December 2019

BRIEFING PAPER: THE "PER BARREL" CREDIT

One Component of Alaska's Oil & Gas Production Tax System

Alaska Oil and Gas Association

What's Inside:

INTRODUCTION

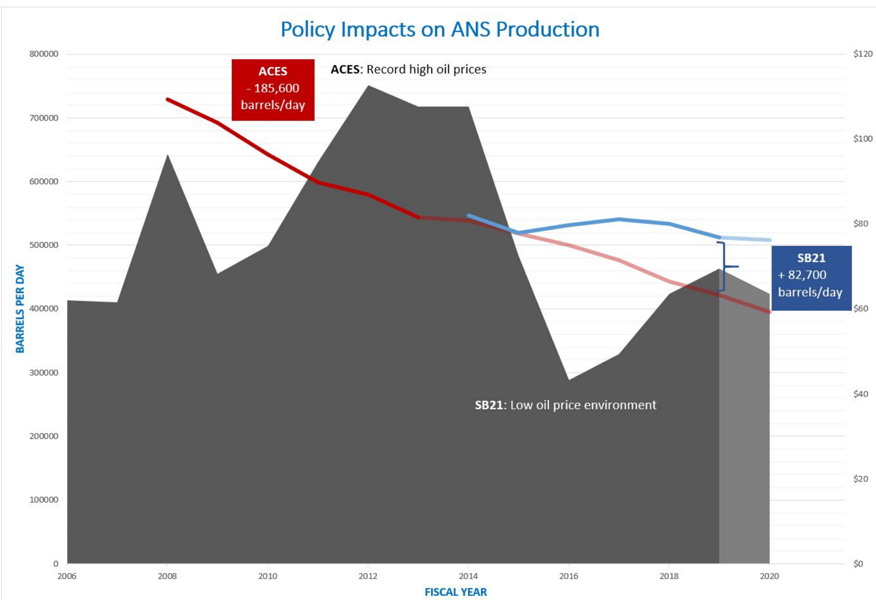
The Alaska oil and gas industry is estimated to contribute over $2.5 billion in royalties and taxes to state and local governments in fiscal year 2020. The industry also accounts for about one-third of all jobs (approx. 110,000) and about one-third of wages in the state. If Alaska wants to retain the strong benefits it receives from the industry, the tax structure needs to be stable and predictable.

Overview

CURRENT TAX SYSTEM INCENTIVIZES PRODUCTION

The industry's production tax has been changed seven times in the last fourteen years. In 2013, and later ratified by voters in 2014, Alaska changed its production tax system from a system called "ACES" to one that was intended to increase production on the North Slope and Cook Inlet. This briefing paper will focus on the Per Barrel Credit; which is a critical component of the current tax system.

From FY08-FY13, during the period of the ACES tax system, production declined by 185,600 barrels per day. Despite record high oil prices at the time prompting increased activity on a global scale, Alaska's production, in contrast, was slated for continued and rapid decline. Since the passage of Senate Bill 21 in 2013, production has stabilized and was to be over 80,000 barrels per day above what was expected under ACES in FY19.



Source: Department of Revenue Fall 2012 & Fall 2019 Revenue Sources Books

KEY TAKEAWAYS:

- Despite record high oil prices during ACES - both actual and forecasted - production rapidly declined.
- From FY08-FY13, production decreased by 185,600 barrels per day.
- Conversely, even with a massive drop in oil prices just as it came into effect, SB 21 stemmed the decline and stabilized production.

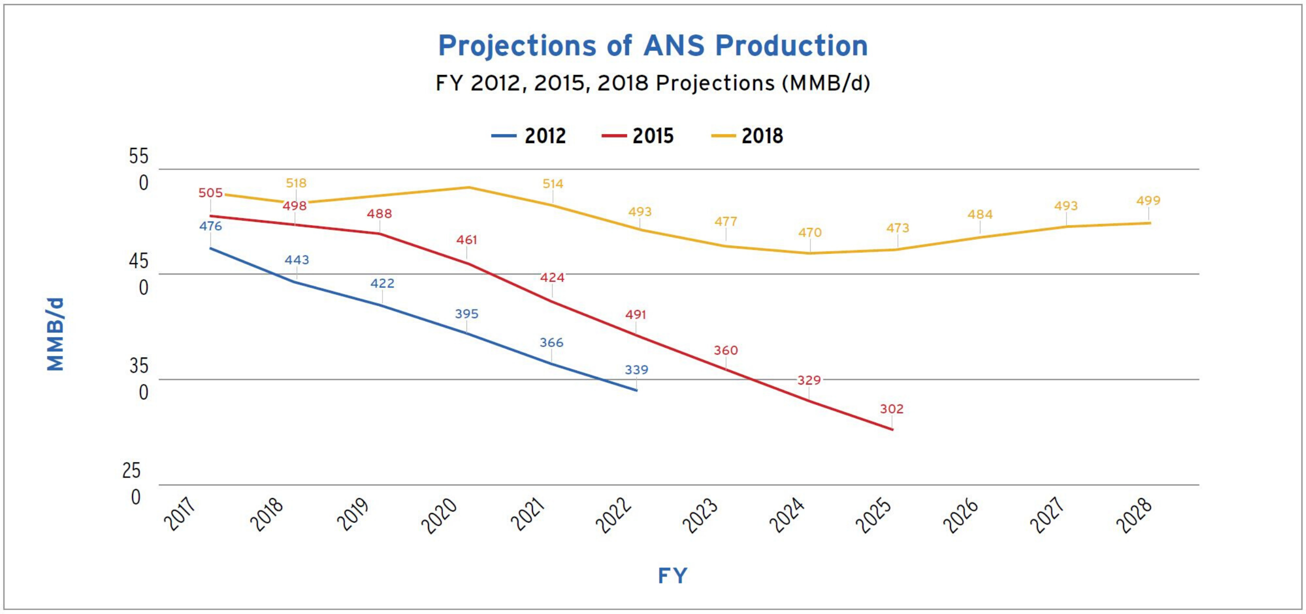
ACES Production
ACES Production Forecast
SB21 Production
SB21 Production Forecast
Price $ Forecast (2012 RSB)
Price $ Forecast (2019 RSB)
Price $ Actual

Did You Know?

THE STATE NO LONGER OFFERS "CASHABLE" CREDITS

While the basic net production tax framework remains, other recent changes have made investments in the state more challenged. For example, passage of House Bill 247 in 2016 and House Bill 111 in 2017 completely repealed all investment-based production tax credits for Cook Inlet and the North Slope. This means the state no longer offers refundable or "cashable" credits, which were only available to companies with taxable production of less than 50,000 barrels per day.

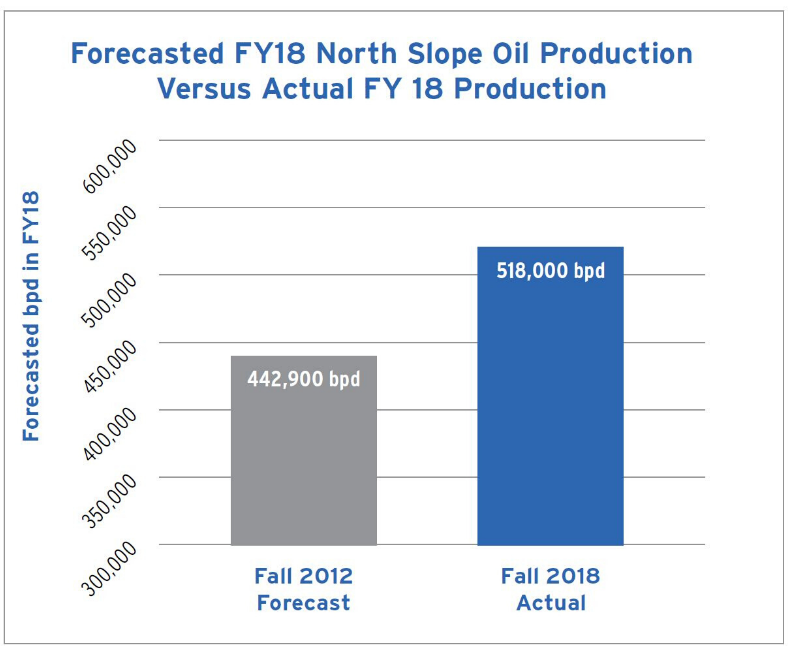
In the Fall of 2012, the State of Alaska forecasted that North Slope production in Fiscal Year (FY) 2018 would be 443,000 barrels per day. Thanks to increased investment and production on the Slope, North Slope production actually averaged 518,000 for FY18, an increase of 75,000 barrels per day.



Source: *Department of Revenue – Chart by Alaskans for Sustainable Budgets, February 2019*

INCREASED PRODUCTION LED TO INCREASED STATE REVENUE

While ACES rewarded spending, the current system rewards production. Assuming price remained equal, the increase in North Slope production between the forecast in FY12 (442,900 barrels per day) versus actuals in FY18 (518,000 barrels per day) resulted in approximately $280 million more in unrestricted revenue for state spending.



Difference in Production

75,100 bpd

Additional barrels per day (bpd) in FY 18 North Slope production versus FY12 forecast

Difference in Revenue

~$280 million

If production would have been as forecasted in FY 12 (442,900 bpd), State revenue would be approximately $280 million less than is predicted for FY18 State due to increased North Slope productions

Source: *Department of Revenue Fall 2012 & Fall 2018 Revenue Sources Books*

The Per Barrel Credit

THE "PER BARREL CREDIT" CREATES PROGRESSIVITY

Despite the recent repeal of all refundable or "cashable" tax credits, efforts have continued to target further changes to the production tax structure. Specifically, efforts have risen to repeal the "Per Barrel Credit," an integral to the tax structure under Senate Bill 21. The Per Barrel Credit is necessary to establish a progressive tax structure on the North Slope, resulting in higher effective tax rates when oil prices are higher, and providing a more competitive tax rate when prices are low.

HISTORY OF THE PER BARREL CREDIT

The Per Barrel Credit is part of SB 21, which dramatically transformed the production tax structure. The primary changes made in SB 21 were:

- increasing the base tax rate from 25% to 35%
- adding a minimum gross floor of 4%
- repealing the progressivity tax (which was added to the base rate), the amount of which depended on oil price, production and field costs
- repealing the 20% transferrable/refundable tax credit for North Slope capital expenditures
- increasing the transferrable/refundable loss tax credit for North Slope expenditures from 25% to 45% for two years, then reducing it to 35%
- adding the Gross Value Reduction (GVR) and the New Oil Credit
- adding the Per Barrel Credit to establish tax rate progressivity based on oil price

These components of Senate Bill 21 work together to calibrate the production tax system. The base tax rate was increased substantially, while the progressivity tax was repealed. The Per Barrel Credit now serves as the progressive element, creating higher effective tax rates at higher oil prices, while keeping the tax competitive at lower prices.

By shifting tax incentives from drilling and facility investment to success in achieving actual production, the revised tax credit structure under SB 21 put more risk on companies, while motivating increased production.

INTEGRAL PART OF THE TAX SYSTEM

The Per Barrel Credit has been left intact since it was adopted as part of SB 21 in 2013 in large part because it is an integral part of the tax calculation and not the same as the investment-based credits (cashable for producers of less than 50,000 taxable barrels per day) eliminated through changes made in 2016 and 2017 (House Bill 247 and House Bill 111, respectively).

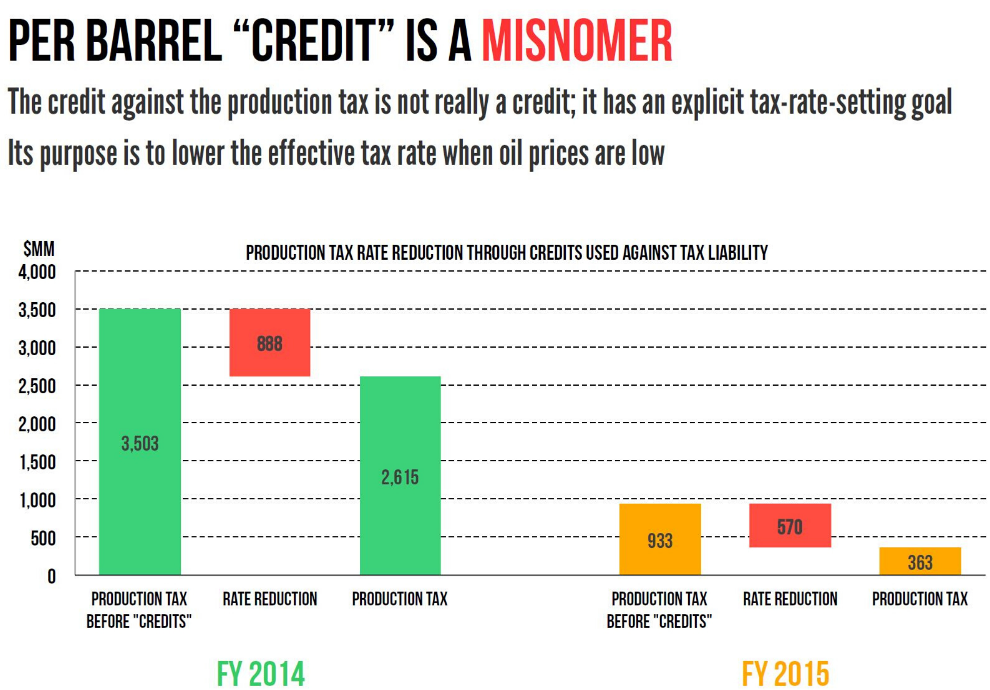
The Alaska Department of Revenue, as well as the Alaska Legislature's own expert consultants, have recognized this important, fundamental trait.

> “With SB 21, the [per barrel] credit is an offset to the tax and is designed to create a progressive element; a little bit lower tax rate at lower prices, a higher tax rate at higher prices. So, it’s hard to really consider them a credit in the context of an inducement to doing work. It’s really what we are calling an integral part of the system.
>
> – Ken Alper, DOR Tax Division Director, June 17, 2015

This chart from Legislative Consultant, Enalytica, shows the how the Per Barrel Credit reduces the production tax rate at different prices.

The average price for Alaska North Slope crude in FY14 was $107.57 and dropped to $72.58 in FY15, and dramatically dropped again in Fiscal Year 2016 to $43.18.

> “[per barrel credit] is an adjustment of effective tax rate to offset high royalty at low oil prices ”
>
> – Roger Marks, Legislative Consultant, April 15, 2017



> ” The credit against the production tax is not really a credit; it has an explicit tax-rate-setting goal.
>
> – Enalytica, Legislative Consultant, June 17, 2015

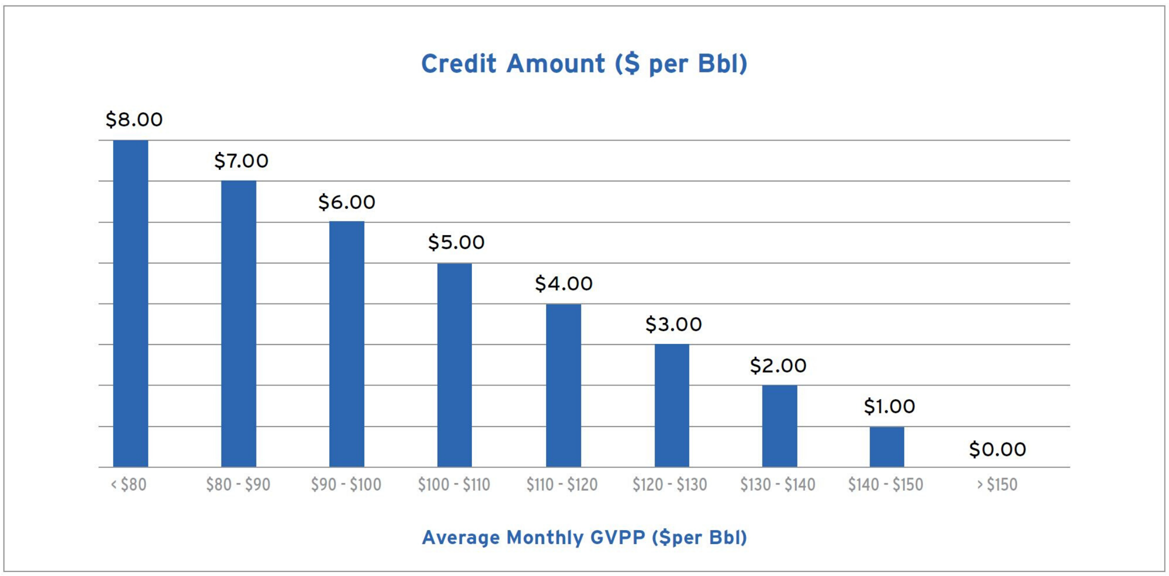
Source: Joint Resources Committee Hearing - Chart by Enalytica, June 17, 2015

WHAT IS THE PER BARREL CREDIT?

The Per Barrel Credit, also known as the "sliding scale" credit, can be found in in AS 43.55.024(j). A producer may apply the Per Barrel Credit against its production tax liability on a monthly basis. The amount of the credit ranges from $8 per taxable barrel to $0 per taxable barrel, depending on the price of oil.

Specifically, the amount of the Per Barrel Credit is based on the average Gross Value at the Point of Production (GVPP), known as the "wellhead value." At a high level, the GVPP is basically the market price of a barrel of oil, minus the transportation costs (marine costs and pipeline tariffs, which approximate $8.50-$10.00 per barrel).

If the average GVPP for the month is less than $80 per barrel, the Per Barrel Credit is $8 per taxable barrel of oil. This is the maximum credit allowable. If the average GVPP for the month is greater than $80 per barrel, but less than $90 per barrel, the credit is $7 per barrel. The amount of the credit continues to drop by $1 for each $10 incremental increase in GVPP, and is zero if the average GVPP for the month is $150 per barrel or higher. The following chart shows these increments:



How it Works

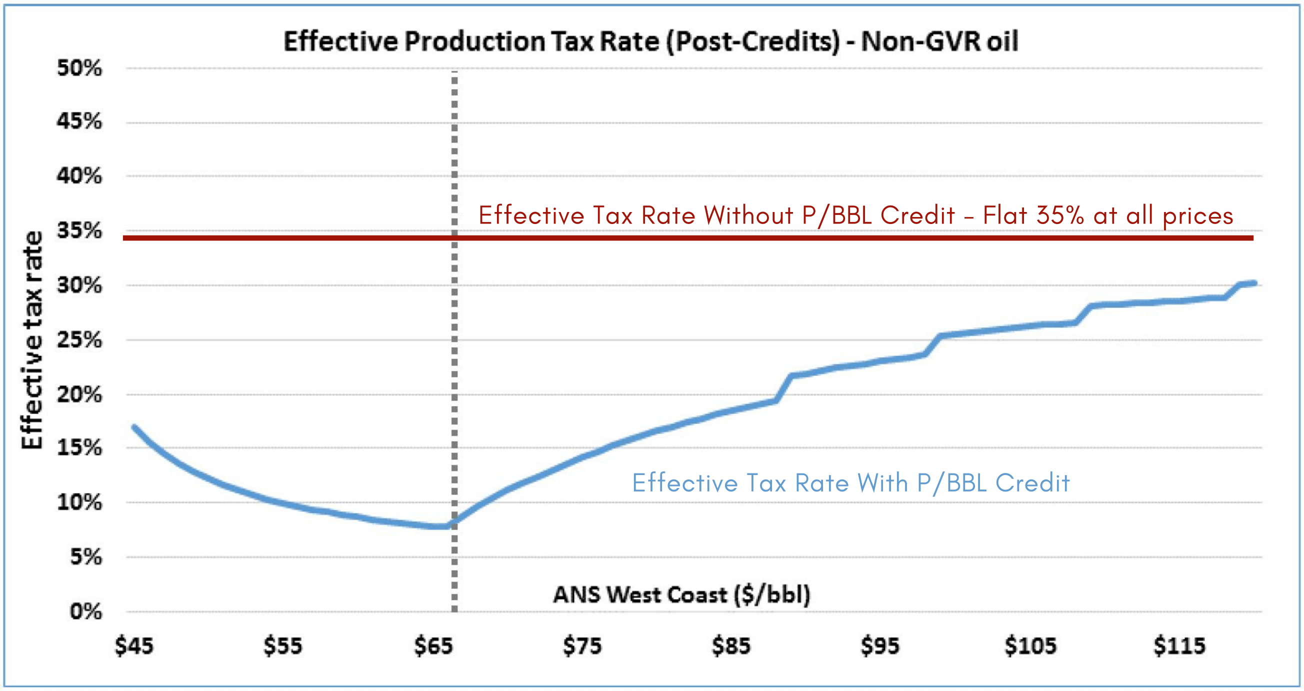
SAMPLE CALCULATIONS [BY THE BARREL]

ANS Oil Price (per barrel)	$85.00	$95.00	$105.00
Transportation Costs	-$8.53	-$8.53	-$8.53
GVPP ("wellhead value")	= $76.47	= $86.47	= $96.47
Deductible Lease Expenditures	-$25.20	-$25.20	-$25.20
Production Tax Value (PTV)	= $51.27	= $61.27	= $71.27
Production Tax = PTV * 35%	35% of PTV → $17.94	35% of PTV → $21.44	35% of PTV → $24.94
base tax - P/BBL Credit	P/BBL Credit → -$ 8.00	P/BBL Credit → -$ 7.00	P/BBL Credit → -$ 6.00
Production Tax*	$ 9.94	$14.44	$18.94

**Unless 4% gross minimum tax (4% of GVPP) is greater*

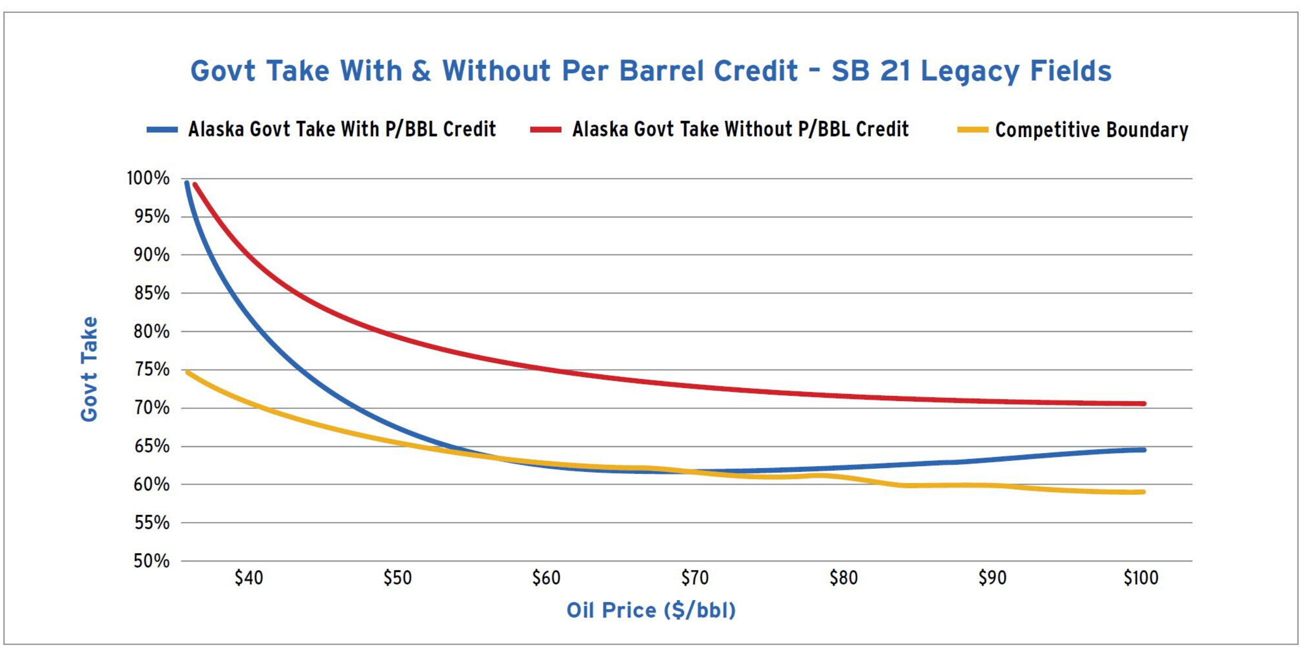
KEEPING ALASKA COMPETITIVE AT LOW OIL PRICES

The amount of the Per Barrel Credit decreases as oil prices rise, resulting in higher effective tax rates at higher oil prices, and more competitive rates when prices are low. The progressive nature of the Per Barrel Credit is shown below:



Source: Department of Revenue, House Resources Hearing Follow-Up, April 2019 (with additions)

As illustrated above, without the Per Barrel Credit as part of the tax rate calculation, the effective tax rate would be a flat 35% at all prices. The following chart shows how the Per Barrel Credit impacts overall government take for Alaska, showing the critical nature of this progressivity element in keeping Alaska competitive at lower oil prices:



Source: Legislative Consultant, Roger Marks, April 2017

LIMITATIONS TO THE PER BARREL CREDIT

The statutory Per Barrel Credit limitations are found in AS 43.55.024(h) and (j).

- The Per Barrel Credit can only be used to reduce taxes for the year in which the oil is produced.
- Any unused portion of the credit cannot be carried back to prior tax years or forward for use in a later year — it is forfeited.
- The Per Barrel Credit is not eligible for purchase by the state, nor can it be transferred to another producer.
- The Per Barrel Credit has an additional limitation: it may not be applied to reduce the North Slope minimum tax, which is currently 4% of GVPP.

HOW IS THE PER BARREL CREDIT DIFFERENT THAN OTHER TAX CREDITS?

All investment-based production tax credits for Cook Inlet and the North Slope have been repealed, which means the State of Alaska no longer offers “cashable” credits. It is important to note that only companies with less than 50,000 taxable barrels per day qualified for payment from the State for these types of credits.

In contrast with the investment-based credits, there is no monetization of the Per Barrel Credit. There is no payment made to companies; no appropriation in the state budget. Its use is constrained within the production tax system as an adjustment to the effective tax rate, adding progressivity based on oil price.

The Per Barrel Credit can only be earned through oil production, which means not only does the State receive production tax revenue when this "credit" is applied, but that it also receives royalties, greater oil and gas property taxes (due to the production facilities, pipelines and other infrastructure necessary for production), and more state corporate income taxes. Increased production also means more jobs in Alaska and a more robust economy.

Frequently Asked Questions

Does the Per Barrel Credit only apply to "legacy" fields?

No. The Per Barrel Credit applies to all North Slope oil that does not qualify for the gross value reduction under AS 43.55.160(f) (and New Oil Credit), regardless of field size, including oil from Badami, Duck Island (Endicott), Milne Point and Northstar, as well as Prudhoe Bay, Kuparuk River and Colville River fields.

Is the Per Barrel Credit a “giveaway” that results in less production and revenue?

No. The Per Barrel Credit is an integral part of the current tax system that provides progressivity to the tax structure while keeping Alaska competitive. Alaska is one of the most expensive places for industry to explore for and produce oil and gas resources, and has one of the highest base tax rates in the U.S. The Per Barrel Credit has worked — production in Alaska has remained steady since the passage of SB 21.

Is the Per Barrel Credit a “hidden” credit that can be repealed without upsetting the production tax system?

No. The Per Barrel Credit is not “hidden” and if eliminated would result in an immediate increase of taxes on the oil industry by nearly $1 billion at current prices.

Experts, including legislative consultants, as well as representatives of the Alaska Department of Revenue, have publicly stated that the Per Barrel Credit is not really a credit — it is an integral and progressive element of the production tax that is an adjustment to the effective tax rate.

Can the state forego the significant revenue impact of the Per Barrel Credit when times are good?

Because the Per Barrel Credit is progressive — it decreases as oil prices rise — the state actually captures a larger share at higher prices.

In Conclusion

Simply put, repealing the Per Barrel Credit would result in an immediate tax increase of equal proportions. At current prices, the repeal of the Per Barrel Credit would more than double industry’s current production taxes. It would be a fundamental change and would remove an integral progressive element from the tax regime. Raising taxes again on the oil industry — for what would be the eighth time in fourteen years — would hamper current and anticipated oil exploration, development, and production activities and negatively impact Alaska’s economic well-being.