AOGA Position Paper: Governor Walker's Oil and Gas Tax Policy Proposal (SB 130 & HB 247)

Governor Walker is proposing dramatic changes to the tax system. His proposed policy will have a negative impact on each AOGA member, regardless of the size of the company. Companies are already cutting back at these low prices and this proposed legislation will chill future investments, causing a compounded impact to the state's economy, impairing future production taxes and royalties.

While it is tempting to simply raise oil taxes when the state is faced with severe budget shortfalls, now is not the right time to increase taxes. In fact, it would be imprudent to ignore the broader collateral damage of such a strategy.

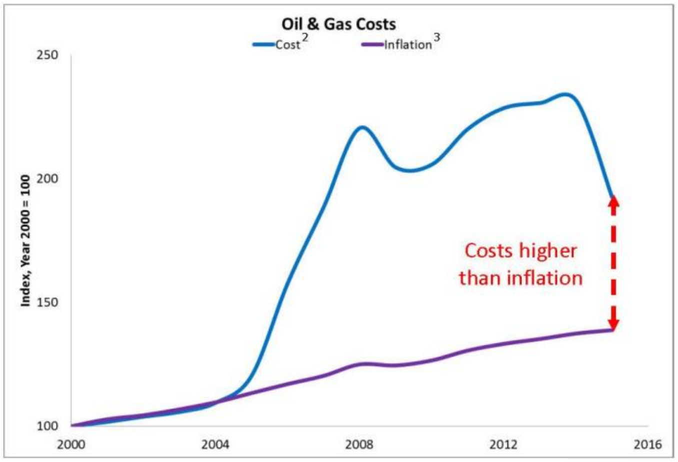
Raising taxes and repealing anchor tax credits when many companies are reporting record losses will deter short and long-term investment behavior and choke off vital future production, a result that far outweighs any theoretical benefits of the Governor's proposed approach.

In his effort to address its fiscal gap, we urge Governor Walker and state policy makers to stay the course and permit the tax system to work as it was intended.

Unprecedented Low Oil Prices

It is impossible to discuss the impacts of Governor Walker's proposed changes to the state's production tax policy without first discussing the unprecedented drop in oil prices. Prices today are not only the lowest we've seen in a decade, but when adjusted for inflation, they are the lowest since the mid-1980's.

In less than two years, we have experienced a 70% drop in oil price. This obviously impacts the State of Alaska's revenues, 90% of which traditionally comes from oil, but also the industry, which receives 100% of its revenue based on the commodity price.



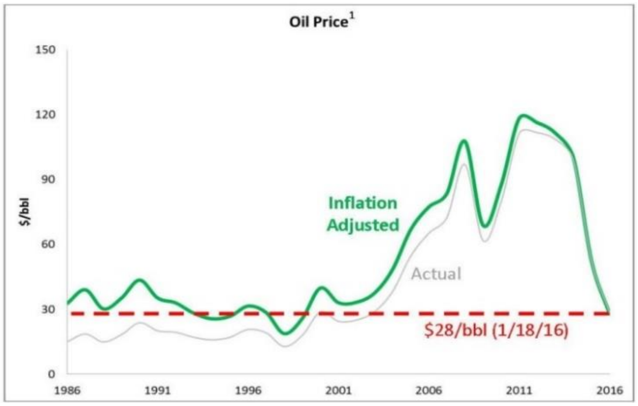
Source: Price: Brent Crude (EIA)

Several companies, both large and small, have posted significant losses for the fourth quarter of 2015. This trend is likely to continue given that oil prices are trending even lower for the first quarter of 2016.

High Cost Environment

Every industry operating in Alaska knows the state is an expensive place to do business. This is especially true for the oil and gas industry.

The following chart demonstrates that while oil and gas development costs grew 90% since 2000, inflation grew only 40% during the same period, meaning that costs have surged more than two times the rate of inflation. Companies are making difficult choices and cutting costs to be more efficient while safely and reliably producing oil and gas. The reality is they are spending less-- which means projects are being delayed and deferred, and, most painfully, Alaska jobs are being lost.



Source: Cost: Upstream Capital Cost Index (IHS/CERA)

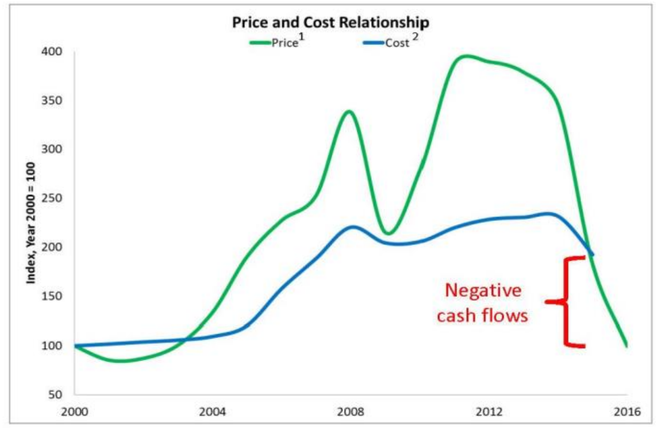
Negative Cash Flow

The high cost environment in Alaska is even more difficult during times of low oil prices. According to the Alaska Department of Revenue Fall Sources Book, the estimated average cost of producing a barrel of oil on the North Slope before tax is approximately $52 per barrel. Companies have to incur that cost before they pay any production tax, corporate income tax or property tax. The $52 per barrel cost before tax includes marine transportation, pipeline tariffs, operating expenses, capital expenditures, and royalties.

Avg. Jan. 2016 ANS Price		$30.28
Downstream Costs		
ANS Marine Transportation	($3.28)	
TAPS Tariff	($6.41)	
Other	($0.87)	
Total Transportation Costs		($10.56)
Royalty		($5.63)
Lease Expenditures		
Operating Expenditures	($18.48)	
Capital Expenditures	($17.68)	
Total Lease Expenditures		($36.14)
ESTIMATED FY16 COSTS OF PRODUCTION BEFORE TAXES		($52.33)

Source: DOR, Fall 2015 RSB

This graph shows the relationship between low price and high cost. In this price environment, companies are cash flow negative.



Source: Inflation: Consumer Price Index (U.S. Dept. of Labor)

Proposal Creates Instability

Governor Walker's tax policy proposal represents the sixth major tax change in the last 11 years[1]. Raising taxes when prices go up, and then raising them again when prices go down, is short-sighted and punitive, makes investors nervous, fails to provide any certainty or stability for industry or the State of Alaska, and is not sound tax policy.

The first theme of the Governor's tax proposal is to reduce the state's annual cash outlay. The state should be wary of implementing dramatic changes to the production tax system with the sole objective of reducing the state's current deficit.

The question becomes how long the oil and gas industry can sustain these prices without making more cuts to survive.

Just like the State of Alaska's budget reductions will impact employment, cutbacks by the industry will affect the number of Alaskans working, the amount of cash that circulates through the state economy, and ultimately, the future health and growth of the industry in Alaska via oil throughput in the Trans Alaska Pipeline, Alaska's economic artery.

It is a well-established fact that the oil and gas industry provides the largest economic multiplier of

[1] Tax changes: 2005-ELF aggregation, 2006-PPT, 2007-ACES, 2010-Cook Inlet Recovery Act, 2013-SB21, 2016-Gov Walker proposal

any industry operating in Alaska. According to the McDowell Group, it is estimated that one job in the oil and gas industry creates twenty additional jobs throughout Alaska's economy. Therefore, when the state invests in its oil and gas industry by incentivizing new projects, it is, by extension, investing in its economy and its people today and tomorrow.

The current tax credit structure fosters economic activity across Alaska, as seen through increased industry investment statewide the past few years. It is indisputable that these policies have generated a direct benefit to the economy as a whole, and should not be viewed as just an arbitrary cost to the state.

Tax Policy Evaluation

Before enacting any changes to the state's tax policy, the proposed changes should be tested against the following criteria:

- *What effect will the policy have on the overall oil and gas **production** in the state?*
- *Will the policy make Alaska more **competitive** on a global scale or less?*
- *Will the policy provide **stability** to the industry and the State of Alaska?*
- *Will the policy provide **predictability** to companies looking to make huge investment decisions?*

AOGA believes the Governor's proposed tax changes fail to address these questions in a positive manner.

Components of Governor's Tax Policy

- *Increases minimum tax by at least 25%*
- *Net Operating Loss tax credits lose value*
- *Set limits on credits- discouraging smaller company investments*
- *Cook Inlet credits eliminated*
- *Interest rates increase significantly*
- *Confidentiality provisions waived*
- *Disguised increase through the change of the application of Gross Value at the Point of Production*

Increases Minimum Tax by at least 25%

The governor's proposal would increase the minimum gross tax from 4% to 5%. While a one percentage point increase might not sound significant, it would represent a 25% increase for those companies who already pay the 4% minimum tax.

Additionally, the Governor's proposal would disallow companies from using any earned or available tax credits to reduce the minimum tax below the new 5% floor. For those companies, large and small, that may have "new oil" tax credits or exploration, drilling or tax loss credits from prior year investments and may be in a loss situation due to the low prices and thus are depending on using those tax credits to support continued investment in the state, the proposal would delay or possibly deny that economic recovery at the very time when the companies need it the most.

In other words, raising the minimum tax affects everyone, and the proposed increase is large enough to cause significant negative impacts on all producers at today's oil prices. It is poor tax policy to engage in nothing more than a flagrant money grab at a time when the state should be encouraging industry to continue making vital investments in the state.

For smaller companies or newcomers to the state who have yet to make a profit in Alaska, they don't pay the 4% minimum tax now, so 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 tax, a punitive tax increase.

Additionally, the proposal would change the way the minimum tax is determined. It would prevent gross revenue reductions, which are incentives critical to encourage "new oil," from being utilized to determine the gross value at the point of production, meaning the economic value and attractiveness of those incentives in current law are dramatically reduced. This adds new cost to potential investments and represents still another tax increase.

Another problematic provision of the governor's proposal is the prevention of a producer's excess tax credits available in one month from being used against the producer's total production taxes for the year. This is nothing more than a disguised tax increase.

The production tax is an annual tax paid in monthly installments, similar in concept to an individual making quarterly estimated income tax payments for his or her personal federal income tax. At the end of the calendar year the producer is required to file a "true-up" or "final tax installment" to allow the correct amount of production tax to be paid based on the producer's entire calendar year of operations. By preventing a company from being able to utilize all of its available tax credits the Governor's proposal would in essence convert the yearly production tax into more of a monthly tax – requiring a producer to file perfect monthly installments or run the risk of losing valuable tax credits.

This change would create unpredictability for companies in estimating its tax burden. Such uncertainty will make it extremely difficult (if not impossible) to accurately analyze the economics of any potential investment opportunity. Perhaps the most somber aspect of this significant tax increase from the State's perspective is that companies are unlikely to have any desire to make investments in moving forward.

Net Operating Loss (NOL) Tax Credits Lose Value

As already stated, the Governor's proposal would prevent the usage of net operating loss, or NOL, tax credits from reducing 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. This coupled with an increase to the minimum tax floor itself, will represent a significant increase to the amount of taxes paid by companies that are already struggling.

According to legislative consultants and independent economists, net operating loss tax credits help level the playing field for new companies trying to get a foothold in Alaska and allow all companies making critical investments to truly understand the economics under which those investments were made. Companies that made important investments in the prior year, even when they were spending more than they were making, would now be prevented from recovering part of that investment.

Net operating loss tax credits are utilized both on the North Slope and Cook Inlet. While the Administration claims to understand the value of net operating loss tax credits for large and small companies, they have essentially eliminated their value in its proposal. Without question, changing their value will have a tremendous impact on companies and their future investment decisions.

Set Limits on Credits – Discouraging Smaller Company Investments

Eliminating or discouraging cash rebates for companies who may not have production or profits disadvantages new companies, especially if they have invested in good faith based on the state's tax policy in existence when the investments were made.

For an incentive to have true value, the incentive must be based on the economics of the project as opposed to the company's profitability.

Setting an arbitrary limit per producer ($25 million) as the Governor's proposal would do is unreasonable and will not be an incentive for investment. Different producers have different needs and uses for credits, and the size of projects vary tremendously. Similar limits were established when several credits were added to Alaska's tax system in 2002-2003. Companies did not find value in the credits, so they were not utilized and many of them were eliminated or changed as the state's tax policy evolved.

Limiting tax credits on the basis of a company's Alaska-hire percentage would further challenge new investment here. It would also raise significant constitutional issues, and Alaska-hire preference in building the Trans Alaska Pipeline System was struck down by the U.S. Supreme Court.

Bottom line, the proposed changes to tax credits will create a massive cold front on an already chilled investment climate across Alaska.

Cook Inlet Credits Eliminated

For the Cook Inlet and Middle Earth, there are two important credits that the governor's proposal would eliminate: the 20% capital expenditure tax credit, and a 40% well lease expenditure credit.

The Cook Inlet drilling tax credits were unequivocally the driver for several key investments in the region that led to increased oil and gas production and jobs. The state has seen an increase in royalty revenue, as have mineral owners, including Alaska Native corporations, who share revenues throughout the state. Additionally, the Kenai Peninsula Borough has benefited from increased revenue from property taxes. While it has been asserted that these credits are going to profitable companies, there are other companies that have made a major capital investment, but have not yet started production or become profitable, and may now choose not to invest in further oil and gas projects if tax credits are changed.

It was asserted that Cook Inlet has gas in search of a market. We disagree. Southcentral utilities have stated that the credits have spurred investment and new gas, which has made gas contracts more competitive, resulting in rate reductions for their customers. Utilities may have current gas contracts in hand, with a supply of gas secured for the next few years, but additional investments are necessary to meet further demand for this growing region as early as 2018. The Interior region may also need gas from Cook Inlet as well. Eliminating these credits puts that investment at risk. Without continued investment, gas production will quickly decline. Such decline could cause higher utility rates for consumers and increase the risk of gas shortages.

Interest Rates Increase Significantly

The governor's proposal would also increase the interest rate for tax over and under payments from the current rate of three percentage points above the federal discount rate to seven percentage points above the federal discount rate. The proposal would also reinstate compound interest.

AOGA supports the current rate and believes it is a reasonable rate, particularly considering the lengthy statute of limitations that provides the Department of Revenue with six years to audit a company's production tax return.

Returning to compound interest could be an incentive for the State to manipulate the completion of audits to allow for more interest to accrue. This is yet another example of increasing unpredictability in Alaska's tax system.

Confidentiality Provisions Waived

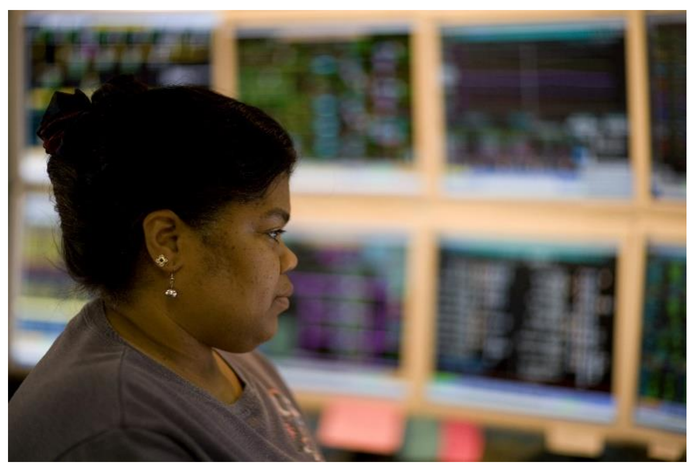
The Governor's bill would provide for public disclosure of a taxpayer's specific information that it provides to document the amount of a tax credit under AS 43.55. This information is currently confidential, and to protect that confidentiality, the law (AS 43.55.890(11)) allows the Department of Revenue (DOR) to disclose information about tax credits only on an "aggregated" basis for a group of three or more taxpayers. The impetus for the proposal arises from credits that are being earned by only one or two taxpayers — too few for disclosure on an aggregated basis.

From a policy perspective, there is a conflict between increasing the competition among taxpayers by making them guess about the particulars of their competitors' businesses, versus having greater public access and oversight of what taxpayers are doing to earn the tax credits they get. One can see merit to both views.

From a legal perspective, however, it is clear that confidentiality must prevail.

Confidentiality of tax information is the mechanism by which taxpayers' constitutional privileges and immunities regarding private, proprietary and commercially sensitive information and materials are reconciled with DOR's goal of having taxpayers report and pay their taxes correctly, and with its need to audit them to ensure they are correct. Without confidentiality, DOR's authority to require information and documents from taxpayers would be materially curtailed by these constitutional constraints.

For taxpayers, however, confidentiality is basically an all-or-nothing proposition — the constitution does not prohibit partial waivers of a privilege or immunity that are limited only to specific information or materials, but it does not authorize partial waivers either. Thus a taxpayer cannot agree to the disclosure of specified information or materials for a tax without the risk that doing so will waive the privilege or immunity for all of its tax information for that tax.



Two examples can illustrate the potential consequences of taking this risk. First, the federal Securities and Exchange Commission (SEC) has strict rules about making public statements that are forward-looking in nature. Internal forecasts and projections are forward-looking by definition, but they can be shared with DOR when relevant to a tax matter because tax confidentiality ensures they will not become public. Second, details of particular sales, trades or other transactions between a producer's business and a third-party may be proprietary or commercially sensitive relative to the producer's competition, and confidentiality allows them to be disclosed to DOR without fear of re-disclosure to that competition.

If an attempted partial waiver can result in confidentiality being completely waived for a given tax, companies could face risks that the SEC, antitrust regulators or other law enforcement agencies might regard DOR as a mere vehicle[2] for companies to make disclosures indirectly that are illegal for them to make directly, with potentially serious implications for anyone attempting to make a partial waiver.

Disguised Tax Increase through Change to the Application of the Gross Value at the Point of Production

The Governor's proposal would also create further uncertainty as to how a producer evaluates potential investment opportunities or calculates its production tax return.

Currently if a producer's marine transportation costs or pipeline tariffs cause the gross value at the point of production to fall below zero, the economics of the investment are not adversely affected as the excess costs are recoverable against the gross value from the producer's overall production when the producer files its production tax return.

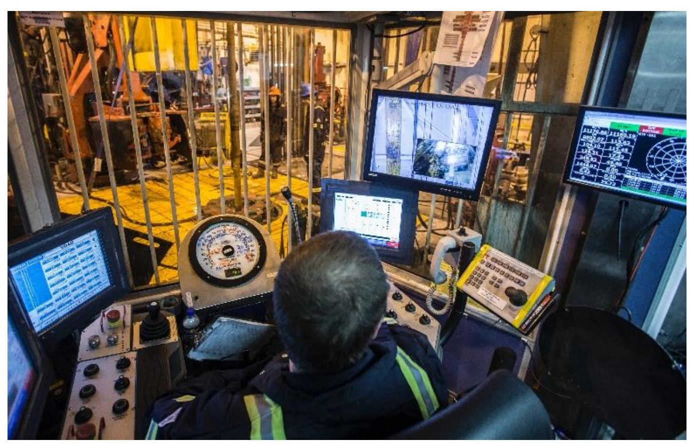
The governor's proposal would prevent the gross value at the point of production from falling below zero but fails to offer any explanation or clarification as to the utilization of the excess marine transportation or pipeline tariff costs that gave rise to the negative gross value at the point of production.

If the Governor intends to limit the determination and application of the gross value at the point of production to a field-by-field or unit-by-unit basis, then he is changing the consolidated way a producer's investments are evaluated and a producer's production tax return is filed.

If the governor intends to apply this provision on a "non-consolidated" or "non-segment" basis resulting in such costs to now be lost, then that change would represent yet another disguised tax increase to producers, further jeopardizing future critical industry investments and severely changing the underlying economics of investments made in prior years to produce more oil and gas.

Do No Harm

AOGA does not support the governor's oil and gas tax policy proposal. Raising taxes on companies that are reporting record losses and are in negative cash flow positions is neither a prudent nor feasible long-term solution, and is certainly not sound tax policy. While we appreciate the need to close the state's fiscal gap, AOGA would advise against taking even more from the oil and gas industry when it is more important for the state to encourage these companies to continue to make critical investments in our collective future. To cripple the oil industry is a misguided attempt to address short-term concerns and will create greater long-term hardships to the state's economy.



Compounding the negative impact of the highly burdensome changes in Governor Walker's latest oil and gas tax policy proposal is the provision that all

[2] Without tax confidentiality Alaska's freedom of information act (AS 40.25) might be interpreted and applied so as to require DOR to disclose commercially sensitive or forward-looking tax information upon request by anyone in the public.

but one of these changes would become effective on July 1, 2016, while one is retroactive to January 1, 2016. It is now February, and companies' operational plans for the full calendar year have already begun to be implemented. Contracts for the entire year have already been entered into, work has commenced, and financial commitments have been made by the companies – all based on the existing tax structure. Any sudden reduction in the tax credits and/or increase in the taxes on such short notice would therefore be, in effect, a retroactive tax change. This would result in a long-term serious impact to Alaska's oil and industry, as well as having an intensely negative impact on the state's reputation throughout the global banking and financial community.

Whether or not the Governor's proposal is enacted, the oil and gas industry will still be the largest annual contributor to state government by far.

The oil and gas industry will contribute 7.5 times more than the Governor's proposed income tax, 50 times more than the proposed revenue from mining, and 37 times more than from commercial fishing.

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When will it be time for the state to realize that enough is enough? Increasing taxes on the industry that is the largest contributor to state government, especially when that industry is suffering major losses could have long-term repercussions to the state's overall economy. Forcing the industry to reduce investments through excessive tax increases in today's economic downturn will lead to reduced industry jobs and which will likely lead to reduced oil and gas production which will lead to reduced revenues next year and only serve to exacerbate the revenue crisis the state currently faces. This is not a sound tax policy. This is not in the State's best interest.

In the spirit of "Let's pull together", and in order to make it through the current economic downturn, we cannot emphasize enough that imposing significant tax increases and eliminating access to critical incentives does nothing to increase production. It creates more harm to Alaska's largest industry and the state's economy as a whole.

AOGA is not asking for a decrease in taxes during this period of low oil prices like many other states and countries are considering, but we are asking that, as the state considers changes to tax policy, to not harm an industry that is already in peril.

OIL & GAS: FUELING ALASKA'S ECONOMY

AOGA Alaska Oil and Gas Association

The Alaska Oil and Gas Association (AOGA) is professional trade association whose mission is to foster the long-term viability of the oil and gas industry for the benefit of all Alaskans.