THE STATE *of* ALASKA

GOVERNOR BILL WALKER

Department of Revenue

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The Honorable Mark Neuman and the Honorable Steve Thompson
Alaska State Representatives
Co-chairs, House Finance Committee
State Capitol Rooms 505 and 515
Juneau, AK 99801

Dear Co-Chairs Neuman and Thompson:

The purpose of this letter is to provide you with responses to the questions asked of the Department of Revenue during our presentation to the House Finance Committee on January 26, 2016. Please see questions in italics and our responses immediately below the questions.

1. In the last taxable year, how much revenue has been impacted by capital- and operating-expenditure deductions, broken down by GVR and non-GVR fields? How much additional production was created from these deductions?

Preliminary results for capital (capex) and operating (opex) lease expenditures on North Slope operations deducted for production tax purposes in FY15 show that about $3.6 billion in capex was deducted and approximately $3.3 billion in opex was deducted in qualified lease expenditures. Of these amounts, preliminary results show that $3.2 billion of capex was spent on non-GVR fields, and about $400 million was spent on GVR-eligible fields. Of the $3.3 billion in opex that was deducted, about $3.1 billion in opex was spent on non-GVR fields, and $200 million was spent in opex on GVR-eligible fields. Note that these numbers represent only lease expenditures that were able to be deducted in calculating tax liability; total lease expenditures including for companies without a tax liability were somewhat higher.

The deductibility of lease expenditures is an integral part of the State's production tax system and the current 35% tax rate would likely have been set lower by policymakers if these expenditures were not deductible. At current prices below $50 per barrel, the 35% deduction is limited by the 4% gross minimum tax. During FY15, if the $6.9 billion in lease expenditures were not deductible, without taking into account changes in production that may result from a high production tax rate, the production tax would have been about $2.1 billion. This amount includes $3.4 billion in production tax before credits minus about $1.3 billion in credits (primarily, a greater amount of per-taxable-barrel credits could be subtracted). Under this scenario, the effective tax rate after credits would have been about 22% of gross value, or about 74% of net production tax value.

Although it is impossible to track additional production from the lease expenditure deductions, we will reiterate that if lease expenditures were not deductible and the tax was levied on the entire gross value before the deduction of expenditures, it is highly unlikely that the tax rate would be set at 35%. Most production taxes in the U.S. are levied on gross value, rather than the net value as is Alaska's tax, and even the highest tax rates on oil or gas are no more than 15% of gross value. Taxing oil or gas at 35% of gross value would likely discourage exploration for and production of oil in the state.

2. *Explain how slide 37 reconciles with previous charts and tables in the presentation, in particular the capex decline on slide 31.*

Slide 37 of the revenue forecast presentation provides a view of total revenue to the state, with 10 years of history and 10 years of forecast data. Slide 31 of the revenue forecast presentation provides a view of North Slope capital expenditures by oil companies, with one year of history and 9 years of forecast data; this information is shown for the fall 2015 forecast as well as compared to the previous, spring 2015 forecast.

Comparing slides 31 and 37 may benefit from a brief explanation. The Department is expecting capital expenditures to decline over the time horizon of our revenue forecast, as shown in slide 31. Lower levels of capital spending are due in part to the fact that few major fields are expected to be developed in coming years. These declining capital spending estimates roughly correlate to estimates of declining production beginning around FY 2020. Future oil revenues, as shown in slide 37, increase from FY 2016 levels through FY 2019, largely due to higher prices. However, beginning in FY 2020, the Department does forecast petroleum revenues to start declining again, because of expected lower production.

If companies were to identify new fields or production areas to develop, this could increase the forecast for capital expenditures, and could also lead to higher petroleum revenues once those fields come into production.

3. *What would be the impact to General Fund revenue of sending only the constitutionally required 25% of royalties to the Permanent Fund?*

This information can be found on slide 40 of the presentation given to the committee. In FY 2016, the projected impact is $48.4 million for oil royalties and $1.1 million for non-oil royalties. In FY 2017, it is $53.9 million for oil royalties and $1.1 million for non-oil royalties.

4. *Why does the Department of Revenue forecast non-petroleum corporate income tax revenue to fall from $136 million in FY 2015 to $105 million in FY 2016?*

One major driver of corporate income tax revenue is the volatility in payment by taxpayers whose profits are affected by commodity prices (minerals prices). The Department's revenue modeling tries to reflect the influence of lower expected commodity prices. Another factor is the expectation of claims under the oil and gas industry service tax credit, which has not yet been used as of FY 2015.

5. *Why is motor fuel tax revenue listed as $42 million this year when it was $80 million last year?*

Motor fuel tax revenue has been about $40 million per year for the past several years, totaling about $41.8 million in unrestricted revenue in FY 2015. The FY 2016 projection is for an increase to $51.2 million in unrestricted revenue; this increase is mostly due to the addition of a new $0.0095 per gallon surcharge on most refined fuel enacted during the 2015 legislative session.

Several proposals for increases to the motor fuel tax have been discussed and it is possible the higher number cited was based on such a proposal. $80 million represents roughly twice the annual revenue from motor fuel (before implementation of the $0.0095 per gallon surcharge).

6. *Provide a walkthrough of deductible lease expenditures.*

The change in Alaska's oil and gas production tax system from a gross revenue based system to a net revenue based system occurred with the implementation of the Petroleum Profits Tax (PPT) in 2006. A net revenue system generally counts "costs of production" as part of the taxable base. Broadly speaking,

the production tax allows for the deduction of "capital expenditures" which are the one-time costs of exploration, construction, or development of fields and facilities, and "operating expenditures" which are the ongoing cost of producing and maintaining those fields.

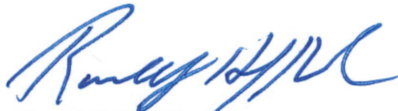
The costs of production under Alaska's production tax system are formally called "lease expenditures." Lease expenditures are defined in AS 43.55.165 as the "direct costs of exploring for, developing, or producing, as applicable, oil or gas deposits" in the state. AS 43.55.165(e) lists several types of costs that are not considered lease expenditures, and are therefore not deductible for the production tax, such as depreciation or depletion costs, lease acquisition costs, and costs for dismantlement or abandonment of an oil or gas facility. Expenditures that qualify as lease expenditures under State law are deductible from the gross value of the oil and/or gas to arrive at the taxable base, known formally as the "production tax value."

One provision of Alaska's production tax that distinguishes it from most other net income type tax systems is that all allowable capital expenditures can be deducted in calculating a tax liability in the year earned. Most other net income type taxes, including Alaska's corporate income tax, require capital expenditures to be depreciated over a number of years.

A history of lease expenditures from FY08 through FY15 and a forecast through FY25 are presented on pages 109-110 of the Fall 2015 Revenue Sources Book.

I hope you find this information to be useful. Please do not hesitate to contact me if you have further questions.

Sincerely,



Randall Hoffbeck
Commissioner