



THE STATE
of **ALASKA**
GOVERNOR BILL WALKER

Department of Revenue

TAX DIVISION

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The Honorable Les Gara
Alaska State Representative
State Capitol, Room 400
Juneau AK 99801

Representative Gara,

This letter is in response to your email dated January 13, 2016, in which you posed several questions about the state's oil and gas production tax. Your questions are restated in *italics* below and our answers follow.

- 1. Please confirm whether North Slope oil companies are allowed to deduct 35% of their capital and operating costs from their net income before paying a net profits tax (it's from their taxable income, right, not from their tax payments?).***

Companies exploring for, developing, or producing oil and/or gas in the state, including the North Slope, are allowed to deduct 100% of their qualified capital and non-capital expenditures (collectively known as "lease expenditures") from their gross value at the point of production to arrive at the production tax value for purposes of the state oil and gas production tax. Lease expenditures are broadly defined in AS 43.55.165 as the "direct costs of exploring for, developing, or producing, as applicable, oil or gas deposits" in the state. AS 43.55.165(e) lists several types of costs that are not considered lease expenditures, and are therefore not deductible for the production tax, such as depreciation or depletion costs, lease acquisition costs, and costs for dismantlement or abandonment of an oil or gas facility.

As stated above, when calculating a tax due under the state's oil and gas production tax, 100% of qualified lease expenditures are subtracted from the company's gross value at the point of production to arrive at the production tax value, or "taxable base." Gross value at the point of production (GVPP) for oil is the value of the taxable oil at point where it is produced, which is generally calculated as the sales price minus the costs to transport the oil to the point where it is sold. Lease expenditures are deducted from the GVPP to arrive at the taxable base. A production tax of 35% is multiplied by the taxable base to arrive at the production tax before credits. If this number is greater than zero, sliding scale per-taxable-barrel credits cannot reduce this amount below the minimum tax, which at current oil prices is 4% of the gross value at the point of production. At low oil prices, the minimum tax effectively limits the benefit that companies receive from the deductibility of lease expenditures.

To summarize, they are able to deduct all of their qualified expenses, not 35%. But the amount remaining after the deduction is subject to the 35% production tax. Therefore, unless there is a limit due to the minimum tax, each dollar of qualified expenditures reduces the producer's taxes by 35 cents.

2. Do lower tax rate GVR fields include Pt. Thomson, all production in NPR-A that has/will come on line, and Ooogaruk and Nikiatchiq? Of the categories of GVR fields, one is all fields that were unitized after 2002, correct? Or is it (participating) areas created after 2002?

The gross value reduction (GVR) provision under the oil and gas production tax is applicable to oil or gas produced on the North Slope from leases, properties or acreage meeting one or more of these criteria:

- (1) the lease or property does not contain a lease that was within a unit on January 1, 2003;
- (2) for properties in a unit before January 1, 2003, the lease or property is from a participating area established after December 31, 2011; or
- (3) the acreage was added to an existing participating area on and after January 1, 2014, and the producer demonstrates to the department that the volume of oil or gas produced is from acreage added to an existing participating area.

So to answer the second part of your question, oil or gas produced from leases or properties that were not unitized as of January 1, 2003 are eligible for the GVR under the first criteria. Among existing producing areas, this includes production from the Oooguruk Unit and from the Nikaitchuq Unit. Production from the Point Thomson unit will be eligible for the GVR based on the second criteria, in that it will be from a participating area that was established after December 31, 2011. Other future fields such as Mustang, and fields under development in the NPR-A will also be eligible for the GVR. Production from new fields not yet in our production forecast likely will also be eligible.

3. Do lower-tax rate GVR fields enjoy the same 35% deduction rate for operating and capital costs as non-GVR fields?

Fields that are eligible for the GVR are allowed to deduct their lease expenditures from their GVPP. After this deduction, they are then able deduct the Gross Value Reduction to reduce their production tax value prior to the application of the 35% tax rate. However, the gross minimum tax may limit this benefit at lower oil prices.

4. What is the approximate effective profits tax rate (the percentage of net profits actually taxed) for GVR, and for Non- GVR discounted North Slope Fields at the following prices: \$60, \$70, \$80, \$90, \$100, \$110, \$120, \$130, \$140, and \$150/bbl?

Please see table below for approximations of effective production tax rates on net value of some "typical" fields with specific assumptions. For this analysis, we assume a "typical" field with \$10 per barrel transportation costs and \$36 per barrel deductible lease expenditures. We do not account for credits other than the per-taxable-barrel credits. Note

that due to the nuances in the tax calculation, these results may not exactly match the Fall 2015 forecast.

Effective Tax Rates on Net Value using Current Assumptions*		
Oil Price	Non-GVR	20% GVR Eligible
\$60	14.3%	0.0%
\$70	10.0%	0.0%
\$80	11.5%	5.9%
\$90	19.1%	10.9%
\$100	23.9%	14.1%
\$110	27.2%	16.3%
\$120	29.6%	17.8%
\$130	31.4%	19.0%
\$140	32.9%	20.0%
\$150	34.0%	20.8%

*Current assumptions include transport costs of \$10 per barrel and deductible lease expenditures of \$36 per taxable barrel, that are typical but will not match exactly Fall 2015 assumptions. For this table, net value is the same as "production tax value," defined in AS 43.55.160. The effective tax rates in this table are calculated by dividing the production tax after credits by the production tax value.

5. *At what price does the 35% tax rate kick in for non-GVR fields?*
6. *At what price does the profits tax fall so low that the 4% minimum gross tax becomes the tax rate?*

We interpret your questions 5 and 6 to be related, and we have reframed them as follows: For non-GVR fields, at what price does the minimum tax of 4% of gross value at the point of production exceed the base tax of 35% of production tax value minus per-taxable-barrel credits? In other words, at what price point do non-GVR fields begin to lose their sliding scale per-taxable-barrel credits? And secondarily, at what price point do non-GVR fields lose all of their sliding scale per-taxable-barrel credits? We have answered these questions with the example below. Please let us know if we misinterpreted your questions.

Using assumptions of about \$10 in transport costs and \$36 per taxable barrel in deductible lease expenditures, applied to a typical field, we estimate that the minimum tax of 4% of gross value at the point of production exceeds 35% of production tax value minus sliding scale per-taxable-barrel credits at about \$76 per barrel. This is illustrated in the calculation below.

Minimum Tax threshold - Base Tax and Minimum Tax using Current Assumptions*	
West Coast Price (\$/tax bbl)	\$76
Transportation (\$/tax bbl)	<u>-\$10</u>
Wellhead Value (\$/tax bbl)	\$66
Lease Expenditures (\$/tax bbl)	<u>-\$36</u>
Net Value (\$/tax bbl)	\$30
Base Tax Rate (%)	x 35%
Base Production Tax before Credits (\$/tax bbl)	\$10.50
Sliding Scale Credit per-Tax-Barrel (\$/tax bbl)	<u>-\$8</u>
Base Production Tax after credits (\$/tax bbl)	\$2.50
Minimum Tax Rate (%)	4%
Wellhead Value (\$/tax bbl)	x \$66
Minimum Tax (\$/tax bbl)	\$2.64

Greater of base production tax after credits and minimum tax

*Current assumptions include transport costs of \$10 per barrel and deductible lease expenditures of \$36 per taxable barrel, that are typical but will not match exactly Fall 2015 assumptions. For this table, net value is the same as "production tax value," defined in AS 43.55.160. The effective tax rates in this table are calculated by dividing the production tax after credits by the production tax value.

Note that in the illustration above, some but not the entirety of sliding scale per-taxable-barrel credits can be used. Because the minimum tax is 14 cents higher per barrel than the base production tax after credits, and the sliding scale credit cannot reduce the tax liability below the minimum tax, this means that the sliding scale credit is reduced by 14 cents per barrel, from \$8 to \$7.86 per barrel. Under these assumptions, at prices greater than \$76 per barrel, producers are able to take their entire sliding scale credit without going below the minimum tax. The exact price will vary depending on specific economics for different fields and producers

Using the same assumptions for transportation costs and lease expenditures, non-GVR fields lose the entire \$8 per-taxable-barrel credit at oil prices of \$50.62 per barrel and lower. At this price, the base tax before credits equals the minimum tax. This is illustrated in the calculation below. The exact price will vary depending on specific economics for different fields and producers.

**Minimum Tax Equal to Base Tax before
Credits, using Current Assumptions***

West Coast Price (\$/tax bbl)	\$50.62
Transportation (\$/tax bbl)	<u>-\$10.00</u>
Wellhead Value (\$/tax bbl)	\$40.62
Lease Expenditures (\$/tax bbl)	<u>-\$36.00</u>
Net Value (\$/tax bbl)	\$4.62
Base Tax Rate (%)	x 35%
Base Production Tax before Credits (\$/tax bbl)	\$1.62
Sliding Scale Credit per-Tax-Barrel (\$/tax bbl)	<u>xxx</u>
Base Production Tax after credits (\$/tax bbl)	\$1.62
Minimum Tax Rate (%)	4%
Wellhead Value (\$/tax bbl)	x <u>\$40.62</u>
Minimum Tax (\$/tax bbl)	\$1.62

Base production tax before credits equals minimum tax, therefore no sliding scale credits can be used

*Current assumptions include transport costs of \$10 per barrel and deductible lease expenditures of \$36 per taxable barrel, that are typical but will not match exactly Fall 2015 assumptions. For this table, net value is the same as "production tax value," defined in AS 43.55.160. The effective tax rates in this table are calculated by dividing the production tax after credits by the production tax value.

7. Can big companies (Exxon/Conoco/BP) reduce their payments of the 4% minimum floor by using the Net Operating Loss credit?

Yes. The only credits that cannot be used to reduce a production tax liability below the minimum tax are the per-taxable-barrel credits for non-GVR production under AS 43.55.024(j), also known as the sliding scale credits. All other credits, including net operating loss credits authorized at AS 43.55.023(b) and per-taxable-barrel credits for GVR-eligible production under AS 43.55.024(i), can be used to reduce a production tax liability below the minimum tax.

8. I understand GVR fields have no minimum tax rate, and their taxes can fall to 0%. Please confirm that.

The minimum tax in AS 43.55.011(f) applies to all North Slope production, so fields that are eligible for a GVR are in principle also subject to the minimum tax. However, the per-taxable-barrel credits earned for those fields, under AS 43.55.024(i) can be used to reduce a production tax liability below the minimum tax down to a minimum of \$0. This credit cannot be used to reduce a production tax liability below \$0.

9. What is the effective profits tax rate GVR fields pay at \$30, \$40, \$50 and \$60/bbl? When does that rate hit 0%?

As shown in the answer to question 4 above, the effective tax rates on net value for 20% GVR-eligible fields reach 0% at oil prices of approximately \$72 per barrel and lower for an illustrative field. The exact price will vary depending on specific economics for different fields and producers.

We hope you find this information to be useful. Please do not hesitate to contact me if you have questions or need additional information.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Ken Alper', with a stylized flourish at the end.

Ken Alper
Tax Division Director