Oil and Gas Tax Credits Overview and Forecast

Oil and Gas Production Tax Statutes contained in Title 43, Chapter 55 authorize several types of credits to be applied against the state's production tax. Among these are credits for capital expenditures (AS 43.55.023(a)), carried-forward annual losses (AS 43.55.023(b)), and exploration expenditures (AS 43.55.025). These are the primary credit programs applicable under the state oil and gas production tax, and are the focus of this report.

Credits may be redeemed in two ways: (1) they may be converted into transferable tax credit certificates and transferred or sold, either to another production taxpayer, or to the state treasury or (2) they may be claimed and applied against a production tax liability on a taxpayer's annual tax filing. For purposes of this report, we assume that companies with tax liabilities will apply their credits against their tax liabilities whenever possible and that companies with no tax liabilities will seek to sell their credits to the state, rather than hold them for future use or sale to third parties.

Exploration tax credits were first available in 2003, and have been expanded in the years since. Prior to revisions to the production tax law in 2007, exploration tax credits could only be redeemed by using them against a tax liability or by selling them to another tax payer. Credits under this program have always been audited by the DOR prior to the issuance of a certificate.

The production tax revisions passed in 2006 created the authority for credits for capital expenditures and net loss carry forwards to be claimed beginning in April 2006, and these credit provisions were further amended by the legislation effective July 1, 2007. The DOR Tax division issues transferable certificates for these two classes of credits after completion of a due diligence review.

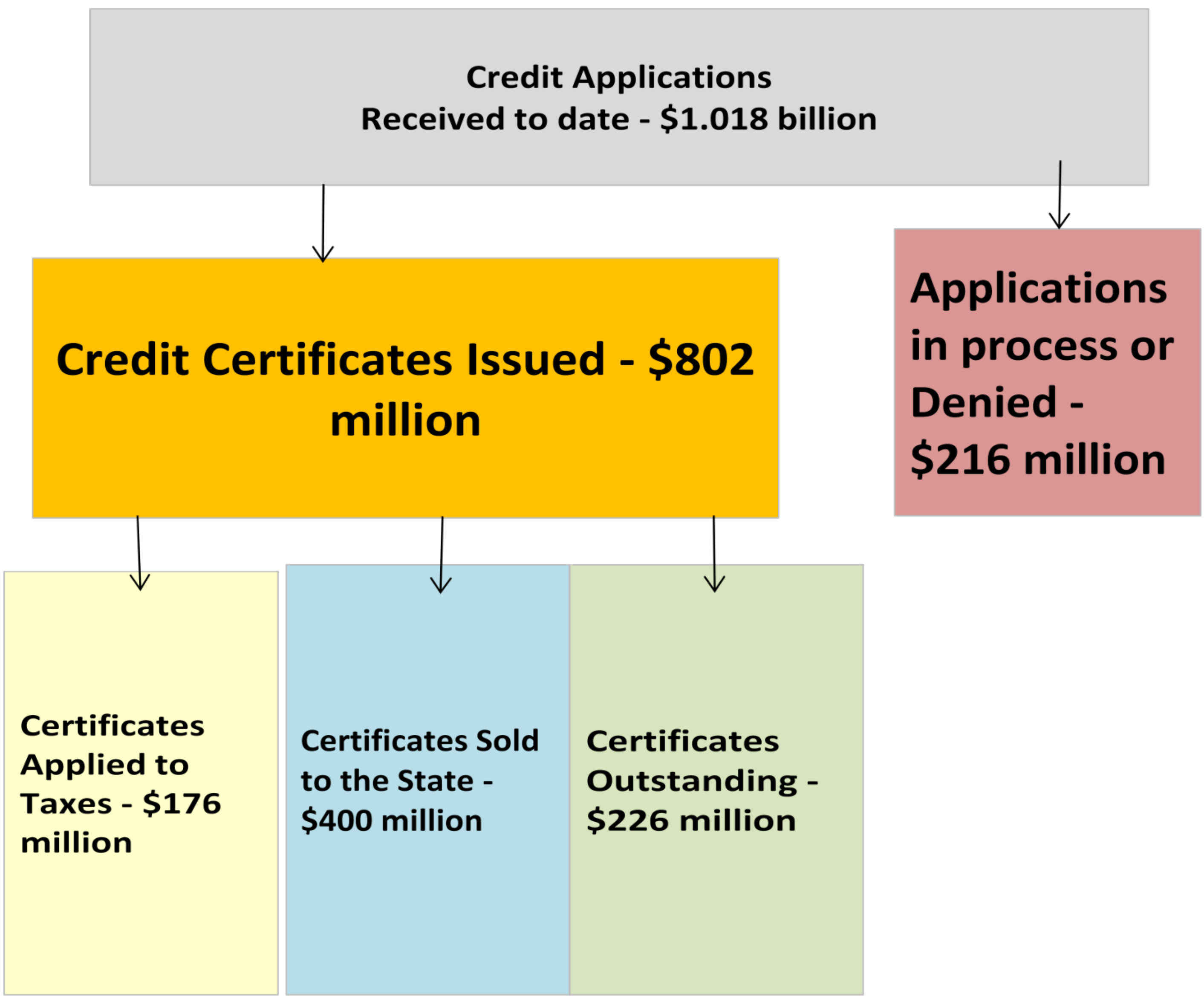
History of Tax Credit Certificates Authorization and Use

Figure 1 on the following page shows the dollar amount of all applications for transferable tax credit certificates received from the credit program's inception to date, as well as dollar value of certificates issued, redeemed and outstanding. In total, companies sought $1.018 billion in credit certificates since the program began in 2003. The applications are split, with $334 million in exploration credits and $684 million capital/net loss carry forward credits. Taxpayers are increasing their use of these credit programs as shown in the credit history table below: For FY 2010, we expect to receive additional requests for credit certificates related to capital expenditures and carried-forward annual losses when annual returns for calendar year 2009 are filed on March 31, 2010.

Amount of Transferable Tax Credit Certificates Sought under AS 43.55.023 and .025

FY 2005 - $21 million
FY 2006 - $27 million
FY 2007 - $151 million
FY 2008 - $326 million
FY 2009 - $320 million
FY 2010 - $172 million (as of February 2010)

Figure 1: Oil and Gas Tax Credits and Certificates to Date



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As can also be seen in Figure 1, $802 million in credit certificates have been issued since the credit program began in 2003; of these, $176 million have been applied to tax liabilities, either directly or through transfers to other companies, $400 million have been sold to the state, and $226 million are still outstanding. In addition to this, there are $216 million in credit applications either in process or denied; it is estimated that about $148 million of these will ultimately be redeemed. From this information, we can determine that the total amount of outstanding certificates and yet-to-be processed applications is just over $374 million.

Figure 2 below shows the payment history for production tax credits certificates that have been sold to the state, along with the appropriations that authorized those payments, either through the Oil and Gas Tax Credit Fund, authorized at AS 43.55.028 or through appropriations prior to the creation of the fund.

Figure 2: Appropriations and Payments Made for Oil and Gas Tax Credits Certificates

Appropriation	CH 6, SLA 2007	54,646,593
Payment	FY 2007 Refunds	(54,646,593)
Appropriation	CH 28 SLA 2007	25,000,000
Appropriation	CH 11, SLA 2008	125,000,000
Earnings		39,116
Payment	FY 2008 Refunds	(54,143,421)
Appropriation	CH29, SLA 2008	325,000,000
Appropriation	CH 27, SLA 2008	175,000,000
Earnings		18,168,845
Payment	FY 2009 Refunds	(193,099,396)
Appropriation	CH12, SLA 2009	(415,000,000)
Appropriation	CH12, SLA 2009	180,000,000
Earnings		2,715,382
Payment		(98,444,018)
Oil and Gas Tax Credit Fund Balance		90,236,508

History of Credits Applied Against Tax Liabilities

In addition to the exploration tax credits under AS 43.55.025 and the capital expenditure credits under AS 43.55.023 (a)(1) & (2), the production tax statutes under the 2006 and 2007 amendments, allowed producers to take against the production tax liability, the transitional investment expenditures (TIE) credits authorized under AS43.55.023(i) and the small producer credits under AS 43.55.024.

Transitional Investment Expenditures (TIE) Credits

The 2006 tax amendments authorized taxpayers to take a 20% credit on allowable qualifying capital expenditures incurred between March 31, 2001 and April 1 2006 with the credit not exceeding 10% of qualified capital expenditures incurred between March 31, 2006 and January 1, 2008. The 2007 amendments revised the credit to cover only producers or explorers not having production prior to January 1, 2008. The TIE credits are not transferable and may not be carried forward beyond 2013.

Small Producer Credits

There are 2 types of small producer credits allowable under the production tax statutes in AS 43.55.024. Under section (a) of the statute, companies producing less than 50,000 barrel per day of oil BTU equivalent may take a credit of up to $6 million against a production tax liability. The credit is allowed for production from wells outside of Cook Inlet and North Slope and can be taken annually; however, the credit may not be converted to transferable cash certificates for cash or transfer, and may not be carried forward. This credit expires in 2016.

The small producer credit under section (d) of AS 43.55.024, is available for companies producing not more than 100,000 barrel per day of oil BTU equivalent and ranges from $12 million to $0 depending on the level of production. Production is not restricted by region. The credit is not cashable or transferable and can only be applied against a production tax liability. This credit expires in 2016.

Credits Applied Against Production Tax Filings

Companies filing production tax annual returns claimed earned production tax credits of $331 million in FY07, $569 million in FY08 and $376 million in FY09, a total of $1.276 billion over the 3 year period. Of these amounts, the producers used these credits to offset their production tax liabilities by $322 million in FY07, $469 million in FY08 and $282 million in FY09 a total of $1.073 billion. Under the 2006 amendments, companies could apply tax credits earned for qualifying capital expenditures in the year that the expenditures were incurred. The 2007 amendments changed the statute to allow only 50% of the credit to be applied against the production tax liability in the year earned, thus the amount of credit earned increasingly exceeded the credits applied against tax liabilities in FY08 and FY09. At the end of FY09, there remains a balance of $203 million of unused credits to be applied against tax liabilities in future years. This is illustrated on Figure 3 below. Figure 4 shows the type of credits applied against production tax liabilities. The amounts reported on the tax filings are subject to audit and may change upon adjustment.

Figure 3: Credits earned versus Credits applied against tax liabilities

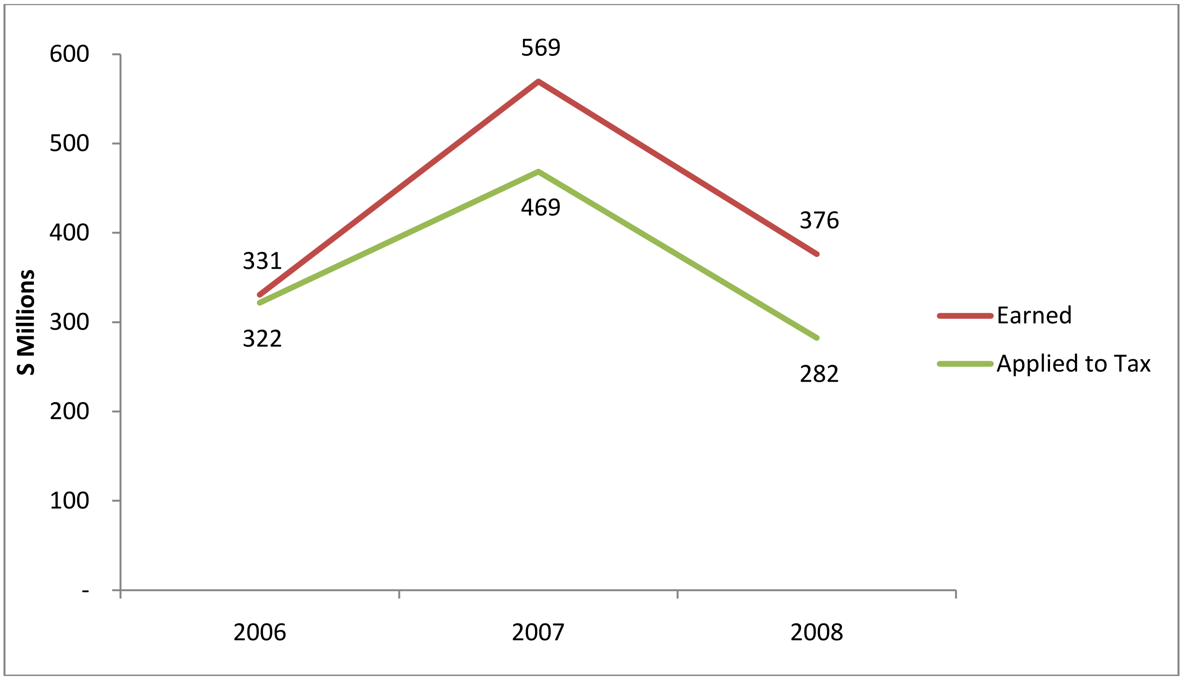
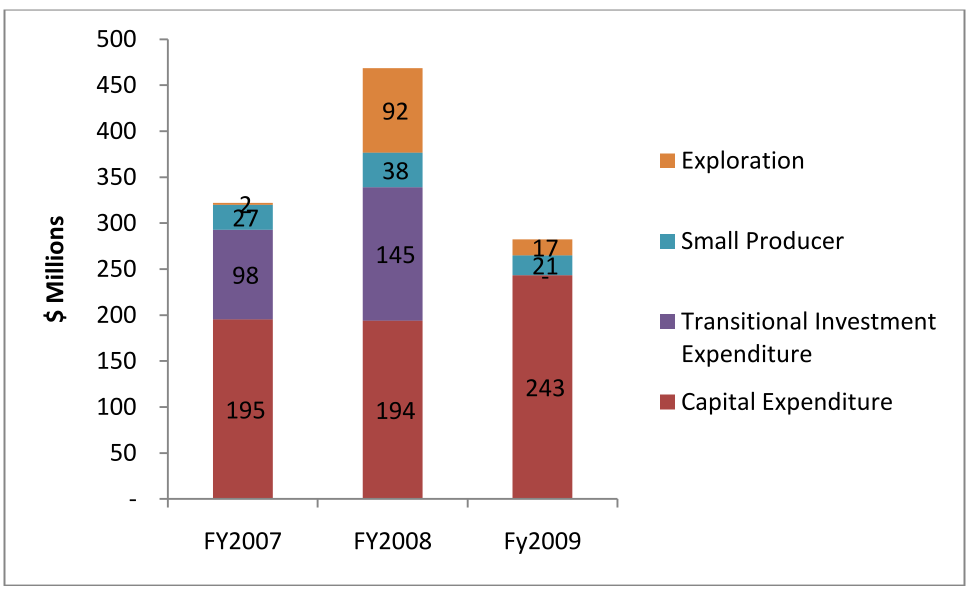


Figure 4: Credits by type applied on tax returns



Oil and Gas Tax Credit Forecast

We project that approximately $340 million in credits would be taken directly against tax liabilities in FY 2010 and that credit offsets would raise to $390 million in FY 2011. We make the distinction between credit offsets and credit certificates only because their impact on state revenues is slightly different. Tax offsets directly reduce the amount of revenue received in the first instance by the state, while credit certificates, when subsequently purchased by the state require the state to allocate general funds for such purchases as part of the budget process. It is important to note that these projections, just like other oil and gas revenue projections are based on assumptions relating to oil prices, investment decisions, and availability of equipment and manpower to complete projects. As economic conditions change, companies continually modify their investment plans. Thus, as with every revenue projection related to oil and gas development, one should avoid assigning an undue amount of certainty to these forecasted numbers.

There are over 20 companies currently funding the development of oil and gas prospects in the state. These prospects may or may not lie within established unit boundaries, and they may or may not qualify for exploration incentive credits. One of the developments, the Oooguruk field, is now in production and another, the Nikaitchuq field, is in active development. As these and other fields come online, it becomes more difficult to project whether credits will be applied against a tax liability, or whether credit certificates will be sought.

Timing of State Payment for Tax Credits

As discussed earlier, AS 43.55.028 authorizes the state to purchase production tax credit certificates directly from companies that have earned them from oil and gas expenditures in the state. Subsections .028(e)(1) through (7) lay out additional requirements a company must meet in order to receive a payment from the state for these certificates. Among the requirements listed is a provision that companies seeking these payments spend, within 24 months of the application period, an amount equal to or exceeding the value of the payment sought. This and other requirements that must be satisfied prior to the payment for credit certificates impact the timing of the state's payment for those certificates.

Conclusions

As of February 20, 2010, the Oil and Gas Tax Credit Fund has a balance of $90 million. This represents appropriations for FY 2007, 2008, 2009 and 2010. The dollar value of requests received for tax credit certificates to date is $1.018 billion. Of this amount, approximately $226 million are outstanding and potentially subject to state purchase. Applications representing an estimated $148 million in tax credits are pending, but these will likely not be issued until FY 2011. For FY 2011, we estimate that an additional $200 million in tax credits will be earned, and available for state purchase. These three estimates total $574 million in potential credits earned and available for state purchase through the end of FY 2011. We are not able to make any projections at this time as to when the state purchases of credits will occur, but based on history, it is likely that the timing of some of the credit purchases will be FY 2011 and beyond. Subject to audit, the information received on the annual tax filings through FY09, indicates that there is a balance of $203 million in tax credits available to be applied against future tax liabilities.

Note about this report: This report was prepared using incomplete data from several different sources specifically for this request. The DOR does not currently have a means to capture all the relevant historical and forecast credit data in a central database available to all groups that rely upon that data. Accordingly, any users of this information should be cautioned that this forecast is subject to change as data becomes available.

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