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Alaska's Vote to Keep Oil Exploration Incentives May Stabilize Production Trends, a Credit Positive

From U.S. Public Finance Weekly Credit Outlook

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On August 28, results showed Alaska's (Aaa stable) ballot initiative to overturn new oil production tax incentives failed by a narrow margin. The outcome is credit positive for Alaska, which in January implemented a new oil production tax law to encourage exploration for new oil fields and halt declines in North Slope oil extraction, which for many years has generated most of the state's operating revenue.

By a margin of 52% to 48%, voters in an August 19 election defeated a measure that would have repealed the new tax law, known as the More Alaska Production Act (MAPA), and reinstated a prior law called Alaska's Clear and Equitable Share (ACES). The state's tally remains uncertified, but ballots remaining uncounted were fewer than the margin against the measure. MAPA ends the escalating tax rates on higher oil values included in ACES, and it exempts 20% of the value of new sources on the North Slope (the state's oil-rich, northernmost region). While producers have no legal commitment to increase Alaskan production, they have indicated a desire to do so under MAPA's more favorable provisions. Federal research has shown ample reserves beyond current fields. By the end of December, the state will publish its first revenue forecast that factors in new production associated with MAPA.

Alaska's oil production peaked at more than 2 million barrels per day in 1988. However, it has declined about 5% annually since then as oil fields on the North Slope have been exhausted (see Exhibit 1). Under both the new oil tax system and its predecessor, both the amount of oil extracted and its market value are key determinants of state tax revenue. Even as its output steadily declined, Alaska's oil fields generated strong revenues in recent years, such as in fiscal 2008, when oil reached a record $147 per barrel and production tax receipts tripled to $6.8 billion..

EXHIBIT 1

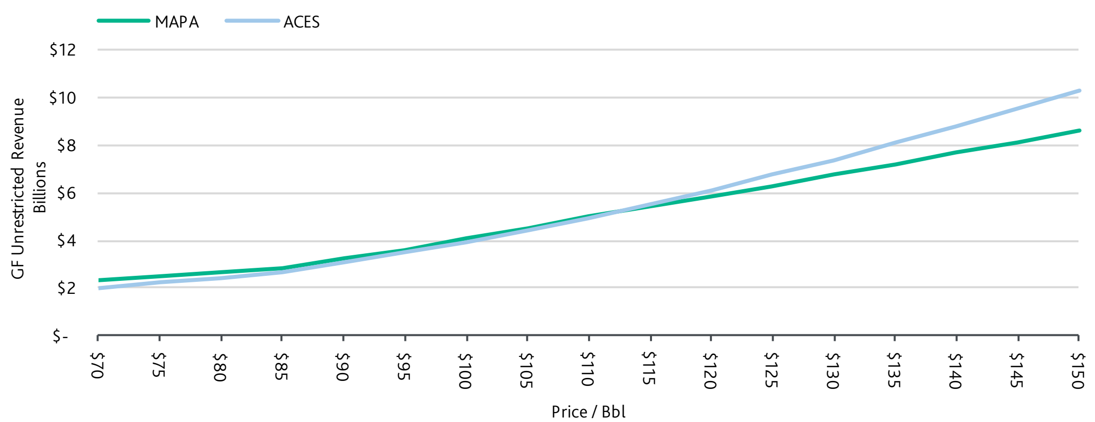
Alaska's Oil Production Has Steadily Declined for More Than Two Decades

Source: Both actual and estimated numbers provided by Alaska Department of Revenue

Pointing to such windfalls in high-price years, proponents of the measure to repeal MAPA had argued that returning to ACES would bring the state more cash. However, state forecasts indicate that while ACES will outperform in general when prices are high, the state expects MAPA to generate a steadier revenue stream overall and to produce better or comparable results until oil prices exceed $110 per barrel (see Exhibit 2).

EXHIBIT 2

MAPA Revenue Is Comparable Until Oil Price Exceeds $110 per Barrel



Source: Alaska Department of Revenue; projection using assumptions for fiscal 2015

Moreover, the trend of declining production could soon reach a crucial point. If the 7.8% production decline seen in 2013 persists or intensifies, the state's oil output could fall below 300,000 barrels a day as soon as 2021. Production that weak could trigger mechanical challenges for the Trans-Alaska Pipeline System (TAPS), an 800-mile pipe that since 1977 has brought oil to the Port of Valdez in south-central Alaska from the North Slope. TAPS, which clogs up as the temperature and pressure created by the flow of oil lessen, may have to be equipped with heaters or otherwise be improved to remain functional at such reduced volumes.

Because of its oil revenues, Alaska has not imposed a tax on personal income since 1980, and it has no broad-based sales tax. Oil production taxes, royalties and other collections will account for 87% of the state's unrestricted general fund revenue in the current fiscal year, according to the state's most recent forecast. Given Alaska's reliance on oil, declining output poses a risk to the state's budget. The current revenue forecast, which does not factor in increased production as a result of the new tax, indicates that the state may need to rely on reserve fund expenditures in coming years to offset revenue shortfalls caused largely by declining oil production.

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Report Number: 174901

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