

State of Alaska
Department of Revenue
Commissioner's Office



SEAN PARNELL, GOVERNOR

333 Willoughby Avenue, 11th Floor

P.O. Box 110400

Juneau, Alaska 99811-0405

Phone: (907) 465-2300

Fax: (907) 465-2394

January 14, 2010

Honorable Governor Parnell,

Recently you requested a review of Alaska's oil and gas production tax, and recommendations for how the production tax could be improved. Enclosed for your review is analysis of Alaska's oil and gas production tax (otherwise referred to as "ACES"), which was compiled at my request by the Department of Revenue's technical staff. The ACES Status Report evaluates whether ACES is meeting its intended goals of providing a fair share of revenue to the state while encouraging investment in new oil and gas exploration and development activities.

Based on the report, I am recommending a collection of potential amendments to ACES and its associated Exploration Incentive Credit (EIC) program. The amendments are primarily intended to accomplish two things: 1. Further incentivize drilling and other production enhancing activities; and 2. Address a number of provisions of ACES that may keep explorers from enjoying the full intended value of the capital credit program.

The status report shows that ACES successfully allowed the state to share in the benefits of high oil prices while accommodating fluctuations in production costs and oil prices. ACES adjusted when oil prices tumbled and kept oil operations in Alaska highly profitable relative to other oil provinces. With respect to the impact that the new production tax has had on investment activity, the report is positive, but ultimately inconclusive. While the overall level of taxation increased with ACES, it distributed the impact of that tax burden in a way designed to incentivize investment in new exploration and development. Since ACES passed the legislature, overall spending on oil and gas activities on the North Slope has increased. However, given only two and a half years of experience, during which time oil prices climbed to \$140 per barrel then plunged to under \$30 per barrel, it would be premature to attribute the increased level of oil company investment to the success of ACES.

Oil taxes are clearly an important factor in industry investment decisions. However, it is misleading to isolate their influence from other key factors, such as world oil prices, geologic potential, access to land, resources and markets, costs of infrastructure and support services, and the legal and regulatory framework. As noted in the report, the true merit of Alaska's current fiscal system can only be determined when it is evaluated in conjunction with these other variables. The scope of the status report, and the limited timeframe since ACES passed, do not allow for such a comprehensive analysis and definitive conclusions.

In addition to documenting several promising trends in industry spending activity, the report notes a number of discrete policy issues associated with the production tax where improvement can be made. These warrant your consideration as potential amendments to the ACES framework.

1. **Increase Credits for All Well-Related Activity to 30%:** The Capital Credit and Exploration Incentive Credit (EIC) programs have been identified as influential in spurring exploration activities. However, the EIC program's 30% credits are only available to wells located more than 3 miles from all existing wells. The state has a significant interest in also incentivizing infill drilling and other well work that will increase oil production, particularly for heavy oil. I therefore recommend expanding the EIC program so that all expenditures related to drilling and well work that add new production or increase the efficiency of existing production will qualify for the 30% EIC credit under AS 43.55.025 regardless of a well's location relative to existing wells.
2. **Increase Access to Capital Credits for New Explorers:** Small producers are currently required to invest in new activities during subsequent years in order to obtain direct payment from the state for previously earned tax credits. This is not an issue for existing producers because they simply deduct credits from their current tax bill and do not need to seek direct payment from the state. Deleting this provision would make the tax credits more accessible to smaller explorers, level the playing field between new and existing operators, and eliminate an unfair double standard.
3. **Accelerate Capital Credit Usage:** Companies currently can only use half of their capital credits in the year they are earned, and the other half the following year. This is true whether the credits are applied against a tax liability or purchased by the state. Taxpayers would see increased value in the credits if they could apply the entire credit in the first year. In addition, this would ease the cost of administering these credits.

4. **Waive Interest on Late Tax Payments Due to Drafting of Regulations:** The ACES regulations, including those defining 'allowable lease expenditures' are being finalized this month. Under the statutes, these regulations are to be applied retroactively to various dates in 2007. To the extent additional taxes are due as a result of the application of the new regulations, such payments would be subject to interest and possibly penalties. While the department can waive penalties, it cannot waive interest charges. A statutory change is required in order to permit the waiver of interest.

I am confident you will find the ACES Status Report informative and interesting. Please consider my recommendations to improve the effectiveness and fair administration of ACES and the EIC program. I look forward to continuing to work with you to encourage additional oil and gas development while preserving Alaska's equitable share of oil and gas profits.

Sincerely,



Patrick S. Galvin
Commissioner