Alaska Oil and Gas Association

AOGA

121 W. Fireweed Lane, Suite 207
Anchorage, Alaska 99503-2035
Phone: (907) 272-1481 Fax: (907) 279-8114

WHITE PAPER

TAX CREDITS UNDER THE PETROLEUM PRODUCTION TAX

October 30, 2007

This paper addresses several questions about the proposed treatment of tax credits under SB 2001 and HB 2001 as introduced by the Administration, and about the underlying tax policies for that treatment. These are cutting in half the credit from capital expenditures that may be taken for the tax year when those expenditures are incurred, repealing the TIE credits after the end of 2007, preventing electric utility rate-payers in Anchorage from receiving benefits from the utility's sale of tax credits, and significant new information-reporting requirements in order to qualify for exploration credits.

A. 50% Limitation on Credit Taken in First Year for Capital Investments.[1]

As introduced, SB 2001 and HB 2001 would create a limit on the amount of tax credit under AS 43.55.023(a) for capital expenditures that a producer may apply against its tax liability for the year when the capital expenditures giving rise to that credit are incurred. Only half of the credit may be taken against the tax that first year, and the remainder carries forward to the next year or subsequent ones until it is used.

We cannot find a sound tax-policy reason for this limitation. The purpose of these credits is to provide an economic incentive for making new capital investments that will result in new production to slow the production decline on the North Slope. Because of the time-value of money for a producer or explorer, dividing this credit into two halves and deferring one of them to the second year would reduce the value of this incentive under the economic analysis for each new investment. This means the State would still end up allowing the same total amount of credit for a capital investment, but it stands to lose production to the extent this deferral impairs the value of the incentive from the credit and makes potential investments less attractive economically.

The only significant thing the State stands to gain from such a deferral is the one-time-only effect on its tax revenue for the 2008 tax year, which will see credits halved for capital expenditures during that year with no capital credits coming forward from 2007. But even this benefit, which is almost entirely of use for purposes of state spending, is diminished by the fact that the effects from the 2008 tax year show up on the State's books in two different fiscal years

---

[1] This limitation does not appear in CSSB 2001(RES).

— namely, FY 2008 and 2009.[2]

Beginning in tax year 2009 and thereafter, the half-credit carried forward from the prior year plus the half-credit for the current year will add up to approximately a full-year credit being taken against the tax each year on that year's production, especially when a taxpayer's capital spending is not changing materially from one year to the next. This means that, after the one-time-only effects on state funds available for spending during FY08 and 09 ripple through, the only benefit the State will be getting from the credit deferral will be its own time-value of money.

It is unnecessary to digress here into the matter of what the State's time-value of money might be. The point is that the very system of incentives for investment under the production tax arises principally from the deduction of capital expenditures as they are incurred and from the tax credits — including the credits under § 023(a) for capital expenditures. For the State these incentives make sense solely because it is a "play" between the companies' time-value of money and the State's own, materially lower time-value of money. In other words, a dollar next year is more valuable to the State than the companies, and so by letting the companies have that dollar now and getting it back next year, the State makes the investment more valuable for them as well as for itself.

The limitation on the capital-investment credit so it is spread out over a minimum of two years is completely at odds with the mechanism by which the credit succeeds as an incentive for investment.

B. "TIE" Credits.

The "transitional investment expenditure" or "TIE" credits are a tax credit for capital expenditures incurred for production and exploration operations during the five years immediately preceding the April 1, 2006 effective date of the PPT.

Initially, they were proposed by the prior Administration as a way to soften the blow of the tax increase under PPT from the prior ELF-based tax for producers and explorers who had invested in good faith in this state in the expectation that the ELF-based tax, would continue to apply and allow their economic expectations for those investments to be fulfilled. Alaska itself has, as an expression of goodwill toward investors and those doing business here, provided similar transitional measures to soften the economic effects of a major transition from one kind

---

[2] The first installment payment to the State in FY 2008 is made in July 2007 for June production, the next is in August for July 2007 production, and so on. The State thus receives tax revenues in FY 2008 from oil and gas produced during the last seven months of calendar year 2007 plus the true-up on March 31, 2008. The only tax payments for tax year 2008 that will be received by the State in FY 2008 are the five installments for production in January – May 2008. The tax effect for the rest of calendar year 2008 from deferring half the 2008 capital-expenditure credit will show up in FY 2009 as the estimated payments and the March 31, 2009 true-up for calendar year 2008.

of tax to another.[3]

As Representative Ralph Samuels has stated during a hearing of the House Special Committee on Oil & Gas during this special session, the TIE credits were transformed by the House Resources Committee during the 2006 regular session into an incentive to invest sooner rather than later. This was done by modifying the TIE credit so that it takes $2 of current capital expenditure in order to get the TIE credit for $1 of pre-PPT capital expenditure. In conjunction with the expiration of TIE credits altogether after 2013,[4] the TIE credits provide an effective incentive to increase investment and to accelerate investments into the near term that might otherwise be made in the mid-to-long term.

The underlying premise of the TIE credits is that the royalty, property tax, state income tax and production tax revenues from the additional production expected to result from the increased level of investment will offset the cost to the state of the TIE credits. In the absence of any contrary indication, it seems premature to abolish the TIE credits after the end of this year.

C. Electric rate-payer benefits from selling tax credits.

SB 2001 and HB 2001 have two mysterious-seeming provisions that forbid "an entity that is exempt from taxation" from applying for a sellable tax-credit certificate under AS 43.55.-023 and from selling exploration tax-credit certificates under AS 43.55.025.[5] In testimony on these Bills, DOR representatives have been unwilling, on taxpayer-confidentiality grounds,[6] to identify who that tax-exempt entity or entities are that these provisions address.

Although we do not know which tax-exempt entity or entities DOR is concerned about, it is a matter of public record that the Municipality of Anchorage in 1996, through its operating division called Municipal Light & Power ("ML&P"), purchased Shell Oil's one-third working interest in the Beluga River gas field northwest across the Inlet from Anchorage. As a result of its working interest, ML&P should be incurring its share of the lease expenditures for the Beluga River Unit that the other working-interest owners there, both taxable, are incurring. This means ML&P should have tax credits from the capital portion of those expenditures, and since it has no

---

[3] For instance, former AS 43.58 (temporary reserves tax), which allowed a dollar-for-dollar credit against the reserves tax for a given year for production taxes paid during the prior calendar year. Similarly the net reserves tax paid for a field gave rise to a dollar-for-dollar credit against future production taxes on production from that field. *See also* 15 AAC 21.650 and 21.660 for transitions from "ordinary" income tax to separate-accounting and back, respectively.

[4] For explorers and producers who did not have production in Alaska before April 1, 2006, the TIE credit expires at the end of the sixth calendar year after the year when they first apply a TIE credit against the tax under AS 43.55.-011(e) on their new production. *See* AS 43.55.023(i)(3)(A)(ii),

[5] *See* SB/HB 2001, Sec. 31 (enacting AS 43.55.023(*l*) to forbid a tax-exempt entity from applying for a tax-credit certificate) and Sec. 40 (enacting AS 43.55.025(g) to forbid a tax-exempt entity form transferring, conveying or selling a tax-credit certificate under § 025).

[6] If the entities DOR is concerned about are actually "exempt from taxation", it seems incongruous to assert that they are "taxpayers" protected by the tax-confidentiality statute.

tax liability to apply those credits, it would be eligible under current law to apply for a transferrable tax-credit certificate. In addition, if the Unit's working-interest owners undertake an exploratory program to extend the field or discover new gas reservoirs in the general vicinity, then ML&P could be eligible for tax credits under the exploration-credit program in AS 43.55.025.

ML&P would be forbidden from getting either kind of sellable tax-credit certificates under the Bills as introduced.

If ML&P could obtain and sell tax-credit certificates under AS 43.55, it would seem that the Regulatory Commission of Alaska would require ML&P to pass its resulting savings from selling such certificates on to its rate-payers.

AOGA takes no position about whether ML&P's rate-payers should get those benefits, or whether the State should get the tax revenue that it would lose if ML&P's tax-credit certificates are sold to a producer who applies them against its production taxes. However, this appeared to us to be a question that the Legislature might wish to answer for itself.

D. Conditioning exploration tax-credits on new requirements to share information.

Under SB 2001 and HB 2001 as introduced, an explorer would have to agree in writing to release proprietary well and seismic information and wellbore samples to the State, even for federal and private lands, in order to qualify for an exploration tax credit. AOGA is not aware of any other state where explorers are required to furnish such proprietary information.

Shooting seismic, taking wellbore cores, and analyzing such data are very costly. Yet undertaking such costs and risks is important to an explorer and can provide it with a competitive advantage in considering the resource potential of a particular area. Requiring an explorer to release such proprietary information to the State diminishes the value of these high-cost investments to the explorer and weakens their value to the potential operator of any area to be developed.

To the extent this proprietary and confidential information must be given directly to the Department of Natural Resources ("DNR"), we believe it would set an extraordinary precedent for a state to use its sovereign taxation powers in order to advance its interests as a mere property-owner.

The confidentiality provisions are also of serious concern. The proposal provides confidentiality protection for only ten years for most of the seismic data required to be produced, and for only two years on the rest. Seismic data typically has a shelf life in exploration areas (especially frontier areas) much longer than ten years. More troubling is that an operator is required, under the proposal, to provide a copy of check shot surveys or vertical seismic profiles. These surveys are expensive and are keys to seismic interpretations. This information generally has an indefinite shelf life and can be used to tie seismic of any vintage, new or old, to wells. Yet under the administration's proposal, such information would be classified as "well data" and afforded only a two-year period of confidentiality. At the very minimum all of the data required to be provided should be kept confidential for at least 10 – 20 years.

The Administration's proposal would also require an explorer to provide one-third of the wellbore core to the state. This requirement would not only be onerous and costly, but would be physically challenging and potentially damaging to the integrity of the entire core. Conventional cores are typically slabbed in half - one half for sampling/destructive analysis, the other half as a reference for geological core interpretation. Half core slabs are larger and more stable in storage and handling than 1/3 cores. Half core pieces also provide better core plugs. To require an explorer or operator to change its normal procedures to immediately provide one-third of the fresh core samples would be expensive and would limit the use of core material by the operator to evaluate and optimize development, which in turn would be both harmful to the producer and the State.

The Administration's proposed changes would be precedent-setting and create difficulties for explorers.

AOGA submits Alaska should reduce burdens on explorers, not increase them.