Alaska's Oil and Gas Production Tax "From ELF to Now"

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OIL & GAS: FUELING ALASKA'S ECONOMY

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INTRODUCTION

What is a production (severance) tax?

- Tax is on the act of producing oil and gas
- Tax is based on value of the resource as produced
- Imposed under the State's sovereign power to tax production not otherwise exempt
  - Generally in Alaska this means the tax applies to production after State and federal royalties (7/8 of production for most pre-1979 leases; less for post-1978 leases having higher exempt royalty rates)

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 Production Tax (PPT)
- July 2007 – 2013: Alaska's Clear and Equitable Share (ACES) *
- 2014 – present: MAPA (SB 21) & SB 138
- Tax regulations

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

WHY THE ELF AND WHAT WAS IT?

State wanted the production tax to be Alaska's primary tax on production

- As fields' reserves are depleted, their economics deteriorate and tax relief becomes appropriate to prevent premature shut-in
- Incentive to develop and produce smaller fields while keeping tax higher on larger, more prolific fields

WHY THE ELF AND WHAT WAS IT?

Economic Limit Factor (ELF)

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?

Tax rate for a given field = ELF x its Base Rate

- **Oil: Base rate 12.25% for 1st 5 years, then 15%**
- **Gas: Base rate 10%**

ELF basically a surrogate for deductions: tax rate reflected net operating margin after pipeline/tanker transportation costs and other limited costs

Field-size added to oil ELF formula in 1989; in 2005 many North Slope fields were lumped together as one for ELF purposes

WHY THE PPT AND WHAT WAS IT?

In 1995-2005 concerns arose over appropriateness of key statutory assumptions in the oil ELF formula

- Kuparuk declined toward statutory 300 b/d per well break-even rate
- “Field-size” made “small” fields too small

Revenue decline, budget deficits and gas pipeline fiscal discussions

WHY THE PPT AND WHAT WAS IT?

PPT was designed to deal with two major shortcomings many saw in the ELF

- 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 PRODUCTION TAX (PPT)

Geographically based production tax versus a field-by-field determination

- Production/expenses treated separately for each of four "segments" within the state
  - North Slope
  - Cook Inlet Oil
  - Cook Inlet Gas
  - "Middle Earth"

PETROLEUM PRODUCTION TAX (PPT)

Taxed a producer's "production tax value" (PTV); i.e., value downhole at the point of severance from the reservoir

- Allowed deduction of most capital costs back to the well bottom versus operating costs only under ELF
- Certain tax credits allowed
- Small producer relief

PETROLEUM PRODUCTION TAX (PPT)

Deductions and credits intended to encourage exploration/development

Same tax rate for oil and gas from a given “segment”

Created “progressivity”

WHY ACES AND WHAT IS IT?

Alaska's Clear and Equitable Share (ACES)

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, including “progressivity”
- 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
- EQUALS gross tax (or minimum tax (on gross value) if higher)
- SUBTRACT allowable tax credits

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?

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

HOW DOES THE PPT/ACES WORK? -NORTH SLOPE

EQUALS the Production Tax Value

PPT (Key Provisions)	ACES (Key Provisions)
Cannot be reduced below zero	Cannot be reduced below zero
Any excess deductions creates NOL tax credit	Any excess deductions create NOL tax credit
NOL Tax credit determined at 20% rate	**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)	ACES (Key Provisions)
22.5%	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)	ACES (Key Provisions)
0.25% per $1/BOE over $40 PTV determined monthly	0.4% per $1/BOE when PTV between $30-92.50 (25%)
Total cannot exceed 25%	PLUS
No brackets - all production taxed at highest rate	0.1% per $1/BOE when PTV greater than $92.50
Maximum base & progressivity - 47.5%	Total cannot exceed 50%
	No brackets - all production taxed at highest rate
	Maximum base & progressivity - 75%

HOW DOES THE PPT/ACES WORK? -NORTH SLOPE

EQUALS Gross Tax / OR Minimum Tax if greater

Minimum Tax Provisions

PPT (Key Provisions)	ACES (Key Provisions)
0-4% of gross value at point of production	0-4% of gross value at point of production
Depending on price of ANS	Depending on price of ANS
Only on North Slope production	Only on North Slope production

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

EQUALS the Production Tax Due

HOW DOES THE PPT/ACES WORK? -NORTH SLOPE

Statute of Limitations for audits

PPT (Key Provisions)	ACES (Key Provisions)
3 years	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)**

WAS ACES WORKING?

ACES highest state tax – no other state tax even close

Production decline continues at alarming rate

- Annual reinvestments at risk
- TAPS issues

Exploration activity continues to fall

- Key explorers looking elsewhere
  - OCS focus
- Drill rig counts
- Industry spend on current infrastructure and current resource base – not resource additions

Industry related jobs losses

Regulatory uncertainties complicate administration/ potential incentives

Alaska investment climate/ fiscal regime rated near bottom

WHY MAPA AND WHAT IS IT?

More Alaska Production ACT (MAPA)

Influenced by many factors:

- Continued liquids production decline
- Alaska falling in state rankings for production while investment and production in other states booming
- Investment tax credits incentive not tied to increased production and hurting state revenues

WHY MAPA AND WHAT IS IT?

Influenced by many factors:

- Focus on increasing production to yield increased future revenues and jobs
- Maintain competitive tax structure at both high and low oil prices
- Insure Alaska remains competitive into the future

KEY CHANGES UNDER MAPA

ACES	MAPA
Unbracketed Progressivity	No tax rate progressivity
25% Base Tax Rate	35% Base Tax Rate
75% Maximum Combined Tax Rate	35% Maximum Tax Rate
20% Investment (Capex) Tax Credits	No Investment (Capex) Tax Credits
Exploration tax credits (20%, 30% or 40%)	20-30% Gross Revenue Exclusion Incentive for New Production
	Sliding Scale Per Barrel Tax Credit for Post 2013 Production
	Production Tax Credits Not Available Against Minimum Tax
	In-State Manufacturing Income Tax Credit
	Competitiveness Review Board

WHY SB 138?

Designed to progress Alaska LNG (AKLNG) Project

Key Changes:

- Allowed State participation in the project
- Allowed State to ensure its gas supply by authorizing DNR to consider changes in certain royalty provisions and DOR to take project production tax as gas

WHY SB 138?

Key Changes (con't):

- Fixed gas production tax rate at 13% on gross value versus PTV
- State participation share ~25% (royalty + production tax)
- Ensured no adverse impact to state oil and gas corporate income tax
- No changes to current oil and gas property tax on existing properties

ARE MAPA AND SB 138 CHANGES WORKING?

SB 21 is working as designed

Under RSB assumptions for oil price and production, SB 21 brings more revenue than ACES would have in both FY 2015 and FY 2016; in fact, in FY 2016, under ACES producers would pay no tax and carry a credit forward.

Main differences are binding gross minimum and elimination of capital credits.

North Slope production and tax	FY2015				FY2016			
	$/bbl	Mbbls	Value ($mm)		$/bbl	Mbbls	Value ($mm)	
Price & Daily Production	$76.31	510	$38.9		$66.03	524	$34.6	
Annual Production								
Total		185,980	$14,192.1			191,294	$12,631.1	
Royalty, Federal bbls		(23,565)	($1,798.2)			(24,291)	($1,603.9)	
Taxable bbls		162,415	$12,393.9			167,003	$11,027.2	
Transportation Costs	($9.31)	162,415	($1,511.3)		($9.17)	167,003	($1,531.8)	
Lease Expenditures	($43.40)	162,415	($7,048.9)		($43.55)	167,003	($7,272.8)	
Production Tax			SB21	ACES			SB21	ACES
Gross Value Reduction			($47.3)				($3.0)	
Prod. Tax Value (PTV)	$23.31		$3,785.6	$3,785.6	$13.29		$2,219.6	$2,219.6
SB21 (35%*PTV)			$1,325.0				$776.9	
ACES (25%*PTV)				$946.4				$554.9
1) Total Tax before credits			$1,325.0	$946.4			$776.9	$554.9
2) $8 /bbl * Taxable bbls			($1,299.3)				($1,336.0)	
3) Max credits (4% floor)			($889.7)				($397.0)	
4) RSB F'cast Credits			($720.0)				($490.0)	
5) ACES 20% Cap Credits				($722)				($797.3)
6) Total Tax after credits			$605.0	$224.4			$286.9	($242.4)

Source: AK DOR Fall 2014 Revenue Sources Book, p99–100 (all figures in $mm; figures in grey are enalytica estimates)

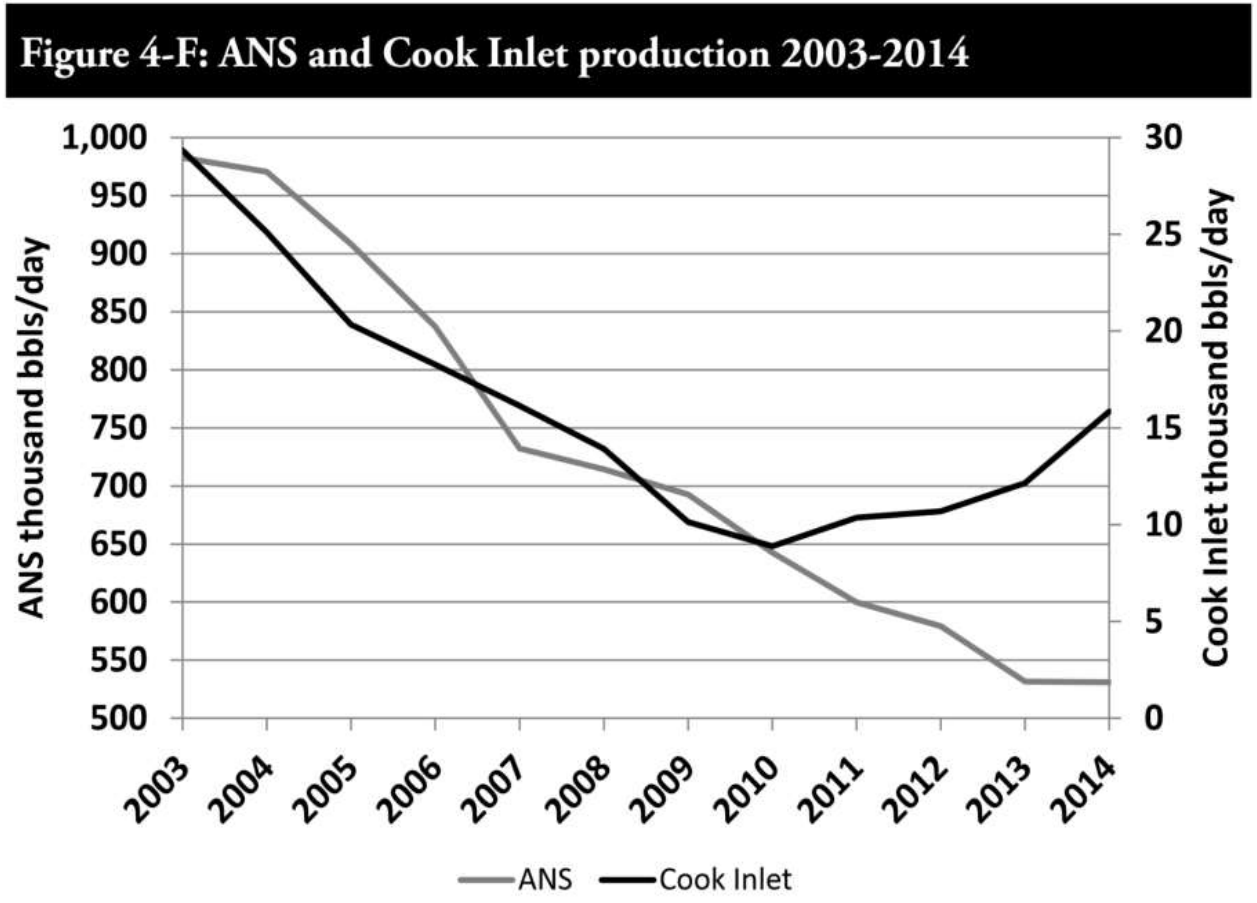
If industry is paying the minimum tax, they are not eligible for the per barrel tax credit

AS 43.55.024(j) "A tax credit under this subsection may not reduce a producer's tax liability for a calendar year under AS 43.55.011 (e) below the amount calculated under AS 43.55.011(f).

The hard floor of SB21 specifies the per- barrel credit for non-GVR production cannot reduce the tax liability below 4%. In contrast, with ACES the .023 qualified capital expenditure credit would have been able to reduce tax liability below 4%, all the way to zero.

–Department of Revenue

Tax credits are a key driver at attracting smaller companies



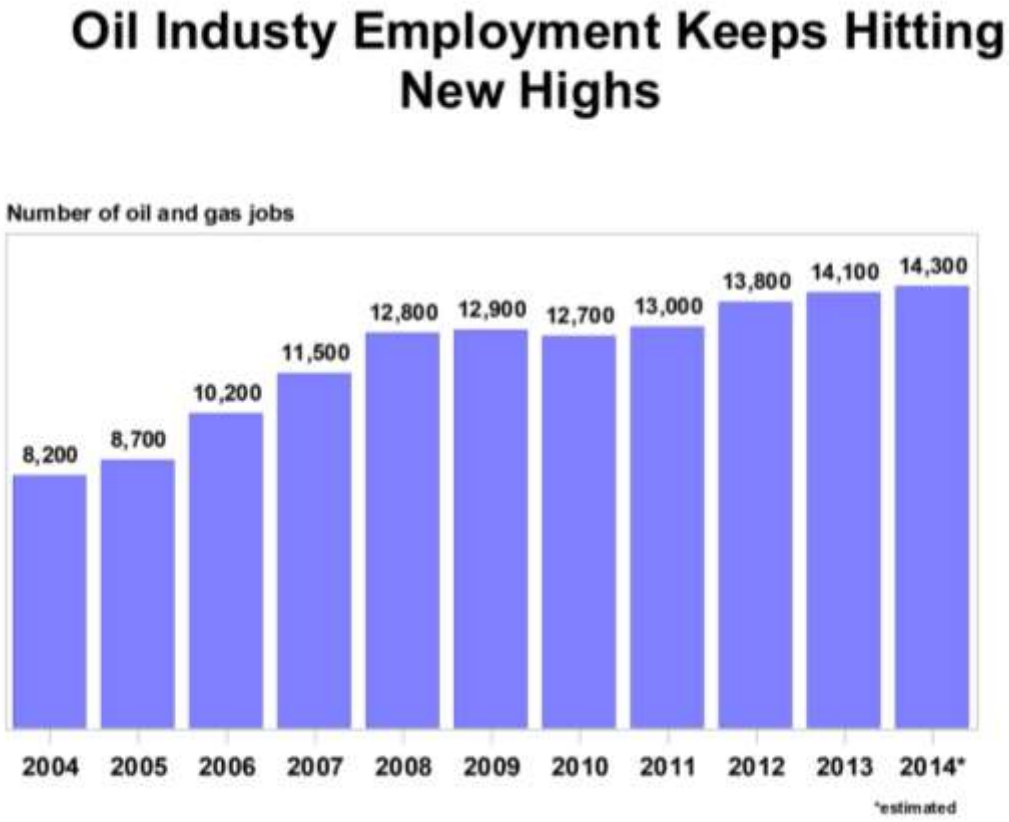
Cook Inlet:

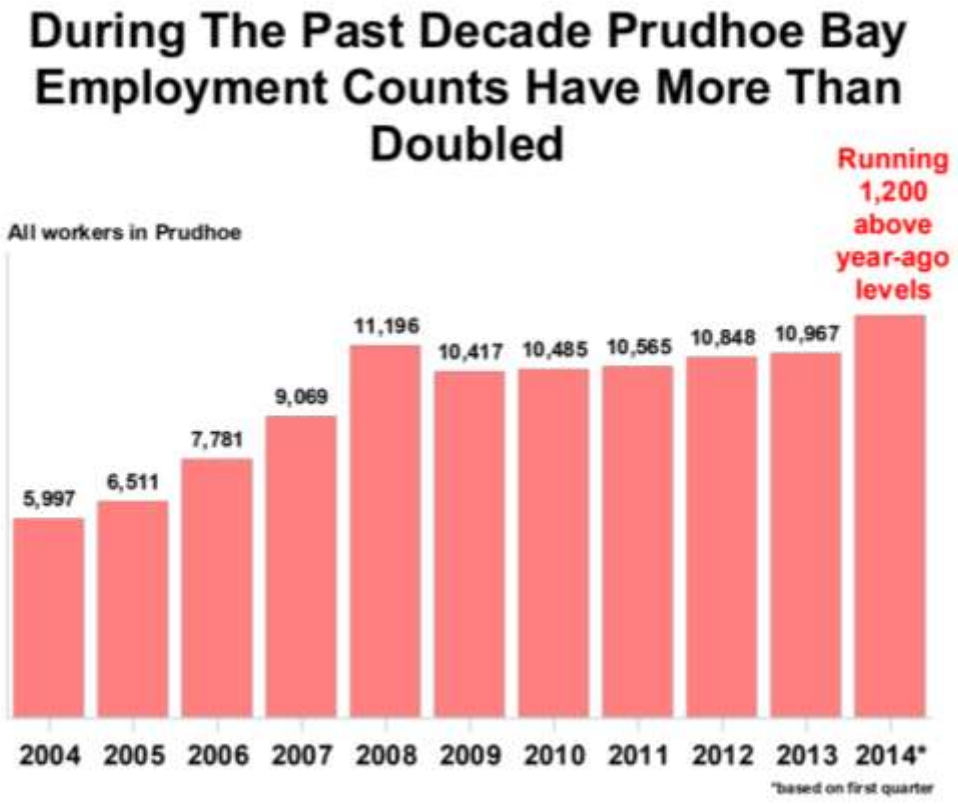
- Apache
- Furie
- Miller Energy
- Blue Crest Energy

North Slope

- Caelus
- Eni
- Respol
- Great Bear
- Brooks Range

Employment on the Slope remains high





Source: Neil Fried presentation to RDC, Nov. 14- Alaska DOLWD, Research and Analysis Section

New projects announced since tax reform passed are currently moving forward

Hilcorp Alaska, LLC

- **New player on the North Slope – acquiring 100% of 2 smaller fields & 50% of 2 others**

bp

- Conducting seismic within Prudhoe – **adding a new rig in 2015, another in 2016**
- Over $1 billion more

CAELUS Energy Alaska

- **New leases acquired– potential $1 Billion investment**

eni petroleum

- Drilling to continue at Spy Island for potential new expansion

REPSOL

- **Spending $240m on seismic and drilling this winter**

ExxonMobil

- Construction of Pt Thomson field – on track for 2016 production

ConocoPhillips

- Two new Rigs at Kuparuk, 2 new rigs on order & 2 billion in additional investment
- Production expected in 2015 in NPRA

Incentives matter. What's next for Cook Inlet?

Hilcorp Alaska, LLC

- Ongoing increased investment – resulting in new exploration/appraisal wells & increased production

Apache

- Applied for five year offshore seismic period with National Marine Fisheries Service

Miller Energy

- Acquired additional state acreage with $1.5 million work commitment
- Constructing new subsea pipeline to Tesoro refinery

BlueCrest Energy

- Plan to drill 3 delineation wells – planning for onshore and offshore development

Agrium
where the future is growing™

- Seeking financing to restart Nikiski fertilizer plant

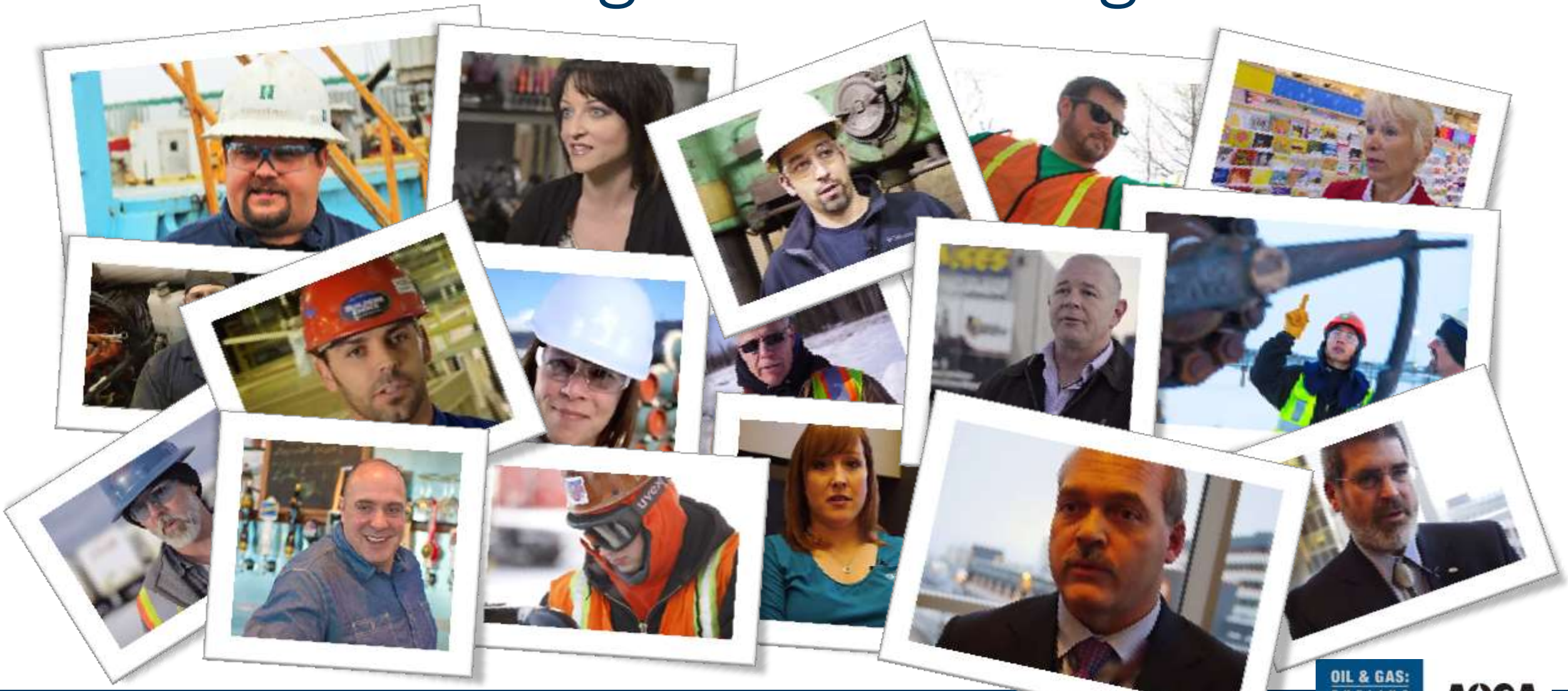
ConocoPhillips

- LNG export reauthorized by DOE of up to 40 BCF thru Feb 2016

FURIE
Operating Alaska LLC

- Ongoing work for new gas production platform

Work together. Win together.



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