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In this installment of Alaska Tax: The Last Frontier, Iversen explores the impact the pandemic has had on the oil and gas industry in Alaska and the recent Alaska Supreme Court decision regarding H.B. 331.

As I write this, Alaska is making its usual rapid transition from fall to winter. We have had a long fall this year (by Alaska standards), with temperate weather and natural beauty that has encouraged residents to get out and hike, fish, hunt, walk the dog, and ride a bike. The pandemic has become a marathon rather than a sprint, and escaping into the outdoors among falling leaves and cooling temperatures feels more like a liberating sojourn than just a walk in the park.

But then, of course, we all must return to reality. And that reality is particularly grim for the oil and gas industry at the moment. The pandemic rages on. Lack of demand for oil has created a supply glut that has kept prices low. Oil and gas companies face difficult choices. In turn, Alaska's revenue stream — which relies heavily on oil — has declined, exacerbating the state's budget problem. North Slope oil patch workers who face extreme conditions in the best of times, working in remote production facilities and living in remote camps for weeks on end, must now endure new complications and protocols because of COVID-19.

The threat of Alaska oil and gas production tax increases exacerbates the stress and uncertainty, whether through the Fair Share Act initiative on the November ballot, which represents a potentially massive tax increase on production from Alaska's largest oil fields, or through legislative action during the upcoming legislative session starting in January.

The financial uncertainty and stress are also acute for oil and gas explorers and producers that invested capital in Alaska oil and gas exploration and development projects in reliance on a rebatable oil and gas production tax credit program. The credits were intended to spur investment in the state — and they worked. But when the price of oil dropped several years ago, state revenue dropped with it and policymakers shorted payments on the credits rather than paying them in full, as had been done in prior years. The state has failed to make a meaningful payment for the credits in recent years. As of January 1, 2020, the outstanding queue of unpaid credits totaled $726 million, mostly for credits that were issued in 2016 and 2017.[1]

To remedy the state's failure to pay off the outstanding tax credits, the Legislature passed H.B. 331 (the Bill) on May 11, 2018, to establish

[1] Letter from acting Department of Revenue Commissioner Michael A. Barnhill to Cathy Giessel, Alaska Senate president, and Bryce Edgmon, Alaska speaker of the House of Representatives (Jan. 29, 2020).

the Alaska Tax Credit Certificate Bond Corp. (the Corporation) in the Department of Revenue, which would be authorized to issue up to $1 billion in bonds to finance purchases of the oil and gas tax credits.[2] But as discussed in previous articles, a lawsuit was brought in Alaska Superior Court challenging the constitutionality of the law on May 14, 2018.[3] On January 2, 2019, a Juneau Superior Court judge granted the state's motion to dismiss for failure to state a claim upon which relief could be granted. The plaintiff appealed, and on September 4, 2020, the Alaska Supreme Court issued its decision: The financing structure created by the Bill violates the Alaska Constitution.[4]

So the companies that invested in Alaska oil and gas projects and rightfully earned rebatable tax credits through qualified investments are left to play a waiting game.

The Rebate Program

A bit of background helps one understand the dilemma faced by companies holding rebatable tax credits. In general, Alaska's production tax is levied on the net revenue of oil and gas production from leases or properties in the state.[5] Net revenue is calculated based on a destination value of the oil or gas, less (1) the pipeline and marine transportation costs to get from the point of production to the destination market, and (2) operating and capital costs for oil and gas exploration, development, or production upstream of the point of production.[6] Net revenue is then multiplied by the tax rate, and the result is reduced by credits.

All Alaska production tax credits can be used to reduce production tax liability, but not all can be carried forward or are transferable or rebatable. The suite of credits that are not rebatable and that cannot be transferred or carried forward is found at A.S. 43.55.024(c) and A.S. 43.55.024(i) and (j). These are often referred to as the small producer credit and per-barrel credits, respectively. The rebatable credits, which are based on upstream expenditures for exploration, development, and production, are found in A.S. 43.55.023(a), (b), and (*l*) and A.S. 43.55.025. Not only can the rebatable credits be purchased by the state of Alaska, they can be carried forward for use against production taxes in a later calendar year, carried back for use against production taxes in a previous calendar year under specific circumstances, and transferred to an oil or gas producer for use against its production tax liability.

These rebatable and transferable credits were largely phased out or repealed through legislation passed in 2016 and 2017. For costs incurred after 2017, the only *transferable* credits that may be earned are for expenditures for oil and gas exploration, development, and production south of the North Slope and outside Cook Inlet, and *rebates from the state for any credits* can be obtained only for credits for costs incurred before July 2017.

While all oil and gas producers that earn or are transferred the credits can use them against production tax liability, there are specific criteria to obtain rebates for them from the state. Only the companies that originally made the investment and earned the credit qualify for the rebates, and they must, among other things, have no production tax liability — or any liability to the state related to their oil and gas operations — and must be small producers, which are defined as those producing fewer than an average of 50,000-Btu-equivalent barrels per day.[7]

The Bill

The Legislature passed the Bill to create the Corporation in the Alaska DOR to finance the purchase of the rebatable tax credits.[8] The Corporation was authorized to issue up to $1 billion in bonds to finance purchases of the tax credits and cover the costs of administering the program.[9] The purchase amount of the tax credits would be the face amount of the tax credits, discounted each year based on the expected

[2] *See* A.S. 37.18.010, et seq. The Senate version of the legislation was S.B. 176. This article refers to H.B. 331 because that was the vehicle that ultimately passed.

[3] *Forrer v. State of Alaska*, 1JU-18-00699 Civil.

[4] *Forrer v. State*, 471 P.3d 569 (Alaska 2020).

[5] A.S. 43.55.011(e); A.S. 43.55.020(e).

[6] A.S. 43.55.150; A.S. 43.55.160.

[7] A.S. 43.55.028(e), (j).

[8] A.S. 37.18.010.

[9] A.S. 37.18.030.

timing of the purchase had it been made under the assumed appropriation to the oil and gas tax credit fund based on a statutory formula.[10]

Several sections of the Bill were intended to head off constitutional attacks based on violations of the prohibition against dedicating future revenues for a specific purpose or the limitations on contracting for state debt. Of particular importance to the lawsuit over the Bill:

> The bonds do not constitute a general obligation of the state and are not state debt within the meaning of art. IX, sec. 8, Constitution of the State of Alaska. Authorization by the legislature and ratification by qualified voters of the state is not required under art. IX, sec. 8, Constitution of the State of Alaska.[11]

Likewise, the Bill states in several sections that funds for the purchase of tax credit certificates are subject to appropriation by the Legislature.[12]

The Lawsuit

The plaintiff who brought the lawsuit over the Bill sought declaratory and injunctive relief on the grounds that it violated several sections of Article IX of the Alaska Constitution.[13] The state moved for summary judgment, arguing that the Bill did not create legally enforceable state debt that would violate Article IX, section 8.[14] The state also argued that the Bill met the Article IX, section 11 exceptions for refunding indebtedness and for "revenue bonds" issued by a public corporation of the state.[15] The superior court rejected the state's section 11 arguments, but agreed that the Bill did not violate the prohibition against contracting for debt under section 8.[16]

The plaintiff appealed.[17] In its decision, the Alaska Supreme Court did not reach the arguments that the Bill violated Article IX, sections 7 and 10, but instead focused on section 8.[18] Article IX, section 8 provides:

> No state debt shall be contracted unless authorized by law for capital improvements or unless authorized by law for housing loans for veterans, and ratified by a majority of the qualified voters of the State who vote on the question. The State may, as provided by law and without ratification, contract debt for the purpose of repelling invasion, suppressing insurrection, defending the State in war, meeting natural disasters, or redeeming indebtedness outstanding at the time this constitution becomes effective.[19]

As the backdrop for its decision, the court discussed the history of runaway state debt starting in the early 19th century that led to state debt limitations throughout the United States.[20] It then shifted to the Alaska Constitutional Convention, which took place over a century later, noting that "the framers of our constitution sought to preserve the role of the people as a check against the incurrence of unnecessary debt, rather than impose a strict debt limit," and that despite differences of opinion, "one commonality is that the Delegates understood that at its core the objective of section 8 was to control and restrict the issuance of bonds."[21]

The court held that the Bill contracts state debt in violation of Article IX, section 8.[22] The court explained that although the Alaska Constitution does not define debt,

> section 8 identifies two primary characteristics of "debt": (1) the debt must be "contracted," implying a volitional act, potentially involving a contract or other promise of repayment; and (2) it must be for a specific "purpose," only a handful of which are permissible.[23]

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[10] A.S. 43.55.028(*l*).

[11] A.S. 37.18.030(c).

[12] A.S. 43.20.046(e); A.S. 43.20.047(e); A.S. 43.20.053(e); A.S. 43.55.028(e); and A.S. 43.55.028(m).

[13] *Forrer v. State of Alaska*, 1JU-18-00699 Civil.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Forrer*, 471 P.3d 569.

[18] *Id.* at 572.

[19] Alaska Const. Art. IX, section 8.

[20] *Forrer*, 471 P.3d at 572-74.

[21] *Id.* at 574, 576.

[22] *Id.* at 593.

[23] *Id.* at 586.

The court looked to section 10 to help delineate section 8's debt limitation.[24] Section 10 allows the state to "borrow money to meet appropriations for any fiscal year in anticipation of the collection of the revenues for that year, but all debt so contracted shall be paid before the end of the next fiscal year" — section 10 is the only vehicle for the Legislature to borrow money for any purpose, but it must be repaid within a year.[25] There is no viable argument that funds borrowed under the Bill bond program would be repaid within a year.

The court also cited section 11, which provides:

> The restrictions on contracting debt do not apply to debt incurred through the issuance of revenue bonds by a public enterprise or public corporation of the State or a political subdivision, when the only security is the revenues of the enterprise or corporation. The restrictions do not apply to indebtedness to be paid from special assessments on the benefited property, nor do they apply to refunding indebtedness of the State or its political subdivisions.[26]

Section 11 provides exceptions to the limitation on contracting debt for the issuance of revenue bonds and some non-volitional obligations. The court reasoned that the Bill bond program did not meet either exception and explained that its financing program was not backed only by the revenue of the Corporation, in contrast with other permissible schemes that concerned revenue bonds with dedicated revenue streams as opposed to "subject-to-appropriation" bonds.[27]

Both parties to the appeal relied on differing interpretations of state debt based on *Carr-Gottstein Properties v. State*.[28] In that case, the Alaska Supreme Court upheld the constitutionality of a lease-purchase agreement in which the Alaska court system leased a privately owned building from the Alaska Department of Natural Resources with the option to purchase at the end of the lease.[29] The court upheld the lease-purchase agreement because the lease:

- had a non-appropriation clause;
- limited recourse to the leased property; and
- did not create an obligation that would bind future generations or legislatures.[30]

In applying the *Carr-Gottstein* test to the Bill, the court in *Forrer* stated that all three parts of the test must be met.[31] The Bill clearly met the first prong, because the language in it provided that the funds for the bond program are subject to legislative appropriation.[32] For the second prong — requiring that recourse be limited to the subject property — the court noted that in *Carr-Gottstein*, the property was privately owned, and it explained that "recourse must be constrained to an identifiable asset that is not government-owned."[33] The court determined that the Bill provided that bondholders' only recourse is to government property, namely funds appropriated by the Legislature and held by the Corporation.[34] Thus, the Bill failed the second prong.[35] And because the arrangement created by the bond program contemplated a multiyear borrowing program that extended beyond the current fiscal year, the court held that the Bill also failed the third prong.[36]

In sum, the court held that the Bill violated Article IX, section 8 and the *Carr-Gottstein* test and did not meet one of the limited exceptions to the prohibition against the state contracting for debt.[37] Accordingly, it ruled that the Bill was unconstitutional.[38]

The state has moved for rehearing to request that the court clarify the scope of its decision to

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[24] *Id.* at 586-87.

[25] Alaska Const. Art. IX, section 10.

[26] *Forrer*, 471 P.3d at 586-87; and Alaska Const. Art. IX, section 11.

[27] *Forrer*, 471 P.3d at 588-89.

[28] 899 P.2d 136 (Alaska 1995).

[29] *Id.* at 138.

[30] *Id.* at 144.

[31] *Forrer*, 471 P.3d at 591.

[32] *Id.* at 591-92.

[33] *Id.* at 592.

[34] *Id.*

[35] *Id.*

[36] *Id.* at 592-93.

[37] *Id.* at 593.

[38] *Id.* at 599.

avoid impacts on other financing programs but is not challenging the decision that the Bill is unconstitutional. Thus, to survive, financing programs similar to the Bill would need to be approved through a bond referendum or a constitutional amendment.

On the Horizon

Now that the tax credit bond program contemplated by the Bill is no longer an option for holders of outstanding tax credits, these companies are left to play a waiting game, hoping for a meaningful appropriation to the oil and gas tax credit fund in the upcoming legislative session. Transferring credits to producers for use against production tax liability is also an option, although the market is limited in light of oil prices. Other options are being considered, although some will require legislative action, and it is unclear what will get traction.

The next installment will include updates concerning potential options for holders of tax credits, the Fair Share Act initiative, and the upcoming legislative session that starts in mid-January. As usual, Alaska taxpayers are going to have a lot to think about. ■