Alaska's Oil and Gas Production Tax
The "ABCs" of ACES

Alaska Oil & Gas Association

Educational Seminar

January 6, 2011

INTRODUCTION

- What is a production (severance) tax?
  - Tax on the act of producing oil and gas
  - Tax levied on the value of the resource produced
  - Under the State's sovereign power to tax production not otherwise exempt
    - Generally in Alaska this means the tax applies to production after State royalties (~7/8's of production)

RECENT PAST

- Alaska's production tax methodology has been substantially changed in recent years
  - Pre-February 2005 – Economic Limit Factor (ELF)
  - February 2005 – March 31, 2006 – Aggregated ELF
  - April 1, 2006 – July, 2007 – Petroleum Profits Tax (PPT)
  - ~July 2007 – Present – Alaska's Clear and Equitable Share (ACES) *
  - Tax regulations

  * Some provisions of ACES made retroactive to enactment of PPT, others to January 1, 2007

WHY THE ELF AND WHAT WAS IT?

- State wanted the production tax to be Alaska's primary tax on production
  - As fields age, their economics deteriorate and tax relief becomes appropriate to prevent premature shut-in
  - Incentive to develop and produce smaller fields while keeping tax on larger, more prolific fields higher

WHY THE ELF AND WHAT WAS IT?

- Formulaic multiplier designed to reduce the effective production tax rate for a field as the field matures and becomes marginal
  - ELF tried to approximate the percentage of production value being consumed as the costs of producing that production
  - Production tax rate reduced to zero when the field was just breaking even
  - In essence, designed to allow the complete development of the field

WHY THE ELF AND WHAT WAS IT?

- Effective tax rate for a given field – it's ELF x the base tax rate
  - Lower base rate for gas
- ELF basically a surrogate for deductions (taxed operating margin; marine, pipeline transportation costs and other limited costs allowed)
- In 2005, Administration aggregated the ELF for most North Slope fields

WHY THE PPT AND WHAT WAS IT?

- As tax rate and production levels began to decline, concern grew over appropriateness of key statutory assumptions in the oil ELF formula
- Revenue decline, budget deficits and gas pipeline fiscal discussions

WHY THE PPT AND WHAT WAS IT?

- **PPT designed to deal with two major flaws many believed the ELF failed to address**
  - **Create significant incentives to encourage exploration and development of oil and gas**
  - **Increase State tax take when oil and gas prices were high, regardless of the size or productivity of the field**

WHY THE PPT AND WHAT WAS IT?

- PPT was dependent on the value of the oil and gas produced
  - Basically a tax on the value of oil and gas when severed from the reservoir
  - Allowed recovery of certain costs back to the bottom of the well
- State's goal to raise industry taxes and PPT seen by some as necessary to help promote major gas development
- More than doubled industry's taxes

PETROLEUM PROFITS TAX (PPT)

- Geographically based production tax versus a field by field determination
  - Production/expenses consolidated from four "segments" within the state
    - North Slope
    - Cook Inlet Oil
    - Cook Inlet Gas
    - "Middle Earth"

PETROLEUM PROFITS TAX (PPT)

- Taxes a producer's "production tax value or PTV", i.e., value downhole at the point of severance from the reservoir
  - Allows deduction of most costs back to the well bottom versus ELF surrogate
  - Certain tax credits allowed
  - Small producer relief

PETROLEUM PROFITS TAX (PPT)

- Deductions and credits intended to encourage exploration/development
- Same tax rate for oil and gas

WHY ACES AND WHAT IS IT?

- Influenced by many factors:
  - Continued rising oil prices
  - Political scandals
  - Prudhoe Bay issues
  - Campaign rhetoric

WHY ACES AND WHAT IS IT?

- Administration and legislature's desire to increase taxes on industry
  - Modified significant provisions of the PPT
  - Added numerous confusing, complicated regulations
  - Diluted many of the intended economic incentives envisioned under the PPT
- More than doubled industry’s taxes. . .again

HOW DOES THE PPT/ACES WORK?

- Gross Value of the oil and gas at the destination/market where it is delivered, sold or refined
  - SUBTRACT
    - Pipeline and marine transportation costs
    - Certain current year lease expenditures
      - Certain current year operating expenses
      - Certain current year capital expenses
- EQUALS the Production Tax Value (PTV)
  - TIMES base tax rate
  - ADD progessivity tax, if applicable
  - SUBTRACT allowable tax credits
  - OR minimum tax (on gross), if higher
- EQUALS the Production Tax due

NOTE: different rules apply to Cook Inlet production

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Gross value of the oil and gas at the destination/market SUBTRACT

PPT (Key Provisions)

Pipeline and marine transportation costs

- Pipeline tariffs and marine tanker costs

ACES (Key Provisions)

Pipeline and marine transportation costs

- Pipeline tariffs and marine tanker costs
- Complicated by Department of Revenue (DOR) regulations

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Gross value of the oil and gas at the point of production (Pump Station One) SUBTRACT:

PPT (Key Provisions)

Certain current year operating expenses (opex)

- Upstream of point of production
- Activity need not be physically on lease or property
- 18 listed exclusions
- Costs related to ULSD
- Excess of FMV of internal/non-arm's length transactions
- DOR allowed to use JIB's as starting point
- DOR could issue regulations to clarify

ACES (Key Provisions)

Certain current year operating expenses (opex)

- Upstream of point of production
- Activity need not be physically on lease or property
- 20 listed exclusions
- ULSD disallowed except for limited amounts
- Entire internal/non-arm's length transaction if in excess of FMV
- DOR not required/allowed to use JIB's
- Costs related to interruption of production disallowed
- 2006-2009 legacy field “standard deduction”
- Deductions limited to those allowed by DOR

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Gross value of the oil and gas at the point of production (Pump Station One) SUBTRACT

PPT (Key Provisions)

Certain current capital expenses (capex)
- Must be capital expense
- Same limitations as opex
- Deductible even if tax credit allowed
- 30¢ per BOE exclusion

ACES (Key Provisions)

Certain current capital expenses (capex)
- Must be capital expense
- Same limitations as opex
- Deductible even if tax credit allowed
- 30¢ per BOE exclusion

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

EQUALS the Production Tax Value

PPT (Key Provisions)

- Cannot be reduced below zero
- Any excess deductions creates NOL tax credit
- NOL Tax credit determined at 20% rate

ACES (Key Provisions)

- Cannot be reduced below zero
- Any excess deductions create NOL tax credit
- NOL Tax credit determined at base tax rate (25%)

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

TIMES the Base Tax Rate

PPT (Key Provisions)

- 22.5%

ACES (Key Provisions)

- 25%
- Special tax rate for non-Cook Inlet gas used in state

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

ADD Progressivity

PPT (Key Provisions)

- 0.25% per $1/BOE over $40 PTV determined monthly
- Total cannot exceed 25%
- No brackets - all production taxed at highest rate
- Maximum base & progressivity - 47.5%

ACES (Key Provisions)

- 0.4% per $1/BOE when PTV between $30-92.50 (25%)

PLUS

- 0.1% per $1/BOE when PTV greater than $92.50
- Total cannot exceed 50%
- No brackets - all production taxed at highest rate
- Maximum base & progressivity - 75%

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

SUBTRACT allowable tax credits

PPT (Key Provisions)

- 20% of current year qualified capex spend
- NOL tax credits from prior years
- Small producer tax credits
- Purchased tax credits
- Exploration tax credits (20%, 30% or 40%)
- Transition investment tax credits

ACES (Key Provisions)

- 20% of current year qualified capex spend - over 2 years
- NOL tax credits from prior years
- Small producer tax credits
- Purchased tax credits
- Exploration tax credits (20%, 30% or 40%)
- TIE credits eliminated after 2007 except for first time explorers

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

OR Minimum Tax if greater

PPT (Key Provisions)

- 0-4% of gross value at point of production
- Depending on price of ANS
- Only on North Slope production

ACES (Key Provisions)

- 0-4% of gross value at point of production
- Depending on price of ANS
- Only on North Slope production

EQUALS the Production Tax Due

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Statute of Limitations for audits

PPT (Key Provisions)

- **3 years**

ACES (Key Provisions)

- **6 years**

HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Interest on Retroactive Application of Tax Regulations

PPT (Key Provisions)

- Applicable

ACES (Key Provisions)

- Not applicable if good faith compliance (2010)

Thank you.