Policy Discussion Regarding Alaska’s Oil and Gas Fiscal System

Commonwealth North
Board of Directors

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Topics

- How the Current Tax System Works
- Results With ACES
- Role of the Producers in the Policy Debate
- What’s a Fair Share?
- Closing
How the Current System Works

- Net Profits Approach with Aggressive Tax Credits (or Rebates)
  - Rewards those who invest/re-invest in Alaska
    - Hits hardest at those profits exported out of Alaska
  - State assumes real exploration risk and low-price risk

- Steep Progressivity Rate
  - State takes an increasing share at higher prices
    - Is a disincentive for new investment looking at “upside” potential
  - However, it also increases the marginal value of new investment
    - New investment immediately lowers a taxpayers’ per barrel profit
      => lowers tax rate on current production
Marginal vs. Effective Tax Rates

Effective Tax Rate: The Tax you’re actually paying.

Marginal Tax Rate: The theoretical tax on the next dollar of profit.
Marginal vs. Effective Tax Rates

**Effective Tax Rate**: The Tax you’re actually paying.

**Marginal Tax Rate**: The theoretical tax on the next dollar of profit.
How It Works for New Entrants

- Assume a new entrant with no current production pursues an exploration project requiring **$200 million** in investment
- Company receives a 20% - 40% investment credit (depending on location), worth **$40 - $80 million**
- Company also receives an additional 25% credit for its “tax loss” or “net operating loss (NOL)”, worth up to **$50 million**
- Total State Participation is **$90 - $130M** of the investment costs.
- *State pays this rebate to the Company regardless of whether the exploration is successful.*

$200 Million
- $40 Million
- **$50 Million**

$70 - 110 Million (at risk for Co.)
How It Works for Incumbents

- Incumbent with current production pursues a development requiring **$200 million** investment
- Company receives a 20% capital investment credit, worth **$40 million**
- By reducing their Production Tax Value (PTV), the company reduces their taxes due by the total capital expense multiplied by the tax rate:
  - Base: $200 million * 25% => worth **$50 million**; plus
  - Progressivity: $200 million * progressivity surcharge rate (which is reduced due to the drop in PTV)
- Total State Participation is over **$90M** of the investment costs.
  - If prices are high, then state participation can exceed 75% of the costs.

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- $50+ Million
<$110 Million (at risk for Co.)
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Affected by the Marginal Tax Rate
Results Since ACES
Based on Available Data

- Revenue Up Significantly
- North Slope Capital Investment Up
Results Since ACES
Revenue is Up

Comparison of Estimated Production Tax Revenue From ACES, PPT and ELF for FY 2007 - FY 2010

Source: DOR Legislative Presentation, February 4, 2010
Results Since ACES
Capital Investment is Up

North Slope Expenditures

Source: DOR Revenue Sources Book, Fall 2008, Fall 2009, Fall 2010
What Is the Responsibility of the Producer in This Policy Debate?

- Simply demand a lower tax burden?
- Provide Factual Data to Support Policy Requests?
- Provide Insight into how investment decisions are made?
- Provide some criteria upon which a “fair” system can be evaluated?
What Is a Fair Share?

Shares of North Slope Oil Profit at Different Prices

Source: DOR Legislative Presentation, February 4, 2010
- Reviewing only “Take” does not reveal the fact that the Producer recovers all costs before taxes are assessed.
- Whereas State share of profit is high at low prices (primarily due to royalty), the Producer retains the majority of the revenue.

Source: DOR Legislative Presentation, February 4, 2010
How Does Alaska Compare?

Note: Total Government Take Percentage; Oil price $70-$150/bbl

Source: DOR Legislative Presentation, February 4, 2010
What Is a Fair Share?

- We Need A **Standard** to Evaluate Whether the Tax System is providing an appropriate share of profits to the Producer.
- Historically, some have used the Standard of one-third to the Producer, one-third to the federal government, and one-third to the State.
- I support a Standard that protects one-third of the profit for the Producer.
One-Third Is a Fair Share

But We Don’t Offer One-Third Now at High Profits

Shares of North Slope Oil Profit at Different Prices

Source: DOR Legislative Presentation, February 4, 2010
One-Third Is a Fair Share

If Progressivity Surcharge is capped at 10%

Share of Total Production Tax Value with Modifications

Percent of Total Production Tax Value

$ per barrel

State
Fed
Producer

48%
18%
33%
In Closing

- ACES has succeeded in providing revenues AND spurring investment;
- ACES reduces investment risk, however, the high progressivity decreases the materiality of Alaska projects, and can be improved;
- Preserving one-third of profits for Producers is an appropriate Standard to use for Alaska’s fiscal system.
  - Capping Progressivity at 10% is a good solution.
Back Up Slides
Types of Analysis done by DOR

- Sample Field Model - Profitability under Different Tax Systems
- Inherent Profitability of Increasing Production
- Profitability of Enhanced Oil Recovery Programs
## Oil Field - Profitability Analysis

### NET TAX SCENARIOS

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Base Rate</th>
<th>Progressivity Rate</th>
<th>Capital Credit Trigger Rate</th>
<th>Industry NPV @ 15% at $40/bbl real ANS WC (mm$)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Field A</td>
<td>Field B</td>
<td>Field C</td>
<td>Field D</td>
</tr>
<tr>
<td>ACES as Proposed - 10% Floor. Broad ring-fence**</td>
<td>25%</td>
<td>$30</td>
<td>0.2%</td>
<td>20%</td>
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<tr>
<td>ACES Proposal - No Floor</td>
<td>25%</td>
<td>$30</td>
<td>0.2%</td>
<td>20%</td>
</tr>
<tr>
<td>PPT Status Quo</td>
<td>23%</td>
<td>$40</td>
<td>0.3%</td>
<td>20%</td>
</tr>
<tr>
<td>High Net Tax</td>
<td>35%</td>
<td>$30</td>
<td>0.3%</td>
<td>20%</td>
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</tbody>
</table>

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~ 2007 Analysis: ACES Special Session

Source: DOR, July 8, 2010
Production Itself Motivates Investment

Production Drives Revenue

<table>
<thead>
<tr>
<th>Decline Rate</th>
<th>15%</th>
<th>6%</th>
<th>3%</th>
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<tbody>
<tr>
<td>Produced Barrels</td>
<td>1.3 bn</td>
<td>3.9 bn</td>
<td>7.5 bn</td>
</tr>
<tr>
<td>Industry Investment</td>
<td>$5 bn</td>
<td>$25 bn</td>
<td>$70 bn</td>
</tr>
</tbody>
</table>

- NPV_{10} = $Bn
- NPV_{0} = $Bn
- NPV_{0} = $/bbl

- $15 - $20
- $22 - $27
- $15 - $20
- $30 - $40
- $55 - $75
- $14 - $19
- $35 - $45
- $90 - $125
- $12 - $17

~ 2007 Analysis: PPT Rates, $70/bbl

Source: DOR, July 8, 2010
Enhanced Oil Recovery (EOR) Program Appears to be Inherently Profitable

**CAPEX for Drilling Program**

**Incremental Production**

**Oil Company Net Present Value**

**Alaska Royalty And Taxes**

Based on BP’s Cost and Production Numbers Provided in Legislative Testimony

- ACES Tax Rates
- $50 oil price

Source: DOR, July 8, 2010