# Alaska Department of Revenue

## Oil and Gas Tax Credits- North Slope Focus

## Presentation to Senate Tax Credit Working Group

Anchorage, October 13, 2015

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# What We'll be Discussing

1. Credits from DOR Perspective
2. Activities since Sept 8th Meeting
3. Categories, Trends, and Latest Data
4. North Slope Tax Regime
5. North Slope Credits
6. How the N.S. Credits Operate in Practice
7. Potential for Legislative Changes

# Credits from DOR Perspective

# Credits from DOR Perspective

- Budgetary Concerns
  - Tremendous growth of the use of the credit program, accelerating in recent years
  - Questions over sustainability of the existing program given current fiscal limitations
  - What are reasonable options looking forward?

# Credits from DOR Perspective

- Actions Taken to Date
  - Restriction on cash repurchases for FY16 to $500 million
  - Worked with industry and financial entities to resolve liquidity issues associated with repurchase limits
  - Over 20 meetings with industry, investment entities, oil and gas service companies, legislators, industry organizations and their representatives to understand how credits are used and discuss possible alternative programs

# Credits DOR Perspective

- Actions Currently in Progress
  - Work with Legislative committees and Senate working group
  - Determine options for a modified credit program
  - Develop plan for transition between current and modified program
  - Finalize plan and draft credit reform legislation

# Activities Since September 8 Meeting

# Activities Since September 8th Meeting

- Information learned at subsequent presentations by producers and finance companies
- Meetings with several producers regarding their specific concerns and suggestions
- Continued development of draft legislation
- Early development of FY17 revenue projections and budget, with discussion of possible fiscal impact of tax credit reform

# Categories, Trends and Latest Data

# Categories, Trends, and Latest Data

- Areas of the State
  - North Slope “North of 68 degrees latitude”
  - Cook Inlet “…Sedimentary Basin”
  - “Middle Earth” (everything else)
- Types of Credits
  - “023” (Expenditures and Operating Losses)
  - “025” (Exploration)
  - “024” (Small Producer, Per-Barrel, <u>Use-or-lose</u>)
  - “43.20” (Taken against Corporate Income tax)
- How they’re used
  - Used against tax liability
  - Repurchased by the State

# FY 2007 thru 2015, $7.4 Billion in Credits

## North Slope

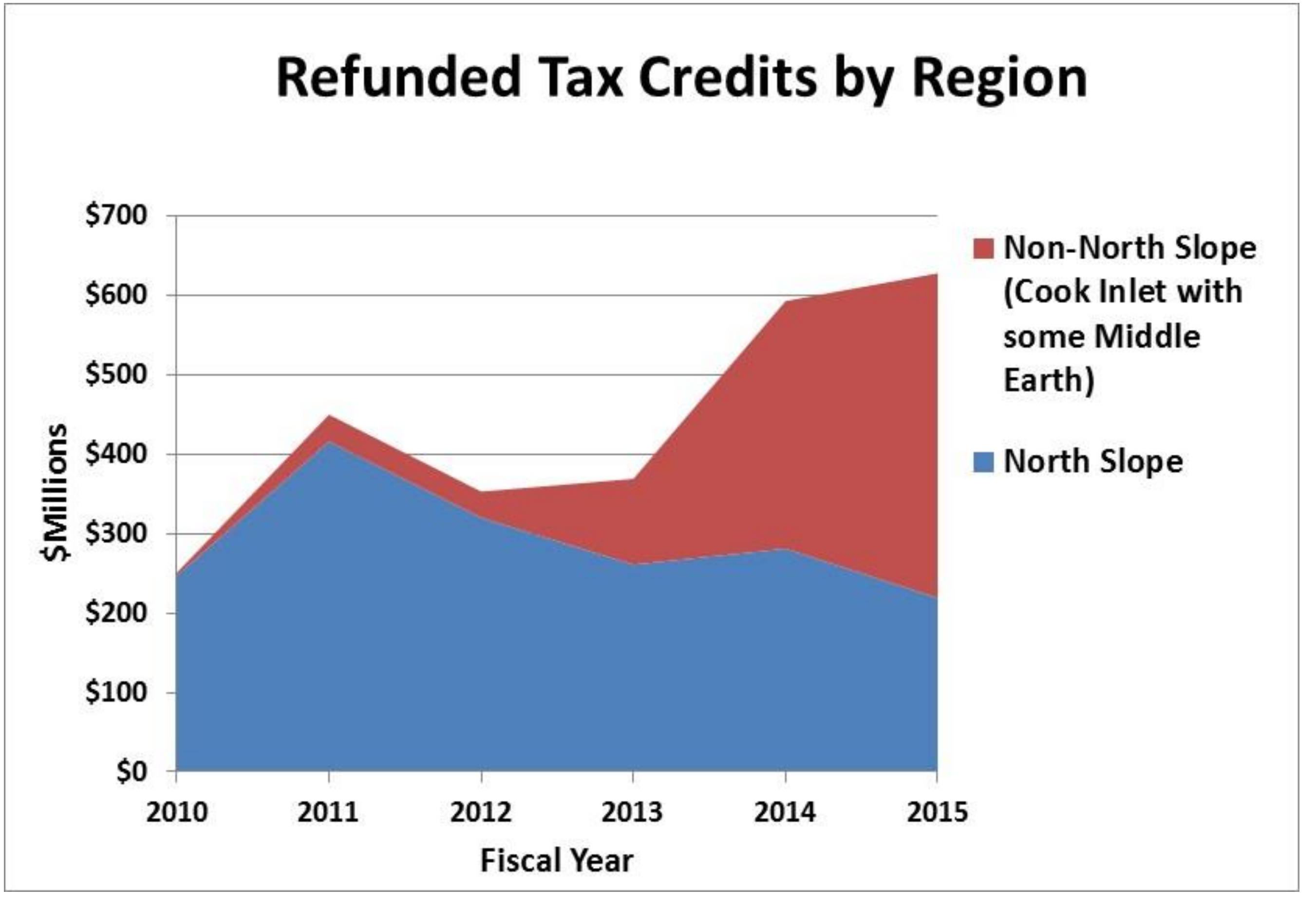
- $4.3 billion credits against tax liability
  - Major producers; mostly 20% capital credit in ACES and per-taxable-barrel credit in SB21
- $2.1 billion refunded credits
  - New producers and explorers developing new fields

## **Non North Slope** (Cook Inlet & Middle Earth)

- $0.1 billion credits against tax liability
  - Another $0.5 to $0.8 billion Cook Inlet tax reductions (through 2013) due to the tax cap still tied to ELF
- $0.9 billion refunded credits (most since 2013)

# Categories, Trends, and Latest Data

- Tremendous growth in non-North Slope (almost entirely Cook Inlet) refunded credits since FY10



# Categories, Trends, and Latest Data

- Preliminary FY15 Totals on Repurchased Credits ($millions)

| | April Report | Prelim Final |
|---|---|---|
| North Slope "023" | $340 | $198 |
| North Slope "025" | $0 | $21 |
| Non-NS "023" | $255 | $384 |
| Non-NS "025" | $26 | $25 |
| **Total** | **$625** | **$628** |

**Non-North Slope was 65% of Credits Repurchased by the State in FY15**

# New Information (Aggregated Data)

**Of the $3 billion in state-refunded credits through the end of FY15:**

- $1.45 billion went to six North Slope projects who now have production
- $0.65 billion went to 13 North Slope projects who do not have any production. Some of these are abandoned, and some are in process
- $0.45 billion went to six non-North Slope projects who have production
- $0.45 billion went to eight non-North Slope projects who do not have any production

# New Information (Aggregated Data)

## Of the $500 million in authorized credit repurchases for FY16:

- About $425 million has already been repurchased
  - About $175 million from North Slope and $250 million from Cook Inlet / Interior
  - Nearly 60% non-North Slope, consistent with FY15 final data
- Nearly all are 2014 NOL's and Cook Inlet Drilling
- Most of the applications we have in-hand don't need to be issued until next July

# The North Slope Tax Regime

# The North Slope Tax Regime

- Commercial Oil production in Alaska started in Cook Inlet:  Swanson River discovery 1958
  - Oil production peaked in 1970 at about 225,000 bbl / day (low of 9,000 in 2010, up to 16,000)
- **Cook Inlet got us Statehood.**
  **North Slope got us Wealth**

# The North Slope Tax Regime

- Major Prudhoe Bay discovery well in December 1967, "step out" well in March 1968 confirmed size of field
- September, 1969 state lease sale for acreage near Prudhoe Bay discovery netted **$900 million** in bonus bids
  - The entire General Fund budget in 1969 was $128 million. In 1971 it was $310 million.
- Delays in pipeline planning and permitting meant that the lease money was largely gone by 1974

# The North Slope Tax Regime

## Four Main Sources of Oil Revenue

**Property Tax ($0.1 billion in FY12, $0.1 billion in FY15)**

- Pipeline, Equipment, Facilities
- Numbers are state share; more is shared with local governments

**Royalty ($2.9 billion in FY12, $1.4 billion in FY15)**

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

**Production Tax ($6.1 billion in FY12, $0.3 billion in FY15)**

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

**Corp. Income Tax ($0.6 billion in FY12, $0.2 billion in FY15)**

- Taxes remaining profit after production tax
- Global income apportionment; 9.4%, but effectively closer to 7%

**Total dropped from $9.7 billion to $2.1 billion in 3 years**

# The North Slope Tax Regime

- Property tax statutes are relatively unchanged since the 1970s, although some properties notably TAPS end up in court nearly every year
- Royalties are set by contract (lease)
- Corporate Income Tax for oil and gas used “separate accounting” 1978-1981 but has been relatively stable since then

Production (or “Severance”) Tax is where all the drama has been in recent memory

# The North Slope Tax Regime

- Pre-1977 Cook Inlet tax regime was a flat percent of the gross, started at 1% & increased to 5% with a minimum cents-per-barrel tax
- ELF 1977 was a 12.25% gross tax (increased to 15% in 1981) with a multiplier (0 to 1) to help challenged fields.
  - Based on per-well production for each field, with the idea that the "economic limit" of 300 barrels/ day the tax would drop to zero
  - Ability to manipulate tax rates with multiple wells, satellite fields
- 1987 "double whammy" between declining prices & revenues plus a 10-year ELF provision expired reducing the Prudhoe multiplier from 100% to 70%

# The North Slope Tax Regime

- 1989 ELF amendments increased the multiplier for Prudhoe Bay and Kuparuk while reducing it on the smaller fields
  - Benefits eroded over time as well productivity declined and “satellite” fields were added
  - Legal issue of “economically interdependent”
  - Gov. Murkowski aggregated the satellites in 2005
  - Regardless, effective tax rate for all fields except Prudhoe and Alpine was below 1% by 2005

# The North Slope Tax Regime

- 2006 Petroleum Production Tax “PPT” changed from taxing gross revenue to net profits
  - Part of SGDA Gasline negotiations
  - First comprehensive use of tax credits
- Final 2006 revenue was about $800 million less than anticipated due to greater than estimated per-barrel spending
- Fall 2007, ACES was passed as a modification to PPT based on current knowledge of costs. Increased “progressivity” at higher prices
  - Prices had recently increased from **$50’s to $70’s**

# The North Slope Tax Regime

- ACES took effect July 1, 2007 (FY08)
- Oil prices spiked to well over $100 within months, creating huge unexpected surpluses
- FY08 – 13, total production taxes of $27 billion
  - (DOR's estimate for SB21 revenue in that time period would have been about $18 billion)
- Paid back $5.5 billion that had been borrowed from CBR for budget shortfalls 1994 – 2004
- Robust capital budget even during national crisis
- In 2002 state was talking about running out of savings in 2 years. By 2013 we had $18 billion in savings not including the Permanent Fund

# The North Slope Tax Regime

## Major Features of SB21- Effective 2014

- Net profits tax at a flat 35%, tied to a 35% Net Operating Loss credit (increased to 45% for 2014-15)
- Elimination of 20% capital spending credit
- Per-taxable barrel credit based on a sliding scale between $0 and $8 per barrel tied to price
- New Oil tax break called a “gross value reduction” exempting 20-30% of gross value from taxation
- Stronger 4% gross-based “floor” on legacy oil, which is the main source of our production tax revenue today
- Reduced interest on unpaid taxes from 11% to 4%
- **Bill assumed oil prices in the $80-$120 range**

# Tax Credits on the North Slope

## ACES “capital” credits were eliminated in 2014

- 45% Carry-forward annual loss (sometimes called “Net operating loss” or “NOL”) credit (AS 43.55.023(b))
  - Reimburses companies for a percentage of their net operating losses

**The Net Operating Loss credit makes up 90% of all repurchased credits on the North Slope today**

# Tax Credits on the North Slope

## A word on Net Operating Loss Credits:

- On the North Slope, NOL credits are an important “playing field leveler” between new companies and the major producers
  - With the 35% profits tax, when a major producer spends $1 it reduces their taxes by 35 cents
  - The 35% Loss credit provides a similar benefit to companies without a tax liability
  - In many ways this is a core provision of the policy to bring competition / new players to the basin

# Tax Credits on the North Slope

**And where did that <u>45%</u> NOL Credit Come From?**

- Under ACES, a North Slope developer received about 45% of his expenditures back via credits: 20% for the capital credit plus 25% for the NOL
- Several projects were under construction as SB21 was being debated. Owners did not want to lose their current level of benefits
- The legislature devised the 45% “temporary bump” as a sort of hold-harmless for these companies

# Tax Credits on the North Slope

- Alternative Credit for Exploration (AS 43.55.025(a)-(f))
  - Called “alternative” because of an older, no longer used exploration credit elsewhere in statute
  - 30-40% refundable credit for certain exploration activities
  - DNR pre-approval and data submission requirements
  - Originally added to statute in 2003, before switch to net profits system
  - Can be stacked with 023(b) (NOL) credits
  - **Sunsets 7/1/16**

**The various “.025” credits made up the remaining 10% of North Slope repurchases in FY15**

# Tax Credits on the North Slope

- Small Producer Credit (AS 43.55.024(c))
  - Credit of up to $12 million / year for producers with less than 100,000 bbl / day of production
    - Ramps down to $0 as production increases from 50,000 to 100,000 bbl / day
  - Not refundable. Cannot reduce taxes below zero. Cannot be carried forward
  - Closed to new applicants in 2016. A company can receive the credit for up to nine years
  - FY15 total on North Slope was $50 million. All taken against tax liability

# How North Slope Credits Operate in Practice

# For Explorers

- Most expenditures qualified for the highest level (40%) of the “exploration” credit
- Most expenditures also qualified for the “carry forward annual loss” or “NOL” credit (25%)
- These were “stackable,” meaning state reimbursed about **65%** of total expenses

# For Developers (pre-Production)

- Most expenditures qualified for Qualified Capital Expenditure (20%) credit
- Most expenditures also qualified for the “carry forward annual loss” or “NOL” credit (25%)
- These were “stackable,” meaning state reimbursed about **45%** of total expenses

# North Slope Credits in Practice- Pre-2014 (ACES era)

## For Producers

- Taxes were assessed based on the 25% base rate plus the “progressive” surtax based on per-barrel profits
- Smaller producers could reduce their tax by up to $12 million, but not to below zero
- Most expenditures qualified for the Qualified Capital Expenditure (**20%**) credit
- The Capital credit could either be used to reduce liability or be repurchased by the state if there was no liability. Capex credit not affected by the 4% minimum tax.

# For Explorers

- Most expenditures qualify for the highest level (40%) of the "exploration" credit
- Most expenditures will also qualify for the "carry forward annual loss" or "NOL" credit (45%)
- These are "stackable," meaning state reimburses about **85%** of total expenses

This is the highest credit percentage in any region or time period, due to the higher SB21 NOL credit plus the sunsetting ACES exploration credit

# For Developers (pre-Production)

- Most expenditures will qualify for the “carry forward annual loss” or “NOL” credit (45%)
- State reimburses **45%** of expenses
  - (same percentage as prior to passage of SB21)

# For Producers

- Profits are subject to the 35% SB21 tax rate
  - For “new” oil, the Gross Value Reduction reduces the number that is subject to the 35% tax
- Smaller producers can reduce their tax by up to $12 million, but not to below zero
- The per-taxable-barrel credit ($0 to $8 for “legacy” oil, $5 for “new” oil) is subtracted from the tax. These cannot be repurchased or carried forward

# For Producers (at very low prices)

- At low prices, some or all of the per-taxable-barrel credit is foregone and producers pay at the 4% gross minimum tax (legacy oil) or zero (new oil)
- If prices stay low, even the major producers could experience Net Operating Losses.
  - Companies producing over 50,000 bbl / day are not eligible to have NOL credits repurchased
  - These companies would use their NOL credits in the following tax year (beginning January 2016) to reduce their payments. NOL credits can be used to reduce payments below the 4% minimum tax

# For Explorers

- Most expenditures qualify for the highest level (40%) of the “exploration” credit
- Most expenditures will also qualify for the “carry forward annual loss” or “NOL” credit (35%)
- These are “stackable,” meaning state reimburses about **75%** of total expenses

# North Slope Credits in Practice- Jan – Jun 2016

## For Developers (pre-Production)

- Most expenditures will qualify for the "carry forward annual loss" or "NOL" credit (35%)
- State reimburses **35%** of expenses

The 35% NOL credit is set to stay at 35% beginning in 2016. This aligns it with the tax rate paid by producers, creating a more level playing field

# For Producers

- **No change from 2015**
- Profits are subject to the 35% SB21 tax rate
  - For "new" oil, the Gross Value Reduction reduces the number that is subject to the 35% tax
- Smaller producers can reduce their tax by up to $12 million, but not to below zero
- The per-taxable-barrel credit ($0 to $8 for "legacy" oil, $5 for "new" oil) is subtracted from the tax.
  - These cannot be repurchased or carried forward, and use is limited by the 4% gross floor

# North Slope Credits in Practice- After July 2016

## For Explorers

- **Most "025" exploration credits expire**
- Most expenditures will continue to qualify for the "carry forward annual loss" or "NOL" credit (**35%**)
- With the sunset of this program we also will lose much of the seismic and down-hole data requirements

# North Slope Credits in Practice- After July 2016

## For Developers (pre-Production)

- **No change**
- Most expenditures will qualify for the “carry forward annual loss” or “NOL” credit (35%)
- State reimburses **35%** of expenses

# North Slope Credits in Practice- After July 2016

## For Producers

- Profits are subject to the 35% SB21 tax rate
  - For “new” oil, the Gross Value Reduction reduces the number that is subject to the 35% tax
- **Small producer credit sunsets gradually.**
  - No new companies can claim it after May 2016, and a company can only receive it for their first nine years of production
- The per-taxable-barrel credit ($0 to $8 for “legacy” oil, $5 for “new” oil) is subtracted from the tax.
  - These cannot be repurchased or carried forward, and use is limited by the 4% gross floor

# Potential Legislative Changes

# Potential Legislative Changes

***These are just some ideas.***
***These are not the administration's proposals, nor is this a comprehensive list***

**Funding**

1. Annual cap on repurchases

**Process**

2. Pre-approval process for credit eligibility
3. As exploration credits sunset, add data submissions requirements as a condition of applying for spending and operating loss credits
4. Confidentiality waiver allowing the state to release more information on repurchases

# Potential Legislative Changes

## Program Changes

5. Eliminate stackable “spending” and “loss” credits
6. Reduce credit percentages
7. Disallow NOL credits in Cook Inlet until 2022
8. Only allow credits targeting gas, not oil

## New Programs

9. State direct loans (likely AIDEA) to projects
10. State direct participation via taking a working interest (would likely require new entity)
11. Hybrid with ability to convert loans to working interest if there is a discovery
(protects state from dry hole / cash call risk)

# Potential Legislative Changes

## Repurchase Rules

12. Per-producer annual repurchase limits
13. Restrict the amount of credits that can be repurchased, via reinvestment requirements or other means. Credits not repurchased can still be sold or held until the company has a tax liability
14. Strengthen the gross minimum tax “floor,” extending it to Cook Inlet and not allowing other credits to reduce payments below it

# THANK YOU

## Please find our contact information below:

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