ALASKA STATE LEGISLATURE

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The Alaska Fair Share Bill: The Case For Reforming Alaska's Oil Tax Laws.

Introduction

Existing tax loopholes and exemptions have cost the state hundreds of millions of dollars in recent years, and may cost the state over $1 billion this year. The Alaska Constitution states that Alaska's natural resources should be managed "for the maximum benefit of the people." Constitution Article 8, Section 2. In 2004 (FY '04) the State of Alaska received $1 billion less in revenue for its North Slope oil than North Slope producers received in net profits. *Source, Ak. Dept. of Revenue*[1]. As the price of oil increases, that imbalance grows. The Alaska Fair Share bill seeks a balance between fairness to the state and those companies that are willing to explore and produce in Alaska.

A few statistics from the Alaska Department of Revenue compel this question: Are Alaskans receiving a fair share for our commonly owned oil resource? For example, at $41/barrel, which oil prices have averaged the first half of this fiscal year, the Department of Revenue estimates company profits exceed state revenue for North Slope oil by more than $2.3 billion. *Dept. of Revenue*.

Two flaws in Alaska's current oil taxation system have presented themselves in recent years. One flaw comes from the way Alaska's Economic Limit Factor (ELF) is written. Under the ELF, the production or "severance" tax rate on oil companies has fallen for over a decade, and will continue to fall. That is because under the ELF most new fields are completely or almost completely exempted from Alaska's 15% severance tax. Those fields include both medium sized fields, and some of the nation's largest oil fields, which produce upwards of 10 million barrels of oil/year.

A second flaw is that oil companies have arguably reaped an unfair share of the state's oil wealth at average and high oil prices. As prices increase, the state's relative profit share falls. Conversely, state taxes are arguably too high at very low prices. The imbalance in favor of industry at high prices is much greater than the imbalance in favor of the state at low prices.

[1] Oil Averaged roughly $31/barrel in FY 2004. At $31/barrel, the Dept. of Revenue estimates oil companies receive $3.45 billion in net profits from North Slope operations, and that the state receives $2.23 billion in royalties and taxes.

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This portion of the tax structure has not been reviewed in 15 years. The only changes in Alaska's oil tax laws have been to offer additional tax reductions for incentive purposes. Under Alaska's Constitution, our oil belongs to all citizens in common. It is incumbent upon government to make sure Alaskans receive a fair share for this public resource, and that a fair share is provided to those companies who have contracted with us to develop and sell it.

A Fair Profit Margin for Alaska's Producers

Ultimately, any tax system has to provide a fair rate of return for Alaska's producers. The Department of Revenue's estimates show the following.

At $21/barrel, companies earn a 26% rate of return on Alaska North Slope operations. That profit margin rises to roughly 40% at $41/barrel.[2] The U.S. Energy Information Administration, which forecasts long-term oil prices, concluded in its December 2004 report that oil would average $35/barrel in the current year, and $52 barrel ($30/barrel adjusted for inflation in 2004 Dollars) by 2025. At the forecasted long-term price of $30/barrel, the company profit margin on North Slope operations is 35%. S&P 500 companies, when profitable, commonly earn rates of return in the 5% - 20% range.

As prices decrease, the rate of return for Alaska producers falls. According to AOGA, "it costs $12.82 per barrel to find, produce and transport oil from the North Slope. . . ." According to AOGA, this is considered "a high end estimate." *Juneau Empire*, 12/13/04.

Analysis Of Impacts and Current Shortfalls

Alaska raises oil revenue under 4 different provisions. In order of magnitude, we raise revenue from oil under our royalty laws, our severance tax, our corporate profits tax, and our property tax. In 2003 the revenue raised under the first 3 provisions was greatly increased because of the high price of oil, which averaged about $28/barrel. The State received:

- $830 million in royalties;
- $599 million in severance taxes;
- $150 million in corporate taxes; and,
- $50 million in property taxes.

Total: $1.64 billion.

2004 Dept. of Revenue Estimates

Last year's Alaska Fair Share Bill, HB 441/SB 321 (sponsors were Reps. Gara, Kerttula, Guttenberg & Croft, and Sens. French, Hoffman and Elton), would have granted the state a more equitable share of oil revenue:

- an additional $110 million at a $22/barrel average price;
- an additional $400 million at $30/barrel; and,

[2] According to the Dept. of Revenue's 2004 estimates, corporate profits from North Slope operations are **$1.6 billion** at $21/barrel; **$2.89 billion** at $28/barrel, and **$5.3 billion** at $41/barrel. State total royalty and tax revenue (part of the property tax is shared with municipalities) at these same prices is **$1.5 billion, $2 billion and $2.96 billion** respectively.

- an additional $500 million at $32/barrel.

2004 Dept of Revenue Estimates.

The Current ELF

Because of the way the ELF works, state oil revenue is projected to steadily fall over the next decade, assuming an average price of $22/barrel, and even assuming stable levels of production. The most recent DOR forecast is for a slight decline in production over the next decade, which will contribute to an even greater decline in severance tax revenue. Of the most recent 14 fields that have come on line since 1989, 11 of them pay a severance tax of 0% or less than 1%.

The ELF was enacted in part because Prudhoe Bay was declining in production by the late 1980's. Proponents argued economies of scale justified a lower tax rate for older, declining fields, and for smaller fields as well. The ELF, which ranges from 0 to 1.0 determines how much of the state's 15% severance tax a field operator must pay.

To determine the severance tax for a particular field, one multiples the severance tax rate (15%) by the ELF. Thus, a field with an ELF of "0" pays a severance tax of 0 x 15%, or 0%. A field with a .5 ELF pays a severance tax of .5 x 15%, or 7.5%. A field with a 1.0 Elf pays a severance tax of 1.0 x 15%, or 15%.

A field's ELF is based upon its size and productivity. As production at Prudhoe Bay declines, its ELF has fallen to roughly .9, so that it pays a roughly 13.5% severance tax. No field has a 1.0 ELF anymore.

The addition of newer, smaller fields with ELF's that give them near or complete exemptions from the state's severance tax, combined with less production at high ELF fields like Prudhoe Bay, are the major reasons state oil revenue is projected to continue to decline in future years.

In 2003 higher oil prices ($28.15/barrel) resulted in $599 million in severance tax revenue. Assuming the Department of Revenue's projection of $22/barrel prices starting in 2006, the falling average ELF will cause severance tax revenue to fall by over 80%. The DOR estimates severance tax income to fall as follows:

Year	**Estimated Price**	**Avg. ELF**	**Avg. Severance Tax %**	**Est. Severance Tax**
2003	$28.15 (actual)	.50 (actual)	7.5%	$599 million (actual)
2006	$22	.47	7.05%	$341 million
2009	$22	.40	6.0%	$287 million
2013	$22	.27	4.05%	$180 million

It is estimated that production will fall by roughly 7% from now through 2013. Today North Slope production is roughly 1 million barrels/day. By 2013 it is projected to fall to roughly 930,000 barrels/day. That is a lesser, though important component of the fall in revenue.

<u>The Alaska Fair Share Bill:</u>

Six legislators (Sens. French & Hoffman, Reps. Gara, Kerttula, Guttenberg and Croft) have introduced legislation this session to reform Alaska's oil tax exemption rules. A version of this bill, the "Alaska Fair Share Bill," was introduced last year. This session's version includes an additional tax relief provision to further encourage future development, and to ensure that future development will be both profitable for producers while in the best interests of Alaskans. The Alaska Fair Share bill works within Alaska's existing severance tax structure, but modifies the ELF in a way that reflects that oil production is more profitable at high prices, and less profitable at low prices. Accordingly, the bill allows the state to share more equally at high prices, and allows some tax relief at low prices.

The bill also recognizes that while some tax break might be justified depending on the size of a field, a complete exemption from Alaska's 15% severance tax doubtfully serves the state's best interests.

To encourage investment in truly marginal oil fields, companies can avoid the largest part of their tax burden by demonstrating this tax structure would make production of a particular field "uneconomic." If Alaska's tax laws were to make a field "uneconomic", the state's "royalty relief" statute will allow a company to apply for relief from a portion, or all, of the state's royalty. Since the state's royalty is Alaska's largest tax, the state's royalty relief law allows producers the incentive they need to avoid any excessive taxation on truly uneconomic fields. The advantage of Alaska's royalty relief statute is that it allows tax relief when a company shows it truly needs tax relief to produce a particular field. But unlike the current ELF, this law doesn't allow tax relief on fields where a tax exemption is unjustified.

Here are the major components of the Alaska Fair Share bill.

1. Establish a Minimum 5% Severance Tax. Eleven of the last 14 fields that have come on line since 1989 pay none, or almost none of the state's 15% severance tax. This proposal establishes a minimum severance tax at 5%. This is more modest than so-called "Shelf the ELF" proposals, which would apply the full 15% severance tax to all fields.

Under current law, and without such a change, the average severance tax has fallen from 13.5% in 1993, to 7.5% today, and it will fall below 5% by 2013. If we do nothing, the fiscal gap will continue to grow as severance tax revenue continues to fall. This proposal will help stem the falling severance tax rate.

2. Adjust Severance Tax Amount Upwards above $20/barrel & Downwards Below $16/barrel. This provision will allow the state's share at average and high prices to rise and fall as oil prices rise and fall. Under this proposal, the state would recover about $500 million more than it does today at $32/barrel.

The Formula: Above $20/barrel, the proposal would multiply the severance tax by this formula: *The Price Per Barrel / 20*. Thus, nothing would change at $20/barrel because the severance tax would be multiplied by 20/20, or by 1. But at $30/barrel, the severance tax would be multiplied by 30/20, or 1.5. Thus, at $30, a field with a 10% severance tax would pay an adjusted 15% severance tax (1.5 X 10%). This still allows oil company income to increase significantly at higher prices. This price factor will never increase the severance tax to more than 25%, thereby also protecting the interest of oil companies in high profits at high prices.

Below $16/barrel, the severance tax **is reduced** by multiplying it by this formula: *The Price/16.* Thus, for example, at $12/barrel, the severance tax would be multiplied by 12/16, and thereby waiving twenty-five percent of the production tax.

3. Tax Relief To Encourage Additional Exploration and Production:

- Deferral Of Severance Taxes Below $10/barrel**.** Below $10/barrel, half the severance tax would be waived and the other half may be deferred. Severance tax payments may be deferred at this price until prices exceed $16/barrel.

- Ensuring Profitability – Severance Tax Relief: Currently Alaska law allows companies a reduction in their Royalty if they can demonstrate to the Department of Revenue that a tax break is needed to make a future or aging field economic to produce. The Alaska Fair Share bill adds that companies can similarly apply for a reduction or elimination of any additional taxes imposed by its provisions by showing that relief is needed to make production of a field economic and profitable.

4. Heavy Oil and Not Affected; Bill Applies Only To North Slope Oil.
The Fair Share proposal exempts “heavy oil” from any of the enhanced taxes to encourage development of that resource. Heavy oil entails a more expensive and intensive extraction process. It also exempts Cook Inlet, and other non-North Slope oil produces from smaller, more expensive fields.

Hearings may show some of these factors should be shifted one way or the other, or that, for example, perhaps some minimum tax might be appropriate for heavy oil.

The Metcalfe, Fineberg & “Shelf the ELF” Proposals

There are many who feel Alaska’s small fields are profitable enough to pay some severance tax. Many small fields have economized by “sharing” processing facilities at larger fields. In addition, many have called for changes in the law that would allow the state to share more equally at high oil prices.

It should be noted that this would not raise as much revenue as more aggressive proposals some have made, and that are worthy of consideration and analysis. Those include:

1) “Shelf the ELF” proposals like that by Rep. Masek in 2003, which would have imposed a flat 15% severance tax on all fields, and eliminated the ELF;
2) lease bid and taxation changes proposed by former Rep. Ray Metcalfe which he believes would fully close the fiscal gap; and,
3) a windfall profits tax proposed by oil industry analyst Richard Fineberg.

The Alaska Fair Share bill does not likely raise as much additional revenue as the above proposals, and seeks to provide companies with adequate incentive to continue with significant exploration efforts into the future.

Conclusion

Many Alaskans have called for a re-examination of Alaska's oil tax rules, and the exemptions they provide. They've included Former Governors Jay Hammond and Wally Hickel, Former Dept. of Revenue Deputy Commissioner and Assistant Attorney General Deborah Vogt, Former Reps. Ray Metcalfe, and John Torgerson, and oil policy consultant Richard Fineberg, among many others. At a time of budget shortfalls, it is important to make sure the state does not grant large tax exemptions to those who don't need them.

The Alaska Fair Share bill seeks a balance between fairness to the state and those companies that are willing to explore and produce in Alaska. At a time when the state is having trouble funding our schools, protecting our neighborhoods and our seniors, and maintaining our roads, state government cannot afford to maintain outdated tax loopholes. Reform of the ELF is needed now.

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ATTACHMENT 1

2004 Department of Revenue Corporate and State Profit Share at Various Annual Average Prices

Sales Price ($/Bbl)	**$14.00**	**$22.00**	**$30.00**	**$35.00**	**$40.00**
Transportation Cost to Market ($/Bbl)	$4.75	$4.75	$4.75	$4.75	$4.75
Wellhead Price ($/Bbl)	$9.25	$17.25	$25.25	$30.25	$35.25
ANS Production (oil and NGL) (Million Bbl/Yr)	357.7	357.7	357.7	357.7	357.7
Production Value (Million $)	3308.7	6170.3	9031.9	10820.4	12608.9
Production Costs ($/Bbl)	6.50	6.50	6.50	6.50	6.50
Production Costs (Million $)	2325.1	2325.1	2325.1	2325.1	2325.1
Company Net Revenue (Millions $)	307.2	1786.1	3265.0	4189.3	5113.7
Percentage Total	**21.3%**	**41.5%**	**45.6%**	**46.8%**	**47.6%**
State Revenue + Muni Share Oil Property (Millions $)	987.2	1573.5	2159.9	2526.4	2892.9
Percentage Total	**68.5%**	**36.6%**	**30.2%**	**28.2%**	**26.9%**

ATTACHMENT 2

ELF Rates and Oil Production for Certain North Slope Oil Fields

Field	Producing Since	Facilities	Annual Oil bbl	2004 ELF Rate
MIDNIGHT SUN	1998	Prudhoe Bay Unit	1,719,308	0.0000
POLARIS (heavy oil)	1999	Prudhoe Bay Unit	917,642	0.0000
ORION (heavy oil)	2002	Prudhoe Bay Unit	368,058	0.0000
AURORA	2000	Prudhoe Bay Unit	3,782,231	0.0000
WEST SAK (heavy oil)	1997	Kuparuk River Unit	2,856,897	0.0000
TABASCO (heavy oil)	1998	Kuparuk River Unit	1,541,615	0.0000
TARN	1998	Kuparuk River Unit	12,342,736	0.0849
MELTWATER	2001	Kuparuk River Unit	2,124,967	0.0000
MILNE POINT	1985-87 and 1989	Milne Point Unit	11,703,713	0.0000
SCHRADER BLUFF (heavy oil)	1991	Milne Point Unit	7,001,109	0.0000
ENDICOTT	1987	Endicottt	9,195,798	0.0006
EIDER	1998	Endicottt	242,135	0.0000
LISBURNE	1987	Lisburne Prod. Center	3,335,277	0.0000
NIAKUK	1994	Lisburne Prod. Center	4,599,262	0.0000
		Total Annual Oil bbl	61,730,748	