Senate CS for CS for HB 111 (Ver C-P): Some Observations

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Summary

- Reduces state credit exposure without compromising competitiveness of overall fiscal system
- Some economic observations regarding the interaction of loss recovery, the per barrel credit, and the gross minimum floor under the CS follow
- Two lingering issues

Preface

- The production tax is a net tax with a 35% rate
- There is a floor on that net tax equal to 4% of gross value
- The per barrel credit and loss recovery perform distinct functions:
  - The per barrel credits provide tax relief to partially offset the high burden of royalties at low prices
    - It reflects this year's business
    - If not used they are lost forever, and the royalty offset role is eviscerated
  - Loss recovery provides for the deduction of costs in computing net value that could not be deducted in prior years
    - It reflects prior years' business
- Since they are distinct issues, using them both is not redundant

The Royalty Problem (Using GVR Oil)

ANS Price	\$50
Transp	(\$10)
Gross	\$40
Upstream Costs	(\$35)
Net Value	\$5
1/8 Royalty	(\$5)
Producer income before prod tax	(\$0)
Govt take before prod tax	100%

CS Summary of Credits and the Floor

- Losses
  - Currently (both Non-GVR & GVR Oil):
    - **<u>Can use losses</u>** to bring tax below floor
  - CS: (both Non-GVR & GVR Oil):
    - **<u>Cannot use losses</u>** to bring tax below floor*
- Per Barrel Credit
  - Currently:
    - Non-GVR Oil: **<u>Cannot use credit</u>** to bring tax below floor
    - GVR Oil: **<u>Can use credit</u>** to bring tax below floor
  - CS: No change

* If non-GVR and GVR losses were treated differently it would be necessary to allocate losses between them, which would be very difficult

Observation 1: "Hardening" the Floor

- Under current law taxpayers can use carried forward loss credits to bring taxes **below** the gross minimum floor
- Under the CS taxpayers can only use carried forward losses to bring the tax **down to the** floor

Hardening the Floor Against Losses: Loss Recovery on Non-GVR Oil

- No loss recovery unless prices above about $65/bbl
  - Losses on production not generated until prices below about $35/bbl
  - Losses on development of other non-GVR oil would have offsetting income at all but very low prices
  - Loss recovery on non-GVR oil does not appear to be a significant problem

Hardening the Floor Against Losses: GVR Oil Tax Calculation @ Current Prices

ANS Price	$50
Transp	($10)
Gross	($40)
Gross minimum @ 4%	$1.60
Per barrel credit	($5.00)
Tax	$0.00

Hardening the Floor Against Losses: Loss Recovery on GVR Oil

- Most new development would be GVR oil
    - Companies with substantial existing production and income could offset GVR losses
- GVR production from companies without existing production
    - Since per barrel credits cannot be carried forward, and because of their value, taxpayers would use per barrel credit first
    - Accordingly, taxpayers might only use losses when prices were high enough such that use of per barrel credit and losses exceeded floor
    - At about $85/bbl, net tax exceeds gross minimum
    - Accordingly, these losses may not be recovered until after GVR status lapses (after 3 or 7 years) and per barrel credit can no longer take tax below minimum. At that point taxpayers may start recovering losses.

Uplift on Cost Recovery

- Provides net present value boost to companies who have to wait to have production/offsetting income
- Currently CS limits only to companies without production
  - Companies with only limited production/offsetting income may not be in a much different situation
- The issue of early GVR cost recovery only at high prices applies here
  - Similarly, may only be invoked after GVR status lapses (after 3 or 7 years of production)

Sequencing Under the CS: Two Possibilities
Non-GVR Oil Assuming a $5 Loss Carried Forward

	A	B
ANS Price	$55	$55
Transp Cost	($10)	($10)
Gross Value*	$45	$45
Upstream Costs	($25)	($25)
Loss	($5)	($0)
PTV	$15	$20
Tax before p/bbl credit @ 35%	$5.25	$7
Per barrel credit	($3.45)	($5.20)
Tax	$1.80	$1.80
*Gross minimum (@ 4%)	$1.80	$1.80

Unresolved Issue 1:

The Order of Deducting Losses vs. Per Barrel Credits

- Recognizing:
  - Per barrel credits lapse if not used
  - Unused losses carry forward if not used
- The CS does not specify which is used first in calculating the tax
- Given the hard floor for non-GVR oil:
  - It will probably be to the taxpayer’s benefit to use the per barrel credits in getting the tax down to the floor, and carrying unused losses forward
  - Would be consistent with utilizing functional intent of the per barrel credits and loss recovery inherent in the statute

Questions

- Should the statute specify the sequence?
  - Do 100% of available losses have to be used first?
  - Do 100% of available per barrel credits have to be used first?
  - Can taxpayer mix?
- Should statute specify the sequence? Should statute leave it up the taxpayer? Should statute leave it up to the Department?

Unresolved Issue 2: What Does it Mean to Use a Credit to Bring Taxes Below the Floor?

- Under the CS, for GVR oil, losses cannot bring taxes below the floor, but the per barrel credit can
- Suppose:
  - Tax before credits: $10
  - Minimum tax: $7
  - Per barrel credits: $5
  - Losses: $4

Taxpayer Options Pursuant to DOR Interpretation in Similar Situations: If you use both credits, they are both the cause of getting below the minimum

Tax before credits: $10

Use $3 in losses to bring tax down to minimum, but not use any per barrel credits to reduce tax further ($3)

TAX $7

Tax before credits $10

Use $5 in per barrel credits, but not use any losses to reduce tax further ($5)

TAX $5

Taxpayer Option Pursuant to Another Interpretation: Only the credit that actually brings you below the floor is the cause of getting below the minimum

- Start out with $10 in tax before credits or losses
- Use $3 in losses to bring tax down to $7 minimum
- Then use $5 in per barrel credits to bring tax down to $2

Analogy

- Suppose you have \$100 in your checking account
- You write two \$100 checks
- Did both checks, or the second check, cause you to be overdrawn?

At Stake

- Recognizing the distinct function of each credit
  - The per barrel credit is not loss recovery
  - Loss recovery is not the per barrel credit

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