Senate CS for CS for HB 111 (Ver C-P): Some Observations

Roger Marks
Senate Finance
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Summary

• Reduces state credit exposure without compromising competitiveness of overall fiscal system

• Some economic observations regarding the interaction of loss recovery, the per barrel credit, and the gross minimum floor under the CS follow

• Two lingering issues
Preface

• The production tax is a net tax with a 35% rate
• There is a floor on that net tax equal to 4% of gross value
• The per barrel credit and loss recovery perform distinct functions:
  – The per barrel credits provide tax relief to partially offset the high burden of royalties at low prices
    • It reflects this year’s business
    • If not used they are lost forever, and the royalty offset role is eviscerated
  – Loss recovery provides for the deduction of costs in computing net value that could not be deducted in prior years
    • It reflects prior years’ business
• Since they are distinct issues, using them both is not redundant
The Royalty Problem (Using GVR Oil)

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
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</thead>
<tbody>
<tr>
<td>ANS Price</td>
<td>$50</td>
</tr>
<tr>
<td>Transp</td>
<td>($10)</td>
</tr>
<tr>
<td>Gross</td>
<td>$40</td>
</tr>
<tr>
<td>Upstream Costs</td>
<td>($35)</td>
</tr>
<tr>
<td>Net Value</td>
<td>$5</td>
</tr>
<tr>
<td>1/8 Royalty</td>
<td>($5)</td>
</tr>
<tr>
<td>Producer income before prod tax</td>
<td>($0)</td>
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<tr>
<td>Govt take before prod tax</td>
<td>100%</td>
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</table>
CS Summary of Credits and the Floor

• Losses
  – Currently (both Non-GVR & GVR Oil):
    • Can use losses to bring tax below floor
  – CS: (both Non-GVR & GVR Oil):
    • Cannot use losses to bring tax below floor*

• Per Barrel Credit
  – Currently:
    • Non-GVR Oil: Cannot use credit to bring tax below floor
    • GVR Oil: Can use credit to bring tax below floor
  – CS: No change

* If non-GVR and GVR losses were treated differently it would be necessary to allocate losses between them, which would be very difficult
Observation 1: “Hardening” the Floor

• Under current law taxpayers can use carried forward loss credits to bring taxes **below** the gross minimum floor
• Under the CS taxpayers can only use carried forward losses to bring the tax **down to the floor**
Hardening the Floor Against Losses: Loss Recovery on Non-GVR Oil

• No loss recovery unless prices above about $65/bbl
  – Losses on production not generated until prices below about $35/bbl
  – Losses on development of other non-GVR oil would have offsetting income at all but very low prices
  – Loss recovery on non-GVR oil does not appear to be a significant problem
<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
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<tbody>
<tr>
<td>ANS Price</td>
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<td>Transp</td>
<td>($10)</td>
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<tr>
<td>Gross</td>
<td>($40)</td>
</tr>
<tr>
<td>Gross minimum @ 4%</td>
<td>$1.60</td>
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<tr>
<td>Per barrel credit</td>
<td>($5.00)</td>
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<tr>
<td>Tax</td>
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</table>
Hardening the Floor Against Losses: Loss Recovery on GVR Oil

• Most new development would be GVR oil
  • Companies with substantial existing production and income could offset GVR losses

• GVR production from companies without existing production
  • Since per barrel credits cannot be carried forward, and because of their value, taxpayers would use per barrel credit first
  • Accordingly, taxpayers might only use losses when prices were high enough such that use of per barrel credit and losses exceeded floor
  • At about $85/bbl, net tax exceeds gross minimum
  • Accordingly, these losses may not be recovered until after GVR status lapses (after 3 or 7 years) and per barrel credit can no longer take tax below minimum. At that point taxpayers may start recovering losses.
Uplift on Cost Recovery

• Provides net present value boost to companies who have to wait to have production/offsetting income

• Currently CS limits only to companies without production
  – Companies with only limited production/offsetting income may not be in a much different situation

• The issue of early GVR cost recovery only at high prices applies here
  – Similarly, may only be invoked after GVR status lapses (after 3 or 7 years of production)
Sequencing Under the CS: Two Possibilities
Non-GVR Oil Assuming a $5 Loss Carried Forward

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<th>A</th>
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<tbody>
<tr>
<td>ANS Price</td>
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<td>$55</td>
</tr>
<tr>
<td>Transp Cost</td>
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<td>($10)</td>
</tr>
<tr>
<td>Gross Value*</td>
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<td>$45</td>
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<tr>
<td>Upstream Costs</td>
<td>($25)</td>
<td>($25)</td>
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<tr>
<td>Loss</td>
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<td>($0)</td>
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<tr>
<td>PTV</td>
<td>$15</td>
<td>$20</td>
</tr>
<tr>
<td>Tax before p/bbl credit @ 35%</td>
<td>$5.25</td>
<td>$7</td>
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<tr>
<td>Per barrel credit</td>
<td>($3.45)</td>
<td>($5.20)</td>
</tr>
<tr>
<td>Tax</td>
<td>$1.80</td>
<td>$1.80</td>
</tr>
<tr>
<td>*Gross minimum (@ 4%)</td>
<td>$1.80</td>
<td>$1.80</td>
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</tbody>
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Unresolved Issue 1:
The Order of Deducting Losses vs. Per Barrel Credits

• Recognizing:
  – Per barrel credits lapse if not used
  – Unused losses carry forward if not used

• The CS does not specify which is used first in calculating the tax

• Given the hard floor for non-GVR oil:
  – It will probably be to the taxpayer’s benefit to use the per barrel credits in getting the tax down to the floor, and carrying unused losses forward
  – Would be consistent with utilizing functional intent of the per barrel credits and loss recovery inherent in the statute
Questions

• Should the statute specify the sequence?
  – Do 100% of available losses have to be used first?
  – Do 100% of available per barrel credits have to be used first?
  – Can taxpayer mix?

• Should statute specify the sequence? Should statute leave it up the taxpayer? Should statute leave it up to the Department?
Unresolved Issue 2: What Does it Mean to Use a Credit to Bring Taxes Below the Floor?

• Under the CS, for GVR oil, losses cannot bring taxes below the floor, but the per barrel credit can

• Suppose:
  – Tax before credits: $10
  – Minimum tax: $7
  – Per barrel credits: $5
  – Losses: $4
Taxpayer Options Pursuant to DOR Interpretation in Similar Situations:
If you use both credits, they are both the cause of getting below the minimum

Tax before credits: $10

Use $3 in losses to bring tax down to minimum, but not use any per barrel credits to reduce tax further

TAX $7

Use $5 in per barrel credits, but not use any losses to reduce tax further ($5)

TAX $5
Taxpayer Option Pursuant to Another Interpretation:
Only the credit that actually brings you below the floor is the cause of getting below the minimum

• Start out with $10 in tax before credits or losses
• Use $3 in losses to bring tax down to $7 minimum
• Then use $5 in per barrel credits to bring tax down to $2
Analogy

• Suppose you have $100 in your checking account
• You write two $100 checks
• Did both checks, or the second check, cause you to be overdrawn?
At Stake

• Recognizing the distinct function of each credit
  – The per barrel credit is not loss recovery
  – Loss recovery is not the per barrel credit