Alaska Oil and Gas Association

AOGA

121 W. Fireweed Lane, Suite 207
Anchorage, Alaska 99503-2035
Phone: (907) 272-1481 Fax: (907) 279-8114
Kara Moriarty, President/CEO

AOGA Testimony on Senate Bill 130
Senate Resources Committee
April 8, 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 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. 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.

As the Resources Committee you are tasked with looking at policies that will either benefit the state's resources or they won't. Currently the policy you have in place for the oil industry places an emphasis on production, investment and jobs. And, while the industry is responding as any business would in this low price environment, we also recognize the value of investment and jobs to Alaska and we are doing our part to sustain what we can in this tough environment. We are doing our best to weather this storm in the interest of long term sustainability for all of us, but changing policies that will have further negative impact on industry will be costly for the state in the long-term.

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.

<u>Slide 1</u>

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 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.

Commissioner Hoffbeck even said as much, two months ago when he said that the motivation to look at oil tax credits was the budget. He went onto say that the motivation was not to redefine oil and gas taxes. Regardless of the motivation, their final proposal in SB130 does both. It increases taxes on the industry to generate more government revenue, and it redefines oil and gas taxes.

<u>Slide 2</u>

As you consider 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?

<u>Slide 3</u>

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.

Speaking of prices, they are the lowest we've seen in more than a decade. 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.

Slide 4

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.

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. 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. That means less investment, less production, less long-term state revenues, and even more Alaskans without a job.

Slide 5

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

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, in 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 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. 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 a flagrant money grab that is large enough to cause substantial negative impacts on all producers at today's oil prices.

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 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. The NOL tax credits allow all companies making critical investment to truly understand the economics under which those investments were made.

SB 130 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. All of these changes to the NOL essentially eliminate the value of the credit in the first place, and will have a tremendous impact on companies.

There are several other major changes proposed to credits, both for the North Slope and Cook Inlet. Arbitrarily limiting cash credits to $25 million per company per year, 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 allow companies to realize the true economics of their developments as originally promised, is bad business practice because it would put some companies at risk of going 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. These credits are not a "cost".

They are an investment by the state with clear benefits. For example, the Department of Revenue showed the State has paid over $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.

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 SB 130 define "outstanding liability to the state" in the broadest of terms. Thus, the State could deny or delay tax credit payments for virtually any outstanding and alleged liability, even if it was with a state agency unrelated to taxes.

Although there are plenty more aspects of this proposal that warrant further discussion, I will conclude by addressing the proposed increase in the interest rate. We are one week away from tax day. Can you imagine filing your taxes, utilizing the best interpretations 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 additional taxes due, you not have to pay compounded interest on top of it. Sound crazy? Well that is the situation the industry is facing with the Governor's proposal and that is why AOGA supports the current rate and believes it is reasonable, particularly considering the lengthy statute of limitations. Because the Department has a track record of taking all six years to complete audits, there could be scenarios where the interest payment is more than the actual tax bill.

<u>Slide 6</u>

Under Governor Hammond, Alaska first established an equitable policy of one-third 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 has explained, 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.

As this slide indicates, at today's prices, due to the regressive nature of the royalty system, government take exceeds 100% at these prices. SB 130 will increase government take, for legacy and new oil alike and also for gas.

Slide 7

The Governor's proposal will not add more oil to the pipeline. There is no plausible scenario where increasing taxes by $782 million dollars will result in increased production. So, let's assume the state begins to see a production decline, and for the ease of math, we just used a 10% decline. Utilizing data from the Department of Revenue, a 10% decline would result in the loss of $793 million dollars in royalties over the next five years. This demonstrates it won't matter if prices go back up to $60 or $80 or $100 per barrel if production declines. Can the state really afford to increase taxes when the long-term potential loss is so significant?

The Administration has said they believe this bill will provide certainty and predictability, I can assure you, none of my member companies sees any certainty or predictability from SB 130. In fact, the message you would be sending is that Alaska has a bit of an identity crisis.

One year, Alaska hangs out the "Open for Business" sign and says, welcome! We want you to spend money here to increase production and create jobs. Please choose Alaska, we have even created incentives to entice you to do business here. The strategy works, companies come, they invest, and the future looks bright.

Fast forward a few years, and the sign seems to change to "Caution". Why? Tell me how many companies, regardless of industry, will beat down Alaska's doors to invest when they can count on their taxes being increased at times of high commodity prices, and then again when prices are low. The policy of the state of Alaska is becoming, "I'm sorry, I know you are bleeding, but the state treasury is broke so we need more money from you anyway."

Would Alaska be considering an increase in fishing taxes if every boat leaving the harbor couldn't pay their daily bills? Or would Alaska consider increasing fuel taxes if the trucking industry was posting record losses? Or on any other industry that is losing money?

We appreciate the need to close the state's fiscal gap. But raising taxes when industry is spending more here than it is making is not a solution to that gap. Instead, it merely addresses short-term concerns at the expense of doing greater long-term harm to the state's economy in the future.

The industry is not before you today asking for a tax decrease or for relief while we struggle though these extraordinarily difficult times. We ask only that you not kick us while we're down because of low prices. You should be asking how tax policy can remain in place that encourages explorers and new entrants, and ensures current producers remain committed to Alaska?

Proceed with caution, because the fact is, an increase will lead to more Alaskans out of work, and less production and less state revenues in the future.