Valuing Carried-Forward Lease Expenditures versus Oil and Gas Tax Credits

State of Alaska

Department of Revenue

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INTRODUCTION / SUMMARY

The purpose of this white paper is to provide a discussion of the proposed changes in the "House" and "Senate" versions of House Bill 111 (HB111), on the specific issue of how they address the value of company losses. Both versions of the bill eliminate the Carried Forward Annual Loss credit, or NOL credit, for the North Slope, and replace it with a structure of carried forward lease expenditures (CFLE). There is some confusion regarding the similarities and differences resulting from in this change. In particular with the Senate bill, which does not change the inherent tax value of the carry forwards, some have expressed concern that the bill simply changes the name of an existing state liability without making any actual improvement to the state's fiscal position.

In both the House and Senate versions of HB111, companies experiencing an operating loss are able to carry forward their excess lease expenditures, at 100% of the amount of the loss. Because Cook Inlet NOLs were already eliminated by HB247 from 2016, effective 1/1/18, this change would effectively end the state's program of direct cash participation in oil development.

Based on the Department of Revenue's spring 2017 forecast, the total amount of oil industry expenditures that result in a loss is about a cumulative $4 billion through the end of FY2027. This is in contrast to the great majority of total lease expenditures, over $50 billion over that time period, which will be expended by producing oil companies for whom this is a partial offset to their gross revenue, resulting in a company profit. Except in times of extreme low prices, it is only the spending by non-producing explorers and developers, less than 10% of total North Slope activity that results in a loss and is eligible, in current law, for cash credits.

Carry forward losses retain value for the company dollar for dollar. They only obtain a <u>tax value</u> to the company when they are eventually used to offset the company's taxes. They cannot be transferred or sold, except as part of the underlying leases: in other words if the company holding them sells part or all of the actual project.

DIFFERENCES BETWEEN HOUSE AND SENATE BILLS

Several separate provisions of the House and Senate versions of the bill modify the way loss value is converted to tax value. The net result is, by 2027, the <u>tax value of carry forwards</u> for the bill that passed the House is $610 million; for the Senate bill it is $1,445 million, a difference of about $800 million. These numbers are prominent within the fiscal note tables and have sparked wide discussion. The difference comes from the following:

1. Senate bill includes Middle Earth carry forwards because it also eliminates the Middle Earth NOL credit (~$60 million)

2. House bill requires using carried forward lease expenditures to zero Production Tax Value (PTV) while still paying minimum tax (~$60 million)
3. Tax value of CFLE is 35% in Senate bill vs. 25% in House bill (~$400 million)
4. House bill reduces value of carry forwards by 10% / year after 7 years (~$300 million)

The third item is the largest, and is tied to the change in the base tax rate by the House from 35% to 25%, along with the elimination of the per-taxable-barrel credit. This results in the substantial tax increase within the House bill, concentrated at oil prices of $60-$90. The difference in the "revenue" portion of the two fiscal notes totals over $1.5 billion over the 10 year forecast period. However, it's important to recognize that the Senate bill is effectively neutral on the revenue side. This $1.5 billion reflects the tax increase proposed by the House which is not included in the Senate version of the bill.

The reduced tax rate (despite the higher actual tax revenue) means when future dollars of carried forward value are "used", they offset the company's taxes by a smaller percentage of their value. The net result is higher taxes paid in the future when the projects come into production. The sum total of the two "tax increases"- both the present one of $1.5 billion and the future one of $0.8 billion- results in the "over $2 billion difference" figure that has been reported in media.

WHY THE GOVERNOR'S PROPOSAL IS A TRUE COMPROMISE

The House has observed that in the Senate bill the value gained due to the state not having to pay cash credits (a feature of both bills), is near-exactly offset by the future cost due to the tax offsets from the carry forwards. This is purposeful: the Senate chose not to address any of the core provisions of the North Slope tax law, SB21, and to ensure that companies using carry forwards are able to take maximum use of them without "waste" or "loss." This "minimizing waste" issue was raised by LB&A consultant Rich Ruggiero during the regular session.

However, it is important to recognize that there are at least three distinct differences, all in the state's favor, when the state liability for company losses is moved from the present to the future:

1) First and most obviously is the time value of money. Just as industry looks at net present values and rates of return, so should the state. A dollar we have to spend, or take as reduced revenue, in 2027 is far less valuable to us than a dollar we spend now. A dollar in the Permanent Fund, earning 7% returns, will be worth nearly $2 in 2027. Carry forward values in the Senate bill do not gain or lose value, so the state "paying" them in the future is an overall gain.
2) Second and equally important is that the state will no longer be exposed to any appropriation demand by the oil industry. The value of these company losses never has to actually come out of the state's pocket. It only is "paid" when there is corresponding

new production related to the obligation. At that time, the state will be receiving new and additional revenue that can only be partially offset by the use of the carry-forwards.

3) Finally, there is the likelihood that a substantial portion of carry forwards will never be used at all. Alaska has spent about $2.3 billion on cash credits on the North Slope, with another roughly $0.5 billion either awaiting payment or in review by the state. Should the program end via legislation passed this year, the state's total cash contribution on the North Slope will be roughly $3 billion. To date, about $1.5 billion has been received by companies who are currently in production. The majority of the remainder is widely expected to result in future production, although in some cases it may not be for a number of years. However, there are projects that have failed, companies who have left the state, and it's possible that there will be others. In the case of future failures, elimination of the cash credit program would mean that the state will not have any responsibility associated with those losses.

IMPORTANCE OF RINGFENCING

The language passed by the Senate, on its own, does not adequately protect the state's interests for issues #2 and #3, above. To strengthen these provisions, the governor has proposed compromise "ringfence" language. The term "ringfencing" broadly means that the costs associated with an oil field are in some way tied to that field. To expand the metaphor, the fence means that the expenses, like livestock, can't "wander off."

The House bill includes language that says that the value of carry forward lease expenditures can only be used to offset actual production value (oil sales) from the field (lease or property) on which they were originally expended. The Senate bill contains no similar provision, meaning expenses could potentially be used to offset oil production anyplace on the North Slope without a requirement that the leases ever come into production. The Senate Finance Committee proposed a partial ringfence in an earlier work draft before the final version that passed the Senate. Senators have since expressed interest in some form of compromise on this issue.

The most dramatic concern with the lack of any ringfencing, is that a failed project could simply sell their entire set of leases to a major producer for pennies on the dollar, who would then effectively "harvest" their losses and use them to reduce the production tax due on production from their legacy fields. This could be done without ever bringing the new project into production.

It is important to note, in current law as well as both bills, if an existing producer with a new project does not incur a loss, spending on the new project can still be used to offset taxes in the year it is incurred. In other words, if Conoco, a major producer, develops Willow, their large and expensive new oil discovery in the National Petroleum Reserve- Alaska, the Willow costs would be able to reduce Conoco's tax liability by offsetting their profits from their share of Prudhoe

Bay, Kuparuk, etc. Only if there were a loss within a tax year, possible during a year of low prices and high investment, would that loss be tied to the Willow property.

This is distinct from how the change would impact a company like Armstrong, who has made a large discovery but has no current production of their own. Under either version of HB111, their expenses would have to be carried until they had revenue against which to offset it. The difference for a company like this is that ringfence language could make it harder for them to market their discovery to major producers, because it could delay the time in which the purchaser can get value back from the expenditures.

The governor has developed language, provided to interested parties, that proposes compromise language on the issue of the ringfence. This would restrict use of the carry forwards until after the field where they were incurred comes into production. At that time they could be used anywhere. The idea is that once a field is on line, the carry forward benefit has served its purpose and there is no reason to further limit a company's ability to monetize the benefit. For example, whereas in the stronger "House" language Field X's costs could only offset Field X's eventual revenues. With the compromise language, once Field X came into production the holders of the associated losses could use them against any other production they had on the North Slope. But importantly, if Field X never came into production, they would not be usable at all. This is an essential state protection.

CONCERN THAT THIS IS THE "ONE SHOT"

Some in the House are concerned that if a "credits only" package passes this year, it would be harder or even impossible to address oil taxes themselves in 2018. Industry would say that this is the eighth change in 12 years, that Alaska is unstable, and so forth.

To this, it is first important to recognize that credit reform itself is substantial progress and a major transformative moment for the state in its relationship with industry. Alaska has been known throughout the world for its unique and generous system of credits, and it is big news for us to eliminate them. It is not something to resist doing out of a belief that there is more to be had in the future if we wait.

Leaving the credit issue on the table in an "all or nothing" strategy would leave the state in the same place it was when we entered this session, with a need to eliminate cash credits and the likelihood that this singular issue would dominate the next session as well. If we hope to move past the credit discussion, we need to take it off the table by eliminating the credits now.

In addition, there is every reason to believe that the legislature intends to address the underlying tax issue in the 2018 session. The Legislative Budget and Audit Committee has recently retained three separate economic consultants, and each has been charged with producing an oil and gas fiscal model this summer. Finally, even a one year delay would add another $200 million or more in additional cash credit obligation for the state.