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** progressivity 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**

<table>
<thead>
<tr>
<th>PPT (Key Provisions)</th>
<th>ACES (Key Provisions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pipeline and marine transportation costs</td>
<td>Pipeline and marine transportation costs</td>
</tr>
<tr>
<td>• Pipeline tariffs and marine tanker costs</td>
<td>• Pipeline tariffs and marine tanker costs</td>
</tr>
<tr>
<td></td>
<td>• Complicated by Department of Revenue (DOR) regulations</td>
</tr>
</tbody>
</table>
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

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

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%

ADD Progressivity
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.