

Alaska's Tax Credit Showdown

by Jonathan E. Iversen



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In this edition of *Alaska Tax: The Last Frontier*, Iversen discusses Alaska's oil and gas production tax credits.

Alaska is a huge state with bountiful resources. Its natural diversity is astounding: massive forests, tundra, glaciers, active volcanoes, rugged mountains, and coastal areas. It is also diverse in terms of natural resource potential, with the oil and gas, mining, timber, fisheries, and tourism industries front and center. Its size is also astounding — with 586,000 square miles of land, Alaska's area is one-fifth that of the lower 48 states.¹

Yet Alaska's size, location, limited infrastructure, ruggedness, and often harsh conditions can hamper the ability to access many of the resources that are needed for the state's economic health. It's no secret that there is some sticker shock that comes with living and

doing business here. Although Alaskans are blessed with abundant resources, it can be difficult and expensive to reap the benefits of those resources.

The last article discussed Alaska's fiscal regime, its dependence on the oil industry for the state's economic health, and its oil and gas production tax, which has been the focus of debate and change for much of the last 13 years. The debate has continued as lawmakers and policymakers struggle to balance budgets in times of volatile oil prices and the need to encourage the investment necessary to monetize Alaska's resources to run state government, create jobs, build and maintain infrastructure, and spur economic activity. Given that oil revenues are vital to the state, that select population centers are almost entirely dependent on local gas supplies for heating and power, and that remote (and not-so-remote) communities lack access to affordable and reliable energy, the oil and gas production tax regime has played and will continue to play a critical role in Alaska's oil and gas development. Production tax credits have been a key component in oil and gas development, and the cost of those incentives made them a target when Alaska's revenues dramatically decreased because of the drop in oil prices.

Alaska's Oil and Gas Production Tax

To understand the role of tax credits in Alaska's oil and gas production tax structure and how they encourage investment in oil and gas exploration, development, and production, it is helpful to briefly review the tax structure.

Alaska's production tax is levied on the net revenues of oil and gas production from leases on properties in the state, except for the federal and state royalty share and for oil and gas used in drilling or production operations, or for re-

¹ See "Alaska Kids' Corner," official Alaska state website (undated).

pressuring.² The calculation starts with destination value, generally the higher of the sales price or a calculated prevailing value.³ The costs of pipeline and marine transportation are subtracted from the destination value to obtain the gross value at the point of production (GVPP).⁴ Operating and capital costs for oil and gas exploration, development, or production upstream of the point of production (called lease expenditures) are subtracted from the gross value at the point of production to reach net revenue, known as production tax value.⁵

It helps to ground this high-level summary in an example that starts with the marketplace and ends with the point of production. Almost all Alaska North Slope (ANS) crude is destined for the West Coast of the United States. Working back from that point, start with the ANS West Coast sales price and subtract the costs of transporting it via tanker from Valdez, Alaska, to the West Coast.⁶ Then subtract the Trans-Alaska Pipeline System (TAPS) tariffs and TAPS quality bank adjustments (to account for differences in crude quality) to reach TAPS pump station number one at the north end of TAPS, which is the point of production for much of ANS crude.⁷ That yields the gross value at the point of production. Subtracting the upstream costs for things like drilling wells and constructing and operating production facilities results in production tax value.

The tax rate is then multiplied by production tax value, and the result is reduced by credits. At a high level, the calculation can be shown as follows:

$$\text{Production Tax Liability} = [(\text{GVPP} - \text{Lease Expenditures}) \times \text{Tax Rate}] - \text{Credits}$$

² Alaska Stat. section 43.55.011(e); and Alaska Stat. section 43.55.020(e).

³ 15 Alaska Admin. Code 55.151.

⁴ Alaska Stat. section 43.55.150. The point of production is generally the point at which oil or gas is accurately metered and tendered into a carrier pipeline or other transportation carrier in a condition of pipeline quality. Alaska Stat. section 43.55.900(21).

⁵ Alaska Stat. section 43.55.160.

⁶ The price of ANS West Coast can be found on the Alaska Department of Revenue Tax Division website.

⁷ There are other points of production for several fields that are upstream of pump station one — this can get complicated.

It is worth noting that this structure is very different from oil and gas severance tax calculations in other states that levy a severance tax on the gross value at the point of production or “wellhead” value.

A Tale of Three Regimes

In thinking about the production tax and production tax credits, it is important to consider the size and ruggedness of the state, where Alaska’s oil and gas resources are located, its population centers, and its infrastructure. These and other factors have caused the production tax to evolve into basically three different structures.

The revenue driver is Alaska’s North Slope, which for production tax purposes is the area of the state north of 68 degrees north latitude; it is the origin of ANS crude oil and home to the massive Prudhoe Bay, Alpine, and Kuparuk River fields and a number of smaller but also important fields, including technological milestones like the Northstar and Oooguruk units.⁸ New discoveries like Caelus’s Smith Bay Project have brought hope for additional development.⁹

The discovery of oil in Cook Inlet was critical for Alaska’s statehood, and Cook Inlet gas is vital for heat and power for Southcentral Alaska, including Anchorage, where almost half of Alaska’s residents live.¹⁰ There are a number of oil and gas fields in Cook Inlet, both onshore and offshore.¹¹

Areas of the state south of the North Slope and outside Cook Inlet are, for production tax purposes, sometimes informally referred to as “Middle Earth.” This encompasses the Nenana Basin and Yukon Flats in central Alaska, Kotzebue, Copper River, Bristol Bay, and the Aleutians. There is no oil and gas production in Middle Earth and the prospective basins are unexplored or underexplored. Several basins in

⁸ See Alaska Stat. section 43.55.023(b) as an example of a reference to “oil and gas deposits north of 68 degrees North latitude.” A map of North Slope units is available on the Alaska Department of Natural Resources website.

⁹ See Caelus’s website.

¹⁰ See Alaska Oil and Gas Association Fact Sheet: Cook Inlet Oil and Gas Production. The Cook Inlet sedimentary basin is defined for production tax purposes at Alaska Stat. section 43.55.900(5).

¹¹ See Alaska Department of Natural Resources Cook Inlet Units and Fields map.

Middle Earth are known to be highly prospective for oil and gas. Some areas are near infrastructure and could be quickly developed to bring oil and gas into production.

The production tax structure, including tax credits, has evolved due in part to the unique characteristics of these three areas: the North Slope, Cook Inlet, and Middle Earth. Each is important to the state and each is treated differently in the production tax law, including the production tax credit structure.

Evolution of the Production Tax Credits

The production tax was relatively stable until 2006 — compared with the last 12 years.

Accordingly, a good starting point to discuss the evolution of tax credits is 2005. At that time the primary credit was a tax credit designed to promote exploration drilling and seismic exploration (exploration credit). The exploration credit was 40 percent for seismic shot outside a unit and either 20 percent or 40 percent for exploration wells depending on the well location and target.¹² To obtain the exploration credit, the explorer had to apply to the Alaska Department of Revenue for a credit certificate, which could be applied against the explorer's production tax liability or sold to a producer to apply against the producer's production tax liability.¹³ There were also exploration incentive credits administered by the Department of Natural Resources.¹⁴

In 2006 the Alaska Legislature made sweeping changes to the production tax by replacing the "gross value" tax structure with the "net value" tax structure.¹⁵ The desire to align the interests of the state with those of oil and gas explorers and producers drove the new structure, and several credits were enacted to promote exploration and development activity and attract new entrants to the state:

- a 20 percent credit for qualified capital expenditures (capex credit), generally defined as lease expenditures for geological

or geophysical exploration or that would be capital costs under the federal tax rules;¹⁶

- a 20 percent credit for a carried-forward annual loss (loss credit) based on lease expenditures that were not deductible in the calculation of production tax value for the prior calendar year;¹⁷
- a 20 percent transitional investment expenditure credit for costs incurred after March 31, 2001, but before April 1, 2006, that would have been qualified capital expenditures;¹⁸
- a credit against production taxes of up to \$6 million per year for Middle Earth oil or gas production;¹⁹
- a credit against production taxes of up to \$12 million per year for small producers;²⁰ and
- the sunset date of the exploration credit was extended from 2007 to 2016.

With the exception of the \$6 million Middle Earth credit, these credits applied statewide. The capex and loss credits could be used against the applicant's production taxes or transferred to a producer for use against its production taxes.²¹ This legislation also introduced the ability to obtain rebates for the capex and loss credits of up to \$25 million per year under particular conditions, including that the applicant is an explorer or small producer without tax liability that continues to invest in oil and gas exploration and development in the state.²²

In 2007 the Legislature again overhauled the production tax regime.²³ The preexisting credits stayed in place and the Legislature made other changes to the tax credit regime, again intending to spur investment:

- an increase to the loss credit rate to 25 percent to match the base tax rate;²⁴

¹² Alaska Stat. section 43.55.025(a).

¹³ Alaska Stat. section 43.55.025(g), (h).

¹⁴ Alaska Stat. section 38.05.180(i); and Alaska Stat. section 41.09.010.

¹⁵ H.B. 3001 (2006).

¹⁶ Alaska Stat. section 43.55.023(a), (k).

¹⁷ Alaska Stat. section 43.55.023(b).

¹⁸ Alaska Stat. section 43.55.023(i). This credit was repealed in 2014.

¹⁹ Alaska Stat. section 43.55.024(a). This credit was never used and sunset in 2016.

²⁰ Alaska Stat. section 43.55.024(c).

²¹ Alaska Stat. section 43.55.023(e), (f).

²² Alaska Stat. section 43.55.023(f).

²³ H.B. 2001 (2007).

²⁴ Alaska Stat. section 43.55.023(b).

- an increase to the exploration credit from 20 percent or 40 percent for exploration wells to 30 percent or 40 percent and its inclusion as part of the tax credit rebate program;²⁵ and
- the creation of an oil and gas tax credit fund for the state to purchase capex, loss, and exploration credits from explorers and small producers with no tax liability, and the removal of the \$25 million limitation on credit purchases.²⁶

Notwithstanding the incentives in place, gas production from Cook Inlet had declined to frightening levels by 2009. Southcentral Alaska was in the midst of an energy crisis: the Agrium fertilizer plant on the Kenai Peninsula had shut down from lack of supply, and communities, including Anchorage, were coping with energy shortages and possible brownouts.²⁷ So in 2010, the Legislature added additional tax credits to promote oil and gas exploration and development in Cook Inlet and to provide gas storage to meet seasonal demand.²⁸

- a credit of up to \$15 million for the cost of establishing a gas storage facility;²⁹
- a 40 percent credit (well lease expenditure credit) for projects south of the North Slope for (1) costs of seismic shot inside a unit and (2) costs for exploration and production wells that are qualified capital and intangible drilling expenditures (including costs for workovers, deepening, sidetracks, and completion or recompletion);³⁰ and
- a credit of up to \$25 million for drilling a deep offshore well in Cook Inlet with a jack-up drilling rig.³¹

In 2012 the Legislature turned its focus to Middle Earth, enacting tax credits for seismic exploration and exploration drilling in particular basins in the state.³² The seismic credit was for up

to \$7.5 million for each of four projects,³³ and the well credit was for up to \$25 million for each of four projects.³⁴

Concerned by declining North Slope production and TAPS throughput levels, in 2013 the Legislature enacted credits designed to increase North Slope production, and also reduced investment-based credits³⁵

- a \$5-per-barrel credit against production tax for newer North Slope oil fields;³⁶
- a “sliding scale” credit for established “legacy” fields (such as Prudhoe Bay) of up to \$8 per barrel when GVPP is less than \$80 per barrel, decreasing by \$1 per barrel for each \$10-per-barrel increase in GVPP to zero when GVPP is \$150 per barrel or higher;³⁷
- a repeal of capex credit for North Slope activity;³⁸ and
- an increase to the loss credit for North Slope activity to 45 percent for 2014 and 2015, and a reduction to 35 percent thereafter.³⁹

Over time the production tax credit structure proved to be a tremendous incentive for oil and gas exploration, development, and production. The rebatable credit program was a key component, especially for exploration companies and small producers that could assign the credits for use as collateral and sources of repayment for financing arrangements.⁴⁰

The credits benefited the North Slope, Cook Inlet, and Middle Earth in different ways, all because of increased investment. The North Slope saw a tremendous increase in investment in exploration, development, and production, yielding several new and very significant discoveries and an actual reversal in the decline of production last year. Several exploration drilling and seismic projects were undertaken in Middle Earth, including by Doyon Limited, an Alaska Native Corporation that has explored for oil and

²⁵ Alaska Stat. section 43.55.025.

²⁶ Alaska Stat. section 43.55.028.

²⁷ *Supra* note 10.

²⁸ H.B. 280 (2010); and S.B. 309 (2010).

²⁹ Alaska Stat. section 43.20.046.

³⁰ Alaska Stat. section 43.55.023(l), (m), (o).

³¹ Alaska Stat. section 43.55.025(a)(5), (l). This credit was never used and sunset in 2016.

³² S.B. 23 (2012).

³³ Alaska Stat. section 43.55.025(a)(7), (n).

³⁴ Alaska Stat. section 43.55.025(a)(6), (m).

³⁵ S.B. 21 (2013).

³⁶ Alaska Stat. section 43.55.024(i).

³⁷ Alaska Stat. section 43.55.024(j).

³⁸ Alaska Stat. section 43.55.023(a)(3).

³⁹ Alaska Stat. section 43.55.03(b).

⁴⁰ Alaska Stat. section 43.55.029.

gas extensively in the Nenana Basin and Yukon Flats, prospects that are roughly 40-60 miles from the Trans-Alaska Pipeline and the likely route of a major gas line that could provide gas to Fairbanks.⁴¹ Cook Inlet exploration and development increased dramatically, leading to increased reserves, stabilization of decline rates, and even steady increases in production, and Cook Inlet Natural Gas Storage Alaska established an underground storage facility to meet seasonal demand. Southcentral Alaska is, at least for now, not facing an energy crisis.

And yet, when oil prices softened in 2015 and fell further in 2016, lawmakers and policymakers faced rising budget deficits and the price tag that came with the rebatable tax credits — a price tag that had historically been paid in full each year.⁴² Despite the earlier repeal of the capex credit for the North Slope, and even though a number of credits were going to sunset on July 1, 2016 — including the Middle Earth “basin” credits, the Cook Inlet jack-up rig credit (which was never used), and the exploration credit for all areas except Middle Earth — the rebatable credit program became a target.

And in 2016, Cook Inlet was in the crosshairs. The capex, well lease expenditure, and loss credits were cut to 10 percent, 20 percent, and 15 percent respectively for 2017 for Cook Inlet and Middle Earth, and were repealed for Cook Inlet January 1, 2018.⁴³ These credits were allowed to continue at the reduced percentages for Middle Earth.

The following year, the focus shifted to the rebatable credits program statewide, with the Legislature repealing the loss credit and ending the ability to obtain rebates for credits for costs incurred after July 2017.⁴⁴ This legislation also repealed the exploration credit for seismic exploration in Middle Earth effective January 1, 2018.⁴⁵

Although the statutory infrastructure to enable credits to be purchased stays in place until

there are no more outstanding rebatable credits, costs incurred after June of 2017 will not be eligible for rebatable credits. However, there has not been a truly meaningful appropriation to the oil and gas tax credit fund for the last two years compared with the outstanding balance of credit certificates awaiting purchase — the fiscal 2018 appropriation was \$77 million to pay down a pre-2017 queue of rebatable credits of around \$470 million.⁴⁶ The DOR estimates a balance of \$711 million of outstanding credits in the purchase queue by the end of June 2018, with the total expected to reach at least \$900 million.⁴⁷

The failure to fully pay the rebatable credits has put tremendous financial stress on many of Alaska’s oil and gas explorers and producers, has generated tremendous uncertainty, and has dampened investment. Some projects have slowed dramatically or been postponed. The need to pay for the outstanding credits is now at the center of the debate in a legislative session that started in mid-January.

On the Horizon

The next article will include a discussion of the payment of the outstanding production tax credits, including the secondary market for the credits, and legislation introduced by the governor to issue bonds to pay for the credits — at a discount.⁴⁸ We have several months left of legislative session, and 2018 is an election year. The uncertainty continues for Alaska’s oil and gas industry. ■

⁴¹ See Doyon Limited’s website.

⁴² See “Working Together to Close the Gap: Revenue Sources Book, Fall 2015,” Alaska DOR Tax Division (2015), p. 77-78 and 99-100.

⁴³ H.B. 247 (2016). Alaska Stat. section 43.55.023(a), (b), (l).

⁴⁴ H.B. 111 (2017).

⁴⁵ Alaska Stat. section 43.55.025(b)(1)(B).

⁴⁶ See “Revenue Sources Book, Fall 2017,” Alaska DOR Tax Division (2017), p. 81.

⁴⁷ *Id.*

⁴⁸ S.B. 176.