Analysis of HB 411: Oil and Gas Production Tax

Presentation to House Finance Committee

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April 10, 2018

BACKGROUND

Four Major Oil and Gas Revenue Sources

Property Tax

Pipeline, Equipment, Facilities. About 80% of property tax collections are credited back to local governments

Royalty

Landowner's share, usually 12.5%. Most North Slope production is on State land. At least ¼ of royalties go to the Permanent Fund

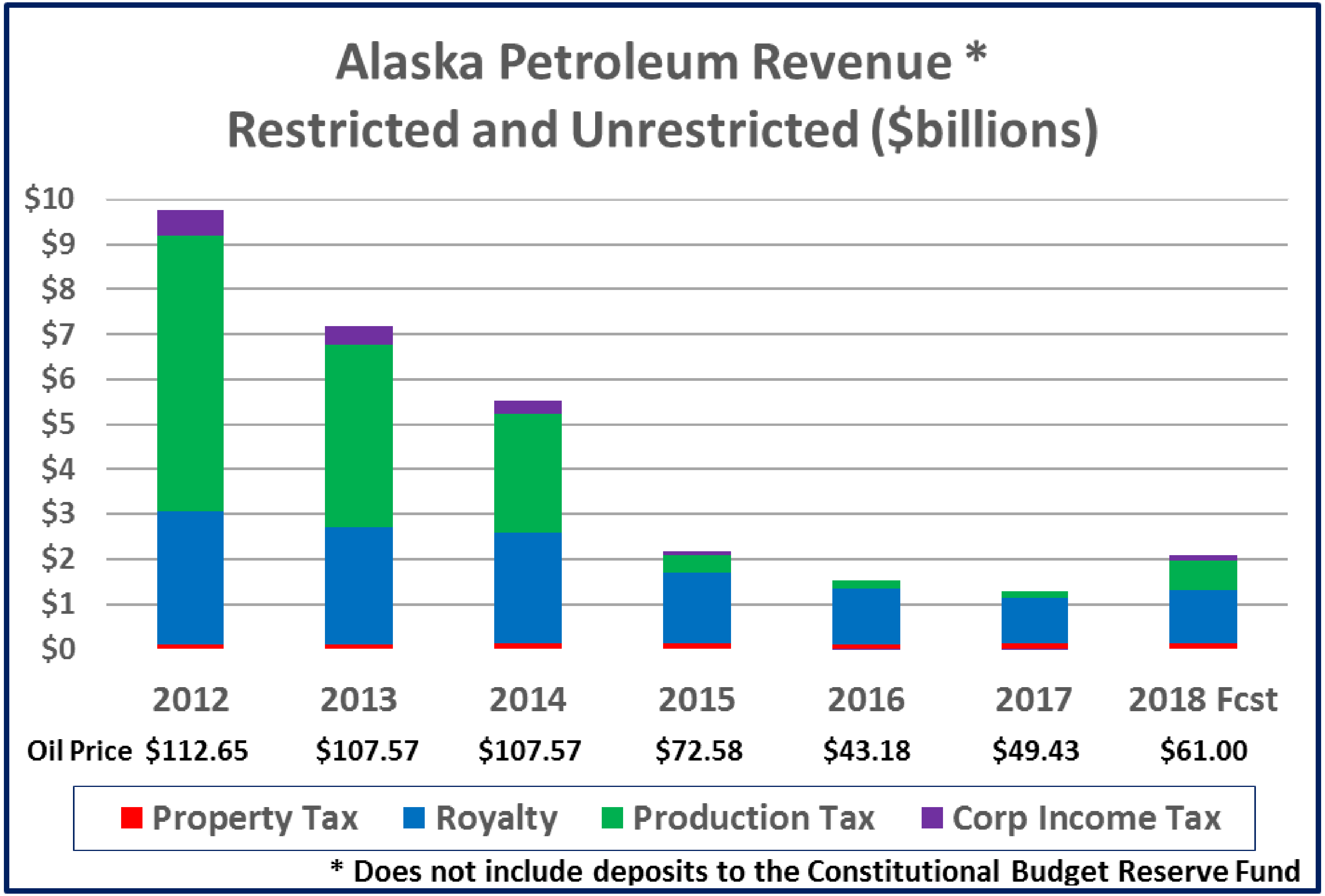
Production Tax

Based on net profits; most of the conflict in recent years is over this tax. North Slope tax is 35% less a variable "per-taxable-barrel" credit, with a gross minimum tax "floor"

Corp. Income Tax

Taxes the remaining profit after production tax, based on global asset apportionment. Rate is 9.4%, but effectively closer to 7%

Oil and Gas Revenue, Fiscal Years 2012-2018



Recent Oil and Gas Tax Credit Reform- Recap

HB 247 Passed June, 2016

- Phased out Cook Inlet and reduced Middle Earth credits
- Extended Cook Inlet gas tax cap, added $1 / bbl oil tax cap
- Added sunset / "graduation" provisions to Gross Value Reduction for new North Slope oil production
- Annual cap on per-company, per-year cash credit payments
- Resident hire priority for cash credit payments
- Limited transparency with annual report of who receives cash for credits
- Increase interest rate on delinquent production taxes for first three years, then reduced to zero
- Technical cleanup and repeal of obsolete language
- Regulation package proposed and adopted, effective 1/1/17

Recent Oil and Gas Tax Credit Reform- Recap

HB 111 Passed July, 2017

- Most credits no longer eligible for state repurchase after 7/1/17, other than refinery / LNG storage
- NOL credit under former AS 43.55.023(b) repealed 1/1/18
- New system of carried-forward lease expenditures beginning 1/1/18
- Process for how carried-forward lease expenditures are used in a future year once the producer has taxable value
    - o "Ringfence," preventing use until the property for which losses were incurred commences regular production
    - o Taxpayer flexibility on use, limited by minimum tax
    - o If unused, lease expenditures begin to lose value after 10 years in most cases

Recent Oil and Gas Tax Credit Reform- Recap

HB 111 Passed July, 2017 (continued)

- Align interest rate changes among all tax types and eliminate three-year interest limitation
- Credits can be carried-back and used against a prior year tax liability including interest and penalties for which an audit assessment has not been issued
- Conditional exploration credits granted at time of application, to ensure place in queue
- Seismic work in Middle Earth no longer eligible for exploration credits after 2017
- Exploration credits in Middle Earth can be used to offset the explorer's corporate income tax
- Delayed repeal of tax credit fund after all are purchased
- Established Legislative working group

BILL ANALYSIS

What Does HB 411 Do?

The two recently passed oil bills were multi-part and complex

Although they had some, mostly indirect, tax impacts, they primarily dealt with <u>tax credits</u> with a focus on <u>cashable credits</u>.

The major tax components set by SB21 in 2013 were left unchanged:

- 35% tax on Production Tax Value (PTV, a measure of Profit)
  - $0 to $8 per barrel "sliding scale" tax reduction (non-cashable credit)
- Gross Value Reduction for production meeting "new oil" criteria, excluding 20% of gross value from any tax
  - Fixed $5 per barrel tax reduction on GVR-eligible oil
- Minimum Tax "floor" of 4% of Gross (wellhead) Value
  - Tax due is "higher of" (35% x Net - $8), or (4% x Gross) for legacy oil

What Does HB 411 Do?

HB411 is a much simpler bill, but it changes several key components of the production tax itself:

- Reduces the 35% tax on PTV to 25%
- Three additional tax "brackets" of a tax surcharge:
  - 5% of portion of PTV greater than $40 plus
  - 5% of portion of PTV greater than $50 plus
  - 5% of portion of PTV greater than $60
- Eliminates the $0 to $8 per barrel tax credit (legacy production)
- Eliminates the $5 per barrel tax credit (new oil production)

Other components are not changed:

- No change to GVR qualifications or rates
- No change to Minimum Tax rate

Initial Observations

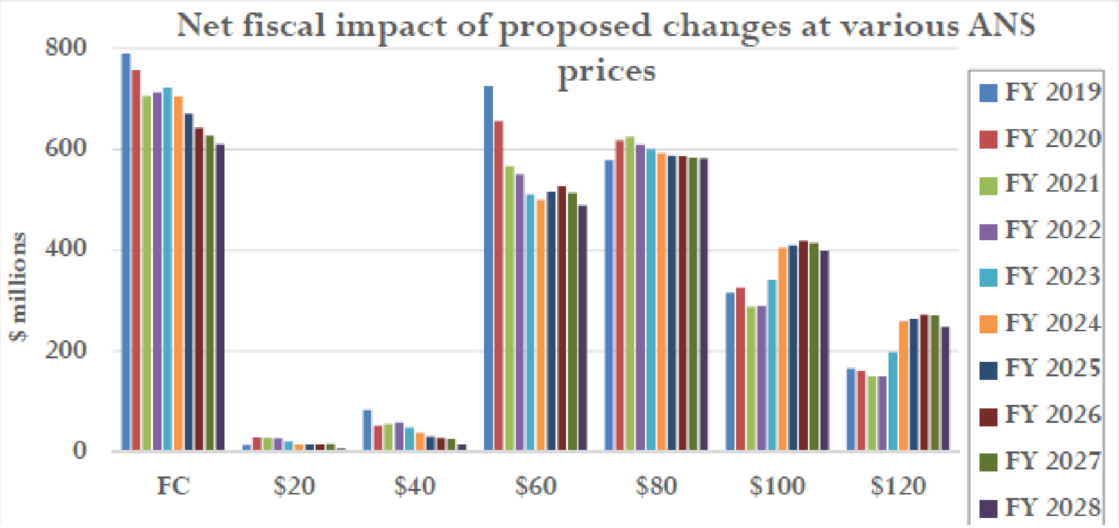
- Very similar to "House" passed version of HB111
  - Slight differences in supplemental tax brackets
  - Also eliminates the $5 per barrel credit for GVR oil
- As with House HB111, revenue impact concentrated at $50-90 oil price
  - Reduces the impact of the minimum tax due to lower "crossover point"
  - Tax impact for GVR oil at low prices due to "hardening floor"
- Tax brackets are materially different from former ACES "progressivity"
  - ACES applied highest tax calculation to all of oil profits, resulting in very high marginal (last dollar earned) tax rates
  - HB411 brackets only charge higher rate on the portion of profits above the rate cutoff. Much lower marginal rate impacts. Similar brackets in HB110 (2011)
  - Brackets tied to BTU-equivalent value, which would be diluted by NS gas production
- Bill length is deceptive
  - 21 of the 25 pages are conforming language related to monthly estimated tax payment and calculation of production tax value

Fiscal Note- Updated Summary Tables

Provisions in HB 411 and their Estimated Fiscal Impacts based on Spring 2018 Forecast ($millions) - FC PRICE Revised 4-10-18 by Dept. of Revenue

Description of Provision	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
1. Effective 7/1/18, the production tax rate for North Slope oil is reduced from 35% to 25% of Production Tax Value. A progressive surcharge is established for North Slope oil. The surcharge is 5% of PTV over $40 per barrel, plus an additional 5% of PTV over $50 per barrel, plus an additional 5% of PTV over $60 per barrel, for a maximum marginal tax rate of 40%. The progressive surcharge would be calculated based on a company's statewide PTV per barrel of oil equivalent.	-$36	-$33	-$67	-$67	-$83	-$120	-$218	-$314	-$341	-$389
2. Effective 7/1/18, repeals per-taxable-barrel credits for North Slope non-GVR oil production.	$1,193	$1,126	$1,078	$1,093	$1,124	$1,138	$1,134	$1,130	$1,120	$1,122
3. Effective 7/1/18, repeals per-taxable-barrel credits for North Slope GVR-eligible oil production.	$45	$32	$43	$48	$54	$39	$36	$38	$35	$26
4. Additional impact of implementing above provisions together.	-$414	-$368	-$348	-$363	-$374	-$353	-$281	-$211	-$187	-$150
Total Revenue Impact	**$788**	**$757**	**$705**	**$712**	**$722**	**$704**	**$671**	**$642**	**$627**	**$610**
Total Budget Impact	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**
Total Fiscal Impact - (does not include potential changes in investment)	**$788**	**$757**	**$705**	**$712**	**$722**	**$704**	**$671**	**$642**	**$627**	**$610**
Tax impact of carry-forward lease expenditures and credits - current law	$228	$558	$956	$1,444	$1,967	$2,407	$2,666	$2,876	$3,051	$3,175
Tax impact of carry-forward lease expenditures and credits - proposed	$188	$427	$695	$1,030	$1,403	$1,714	$1,898	$2,045	$2,169	$2,259
Change in year-end balance due to proposal	**-$39**	**-$130**	**-$261**	**-$414**	**-$564**	**-$693**	**-$767**	**-$832**	**-$882**	**-$916**

NOTE: The fiscal impact of this proposal is an estimate based on the Spring 2018 revenue forecast. **Estimates shown here are draft / preliminary based on our interpretation of possible changes, and do not include any changes in company behavior as a result of this proposal. We reserve the right to make modifications to estimates for any forthcoming fiscal notes.**



HOW TO READ THIS PAGE

Revenue change of separate bill sections (at forecast price)

Total Revenue Change

Change in value of carry-forward expenditures

Total revenue change at different prices

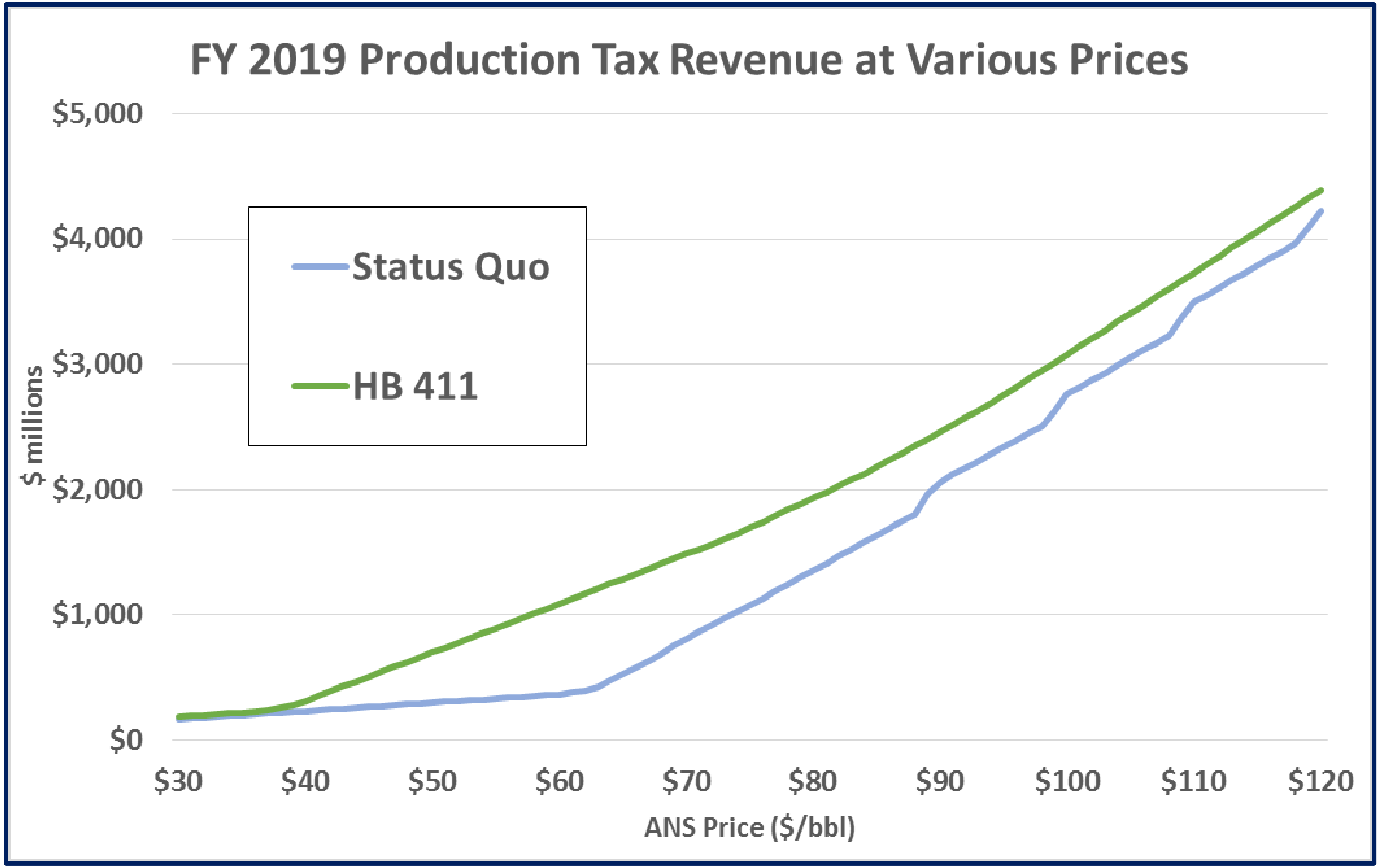
Revenue Impact of HB 411 is a Function of Price

Production Tax Calculation At Different Prices

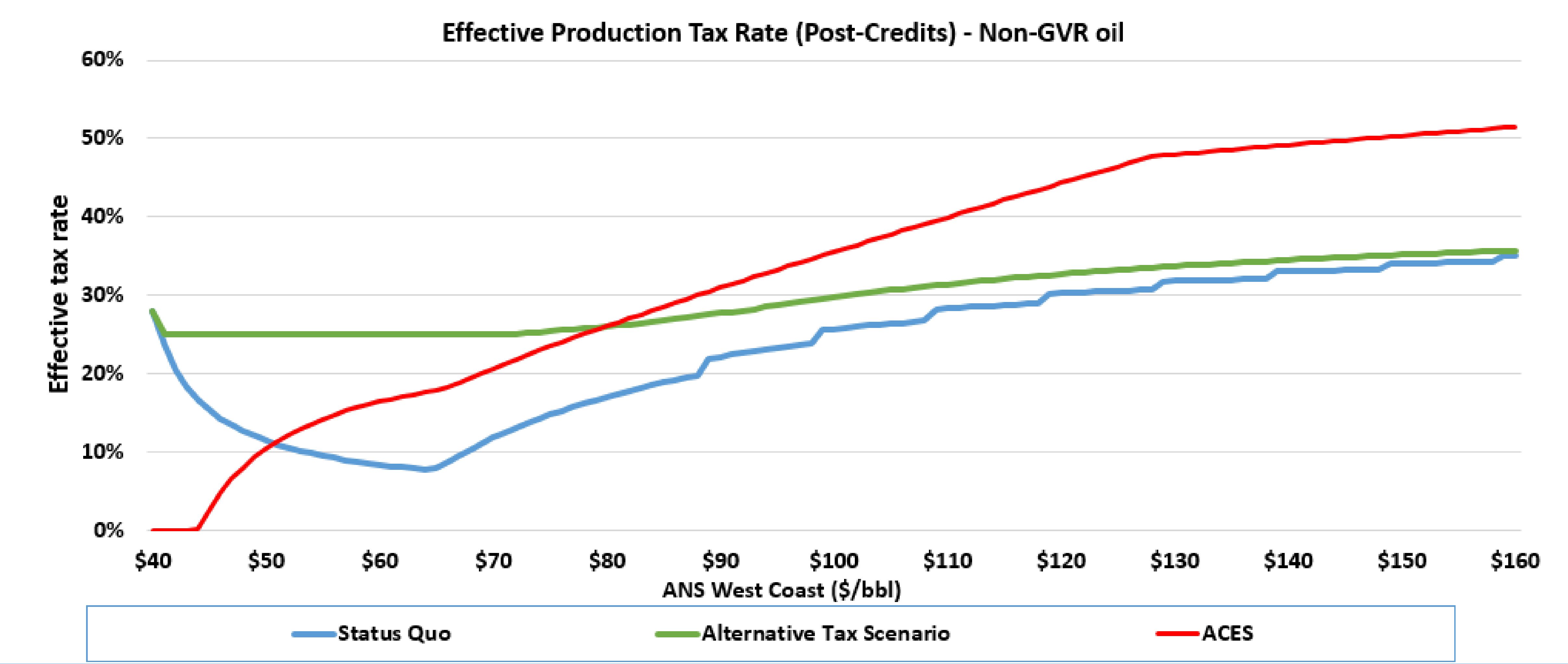
per one barrel of taxable North Slope non-GVR oil; FY19 costs per Spring 18 RSB

	Price	**$40**	**$50**	**$60**	**$70**	**$80**	**$90**	**$100**	**$110**	**$120**
	Transport	$8.87	$8.87	$8.87	$8.87	$8.87	$8.87	$8.87	$8.87	$8.87
	GVPP	$31.13	$41.13	$51.13	$61.13	$71.13	$81.13	$91.13	$101.13	$111.13
	Lease Expend	$26.41	$26.41	$26.41	$26.41	$26.41	$26.41	$26.41	$26.41	$26.41
	PTV (net)	$4.72	$14.72	$24.72	$34.72	$44.72	$54.72	$64.72	$74.72	$84.72
	Tax at 35%	$1.65	$5.15	$8.65	$12.15	$15.65	$19.15	$22.65	$26.15	$29.65
	Per-BBL Credit	$8	$8	$8	$8	$8	$7	$6	$5	$4
Existing	Tax per Net	-$6.35	-$2.85	$0.65	$4.15	$7.65	$12.15	$16.65	$21.15	$25.65
Existing	4% Minimum Tax	$1.25	$1.65	$2.05	$2.45	$2.85	$3.25	$3.65	$4.05	$4.45
Existing	**Higher Of**	**$1.25**	**$1.65**	**$2.05**	**$4.15**	**$7.65**	**$12.15**	**$16.65**	**$21.15**	**$25.65**
Proposed	Tax at 25%	$1.18	$3.68	$6.18	$8.68	$11.18	$13.68	$16.18	$18.68	$21.18
Proposed	Bracketed Taxes	$0.00	$0.00	$0.00	$0.00	$0.24	$0.97	$2.21	$3.71	$5.21
Proposed	Total Tax per Net	$1.18	$3.68	$6.18	$8.68	$11.42	$14.65	$18.39	$22.39	$26.39
Proposed	4% Minimum Tax	$1.25	$1.65	$2.05	$2.45	$2.85	$3.25	$3.65	$4.05	$4.45
Proposed	**Higher Of**	**$1.25**	**$3.68**	**$6.18**	**$8.68**	**$11.42**	**$14.65**	**$18.39**	**$22.39**	**$26.39**
	Forecast Tax Increase with 170 million taxable barrels ($millions)	**$83**	**$403**	**$725**	**$677**	**$578**	**$400**	**$316**	**$240**	**$165**

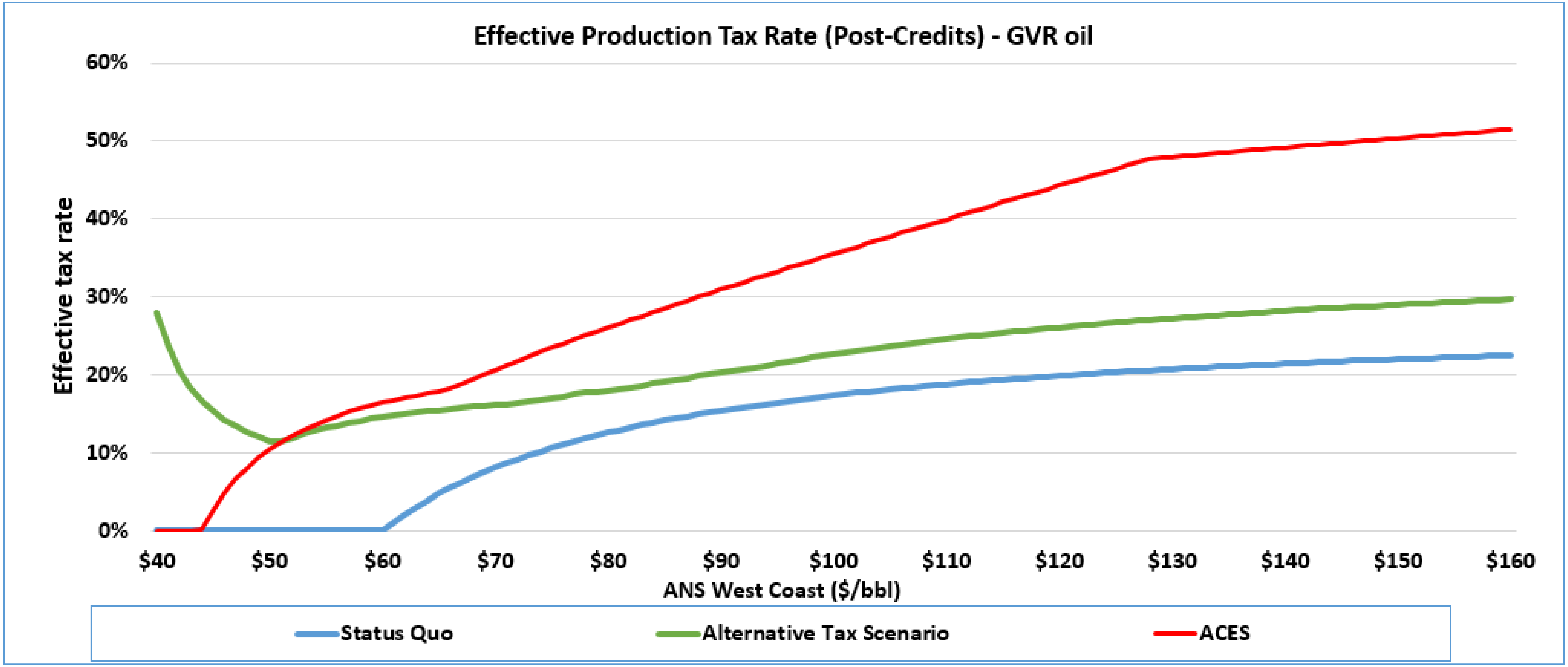
Revenue Impact of HB 411 is a Function of Price



Effective Tax Rate is Also a Function of Price



Effective Tax Rate is Also a Function of Price



DISCUSSION

Bill in Context of Ongoing Activities

HB111 created a working group to look at outstanding issues

- The group has not had substantive meetings yet, and has not offered suggestions

LB&A has hired three consultants to analyze our system

- Only one of the three has presented general information to the legislature, no public discussions as of yet

The Administration introduced HB331 / SB176, to deal with remaining balance of cashable tax credits

The Department of Revenue has identified several other issues that could be addressed by the committee and consultants

Potential Issues for Ongoing Discussion

Items in blue are addressed in HB331/ SB176

Items in green are addressed in HB411

- **Outstanding tax credits due to state no longer making open-ended purchases ($807 million through 2017 plus ~$150 million pending)**
- **Equity between major producers and new explorers as we phase out cash credits**
- **Ongoing debate on "fair share" at different price points**
- **Imbalance between 35% offset for spending and losses and a lower effective tax rate on profits**
- **Large future tax offsets if major recent discoveries are developed**
- Limited "upside" to the state during price spikes
- Long-term viability of Cook Inlet tax "caps"
- High volatility and complex administration of a net profits tax system

Issues for Consideration- Industry Profitability

Oil profitability estimates are up dramatically since 18 months ago, whereas production tax forecasted revenues are not

Fall 2016 forecast for FY2019

- $60 oil price with 442,100 bbl / day ANS production
- PTV (profit on taxable barrels) forecast $1.8 billion*
- Production tax forecast $248 million (13.9%)
- Statutory credit calculation $54 million

Spring 2018 forecast for FY2019

- $63 oil price with 526,600 bbl / day ANS production
- PTV (profit on taxable barrels) forecast $4.7 billion
- Production tax forecast $410 million (8.7%, +$162 million)
- Statutory credit calculation $184 million (+$130 million)

* PTV calculation is after paying royalty and property tax, but before production tax, and state and federal income taxes

Issues for Consideration- Historic Gross Tax

Before the switch to a net profits tax in 2006, Alaska's oil production tax, the "ELF" (economic limit factor), was a gross tax that varied from field to field.

The average tax rate was:

- 1995: 11.8%
- 1998: 10.5%
- 2001: 8.3%
- 2004: 6.4%
- 2006: 6.7%

Although taxes were much higher in the era of high prices, since 2015 the production tax has been almost entirely based on the 4% gross tax

Under HB411 most companies would pay above the 4% minimum tax at prices above about $40

Issues for Consideration- Tax Stability

Alaska has developed a reputation for an unstable tax regime, with seven changes in the past 13 years:

1. 2005: Gov. Murkowski aggregates Prudhoe Bay satellite fields for ELF calculation
2. 2006: Petroleum Production Tax “PPT” changed from taxing gross revenue to net profits
3. 2007: Alaska’s Clear and Equitable Share “ACES” corrects revenue shortfalls due to bad cost estimates in PPT
4. 2010: Cook Inlet Recovery Act “CIRA” provided additional credits outside the North Slope targeted at southcentral gas supply issues
5. 2013: SB21 was a tax cut primarily impacting higher prices and providing “new oil” benefits via the “gross value reduction”
6. 2016: HB247 began tax credit reform, phasing out Cook Inlet credits and limiting “new oil” benefits
7. 2017: HB111 completed tax credit reform, eliminating cashable credits and providing for carried-forward losses

Issues for Consideration- New Fields

The tax change could have unusual impacts on the economics of future projects

- HB111 eliminated cashable credits for operating losses, and replaced them with carry-forward lease expenditures
- These can be used to reduce future taxable profits, once the underlying leases are in production
- Carry-forwards can only be used to reduce taxes to the minimum tax and not below
- During the 3 to 7 years a field earns the GVR, the per-taxable barrel credit can further reduce taxes to zero
- Once the GVR is sunset, the per-barrel credit cannot be used below the minimum tax

Issues for Consideration- New Fields

The tax change could have unusual impacts on the economics of future projects (continued)

- The current system assumes that the minimum tax will be the actual tax paid, even at higher prices, until a company is able to “use up” (recover) all of their development costs as carry-forward lease expenditures
- For new producers, current law allows the tax to go to zero but in HB411, with no $5 per barrel credit, the minimum tax would be paid in those years resulting in a 4% tax obligation
- After the GVR sunsets, the 4% tax would be paid under both status quo and HB411 until lease expenditures are exhausted
- The reduced base rate also means carry forwards effectively have less value
- Depending on the price in the year oil is produced, it may take more carry-forwards to reduce taxes to that minimum tax level
- This could mean it would take fewer years before the regular tax based on profits would kick in

Issues for Consideration- New Fields

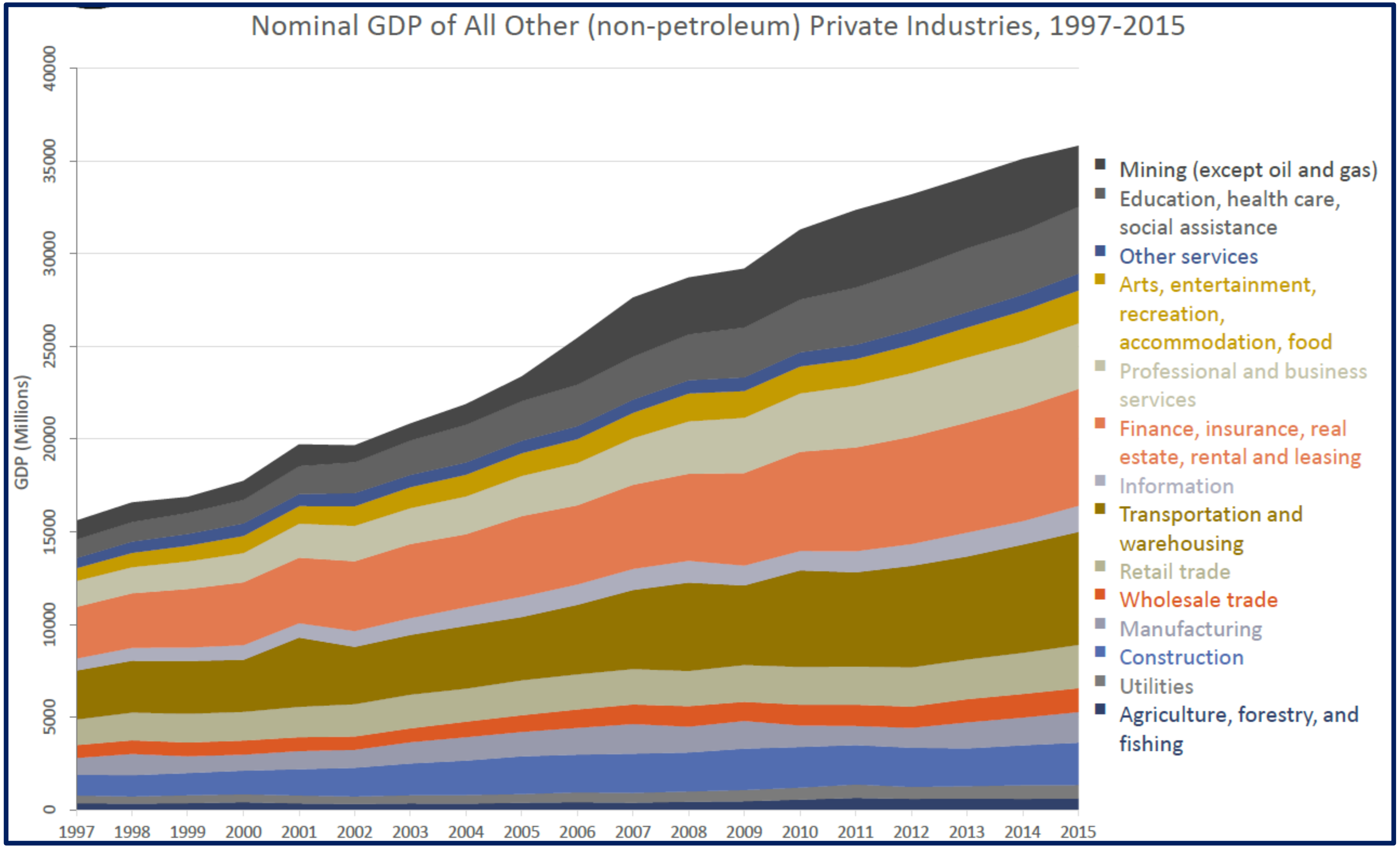
Life Cycle Analysis for hypothetical new field

(Large field model; 750 million barrels, 120,000 bbl / day peak production)

Oil Price	Total Production Tax ($millions)		Producer IRR		Break Even Price (NPV10)	
	Status Quo	HB411	Status Quo	HB411	Status Quo	HB411
$60	$5,913	$7,888	7.5%	7.0%	$72	$75
$70	$9,442	$11,366	9.6%	9.1%		
$80	$13,484	$15,229	11.4%	10.8%		
Spring 18 FC	$6,440	$8,352	7.9%	7.4%		

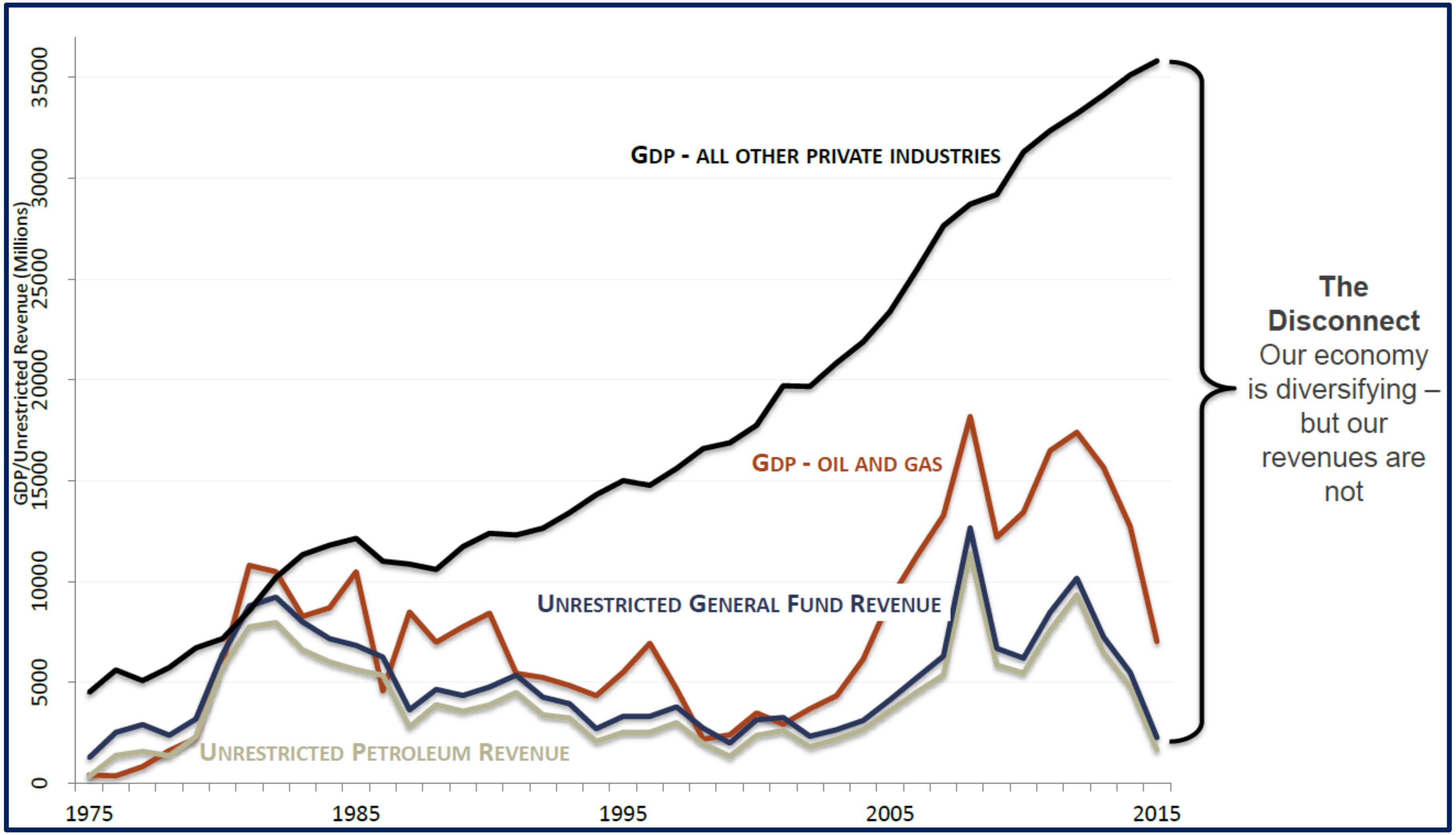
CONCLUSION

From Commissioner Navarre's 3/20 Presentation



The overall Alaska economy has grown steadily…

From Commissioner Navarre's 3/20 Presentation



...while the state's revenue has tracked closely with just the oil and gas industry

Final Observations

- The legislature appears to be reaching consensus on a partial fiscal plan relying on a structured use of Permanent Fund earnings
- The apparent remaining budget gap will likely be in the $500 to $700 million range
- <u>The most appropriate mechanism to fill this gap is via a broad based tax tied to the overall state economy</u>
- Oil and gas taxation should be based on fair share and related economic development issues, not budgetary need in any specific year
- Major oil and gas tax changes should be backed by substantial analysis and review looking at both unique local factors as well as global comparables
- Last year the legislature set in motion a process to revisit these fair share issues with the intention to use this to inform the next major tax rewrite
- Until the completion of the process set in motion last year, it may be premature to address a substantial tax revision at this time

THANK YOU

Please find our contact information below:

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