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ALASKA OIL AND GAS ASSOCIATION
TESTIMONY ON HCS CSSB 21(RES)
TO THE HOUSE FINANCE COMMITTEE

April 9, 2013

Good Morning. My name is Kara Moriarty and I am the Executive Director of the Alaska Oil and Gas Association, commonly known as "AOGA". AOGA is the professional trade association that represents 15 member companies accounting for the majority of oil and gas exploration, development, production, transportation and refining of oil and gas onshore and offshore in Alaska. These comments regarding the House Resources Committee Substitute for Committee Substitute for Senate Bill 21 have been reviewed by all our members and approved unanimously.

Overview. Alaska's greatest challenge today, which industry shares with the State, is the decline of oil production from the North Slope. As with any non-renewing resource, it gets more and more expensive to produce the next barrel of oil or Mcf of gas as a field is depleted, and inevitably you one day reach a point where the cost of producing the next barrel or Mcf will exceed the value of production, and production will cease. This destiny was the certain fate of the Prudhoe Bay field even when it first came into production in 1977. At that time the best estimate for its total oil production was 9.6 billion barrels. But last October it produced its 12 billionth barrel, and there is a good chance for an additional 2 billion barrels or more. These facts illustrate how much expectations can change as a result of new investments and projects to increase the total recovery from a field. We believe opportunities similar to this are still possible in the future, both for legacy fields and for others that have more recently come into production. To realize this potential, though, these opportunities must win the competition against opportunities elsewhere for a finite pool of investment dollars.

With respect to oil and gas taxes, the great issue facing Alaska is that there is a fundamental

trade-off between short-term and long-term benefits and results for Alaskans. At one extreme, if the tax is 100%, the State would have the greatest possible share, but nothing to be sharing in. And at the other extreme, Alaskans would enjoy the greatest possible development of their resources and the greatest economic activity from that development, but their state government would have no tax revenue from that activity if the tax rates are zero. Clearly, as Alaska comes down from a 100% rate, there becomes more and more production available to tax, and initially the state's tax revenue increases over all even though the tax rate becomes less. Yet the zero-percent example shows the State can overshoot the mark. The challenge for the State and you, in particular, as the Legislature lies in striking a balance between the size of the economic development activity that occurs and the rate of tax applied to that activity.

Our role is to share with you our perspective about how close Alaska is to having such a balance. And, frankly, Alaska is too far toward overtaxing and shrinking the economic "pie" available to be shared in the future. AOGA has testified, individual companies have testified and even the consultants hired by you and the Administration have testified that the present tax system is not competitive with the opportunities industry has elsewhere.

AOGA has heard a lot of concern, and so have you, that there is – quote – "no guarantee" – unquote – that Alaska will see any increase in industry spending and activity if the State changes its tax system to make investment opportunities here more competitive. As a former elementary school teacher, I see this as unfounded. It would be like saying you don't to cut the stem of an apple hanging from a tree, without a guarantee it will fall to the ground.

Just as the Law of Gravity will make that apple fall without any stated guarantees, so there is a similar law — an economic law of business — that assures a positive response if you make Alaska more competitive. This law of business is the principle of making the most for the shareholders' money. Right now the present tax regime is not competitive with opportunities elsewhere, and so money gets invested elsewhere in order to get more for the shareholders' money. But if Alaska makes its opportunities better than Outside competition by reforming the taxes, it stands to reason that more investment will be made here because a greater number of Alaskan opportunities could then make more for the shareholders' money than the competition. And this 'gravitational attraction' to invest here becomes stronger as prices increase. Even my former students would understand that if I will let them have more jelly beans for a nickel than the teacher down the hall, they will give their nickels to me. If a restructuring and tax rate reduction make investments here more competitive, companies will want to

make more investments here, even if there are no specific guarantees. Their shareholders will demand it.

What the House Resources CS would do. *Progressivity repeal*. Both the Senate-passed Bill and the House Resources CS for it would repeal the ACES progressivity, which would be a material step forward for three reasons. First, progressivity under ACES takes away too large a share at current prices, at about $100/barrel the tax rate is just over 40%. Second, progressivity guts the upside potential for Alaska investments, which is the one economic advantage that Alaska's remoteness offers. This happens because, the more that the upside is realized, the more of it progressivity takes away and not just from the upside, but from the $30 baseline value as well. And third, as BP explained in its testimony to the House and Senate Resources Committees on February 20, when you have a plan of development with several elements in it, progressivity makes it impossible to analyze and quantify the tax effect of any single element because the progressivity for all of the elements together is greater than the sum of the progressivities for each one separately.

Base tax rate increase. The House CS would raise the base tax rate from 25% to 33%, while the Senate's version would raise it to 35 percent. Either would be a step in the wrong direction because we have consistently testified that the present 25% rate is too high even without progressivity. We are also concerned that a 33% or 35% rate could end up setting an inappropriate kind of "floor" on state tax expectations for future oil or gas developments, even though they might have very different economics from the ones that have been analyzed for Senate Bill 21. Obviously, if AOGA were forced to choose between a 35% rate and a 33% one, we would choose 33%, but nonetheless something lower would be even better. A lower rate would be better for Alaskans, not just for industry, because of the business counterpart to the Law of Gravity that I discussed earlier, which will attract additional investment here.

Tax credits and the gross-revenue reduction for new production. The House Resources CS would phase out the present 20% "qualified capital expenditure" or QCE tax credit at the end of 2013 for North Slope expenditures. If this were standing alone, AOGA would be against it. But the House CS offers other incentives that tend to offset this loss of the QCE tax credit.

For new production, that is, production from units containing no land that had been unitized as of January 1, 2003, or from a participating area established after 2011 and within a pre-2003 unit that contains a reservoir that had already been in a participating area before December 31, 2011, or from acreage added to a participating area after 2013, the gross revenue from this new production would be

reduced by 20% in computing the gross value of the point of production (GVPP), and there would be a tax credit of $5 per barrel for oil falling in any of these new-production categories. For all other North Slope oil production, there would be a "sliding scale" tax credit starting at $8 a barrel when the GVPP is less than $80 a barrel. The credit would decrease by $1 a barrel for each $10 increment above that, reaching zero when the GVPP per barrel is $150 or more. In doing this the House Resources CS fills a gap in the Senate-passed version of the Bill, by providing a tax incentive for the 80 – 90 percent of the remaining oil potential that is within Alaska's jurisdiction to tax and within its control to develop or not develop, as it may choose.

The House CS would also change the exploration credit under AS 43.55.025 by removing the distance-from-the-nearest-well requirement in (c)(2)(B) for middle Earth exploratory wells. We believe the removal of the distance requirement should be extended to the North Slope as well.

In addition, the House CS would delay the sunset of the small-producer tax credit from 2016 to 2022, which is something AOGA has specifically advocated for in our testimony to other committees regarding Senate Bill 21 and its companion, House Bill 72. This extension was included in the original SB21 and we believe the administration showed wise policy judgment in their decision to do so.

Lastly, the House Resources version maintained the change to the loss carry-forward (LCF) annual loss credit allowing companies that spend more money than they make in Alaska to take the loss in the form of a credit that is redeemable by the state or transferrable to another taxpayer. AOGA believes this particular credit is extremely valuable to the current and any new small producers in reducing the upfront risk associated with new field development. The rate for the LCF credit as a matter of policy by the administration, has matched the base rate at 33% under the House Resources CS.

AOGA does not believe the State's tax policy should create winners and losers among taxpayers without a very sound reason for doing so. As a matter of general principle, therefore, we would support the new tax credits being proposed in the CS, the extension and broadening of the existing small-producer and exploration tax credits respectively, the gross-revenue reduction and $5 a barrel tax credit for new production, and the sliding-scale tax credit for legacy production. And we would oppose the sunset of the QCE tax credit at the end of this year if the tax credit was standing alone. To the extent, however, that these different measures and other provisions in the House Resources CS may be seen as trade-offs against one another, different provisions have different degrees of importance for individual members of AOGA. Accordingly, we refrain from expressing views about whether any such trade-off is

good or bad overall, and we leave it to individual companies to offer their own opinions on such questions if they choose to do so.

Statutory interest on tax underpayments. The House Resources CS addresses a concern we have raised in our earlier testimony on SB 21 and House Bill 72, that a six-year statute of limitations for auditing and a minimum interest rate of 11% compounding quarterly can nearly double-up any underlying tax liability that the audit may find. The heightened risk this causes is a material factor in terms of Alaska's competitiveness relative to other places. That risk — and not just the reward that an investment can make under the tax laws — is an integral element in an investor's comparison of investment opportunities here versus elsewhere. We endorse this change, which serves to compensate the State reasonably for any lost use of funds that it suffers from a tax underpayment.

We would point out to you, however, that the House Resources CS does not address the interest rate under AS 43.05.280(a) for tax overpayments, which provides "Interest shall be allowed and paid on an overpayment of a tax under this title at the rate and in the manner provided in AS 43.05.225(1)." This reference to AS 43.05.225(1) should be changed to parallel the changes that the CS makes to other sections that refer to AS 43.05.225(1).

Joint-interest billings ("JIBs"). The question of using JIBs as the initial source for a taxpayer's lease expenditures is not about how much a taxpayer will be able to deduct. It is about how effectively the Department will administer the tax, and about how producers can comply with it.

Consider the situation of a producer who owns part of a field but is not the operator of that field. Unless and until the non-operators audit the JIBs they have received from the operator, the only information they have about how much is being spent, and for what, is the information provided by the operator in support of the JIBs, plus the annual budget for the field that the operator proposed and they approved. Without any detailed back-up documenting the cost items being invoiced in the JIBs, how can a non-operator know whether a particular cost-item that it has been billed for is actually deductible as a lease expenditure?

A non-operator in this position would be a lot like you or me regarding our home mortgage payments if we didn't have a year-end statement from the bank itemizing how much we paid as principal, how much as interest, and how much of the escrow was paid for property tax. We would know the total amount we paid to the bank, but we wouldn't know how much to itemize on our tax returns as mortgage interest and property tax. The non-operator is in a similar position of not having the information needed

to figure out how much of the JIBs it paid is deductible and how much isn't. Yet this is how the ACES tax currently operates.

Now consider the situation from the tax-enforcement side, where the Department is auditing the claimed lease expenditures for a field with an operator and three non-operators. Typically, the Department will send different auditors to each of these four companies. Once there, the auditor will find that a non-operator doesn't really have any detailed books and records to determine whether the non-operator's lease expenditures based on the JIBs from the operator actually qualify as allowed lease expenditures. Thus the non-operator has to try to get access to those underlying books and records from the operator so the auditor can see them. This means the Department audits the same underlying set of books and records four times, once for each of the three non-operators, and again in the audit of the lease expenditures the operator itself claimed for tax purposes. And it also means the operator has to support each of the non-operators in their audits in order for them to show the non-operators' claimed lease expenditures were allowable.

Throughout the Department's two-and-a-half-year process of writing regulations to implement ACES, AOGA consistently said the Department ought to audit the system of accounts that the operator maintains under the joint-interest billing agreement. In that audit, the Department could apply exactly the same standards it has established by regulation to determine which particular accounts or cost-codes in the system are allowed or not allowed. The Department could share the results of that audit with all the owners of that field, informing them which cost-codes or accounts are not deductible. This would allow each participant in the field, including the operator, to report and pay its tax liability correctly without deducting anything from the disallowed cost-categories and accounts. Audits of the non-operators would simply be a verification that they did not deduct any of the disallowed costs. And after the first audit of the system of accounts which the operator maintains, the audit of the operator and its system of accounts for joint-interest billings for that field would simplify to a verification that the same kinds of data are still flowing into the same cost-codes and accounts, with an examination of any new accounts or cost-codes to determine whether or not they are deductible.

The Department readily could set up this much more efficient way to administer the tax by regulation. And its auditors are naturally unwilling to adopt an audit approach that falls outside the four corners of what the regulations currently provide for. The House Resources CS would enact the substance of AS 43.55.165 (c) and (d), and thus restore the original statutory authority that the

Department earlier said it lacked. If the Department then used this regained authority to administer the tax as efficiently as it could, a great deal of uncertainty and wastefulness in the current way the tax is being administered could be avoided.

What the House Resources CS would NOT do. There are several areas of the current production tax AOGA believes should be changed to make it a more efficient tax that are not addressed in the current bill, but in the interest of time, I want to briefly mention three specific problem areas:

1) Six-year statute of limitations. Even if the interest rate on tax underpayments is changed, a six-year statute of limitations will remain. The three-year statute under AS 43.05.260 works perfectly well in practice for all of the other taxes an industry participant pays, because it allows the three-years to be extended repeatedly by mutual agreement of the Department and the taxpayer.

2) Costs to respond to an "unscheduled interruption ... or reduction in ... production" or an "unpermitted release of a hazardous substance or [natural] gas". AS 43.55.165(e)(19) disallows costs incurred "in response to ... [an] unscheduled interruption ... or reduction in the rate of ... production" or to an "unpermitted release of a hazardous substance [such as crude oil] or [natural] gas[.]" This disallowance causes problems because there are no standards of materiality for determining whether it applies or not. We are not asking you to try to write the answers to these questions in the statute. We suggest, instead, that you expressly give the Department of Revenue the duty to adopt regulations that set reasonable thresholds for materiality about how long an "interruption" has to last, about how large a "reduction" in production has to be, about how much an unauthorized release has to be or in what circumstances must it occur, and about how much the cost "incurred … in response to" such situations has to be in order trigger a disallowance under AS 43.55.165(e)(19).

3) Transportation costs for regulated pipelines. The ACES legislation in 2007 amended AS 43.55.150, the statute that determines the gross value at the point of production on the basis of destination prices or values minus the costs of transporting the oil or gas to those destinations from its point of production in the field. This is known as the netback approach. AOGA is not objecting to the netback approach itself. Instead, we are concerned about the amended version of AS 43.55.150, which provides that "[i]f the department finds that ['a shipper of oil or gas is affiliated with the transportation carrier'] ..., the gross value at the

point of production is calculated using the actual costs ... or the reasonable costs of transportation as determined under this subsection, whichever is lower." This concern arises specifically in the context of pipelines whose carriage of oil or gas in intrastate commerce is regulated by the Regulatory Commission of Alaska (the "RCA") and whose carriage of oil or gas in interstate commerce is regulated by the Federal Energy Regulatory Commission ("FERC").

We believe the cost for transportation through a regulated pipeline should be the tariff the RCA or FERC allows that pipeline to collect. If the tariff turns out not to have been correct, the RCA or FERC will remedy that through a refund order. There is no need for the Department of Revenue to restate a regulated tariff on the basis of what it, the Department, thinks the tariff should be. We believe the statute should say that "tariff rates that a regulated carrier is allowed to collect by the Regulatory Commission of Alaska or another regulatory agency are reasonable for purposes of this section."

Conclusion, In terms of structurally reforming the present ACES tax, the House Resources CS has considerable technical merit. Its repeal of the high ACES progressivity would eliminate a great deal of complexity in the tax and uncertainty in analyzing the tax effects on projects. Its reform of the interest rate for tax underpayments would significantly reduce the risk from tax underpayments being doubled-up by the interest after a six-year audit. It would extend or broaden existing tax credits for small-producers and the exploration provisions, and it would create a gross revenue reduction and a system of per-barrel tax credits that is directed to new development and production as well as more production from legacy fields on the North Slope. And it would restore the Department's clear authority to administer the tax in a more efficient and effective way by using joint-interest billings as a tool for compliance, while at the same time rigorously auditing those billings to prevent the deduction of billed cost-items that are not deductible under the tax.

The principal downside we see in the House Resources CS is the tax rate. We believe even a 33% rate falls on the high side of the sweet spot where a lower rate, greater investment and the resulting production will combine to optimize the State's overall position for the future. However, that is a judgment call for you to make as the people's elected representatives. All we can promise is that, whatever you view as the optimal point, will yield effects in terms of investments being made here instead of somewhere else. You don't need promises about what individual companies might or might

not do. Instead, you can count on those companies' shareholders to expect, and demand, that investment opportunities here that beat the competition will be pursued, instead of a less competitive alternative elsewhere.