APRIL 2021

ISSUE BRIEF: REFUNDABLE TAX CREDITS

ALASKA OIL & GAS ASSOCIATION

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Background

HOW IT STARTED & RECENT APPROPRIATIONS

Since 2003, the Alaska State Legislature established various oil and gas tax credits to incentivize new exploration, development and production, encourage small producers (less than 50,000 barrels/day of taxable production) to enter the Alaska market, and incentivize investment in gas storage facilities and refineries. In 2007, the Oil and Gas Tax Credit Fund (AS 43.55.028) was also established to facilitate payment for refundable tax credits, which included a minimum payment formula for refundable ("cashable") credits tied directly to production tax revenue (i.e. "statutory minimum payment").

From FY08-FY15, the State of Alaska paid all tax credits in full as purchase requests were submitted by credit holders. However, facing a significant drop in oil price in late 2014 and resulting fiscal challenges, the State was no longer able to pay all pending tax credits:

- FY16: veto set total appropriation at $500 million
- FY17-19: at or near the statutory minimum payment
- FY20-21: no payments in anticipation of Alaska Supreme Court decision on passage of HB331

As the credit program was no longer feasible given the State's new fiscal position, all investment-based production tax credits for Cook Inlet and the North Slope were completely phased out with the passage of HB247 in 2016 and HB111 in 2017. The gas storage facility and refinery credits have also sunset. This means the State no longer offers refundable oil and gas tax credits.

Current Status

OUTSTANDING BALANCE & FY22 BUDGET FORECAST

Despite the end of the refundable tax credit program, a significant balance of owed credits remains on the State of Alaska's books. In 2018, the Legislature passed HB331, a Walker Administration "subject-to-appropriation" bond program as a solution to pay down this outstanding debt. However, this program was found unconstitutional by the Alaska Supreme Court in September 2020.

As of the Department of Revenue's Spring 2021 Forecast, it is estimated $744 million in outstanding credit certificates are still pending state purchase. The statutory minimum payment for FY22 is forecasted at $114 million.

Purpose

ORIGINAL PURPOSE & POSITIVE IMPACT

While in the long-term, the refundable tax credit program did not prove sustainable for the State of Alaska, the original purpose and impact proved successful. To date, oil and gas credits have:

Helped heat Alaskan homes:

- Incentivized take-over of aging Cook Inlet assets, extending field life
- Brought new companies into Alaska to explore for natural gas
- Incentivized gas storage in Cook Inlet to meet seasonal demand in Southcentral Alaska, resulting in Cook Inlet Gas Storage Alaska (CINGSA) gas storage facility
- Southcentral gas supply shortage essentially solved; threat of brown-outs gone
- Enhanced economics of LNG tank storage in Interior, increasing security of winter gas supply
- Protected energy security of tens of thousands of Alaskans

Led to new production and created potential for more production:

- New fields with new oil and natural gas resources: Pikka, Nuna, Cosmopolitan, etc.
- Enhanced economic stimulus for all Alaskans - more exploration and production resulting in new jobs, new royalties, and new revenues for essential state services

Sources: Department of Revenue Spring 2021 Revenue Sources Book, March 15, 2021;
Department of Revenue HB331 Presentation to House Resources Committee, March 30, 2018

Entities Impacted

IN-STATE REFINERIES, SMALL PRODUCERS, AND MORE

While there are other entities around the state that also hold these credit certificates, such as the Interior Gas Utility (IGU), half of AOGA's membership is impacted by this outstanding balance. These include in-state refineries and small producers in Alaska with less than 50,000 barrels/day of taxable production:

- ASRC/Petro Star Inc.
- BlueCrest Energy
- Eni
- Furie Operating Alaska, LLC
- Glacier Oil & Gas Corp.
- Repsol

FY22: Why It Matters Now

NOW MORE THAN EVER, FUTURE INVESTMENT DEPENDS ON STATE ACTION

Whether or not you agree with the tax credit program is not the question for today. The most critical issue now is whether the State of Alaska should follow through on its prior commitments, and the impact of not doing so.

The tax credit program was successful in bringing in billions of investment dollars to Alaska. Much of the new production we are seeing today, along with the huge new projects now under development, are an important result of those investments. However, that is not the end of the story.

The State's future is dependent on its actions today. Alaska has immense undeveloped – and undiscovered – natural resources. Tremendous investments are required up-front before those resources can contribute to the economy. Alaska must compete with other places around the world for investment dollars, and the State's reputation is critical to attracting investment. Payment for the pending cashable credits is a key consideration for companies evaluating their current and future investments in the State compared with other investment opportunities.

Even strictly Alaska-focused companies rely on owners/investors from all over the world. Statewide, hundreds of millions of barrels of oil, along with trillions of cubic feet of gas, sit in the ground waiting to be developed by many of the very same companies influenced to invest here by the State's tax

credit programs. Our Alaskan refiners, who made critical investments based on the promise of tax credits, are the ones who will continue to perform the vital process of converting those crude resources into the products used every day by Alaska's residents. The development of these resources will undoubtedly benefit Alaskans, both as a source of heat for their homes, as well as government revenue that supports essential quality of life services.

However, before these benefits can be realized, companies must first convince their management and investors to divert hundreds of millions of their dollars to Alaska-based projects, instead of investing somewhere else. Over the past two years, many have chosen to invest elsewhere.

In total, billions of dollars were invested in Alaska by several different companies, a much greater amount than the tax credits earned. This investment was based on a promise that the State would reimburse a portion of those investments through the payment of credits in full every year, despite the annual minimum payment statute. Today, the State has begun to receive the benefits of these programs, yet this promise remains unfulfilled.

In Conclusion

Now more than ever, with the State two full years behind on even the minimum statutory payments, it is increasingly important to send a message to investors, producing companies, explorers, refineries, and financial institutions that Alaska is a trusted partner and an attractive place to do business.

AOGA recognizes the serious budget challenges the State of Alaska is facing; thus, we are not advocating a full immediate payout of the credits at this time. However, we do support the State funding the minimum statutory payment of $114 million in the FY22 operating budget, as supported by the Spring 2021 Forecast.

Frequently Asked Questions

Isn't non-payment on these tax credits really only impacting banks and other financial institutions that would get the payments for the certificates?

No. First, not all tax credit certificates are assigned to financial institutions. A very substantial portion of the outstanding tax credit certificates are held directly by oil and gas companies that are still doing business in Alaska and that are currently considering whether and how much to invest in the state going forward.

Second, those tax credits that are assigned to financial institutions still have a company client who invested significantly enough in Alaska to earn them. Alaska benefitted from these investments and the companies relied on the promise of payment when entering into these financing arrangements.

Third, it's important to remember the money invested in these credits by financial institutions is not actually the financial institutions' money – it is from public employee retirement pensions, private employee retirement pensions, and union pensions, as well as other public and private funds – all of which believed Alaska a good, sound place to invest their earnings and a partner that would fulfill its obligation.

As major financial institutions like Wells Fargo, JPMorgan, Goldman Sachs, and Bank of America are refusing to invest in Alaska, it's more important than ever that the State keeps its word, fulfilling its commitment with those mid-sized financial institutions and investment firms that have invested, and continue to want to invest, in Alaska.

Our state has multiple pending development projects that will need significant financing to move forward. These and other financial institutions stand ready to continue investing in Alaska at a time of great potential. Alaska needs to honor its commitments.

The refundable oil and gas production tax credits were only available to companies with less than 50,000 barrels/day of taxable production, but there were other types of refundable tax credits too. What are some examples?

<u>Gas Storage Facility Tax Credit (AS 43.20.046) & Liquified Natural Gas Storage Facility Credit (AS 43.20.047)</u>

These tax credits were established for owners of gas storage facilities to incentivize the start of commercial operations, with credits based on cost and on the amount of cubic feet of gas storage capacity. This led to the gas storage facility established by Cook Inlet Natural Gas Storage Alaska (CINGSA) to meet winter demand in Southcentral Alaska. Here's another example:

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The Interior Gas Utility (IGU) was established in November 2012 with the goal of bringing economic and environmental well-being to the residents of the Interior. From 2017-2019, the construction of a 5.25-million gallon LNG storage tank in South Fairbanks was initiated to provide an increased level of seasonal supply by storing LNG produced in the summer for use in the winter. This storage facility has allowed IGU to increase its security of gas supply from approximately five days to a 30-day peak usage supply, and has enabled IGU's existing LNG storage tanks to be re-deployed to supply its distribution system in North Pole.

The Department of Revenue has accepted IGU's application for $15 million of LNG storage facility tax credits that form an important component of the economics of the tank. These credits are vital in helping reduce the cost of providing natural gas to Interior residents, which in turn will substantially improve air quality in the region.

As of this writing IGU awaits a Legislative appropriation to fund the credits.

<u>In-State Oil Refinery Tax Credit (AS 43.20.053)</u>
Today, Alaska has three in-state refineries (North Pole, Valdez, Nikiski) manufacturing heating oil, jet fuel, diesel, gasoline, propane, asphalt, turbine fuel, and heavy oils, much of which is used by Alaskans right here at home.

However, this was not always a given. In 2014, Flint Hills announced they were closing their refinery in North Pole, underscoring the challenging economic climate faced by the refining industry in Alaska. This generated discussion across the state on how best to preserve surviving Alaska refiners. The in-state refinery tax credit, established strictly for qualified infrastructure investments made from 2015-2019, was to allow for reinvestment in facilities to ensure the health of the refinery industry remained strong.

For example, in 2016, Petro Star (subsidiary of ASRC) commissioned a new asphalt production unit, a significant investment. In addition to generating local jobs, the asphalt unit addressed an immediate need created by Flint Hills' closure for a local source of asphalt oil in the Interior. By offering local supply, Petro Star enabled the State of Alaska, the largest consumer of asphalt oil, to avoid high transportation and additional handling costs associated with trucking asphalt into Interior and Central regions of Alaska. In 2017 alone, Petro Star estimates this generated a savings of $2.4 million in total to consumers of asphalt oil, a significant portion of which was passed on to the State through companies providing contract paving services.

In yet another example, the Flint Hills' closure put Golden Valley Electric Association (GVEA) in a challenging position, facing a $21 million increase in fuel costs. In cooperation with GVEA and as a result of the refinery tax credit, Petro Star was able to retool its operations and construct a new

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naphtha splitter dedicated to producing a lower-cost/lower-sulfur turbine fuel for GVEA's LM6000 gas turbine generator. In 2017 alone, GVEA projected a 30% fuel cost savings for ratepayers, equivalent to $8 million. This savings is on top of avoiding the added expense of having to import ultra-low sulfur diesel, a direct result of Petro Star stepping in to replace Flint Hills as GVEA's local fuel supplier in 2014. This long-term agreement between Petro Star and GVEA not only represents significant savings to GVEA's members, but also provides for the use of LNG by GVEA in the summer months when it becomes available in the Interior.

Without the incentive for capital projects, these investments may not have received ASRC Board approval, leaving the Interior to face higher costs for its paving projects and significantly higher electrical rates.

The refundable tax credit program has come and gone. Explorers and producers that participated have already invested their money in Alaska projects, and prospects have already been discovered and/or developed. Does the State really benefit if the tax credits get paid now vs. later?

In the past, oil and gas explorers and producers have invested the proceeds of refundable tax credits back into Alaska projects. Payment of outstanding tax credits will at the very least encourage, if not directly fund, further exploration, development and production of oil and gas in the state. In other words, this payment not only fulfills a commitment by the State, but leads to investment back into Alaska. The result? More Alaska jobs, more oil and gas production, and more revenues to the State.

Additionally, although the refundable tax credits led to some very significant discoveries, there are still prospects that have yet to be developed. Some of these are held by companies that earned refundable credits that remain unpaid. Exploration and development are sequential: just because a prospect is discovered, does not mean it will be developed. Whether these earned tax credits are paid by the State is a very important factor for explorers and producers contemplating whether to invest in the development of Alaska prospects. Turning a promising exploration result into a producing development is an expensive undertaking, and payment for the refundable credits can help that happen.

Companies holding outstanding tax credits—many of which are still doing business in Alaska—invested in reliance on the tax credit program. Failure to pay for credits for so long has put many companies under financial stress and the result may be lost jobs for Alaskans. Appropriating at least the statutory minimum payment for this obligation, if not more, will send a clear and positive message to these companies and others contemplating investing here that Alaska is genuinely open for business. Not paying for the credits says just the opposite.