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February 27, 2006

This memorandum begins with a general discussion of the workings of HB 488 and SB 305, the House and Senate versions of the Governor's bill repealing and replacing Alaska's tax on oil and gas production. It then identifies and discusses three issues raised by legislators in hearings on the bill. For each of the three issues raised by legislators, this memorandum suggests potential amendments to the Governor's bill to address concerns voiced by legislators.

General Discussion of the Workings of the PPT

The Governor's proposed legislation is referred to as the "petroleum production tax" or "PPT." The PPT taxes net profits at the point of production. Net profits are calculated by starting with gross profits at the point of production, then subtracting capital and operating expenses incurred upstream of the point of production. The first \$73 million in net profits per producer per year is exempt from taxation, with net profits in excess of \$73 million per producer per year treated as taxable income.

After subtraction of the first \$73 million in net profits, the remaining net profits, or taxable income, is multiplied by the 20% tax rate to arrive at a producer's initial tax liability. This initial tax liability may be further reduced by the application of tax credits, which may be applied dollar-for-dollar against the initial liability. Tax credits are available for 20% of losses as calculated annually at the point of production and 20% of capital expenses incurred upstream of the point of production.¹ Also, the value of tax credits purchased from those without sufficient net profits to fully utilize their own losses and credits may be applied to reduce a producer's initial tax liability. And while a producer's own tax losses and capital expense tax credits can be used to reduce its tax liability as low as \$0, tax losses and capital expense tax credits purchased from others cannot reduce a producer's tax payments to the State below 80% of the amount the producer calculated before application of losses and credits purchased from third parties.

An example of the workings of the PPT for an individual producer is set forth in the following table:

¹ For certain exploration capital expenditures incurred anywhere in the State during the first year of the PPT or south of 68 degrees, 15 minutes North latitude during the first four years of the PPT, an explorer or producer may take tax credits of up to 40% in lieu of the PPT's 20% tax credit for same exploration capital expenditures. As a result, the value provided by the State for these expenditures may rise to a total of 60% of the expenditures.

Example of Workings of PPT for Individual Producer

Gross value at point of production	\$1,000,000,000
- Capital expenses	\$ 350,000,000
- Operating expenses	\$ 50,000,000
= Net profits (net value at point of production)	\$ 600,000,000
- \$73,000,000 annual profits exemption	\$ 73,000,000
= Taxable income	\$ 527,000,000
X 20% tax rate	\$ 105,400,000
Initial tax liability, before credits	\$ 105,400,000
- Producer's own capital expense tax credits (\$350,000,000 x 20% = \$70,000,000)	\$ 70,000,000
= Tax liability after application of producer's own credits	\$ 35,400,000
Maximum usage of purchased tax credits (\$35,400,000 x 20% = \$7,080,000)	\$ 7,080,000
Amount producer pays State, if max. credits purchased	\$ 28,320,000

1. Tax deductions, losses, and credits are of greater value to established major producers than to those the State seeks to attract: explorers, small producers, and new entrants.

The PPT is intended to bring explorers and new producers to the State of Alaska. Yet explorers and new producers will want to know that they can compete with existing, major producers on equal footing. This has not always been the case in the past. For example, explorers, potential new entrants, and those leaving the State after determining that they cannot compete have complained that the tariffs for transportation of oil through the Trans Alaska Pipeline System (TAPS) have exceeded just and reasonable rates, to the disadvantage of those without an ownership interest in TAPS. The problem with excessive TAPS tariffs, they argue, is compounded by the fact that the overages they must pay are paid to their competitors, since those that own TAPS are also the largest explorers and producers in this State.

Explorers, small producers, and potential new entrants may argue that the PPT's mechanisms for monetizing losses and tax credits exacerbates an uneven playing field in much the same way as do TAPS tariffs. Their argument may be expressed as follows: Those testifying before the legislature on behalf of the Administration have stated that major, existing producers will be able to immediately take full advantage of tax credits generated from their own activities—they can use 100 cents of every dollar, without limit. These same witnesses have acknowledged that transferable tax credits available through existing programs typically sell for \$0.90 on the dollar, and one should expect no more with the PPT. Further, they have revealed that the price offered by major, existing producers to explorers, small producers, and new entrants for the latter's transferable tax credits could be substantially less than \$0.90 on the dollar in the event of low oil prices, which are apt to trigger the Section 12(e) percentage limit on use of transferable or purchased tax credits.

The Administration seems to agree, then, that tax credits available to explorers, small producers, and new entrants will be worth no more than \$0.90 on the dollar, and possibly substantially less, even though those credits cost the State the full dollar, and major existing producers can take full advantage of 100 cents on the dollar. This inequity in value of tax credits is compounded by the fact that \$0.10 or more of every dollar in tax credits made available because of expenditures by the explorers, small producers, and new entrants will, in fact, be paid over to their competitors—the major, existing producers who buy their tax credits at a discount.

Administration witnesses have justified the PPT's approach to delivering value on two grounds. First, they state—correctly—that if the State was left to fund direct payments for the credit amounts through annual appropriations, in an era of low oil prices the legislature might fail or refuse to do so. Second, they state—also correctly—that the percentage limit on use of transferable tax credits protects the State's treasury. However, there may be an alternative or supplemental approach that accounts for the Administration's concerns in a fashion less likely to increase the disparity between major, existing producers and the explorers, small producers, and new entrants.

Undoubtedly, the Administration, all explorers, and all producers would rather not count on affirmative funding actions by future legislatures to assure that parties are rewarded for incurring expenses related to Alaska's upstream exploration, development, and production. However, HB 488 and SB 305 could be amended to recognize that future legislatures may choose to take affirmative funding actions, and only if they do not will the system of automatic transferable tax credits come into play. As a consequence, at least in robust years the State would be more apt to fund directly what it is going to pay for one way or another, and thus fully reward explorers, small producers, and new entrants for their own expenditures, rather than aggravating uncompetitive conditions.

Additionally, the bill could be amended so that in lean years the explorers, small producers, and new entrants are not "limited-out" while the major, existing producers take full value for their expenditures. While a limit is desirable to protect the public treasury, the limit could be more equitably formulated. For example, a threshold for minimum payments or maximum credits could be established, then credits could be prioritized so that they are not all taken in a year when the State cannot afford it, but some portion of everybody's credits roll forward into more lucrative years. For example, the PPT as currently drafted puts a 20% value on all capital and operating expenses incurred upstream of the point of production, which is taken either as a deduction from gross profits or as a loss; it puts an additional 20% value on the very same capital expenses, which value is taken as a capital expense tax credit. Rather than allowing a major, existing producer to take 100% of both forms of value during a lean year while an explorer, small producer, and new entrant takes little or none, instead deductions and losses could be taken first by all players, and some portion or all of every player's capital expense tax credits could be rolled forward into future tax years if the pre-determined overall limit on credits came into play.

Also, if tax credits that must be bought and sold to be monetized are to play a continuing role in the PPT, the legislature may want to consider establishing a minimum price that must be paid to buy these tax credits—say \$0.95 cents on the dollar. Even at \$0.95 cents on the dollar, the \$0.05 amount ought to be sufficient “free money” to entice a major, existing producer to still buy transferable tax credits, yet the floor price will protect explorers, small producers, and new entrants from larger and potentially anti-competitive erosions in the value of their credits.

If the bill’s language on tax credits is not amended, disparate treatment of existing, major producers and explorers, small producers, and new entrants may become the rule, as can be seen from the example of the workings of the PPT set forth on page 2. There the producer with \$1 billion in net income can fully utilize its own deductions and credits by taking deductions of \$400,000,000, which carry a cash value of \$80,000,000, and credits of \$70,000,000, for a combined tax savings in the year at issue of \$150,000,000, while explorers, small producers, and new entrants that must rely on the very same producer to monetize their tax credits can only sell that producer credits with a total value of 1/20th that amount—just over \$7,000,000. As a result, their credits may sell into a constrained market at substantially less than \$0.90 on the dollar or be rolled forward into future years, with their time value significantly eroded.

2. The \$73,000,000 tax free allowance was devised to protect those that do not currently pay taxes; its phase-out would prevent an abrupt imposition of taxes on those formerly untaxed, yet discourage multiplication of amounts escaping taxation.

The PPT allows each producer to take its first \$73,000,000 in net profits each year tax-free. The Administration has explained this tax-free allowance by stating that a producer generating revenues from a 5,000 barrel/day field should not have to pay taxes when oil is selling for \$53/bbl on the West Coast and its net profits at the point of production total \$40/bbl. One could question this rationale, and further ask about the implications of a \$73,000,000 per producer per year tax-free allowance on the public psyche when and if Alaskans are asked to start paying state income taxes on their own, substantially smaller net incomes.

Perhaps a better rationale for the \$73,000,000 per producer per year tax-free allowance is that it is intended to allow those that currently pay little or no state production taxes to continue paying little or no state production taxes, and thus avoid the abrupt imposition of taxes. However, as currently formulated, the tax-free allowance benefits major, existing producers as well, even though they proposed its elimination. Furthermore, with time, the tax-free allowance encourages the proliferation of new entities for the sole purpose of multiplying income escaping taxation.

When considering whether the \$73,000,000 tax-free allowance is necessary to blunt the imposition of taxes on smaller players, it is important to note that, unlike the current system, at all oil and gas prices the PPT already taxes only the profitable, and further includes substantial credits for capital expenditures, which credits effectively permit a percentage of net profits to escape taxation. Thus, the impacts on a small player have already been softened even without the \$73,000,000 tax-free allowance, in a way they would not have happened with other possible changes to the State’s production tax regime, such as a simple repeal of the economic limit factor (ELF). Still, if legislators choose to leave the tax-free allowance in place in light of expenditures made by industry with the expectation of lower taxes, the tax-free allowance could be phased out. Phasing out could be accomplished by reducing the allowance each year for a period of

years or simply sun-setting the full allowance a number of years hence. In either case, the largest value of the allowance would be received in the early years of the new tax regime, and thus substantially improve a producer's net present value calculations (whereas allowances to be received in years after a possible sunset date would be of lesser value—and a lesser loss—to producers).

If the tax-free allowance is to be phased out, a phase out over five years may discourage the proliferation of entities created or entering Alaska for no reason other than multiplication of income escaping taxation, whereas a phase out over a longer period (such as ten years) may mean that multiplication is still worthwhile and can be accomplished without clearly triggering the Department of Revenue's ability to aggregate taxpayers under Section 21(j) of the bill.

3. The PPT may obligate the State to pay up to 40% of abandonment costs, even for fields with little in net profits left to garner.

Through the PPT the State conveys value—either as a deduction, loss, or transferable tax credit—equal to 20% of all operating costs and 40% of all capital costs incurred upstream of the point of production. In exchange, the State receives 20% of all taxable net income earned upstream of the point of production from and after July 1, 2006. The State's 20% share of net profits and obligation to “pay” 20-40% of costs applies to all oil and gas fields throughout the state—whether on state, federal, or private lands, and without regard to the stage of field life. Thus, for fields past their prime, and even for fields where production has ceased but abandonment has not been completed, as well as for wells, facilities, and fields abandon during the five year “look-back” period for transition expenses, the State through the PPT is undertaking to “pay” (through deductions and credits) up to 40% of abandonment costs, though those costs currently fall exclusively upon oil and gas companies that undoubtedly accounted for their obligation to cover such costs in years past when deciding whether to invest in particular fields. As a consequence, the PPT's treatment of abandonment expenses may result in a huge and disproportionate liability for the State where it currently has none.

There a number of ways in which the legislature could change the treatment of abandonment expenses by amending HB 488 and SB 305. First, abandonment expenses could be disallowed when calculating deductions, losses, and tax credits. Alternatively, abandonment expenses could be prorated, based on the number of barrels of oil (or barrel-equivalents in the case of gas) produced before the effective date of the PPT and the number produced thereafter. Additionally, since the Internal Revenue Code or the PPT's definition of “qualified capital expenses” may allow producers (and former producers) to claim that some or all abandonment expenses are capital expenses subject to a 40% benefit, the PPT could be amended to limit producer benefits at State expense to 20%—that is, require all abandonment costs to be treated as operating costs for purposes of the PPT.

Conclusion

This memorandum does not attempt to identify or address all issues surrounding HB 488 and SB 305, the petroleum production tax legislation introduced by the Governor. Rather, it selects three concerns raised by legislators, discusses them, and provides suggestions on how these concerns could be met through amendments to the proposed legislation. If legislators are interested in further pursuing the possibility of one or more of the amendments mentioned, I recommend that Administration personnel be included in the drafting process to assure that there is no unintended damage to the overall regime of taxation. Also, I would be happy to assist in drafting or reviewing any such changes to the language of the bills.