

COST ALLOCATION METHODOLOGY AND IMPACT ON CSSB 305 (FIN)

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Alaska Department of Revenue

Cost Allocation Implications

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- With a separate oil and gas tax system, how costs are allocated between oil and gas has a significant impact on both the oil tax and the gas tax, and on the overall tax
- Because oil and gas are generally produced together, it is not easy or straight forward to determine the costs applicable to the gas or oil 'produced'
- The cost allocation method could result in uncertainty, disputes, and delays
- Cost allocation should be specified in the statute, and is a very important policy decision
- CSSB 305(FIN) requires DOR to develop regulations to allocate costs; requires DOR to "consider" allocating on a BOE basis

Different Cost Allocation Options

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- Detailed purpose item by item attribution methods
 - ▣ Army of accountants for all parties
- Formula or Rule based attribution methods
 - ▣ Simpler to administer, more difficult to initially agree
- Zero Sum Game, for every 'winner' there is a 'loser'

Item by Item Attribution

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- Used elsewhere in the world
- Generally self certified by the Producers, checked/audited by the regulator
- Historically in other jurisdictions, attribution differences have led to a considerable number of disputes especially where there is significant difference in oil and gas tax rates
 - ▣ Producer versus government
 - ▣ Producer versus producer
 - Under CSSB305 (FIN) each producer is affected differently, so to the extent that producers have any discretion in how costs are allocated, it could result in disputes between working interest owners and delay investment decisions

Formula or Rule Based Attribution

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- May not accurately reflect the “true” purpose of the cost

- Examples include attributing costs based on
 - ▣ Proportion of Production on a BTU basis (BOE)
 - ▣ Proportion of Sales Value - e.g. Gross Value at Point of Production (PoP)
 - ▣ Proportion of remaining Reserves
 - ▣ Rule of dominant use - either gas or oil
 - ▣ Deemed oil unless item is 100% gas related
 - ▣ Combination of any of the above

Impact of Cost Allocation Choices

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- CSSB305 (FIN) requires the allocation of costs to oil or to gas, but does not prescribe the allocation method:
 - ▣ Allocation of individual costs would be highly impractical and would require significant auditing resources.
 - ▣ How should costs related to lease acquisition, exploration, appraisal and development activities be allocated? There is no current production associated with these costs?

Impact of Cost Allocation Choices

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- To examine the potential economic impact of the allocation method, three somewhat diverse cost allocation possibilities are compared:
 1. By Rule: based on relative BOE production
 2. By Rule: based on relative gross value at Point of Production (PoP)
 3. On Item by Item basis: assumed “actual” costs are split 90/10 between oil and gas

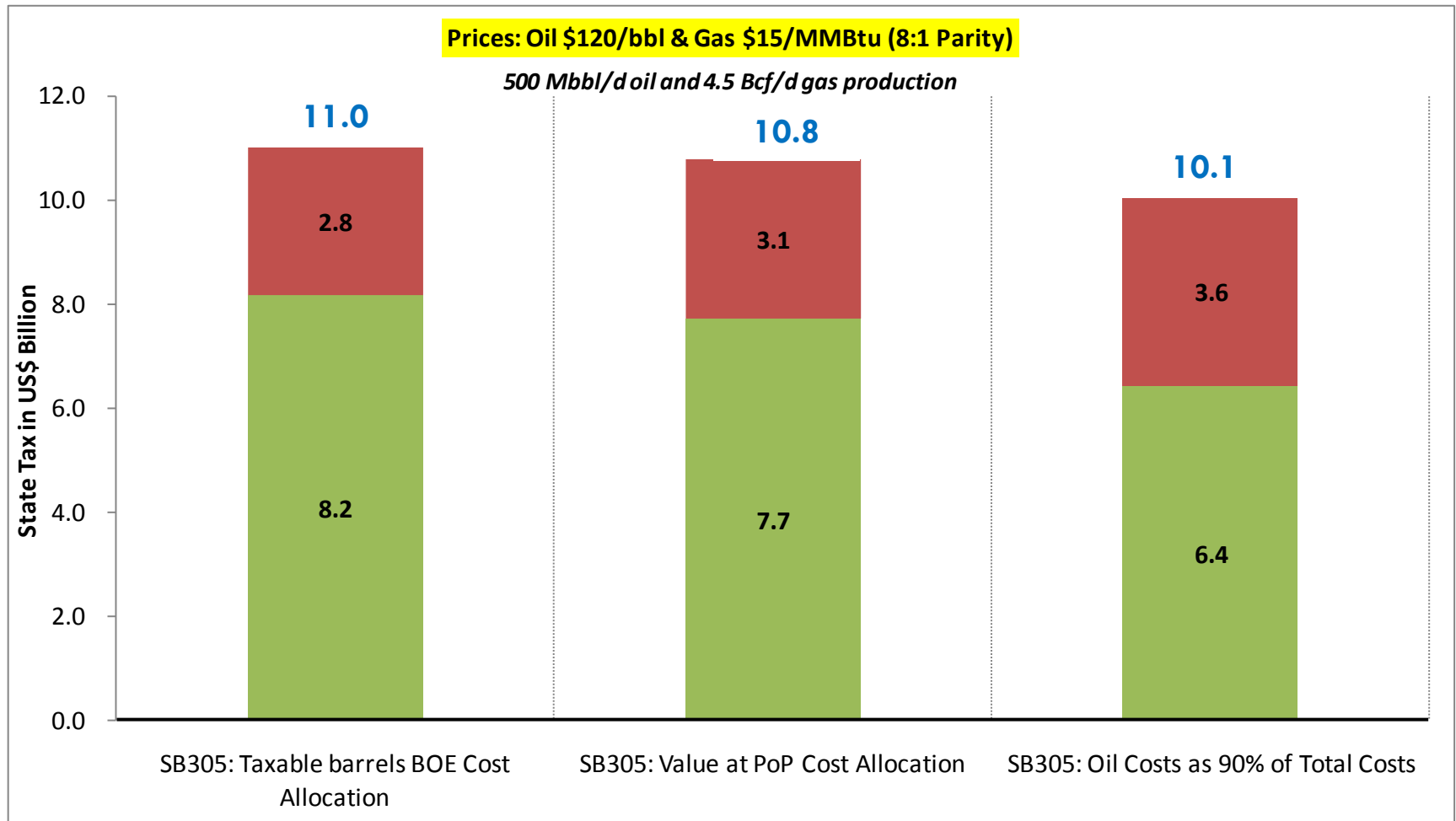
Cost Allocation Example Data

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	Oil	Gas	Total
Production (MMboe)	183	274	457
Gross Value at PoP (\$MM) – \$120 and 15:1	20,714	5,749	26,463
Gross Value at PoP (\$MM) – \$120 and 8:1	20,714	17,246	37,960
Split Based on BOE (%)	40%	60%	100%
Cost Allocation (\$MM)	1,760	2,640	4,400
Split Based on Gross Value at PoP (%) – 15:1	78%	22%	100%
Cost Allocation (\$MM)	3,444	956	4,400
Split Based on Gross Value at PoP (%) – 8:1	55%	45%	100%
Cost Allocation (\$MM)	2,401	1,999	4,400
Split Based on assumed “Actual” (%)	90%	10%	100%
Cost Allocation (\$MM)	3,960	440	4,400

At Low Parity – Moves \$900MM in total taxes Changes oil taxes by \$1.8Bn

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At High Parity – Moves \$1.0Bn in total taxes Changes oil taxes by \$1.8Bn

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