it to market – before a company pays even one penny of tax – is $50/barrel.

Yet despite this, here we are, testifying about legislation to add costs for industry.

Let me be very clear: if additional taxes are levied on the industry, either in the form of increasing the minimum tax, hardening the minimum tax floor or eliminating tax credits, there will be less oil production and fewer jobs.

It is really quite simple. Industry is cash negative. They don't have any more money to give for increased costs from government. Some companies may already be burning through savings to pay for operations, and the reserves are not unlimited.

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

However, the motivation behind this current proposal is not to increase production, make Alaska more competitive or create stability or predictability. Rather, it is purely driven by the state's desire for more money, now.

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, if prices average around $40/barrel for 2016, the industry will suffer just over a $800 million "loss" in the state of Alaska. That is a staggering number. It's remarkable that serious considerations are being made to increase taxes on the state's largest private sector economic driver when that industry is facing a staggering downturn.

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As I also mentioned earlier, the House Resources Committee Substitute does not have the same level of impact as the Governor's original proposal. But it still causes industry concern.

AOGA supports the current law with simple interest for overpaid and/or underpaid taxes. It is appropriate in light of the length statute of limitations which gives the Department of Revenue six years to audit a company's production tax. Compounding the interest over a 6 year period, even at the current rate, would add more than 25% of the bill before the audit is done.

Today is April 1, 15 days to tax day. Can you imagine filing your taxes, utilizing your best interpretation of the tax code, and 1 – 2 – 3 – 4 – 5 – 6 years later, the IRS comes back and says, I'm sorry, we have finally finished auditing your taxes, and not only do you have to pay the tax bill, you have to pay compounded interest on top it. This is the situation industry currently faces with this proposal. There could be likely scenarios where the interest payment is more than the actual tax bill.

Another major concern relates to a so-called "loophole" in calculating a net operating loss (NOL) tax credit.

NOL tax credits are utilized both on the North Slope and Cook Inlet and were established in part to help level the playing field for new companies trying to get a foothold in Alaska. The NOLs arise before these companies have enough production to cover their costs, and the credit allows them to realize a benefit from their lease expenditures by getting tax-credit certificates for them.

For companies who qualify for the gross value reduction, being able to use that reduction in determining their NOL is a significant factor in their project economics. Losing the ability to use it will result in a tax increase for the very companies that policy makers wanted to attract to Alaska.

Yet another disincentive for future investment is the setting of arbitrary limits on credits of any dollar amount per company, especially when even the "smallest" of projects range in the $500 million - $1 billion range. Eliminating or discouraging cash rebates for companies that may not yet have production or profits, would disadvantage new companies that have invested here in good faith based on the tax policy in place when the investments were committed.

Phasing out and eliminating two important credits for Cook Inlet and "middle earth" is also dangerous. Some argue those credits are no longer necessary, but they have attracted new companies here, and production has increased. Some companies have already entered into contracts and made large financial commitments for spending over at least the next year. Abruptly terminating or changing those credits after the fact will not attract these types of investments in the future.

The House Resources CS also creates a working group to specifically focus on Cook Inlet. This group, in addition to the Oil and Gas Competitive Review Board, signals to industry that even if changes are made this session, that additional changes are coming. Once again, the State will be looking at making a change to the fiscal system signaling to investors that the state fiscal regime is not be stable or predictable.

The proposed revisions in Section 17 of CSHB 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.” Even though the House Resources CS does try to minimize the impact of this “outstanding liability” section, it still creates uncertainty for companies when trying to determine economics of a project.

Finally, retroactively applying regulations is concerning and will again, cause additional instability.

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Whether or not the production tax is raised, 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.

In this environment some companies may find themselves in the position of borrowing money just to keep the doors open for business. We cannot emphasize enough any increase in cost will have a serious negative impact on industry and Alaska.

The industry is not before you today asking for tax relief while we struggle though extraordinarily low prices. We do ask, however, at this trying time, you do no harm.