

SCOMM

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State Revenue & the Petroleum Profits Tax

House Special Committee on Oil and Gas, February 8, 2007

Alaska Department of Revenue

Jon Iversen, Director, Tax Division and

Cherie Nienhuis, Petroleum Economist

Revenue Projections

- Fall 2006 RSB Projections
- Oil Price Update
- Price and Production Variance from Fall Projections



Oil Dependency

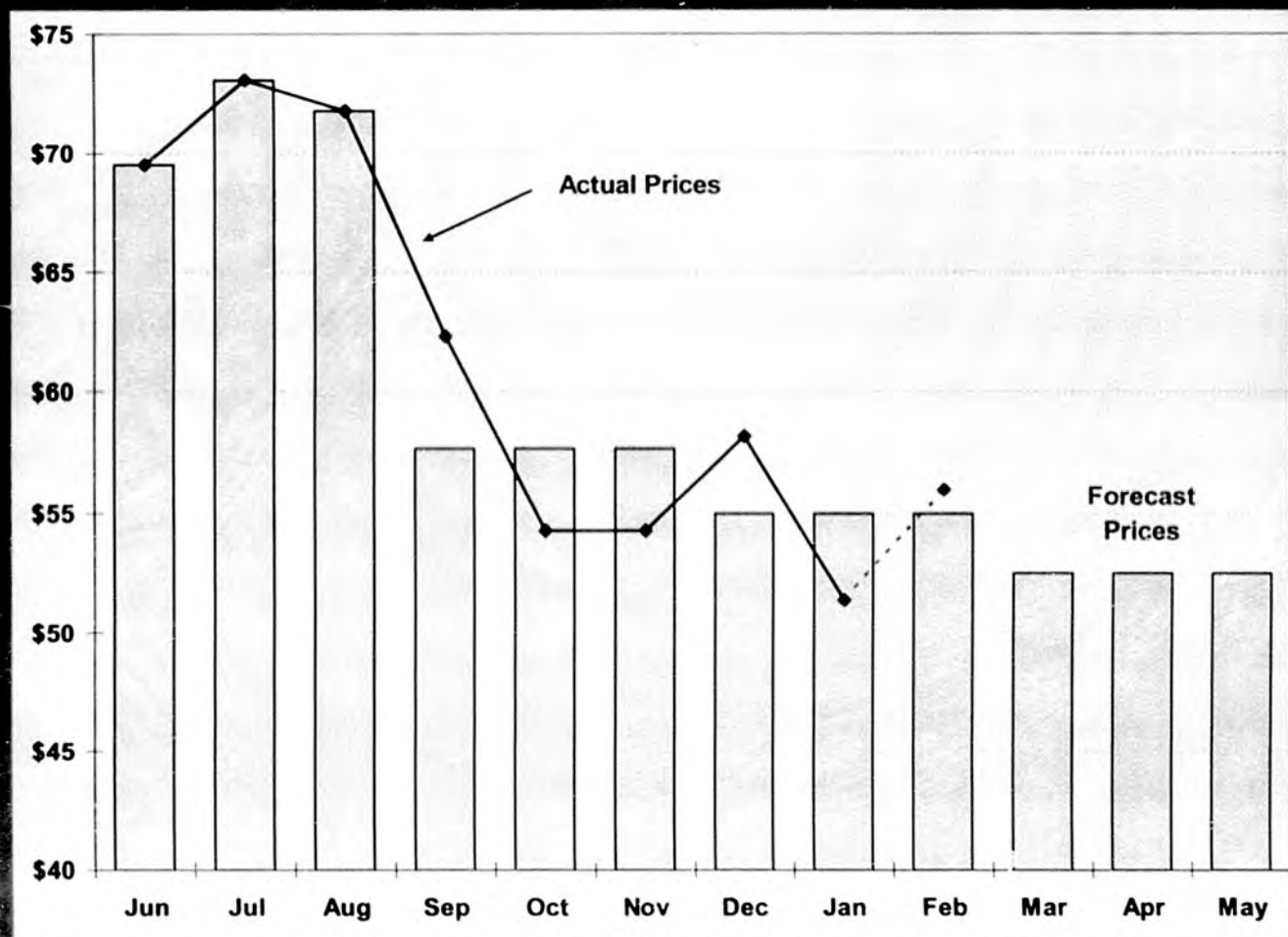
FY 2007 General Fund Unrestricted Revenue, Millions

Royalty – Net PF	1,503.9	30.6%
Production Tax	2,067.2	42.1%
Income Tax	657.2	13.4%
Property	51.7	1.1%
Bonus, Rent, etc	51.4	1.0%
Total Oil	4,331.5	88.2%
Non-Oil	580.8	11.8%
Tot Budget	4,912.3	100.0%

Source: Fall 2006 *Revenue Sources Book*, page 89.

ANS Crude Oil Prices

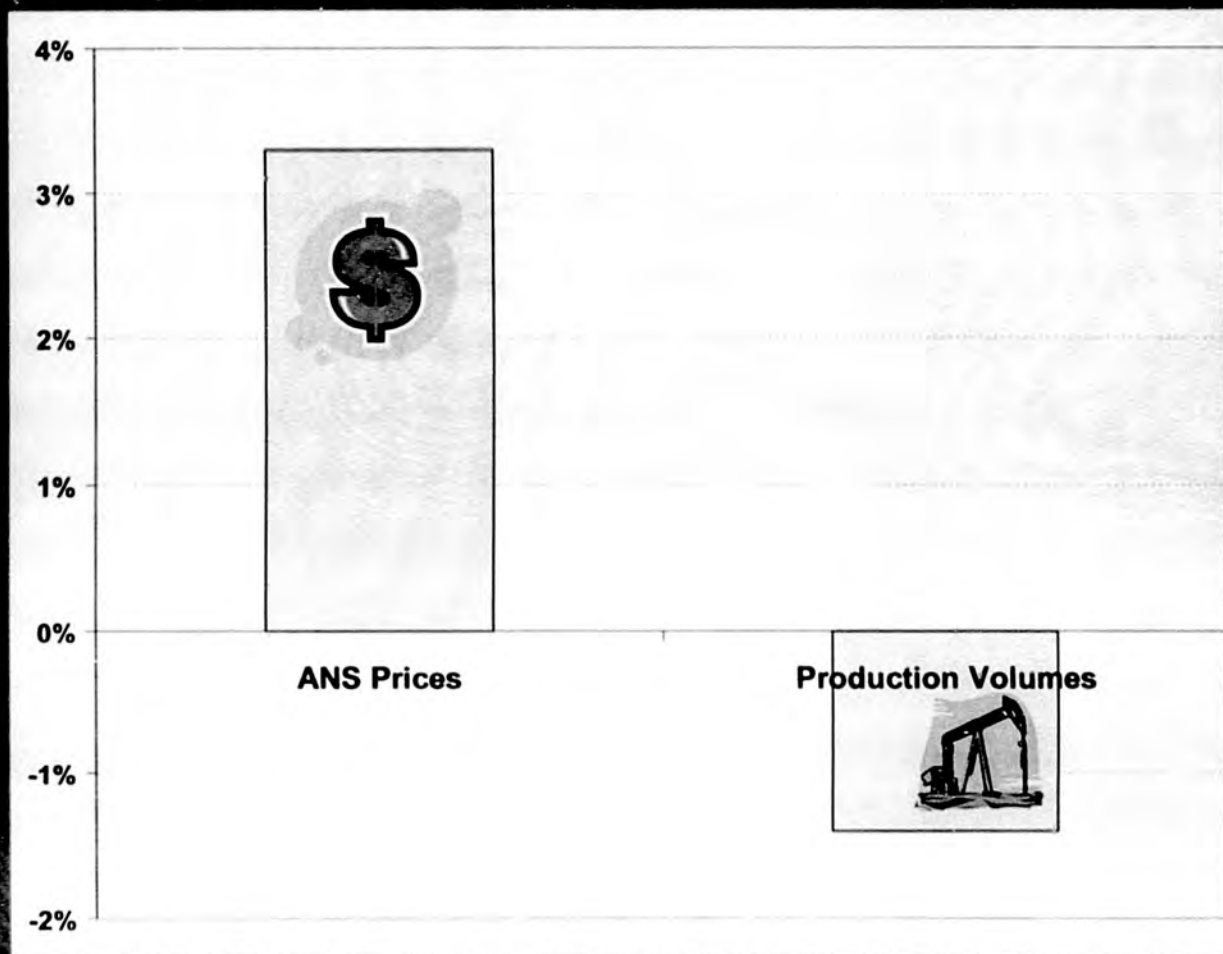
FY 2007 Forecast, Dollars per Barrel



Notes : [1] Forecast from Fall 2006 Revenue Sources Book. [2] Actual prices for February are only for the period February 1 through 6, 2007.

Variance in Key Factors

For FY 2007, Year-to-Date Changes From Fall Forecast



Note: In the Fall 2006 *Revenue Sources Book*, ANS prices were forecast to average \$59.15 per barrel for FY 2007. Through February 6, 2007, prices averaged \$61.20 per barrel, which is \$2.05 or 3.3% above the forecast. ANS crude oil production was forecast to average 739,618 b/d. Through February 6, 2007 production averaged 729,710 b/d, which is 9,908 b/d or 1.4% below the forecast.

Petroleum Profits Tax

- **Difference Between ELF and PPT Tax**
- **“True-Up” Payment and FY 2007 Total**
- **Regulations Status**

PPT Tax Calculation

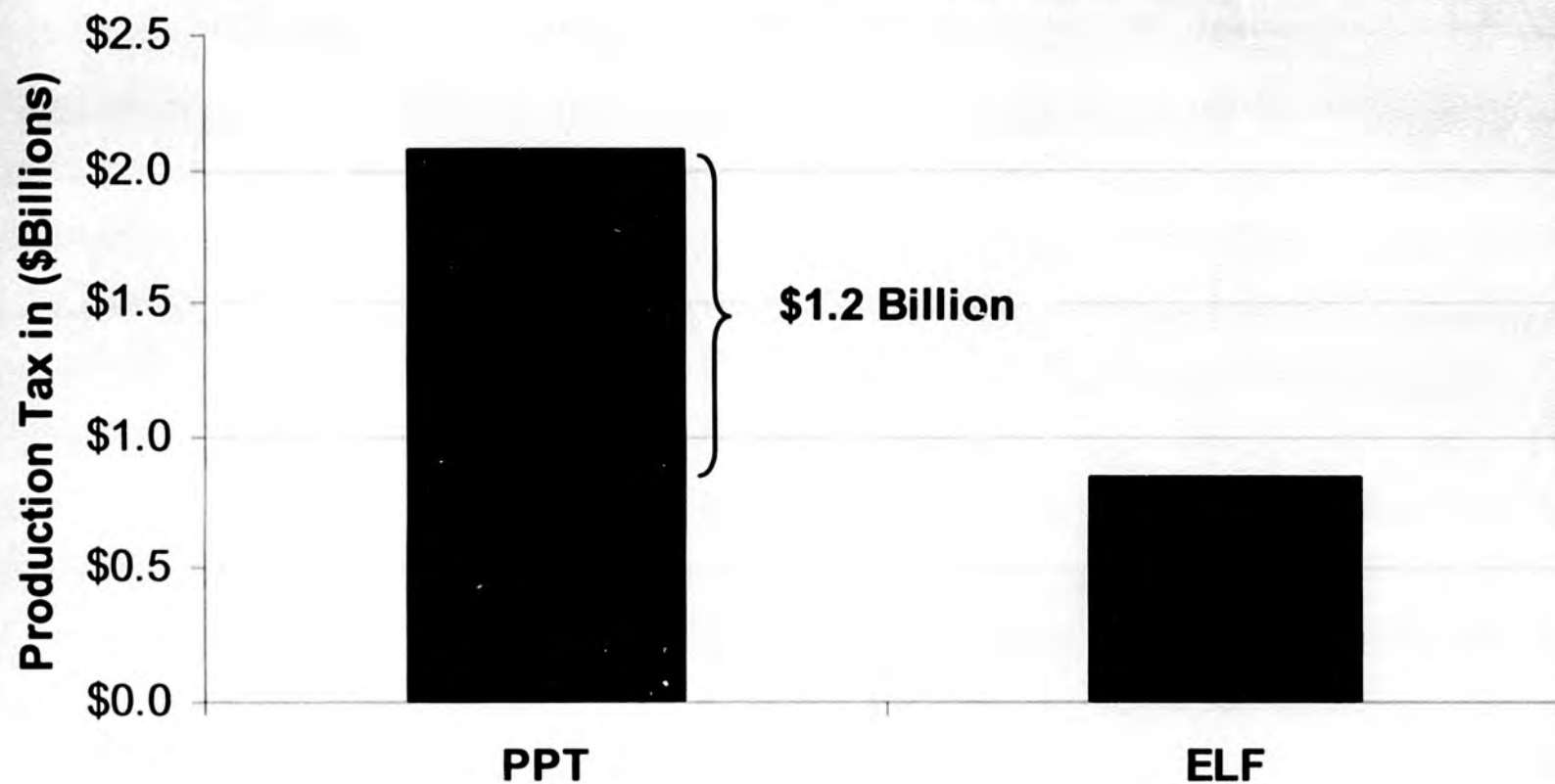
$$\text{PPT Tax Liability} = [(\text{Value} - \text{Costs}) \times \text{Tax Rate}] - \text{Credits}$$

- **Value** = Volume of Oil and Gas Produced x Wellhead Value
- **Costs** = Operating Expenditures + Capital Expenditures
- **Tax Rate** = 22.5% + 0.25% for every \$1 per barrel that this "net income" exceeds \$40
- **Credits** = (20% x Capital Expenditures) + (20% x Eligible Transition Expenditures) + Base Allowance (up to \$12 million per Company producing less than 100,000 BTU equivalent barrels per day)

PPT True-Up Payment

- **Due End of March**
- **Estimate = \$0.95 billion**
 - **April, May = \$0.29 billion**
 - **June – December = \$0.66 billion**

FY 2007 Production Tax Comparison - PPT & ELF



PPT total includes tax liabilities for the difference between the ELF and the PPT payment for the months of April and May, 2006.

PPT Regulations Status

- **Publicly Noticed Workshops Oct - Nov**
- **Draft Regulations Created**
- **Public Comments & Hearing: Dec 13 – Jan 17**
- **Issues Raised:**
 - **Transfer of Exploration Credits**
 - **Clarification of Lease Expenditures**
 - **Overhead Rates (Too high-Too low)**
 - **Ring Fencing Losses**
 - **Information Reporting Requirements**
 - **Inclusion of Penalty Provisions**

PPT Regulations Status

- **Estimated Revision Time: Mid February**
- **Final Review**
 - **DOR Director & Commissioner**
 - **Department of Law**
 - **Lieutenant Governor's Office**
- **Expected Implementation – April**
- **Second Regulation Project-Spring '07**
(To include: Clarifying allowable lease expenditures and use of operating agreements)



STATE OF ALASKA
DEPARTMENT OF
REVENUE

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Alaska Department of Revenue

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January 17, 2007

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Gary Rogers
Tax Division
Alaska Department of Revenue
550 W. 7th Ave., Suite 500,
Anchorage, AK 99501

Re: Proposed Changes Title 15 of the Alaska Administrative Code
AS 43.55 Petroleum Profits Tax

Dear Gary:

On behalf of many of the State's non-producer explorers this letter is drafted for the Department's review in its analysis of the impact and implementation of the proposed Petroleum Profits Tax ("PPT") regulations under 15 AAC 55. The proposed changes will place additional and extreme economic burdens on the State's explorers that we are certain was not intended in the drafting of these proposals and assuredly was not the intention of the legislature in the enactment of the PPT. We ask that the Department consider these comments and incorporate corrective changes to their proposed regulations. We would be most happy to assist the Department in any way we can in rectifying these drafting issues.

In review of the proposed changes to regulations under 15 AAC 55 it appears that the Exploration Incentive Credits ("EIC") derived by an entity that is not currently paying PPT is severely economically disadvantaged when attempting to market EICs to an entity that is paying PPT. Worse, the retroactive provisions of the proposed regulations place into question ongoing negotiations and agreements

that have already been reached with regard to the transfer and sale of EICs. These provisions will have large negative economic impacts to new and potential new entrants into oil and gas exploration activities in the State of Alaska. This seems directly counter the Alaska Legislature's and the Palin Administration's repeated statements that exploration is the key to Alaska's future and that Alaska is open for business.

Many questions arise related to treatment of EICs under the proposals. How do the current proposed regulations deal with EICs that have been purchased and applied to prior months but after April 1, 2006 to which these regulations purport to be retroactive? How do these proposals deal with EICs under contract to be purchased that may now be used, if at all, in only 1/12th increments against estimated monthly payments. Additionally, it appears the amounts claimed in the prior year may be subject to adjustment and reduction later (in March of the subsequent year). By attempting to protect the State's cash flow, position on estimated payments made by Producers who pay PPT the Department has effectively severely diminished the time value and even placed at question the eventual fair market value of EICs that explorers wish to market to producers. The inability to market EICs, or the reduction in the perceived fair market value of EICs, to PPT payors acts to **significantly increase** the costs of oil and gas exploration in the State of Alaska. The diminution in value of exploration incentives provided by the legislature is in direct contravention to stated intent and should not be part of these regulations. Without the incentives provided many projects will not occur and current projects will be reevaluated and likely curtailed.

As example of the legislature's intent in passage of the bills creating Exploration Incentive Credits lets look to current statutory legislative history. The March 5, 1993 Senate Journal entry introducing SB151 which would eventually be enacted by passage of HCS SB151(FIN) am H which called for the creation of an allowance for the current Exploration Incentive Credits found in AS 41.09.100. In his letter introducing the bill to the President, Governor Hickel stated that:

"Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill providing for monetary incentives in the form of certain credits to be applied against taxes and other obligations to the state for oil- and gas-related geophysical and exploratory activities performed by a qualified applicant. **This bill should provide a valuable tool for the state to encourage oil and gas exploration in Alaska.**" (Emphasis added).

The Department of Natural Resources in codifying the mandate of AS 38.05.180(i) Exploration Incentive Credits found the legislature's purpose in providing for the statute to be:

"The credit under this chapter is designed to encourage exploration of remote areas within the state for which the data received by the department will be of value to the state's resource evaluation program." 11AAC 89.010(b)
Applicability: purpose.

To encourage that exploration from new entrants and into remote areas the Exploration Incentive Credit provisions currently provide that:

"An explorer may transfer, convey, or sell its production tax credit certificate to any person, and any person who receives a production tax credit certificate may also transfer, convey, or sell the certificate."
AS 43.55.025 (g).

So an explorer need not have current production or be paying production taxes to benefit from the provisions of the law. These credits once conveyed may be used by the producer paying production taxes to offset taxes due:

"A producer that purchases a production tax credit certificate may apply the credits against its production tax liability under AS 43.55.011(e) or (f). Regardless of

the price the producer paid for the certificate, the producer may receive a credit against its production tax liability for the full amount of the credit, but for not more than the amount for which the certificate is issued. A production tax credit allowed under this section may not be applied more than once."
AS 43.55.025 (h).

The legislature, when it enacted the EIC programs and legislation, clearly intended that explorers would have the ability to quickly and efficiently transfer for value their EICs which the Departments proposals would now act to impede. The economics of the non-producers exploration activities are directly impacted by the ability of the explorer to transfer the EICs generated by qualified expenditures. They act to provide a cash source at the end of the exploration activity which acts to reduce the overall cost of the exploration effort. To transfer those EICs there must be a viable market for them wherein producers can utilize them to the fullest extent possible. The State, through its various EIC initiatives, chose to share the economic risks of exploration and these administrative rules would undo that sharing. When the full exploration risk is placed on the explorer because EICs are discounted by potential purchasers the number of exploration projects that would otherwise have proceeded will be lessened and the extent of projects that move forward curtailed. The incentive to explorers to go find and develop more oil and gas in the State will be lost at the worst possible time for the State.

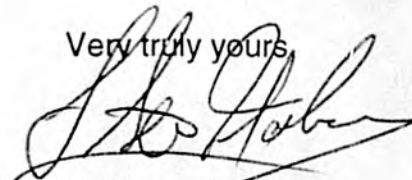
The proposed regulations as they relate to non-producer explorers create tremendous economic hardship and will work to undo much of the legislature's prior efforts to the detriment of the State of Alaska. These proposals clearly negatively impact the successful pre-existing EIC programs, unintentionally or otherwise, by imposing much more restrictive measures on the utilization of purchased EICs. Respectfully, we request that the Department reconsider providing a preference for first use and application of transferred Exploration Incentive Credits against taxes due, allow those transferred credits to offset the estimated monthly payment due from a producer under the

Mr. Gary Rogers
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PPT in any one month in which the EICs are validly applied rather than in 1/12th increments, alternatively exclude from application of the monthly limitations Exploration Incentive Credits derived by non-producers under AS 43.55.025, AS 38.05.180(i) and AS 41.09.010, or at the very minimum grandfather those previously approved EICs and EIC qualified expenditures that have already been expended allowing for immediate credit application to PPT payments due from producers.

Very truly yours,



F. Steven Mahoney
Mahoney & Associates, LLC.

Cc: James Mery, Senior VP, Lands and Natural Resources, Doyon Limited
Sherron G. Perry, President, Fairweather
Mitch Usibelli, Manager, Usibelli Energy LLC.
Tom Dodds, President, Andex Resources LLC
Teresa Imm, Director Resource Development, ASRC
Jim Winegarner, VP Lands, Brooks Range Petroleum Corporation
AW Rutter Jr., VP, Rutter Wilbanks Corporation

Members of the House of Alaska's 25th Legislature
Members of the Senate of Alaska's 25th Legislature

Enclosure:

Statutes:

AS 38.05.180 (i). The commissioner may provide for the establishment of an exploration incentive credit system under which a lessee of state land drilling an exploratory well on that land may earn credits based upon the footage drilled and the region in which the well is situated. The commissioner may also provide for credits to be earned by persons performing geophysical work on state land, if that work is performed during the two seasons immediately preceding an announced lease sale and on land included within the sale area and the geophysical information is made public following the sale. Credits may not exceed 50 percent of the cost of the drilling or geophysical work. Credits may be used during a limited period established by the commissioner and may be assigned during that period. Credits may be applied against (1) royalty and rental payments for oil and gas or for gas only payable to the state or (2) taxes payable under AS 43.55. A credit may not exceed 50 percent of the payment toward which it is being applied. Amounts due the Alaska permanent fund (AS 37.13.010) shall be calculated before the application of credits under this subsection.

Sec. 41.09.010. Exploration incentive credits.

(a) Under an incentive program distinct from the exploration incentive credit authorized by AS 38.05.180 (i), the commissioner may extend to a qualified applicant an exploration incentive credit for each of the following activities performed on land in the state, regardless of whether the land is state-owned land:

- (1) geophysical work on land that is not subject to a credit under AS 38.05.180(i);
- (2) drilling a stratigraphic test well; and
- (3) drilling an exploratory well.

(b) An exploration incentive credit extended under (a) of this section may be applied against

(1) a payment or obligation against which a credit authorized by AS 38.05.180(i) may be claimed;

(2) taxes payable under AS 43.20; and

(3) oil and gas bonus payments due the state under AS 38.05.180 (f).

(c) An exploration incentive credit may be extended under (a) of this section to a qualified applicant if

(1) application for the exploration incentive credit is made by the qualified applicant to the commissioner and is approved before drilling or geophysical work commences;

(2) all geophysical work is performed, and all stratigraphic test wells or exploratory wells are drilled, after August 7, 1994, and before July 1, 2007; and

(3) copies of all raw and processed data derived from drilling a stratigraphic test well or exploratory well or performing geophysical work are provided by the qualified applicant to the commissioner within 30 days after the completion, abandonment, or suspension of the well or completion of the geophysical work.

(d) Data derived from drilling a stratigraphic test well or exploratory well that is provided to the commissioner under (c)(3) of this section shall be kept confidential for 24 months after receipt by the commissioner unless the owner of the well gives written permission to the state to release the well data at an earlier date, and, notwithstanding AS 31.05.035 (c), confidentiality may not be extended beyond 24 months. The provisions of AS 38.05.035 (a)(9)(C) apply to other data provided to the commissioner under (c)(3) of this section, except that the commissioner, under appropriate confidentiality provisions and without preference or discrimination, may display to all interested third parties, but may not distribute or transfer in hard copy or electronic form, those data with respect to all land if the commissioner determines that the limited disclosure is necessary to further the interest of the state in evaluating or developing its land.

(e) The amount of an exploration incentive credit extended under (a) of this section is determined by the commissioner and shall be based on eligible costs, approved by the commissioner, of performing geophysical work, drilling a stratigraphic test well, and drilling an exploratory well. The amount of an exploration incentive credit may not exceed 50 percent of eligible costs relating to activities performed on state-owned land and 25 percent of eligible costs relating to activities performed on land in the state not owned by the state.

(f) The amount of an exploration incentive credit extended under (a) of this section may not exceed \$5,000,000 per eligible project, as defined by the commissioner by regulation. The total of all credits extended by the commissioner under (a) of this section may not exceed \$30,000,000.

(g) An exploration incentive credit must be used within five years after it is extended under (a) of this section, and may be assigned by the qualified applicant to another person for the purposes described in (b) of this section.

(h) Amounts due the permanent fund under AS 37.13.010 shall be calculated before the application of a credit extended under (a) of this section.

(i) The commissioner may not allow to a qualified applicant the claim of an exploration incentive credit under this chapter for an activity of the qualified applicant that occurs in any year in which the qualified applicant owes a liquidated debt to a state agency or to a public corporation of the state. The applicant's failure to obtain the claim of the exploration incentive credit under this subsection waives the credit for those activities in any subsequent year. In this subsection, "liquidated debt" means a debt that is

immediately and unconditionally due, either by agreement of the state and the qualified applicant or by law, and that involves an obligation or payment against which the exploration incentive credit may be claimed under (b) of this section.

Sec. 43.55.025. Alternative tax credit for oil and gas exploration.

(a) Subject to the terms and conditions of this section, a credit against the production tax due under AS 43.55.011 (e) or (f) is allowed for exploration expenditures that qualify under (b) of this section in an amount equal to one of the following:

(1) 20 percent of the total exploration expenditures that qualify only under (b) and (c) of this section;

(2) 20 percent of the total exploration expenditures for work performed before July 1, 2007, and that qualify only under (b) and (d) of this section;

(3) 40 percent of the total exploration expenditures that qualify under (b), (c), and (d) of this section; or

(4) 40 percent of the total exploration expenditures that qualify only under (b) and (e) of this section.

(b) To qualify for the production tax credit under (a) of this section, an exploration expenditure must be incurred for work performed on or after July 1, 2003, and before July 1, 2016, except that an exploration expenditure for a Cook Inlet prospect must be incurred for work performed on or after July 1, 2005, and

(1) may be for seismic or geophysical exploration costs not connected with a specific well;

(2) if for an exploration well,

(A) must be incurred by an explorer that holds an interest in the exploration well for which the production tax credit is claimed;

(B) may be for either an oil or gas discovery well or a dry hole; and

(C) must be for goods, services, or rentals of personal property reasonably required for the surface preparation, drilling, casing, cementing, and logging of an exploration well, and, in the case of a dry hole, for the expenses required for abandonment if the well is abandoned within 18 months after the date the well was spudded;

(3) may not be for testing, stimulation, or completion costs; administration, supervision, engineering, or lease operating costs; geological or management costs; community relations or environmental costs; bonuses, taxes, or other payments to

governments related to the well; or other costs that are generally recognized as indirect costs or financing costs; and

(4) may not be incurred for an exploration well or seismic exploration that is included in a plan of exploration or a plan of development for any unit on May 13, 2003.

(c) To be eligible for the 20 percent production tax credit authorized by (a)(1) of this section or the 40 percent production tax credit authorized by (a)(3) of this section, exploration expenditures must

(1) qualify under (b) of this section; and

(2) be for an exploration well, subject to the following:

(A) for an exploration well other than a well that is described in (B) of this paragraph, the well must be located and drilled in such a manner that the bottom hole is located not less than three miles away from the bottom hole of a preexisting suspended, completed, or abandoned oil or gas well; in this subparagraph, "preexisting" means a well that was spudded more than 150 days but less than 35 years before the exploration well was spudded;

(B) for an exploration well that explores a Cook Inlet prospect, the well must be located at least three miles from any other well drilled for oil and gas with all distances measured as the horizontal distance between exploration targets, except that the exploration well that is located within three miles of a well drilled for oil and gas qualifies for the tax credit authorized by this subsection if the exploration well tests potential hydrocarbon traps that the commissioner of natural resources determines, after analyzing evidence submitted by the explorer and from other information that the commissioner of natural resources determines relevant, constitute a distinctly separate exploration target.

(d) To be eligible for the 20 percent production tax credit authorized by (a)(2) of this section or the 40 percent production tax credit authorized by (a)(3) of this section, an exploration expenditure must

(1) qualify under (b) of this section; and

(2) be for an exploration well that is located not less than 25 miles outside of the outer boundary, as delineated on July 1, 2003, of any unit that is under a plan of development, except that for an exploration well for a Cook Inlet prospect to qualify under this paragraph, the exploration well must be located not less than 10 miles outside the outer boundary, as delineated on July 1, 2003, of any unit that is under a plan of development.

(e) To be eligible for the 40 percent production tax credit authorized by (a)(4) of this section, the exploration expenditure must

(1) qualify under (b) of this section;

(2) be for seismic exploration; and

(3) have been conducted outside the boundaries of a production unit or an exploration unit; however, the amount of the expenditure that is otherwise eligible under this subsection is reduced proportionately by the portion of the seismic exploration activity that crossed into a production unit or an exploration unit.

(f) For a production tax credit under this section,

(1) an explorer shall, in a form prescribed by the department and within six months of the completion of the exploration activity, claim the credit and submit information sufficient to demonstrate to the department's satisfaction that the claimed exploration expenditures qualify under this section;

(2) an explorer shall agree, in writing,

(A) to notify the Department of Natural Resources, within 30 days after completion of seismic or geophysical data processing, completion of a well, or filing of a claim for credit, whichever is the latest, for which exploration costs are claimed, of the date of completion and submit a report to that department describing the processing sequence and providing a list of data sets available; if, under (c)(2)(B) of this section, an explorer submits a claim for a credit for expenditures for an exploration well that is located within three miles of a well already drilled for oil and gas, in addition to the submissions required under (1) of this subsection, the explorer shall submit the information necessary for the commissioner of natural resources to evaluate the validity of the explorer's claim that the well is directed at a distinctly separate exploration target, and the commissioner of natural resources shall, upon receipt of all evidence sufficient for the commissioner to evaluate the explorer's claim, make that determination within 60 days;

(B) to provide to the Department of Natural Resources, within 30 days after the date of a request, specific data sets, ancillary data, and reports identified in (A) of this paragraph;

(C) that, notwithstanding any provision of AS 38, information provided under this paragraph will be held confidential by the Department of Natural Resources for 10 years following the completion date, at which time that department will release the information after 30 days' public notice;

(3) if more than one explorer holds an interest in a well or seismic exploration, each explorer may claim an amount of credit that is proportional to the explorer's cost incurred;

(4) the department may exercise the full extent of its powers as though the explorer were a taxpayer under this title, in order to verify that the claimed expenditures are qualified exploration expenditures under this section; and

(5) if the department is satisfied that the explorer's claimed expenditures are qualified under this section, the department shall issue to the explorer a production tax credit certificate for the amount of credit to be allowed against production taxes due under AS 43.55.011(e) or (f).

(g) An explorer may transfer, convey, or sell its production tax credit certificate to any person, and any person who receives a production tax credit certificate may also transfer, convey, or sell the certificate.

(h) A producer that purchases a production tax credit certificate may apply the credits against its production tax liability under AS 43.55.011(e) or (f). Regardless of the price the producer paid for the certificate, the producer may receive a credit against its production tax liability for the full amount of the credit, but for not more than the amount for which the certificate is issued. A production tax credit allowed under this section may not be applied more than once.

(i) For a production tax credit under this section,

(1) the amount of the credit that may be applied against the production tax for each calendar year may not exceed the total production tax liability under AS 43.55.011 (e) or (f) of the taxpayer applying the credit for the same calendar year; and

(2) an amount of the production tax credit that is greater than the total tax liability under AS 43.55.011 (e) or (f) of the taxpayer applying the credit for a calendar year may be carried forward and applied against the taxpayer's production tax liability under AS 43.55.011(e) or (f) in one or more immediately following calendar years.

(j) Notwithstanding any other provision of this title, of AS 31.05, or of AS 40.25.100, the department shall provide to the Department of Natural Resources information submitted with a claim under this section to support the eligibility of an exploration expenditure, including seismic exploration data and well data, and any information described in (f)(2) of this section received by the department.

(k) In this section,

(1) *[Repealed, Sec. 34 ch 2 TSSLA 2006]*.

(2) "Cook Inlet prospect" means a location within the Cook Inlet sedimentary basin, as that term is defined by regulation adopted to implement AS 38.05.180 (f)(4);

(3) *[Repealed, Sec. 34 ch 2 TSSLA 2006]*.