

Fiscal Policy Note

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Taxing The Gas Reserves: A Risky Policy

By Scott Goldsmith

On November 7, Alaska voters will decide whether the state government should start taxing the natural gas reserves in the two largest North Slope gas fields. The idea behind the proposal is to jump-start construction of a gas pipeline.

The North Slope has one of the largest accumulations of natural gas in the U.S., and Alaskans have been waiting a long time for a pipeline to carry that gas to market. Recent higher gas prices have made the project more attractive.

Several oil companies hold leases on the gas. They've taken steps toward a pipeline—like negotiating fiscal terms with the state—but they haven't committed to building one. Supporters of the reserves tax think they're delaying the project (for various possible reasons) and should be pushed.

The ballot proposal calls for the oil companies to pay a reserves tax—a tax on gas in the ground—until a pipeline is completed and North Slope gas is up for sale. It offers incentives for them to speed up the project: the sooner the pipeline is finished, the less they pay; and later they would recover some of what they did pay, in credits on gas production taxes.

They could also decide not to pay and give up the leases—which the state would then re-bid, hoping to find other companies willing to push the project.

Alaskans are sharply divided about how the proposal would affect pipeline timing as well as oil and gas activity.

- Supporters say the tax would speed up gas development and increase state revenues, without adding to pipeline costs or risking oil and gas activity.
- Opponents say the tax would slow or even stop gas development, reduce state revenues, and make the industry less likely to look for new oil and gas.

What would happen? That's impossible to say. There's a lot of uncertainty about how the industry would respond, how the language in the proposal may be interpreted, potential legal issues, and more.

Given the uncertainty, we think it's useful for voters to consider whether the gains supporters predict are likely, and whether they justify the risks opponents predict.

Our analysis suggests the initiative would create only a small incentive for speeding up a pipeline project—and at the same time increase pipeline costs and discourage new investment on the North Slope. Re-bidding the leases wouldn't guarantee the state new leaseholders eager to move ahead. All that would be bad for Alaska, which depends heavily on income from petroleum development. But continuing development requires new investment.

There are other ways to encourage development—like the state's new Petroleum Production Tax, which offers investment credits and links taxes to profits. But keep in mind that while the state can encourage development, it can't force a decision to build a pipeline. In the end, businesses will decide when to put up the money and build a pipeline.

- **How much the state would collect from a reserves tax depends on how much the leaseholders could reduce their tax liability** through write-offs on other petroleum taxes. The reserves tax could amount to \$800 million a year until gas sales started—or it might be only half that much.
- **How much of a cost burden the initiative would ultimately put on the leaseholders depends on the size of later tax credits and other uncertainties.** It could be anywhere from \$1 billion to \$4 billion or more—adding to North Slope operation costs and to uncertainties about future planning.
- **The financial incentive to build the pipeline sooner would be small, compared with the cost burden.** Estimating the relative size of the incentive and the cost is difficult, given all the unknowns—but the incentive would most likely be pennies for every dollar of costs.
- **Most analysts think the initiative would make the pipeline more expensive, less profitable, and less likely to be built.** But some say it would become less expensive, because oil profits would pay the reserves tax.
- **The state has no guarantee of finding new leaseholders more in tune with the state's interests,** if the current leaseholders decided to turn back the leases rather than pay the reserves tax.
- **Investment to find more oil and gas at Prudhoe Bay and Point Thomson would tend to dry up,** because of the risk that any new gas would be taxed. Oil and gas are intermingled in the fields, and some people argue there isn't much of either left to be found. But the state is counting on new oil finds at Prudhoe Bay to help stem the decline in production over the next decade.
- **The initiative is likely to have unintended consequences,** because there has been little analysis of its potential legal, commercial, and other effects.

A LITTLE HISTORY

The North Slope gas reserves that would be taxed lie under land the state owns, but it has leased the oil and gas rights to oil companies. Oil and gas are intermingled in North Slope fields, and oil has been produced since 1977, when the trans-Alaska oil pipeline was completed.

There was also considerable activity toward authorizing and building a gas pipeline in the 1970s. But then domestic gas prices fell, making it uneconomic to get North Slope gas to market. The price dropped as the supply increased, after the federal government deregulated the wellhead price of gas.

Gas prices remained low for many years, but the oil companies made use of the gas to increase production of the higher-value oil. As the gas was produced it was reinjected into the reservoir, adding pressure and allowing more oil to come to the surface.

This use of gas has helped increase the estimate of recoverable oil from the Prudhoe Bay field—from the original 9 billion barrels to 13.8 billion barrels, according to the Alaska Department of Natural Resources.

PIPELINE TIMING

In recent years the price of gas has increased, renewing interest in getting North Slope gas to market. Some analysts think there is a window of opportunity for an Alaska gasline—a window that may close if the project is delayed.

They believe competing projects to import liquified natural gas (LNG) into the domestic market or to build coal-fired electric power plants could reduce demand for natural gas, if a pipeline project doesn't move forward quickly.

The state government estimates that Alaska gas could be on the market by 2016, taking into account planning and construction time.

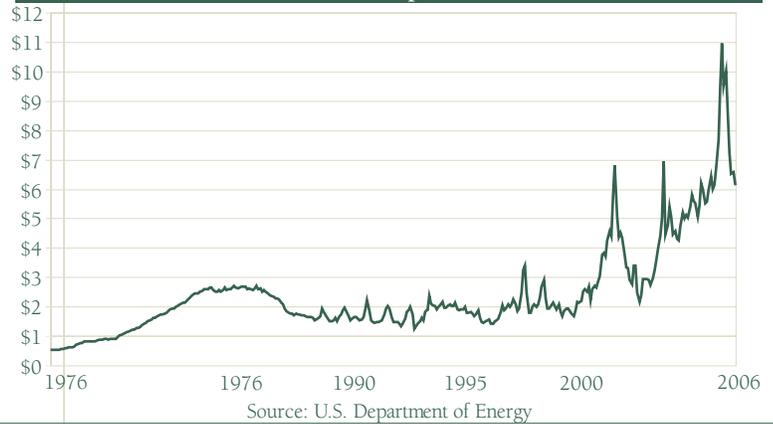
No pipeline will be built until the North Slope leaseholders agree, but they alone don't control pipeline timing. Any project will also require agreement by the financial community, the state, numerous federal agencies, and (depending on the route) Canadian governments.

THE BALLOT INITIATIVE

Some Alaskans believe the oil companies are warehousing Alaska gas—deliberately holding it off the market—as part of a business strategy. They cite various possible reasons for such a strategy. For instance, the companies are trying to extract tax concessions from the state; or they have reserves elsewhere they want to develop first; or they expect much higher gas prices in the future.

Others disagree. They think that if the project is economically feasible, the oil companies wouldn't be delaying it. They think the companies are moving cautiously because of the complexities, costs, and risks surrounding a project with an estimated price tag of \$20 to \$25 billion.

Natural Gas Wellhead Price, 1976 - May 2006
(In Dollars per MCF)



We of course don't have access to strategic plans of the oil companies, so it's impossible to know if they are or aren't moving as quickly as they can toward a gas pipeline.

But the idea behind the ballot initiative is that if the companies are delaying the project, taxing the reserves until North Slope gas is on the market—and later rebating some of that tax through credits on gas production—would create an incentive for them to speed up the project.

Alternatively, the leaseholders could turn the leases back to the state, which could then re-bid them—in the hope that this re-shuffling of the deck would get new leaseholders more eager to move forward with a pipeline.

OTHER RISKS

Our analysis suggests that the initiative is likely to be a cost burden without speeding up development. It could also have other unintended consequences, not quantifiable in dollars. Here are some of the issues that haven't been adequately discussed so far.

- How will the terms of the initiative be interpreted (there is room for different interpretations), and how would the tax credits be calculated, since the new system for taxing petroleum production doesn't distinguish between oil and gas?
- How would the individual leaseholders respond, since they all have different commercial interests?
- How are court fights over the initiative likely to turn out, and how long might they drag on? Several possible legal and constitutional issues have been suggested but not analyzed.
- How would the initiative affect the business environment? Will businesses see Alaska as a place that sets commercial policy by initiative?
- How would the state budget be affected by the unpredictability of revenues from the initiative?

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