Thoughts on Alaska Oil & Gas

Brad Keithley's Blog

Five things to look for in oil tax reform …

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Politico, a mostly online newspaper that covers national political affairs — and with which I often open my mornings — routinely attempts to provide readers with a guide to significant upcoming events with a list — usually five — of what they consider the most important things to look for as the event unfolds.

As Alaska begins to consider changing its approach to oil taxes in the upcoming session, I have developed a list of five characteristics that I will look for in evaluating various proposals. I share them for whatever value that may have to others.

1. *Competitive Rates.* As a number of other commentators have observed, one of the most important characteristics of ACES that needs to be addressed in order to restore investment is the level of tax — the "tax rate." As former Division of Revenue economist Roger Marks summarizes in a recent piece in the *Oil & Gas Finance Journal*, Alaska's current tax rate under ACES is "fourth highest out of 24 [comparable] regimes." A "comparable regime" means a place "with a comparable risk/reward balance [to Alaska], in terms of features such as reserves, costs, and geological risk."

"For 17 of those regimes Alaska's effective tax rate ranged from 12 to 37 percentage points higher. At a $118/bbl market price, and a $91/bbl net value, each percentage point difference is worth 91 cents/bbl after-tax."

Marks concludes, "because of taxes, … producers can demonstrably make considerably more money nearly anywhere else in the other comparable jurisdictions than in Alaska."

Achieving tax rates *competitive with comparable jurisdictions* is critical if Alaska is to reestablish significant investment. But rates aren't the only characteristic that is important. Read on …

2. *Durability.* While Alaska previously had made occasional adjustments to its tax policy prior to 2007, none came close to the sea change created by ACES. Compared with ACES, the previous changes mostly could be described as tweaks. By some estimates, ACES increased oil taxes by over 400%.

Because the revised tax applied equally to both old and new investments, ACES had the effect of dramatically altering the economics of investments made not only subsequent to its passage, but also those that were made prior to 2007. At least from the perspective of investors, the 2007 passage of the tax had the effect of retroactively confiscating a significant portion of the return which they had anticipated earning from prior investment decisions.

Going forward, investors will evaluate any proposed change in Alaska's tax structure not only from the perspective of what the change is, but also whether the change is likely to be durable. Now that Alaska has demonstrated an inclination to apply tax changes retroactively to prior investments, investors will be highly concerned about being caught again in a situation where they make long term investment decisions and the state thereafter once again increases the tax structure after a few more years. Investors will be much less likely to invest if that potential remains.

While some legislators (including Republicans) have suggested that the legislature is not able to provide certainty about its tax policy, that is not the case. The state clearly has the power to enter into long term, binding contracts with investors, such as it does with unions and has with investors through oil & gas leases.

Some suggest that the power to tax is unique and one legislature cannot contract away a subsequent legislature's ability to exercise that power. Even if that is true, however, there are other ways of stabilizing total state take, such as by providing that any future increases in taxes can be taken as a credit against royalty. Such "economic stabilization" clauses are common throughout the world.

The extent to which the legislation provides for durability is important. Investors will be ***much*** less likely to commit to substantial, long term projects — the very type of projects that result in significant additions to the supply base — without some assurance that the revised system is durable.

3. *Neutrality.* As I have written elsewhere, one of the worst characteristics of ACES is its vastly differing treatment of various sources of supply. Production from existing units is taxed at a significantly higher rate than is otherwise needed in order to fund direct state subsidies (what some refer to euphemistically as "credits") of up to 60% of total costs for activities undertaken outside of the units.

The result is that activity inside existing units is artificially suppressed while activity outside of existing units is artificially subsidized, appearing to make those activities economic, when they likely are not. ***No*** activity is left to respond to pure market signals.

This approach makes no sense in Alaska's current situation. As I have previously explained, by far the largest new production potential lies inside of Alaska's existing units, and the sources of supply inside the existing units likely can be brought on line faster than those that are located farther from existing infrastructure. As a result, if anything Alaska should favor higher tax credits for the development of new fields located inside of existing units than outside. Currently, however, ACES produces the opposite result.

At their core, credits are a way of substituting government's judgment for business in picking economic winners and losers. Through tax policy, the government favors investment in some activities — the winners – and discourages investment in others — the losers — by raising their costs. ACES backs the wrong horses.

Rather than attempt to outguess the market, the government should adopt a neutral stance between fields and let the market decide which are the most economic to produce.

4. *Simplicity/Predictability*. One of the most consistent complaints from current and potential investors about ACES is its complexity. While companies can employ people and computing power to deal with complex equations, generally speaking simple tax structures attract more investment than complex structures.

There largely are two reasons for that. The first is that investors generally are concerned that complex tax structures have a greater potential for producing surprises than simple ones — and their experience is that, when they arise, surprises generally produce bad things.

The second reason is that complex tax structures usually are the result of a lot of fine tuning, and that once legislators and regulators start down the road of "managing" investments through the use of the tax code, they can't resist the temptation to continue fiddling with the knobs as the tax structure fails to produce the results that they intended. As a result, complex tax structures tend to be changed more often than simple ones, making them much less predictable.

ACES, literally, is one of, if not the most complex oil tax structures in the world. (With the exception of the 1970 -80′s era federal windfall profits tax, ACES is by far the most complex structure with which I have dealt.) It also is one of the least predictable. Even five years after its passage, very few, if any, audits have been completed and the implementing regulations, which at times are extremely vague, have yet to be interpreted. As a consequence, even now, five years after passage, investors are not certain how ACES ultimately will be applied to investments.

Investors understandably favor simplicity and predictability. To help improve the investment climate in Alaska, the coming changes to the Alaska tax structure should make a ***significant*** move in that direction.

5. *Alignment*. As I explain in a recent piece in the *Alaska Business Monthly*, Alaska's current oil policy is significantly out of alignment with the state's own objectives. Certainly part of that relates to the tax code. As explained above, ACES attempts significantly to tilt private investment in Alaska away from the state's largest and best defined new prospects to smaller, uncertain and unknown opportunities. By overcharging potential production from its best prospects in order to subsidize exploration of others, Alaska's policies impair the achievement of its own objectives.

But the misalignment between policies and objectives goes much further. The state's recent actions regarding the Pt. Thomson leases provide another good example.

After protracted legal proceedings, this year the Pt. Thomson owners agreed to pursue the development of the field.

Like its approach to tax credits, however, the state's efforts at directing these investment decisions have created unintended consequences. As operator, Exxon already has spent in excess of $1 billion on the Pt. Thomson project and estimates that, before completion, it will spend billions more. At the same time, investment in the development of the oil available in other existing North Slope units has declined.

In the absence of developing a major gas market, the maximum production anticipated from Point Thomson is 10,000 barrels of liquids per day, which is significantly smaller than other potential opportunities available in the existing units and a minor offset to the anticipated net loss of 50,000 barrels per day of production projected by the state between 2011 and 2015.

As a consequence, the effect of the state's efforts at Pt. Thomson essentially has been to focus investment on one project on the North Slope, likely at the expense of others offering significantly greater potential.

The reason that the state pursues such counter productive efforts is that the state currently does not have either the ability — or, seemingly, even a compelling economic interest — in determining which projects make the most economic sense. Instead, the state's decisions are driven largely by political reasoning. In essence, the state acts as a back seat driver, attempting to steer industry investment indirectly and towards non-economic objectives.

Recently, a co-author and I proposed a means of better achieving alignment between the state's actions and objectives that has proven highly successful in other parts of the world and, I firmly believe, would have the same result in Alaska. While the proposal met some criticism, I anticipate that support will grow as others come to realize that a revised tax policy alone will be insufficient to attract the levels of investment – estimated by DNR Commissioner Dan Sullivan to be a minimum of $4 billion/year – required to realize Alaska's full oil potential.

Any tax reform proposal should progress toward alignment.

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ONE RESPONSE TO FIVE THINGS TO LOOK FOR IN OIL TAX REFORM …

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