Alaska Oil and Gas Association

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AOGA Testimony on Committee Substitute for Senate Bill 130

Senate Finance Committee

April 13, 2016

Good Afternoon Madam Chair 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 for the oil and gas industry and I thank you for the opportunity to testify today on the Committee Substitute for Senate Bill 130, Governor Walker's oil and gas tax policy proposal. Although I am here on behalf of a diverse group of companies, my testimony today represents the thoughts and sentiments of each and every member, which was approved by unanimous consent.

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.

You've been asked, again, for the 6th time in 11 years to examine and change oil tax policy. No other industry has had so many changes to its fiscal structure in Alaska. And, we can find no other jurisdiction in the world that has considered changing oil tax policy more than Alaska. Nevertheless, here we are, in a low price environment, considering changes to the oil industry.

In fact, the only reason you are being asked to change the policy, again, is because of oil prices. The Administration stated to us before they introduced the original bill, and they've said it to you here, that they would not have introduced this bill if they didn't need more money for government. They have also said this was a credit reform bill, but make no mistake, SB 130 and the CS before you increases taxes on the industry to generate more government revenue, and it redefines oil and gas taxes.

Slide 2

As you consider the CS for SB 130, we encourage you to ask us, ask the Administration, ask your consultants, and ask yourselves, four important questions.

Will the Governor's bill increase production? Will it make Alaska more or less competitive, will SB 130 provide stability, and will it provide predictability?

More importantly, as the Senate Resources Committee Chair said, another question to ask yourselves is how will this affect Alaska families, businesses and jobs?

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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.

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, Alaskans, and the state as a whole get through this low price environment.

Objectives like stability and predictability are important in any business setting. But let's not lose sight of the prize here. More oil and gas production is the ultimate objective for Alaskans and Alaska's oil and gas industry. For the first time since 2002, we have seen a production increase. From March 2015 to March 2016, we've seen an increase of just over 4,000 barrels a day, which is just under a 1% increase.

It is also important to look at the forecast for the outlying years. Two and a half years ago, in Dec. 2013, the production forecast for FY16 was 487,600 barrels per day. We are now on track to realize an increase of 33,000 barrels per day over that forecast, even though oil prices have plummeted by 70% during the same time frame. The next few years are forecasted to bring similar results. Even though the price forecast today is about $50 less per barrel than the price forecast in 2013, the Spring 2016 production forecast is still 50,000 barrels per day more in 2020. And more production is always good for the state, regardless of oil price.

Why is increased production so important? I find it a bit puzzling that I even have to explain why increased production is a good thing for Alaska, but some have suggested that the state is not receiving value for the oil, so why does it matter that we have increased production.

Let me give you an example of not only how the current tax system is working for Alaska, but also how increased production is generating more revenue for Alaska, even in this low price environment.

Slide 4 – Monopod

This is a picture of the “one-legged wonder”, the Monopod. The Monopod is one of 17 operating platforms in Cook Inlet, and was the world’s first monopod platform.

But the Monopod is no spring chicken, it’s like me, over 40, and when Hilcorp acquired the asset in 2011, production had dropped to just 600 barrels per day. It was one of the aging platforms that led to the Cook Inlet Recovery Act as overall production had dipped to about 8-9,000 barrels per day in 2009.

Hilcorp bought the assets, and started to invest in projects to increase production. Mr. Wilkens will give you the details, but you can see from the stats the benefits of increased production.

The cash benefit to the state treasury from the Monopod comes in the form of royalties. We hear comments that no other taxing province in the US has a zero tax rate on oil, in fact, I believe the Tax Director has testified as such. That is very wrong! On the federal offshore properties, there is no production tax, since the land owner is the US government who gets 100% of its value from its land from the royalties alone.

Approximately 16% (1/6) of all oil produced in the US comes from federal OCS lands, and that has a zero tax rate. The land owner receives full value from the royalties alone.

To suggest increased production is not a benefit to the state is dumbfounding because Just this one example of the Monopod clearly shows that when you focus on increasing production, versus production taxes, production can generate more revenue to the state.

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Another suggestion that has been made about the Cook Inlet Recovery Act is that the focus was on gas, and that the benefit was not supposed to be for oil fields. We’ve just illustrated why increased production is good for the state treasury, but for Cook Inlet specifically there is another benefit to increased oil production, a value added benefit.

This slide is from a 2009 presentation Tesoro made for an AOGA educational seminar.

It was when Cook Inlet was at the bottom. This slide illustrates where Tesoro was importing oil from at that time because Cook Inlet production was so low and North Slope crude was not always available. Tesoro has operated the refinery in Nikiski since the 60's and I don't need to tell you the benefits of that refinery because you heard it first-hand last week in testimony for the royalty oil contract you are likely to approve, which helps Tesoro and provides revenue to the state.

The point is, without the increase in oil production, Tesoro would have to once again look outside Alaska for oil to refine to meet the needs of Alaska's transportation and construction needs. If they have to go back to importing, the oil will invariably cost more, which will cause Alaskans to pay more for the products.

Slide 6

I've mentioned the precipitous drop in oil price. You are well aware of the impact this has had on the State of Alaska's revenues. While it is significant that the state has historically received 85-90% of its revenue from oil, it's important to recognize that our 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.

And these low prices are causing the industry to be cash flow negative. What does that mean? That means we are not collecting enough revenue each day to pay our daily bills.

The oil and gas industry is no different than any other business that does not have enough cash flow to pay their expenses. They cut back. Unfortunately, we have seen a dramatic increase in project delays, deferrals, and rigs going idle. Most painfully, Alaskans have lost jobs. We recognize that state employees are losing their jobs too. Estimates from the operating budget passed by the House will result in 50 fewer state employees. But for the oil and gas industry, the job loss has been even more severe. Individual companies can give you specific job loss numbers, but by June of this year, over 1,000 Alaskans will no longer be working directly for the industry. This does not include the contractor workforce.

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To add insult to injury, Alaska has been and continues to be a high cost environment. According to the Department of Revenue's Spring Sources Book, the estimated average cost of producing a barrel of oil on the North Slope and getting it to market on the West Coast – before a company pays even one penny of tax – is right around $50/barrel.

Yet despite this, here we are, testifying about legislation to add significant additional costs to the industry by raising the production tax and eliminating incentives.

Let me very clear. If you raise taxes or reduce credits, there will be a negative impact. This is not about politics, it is about economics. It is very simple. Because the industry is cash negative, some companies may already be burning through savings to pay for operations, and the reserves are not unlimited. If a company has $100 million to spend in Alaska, and the government wants to take an additional $20 million, they will have no choice but to further eliminate operating and/or capital expenditures by $20 million. They will not be able to get more money to spend in Alaska on investment just because taxes increase or credits go away. That means less production, less long-term state revenues, and even more Alaskans without a job.

Slide 7

Even though the state is not making as much in production taxes, when coupled with the regressive royalty system in Alaska, overall government take is very high. In fact, at these prices, it is already 100%. SB 21 was designed to get back to the old rule of thumb first established by Governor Hammond that the split should be 1/3 for the state government, 1/3 for the federal government, and the last third for industry. And as you can see, government take is about 62% in a price range from $60-150, including government take on new oil.

This is why it is important to look at the production tax, in conjunction with the rest of the fiscal system. As Division of Oil and Gas Director Corri Feige stated during previous testimony to House Resources, companies lump taxes and royalties as a cost. Any increase in production taxes, will impact overall government take.

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In the interest of time, I will not belabor each and every concern we have with the CS. However, I do want to comment on a few of the substantial concerns.

First and foremost, we described the CS as a nuclear bomb for Cook Inlet and we stand by that statement. The CS would be an enormous change for the Inlet by reducing the credits by half in just 8 months, and then completely eliminating the credits in 2018. Even though the Inlet will not pay a production tax after 2018, introducing this dramatic shift in policy with no consultation with stakeholders is sending a chill through the Inlet. At these prices there will not be a lot of drilling with this new system. Remember, the Inlet was paying little to no production taxes when the credits were created to entice companies like Hilcorp and Blue Crest to Alaska. The credits were necessary to offset the high cost environment. If you remove the credits it will take a much higher oil price for the companies to make additional investments. Capital expenditures will go down and you will not see the activity level that had led to increased production and increased state royalties.

In addition, for companies like Hilcorp who no longer receive refundable credits because they have reinvested and increased production, they no longer qualify for cashable credits. They utilize the credits in Cook Inlet to offset their tax liability on the North Slope, which has been a huge incentive and benefit when acquiring North Slope assets. If the state truly wants new players to the Inlet and the Slope, changes to the CS need to be considered. This bill impacts the entire industry, but it could also easily be called the “Hit to Hilcorp”.

In addition to the new concept for Cook Inlet, the CS also includes a new concept first added in the other body, and that is the limit on new oil. Adding a limit to the Gross Value Reduction or the GVR, especially such a short time span of 5 years, will erase the whole intent of the GVR in the first place. As your consultant said yesterday in Senate Resources, eliminating the GVR can wipe out all the value at even $60/oil. This change will have a major impact on current or future GVR projects. As Mr. Mayer said, the impact of a 10 year limit would be much lower, and a 15 year limit preserves almost all of the status quo value.

Another hit to small producers is not allowing the GVR to be calculated for the company’s net operating losses. The whole purpose of the GVR was to lower the effective tax rate on new production. This change will be an immediate tax increase for companies who utilize the GVR.

Another hit is the proposal to arbitrarily limit cash credits. The Governor’s original proposal of $25 million per company was especially egregious, especially when considering even the “smallest” of project are easily in the 500 million - $1 billion range. Again, we agree with enalytica on this point and that application of a credit limit for projects under development, even a limit of $85 million per company, could have major adverse impacts. If the companies stop investing, especially in this price environment, will the loss of long-term revenue be worth it to the state?

Cashable credits will unfortunately be a self-correcting problem. The credit estimates for this fiscal year are based on work that was completed at least 12-18 months ago. Prices were higher then. If prices stay where they are, there is no way you will see the level of investment from a year or two ago. Companies are already scaling back, as they scale back, there will be less credits. Eliminating or discouraging cash rebates for companies when they invested in good faith based on the tax policy in place when the investments were committed does not send an “open for business” sign to any company.

Credits are a part of Alaska’s tax policy system. They were created to incentivize investment behavior and they have worked. Today they are described as a “cost”, a drain on Alaska’s treasury.

Credits are an investment by the state with clear benefits. The state has spent $8 billion in cumulative credits from FY 07-16. That implies a huge capital investment of $30-40 billion. Additionally, during that same time the state collected over $32.8 billion in cumulative tax revenues.

Even though we have other concerns, such as interest rates and retroactivity, the last concern with the CS that I want to address is the Alaska Hire provisions. Basing the priority order of tax credit payment on a company’s local hire percentage would make it difficult, if not impossible, for companies to project and evaluate their business plans and investments because their contractors’ and subcontractors’ Alaska hire percentages are outside the operator’s control. This provision creates numerous questions and concerns.

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. And the direct companies I represent have an instate hire rate of over 80%.

What adds insult to injury is the retroactivity of this provision. The tax credit repurchases would receive priority for payment based on the resident hire percentage in the prior year (assuming that we all know how to measure that and the constitutional challenges that might arise). For credits filed in 2016 (for 2015 expenditures) and those filed in 2017 (for 2016 expenditures prior to the new law taking effect), there would have been no way for the producer to have known. Retroactively changing the laws is grossly unreasonable. If this provision is adopted, a longer transition time should be considered.

This provision is like the IRS changing the tax laws in April for last year's income.

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The only bright side of the CS is that it does not include some the more negative aspects of governor's proposal. In the interest of time, I'd like to discuss two.

First, it does not increase the minimum gross tax from 4% to 5%. Although a one percentage point increase might not sound significant to some, in reality, that would represent at least a 25% increase for those companies who already pay the 4% minimum tax – on their gross revenues.

For smaller companies or newcomers to the state who have yet to make a profit in Alaska, they are not required to pay the 4% minimum tax under current tax law. 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 value tax, a punitive tax increase described by the Administration as an "infinite increase."

Additionally, the CS does not raise industry taxes by incorporating the Governor's proposal to "harden the floor", a proposal that would have not allowed companies to use any earned or available tax credits to reduce the minimum tax below the minimum floor. Hardening the floor impacts all companies, large and small, especially those that have earned "new oil" tax credits or loss credits from prior year investments for explorations and drilling and prior year losses, while also operating in the red due to low oil prices.

There has been a lot of education and insight shared about the effects of hardening the floor. As enalytica explained yesterday, the CS avoids raising taxes on losses the company is experiencing, and it shifts government take up in low prices. It is becoming clear that even though there may be a short term benefit to the state and its cash flow, the state will still have to pay these credits, so it's just a postponement of the payment. Hardening the floor would simply cripple companies now while pushing out the time the state has to allow the NOL tax credits to be used, thus what the hardening of the floor really does is further penalizes companies at a time they are bleeding cash. It is encouraging to see many have abandoned this idea.

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In conclusion, I'd like to revisit the policy questions that I posed at the beginning.

Will this increase production? Frankly the answer is no. This is a significant threat to Cook Inlet production. Dramatically and adversely changing the tax system in the Cook Inlet as proposed in the CS will decrease production of oil and gas in the Inlet. For the North Slope, there will also be a negative impact, especially on smaller fields. Alaska needs every company to be successful because the state needs increased production from every field and region. This CS will not add more production

Will this make Alaska more competitive? No. Again, many of the proposals that were included in the Governor's bill remain in the Committee Substitute and make it very difficult to attract new investment and companies to Alaska.

Will it provide predictability? No. The only thing that seems to be predictable, even with this CS, is that the state will constantly change tax policies, regardless of oil price, and regardless of the economic condition of the industry. We hear that everyone has to pay something to solve the state's fiscal crisis. We would ask, what other industry is being asked to pay, or in our case, pay more when the state has clearly demonstrated that industry is losing money?

Will this CS be a positive for Alaska families, businesses and jobs? No. If you passed this CS in its current form there would be less investment by companies, which will result in less production and job loss. You are likely to hear or have heard the passionate plea from Alaskans who have already suffered from the current economic situation on Saturday. Alaska families, businesses and jobs will continue to be affected in a negative way with the adoption of this CS.

Lastly, will this CS provide stability? No. We recognize that many of you are looking for ways to fill the state's budget gap and you see increasing taxes on the oil industry as part of the solution to create a stable environment for Alaska. Our job is to tell you how the industry will react to those changing policies. The CS is bad for Alaska. It is destined to make the economic situation for the industry even worse, and when the industry suffers, the state suffers too. And if policy makers do not find a way to solve the entire solution for the state this year, our fear is we will find ourselves in a similar situation next year.

The industry is not asking for a tax decrease or for tax or royalty relief while we struggle though extraordinarily low prices and we asked that you proceed with caution. The tax policy before you will not encourage new entrants to come to Alaska, it will not ensure current producers will remain committed to Alaska, it will not lead to more jobs or more production, it will not lead to more long-term revenues to the state, and it will not improve Alaska's long-term fiscal future.