SB 21, Why It's a Pathway to Poverty & Guarantees Perennial Deficits

Rep. Les Gara, March 5, 2014

The actual provisions of SB 21 are not well known yet are among the most damaging provisions to Alaska, and its ability to fund schools, and services needed to provide opportunity, needed energy projects, and dignity to those born without privilege. Apart from the major flaw - that it doesn't provide any assurance that Alaska will get anything for the low tax rate and billions in revenue it gives away - the sound bites diverge greatly from what the bill actually does.

SB 21 guarantees deficits and continued pressure to cut school and social service funding because there is no windfall profits share that will ever allow the state to receive any significant revenue in months of high prices.

It guarantees increasing deficits because of a little know, even lower, so-called "new oil" tax rate. Increasing amounts of oil under SB 21 will be taxed at one of the lowest rates in the world, below 20%. No realistic amount of new production can make up for a tax rate that low.

Also provided is the state's own admission that SB 21 raises less money than ACES did at low prices from $90 to $110 per barrel – an analysis by administration officials and paid experts provided consistently for three months between January and April 2013 that it has conveniently changed by billions of dollars as we near the August referendum.

A fair tax, that allows us to periodically hit surpluses until oil production declines flatten out, requires a reasonable windfall profits share so Alaskans can prosper when oil companies are making record and near record profits. And it requires smart incentives that require companies to invest in Alaska production to earn reasonable tax breaks.

1. The Hidden "New Oil" Tax Rate: Logic-twisting, and Forces the State to Run on a 17% Tax on Profits – *One of the Lowest Rates In The World.*

Alaska cannot afford to fund schools, roads and basic services at a 15 to 19% tax rate on profits. That's one of the lowest in the world, and over time most oil in Alaska will fall under the definition of "new oil." It replaces an effective ACES rate of roughly 37% of profits. Cutting that in half, combined with the projection of continuing oil declines at the same rate as projected under ACES (actually a little greater decline), guarantees poverty over prosperity.

The so-called "New Oil" rate, at today's prices ($105 per barrel) is a 17% rate on corporate profits. As time passes, most and then all oil will qualify as "new oil". A 17% tax on profits is one of the lowest rates in the developed world. This provision appeared in the last committee before the bill passed, House Finance. It received essentially no debate. That's how the Legislature passes the worst provisions – in the last committee, with no real debate or analysis.

SB 21 defines and taxes "new oil" both thoughtlessly and by twisting logic.

"New oil" is defined through twisted logic. It include oil that was moved forward under ACES, committed to under ACES, in fields that began producing <u>two years before SB 21 passed</u> - in 2011. It is illogical to give this extra "incentive" to oil that was already committed to, and in some cases, already producing, before SB 21 passed. New Oil by any logical definition means new fields, or in a truly new area in a legacy or other existing field, though in fairness oil in existing fields would likely be produced by the company that sunk the initial investment into those fields.

So a new area in Prudhoe or Kuparuk, which we know companies would produce rather than leave in the ground, or in Point Thompson which Exxon was ordered to move ahead to produce three years ago, will get this low "new oil" rate. Mustang, and the southwest corner of Kuparuk, committed to before SB 21, will get the unsustainably low "new oil" tax rate. Companies will pressure the Parnell Administration to give much "new oil" in Prudhoe and Kuparuk the new low rate. Repsol, which announced it was investing $750 million in Alaska three years ago because we were a good place to do business, with good prospects, will get that tax break for work they already committed to (though they have since changed their story, saying they really like SB 21 - surprise)

Attachment 1, produced by Parnell consultant EconOne in 2013, shows the new oil rate for fields with a 12.5% royalty, and fields with a 16.67% royalty. The latter get charged a higher royalty by the Department of Natural Resources because they are deemed especially economic and productive. Yet the new oil rate is inexplicably lower for those fields, and that lower rate was never explained in committee.

Chart 1 over-estimates the tax on the 12.5% AND 16.67% "new oil" fields, and the Legacy fields because it is based on the "Wellhead Value" of oil (wellhead is the oil price minus the deduction of transportation costs, which average roughly $10/bbl). SB 21 is based on the "Point of Production" value, which is roughly $10 higher than the wellhead value.

Outside of the new oil provision, under SB 21 the tax on Legacy Oil reaches a high of 35% at $150 at the point of production, or $160 in wellhead value.

Attachment 2 shows the proper calculation – what the tax rate would be if the chart properly used SB 21's "point of production definition", as the point of production price is $10 higher than the wellhead price shown on the chart, and as such slightly overestimates the tax rate under SB 21. Basically, Attachment 1 is $10 off, and the tax rate it shows, for example, at $110 per barrel, is really the tax rate we get when oil reaches $120 per barrel.

Attachment 2 fixes this EconOne "Mistake". As you can see, at today's prices new 12.5% royalty oil is taxed at 16% of profits. Legacy Oil at places like Prudhoe is taxed at 26%, rather than the roughly 35% rate under ACES. At high prices of $120 per barrel, "new oil" is taxed at an unsustainably low 19% of profits. Legacy oil is taxed at 28%.

We will never get out of deficit spending and continuous budget cuts, and our course of underfunded schools, at 17% to 19% rates. The big promise of SB 21 - "New Oil" - condemns Alaska to poverty.

Even "legacy oil" under SB 21 makes very little sense. SB 21 billed a 35% profits tax. But it is really a 27% profits tax at $110 per barrel, and doesn't reach the promised 35% tax on profits until prices we've never seen before - $160 per barrel. Attachment 2.

2. Fake Production Forecasts: Touts of "1 Million Barrels a Day" Have Become a Production Decline to 285,000 Barrels per Day By 2024

Now that the highly-paid consultants are gone, and SB 21 doesn't need to be pitched to a legislature eager for arguments to giveaway tax revenue, the truth has come out.

The State changed its oil forecasting methodology in the Spring 2013 Department of Revenue Sources Book, under ACES, and uses the same one now under SB 21. Oil production forecasts in the Spring 2013 Sources Book (the last one under ACES) showed what were likely exaggerated declines under ACES (Conoco conceded the production decline would fall to 2-3% under ACES by 2017 but the State's forecast during the SB 21 debate estimated an exaggerated and continuous 5-6% rate of decline after 2017, Petroleum News Article Attachment 3). They exaggerated the ACES decline to show less oil, and a smaller differential in revenue between ACES and SB 21.

The Spring 2013 ACES forecast shows a decline under ACES from 538,000 barrels per day in 2013 to 344,0000 barrels per day by 2022. Attachment 4. You'd think that would improve under SB 21 given the Administration's promises.

But, regardless of the exaggeration the Administration made under ACES, their ***Fall 2013 Revenue Sources Book forecast under SB 21 is more telling***. The Department now predicts, under the same production forecast methodology, that oil will decline at an even faster rate now.

From 2014 to 2023 oil production falls from 508,000 barrels per day to 313,000 barrels per day. Attachment 5.

It gets worse.

In a recent chart prepared by the Office of Management and Budget, with the Department's 2024 forecast added, oil ***production falls an additional 44,000 barrels*** from 2023 to 2024 ***to 285,000 barrels a day. That's a 44% production decrease*** in the first 11 years of SB 21.

This harkens back to oil company admissions in 2013 that SB 21 wouldn't work. Instead of writing a bill that required promises of new production, Governor Parnell wrote one that led to oil company testimony that the new bill would not move the needle to create any significant new Alaska investment. Attachment 15.

So - SB 21, by the state's own admission, results in a steadily increasing 44% decline in oil production over the next 10 years. If you look at the chart closely, the decline rate in the later years is slightly faster under SB 21 (attachment 5 and 6) than it is under the last ACES forecast (attachment 4).

Faced with unpleasant facts, the Administration has suddenly claimed these forecasts are "conservative". But that contradicts their testimony in committee, when they testified the new forecast methodology used since the spring of 2013 was aimed at being the ***most accurate*** possible, because in prior years they used a formula that underestimated the decline rate. So, their admission on the record is that these forecasts are as accurate as possible, not conservative underestimates of production. Attachment 7, Committee Testimony, pp. 27-28.

The Department's forecasted decline from 2014-2024 is charted by the bar graph in Attachment 8, using the most recent Department of Revenue Forecast numbers.

So - that's 44% less oil, much of which will be taxed at the "new oil" rate of roughly 17%. That's approximately half the tax rate of ACES, and roughly half the oil we have running through the pipeline ten years from now. So, with roughly half the tax rate and half the oil, that will produce roughly 1/4 of the revenue we received last year, ten years from now. Oil, under SB 21, simply won't be able to fund schools, basic services, and the services of those with no voice will disappear first.

3. SB 21 Does Not Raise More Money than ACES - The New Parnell/Oil Company Spin

After the "new oil" provision was added in April, 2013, the state and its army of experts provided its "fiscal note", or analysis of how much money SB 21 will produce compared to ACES. We showed that they trimmed this loss under SB 21 by ignoring the evidence from Conoco, where Conoco admitted the decline rate would fall to 2-3% a year starting in 2017 without any change in the law (we expect them to revise their oil forecast before the August vote, using Conoco's pre-SB 21 predictions, to make it look like the decline rate is falling under SB 21).

The reason the Administration wanted a steeper decline rate when SB 21 was being debated was that the less oil the lower the revenue under the higher income-generating ACES law. But for the moment, let's use the revenue loss estimates under SB 21 that the Administration provided. These are numbers they promoted for three months in 2013, fully knowing the costs of North Slope development costs from last winter's exploration and drilling season.

Through April 2013, they conceded SB 21 would cost the state significant revenue losses even at low prices of $90 per barrel. They underestimated the SB 21 loss to be, by 2017, $325 million at low $90 per barrel prices; $475 million at low $100 per barrel prices; and $1,125 billion at $120 per barrel. Attachment 9.

If they used Conoco's predicted decline rate of 2-3% starting in 2017, the loss at those prices would be nearly double, and roughly $2 billion at $120 per barrel. Attachments 10 - 11.

Today the new argument after three months of "expert" and Administration testimony from January to April, 2013, when the costs of production were known, is nothing but political. They now argue that costs on the North Slope are suddenly much higher, even though they knew those costs last April. They argue that while SB 21 was shown to lose money for the state at prices of $90 per barrel, not both laws raise the same money at $110 per barrel.

The argument contradicts everything they said throughout all of 2013. It comes from an administration that hid experts from the Legislature (it hired the experts we had under ACES just so no one else could hire them, and then would not let them testify or speak to the public). It comes from an Administration that spun oil numbers during the 2013 legislative session.

This is a Governor who, between he and his commissioners, created the expectation that the new bill would produce 1 million barrels a day if we just passed it. Instead, production projections since SB 21 passed show a decline to 285,000 barrels a day in ten years.

The Administration and its experts never once said - during their 2013 sales pitch - that we'd only get 285,000 barrels a day ten years from now under SB 21.

The argument that oil costs so radically changed by November 2013 from April 2013, that the revenue forecasts radically changed, is not believable.

4. The Failed History of Low Oil Taxes without Investment Incentives

SB 21 is very much like the failed ELF. It is based on the false premise that a very low oil tax will attract tons of new development in Alaska, when oil is a world commodity, and they can spend their money anywhere in the world. Like the ELF, SB 21 has very little in the way of tax credits to reduce tax rates if companies invest ***in Alaska***. The "incentive" is a 16% tax rate for "new oil," that expressly lets companies tax these tax savings and spend them outside Alaska. That's what they are doing with the bulk of those savings. "New" investment dollars that are being touted are largely for projects announced under ACES: Pt. Thompson, CD-5 in NPR-A, the Southwest corner of Kuparuk, and Repsol's investments it promised in 2011.

How well did a low tax, requiring nothing of companies to get those tax breaks, work under the ELF?

By 2006, 15 of 19 North Slope Fields paid a 0% - 1% tax. Attachment 12. That should have brought tons of new oil under their trickle-down economics logic.

But instead, with rising prices, from the norm of $18 per barrel back in the 1990's and early 2000's, to roughly $60 per barrel by 2006, oil production under this very low tax fell over the long term at a roughly 6% a year clip. Attachments 13 - 14.

Low taxes simply let companies take their profits to jurisdictions with bigger pools of easier to produce oil. That's what SB 21 is doing. That's how oil investment works. Even in the low tax jurisdictions around North America, conventional oil production is falling. The only rises come from the new technology that allows fracking.

Likewise, under SB 21, the large tax breaks aren't required to be spent in Alaska. Smart companies are taking the money they've received in tax breaks, and sending most of it abroad. How else do you explain a 44% production decline over the next ten years, when SB 21 was supposed to bring in large amounts of new oil in the out years?

And, even if the decline stems some, it will never result in a law that breaks even with ACES because of the low "new oil" tax rate.

5. Replacing SB 21 after the Referendum: Fair Tax Reductions with Production and Alaska Investment

Republican Senator Bert Stedman has offered legislation with a smart, logical, higher tax rate on legacy oil, which took in rates of return higher than the low tax North American jurisdictions like Texas and others. Rates of return on Prudhoe, Alpine and Kuparuk exceeded 70%.

We have offered what we think is smarter legislation, which would do what some Republicans conceded privately we should have done. Attachment 15. They conceded privately that simply adjusting ACES would have been the smartest thing to do. We have done that smartly. And industry, privately, only complained that ACES taxed too high at high prices - something that was Governor Parnell's position as late as 2011.

ACES did tax too high at very high prices - we have to leave a reward for companies on the high side while still treating Alaska fairly. So at roughly $120 per barrel we reduce the progressivity slope so tax rates at high prices above that level rise at a much slower rate. And cap the highest tax rate no matter how high the price of oil at 50% instead of the 60% under ACES.

We use the very fair ACES base tax rate of 25% - a conservative rate by world standards. That rate remains in place until $30 of profit on a barrel of oil is made. Only then does the progressivity rate kick in for the next $40 of price increases, to modestly raise the tax rate as companies take in windfall profits at higher prices. Then at roughly $120 per barrel that progressivity rate falls to meet the valid industry concern that they want the attraction of very high profits at very high prices. Both as partners, the state and industry will receive fair revenue at those prices.

Investment Incentives. We reward companies with a tax credit for exploring new fields. We offer a 5 - 7 year limited modest tax decrease for new oil in new fields, and in new areas in existing fields.

We offer AIDEA low interest loans to independents that are locked out of North Slope processing facilities, which have blocked oil development by independents. The loans will help them finance their own processing facilities.

And we offer a slightly lower tax rate on heavy oil, and research and development credits for researching heavy oil production technology. The testimony has been that technology, not tax rates, is what prohibits large-scale production of our 2 billion+ barrels of producible heavy oil.

And we allow the state to invest in exploration of promising fields companies refuse to produce.

Conclusion

1. Production forecasts show SB 21 results in a 44% production decline in the next decade.

2. The SB 21 New Oil tax rate will lead Alaska to poverty

3. Low tax rates send money to the world's easiest, most profitable fields. Investment incentives requiring in-state investment don’t.

4. The shift of "facts" is spin. State documents show SB 21 loses money at prices of $90 per barrel and lower. And without spin, at $110-$120 per barrel we lost from $1 - $2 billion a year in revenue.

5. SB 21 guarantees deficits because there is no windfall profits share. A fair tax, that allows us to periodically hit surpluses until oil production declines flatten out, requires a windfall profits share so Alaskans can prosper when oil companies are making record and near record profits.

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