

Special Resource **Supplement**

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Oil tax adjustment—what are prospects for 2012?

Contentious bill dominated 2011 legislative session

Oil and gas taxation was the central issue of the 2011 state legislative session and it is likely to dominate the 2012 session as well. House Bill 110, Gov. Sean Parnell's bill to adjust the state production tax downward, passed the House narrowly and is now in the state Senate. The House Republican majority supported the governor's bill but the Senate leadership, a coalition of Republicans and Democrats, questioned it and held the bill for further work in 2012. It is now in the Senate Labor and Commerce Committee. Sen. Dennis Egan, D-Juneau, chairman of that committee, said his committee will hold hearings on the bill in September.

A concern of the Labor and Commerce committee is the trend of employment, and particularly of resident Alaskans, on the North Slope. The governor has argued that lowering the tax will result in increased investment and employment of Alaskans.

Prospects for HB 110 now complicated by special session?

Prospects for HB 110 in the 2012 session may have been further complicated by the politics surrounding the Legislature's special session, which extended from the end of the regular session April 17 to adjournment of the special session May 14. This involved the Senate's insertion of language in the state capital budget to attempt a "veto proof" of approximately \$400 million in energy projects, following the governor's implied threat of major vetoes over HB 110. The Senate ultimately dropped the contested veto proofing language. The governor's vetoes of projects in the capital bill are expected before July 1.

What is this bill about? The governor argues that Alaska's high production tax rate is discouraging industry investment on the North Slope and that new investment is urgently needed to put new oil into the Trans Alaska Pipeline System. Oil mov-

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Oil through TAPS declining at 6 percent/year

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ing through TAPS is declining at about 6 percent yearly. The volume is now about 630,000 barrels per day and at the current rate of decline will be in the 500,000-plus barrels/day range in three to four years, a rate at which the pipeline will experience operating problems. Additional investments could mitigate some of those problems.

Background on the tax, “ACES”:

Alaska’s production tax, ACES (“Alaska’s Clear and Equitable Share”) is a net profits-type tax with a base rate of 25 percent of profits, which are calculated after production and transportation costs are deducted from sales revenues. If oil prices rise above \$40 per barrel net profit the tax rate escalates on a “progressivity” formula. At the current market price of \$100 per barrel-plus the average tax rate for all production is above 50 percent. Some producing companies make the argument that the tax rate on specific projects can be much higher if the project is in an existing field where there is infrastructure and development costs are lower. In some of these cases total “government take” (the production tax, state royalty and property tax) can exceed 80 percent.

The governor has argued that these rates are much higher than in other states, such as North Dakota, that are now competing for industry investment, and that as a result capital has flowed to other U.S. locations instead of Alaska. North Dakota is booming but Alaska is stagnant despite high oil prices. When other producing regions of the world with tax and royalty systems similar to Alaska’s are included in the analysis, Alaska still comes out in the high ranges.

However, many producing regions, such as in the Middle East, have government takes that are as high or higher than Alaska’s but these fiscal systems are fundamentally different. They are usually production-sharing contracts with provisions for rapid capital recovery, participation of state-owned companies in financing, for example. One analysis legislators are waiting for this summer is a new report by consultant Pedro van Meurs on Alaska’s ranking in world fiscal systems. This will provide an independent comparison.

Some legislators question whether the high tax rate is really the main cause of the slowdown in slope development. They point to environmental permitting issues that impede access to the National Petroleum Reserve-Alaska and the offshore Outer

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Potential for new exploration on slope

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Continental Shelf, which industry and government geologists agree is highly prospective. All of that is true, but the administration argues there is still substantial potential for new oil in the onshore central North Slope area open to exploration and development. Some of the greatest potential is within existing producing fields, in heavy oil deposits, for example.

Small independents like Brooks Range Petroleum are exploring prospects near the existing fields, aided greatly by generous state exploration incentives, but the prospects for discoveries are modest. There is, potentially, a significant new development in shale oil by another independent, Great Bear Petroleum, but the technical viability of this must be confirmed in test drilling planned for next winter. Subsequently, the economic viability must be determined because of the extensive surface infrastructure that will be required.

The small independent companies, however, agree with the large producing companies that their prospects would be greatly enhanced by passage of the governor's HB-110. They have told this to legislators. We are also struck by the fact that there isn't more exploration by small companies on the slope despite the generous state incentives which can pay much of the cost of exploration.

Despite incentives, exploration still at low levels

Despite the incentives the production decline continues and that new exploration is at the lowest rate in years. Given this, what's the problem with adjusting the tax? Basically, it is that many legislators, particularly in the Senate, do not trust the industry's claim that a lowering of the tax rate will bring more investment. The state is basically being asked to give up substantial revenues without a guarantee from industry that investment will follow.

It is difficult to counter this. Legislators are criticizing the Department of Revenue for not making the case for the governor's bill effectively, but our sense is that the department did as well as it could have. Basically, the industry didn't give the governor a lot of help, in our opinion. From the beginning of this initiative in late 2010 the governor said he wanted the industry ready to support his effort with, if not hard guarantees, at least convincing assurances of what the state would get for giving up revenues. This didn't happen, we believe.

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State “giving up” billions with no guarantees of investment?

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The criticism—the state “giving up billions” with no guarantees—resonated with the public (it fits too easily on a bumper sticker). For HB 110 to pass next year the governor and the industry are going to have to come up with a way to deal with the argument.

What could be done in 2012? Here are some thoughts

Our thoughts mainly are what in might be politically possible. It is always possible, of course, that HB 110 could pass in some form similar to its current version, i.e. a reduction of the tax rate. That doesn't have any politically-important “guarantee” and it would take a huge amount of muscle by the governor to accomplish. It would be very politically messy. However, it is always a possibility.

Another approach might be one using a concept that has found political acceptance in the Legislature, some form of investment tax credit that guarantees investment if the credit is paid. The state now has a set of these front-end tax credits for exploration and general capital investment by industry. The 2010 bill setting up the “Cook Inlet jack-up rig stampede” (a massive credit for the first jack-up rig to sink the bit in Cook Inlet) is considered a success because two jack-up rigs are on the way to the Inlet.

Industry has argued that the financial effect with ramped -up tax credits cannot equal the benefit, to an investor, of a reduction in the high progressivity tax rate. However, we can't believe that smart people couldn't figure out something similar that would work. Sen. Tom Wagoner, R-Kenai, may be on to something with his bill in the Senate setting up an Alberta-style tax holiday for new fields and new oil developed in existing fields. The fiscal effects of Wagoner's approach haven't been examined, but it might offer an avenue.

Another way to do this is to somehow condition passage of HB 110 on certain investment thresholds being met. The governor in effect suggested something like this when he told legislators that if they aren't satisfied with industry's reaction to HB 110 passage they can always repeal the bill. We think at some point a general tax reduction might be possible but an interim step might be needed.