April 29, 2013

The Honorable Sean Parnell
Governor
State of Alaska
P.O. Box 110001
Juneau, Alaska 99811-0001

Re: HCS CSSB 21(FIN) am H -- relating to the interest rate due on delinquent taxes; providing a tax credit against the corporation income tax for qualified oil and gas service industry expenditures; relating to substantial changes to the oil and gas production tax; and establishing an Oil and Gas Competitiveness Review Board
Our file: JU2013200214

Dear Governor Parnell:

At the request of your legislative director, we have reviewed HCS CSSB 21(FIN) am H, relating to the interest rate applicable to certain amounts due for fees, taxes, and payments made and property delivered to the Department of Revenue; relating to appropriations from taxes paid under the Alaska Net Income Tax Act; providing a tax credit against the corporation income tax for qualified oil and gas service industry expenditures; relating to the oil and gas production tax rate; relating to gas used in the state; relating to monthly installment payments of the oil and gas production tax; relating to oil and gas production tax credits for certain losses and expenditures; relating to oil and gas production tax credit certificates; relating to nontransferable tax credits based on production; relating to the oil and gas tax credit fund; relating to annual statements by producers and explorers; establishing an Oil and Gas Competitiveness Review Board; relating to the determination of annual oil and gas production tax value including adjustments based on a percentage of gross value at the point of production from certain leases or properties; and making conforming amendments.

The majority of the bill would amend AS 43.55 (Oil and Gas Production Tax and Oil Surcharge). In addition, the bill would amend the statutory interest rate for delinquent taxes under AS 43 (Revenue and Taxation) and provide a corporate income tax credit for qualified oil and gas service industry expenditures. The bill also would establish an Oil and Gas Competitiveness Review Board in the Department of Revenue (DOR).

Our review of the bill's substantive provisions follows:

I. OIL AND GAS PRODUCTION TAX

A. Production Tax Rate Levied

The bill's major provisions would amend the base tax rate and eliminate the progressivity tax for oil and gas produced on or after January 1, 2014. Alaska Statute 43.55.011(e) levies the production tax (although some subsets of production are subject to tax ceilings that affect the amount of tax levied).[1] Under current law, the state levies a flat tax rate of 25 percent on a producer's annual production tax value of the oil and gas it produced during a calendar year. The state levies an additional progressivity tax each month, based on the average monthly production tax value of the producer's oil and gas.[2]

Section 4 of the bill would amend AS 43.55.011(e) to levy a tax of 35 percent of the annual production tax value of all oil and gas produced each calendar year on or after January 1, 2014, from each lease or property in the state, excluding any oil and gas the ownership or right to which is tax exempt or constitutes a landowner's royalty interest.

Section 5 of the bill would amend AS 43.55.011(g) to eliminate the progressivity tax for oil and gas produced on or after January 1, 2014, but the progressivity tax would still apply to oil and gas produced through December 31, 2013.

Several sections of the bill make amendments related to the amendments in secs. 4 and 5.

Section 9 of the bill would amend AS 43.55.020(a) to provide for monthly installment payments of estimated taxes for oil and gas produced on or after January 1, 2014. These changes would incorporate the new base tax rate of 35 percent, eliminate the progressivity tax on oil and gas produced after December 31, 2013, add reference to the gross revenue exclusion in section 29, discussed below, and make conforming amendments to the tax calculation for oil and gas subject to AS 43.55.011(p) (an existing tax ceiling of four percent of the gross value at the point of production for new oil and gas outside the Cook Inlet sedimentary basin and south of 68 degrees North latitude).

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[1] There is one exception to production taxes levied under AS 43.55.011(e): The tax on a private landowner's royalty share is levied under AS 43.55.011(i). Even though that tax would not be changed by this bill, there are conforming amendments related to AS 43.55.011(i). See sections 6 (conforming amendment to AS 43.55.011(i)) and 10 (conforming amendment to AS 43.55.020 (d)).

[2] AS 43.55.011(e)(2) and (g). In general terms, the "production tax value" is the value net of costs of exploration, development, and production. More precisely, the production tax value is the gross value at the point of production (which is the sales value less allowable transportation costs) less adjusted lease expenditures. AS 43.55.150; AS 43.55.160(a). The term "progressivity" rate or tax is widely used, but the term is not actually found in the existing statute or the bill.

Sections 6, 10, 13, and 33 of the bill are technical amendments relating to the tax on a private landowner's royalty interest. The amendments do not substantively change the tax but simply accommodate changes in statutory cross references due to other provisions of the bill.

Last, sec. 1 of the bill would amend AS 29.60.850(b), relating to amounts the legislature may appropriate to the community revenue sharing fund, to remove a 20 percent appropriation limit, and to substitute the suggested funding source to taxes paid under AS 43.20.030(c) (Alaska Net Income Tax Act) rather than from taxes paid under the progressivity portion of the production tax (AS 43.55.011(g)), since the latter would no longer be operative after 2013.

B. <u>Calculation of Production Tax Value and Gross Revenue Exclusion</u>

Because the production tax statute provides for special tax treatment -- tax ceilings, a tax floor, and certain tax credits -- for specific categories of oil and gas, the amount of tax levied by AS 43.55.011(e) must be separately calculated for each of those categories of oil and gas. That, in turn, requires that an annual production tax value be separately calculated for each category. Alaska Statute 43.55.160(a)(1) identifies those categories and specifies how the annual production tax values are calculated.[3] Section 28 of the bill would make some language changes in AS 43.55.160(a) to improve clarity. The clarifying changes do not affect the calculation of annual production tax value -- it remains the gross value at the point of production of taxable oil, gas, or oil and gas in a given category, less the producer's adjusted lease expenditures applicable to the oil, gas, or oil and gas respectively, in that category produced by the producer.

Section 28 of the bill also would incorporate the applicable tax credit sunset provision in the affected category described in AS 43.55.160(a)(1)(B) (qualifying oil and gas produced outside Cook Inlet and the North Slope) and conforms AS 43.55.160(a)(1)(E) to the amendment made by sec. 7 of the bill.

Section 29 of the bill would add two proposed new subsections (f) and (g) to AS 43.55.160 allowing for a reduction in the gross value at the point of production of certain oil and gas for the purpose of calculating the annual production tax value.[4] The proposed new subsections were commonly referred to during much of the legislative process as the "gross revenue exclusion" or "GRE," and legislative debate indicates that the GRE is meant to incentivize new oil and gas production.

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[3] The categories are set out in AS 43.55.160(a)(1)(A) - (G) and include, inter alia, North Slope oil and gas (other than certain gas used in the state), Cook Inlet oil produced from each lease or property before 2022, Cook Inlet gas produced from each lease or property before 2022, gas produced outside Cook Inlet before 2022 and used in the state, and oil and gas (other than certain gas used in the state) produced outside Cook Inlet and outside the North Slope during the time that the oil and gas qualifies for a tax credit under AS 43.55.024(a) and (b).

[4] Gross value at the point of production for oil and gas means the value of the oil (or gas) at its point of production without deduction of any costs upstream of that point of production. AS 43.55.900(12)(A) (oil) and (B) (gas).

Under proposed new AS 43.55.160(f), added by sec. 29 of the bill, qualified oil and gas produced on or after January 1, 2014, from a lease or property north of 68 degrees North latitude (the North Slope), not including gas produced before 2022 and used in the state, would be eligible for a 20 percent reduction in the gross value at the point of production. To qualify for the reduction, the oil or gas would also have to be produced from

> (1) . . . a lease or property that does not contain a lease that was within a unit on January 1, 2003;
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> (2) . . . a participating area established after December 31, 2011, that is within a unit formed . . . before January 1, 2003, if the participating area does not contain a reservoir that had previously been in a participating area established before December 31, 2011;[5] [or]
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> (3) . . . acreage that was added to an existing participating area by the Department of Natural Resources [DNR] on or after January 1, 2014, and the producer demonstrates to the department [DOR] that the volume of oil or gas produced is from acreage added to an existing participating area.

In addition to the 20 percent reduction that would be available under AS 43.55.160(f), sec. 29 of the bill also would make available an additional 10 percent reduction in the gross value at the point of production in AS 43.55.160(g). To qualify for this additional 10 percent reduction, the oil and gas would have to be "produced from a unit made up solely of leases that have a royalty share of more than 12.5 percent in amount or value of the production removed or sold from the lease as determined under AS 38.05.180(f)." The additional 10 percent reduction does not apply if the royalty obligation for one or more of the leases has been reduced to 12.5 percent or less under AS 38.05.180(j) for any part of the calendar year for which the production tax is calculated.

Section 29 of the bill would potentially raise two questions relating to the 10 percent gross revenue exclusion. The first is whether subsection (g) would apply only to units comprised of state oil and gas leases and gas only leases or whether it could include units with federal or private leases with a greater than 12.5 percent royalty. Because of the explicit reference to AS 38.05.180(f), which provides the commissioner of natural resources with authority to issue oil and gas leases on state land and reserve royalty shares for the state, we conclude that the provision applies to state leases only.

The second question raised is whether subsection (g) would apply only to production from qualifying leases or properties located north of 68 degrees North latitude. Subsection (g) lacks the explicit limiting language of subsection (f) to that effect, but subsection (g) would provide that the 10 percent reduction is "in addition to the reduction under (f) of this section." Since the reduction under subsection (f) is limited to oil and gas produced from North Slope leases or properties, the additional 10 percent gross revenue exclusion under subsection (g) would apply

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[5] The Department of Natural Resources approves applications for establishment or expansion of a participating area. AS 38.05.180; 11 AAC 83.351.

only to oil and gas from North Slope leases or properties. Statements from the Senate floor debate strongly support this interpretation.[6]

C. Production Tax Credits

The bill would amend production tax credits, including credits based on qualified capital expenditures, a carried-forward annual loss credit, and the alternative tax credit for oil and gas exploration. The bill also would establish two new non-transferable tax credits based on oil produced from leases or properties on the North Slope. Last, the bill would amend provisions relating to transferable tax credit certificates.

Qualified capital expenditure credit. Section 14 of the bill would amend the 20 percent qualified capital expenditure credit in AS 43.55.023(a). The bill would limit the credit to qualified capital expenditures incurred before January 1, 2014, for exploration, development, or production of oil and gas deposits north of 68 degrees North latitude. But the bill would allow continuation of the 20 percent credit for qualified capital expenditures incurred before and after January 1, 2014, for exploration, development, or production of oil and gas deposits south of 68 degrees North latitude.

Carried-forward annual loss credit. Section 15 of the bill would amend AS 43.55.023(b), the 25 percent carried-forward annual loss credit for lease expenditures incurred to explore for, develop, or produce oil and gas deposits in the state. A loss under this provision is the amount of a producer's or explorer's adjusted lease expenditures that were not deductible in calculating production tax values for the calendar year. Essentially, if a company's costs exceed the value of its oil and gas production, the difference will be its loss for the year. The current 25 percent credit would remain in place for expenditures incurred north of 68 degrees North latitude and anywhere in the state through December 31, 2013. But on or after January 1, 2014, and before January 1, 2016, the credit would increase to 45 percent of a carried-forward annual loss for expenditures incurred to explore for, develop, or produce oil and gas deposits north of 68 degrees North latitude. On or after January 1, 2016, the credit would decrease to 35 percent of a carried-forward annual loss for expenditures incurred north of 68 degrees North latitude. The loss credit for lease expenditures incurred to explore for, develop, or produce oil and gas deposits south of 68 degrees North latitude does not change -- it remains 25 percent of a carried-forward annual loss.

Per barrel credits. Section 21 of the bill would create two alternative, non-transferable tax credits in proposed new AS 43.55.024(i) and (j) applicable to each taxable barrel of oil produced during a calendar year north of 68 degrees North latitude after December 31, 2013. Subsection (i) would provide a flat $5 credit for each barrel of oil that qualifies for a gross value reduction under AS 43.55.160(f) or (g), which are new subsections added by sec. 29 of the bill discussed above (and commonly referred to as the gross revenue exclusion or GRE). A tax credit under subsection (i) may not reduce a producer's AS 43.55.011(e) tax liability below zero.

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[6] Senate Floor Session, April 14, 2013, at 1:00 p.m., available at http://www.360north.org/gavel-archives/?event_id=2147483647_2013041271.

Subsection (j) would provide a variable credit applicable against a producer's tax liability for a calendar year under AS 43.55.011(e) based on the gross value at the point of production of each barrel of taxable oil produced during a month north of 68 degrees North latitude after December 31, 2013, that does not meet any of the criteria of AS 43.55.160(f) or (g) (i.e., production that is not eligible for a GRE). The credit would vary on a sliding scale based on $10 increments of the gross value at the point of production and would range from $8 a barrel for a monthly average gross value at the point of production of less than $80 a barrel to $0 a barrel when the average gross value at the point of production is equal to or greater than $150 a barrel. At a gross value between $100 and $110 per barrel, the credit would be $5 per barrel. A credit under subsection (j) may not be applied to reduce a producer's AS 43.55.011(e) tax liability below the minimum tax for oil and gas produced north of 68 degrees North latitude as set out in AS 43.55.011(f).

Alternative tax credit for oil and gas exploration. The alternative exploration tax credit under AS 43.55.025 provides credits in connection with certain oil and gas exploration wells and seismic exploration. Credits are currently limited to expenditures incurred for work performed before July 1, 2016. Section 23 of the bill would extend the sunset date to January 1, 2022, but only for exploration wells drilled and seismic exploration conducted outside the Cook Inlet sedimentary basin and south of 68 degrees North latitude and qualifying under AS 43.55.025(a)(1), (2), (3), or (4). This extension would not apply to the basin credits for exploration wells (AS 43.55.025(m)), the basin credits for seismic exploration (AS 43.55.025(n)), or the Cook Inlet jack-up rig credit (AS 43.55.025(*l*)).[7]

Furthermore, secs. 22 and 24 of the bill would amend AS 43.55.025(a) and (m) to remove the "3-mile well limit" as a condition of qualifying for an exploration well basin credit. Under the amendment, the bottom hole of an exploration well that may qualify for a basin well credit would not have to be more than three miles away from the bottom hole of a preexisting oil or gas well in order for the incurred expenditures to qualify for credit.

Timing of certain credits. Under current law, not more than half of a qualified capital expenditure tax credit under AS 43.55.023(a) may be used against any one year's production tax liability. Similarly, under current law, a producer or explorer qualifying for a transferable tax credit certificate for a 20 percent qualified capital expenditure credit or a 25 percent carried-forward annual loss credit based on expenditures incurred north of 68 degrees North latitude is issued two transferable tax credit certificates, each for 50 percent of the total credit, and only one of the certificates may be used during the first year. The bill would eliminate these timing restrictions so that 100 percent of affected tax credits and tax credit certificates based on expenditures incurred on and after January 1, 2013, would be available for immediate use. See bill secs. 14, 16, 17, 18, 25, 26, and 32.

Last, on January 1, 2014, the bill would repeal AS 43.55.023(i), the transitional investment expenditure credit (TIE credit) and related provisions for certain expenditures incurred after March 31, 2001, and before April 1, 2006, since the TIE credit may not be taken for any calendar year after 2013. See bill secs. 19 and 33.

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[7] "Basin credits" are credits limited to expenditures incurred for exploration conducted in specific geological basins identified in AS 43.55.025(o).

D. Miscellaneous Production Tax Provisions

Section 7 of the bill would amend AS 43.55.011(o), which sets a tax ceiling for gas produced outside Cook Inlet before 2022 and used in the state, to clarify that this ceiling would not apply to gas that qualifies for a different tax ceiling under AS 43.55.011(p). Section 8 of the bill would extend, from 2022 to 2027, the tax ceiling in AS 43.55.011(p). Section 9 of the bill would make a clarifying amendment relating to the calculation of monthly installment payments for oil and gas subject to AS 43.55.011(p).

II. INTEREST RATE ON DELINQUENT TAXES

Under Alaska law, taxpayers are required to pay interest on delinquent (overdue) tax liabilities. Delinquent tax liabilities can arise for several reasons, including a taxpayer's failing to pay a tax by the statutory due date, filing an amended return showing additional tax due, or receiving an assessment for additional tax after an audit.

Section 2 of the bill would amend AS 43.05.225, changing the interest rates applicable to delinquent taxes under AS 43.[8] Currently, delinquent taxes bear interest in a calendar quarter at the rate of five percentage points above the annual rate charged member banks for advances by the 12th Federal Reserve District, or at the annual rate of 11 percent, whichever is greater, compounded quarterly as of the last day of the quarter. Under AS 43.05.225(1)(A), as amended by sec. 2 of the bill, the interest rate would remain through December 31, 2013. Under AS 43.05.225(1)(B), on or after January 1, 2014, a delinquent tax would bear a lower interest rate than previously, at the rate of three percentage points above the annual rate charged member banks for advances by the 12th Federal Reserve District. The interest rate for delinquent gaming fees and for unclaimed property not timely paid or delivered remains at 12 percent under AS 43.05.225(2).

Section 2 of the bill is not clear, however, as to whether interest on or after January 1, 2014, is compounded quarterly. The existing statute and AS 43.05.225(1)(A) explicitly provide for quarterly compounding of interest prior to January 1, 2014, but AS 43.05.225(1)(B) does not do so for interest on or after January 1, 2014. Our review of the committee hearing testimony, DOR fiscal notes, and other documents in the legislative record, such as sectional analyses, reveals no indication of any legislative intent to eliminate quarterly compounding after January 1, 2014. Because the omission appears to be unintended and under AS 43.05.225(1)(B), a delinquent tax would still bear interest in "each calendar quarter," the bill would not preclude quarterly compounding. We therefore would recommend that the DOR consider adopting regulations explaining its interpretation and implementation of the new interest rate, but to eliminate any doubt as to compounding, we also recommend legislative clarification when the legislature is next in session.[9]

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[8] Interest due on refunds of overpaid taxes would also effectively change because such interest is calculated "at the rate and in the manner provided in AS 43.05.225(1)." AS 43.05.280(a).

[9] AS 43.05.080 (granting DOR authority to adopt regulations necessary for the enforcement of the tax, license, or excise tax laws it administers); see State v. Cofey, 36 P.3d

Section 30 of the bill would amend AS 43.56.160, the interest and penalty provision for oil and gas exploration, production, and pipeline transportation property taxes. When a property tax levied under AS 43.56.010(a) becomes delinquent, it bears interest at 8 percent per year. Section 30 of the bill would allow this rate to continue through December 31, 2013, but on or after January 1, 2014, the interest on delinquent taxes would be assessed at the rate specified in AS 43.05.225.

III. INCOME TAX CREDIT

Section 3 of the bill would amend AS 43.20 (Alaska Net Income Tax Act) by adding a proposed new section, AS 43.20.049, to establish a tax credit for qualified oil and gas service industry expenditures incurred in the state. A taxpayer would be able to claim a tax credit for 10 percent of qualified oil and gas service industry expenditures incurred in the state, but the credit could not exceed $10,000,000 in a tax year. A taxpayer would be able to carry forward for five years any unused credit or portion of a credit. A taxpayer that claimed expenditure towards this credit would not be able to claim that expenditure as a deduction under AS 43.20, as a credit or deduction under another provision in AS 43, or for any federal credit claimed under AS 43. This credit would be effective for tax years beginning after December 31, 2013.

Additionally, in a year when three or more taxpayers claimed this tax credit, the DOR may publish the aggregated amount of these claimed credits and a description of the expenditures forming the basis of the credits.

IV. OIL AND GAS COMPETITIVENESS REVIEW BOARD

Section 31 of the bill would amend AS 43 to add new sections, AS 43.98.040 - 43.98.070, to establish an 11-member Oil and Gas Competitiveness Review Board (board) in the DOR. The board would include the commissioners of natural resources, revenue, and environmental conservation and the chair of the Alaska Oil and Gas Conservation Commission or their designees. The governor would appoint the other members, who would include two members nominated by the two leading nonprofit oil and gas industry trade associations, two members of the public who do not represent the oil and gas industry, and three members of the public who have specific expertise, including a petroleum engineer, geologist, and financial analyst. The governor would designate every two years a member to serve as the chair and would have the discretion to remove and replace board members.

The board's duties would include considering fiscal policies and levels of investment relating to oil and gas exploration, development, and production in the state and reviewing the state's competitive position to attract and maintain investment in the oil and gas sector in the state. By January 31, 2015, and 2021, the board would make written findings and recommendations to the legislature on issues such as the state's regulatory and permitting environment, the competitiveness of the state's oil and gas tax regime, and the state's ability to attract investment in the oil and gas sector.

733, 737-38 (Alaska App. 2001) (relying on Alaska Supreme Court case law to explain that agencies have authority to resolve ambiguities in statutes).

Section 34 of the bill would provide provisions for the board to sunset on February 28, 2021. And sec. 37 of the bill, an uncodified transition provision, would provide that the governor would appoint the initial members of the board before January 1, 2014.

Other than as noted, the bill presents no constitutional or other legal concerns.

Sincerely,

Michael C. Geraghty
Attorney General

MCG:DEB:pav