Comments on SB 21/HB 72

Before the Senate and House Resources Committees

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Background

- Testifying on my own behalf
  - Not representing a client or being paid
  - Bearing my own expenses
- My background
  - Corporate executive (1984 – 1990)
  - Attorney
    - Thirty five years total (full time oil)
    - Been a partner in regional, national and global law firms
    - During my career, have advised major oil companies, mid-majors, small independents, industrial consumers
  - Write often on Alaska oil & gas issues (among others, column for *Alaska Business Monthly)*

Five things …

- Competitive rates
- Durability
- Neutrality
- Simplicity/Predictability
- Alignment

- **Goal: Grow the pie**

2/15/13 Five things to look for in oil tax reform … | Thoughts on Alaska Oil & Gas

Thoughts on Alaska Oil & Gas
Brad Keithley's Blog

Five things to look for in oil tax reform …

Posted on November 23, 2012 | 1 Comment |

Politico, a mostly online newspaper that covers national political affairs – and with which I often open my mornings – routinely attempts to provide readers with a guide to significant upcoming events with a list – usually five – of what they consider the most important things to look for as the event unfolds.

As Alaska begins to consider changing its approach to oil taxes in the upcoming session, I have developed a list of five characteristics that I will look for in evaluating various proposals. I share them for whatever value that may have to others.

1. *Competitive Rates*. As a number of other commentators have observed, one of the most important characteristics of ACES that needs to be addressed in order to restore investment is the level of tax – the "tax rate." As former Division of Revenue economist Roger Marks summarizes in a recent piece in the *Oil & Gas Finance Journal*, Alaska's current tax rate under ACES is "fourth highest out of 24 [comparable] regimes." A "comparable regime" means a place "with a comparable risk/reward balance [to Alaska], in terms of features such as reserves, costs, and geological risk."

"For 17 of those regimes Alaska's effective tax rate ranged from 12 to 37 percentage points higher. At a $118/bbl market price, and a $91/bbl net value, each percentage point difference is worth 91 cents/bbl after-tax."

Marks concludes, "because of taxes, … producers can demonstrably make considerably more money nearly anywhere else in the other comparable jurisdictions than in Alaska."

Achieving tax rates *competitive with comparable jurisdictions* is critical if Alaska is to reestablish significant investment. But rates aren't the only characteristic that is important. Read on …

2. *Durability*. While Alaska previously had made occasional adjustments to its tax policy prior to 2007, none came close to the sea change created by ACES. Compared with ACES, the previous changes mostly could be described as tweaks. By some estimates, ACES increased oil taxes by over 400%.

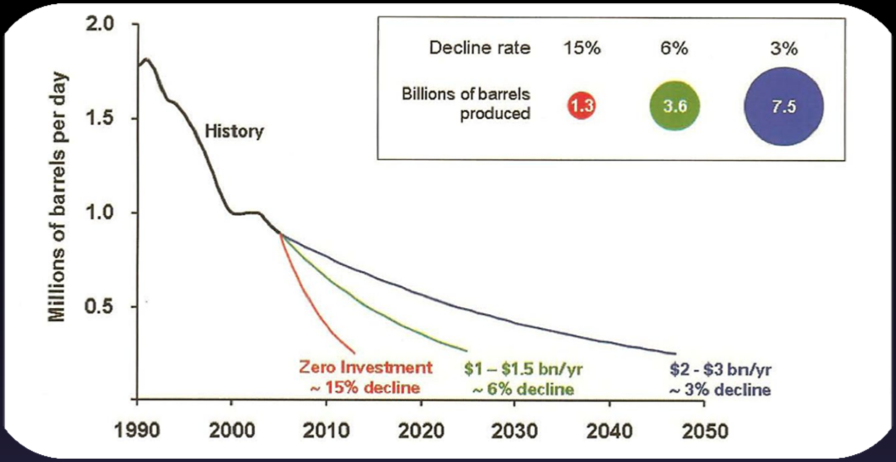
bgkeithley.com/2012/11/23/five-things-to-look-for-in-oil-tax-reform/ 1/5

Goal: Grow the pie

- Art. VIII, Sec. 2

  "[t]he legislature shall provide for the … development… of all natural resources belonging to the State… for the ***maximum benefit of its people****."*

- Not just current, but ***all*** generations
- From my perspective, an important question is what policy achieves the best return overall, not what produces the largest short term revenue stream



Sample calculation (before NPV):*

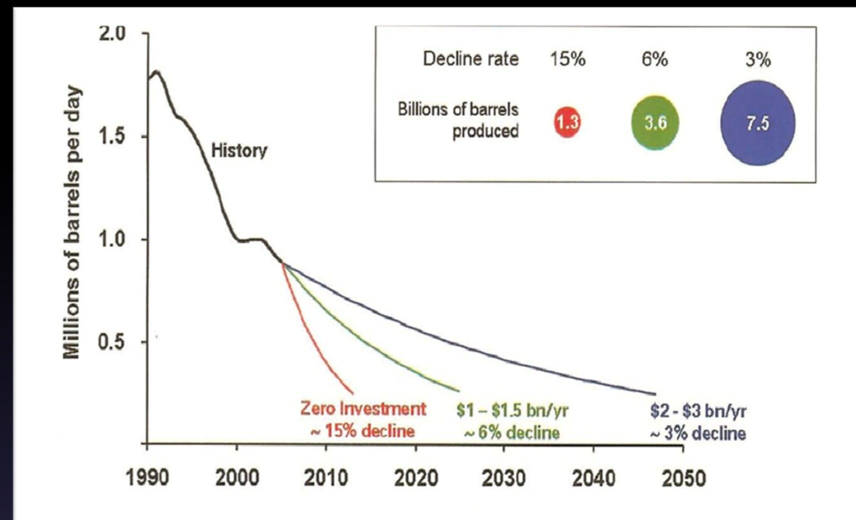
7.5 Bbbl x $29 = $217.5 Billion
3.6 Bbbl x $34 = $122.4 Billion

**Tax levels based on DOR/DNR SRES 2.15.2013 Presentation (p.5-6), includes royalty and production tax.*

Competitive Rates

- What are competitive rates
  - Those necessary to attract *sustained, long term* capital
  - Sufficient to move the decline curve to the right
- DNR Commissioner Sullivan

  "We need $4 billion [a year] minimum, and we're not even close to that now …"



2/16/13 Alaska Journal of Commerce | DNR commissioner: Oil investments must ramp up

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DNR commissioner: Oil investments must ramp up

BY TIM BRADNER, ALASKA JOURNAL OF COMMERCE

The petroleum industry has to ratchet up Alaska investments in new exploration and development to at least $4 billion a year if the decline in oil production is to be reversed, state Commissioner of Natural Resources Dan Sullivan says.

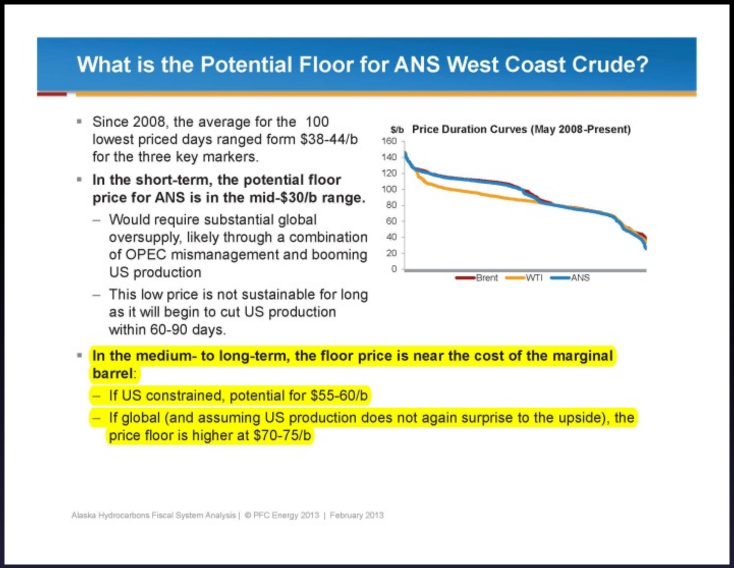
"We need $4 billion minimum, and we're not even close to that now," Sullivan told the Resource Development Council in Anchorage Sept. 15. RDC is natural resource development advocacy group. The number could be higher, too.

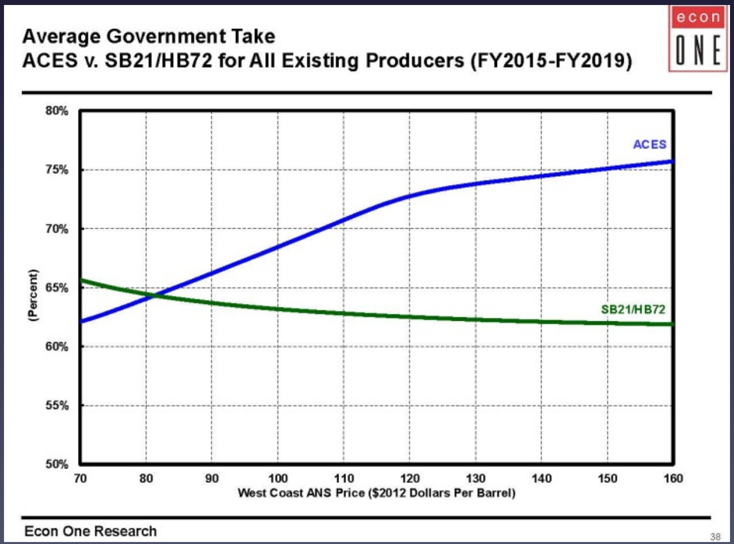
The industry is now spending about $2.5 billion a year in capital investment, according to the state Department of Revenue, but most of that is related to facility upgrades in existing fields and not in new drilling or developments that add new production.

Sullivan said he has read reports that 2012 is a record year for new industry capital investment.

Competitive Rates

- In order to attract sustained, long term capital, ***Alaska must be competitive across the full, anticipated, long term price range, not just a portion***
- The problem with ACES is that it is uncompetitive at the higher ends of the range
- As currently constructed, SB 21/HB 72 may simply reverse the problem





Durability

- What is durability
  - Investors are able to rely on fiscal terms over full investment cycle
  - Substantial, decline rate changing investments contemplate 15 – 25 year payout
- SB 21/HB 72
  - No durability mechanisms included
    - Not established by contract
    - No economic stabilization clause
  - Somewhat internally unstable
    - 20% GRE (ELF experience)

Durability

Canadian approach: Long-term durability depends on producer involvement

"[BC Premier Christy] Clark said Wednesday she will not be able to discuss any of the proposals that are being considered for the new tax regime until after negotiations are complete.

*"**We have to make sure that**, first of all, we are getting maximum benefit for the people of our province, and at the same time that **we aren't imperiling their business case**," she said.*

*"Because **if we want to be competitive, we need to do that through the course of negotiations with (industry), so that's what we're working on right now**."*

Oil and gas producers balk at LNG tax

Association is cool to premier’s plan to rake in revenues from gas exporters

BY PETER O'NEIL, VANCOUVER SUN FEBRUARY 14, 2013

An artist's rendering of the planned Kitimat Apache Canada LNG facility, one of several proposed for northwestern B.C.

OTTAWA — Canada's oil and gas industry disagrees with B.C. Premier Christy Clark's plan to rake in extra revenues from future liquefied natural gas plants.

A spokesman for the Canadian Association of Petroleum Producers said Wednesday the industry doesn't share the Clark government's view that B.C.'s LNG sector, once it's up and running, will have a significant competitive advantage compared to its assumed top competitor, Australia.

Clark's government revealed this week it plans to collect a new tax from LNG exporters to help ensure the province can cash in on the expected boom.

"That resource belongs to British Columbians, and I am determined to make sure that the people of this province share in the benefits of that resource," Clark said Wednesday, when talking about the need for a new tax on LNG.

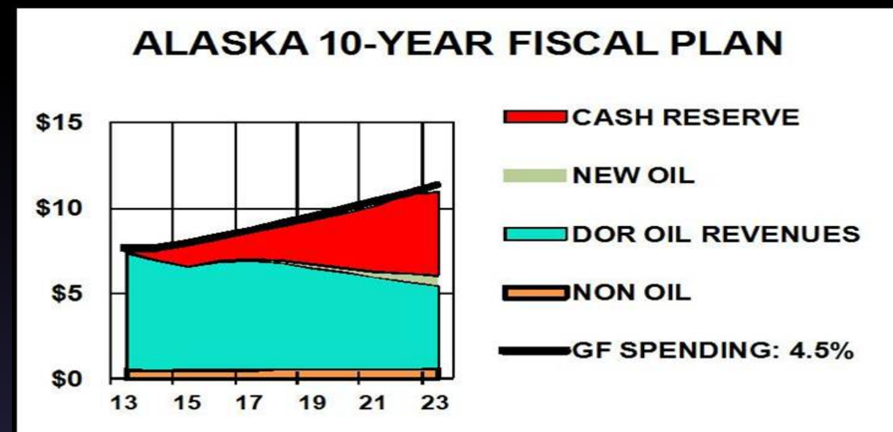
The new tax is expected to play an essential role in building Clark's promised Prosperity Fund, which her government announced in Tuesday's throne speech.

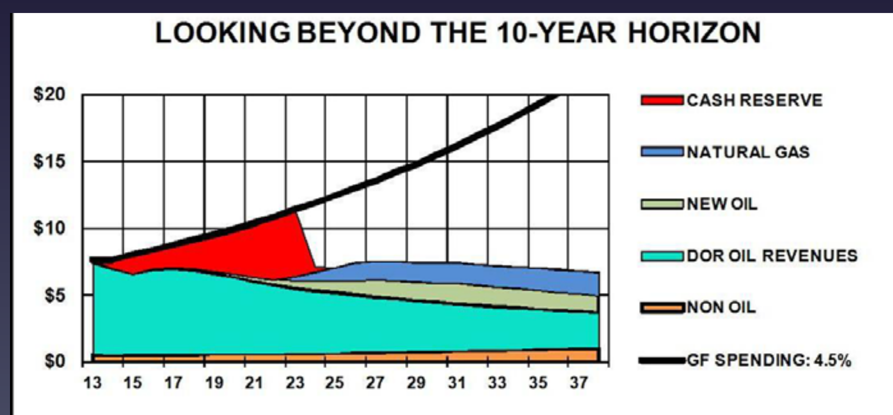
Durability

Durability also depends on overall fiscal policy …

*"In its 10-year fiscal plan, the state Office of Management and Budget (OMB) projects that spending the cash reserves might fill this gap until 2023 …. **But what happens after 2023**?"*

*"Reasonable assumptions about potential new revenue sources suggest we do not have enough cash in reserves to avoid **a severe fiscal crunch soon after 2023, and with that fiscal crisis will come an economic crash**. "*





- **SB21/HB 72 assumption of durability appears to be based on hope, not much more**

Neutrality

- What is neutrality
  - Letting market decide what investments are best
  - Government bias impairs benefitting from changing technology and market dynamics
- Oil market is dynamic
  - New technology provides new access
  - New understanding of old information
  - Opportunities that might seem the best today are overtaken by new technology and understanding
- Providing incentives to some areas burdens others

Neutrality

- Alaska has significant potential in realizing improved recovery rates from existing fields
  - BP: "*When production started at the Prudhoe Bay field the recovery rate of the 25 billion barrels of oil in place was expected to reach 40 percent. Today, using new technologies that estimate has increased to more than 60 percent.*"
  - Each 1% improvement in Prudhoe recovery rate equals an additional 250 MMbbls
- Consistent with focus elsewhere
  - Current emphasis in Norway

Estimated Undiscovered Conventional Oil Resources on Alaska North Slope

econ ONE

	Technically Recoverable Resources P95	Technically Recoverable Resources Mean	Technically Recoverable Resources P5	Economically Recoverable @ $90/bbl	Expected Typical Field Size
	(Million Barrels)				
	(1)	(2)	(3)	(4)	(5)
Central North Slope	2,800	3,400	3,900	3,000	32 - 64
Beaufort Sea	400	8,200	23,200	5,800	-
Chukchi Sea	2,300	15,400	40,100	9,900	-
NPRA	400	900	1,700	500	32 - 64
ANWR	5,900	10,400	15,200	9,900	64 - 128
Total		**38,300**		**29,100**	

Source:
USGS Reports 2011–1103 and 2009-1112;
BOEM, Assessment of undiscovered technically recoverable oil and gas resources of the nation's outer continental shelf.

Econ One Research 6

SB 21/HB 72

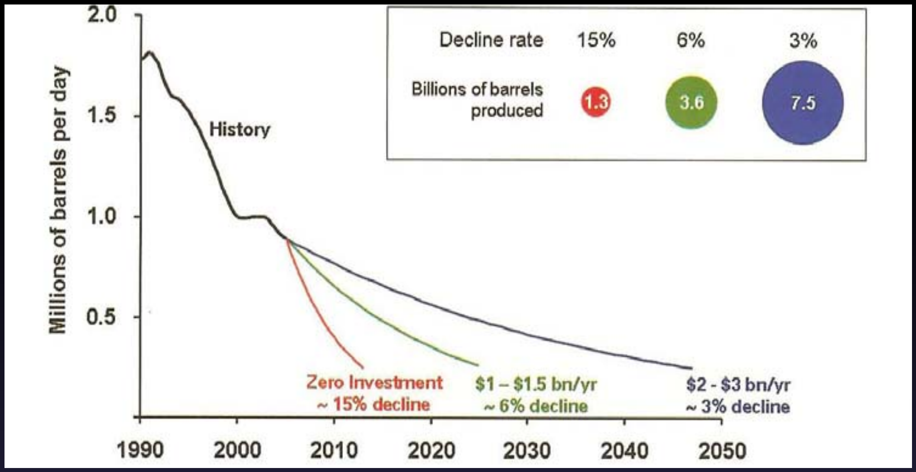
- Better than ACES, but still attempts to direct investments
- Favors investment in new fields (bill does significantly expand what is considered new)
- But burdens investments that are designed to increase ultimate recovery in old fields

Simplicity/Predictability

- What is simplicity
  - Easy to administer; not subject to significant interpretation/dispute
  - Easy to calculate and compare to other investment alternatives across a range of prices
- SB 21/HB 72
  - Structure much more simple than ACES
  - Meets global expectations for simplicity
  - GRE is a simple way to deal with preferred investments (if that is a valid goal)

Alignment

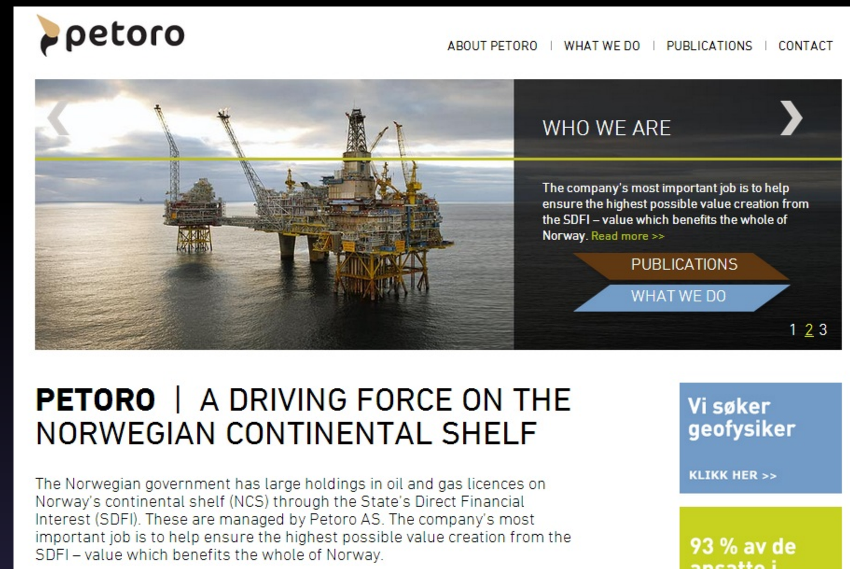
- What is alignment
  - Aligned with investors in growing the pie (moving the decline curve to the right)
- Alaska's approach
  - Relies on indirect policy tools
    - Carrot (fiscal tools)/stick (regulatory action)
    - Relies on consultants for understanding of industry
    - Analogous to driving a car from the back seat
  - Not "in the game," seeing shifts in market dynamics and identifying new opportunities



- SB 21/HB 72
  - Continues the same approach
  - Continues to look at the industry from the outside and use indirect policy tools

Alignment

- Current approach worked in a Prudhoe-dominated world
  - Uncertain it works as well in a dynamic environment dependent on continual investment
- There may be other ways, but the best I have seen in the world is Norway's co-investment approach
  - Results in an intense and collaborative focus on developing state resources
  - Developed when Norway realized "royalty" model was not resulting in optimum investment



"The company's main objective is to ***maximize the economic value of the state's oil and gas portfolio*** *on the basis of sound business principles. …*

… The company's ***ability to create value is closely related to its ability to collaborate with and influence operators and other partners.****"*

Summary of Conclusions

Better than ACES … but material concerns remain,
more likely to result in short term than long term investments

- **Competitive rates**
  - SB21/HB72 not competitive at full range of anticipated prices
  - "Mostly competitive" isn't good enough when evaluating long term investments
- **Durability**
  - No mechanism included to ensure durability
  - State's financial position creates significant concerns around long term durability
- **Neutrality**
  - Significantly reduced tilt, but some bias nevertheless remains against important investment opportunities
- **Simplicity/Predictability**
  - Substantially improved
- **Alignment**
  - Same approach as past policy, but with an uncertain effect in an increasingly dynamic and competitive world

Recommendations

- **Adopt SB 21/HB 72 with amendments:**
  - Make competitive across all anticipated price ranges, not just the higher end (avoid a tax increase at the lower end)
  - Provide GRE or similar incentives for investments designed to increase ultimate recovery in existing fields (enable them to compete on level playing field)
- **As important, identify fiscal policy concerns in forwarding the bill to Senate and House Finance Committees**
  - Changing tax policy without fiscal policy likely will encourage only short term investments
  - There are long term fixes: ISER "sustainable budget" model
- **Hold hearings on co-investment model**
  - Norway also made the shift from "royalty" to "co-investment" model
  - Compare against other ways of developing "forward looking radar" for Alaska
  - Evaluate potential contribution toward Commissioner Sullivan's $4 billion goal