Alaska Oil and Gas Association

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TESTIMONY OF THE ALASKA OIL AND GAS ASSOCIATION AT THE PUBLIC HEARING ON PROPOSED REGULATIONS IMPLEMENTING CHAPTER 3, SECOND SPECIAL SESSION LAWS OF ALASKA 2017 ("HB 111")

OCTOBER 17, 2017

Good morning. My name is Kara Moriarty and I am president of the Alaska Oil and Gas Association, or "AOGA." For nearly half a century AOGA has been the trade association of the petroleum industry in Alaska, and our members actively continue to explore for, discover, develop, produce, transport, and refine oil and gas in the state. As with our comments ("Scoping Comments") submitted in response to the August 6th "Notice of Public Scoping and Workshop" on regulations to implement HB 111, all of our members have had the opportunity to review and comment on this testimony as it was being developed, and it has been approved without dissent.

Our testimony today addresses the proposed regulations for HB 111 at a broad level, and for the Department's convenience, I am submitting for the record the written text of this testimony. However, we reserve our right to submit a more detailed and technical review in written comments by November first.

The most salient feature of HB 111 is its phase-out and termination of most of Alaska's present system of tax credits, including all credits and credit certificates that can be cashed out with funds from the Oil and Gas Tax Credit Fund under AS 43.55.028.

We would like to begin our discussion on a positive note by observing that the proposed regulations appear to respond appropriately to four concerns that we raised in our Scoping

Comments. First, proposed 15 AAC 55.365(e) correctly resolves a potential technical timing problem in HB 111 and avoids a result that the legislature manifestly did not intend with respect to the ability to assign tax credits generated under AS 43.55.023(b) for calendar year 2017.

Second, our Scoping Comments expressed concern that the regulations on ring-fencing of lease expenditures incurred for a lease or property before it begins regular production might define "category" in a way that does not match the categories set out in AS 43.55.160(a)(1)(A)-(G) and (h)(1)-(4) . The proposed regulations do not seek to ring-fence such lease expenditures in this way.

Third, we were concerned in the Scoping Comments that statutory language in Sections 6, 9 and 16 of HB 111 might be construed and applied in the regulations differently from what Article IX, section 17(a) of the Alaska Constitution requires and could thereby prevent the carryback of credits against an increase in tax liability for a prior year arising from administrative proceedings or litigation that does not directly involve the production tax itself, but involves only indirect matters like transportation costs that affect the calculation of the amount the tax liability for the respective prior year. The proposed regulations — and 15 AAC 55.305(c) and (d) in particular — do not seem to construe and apply that statutory language in this way. In particular, Example 1 in subsection (d) refers specifically to "a decision of a regulatory agency that results in a retroactive change to costs of transportation that has a corresponding increase on the production tax value[.]" We see this as applying, for instance, to FERC's Opinion 544 for TAPS, and would like to confirm this on the record, if we may. So, let me ask, does the Department agree that Opinion 544 would be covered by Example 1 for taxpayers with open, unaudited tax years to which Opinion 544 (or FERC orders pursuant to Opinion 544) apply? You needn't answer right now, but if you answer after this hearing, please do so in writing so I can distribute it verbatim to AOGA members.

Fourth, in Example 2 in our Scoping Comments, we showed how a net operating loss for any given period is a function of both the amount of lease expenditures incurred in that period, and the level of oil prices for that period. In that example, there was no operating loss in the first half of the year even though the great majority of the year's lease expenditures were incurred then, because oil prices in the first half were high enough to cover those costs with a little net revenue left over; and in the second half of the year oil prices were so low that, even with lease expenditures at a much lower level than the first half, there was an operating loss in the second half that was big enough to put the entire year into a net loss position.

For 2017, proposed 15 AAC 55.525(m) seems to deal specifically with this by limiting purchases by the Tax Credit Fund for a certificate issued under AS 43.55.023(d) for an operating loss "under AS 43.55.023(b), as the provisions of that subsection read before January 1, 2018, for lease expenditures incurred in 2017." Only "one half of the amount of [the] tax certificate" may be purchased by the Fund.

We understand this to mean, as it is put into operation, that any net operating loss under AS 43.55.023(b) is determined for the full year of 2017, but only half of the tax certificate under AS 43.55.023(d) for that loss can get paid from the Fund. And the second half of the lease expenditures reflected in the certificate will not carry forward as a carried-forward annual loss into 2018 because they are already included in the certificate. If this is indeed the operational effect of 15 AAC 55.525(m), then this neatly avoids all the analytical complexities, paradoxes and inequities that our Example 2 illustrates if one were to try instead to quantify the first-half loss for 2017 purely on a stand-alone basis. Of course, if we are incorrect about how 15 AAC 55.525(m) will work in practice, then it needs to be rewritten so it is clear about how it works.

By noting these positive aspects of the proposed regulations, we are not saying they are free of errors, problems and questions.

For example, we are concerned about the last sentence in 15 AAC 55.305(c) regarding the assessment of penalties. By its terms this sentence applies only to a situation where "a producer under reports tax due on its original return in order to file an amended return and carryback tax credits [to that tax year.]" Does this mean the Department cannot assess any of the listed penalties when the underreporting was <u>not</u> made "to file an amended return and carryback tax credits [to that tax year]" even though there is another ground for assessing such a penalty? We doubt the Department intends that; but if a penalty <u>can</u> be assessed on one of those other grounds in such a situation, then we don't see what this last sentence in subsection (c) accomplishes — isn't such a purposeful underreporting in itself already "civil fraud, failure to pay, or negligence or intentional disregard"? If so, then the last sentence is unnecessary.

Alternatively, if somehow such a purposeful underreporting in order "to file an amended return and carryback tax credits" is not already "civil fraud, failure to pay, or negligence or intentional disregard" in itself, then the regulation needs to identify what the taxpayer's specific intent for the underpayment must be in order for it to fall within the scope of the last sentence in -.305(c) but outside the existing scope of the other penalties for "civil fraud, failure to pay, or negligence or intentional disregard[.]" Basic principles of equity and Due Process require that, if a taxpayer can be punished for having such an intent, it must be aware of what that intent is.

Another issue we have with 15 AAC 55.305(c) is that its first two sentences both allow the carried back credit to be applied only against "the additional amount of tax and associated interest." However, AS 43.55.023(c)(3), 43.55.023(e)(2) and 43.55.025(h) as respectively enacted in Sections 6, 9 and 16 of HB 111 all provide that the credit "may … be used to satisfy a tax, interest, penalty, fee, or other charge[.]" By excluding any "penalty, fee, or other charge[]", the proposed regulation is inconsistent with its underlying statute and, at least to that extent, would be invalid under AS 44.62.030. There is a parallel problem with 15 AAC 55.370(e).

A third concern with 15 AAC 55.305(c) is the following sentence in it, which appears near the middle of page 5 of the Proposed Regulations:

> A producer that elected to apply the tax credit in AS 43.55.024(j) in that prior year may, in its amended return reporting the additional amount of tax, withdraw the producer's application of THE tax credit in AS 43.55.024(j) in order to carryback a tax credit under AS 43.55.023 or 43.55.025 or a tax credit certificate under AS 43.55.023 or 43.55.025 for application against the additional amount of tax provided no claim for refund would result and no assessment has been issued by the department for the prior year. [emphasis added]

Our concern with the "THE" that is emphasized with capital letters in the written text of these comments is that it implies that only the entire amount of the sliding-scale credit under AS 43.55.024(j) may be "withdraw[n]" — that is, it is an all-or-nothing proposition for such a withdrawal.

AS 43.55.024(j) says categorically that a "producer may apply" these credits without limitation, except they "may not reduce [the] producer's tax liability for a calendar year under AS 43.55.011(e) below the amount calculated under AS 43.55.011(f)." This does not allow any leeway for the Department, by regulation, to limit or restrict the use of these credits any further as proposed in 15 AAC 55.305(c).

Alternatively, if any withdrawal of a credit under AS 43.55.024(j) is allowed at all, we believe only the portion of the credit that brought the tax under AS 43.55.011(e) down to the minimum tax under AS 43.55.011(f) should be withdrawn, so that — in the event the Department on audit raises the production tax value above the crossover point where the minimum tax becomes payable — any initially unused portion of that credit remains available to reduce the tax under the audit back down toward that crossover point. Otherwise the Department will be taking away part of the credit to which the producer is statutorily entitled.

Similarly, if the audit increases the gross value at the point of production so that the per-barrel amount of the credit under AS 43.55.024(j) is greater than the per-barrel amount that the taxpayer filed, this increase in the credit should also be applicable — the same as any initially unused portion of the original per-barrel amount — to reduce the tax down toward the statutory crossover point where minimum tax becomes payable.

Our final concern with 15 AAC 55.305(c) is the restriction imposed by the regulation that the carry back of any tax credit cannot result in a tax overpayment or claim for refund. AS 43.55.023(c)(3), 43.55.023(e)(2) and 43.55.025(h) as respectively enacted in Sections 6, 9 and 16 of HB 111 all provide that the credit can be carried back to "satisfy a tax, interest, penalty, fee or other charge" without limitation to whether such carried back credit results in a tax overpayment or a claim of refund for such earlier tax year. The plain language of sections 6, 9 and 16 of HB 111 does not prohibit the use of any carried back tax credits to create an overpayment or claim a tax refund. While there were some brief comments made by a single legislator on this issue during the legislative process surrounding the enactment of HB 111, the Legislature as a body choose not to include any restrictive language preventing the use of carried back tax credits to generate a tax overpayment or claim of refund in the actual bill that was passed and signed into law. By establishing such a restriction, the proposed regulation is inconsistent with its underlying statute and, at least to that extent, would be invalid under AS 44.62.030.

Moving now to the subject of conditional tax credit certificates under AS 43.55.025(q), we understand the intent and purpose for that statute are to allow the holder of such a conditional certificate to secure a place in line under AS 43.55.028 among all others who are seeking payment from the Tax Credit Fund for their respective certificates. Proposed 15 AAC 55.356(e) generally implements this purpose reasonably, but we are concerned about the provision in paragraph (1)(A) regarding denial by the Department of a conditional-certificate holder's application.

Being in line under AS 43.55.028 not only determines priority for when a holder's regular tax credit certificate is purchased by the Fund, but also the amount that the Fund pays for that certificate if payments are proportionally reduced from the certificate's face value. We believe that a dollar spent to earn a conditional tax credit certificate is just as worthy of being paid by the Fund as a dollar spent to earn a regular tax credit certificate, and accordingly we ask the Department to let the face amount of a conditional tax credit certificate reserve the same opportunity for payment by the Fund as the face amount of a regular certificate — after all, the supporting data for the underlying conditional tax credit will have been duly submitted to the Department of Natural Resources at least six months earlier (except for a credit under AS 43.55.025(k)), so its face value should be comparably reliable as that for a regular tax credit certificate.

We propose that the Department change proposed 15 AAC 55.365(e) so that, for purposes of priority in receiving payment from the Fund and for any pro rata discount reflected in that payment, the face amount of a conditional tax credit certificate is counted the same as the face amount for a regular tax credit certificate. If the Department denies the application for the conditional tax credit certificate, the holder of that conditional certificate should be able to "back-fill" that certificate's face amount with the face amount of other certificates it is holding. Only if the holder has nothing to back-fill with would the Department's denial of the conditional certificate's application affect the amount to be paid by the Fund to that holder.

Finally, before closing, let me state that no statement or omission in this testimony is intended to, nor may be construed to, express or imply any endorsement of or acquiescence in Advisory Bulletin 2016-01 dated December 21, 2016 or Advisory Bulletin 2017-01 dated March 31, 2017.

Thank you on behalf of AOGA and its members for the opportunity to testify today, and for your attention and consideration of what we have said.