SB 114

Oil Revenue Reform Bill

Presentation to Senate Finance Committee – March 31, 2023

"The legislature shall provide for the utilization, development, and conservation of all natural resources belonging to the State, including land and waters, for the maximum benefit of its people."

-Article 8, Section 2, Constitution of Alaska

SB 114: Three Common Sense Reforms

Closes Income Tax Loophole for Highly Profitable Petroleum Business S-Corps

Reduces the Sliding Scale Per-Barrel Credits & Requires Investment Match

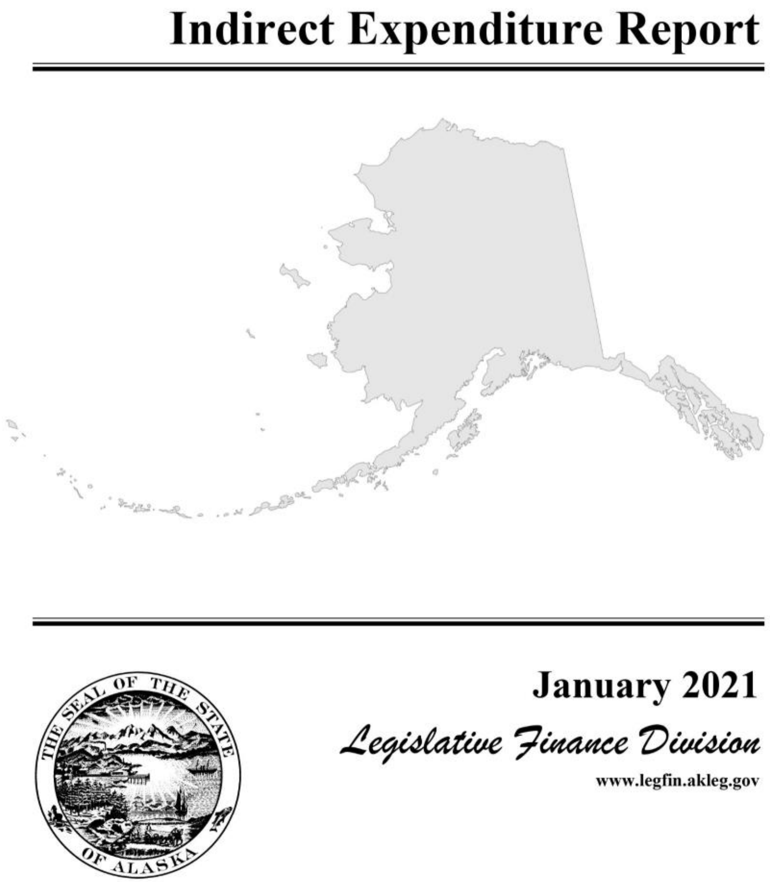
Ringfences Losses on Alaska's Most Profitable North Slope Fields

Closing the S-Corporation Tax Loophole

“S Corporation” stands for “Subchapter S corporation”, or sometimes “Small Business Corporation." It is a special tax status granted by the Internal Revenue Service that lets corporations pass their corporate income, credits and deductions through to their shareholders.

The S-Corp Loophole

- Alaska incorporates the federal Internal Revenue Code as its tax code.
- The IRS taxes “pass-through” entities like privately owned S-Corps at the owner level to ensure taxes are collected on profits.
- But in 1980 Alaska repealed the personal income tax with HB 1040.
- This created a loophole for S-Corps to avoid paying taxes in Alaska, unlike regular public Corporations.



The Nonpartisan Legislative Finance Division Recommends Closing this Loophole

“Should it be Continued, Modified, or Terminated?”

“Recommend termination. "S" corporations are exempt from the federal corporate income tax because income from these corporations is taxed under the personal income tax. Without a state personal income tax, these corporations receive the legal benefits of incorporation without any state tax liability.”

-Indirect Expenditure Report, January 2021, Page 144

The Department of Revenue Presented this Concern to the Legislative Fiscal Policy Working Group in 2021

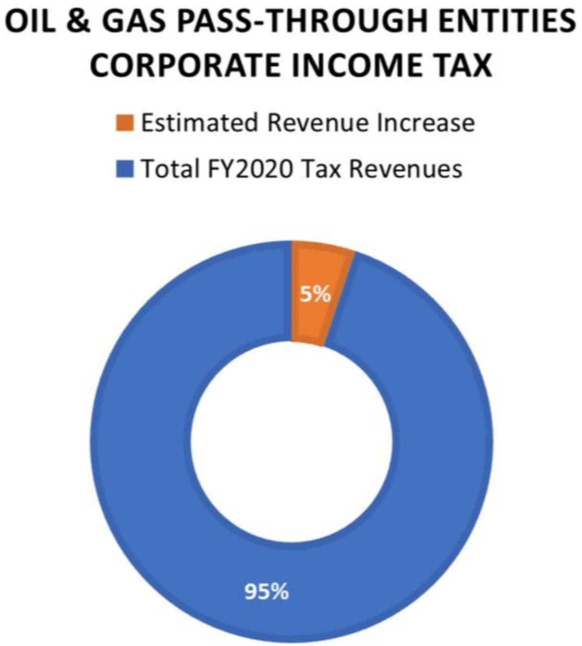
Existing Revenue: Expand Corporate Income Tax to Oil and Gas Pass-through Entities

Description: This option proposes to tax oil and gas pass-through entities at the same rate as the current Corporate Income Tax on C-Corporations. This option defines "entities" to mean sole proprietorships, partnerships, and S-Corporations. This option would apply to any business who files a return, claim for credit or report under AS 43.55 (oil and gas production tax).

First Full Year Impact: $67.1 million in FY 2022

Using our July 2021 ANS price update as the basis, the estimate is that this could increase corporate income revenue by $47 to $61 million per year from FY 2022 to FY 2030. The FY 2022 estimate includes retroactive application to 1/1/2021. The range is due to forecasted changes in production, oil prices, and anticipated company profitability this period.

Costs: There are no incremental costs to implement this change.



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Source: "Comprehensive Fiscal Policy Plan for Alaska" presented by Commissioner Lucinda Mahoney August 10, 2021

Now is the Time to Close this Loophole

The Department of Revenue estimated that over just FY22 and FY23, Alaska will have lost $194 million in revenue due to this defect.

Source: Fiscal Note SB 106-DOR-TAX-4-29-22, 32nd Alaska State Legislature

The SB 114 Solution

Closing this Loophole Levels the Playing Field Between Privately Owned S-Corps and Public C-Corporations

- Applies only to oil & gas production or pipeline transportation pass-through entities
- 9.4% Tax rate that matches percent tax on Alaska's highest tax bracket for C-Corps
- Applies only to profits over $4 million

Alaska's S-Corp Shareholders will Receive Federal Tax Benefits

The owners of an S-Corp pay federal income taxes as individuals. If they are high income earners, they likely pay at the top marginal tax rate of 37%.

Since the amount of taxes they pay to Alaska is deductible from their federal taxable income, their taxes due to the IRS will be reduced by 37% under this provision.

Reducing the Sliding Scale Per-Barrel Credits & Requiring Investment “Match”

Current Law: For new fields in their first seven years of production, the per-barrel credit is a flat $5/barrel, unless oil prices exceed $70 for any three years.

Current Law:
For the state's major producing North Slope fields, the credit is based on a sliding-scale of average gross wellhead value:

- $8/barrel at less than $80;
- $7/barrel at $80 to less than $90;
- $6/barrel at $90 to less than $100;
- $5/barrel at $100 to less than $110;
- $4/barrel at $110 to less than $120;
- $3/barrel at $120 to less than $130;
- $2/barrel at $130 to less than $140;
- $1/barrel at $140 to less than $150;
- $0/barrel at $150

How the Per-Barrel Credits Evolved During the Legislative Process

- SB 21, the “More Alaska Production Act” (MAPA), was introduced in 2013 with no per-barrel credits.
- The Senate added a flat $5 per-barrel credit for all producers. When SB 21 passed the Senate on March 21, 2013, the Governor, industry, and others supported just a $5 credit.
- The House made the $5 credit apply to the new fields and added the $8 to $1 sliding-scale per-barrel credits for existing fields.

→As oil prices drop, and production tax revenue decreases, the tax credits increase – amounting to even lower production tax revenue.

The Senate had little time to analyze the sliding-scale per-barrel credits added by the House

SB 21 was transmitted back to the Senate with the sliding-scale per-barrel credit on April 13, 2013—the day before the Legislature adjourned *sine die*.

Relying on the House committee vetting process, on April 14, 2013 the Senate voted to concur with the changes to SB 21 just hours before adjournment.

The fiscal modeling for the final House Finance version of SB 21 assumed the $5 tax credit would apply.

The fiscal note only modeled revenue differences at $90, $100, and $120 oil prices.

But since the per-barrel credits went into effect on January 1, 2014—nearly a decade ago—only nineteen months have seen high enough oil prices to provide the producers with anything less than the full $8 credit.

Source: Fiscal Note Analysis #14, HCS CCSSB 21(FIN) (4/11/2013); Alaska Department of Revenue – Tax Division, Prevailing Values ANS West Coast Average Spot Price, http://www.tax.alaska.gov/programs/oil/prevailing/ans.aspx.

Since 2014 Alaska has lost $7.2 billion to the per-barrel credits

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Historical Production Tax Credits
Detail, FY 2013 - FY 2032

		Millions of Dollars									
		History									Preliminary[1]
		FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
…	…	…	…	…	…	…					
	Credits Used Against Tax Liability[4,5]										
	North Slope										
9	Qualified capital expenditure, AS 43.55.023(a); Carry-forward annual loss, AS 43.55.023(b); Well lease expenditure, AS 43.55.023(l)	486	332	0	*	*	*	*	*	*	*
10	Transitional Investment Credit: AS 43.55.023(i)	*	0	0	0	0	0	0	0	0	0
11	Per taxable barrel credit, AS 43.55.024(i)-(j)[6]	0	516	524	86	536	1,001	1,037	613	749	1,018
12	Small producer credit, AS 43.55.024(a)(c)	*	*	*	*	*	*	*	*	*	*
13	Credits under AS 43.55.025[2]	*	*	*	*	*	*	*	*	*	*
14	**Total North Slope**	**536**	**907**	**575**	**120**	**570**	**1,034**	**1,061**	**621**	**788**	**1,206**

Source: Revenue Sources Book Spring 2023

Alaska is projected to lose another $8.7 billion in the next nine years.

Chapter 8
4

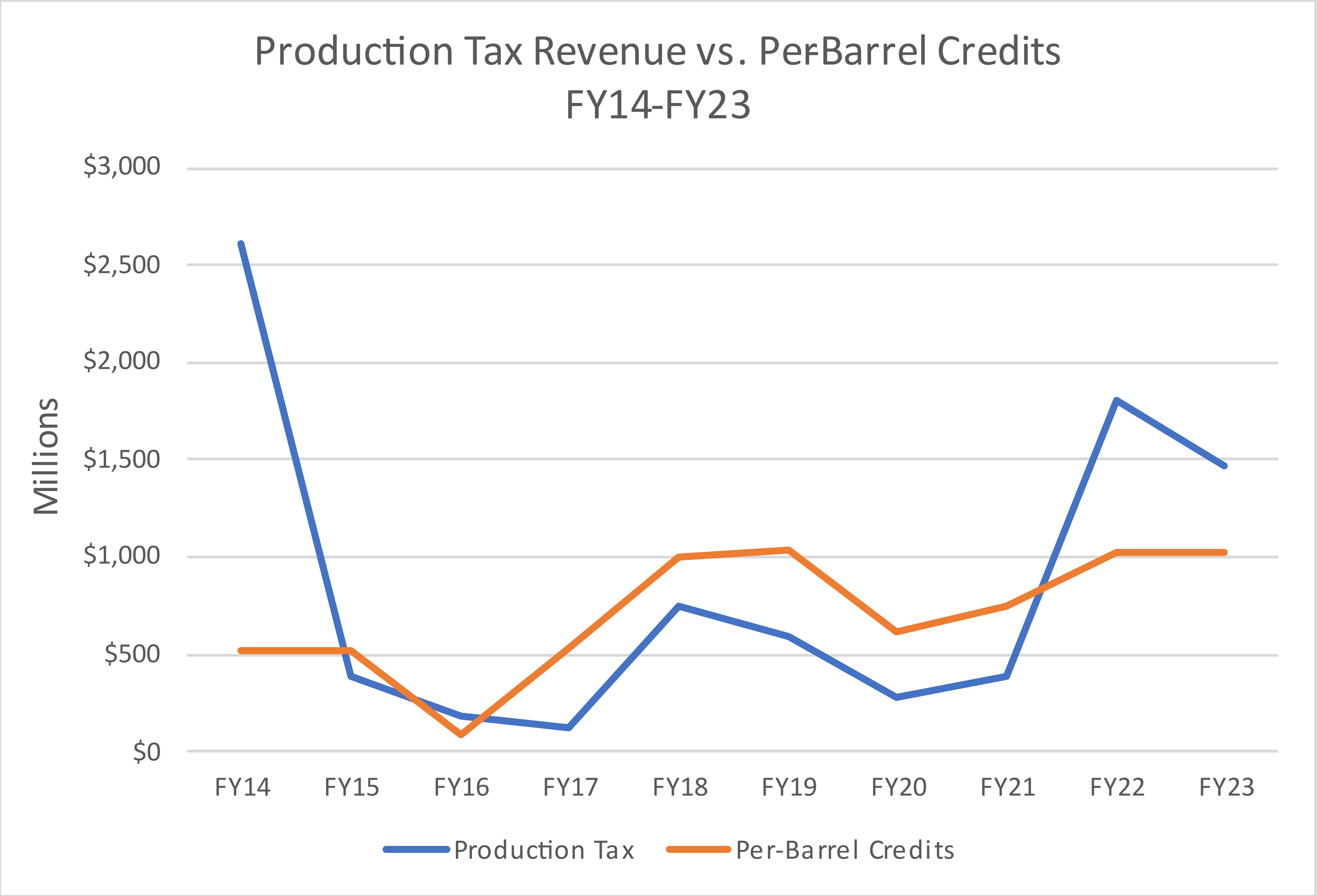
Historical Production Tax Credits
Detail, FY 2013 - FY 2032 (continued)

		Millions of Dollars									
		Forecast									
		FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032
	...	...	...	...	...	...	...				
	Credits Used Against Tax Liability[4,5]										
	North Slope										
9	Qualified capital expenditure, AS 43.55.023(a); Carry-forward annual loss, AS 43.55.023(b); Well lease expenditure, AS 43.55.023(l)	67	0	0	0	0	0	0	0	0	0
10	Transitional Investment Credit: AS 43.55.023(i)	0	0	0	0	0	0	0	0	0	0
11	Per taxable barrel credit, AS 43.55.024(i)-(j)[6]	1,087	1,138	1,078	1,092	1,027	956	822	767	851	967
12	Small producer credit, AS 43.55.024(a)(c)	1	1	1	1	0	0	0	0	0	0
13	Credits under AS 43.55.025[2]	0	0	0	0	0	0	0	0	0	0
14	**Total North Slope**	**1,154**	**1,139**	**1,079**	**1,093**	**1,027**	**956**	**822**	**767**	**851**	**967**

In just FY23 and FY24, the credits will cost the state $2.2 billion.

Source: Revenue Sources Book Spring 2023

History of Production Tax Revenue vs. Per-Barrel Credits Deducted



Source: Fall 2022 Revenue Sources Book & Spring 2023 Update

The Per-Barrel Credits Have Not Incentivized Investment on the North Slope: Expenditures

Alaska Department of Revenue
Tax Division

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Reported ANS Lease Expenditures and Capital Lease Expenditures:
CY 2013 - CY 2022
Revised February 17, 2023 by Economic Research Group

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Qualified Capital Expenditures ($ Millions)										*Preliminary*
	CY 2013	CY 2014	CY 2015	CY 2016	CY 2017	CY 2018	CY 2019	CY 2020	CY 2021	CY 2022
Prudhoe Bay Unit	$826	$877	$773	$476	$356	$202	$391	$119	$106	$220
All Other ANS	$2,394	$3,065	$3,285	$1,555	$1,162	$1,622	$1,935	$1,815	$1,381	$1,590
Total ANS	**$3,220**	**$3,942**	**$4,058**	**$2,031**	**$1,518**	**$1,824**	**$2,326**	**$1,934**	**$1,487**	**$1,811**

Source: DOR Reported ANS Lease Expenditures and Capital Lease Expenditures: CY 2013 – CY 2022

The Per-Barrel Credits Have Not Incentivized Investment on the North Slope: Credits

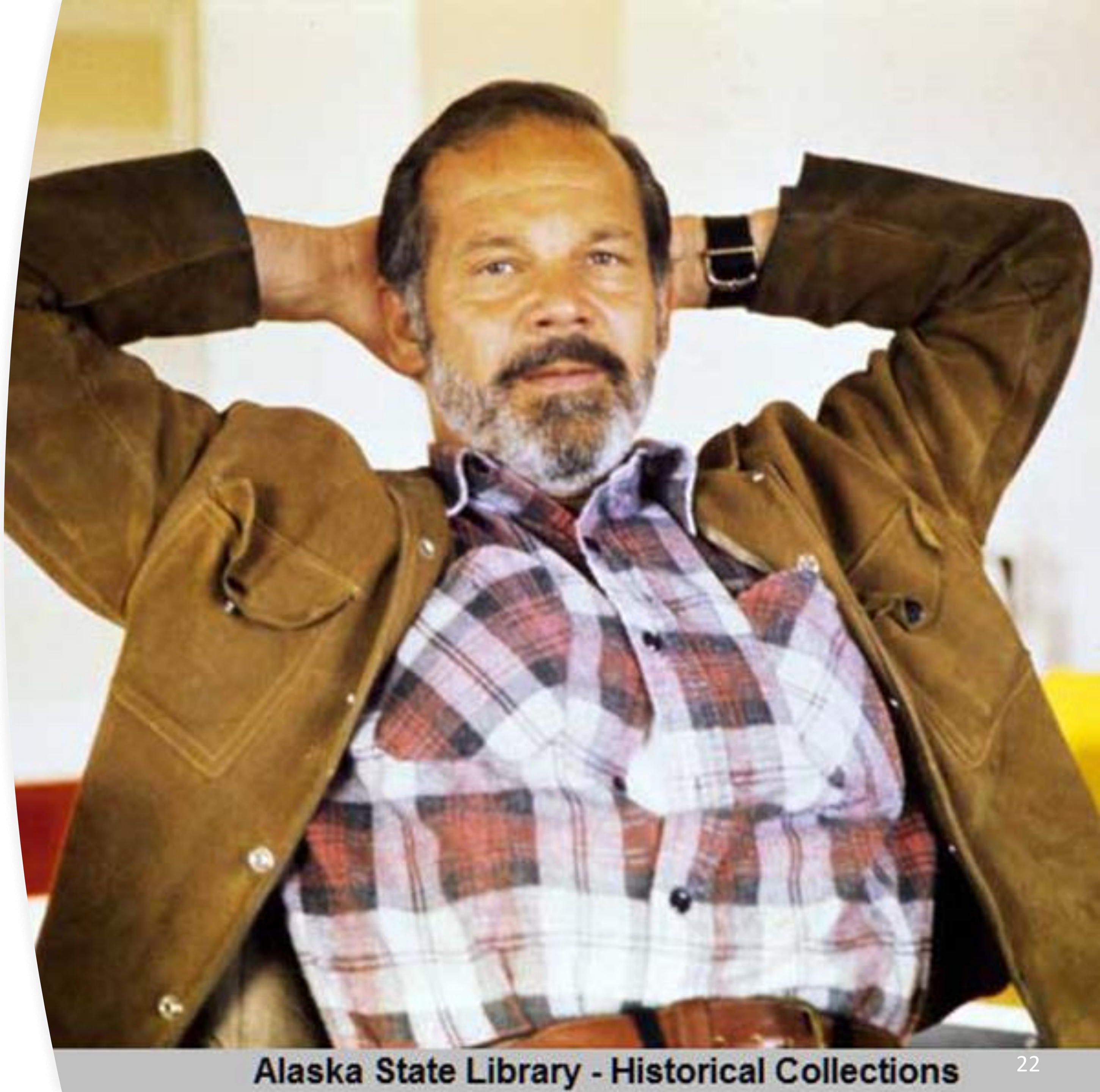
Estimated Prudhoe Bay Per-Barrel Credits

	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Total value of per-taxable-barrel credits used against tax liability ($millions)	516	524	86	536	1001	1037	613	749	1018
Prudhoe Bay % of ANS Production	56.4%	54.6%	54.5%	54.4%	52.2%	52.1%	51.5%	53.3%	55.3%
Estimated value of per-taxable-barrel credits applicable to Prudhoe Bay ($millions)	291	286	47	292	522	541	316	399	563

Estimated per-barrel credits for the Prudhoe Bay Unit were generated by the Legislative Finance Division and are based on methodology and assumptions proposed by the Department of Revenue by email to the bill sponsor on 3/28/23.

“Development that actually costs the state remains Alaska’s least understood and most pressing economic problem. Few politicians seem concerned that we do not extract enough wealth from new resource development to offset its costs.”

-Governor Jay Hammond



The SB 114 Solution

SB 114 reduces these credits to a $5 to $1 sliding scale and ties the credits to capital investment in Alaska:

- Per-barrel credit ranges from $5 to $1 for wellhead value ranges from $80 to $110.
- Producers earn the credits only up to the amount matching their qualified capital expenditures from the same tax year.

The new investment caveat encourages investment spending on projects in Alaska that will maintain production, create jobs for Alaskans, and promote industry growth.

The SB 114 Solution

SB 114 returns the amount of the per-barrel credit to, at most, the $5 value that was acceptable to the Senate, the Governor, and industry supporters when SB 21 passed on the Senate Floor on March 21, 2013.

Ringfencing North Slope Fields

Ringfencing: Limiting the deduction of lease expenditures to those fields where the expenditure is incurred.

Current law Advantages Incumbent Producers

- The producer with profits from existing fields can save on taxes as expenses are incurred.
- The newcomer must carry forward their “losses” until the field comes into production.
- Both would earn tax offsets for their spending, but the incumbent gets them much sooner.

Ringfencing: Why is it Needed?

- Under our tax code, incumbent producers are able to immediately write off their new field expenditures against their existing field production taxes. For every $1 billion in expenditures, the State generally loses $350 million in production taxes. This has the potential to cause severe shock to the State's cash flow.
- New producers do not have this same advantage – and must wait until oil production flows before writing off their field expenditures.
- Of particular concern is oil development on federal land, because Alaska subsidizes 35% of the development yet receives no royalties and very little production tax value.

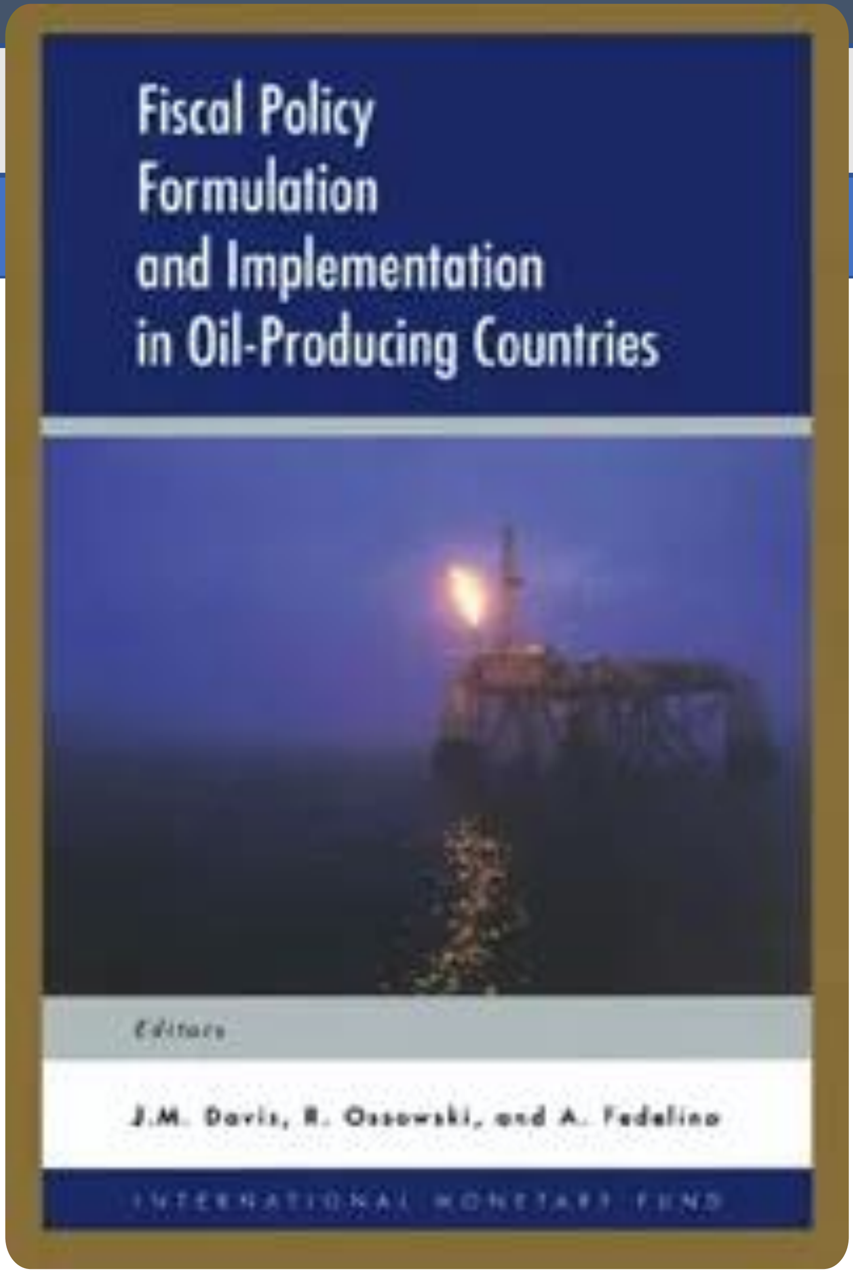
The SB 114 Solution

- Ringfence fields on the North Slope. Limits the deduction of lease expenditures to those fields where the expenditure is incurred.
- When new fields start producing oil, the accrued lease expenditures are then taken.
- Incumbent producers will be incentivized to faster development and completion of a project.
- Levels the playing field - Provides equal treatment to incumbent producers and new producers.

History of Ringfencing

- 1977-2005 - Ringfencing was standard in Alaska
- 2006-2023 – (North Slope) Comingled net profits
- 2006-2016 – (Cook Inlet Oil): Each field capped at ELF rates (Zero)
- 2007-2023 – (Cook Inlet Oil): Capped at $1/bbl

Ringfencing is a common aspect of oil revenue systems across the world



“Ring-fencing rules matter for two main reasons:

- Absence of ring-fencing can postpone government tax revenue because a company that undertakes a series of projects will be able to deduct exploration or development expenditures from each new project against the income of projects that are already generating taxable income.

- As an oil and gas area matures, absence of ring-fencing may discriminate against new entrants that have no income against which to deduct exploration or development expenditures.”

-Emil M. Sunley, Thomas Baunsgaard, and Dominique Simard

Source: International Monetary Fund Publication “Fiscal Policy Formulation and Implementation in Oil-Producing Countries: Chapter 6 Revenue from the Oil and Gas Sector: Issues and Country Experience,” August 21, 2003

Economists have criticized other oil producing jurisdictions for not using ringfencing

Tom Sanzillo, Director of Financial Analysis
July 2021

Institute for Energy Economics and Financial Analysis
IEEFA.org

Lack of Ring-Fencing Provision Means Guyana Won't Realize Oil Gains Before 2030s, if at All

Loophole Allows ExxonMobil-Led Development Team To Use Profits To Pay for More Oil Exploration in Guyana

Executive Summary

Over the next five years, revenues from Guyana's newly discovered oil reserves being developed by an ExxonMobil-led development team will not be enough to cover Guyana's budget deficit, support new spending and build its wealth. Over the longer term, a declining oil and gas sector is highly unlikely to provide Guyana with the robust revenues promised.

This was the conclusion of the Institute for Energy Economics and Financial Analysis (IEEFA) first report that studied a 2016 agreement between Guyana and the ExxonMobil-led consortium, which also includes the China National Offshore Oil Company (CNOOC) and Hess Corp.

This paper focuses on one provision of the contract that allows the contractor to apply any exploration costs it incurs anywhere on the area under contract and to charge 100% of the costs immediately against the active wells. Right now, this means that the contractor can explore for oil at the Tanager and Redtail sites,[1,2] for example, and charge its expenses against Guyana's oil profits from the Liza 1 site. Guyana's profit drawn from the Liza 1 site is reduced as a result of this loophole. Put another way, Guyana's profit during the 2021 fiscal year will be reduced to pay for oil and gas that may not be extracted until 2030 or later.

Since December 2019, when the Liza Phase One field commenced production, ExxonMobil and the Government of Guyana have announced at least six new oil discoveries on the Stabroek oil development site. They have also announced at least four instances where drilling produced dry holes.

- The discoveries have been celebrated as evidence that future revenues will be robust. The dry holes were met with muted consternation. None of the announcements have been met with an accounting of the exploration costs and discussion of how they will be paid.

[1] Reuters. Exxon says its latest discovery offshore of Guyana is not financially viable. November 17, 2020.
[2] ExxonMobil. ExxonMobil announces Redtail discovery offshore Guyana. September 8, 2020.

"Governments typically utilize ring-fencing provisions to prevent oil companies from using losses incurred on one site from sheltering the profits from other, more lucrative investments…

"Unfortunately, Guyana has granted the contractor a blank check with regard to future development. The result is that the contractor has a powerful incentive to continue to add costs to the project. The net effect is to push back the point at which Guyana maximizes its cash benefit."

-Tom Sanzillo, Director of Financial Analysis

Institute for Energy Economics and Financial Analysis

Source: "Lack of Ring-Fencing Provision Means Guyana Won't Realize Oil Gains Before 2030s, if at All," Institute for Energy Economics and Financial Analysis. July 2021

“I clearly recognize the need for new revenue for Alaska. In my opinion that new revenue does need to include some additional amount from the oil and gas industry.”

-Aaron Schutt, CEO, Doyon, Limited

Speaking as a surrogate for OneAlaska – Vote No on 1

Commonwealth North event “Discussion of Ballot Measure 1: The Oil Tax Initiative”

“I have no doubt that oil taxes will be part of the conversation in the Legislature… Any proposal needs to be examined and reviewed and the Legislature tends to be a better format for that.”

-Kara Moriarty, Campaign Manager, OneAlaska, Vote No on 1

Anchorage Daily News “Oil tax initiative fails, pushing question of where to look for new revenue sources back to Alaska Legislature,” November 17, 2020

Questions?