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Oil Company Upstream Capital Spending

This Memorandum is an update to a previous note dated October 3, 2007 on this same matter. Additional data on Capital Expenditures and Acquisitions has been incorporated below and supplemented with further analysis.

BACKGROUND

Like any corporation, oil companies are by definition in business to make a profit. Taxes and other forms of government take govern the amount of profits that a government deems it appropriate for an oil company to make. With all things being equal (which they rarely are), oil companies would preferentially invest in areas with the lowest overall government take (whether achieved through taxation or otherwise); however, this is not the real world calculus.

When prospectivity (the likelihood of making a discovery) and materiality (the expected size of such a discovery) are added to the investment decision criteria, oil companies quite often end up investing in countries with relatively high or above average levels of government take. They do so because they believe (and often realize) that notwithstanding the high government take investments in those countries will generate absolute levels of profit unachievable in countries with lower levels of take. Thus, countries that offer extraordinary potential (like Angola, Russia, Kazakhstan, Libya and Iraq) are able to command a greater share of the total pie while, at the other extreme, areas which have extremely favorable tax regimes (like Ireland and Morocco) still do not attract significant industry interest.

The number of locales in the world that offer the larger oil companies the needed level of materiality to invest are increasingly limited in number. ExxonMobil, BP, Chevron and ConocoPhillips for example, together produce over 12 million barrels of oil equivalent per day – to simply replace their production they need to add to their reserves a Kuparuk size accumulation every 8 to 9 months!

Thus, the investment decisions of oil companies are governed by a number of factors. These include both the unit level of profitability available (a reflection of the overall level of government take), and the size of the investment opportunity.

CAPITAL SPENDING COMPARISON

The oil companies have compared Alaska's fiscal regime mainly to other lower 48 US fiscal regimes; however, such a comparison would only be valid for a small portion of their overall capital spending over the past few decades. Indeed, typically over 70% of the E&P capital spending of companies such as ExxonMobil, BP, Chevron and ConocoPhillips are outside the US.

As the oil companies continue to assert, the fiscal regime in the Gulf of Mexico (GOM) is more favorable than ACES. But given that, why do the companies predominately invest outside the US in countries with fiscal regimes far less contractor friendly than Alaska? Indeed, why not spend all of their capital in the Gulf of Mexico? Reasons include:

- Scale: there are not enough opportunities in the GOM for companies of this scale to increase production, "book barrels" and maintain high reserves replacement ratios; and
- Diversification: best practice portfolio management strategies typically promote investments in various locations, i.e. avoid "putting all the eggs in the same basket".

As a result, a number of the countries that have been the recipients of significant capital spending have fiscal regimes that are seen as less favorable (and in some cases much less favorable) than in the lower 48 US. In fact, countries such as Indonesia, Norway, Angola and Iraq typically have average and marginal tax rates/government takes above those in place in Alaska, regardless of price.

It is thus misleading simply to compare Alaska's terms with those available in the Gulf of Mexico or other US jurisdictions. Given the amount of investment capital being spent by the large oil companies each year, Alaska is presently not competing with the GOM for funds; it is competing with these other, mostly high cost (from a government take perspective) international opportunities.

The following table illustrates the upstream capital spending of ExxonMobil, BP, Chevron, and ConocoPhillips from 2002 through 2009.

	US$ Millions	2009*	2008	2007	2006	2005	2004	2003	2002
Exxon-Mobil	US	3,585	3,334	2,212	2,486	2,142	1,922	2,125	2,357
	International	17,119	16,400	13,512	13,745	12,328	9,793	9,863	8,037
	US Share (%)	17%	17%	14%	15%	15%	16%	18%	23%
	TOTAL	20,704	19,734	15,724	16,231	14,470	11,715	11,988	10,394
BP	US	6,169	10,359	5,096	4,605	3,870	4,096	4,097	4,303
	International	8,727	11,868	9,111	8,513	6,367	7,097	11,273	5,396
	US Share (%)	41%	47%	36%	35%	38%	37%	27%	44%
	TOTAL	14,896	22,227	14,207	13,118	10,237	11,193	15,370	9,699
Chevron	US	3,261	5,516	4,558	4,123	2,450	1,820	1,641	1,888
	International	13,848	11,944	10,980	8,696	5,939	4,501	4,034	4,395
	US Share (%)	19%	32%	29%	32%	29%	29%	29%	30%
	TOTAL	17,109	17,460	15,538	12,819	8,389	6,321	5,675	6,283
Conoco-Phillips	Alaska	832	1,414	666	820	746	645	570	706
	US (Continental)	2,668	3,836	3,122	2,008	891	669	848	499
	International	5,959	11,206	6,147	6,685	5,047	3,935	3,090	2,071
	Alaska Share (%)	9%	9%	7%	9%	11%	12%	13%	22%
	US Share (%)	37%	32%	38%	30%	24%	25%	31%	37%
	TOTAL	9,459	16,456	9,935	9,513	6,684	5,249	4,508	3,276
TOTAL	US	16,515	24,459	15,654	14,042	10,099	9,152	9,281	9,753
	International	45,653	51,418	39,750	37,639	29,681	25,326	28,260	19,899
	US Share (%)	27%	32%	28%	27%	25%	27%	25%	33%
	TOTAL	62,168	75,877	55,404	51,681	39,780	34,478	37,541	29,652

*Source: Company annual reports and press releases. - *2009 figures for ConocoPhillips are budget, not actual. Note: the scope of the activities included under Upstream Capital Spending varies from company to company, with ExxonMobil reporting Capital and Exploration Expenditures, BP reporting Capital Expenditure and Acquisitions, Chevron reporting Capital and Exploratory Expenditures and ConocoPhillips reporting Capital Expenditures and Investment.*

It is very clear from the above data that these companies invest more of their E&P budget outside the US than in the US, with overall only 27% percent of their upstream investment directed to US projects in 2009. Over the period from 2002 to 2009, the share of the US in these companies' total investment has dropped from 33% to 27%. Annual fluctuations in capital spending are often influenced by major acquisitions, such as Chevron's merger with Unocal in 2005 and ConocoPhillips' merger with Burlington Resources in 2006. In 2009, the total upstream capital spending outside the US represented over US$45 billion, while the US share represented over US$16 billion dollars.

Out of these four companies, ExxonMobil is the company which allocates the most significant portion of its budget to international investment, with over 80% of capital spending outside the US in 2009.

BP on the other hand has the highest percentage of its upstream capital spending in the US, representing over 40% in 2008 and 2009. This split is in part the result of BP's investments in US shale gas, such as the acquisition of Chesapeake's interests in the Arkoma Basin Woodford and Fayetteville Shale plays in 2008 for over US$3.6 billion.

Chevron's US upstream investments have dropped from 32% to 19% from 2008 to 2009. Chevron's international focus is expected to remain strong in 2010 as reflected by its international upstream budget of US$13.2 billion out of a total upstream budget of US$17.3 billion, with major projects in Western Australia, GOM, Brazil, Nigeria, Angola, Thailand, China, and Canada.

ConocoPhillips' share of US spending significantly fluctuated since 2002, with a recent increase to 37% of its total upstream budget. The share of Alaska, out of total upstream budget, has dropped from 22% in 2002 to 9% in 2006 and remained below 10% since then.

At the macro level there is no discernable change in investment patterns as Alaska moved from ELF to PPT to ACES. The continued investment by the large companies in high government take countries reflects the fact that, in deciding where to invest, government take is one of the factors considered but is demonstrably not, in and of itself, the controlling or deciding factor. In addition, it would be misleading to only compare the fiscal regime in Alaska with regimes in the lower 48 US, or other low government take regimes, as given strategic, investment community and growth drivers the large companies have and will continue to invest in high government take regimes which offer similar resource development opportunities.

Very truly yours,

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