# SPONSOR STATEMENT

## SB 321: The Alaska Fair Share Bill

## A Rational Approach To Fixing Alaska's Oil Tax Laws

Under Alaska's Constitution, oil belongs to all citizens in common. It is incumbent upon government to make sure that Alaskans receive a fair share for this public resource and that a fair share is provided to those companies who have contracted with us to develop and sell it.

SB 321, the Alaska Fair Share bill, fixes two flaws with Alaska's current oil taxation system. One flaw comes from the way Alaska's Economic Limit Factor (ELF) is written. Under the ELF, the production or "severance" tax rate on oil companies has fallen for over a decade, and it will continue to fall. That is because under the ELF most new fields are effectively exempted from Alaska's 15% severance tax.

A second flaw is that oil companies have arguably reaped an unfair share of the state's oil wealth at average and high oil prices. The windfall at high prices has not been shared evenly. At successively higher prices the imbalance between corporate profits and state oil revenue grows greater. The Department of Revenue estimates that at $30/barrel, oil companies receive $1.2 billion more in profits than the state receives in total oil revenue.

This portion of the tax structure has not been reviewed in 15 years. People from across the political spectrum, from Governors Jay Hammond and Wally Hickel, to Former Deputy Commissioner of Revenue Deborah Vogt, to Ray Metcalfe, Clem Tillion, and Rick Halford have called for a review of the current tax structure. SB 321 does that. It raises roughly $110 million at average oil prices, and $400 million at prices of $30/barrel.

### Summary of Proposal

1. **SB 321 Establishes a Minimum 5% Severance Tax**.

   Eleven of the 14 fields that have come on line since 1989 pay none, or almost none, of the state's 15% severance tax. This proposal establishes a minimum severance tax at 5%.

   Under current law, and without such a change, the average severance tax has fallen from 13.5% in 1993 to 7.5% today, and it will fall below 5% by 2013. If we do nothing, the fiscal gap will continue to grow as severance tax revenue continues to fall.

2. **SB 321 Adjusts Severance Tax Amount Upwards above $20/barrel and Downwards below $16/barrel**.

   This provision will allow the state's share at average and high prices to rise and fall as oil prices rise and fall. Under this proposal, the state would recover about $500 million more than it does today at $32/barrel.

   **The Formula**: Above $20/barrel, the proposal would multiply the severance tax by this formula: *The Price Per Barrel / 20*. Thus, nothing would change at $20/barrel because the severance tax would be multiplied by 20/20, or by 1. But at $30/barrel, the severance tax would be multiplied by 30/20, or 1.5. Thus, at $30, a field with a 10% severance tax would pay an adjusted 15% severance tax (1.5 X 10%). This would still allow oil company income to increase significantly at higher prices. This price factor will never increase the severance tax to more than 25%, thereby also protecting the interest of oil companies in high profits at high prices.

Below $16/barrel, the severance tax **is reduced** by multiplying it by this formula: *The Price/16.* Thus, for example, at $12/barrel, the severance tax would be multiplied by 12/16, or .75, thereby waiving 25% of the production tax.

**3. SB 321 Allows for Deferral of Severance Taxes below $10/barrel**

Below $10/barrel, half the severance tax would be waived and the other could be deferred. Severance tax payments could be deferred at this price until prices exceeded $16/barrel.

**4. SB 321 Includes Inflation Adjustments**

These price factors will be adjusted for inflation. Thus, for example, as inflation occurs the formula will use a higher price before the high price factor kicks in to multiple the severance tax. Since oil company costs increase over time, the high price multiplier arguably shouldn’t kick in until high prices.

**5. SB 321 Exempts Heavy Oil from Enhanced Taxes**

The Fair Share proposal exempts “heavy oil” from any of the enhanced taxes to encourage development of that resource. Heavy oil production entails a more expensive and intensive extraction process.

## Analysis Of Impacts and Current Shortfalls

Alaska raises oil revenue under four different provisions. In order of magnitude, we raise revenue from oil under our royalty laws, our severance tax, our corporate profits tax, and our property tax. In 2003 the revenue raised under the first three provisions was greatly increased because of the high price of oil, which averaged about $28/barrel. The state received:

- $830 million in royalties;
- $599 million in severance taxes;
- $150 million in corporate taxes; and,
- <u>$50 million in property taxes</u>.

Total: $1.64 billion.

*Figures provided by Department of Revenue*

The proposal in SB 321 grants the state a more equitable share of oil revenue:

- an additional $110 million at a $22/barrel average price;
- an additional $400 million at $30/barrel; and,
- an additional $500 million at $32/barrel.

According to the Department of Revenue, at $30/barrel the oil industry receives 60%, or $1.2 billion, more in corporate profits than the state receives in revenue. The imbalance is greater if corporate profits are just considered as the amount the companies earn minus their current costs.[1]

At the projected average price of $22/barrel, the industry takes roughly 13%, or $210 million, more than the state. At high January 2004 prices of $34/barrel, an equal share between the state and industry would bring in more than $600 million in revenue. The higher the price, the more the imbalance grows. This is shown in the following table:

| Price | Company % | Company Profits | State % | State Revenue |
|---|---|---|---|---|
| $30/brl | 61% | $3.242 billion | 39% | $2.081 billion |
| $22/brl | 54% | $1.735 billion | 46% | $1.523 billion |

## The Current Economic Limit Factor (ELF)

Because of the way the ELF works, state oil revenue is projected to fall steadily over the next decade, assuming an average price of $22/barrel, even assuming stable levels of production. The most recent Department of Revenue forecast is for a slight decline in production over the next decade, which will contribute to an even greater decline in severance tax revenue. Of the 14 fields that have come on line since 1989, 11 of them pay a severance tax of either 0% or less than 1%.

The ELF was enacted in part because Prudhoe Bay was declining in production by the late 1980s. Proponents argued economies of scale justified a lower tax rate for older, declining fields and for smaller fields as well. The ELF, which ranges from 0 to 1.0 determines how much of the state's 15% severance tax a field operator must pay.

To determine the severance tax for a particular field, one multiples the severance tax rate (15%) by the ELF. Thus, a field with an ELF of "0" pays a severance tax of 0 x 15%, or 0%. A field with a .5 ELF pays a severance tax of .5 x 15%, or 7.5%. A field with a 1.0 Elf pays a severance tax of 1.0 x 15%, or 15%.

A field's ELF is based upon its size and productivity. As production at Prudhoe Bay declines, its ELF there has fallen to roughly .9, so that it pays a roughly 13.5% severance tax. No field has a 1.0 ELF anymore.

The addition of smaller fields with ELFs that give them near or complete exemptions from the state's severance tax, combined with lower production at high-ELF fields like Prudhoe Bay, are the major reasons state oil revenue is projected to continue to decline in future years.

In 2003, higher oil prices ($28.15/barrel) resulted in $599 million in severance tax revenue. Assuming the Department of Revenue's projection of $22/barrel prices starting in 2006, the falling average ELF will cause severance tax revenue to fall by over 80%. The department estimates severance tax income will fall as follows:

[1] The "profits" definition the Department of Revenue has used deducts a certain amount of revenue to cover past sunk facility costs, and future capital costs.

| Year | Estimated Price | Avg. ELF | Avg. Severance Tax % | Est. Severance Tax |
|---|---|---|---|---|
| 2003 | $28.15 (actual) | .50 (actual) | 7.5% | $599 million (actual) |
| 2006 | $22 | .47 | 7.05% | $341 million |
| 2009 | $22 | .40 | 6.0% | $287 million |
| 2013 | $22 | .27 | 4.05% | $180 million |

It is estimated that production will fall by roughly 7% from now through 2013. Today North Slope production is roughly 1 million barrels/day. By 2013 it is projected to fall to roughly 930,000,000/day. That is a lesser, though important component of the projected decline in revenue.

## The Metcalfe, Fineberg, and "Shelf the ELF" Proposals

There are many who feel Alaska's small fields are profitable enough to pay some severance tax. Many small fields have economized by "sharing" processing facilities at larger fields. In addition, many have called for changes in the law that would allow the state to share more equally at high oil prices.

It should be noted that this would not raise as much revenue as more aggressive proposals some have made, and that are worthy of consideration and analysis. Those include:

1. "shelf the ELF" proposals like that by Rep. Masek in 2003, which would have imposed a flat 15% severance tax on all fields and eliminated the ELF;

2. lease bid and taxation changes proposed by former Rep. Ray Metcalfe, which he believes would fully close the fiscal gap; and,

3. a windfall profits tax proposed by oil industry analyst Richard Fineberg.

SB 321, the Alaska Fair Share bill, will probably not raise as much additional revenue as these other proposals. It aims, however, to provide companies with adequate incentives to continue with significant exploration efforts into the future.

## Conclusion

At a time of budget shortfalls, it is important to make sure the state does not grant large tax exemptions to those who don't need them. SB 321, the Alaska Fair Share bill, seeks a balance between fairness to the state and to those companies that are willing to explore and produce in Alaska. SB 321 makes the law progressive by modestly increasing taxes at high prices and granting incentives at low prices.

Please feel free to call if you have any questions.