



Bradford G. Keithley
PHONE: (907) 263-6955
FAX: (907) 263-6455
EMAIL: BKeithley@perkinscoie.com

1029 West Third Avenue, Suite 300
Anchorage, AK 99501-1981
PHONE: 907.279.8561
FAX: 907.276.3108
www.perkinscoie.com

February 7, 2013

The Honorable Senator Cathy Giessel
Chair, Senate Resources Committee
State Capitol, RM 427 465-3875
Juneau, Alaska 99801-1182

Re: Supplemental Materials to February 4, 2013 Hearing

Dear Senator Giessel:

Thank you for the invitation to testify before the Senate Resources Committee on Monday, February 4, 2013, on "Oil Resources: Economic Challenges & Opportunities." The purpose of this letter is to provide supplemental materials which were requested and I offered to provide during the course of the hearing.

The first is the source document for the graph which I included at Slide 23 of my testimony. That graph is from testimony submitted before Senate Resources in 2006 and shows the anticipated North Slope oil decline curve under three investment scenarios. During the course of the testimony Senator Micciche asked for the source of the graph and I promised to provide it.

Attached as Appendix A is a document entitled, "BP Presentation on Proposed PPT, Alaska State Legislature, House & Senate Resources Committees, 28th February 2006." The document is publicly available at http://www.akrepublicans.org/houres/24/pdfs/houres_hb488_12.pdf. The graph included with my testimony appears at page 9 of the testimony. The testimony accompanying the graph is as follows:

The black line on this chart shows the history of North Slope production. The coloured lines look forward to the future.

With no investment the natural decline of the fields would be the lower red line and with in (sic) 10 years the business would be gone.

With the current levels of investment of \$1 – 1.5 billion/year (which assumes the current tax regime), history tells us that decline will be around six percent per year. With that

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trajectory we can expect the business to last around 25 years, but nowhere near long enough to enable gas.

In order to enable gas we must reduce the rate of decline even more. 3% decline would require twice as much capital as is being spent today (\$2 - \$3 bn dollars per year). That is \$20 to \$30 billion dollars over the next decade alone. Alaska must compete to attract these dollars!

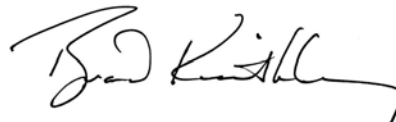
As I said during the hearing, an additional chart going to a similar point was submitted during last year's session. That chart appears at page 9 of the testimony attached as Appendix B. The testimony is publicly available at http://www.legis.state.ak.us/basis/get_documents.asp?session=27&docid=13139.

In addition to these charts, I promised also to submit an additional piece that I had written previously which explained further the points I raised at Slides 27 – 29 of my testimony (“Where do we go from here”). That piece, “Five things to look for in oil tax reform ...,” is attached at Appendix C. It is publicly available at <http://bgkeithley.com/2012/11/23/five-things-to-look-for-in-oil-tax-reform/>.

I have provided a copy of this letter and the attached materials by email to the other members of the Committee and Ms. Long. Because the materials are referred to during the course of the testimony, I would request also, if appropriate, that the materials be included additionally in the online folder appropriate to the hearing.

Please do not hesitate to advise me if further materials or explanation are appropriate. Thank you again for the opportunity to appear before the hearing.

Very truly yours,



Bradford G. Keithley

cc: Senator Dyson, Vice Chair
Senator Micciche
Senator Bishop
Senator McGuire
Senator Fairclough
Senator French
Ms. Sharon Long

BP Presentation on Proposed PPT

Alaska State Legislature
House & Senate Resource Committees
28th February 2006

Introduction – Ken Konrad

My name is Ken Konrad. I am Vice President, Gas for BP Alaska. We are here today to talk to you about the proposed PPT legislation – HB488 / SB305. I will make a few opening comments and then turn things over to Angus Walker and our PPT team.

Agenda



- How we got here
- Current realities of the Alaska North Slope
- Global perspective
- Impact of PPT on BP Alaska

Ken Konrad: Gas Vice President BP Alaska
Angus Walker: Commercial Vice President BP Alaska
Ray Hall: Senior Tax Economist BP Group
Tom Williams: Alaska Tax Counsel BP Alaska

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How we got here

Last week, after more than two years of negotiations, and a lot of hard work on all sides, we reached a very finely balanced agreement with the administration on a predictable and durable Fiscal Contract with Alaska. The Fiscal Contract will establish clear rules governing payments-in-lieu of taxes we would make to the State, including a PPT payment incorporated by reference from this legislation. Once ratified, the Fiscal Contract will enable a gas pipeline to advance in partnership with the State as an equity participant.

Much of what is contained in the PPT legislation was born in part out of the Fiscal Contract negotiations we've been in with the administration. I thought it would be useful to share an overview as to how and why we arrived at this point given that many of the discussions to date have been confidential as stipulated in the SGDA.

Mother Nature - oil and gas are unavoidably linked

Oil and gas form together when plants (and dinosaurs) are buried deep beneath the Earth's surface and, under great heat and pressure, are transformed into oil and gas.

The oil and gas co-exist in the same underground reservoirs, they are produced together through the same wells, flow together through the same flowlines and are processed together in the same facilities. Some fields have more oil than gas and some fields have more gas than oil or condensate. But it is exceedingly rare that one is produced without the other.

Because oil and gas co-exist physically, and are produced together through the same investments made in wells and facilities, they are also linked economically.

This inextricable physical and economic linkage is widely recognized by both governments and investors around the world.

North American royalty contracts cover both oil and gas. Internationally, production sharing contracts include terms for both oil and gas. General oil and gas tax laws across the U.S. and internationally always address both oil and gas.

Governments want to know how much money they will receive from oil and gas production. Similarly, investors need to know how much they will pay governments when oil and gas is produced and sold and make their investment decisions accordingly.

The economic linkage of oil and gas is particularly acute here in Alaska when considering a gas pipeline given the unique operating challenges on the North Slope and the criticality of economies of scale.

Oil Decline - additional oil investment needed to support ANS gas development

We, the producers and the State, currently have a problem. ANS oil production has been declining for over 15 years and *has been on an unsustainable trajectory*. Investment by all of industry has been insufficient to limit decline.

Unless we, and here I mean the entire industry in partnership with the State, are able to maintain economic levels of oil production to support and maintain vital North Slope infrastructure for many decades to come, a gas project can't be successful – it simply cannot be burdened with the cost of uneconomic oil production.

Investors need confidence that the fiscal regime will be sufficiently competitive to attract the enormous amounts of additional capital needed to maintain economic levels of ANS oil production for decades. Providing this confidence benefits both the State and investors against our common enemy – *production decline*.

Building a gas pipeline is effectively a commitment by the major producers to maintain vital North Slope infrastructure for another 40-50 years – This is a daunting challenge.

- Will there be enough investment to stem the long term decline in ANS production?
- Will there be sufficient oil production to keep the unit costs of operating TAPS at an economically viable level?
- Will there be sufficient oil production to cover the operating and maintenance investment costs of operating aging production facilities?

The answer can be yes. We know the oil is up there. Billions of barrels of oil that might otherwise be left behind in producing fields can be accessed. Viscous oil in and around existing infrastructure that was discovered decades ago holds promise. Exploration near existing fields and beyond in areas like NPRA may have potential.

But it is all very difficult. ANS production is declining for a reason – not for lack of oil, but for a lack of profitable ways to extract it. The totality of industry costs and taxes are high. But, we do believe with the right technology and the right fiscal regime, these historically unprofitable investments can be made viable so industry can convert resources into production to sustain ANS infrastructure.

This is why oil taxation policy should *appropriately balance risks and rewards* to enable this additional investment. Even prior to this proposed tax increase, investment has been insufficient to prevent ongoing production decline. The legislature needs to very carefully consider the impacts of a very large tax increase on future investment and long term production.

This is an important decision. And it should not and cannot be a shortsighted decision based on next year's budget or political calculus – this is our collective future.

Are we feeding or starving the golden goose? Will North Slope investment increase or decrease as a result of significantly higher taxes? Will the long term decline in oil production increase or decrease as a result?

What are the knock-on revenue effects on royalty, State Corporate Income Tax, and AVT taxes if investment is impacted? Is a high tax rate at modest prices appropriate?

The evolution of PPT and the Fiscal Contract negotiations

There has been a lot of speculation and innuendo about positions taken by both sides through the negotiation on the PPT. Unfortunately, this appears to be driving perceptions about what the tax rate should be rather than what is right for Alaska and what is right for industry.

I'd like to briefly give you an overview of how the PPT negotiation unfolded to hopefully clear the air and help us focus directly on the real issues at hand.

Since the onset of the fiscal contract negotiations, and indeed years before, BP has sought to make clear the importance of having a competitive and durable fiscal platform for both oil and

gas to underpin a massive gas investment. Including both in the Fiscal Contract is important for two fundamental reasons among others.

First, it provides confidence that the level of taxation will be competitive to enable the additional investments needed to mitigate the ongoing decline in ANS oil production so vital infrastructure can be maintained for another 40-50 years.

Second, it protects us from after the fact tax increases on our business after a gas pipeline has been built and we have no choice but to pay and produce regardless. This is what happened as TAPs entered service some 30 years ago.

In summary, both a competitive and durable oil tax regime are essential and should align well with State goals.

In the summer of 2005, the administration advised us that although they respected the importance to investors of having competitive and durable rules for both oil and gas in the Fiscal Contract, they did not see the ELF regime as properly suited as a long term solution. The concern being the tax base underpinning ELF was declining with time.

The concept of a PPT type structure was proposed by the administration to fix the so called ELF problem. We responded to the administration that if populated with balanced numbers, the PPT could be a viable long term structure with potentially positive attributes for both the State and industry.

In this regard we agreed to move off our preferred position which was to simply utilize the existing ELF based system for the duration of the fiscal contract and consider the PPT structure.

At that time, the mutually agreed goals of both sides for the PPT included:

1. all barrels should be subject to taxation
2. provide the State a balanced and proportionate share of the price / profit upside
3. stimulate additional investment critical to reduce long term production decline

Proposals were discussed intermittently through yearend and it was clear that there was a significant difference of opinion as to what numbers would create a balanced PPT that met these goals.

During that time, the State initially proposed and held to a 20% tax rate. The Sponsor Group had proposed a tax rate of 12.5% which we estimated would have increased State revenues by hundreds of millions of dollars per year at current prices and tens of billions of dollars over the long term relative to ELF. It would also have, we believe, stimulated more investment, more jobs and most critically more long term production.

On Saturday, February 18th, following a long and at times difficult negotiation, we were able to agree and conclude the gas portion of the Fiscal Contract with the State. The following day, we made another PPT proposal for the State to consider in advance of the planned executive meeting, including our Chief Executive, Dr. Tony Hayward.

This proposal made a very substantial move towards the administration's position while providing more support for investors at low to moderate prices where everyone agrees Alaskan investments are extremely challenged.

On Monday morning, February 20th, the Governor outlined to Dr. Hayward and the other executives his 20 / 20 PPT proposal. The proposal we had made to the administration the day before was rejected.

BP has agreed with the Governor that we will not oppose the rates and figures in the proposed PPT legislation before you today. Our Chief Executive and others have made the extremely difficult decision to accept the Governor's terms as a means to finalize a Fiscal Contract. We do believe that this PPT is at the far outer fringe of what should be seen as a reasonable or plausible range of outcomes.

We also need to be very frank with this legislature by saying upfront that we do not believe the 20% rate will maximize investment or in turn maximize long term production. Although the PPT structure has significant merit, and we support it, the overall size of the tax increase outweighs, we believe, the other benefits and goes well beyond optimum.

I hope this context has been helpful. We genuinely hope that this bill can be progressed in a thoughtful and objective manner. Alaska is at a crossroads.

I'll now turn things over to Angus Walker and our PPT team.

Introduction – Angus Walker

I am Angus Walker and I am the Commercial Vice President of BP Alaska.

I would like to start by thanking this Committee for this opportunity to provide testimony on the very important matter of House Bill 488 / Senate Bill 305

We recognise that between PPT and in due course the Gas Fiscal Contract you have decisions to make of great importance for the future of Alaska. We respect the responsibility that the Legislature has to do the right thing for Alaska and hope that we can inform those decisions through our testimony.

I would like to introduce my associates –

Ray Hall: Senior Tax Economist with BP Group in London

An economist by background, Ray has worked with BP since 1988, initially in commercial roles but latterly as a senior adviser on fiscal issues. Ray has held positions in organizations outside of BP including the United Kingdom Offshore Operators Association (UKOOA) and the International Association of Oil & Gas Producers (OGP). His most recent focus areas have been UK, Norway, Egypt and Trinidad.

Tom Williams: Tax Counsel for BP Alaska

It is particularly appropriate to have Tom here. He was Commissioner of Revenue for Governor Hammond and is widely recognised as the creator of ELF.

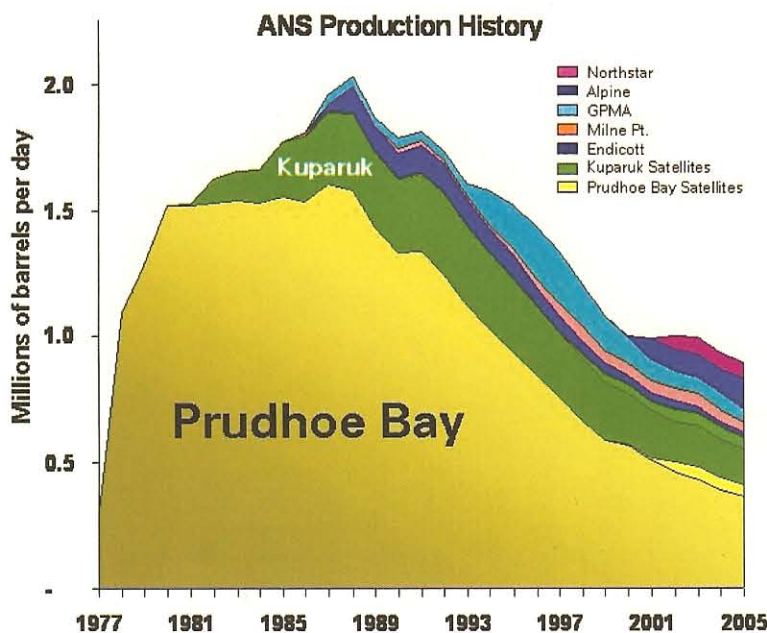
Our testimony will be in three parts, all of which are directly relevant to PPT and the issues before you:

- I will start by describing the current realities of our business and the remaining resources of the North Slope
- Ray will provide a global perspective by comparing fiscal regimes in a selection of the countries in which we do business
- I will conclude by describing the impact of this PPT legislation on BP's business in Alaska

It should be noted that since BP only has leases on the North Slope and in the Beaufort Sea, our remarks will be confined to that business and not other basins like the Cook Inlet in which we do not participate.

Current realities of the Alaska North Slope

Alaska North Slope: The Current Reality



- **Production declining at 6%**

- **ELF has stimulated additional investment through low tax rates**

We're looking at a profile of historical production from 1977 through 2005. The North Slope has produced over 15 billion barrels of oil to date, and while we look back with envy at the days of peak production it is clear that the business today is very different than it was 20 years ago.

To date BP has invested \$24 billion to create the Alaska business we have today. We have paid over \$32 billion of tax to the State of Alaska and \$24 billion of tax to the federal government.

In total we estimate that the North Slope participants have generated \$120 billion in taxes for Alaska & the Federal Government since first production in 1977. In addition, as an industry, we generate more than 34,000 jobs in Alaska every year.

But the harsh reality is that since production peaked in 1988, production has declined at an average 6%.

What this doesn't show is the underlying decline which would have occurred without the tens of billions of dollars industry has invested to stem decline. Natural decline of these fields is around 15%. As an industry we've managed to stem that decline to, on average, 6% over the last ten years by investing between 1 and 1.5 billion dollars a year in the North Slope business.

ELF has worked as intended

Each of the small wedges on this production profile represents the contribution from one of the North Slope's smaller fields. Many of these fields would not have been developed without ELF. And yes, whilst much but not all of this production pays Production Tax, it all pays property tax, royalty and state income tax and helps keep TAPS operational and economic.

ELF has and continues to encourage investment in these small or less productive fields, and has played a significant role in stemming overall North Slope decline.

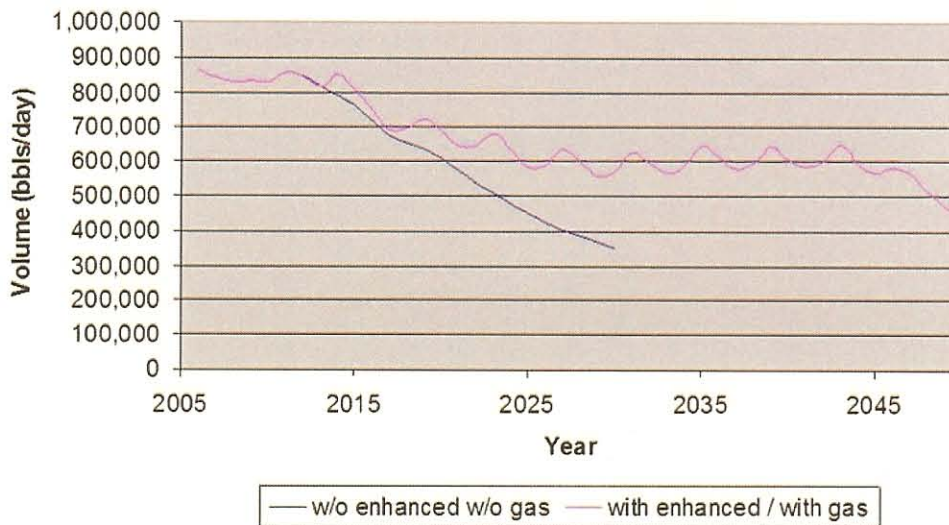
However, we recognise that ELF was designed as a surrogate for profitability and while it has been effective it is not perfect in today's price environment. And it is for that reason that we are supportive of adopting the PPT structure proposed by the Administration.

One of the most important issues for this committee to consider is the impact PPT will have on the decline of the Alaska North Slope.

DOR Scenarios



Figure 1
Volume Scenarios



Source: DOR Testimony: PPT Analysis020106 (DOR).ppt

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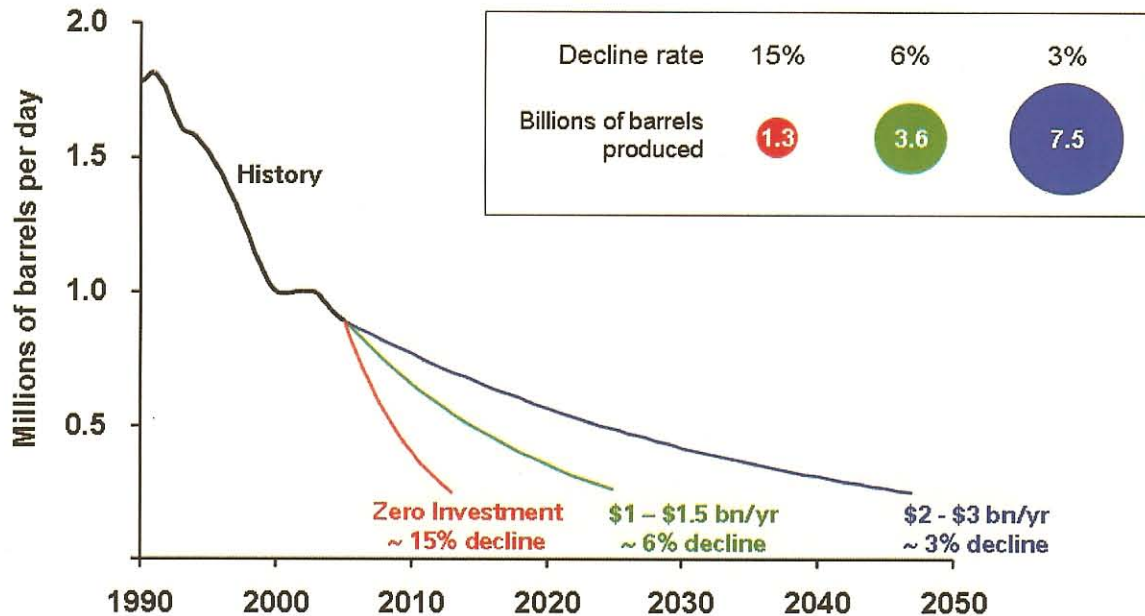
You will recognise the above slide from Roger Marks' presentation last week. It shows two forecasts of future production – the lower blue forecast represents a future without gas, the upper pink line represents a future where the oil business is revitalised by gas.

We agree that the futures with and without Gas look very different. A future without Gas is very much shorter and far less exciting than a future with gas!

But, for Gas to work, it must be built on the foundations of a healthy oil business, a business which must remain healthy for 45 years.

So what will it take to keep the oil business healthy?

Investment & Decline



We share the challenge of keeping Alaska competitive

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The simple answer is to stem decline.

The black line on this chart shows the history of North Slope production. The coloured lines look forward to the future.

With no investment the natural decline of the fields would be the lower red line and with in 10 years the business would be gone.

With the current levels of investment of \$1-1.5 billion / year) (which assumes the current tax regime), history tells us that decline will be around six percent per year. With that trajectory we can expect the business to last around 25 years, but nowhere near long enough to enable gas.

In order to enable gas we must reduce the rate of decline even more. 3% decline would require twice as much capital as is being spent today (\$2 - \$3 bn dollars per year). That is \$20 to \$30 billion dollars over the next decade alone. Alaska must compete to attract these dollars!

We share the challenge of keeping Alaska competitive: the State's part is to maintain stability and keep Alaska attractive to investors; our part is to provide the technology, innovation and investment.

The tax regime you approve will directly impact how attractive Alaska is and what the future decline will be. It is in the interest of all (industry and Alaska) that we focus on growing the pie rather than taking an increasing share of a declining pie.

So where will we find all this oil to stem decline?

The good news for Alaska is that we have a huge resource base!

Alaska has lots of oil and gas!



Billion barrels equivalent			
	Produced		15
	Known Remaining		17.5
	Developed	- Light	3.5
		- Viscous	0.3
	Undeveloped	- Light	4
		- Viscous	0.7
		- Heavy	3
		- Gas	6
	Yet to Find (Exploration)		5

Recoverable Resource



Source: DOR / USGS / BP

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To date we have produced 15 billion barrels, but there are 17.5 billion barrels remaining that we already know about, 3.8 billion barrels of which have been developed to date.

The remaining 14 billion barrels consists of:

- 3.5 billion bbls of light oil remaining in the existing reservoirs
- 1 billion bbls of viscous oil which we have started to produce
- 3 billion bbls of heavy oil lying in shallow formations below the permafrost
- 6 billion bbls of gas which we are working so hard to get to market

The scale of this known resource greatly exceeds that expected from future exploration. Future discoveries are expected to be of the order of 50-150 million barrels. It's not to say you should stop exploring, but you cannot rely on exploration to stem the decline of the North Slope.

While BP isn't exploring in the conventional sense, we are adding barrels. We're not only looking at develop our share of the 17.5 billion barrels, but we're looking to make it even bigger.

To put that in perspective, every time we increase the recovery efficiency by just 1% we access an additional 600 million barrels (400 mmbbls light oil and an additional 200 mmbbls heavy oil)..... Every 1% is equivalent to another Alpine!

It is for this reason we're investing in technology. We're exploring within our existing fields.

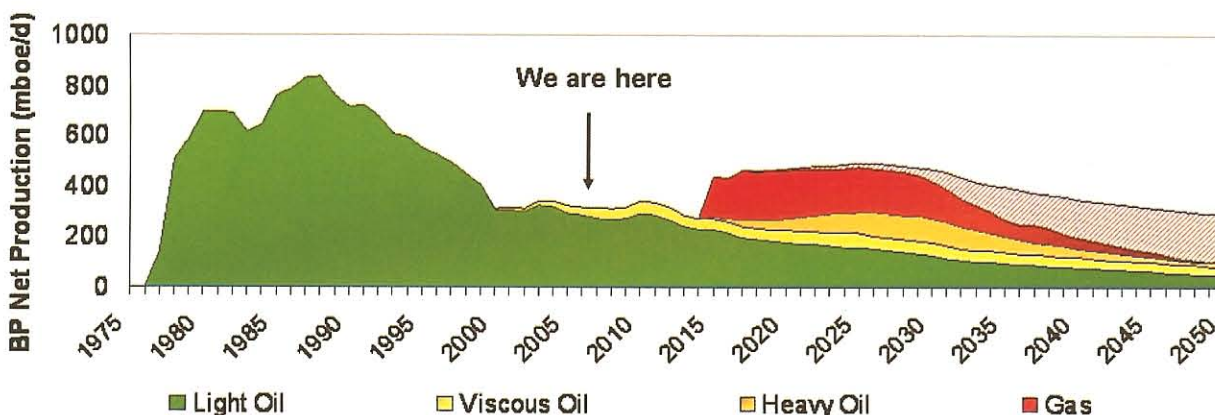
One example is that we're spending in excess of \$100 million implementing innovative technology to increase recovery at Endicott. If we're successful at Endicott it could add hundreds of millions of barrels of production across the North Slope. (Another Alpine?)

To develop the 14 billion barrels we know about would require well in excess of \$100 billion. And that kind of investment can only come from the Major oil companies of the world a fact supported by Pedro Van Meurs testimony. It thus mystifies us why so much of the testimony given to this Committee by Pedro Van Meurs focussed on the impact of PPT on new entrants when the future of the North Slope is dependant on making Alaska attractive to Major oil companies.

This is the reality of our business and the reality of the North Slope today.

It's the reality we encourage you to look at as you consider House Bill 488 / Senate Bill 305.

A 50 year vision



This is the graphic we use when we describe our vision for our business in Alaska.

It shows BP's production both historical and future. A few points we always make when we talk to this are:

- The future will be very different to the past.
- Three businesses built on top of each other all of which must be healthy.
- We face enormous challenges in creating this future
- Attractive and stable fiscal terms are key to making this happen, without it our vision will not come true.

I will now hand over to Ray Hall, who is going to provide a global perspective after which I will describe the impact of PPT on BP's business in Alaska.

Global Perspective

Refer to Raymond Hall's slides

[2006-02-28 BP Testimony - Global Perspective.pdf]

Impact of PPT on BP in Alaska

Much of the analysis presented to this committee has been based on specific cases – (50, 150, 500 mmbbl fields). These are of course academic examples and what I will do is to clarify the impact of implementing PPT on BP's business in Alaska.

I will do this through the lens of Government take.

Government Take



$$\text{Government Take} = \frac{\text{Total Taxes}}{(\text{Total Taxes} + \text{Industry Profit})}$$

Government Take in Alaska comprises 5 elements:-

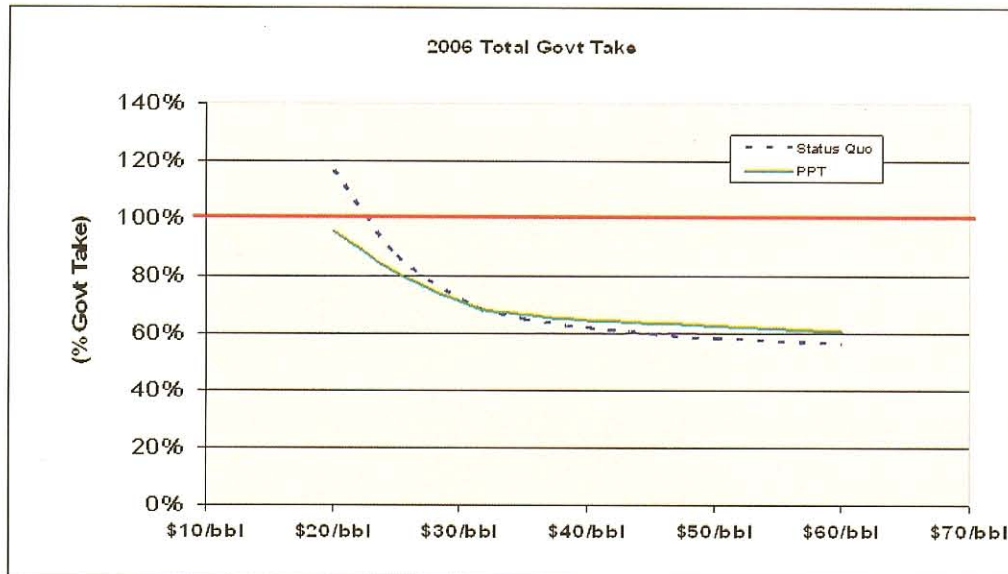
- | | | |
|--|---|---------------|
| <ul style="list-style-type: none">• Royalty• Production Tax• Property Tax• Income Tax | } | State Taxes |
| <ul style="list-style-type: none">• Federal Income Tax | | Federal Taxes |

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Government take is the percentage of total profit which is taken by government (in this case both State & Federal) with the remaining being the profit which goes to the investor.

Government Take is made up of a total of five elements: State income tax, property tax, royalties, production tax, and Federal income tax. The Investor's take is the investor's profit.

PPT Impacts on BP Alaska Government Take vs. Price



- **Government Take extremely high at low & medium prices**
- **Investors must make a reasonable return at medium to high prices for Alaska to be attractive**

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This chart shows the total Government take at different oil prices for the current Elf based system and PPT.

That's the real Government take on BP's business in Alaska.

The first point to note is that at low prices we do not make a profit. We make a loss. But regardless we continue to pay Royalty, Property Taxes and State income tax, which results in a government take of greater than 100%.

Under PPT, the Government take is around 70% at the moderately high price of \$30 / bbl. This is very high & especially considering the very high cost of doing business in Alaska.

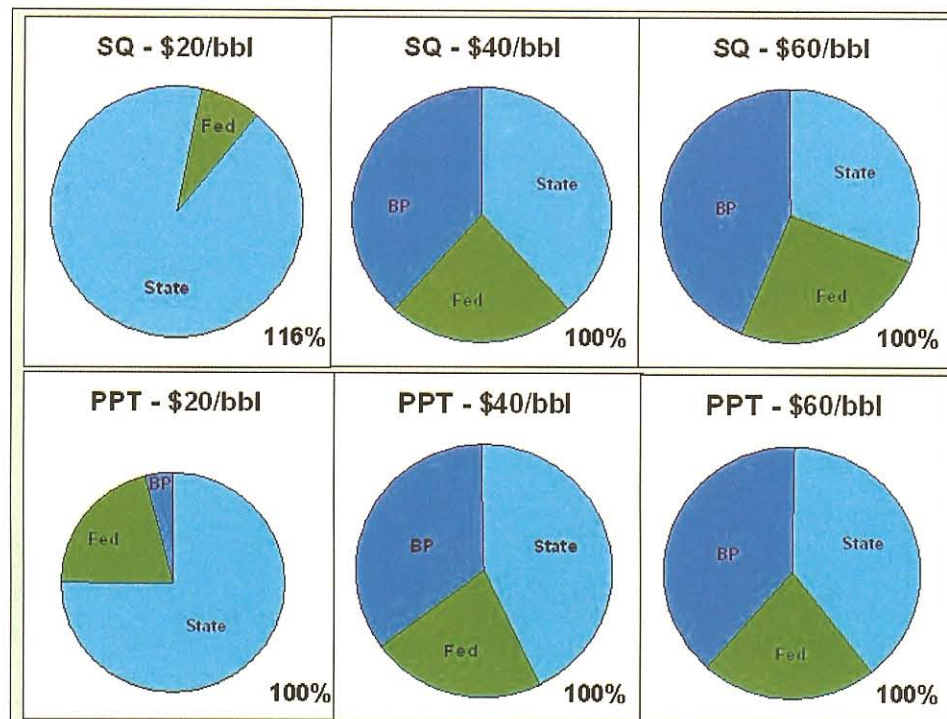
We absolutely must make a good profit in Alaska when prices are high. We make no profit when prices are low. Alaska is a price play and if you take away the upside price incentive then there is no reason for us to be here.

Alaska is a mature business with a challenged resource. In our opinion you should be concerned about overtaxing the industry rather than undertaxing it.

PPT Impacts Government Take (%)



Status Quo



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Here we can see the split between State, Federal and BP take under the current regime and PPT at low, medium and high prices.

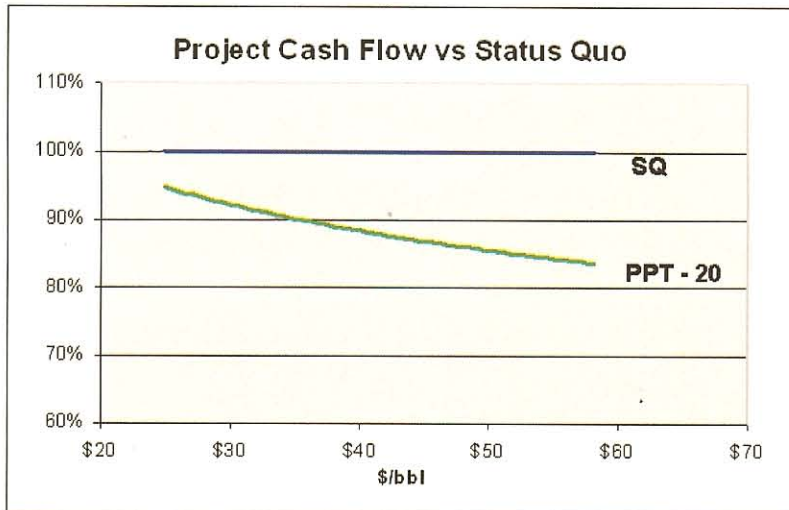
The left hand pies illustrate the problem for BP at low prices. Under the current system BP makes a loss at \$20 / bbl.

At \$60 / bbl the current system provides a higher % to the industry than to the State, but that is not new news. Alaska's fiscal system was designed to protect the state at low prices and compensate the industry at high prices. That is the nature of a regressive tax regime.

Under PPT, we would make an extremely modest profit at \$20. At \$40 the state gets a considerably higher share than BP. At \$60 the State's and BP's take is balanced.

Introduction of PPT squeezes our profit at higher prices, and let's not forget we make the investments, we take the risks and absolutely we have to make a good profit at high prices for Alaska to be attractive.

PPT Impacts Project Cash Flow



- **Rate of Return improves, but it's only one measure**

- **Project Cash is lower at all prices**

So what about future investments? We agree with Pedro Van Meurs, PPT will tend to increase the rate of return on many new projects, but we look at many metrics when making decisions about investing (Net Present Value (NPV), Net Income, and cash flow per barrel are but a few examples).

This graphic shows how PPT (20/20) impacts a new investment.

Rate of return is increased due to the positive impact of the capital credits on the upfront investment, but

Total return to the investor (after tax cash flow) is decreased due to the increased state take. This project takes the same effort / capacity to execute regardless of the tax regime. Increasing State take reduces total returns to investors making investments less attractive.

It is thus our sincere belief that the best result for Alaska is to implement a Petroleum Production Tax with a tax rate less than the 20% proposed by the Administration.

I would like to leave with you the key messages from this testimony.

PPT: Key Messages



- **Decline is a problem**
Alaska has been in decline because profitability has been insufficient to attract capital, not due to a lack of resources
- **Large increases in investment are required**
To stem ongoing decline and attract the required investment (\$50 - \$100bn), PPT must work for the major investors
- **Capital is mobile**
International investment flows to basins where it can earn a profit
- **Profit-based taxes are superior to revenue-based taxes**
The PPT structure has merit and could serve Alaska well for the long term
- **Higher taxes means less investment**
The 20% rate is very high and will not maximize investment and production
- **Oil needs Gas . . . and Gas needs Oil**
For Gas to work, the Oil business must be healthy

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On behalf of BP I would like to thank you for this opportunity to testify and wish you well with your deliberations.

We will of course be available to provide further testimony as appropriate.



BP Testimony to House Resources and House Energy

Damian Bilbao, Head of Finance, Developments and Resources

April 25, 2012



BP in Alaska

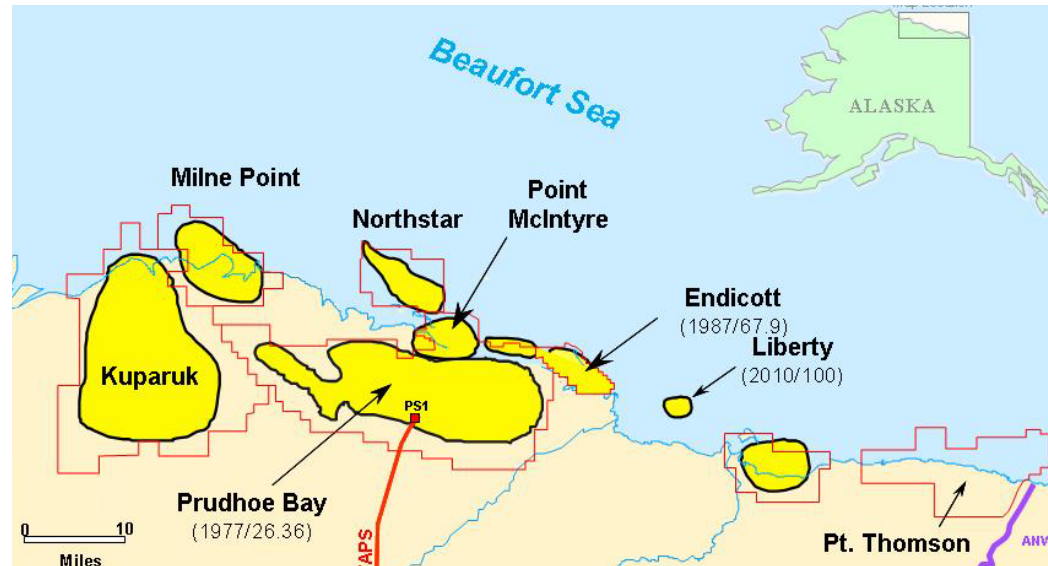
How BP makes investment decisions

What could growth in investment mean for Alaska's future

BP in Alaska since 1959



- 53 years in Alaska
 - Office opened in 1959
- \$13.4 billion in upstream spend with Alaska Firms the last 10 years
- 2,100 Employees (82% Alaska residents)
 - 275 APICC students hired in last 10 years
 - 54 internships, 100+ fulltime jobs in last 5 years
- 6,000+ Contractors
- \$70 million of direct community investment since 2001





BP in Alaska

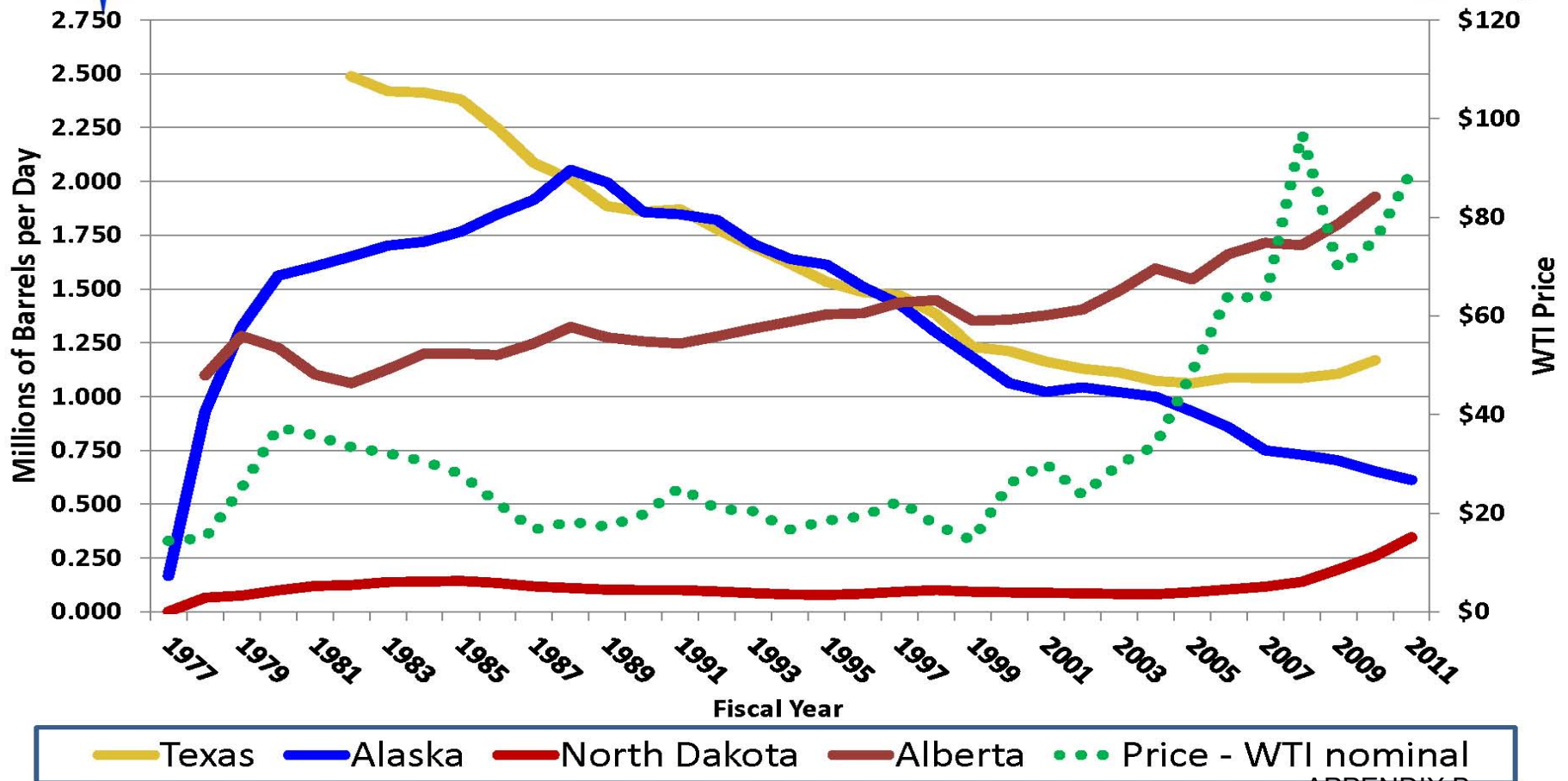
How BP makes investment decisions

What could growth in investment mean for Alaska's future

Global investment is limited and goes to the most attractive regions



Historical Oil Production: How Did Our Competition Fare When Prices Spiked?

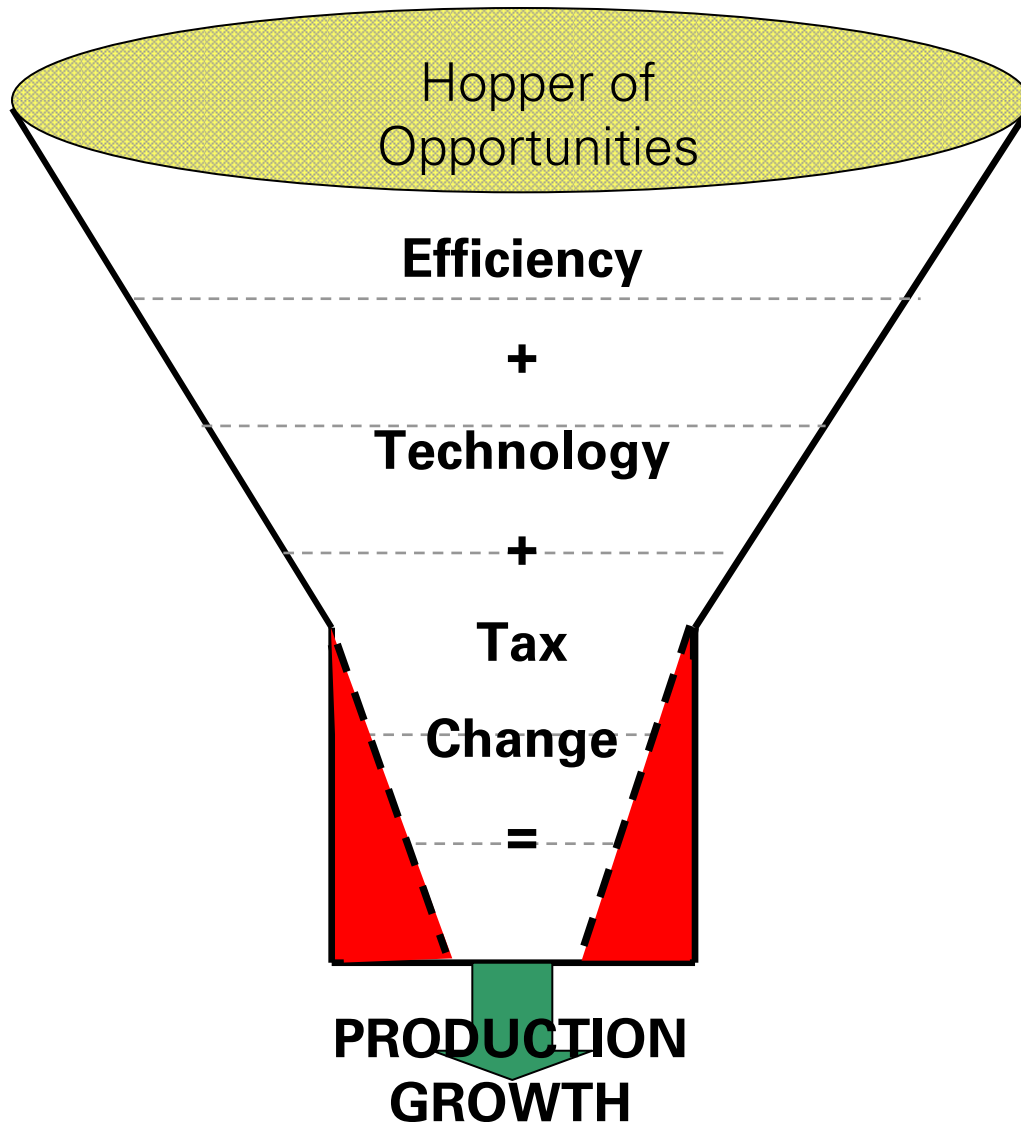


4/21/2012

Department of Revenue

APPENDIX B
5 of 10

The tax policy will greatly influence how many projects move forward



- Healthy base business
- Brightwater, Multi-lateral drilling, Lo Sal, etc.
- \$5 billion in potential new investment
 - Prudhoe I Pad
 - Kuparuk Eastern NEWS
 - Prudhoe Sag @ scale
 - Add'l drilling in legacy fields

Agenda



BP in Alaska

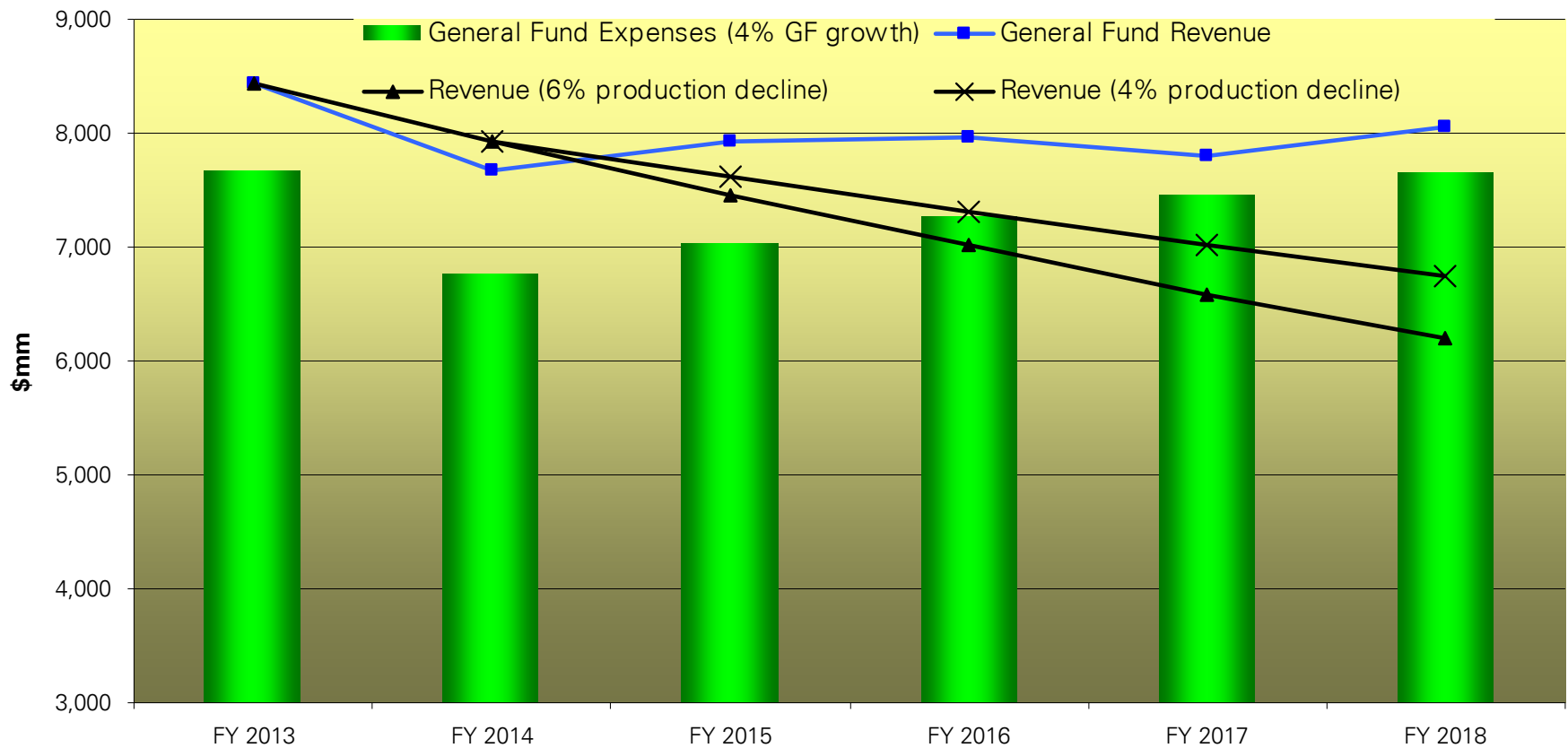
How BP makes investment decisions

**What could growth in investment mean for
Alaska's future**

Declining production is a crisis



GF Revenue versus Appropriations FY13 to FY 18
Spring 2012 Revenue Forecast With 4% GF Growth beginning in FY2014

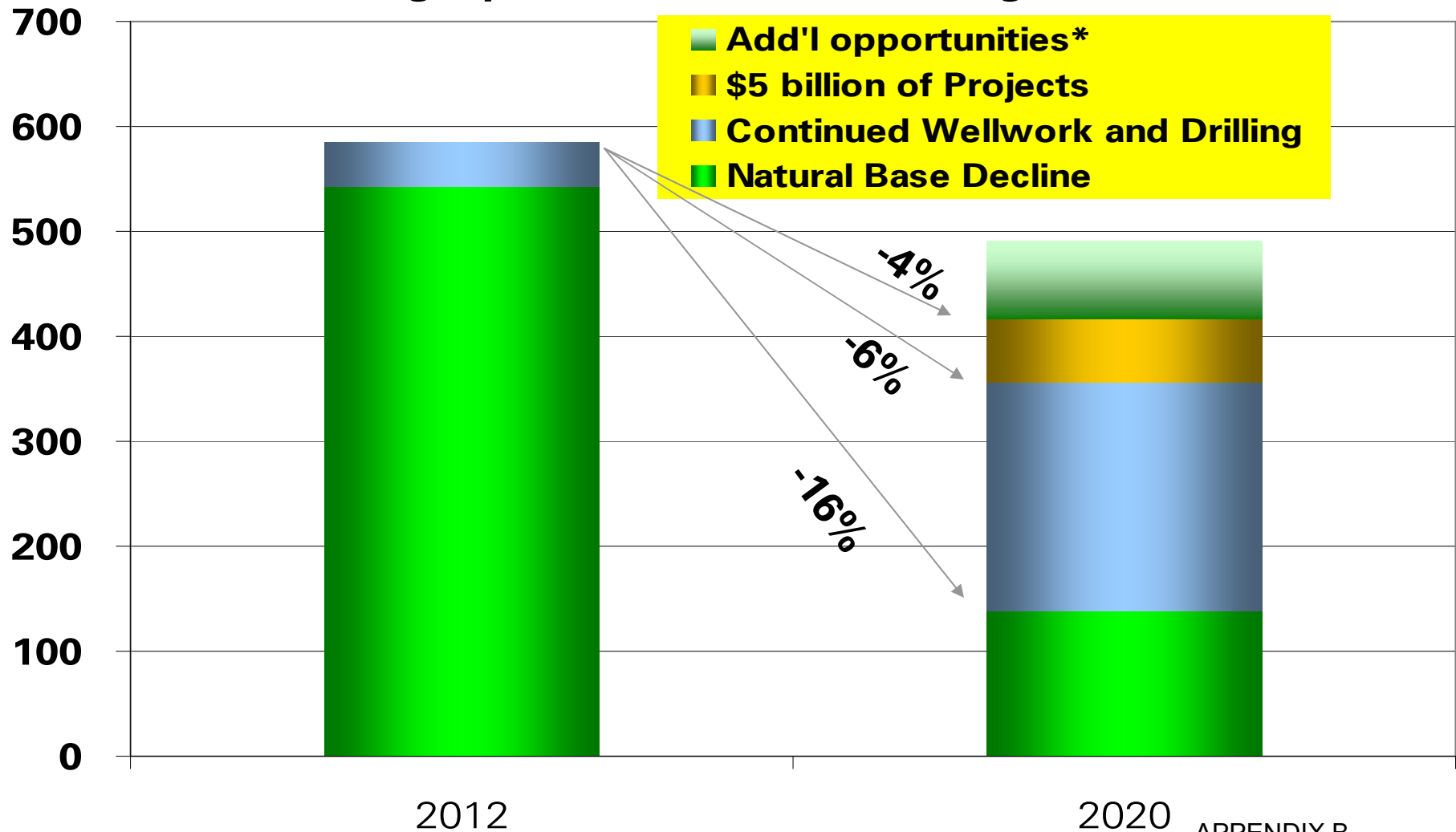


Source: Office and Management and Budget presentation to House Resources, April 25, 2012

Two-thirds of production in 2020 derives from activity performed from 2012 to 2020



Legacy Field Production mb/d gross



* Indicative

Key Messages



- ACES is a no growth policy that bets Alaska's future on high oil prices
- Legacy fields are the only near-term option for new production
- If taxes do not change, our business will have to
- Other regions, like Alberta, have lowered taxes and increased investment and production

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%.

Because the revised tax applied equally to both old and new investments, ACES had the effect of dramatically altering the economics of investments made not only subsequent to its passage, but also those that were made prior to 2007. At least from the perspective of investors, the 2007 passage of the tax had the effect of retroactively confiscating a significant portion of the return which they had anticipated earning from prior investment decisions.

Going forward, investors will evaluate any proposed change in Alaska's tax structure not only from the perspective of what the change is, but also whether the change is likely to be durable. Now that Alaska has demonstrated an inclination to apply tax changes retroactively to prior investments, investors will be highly concerned about being caught again in a situation where they make long term investment decisions and the state thereafter once again increases the tax structure after a few more years. Investors will be much less likely to invest if that potential remains.

While some legislators (including Republicans) have suggested that the legislature is not able to provide certainty about its tax policy, that is not the case. The state clearly has the power to enter into long term, binding contracts with investors, such as it does with unions and has with investors through oil & gas leases.

Some suggest that the power to tax is unique and one legislature cannot contract away a subsequent legislature's ability to exercise that power. Even if that is true, however, there are other ways of stabilizing total state take, such as by providing that any future increases in taxes can be taken as a credit against royalty. Such "economic stabilization" clauses are common throughout the world.

The extent to which the legislation provides for durability is important. Investors will be **much** less likely to commit to substantial, long term projects — the very type of projects that result in significant additions to the supply base — without some assurance that the revised system is durable.

3. Neutrality. As I have written elsewhere, one of the worst characteristics of ACES is its vastly differing treatment of various sources of supply. Production from existing units is taxed at a significantly higher rate than is otherwise needed in order to fund direct state subsidies (what some refer to euphemistically as "credits") of up to 60% of total costs for activities undertaken outside of the units.

The result is that activity inside existing units is artificially suppressed while activity outside of existing units is artificially subsidized, appearing to make those activities economic, when they likely are not. **No** activity is left to respond to pure market signals.

This approach makes no sense in Alaska's current situation. As I have previously explained, by far the largest new production potential lies inside of Alaska's existing units, and the sources of supply inside the existing units likely can be brought on line faster than those that are located farther from existing infrastructure. As a result, if anything Alaska should favor higher tax credits for the development of new fields located inside of existing units than outside. Currently, however, ACES produces the opposite result.

At their core, credits are a way of substituting government's judgment for business in picking economic winners and losers. Through tax policy, the government favors investment in some activities — the winners — and discourages investment in others — the losers — by raising their costs. ACES backs the wrong horses.

Rather than attempt to outguess the market, the government should adopt a neutral stance between fields and let the market decide which are the most economic to produce.

4. *Simplicity/Predictability.* One of the most consistent complaints from current and potential investors about ACES is its complexity. While companies can employ people and computing power to deal with complex equations, generally speaking simple tax structures attract more investment than complex structures.

There largely are two reasons for that. The first is that investors generally are concerned that complex tax structures have a greater potential for producing surprises than simple ones — and their experience is that, when they arise, surprises generally produce bad things.

The second reason is that complex tax structures usually are the result of a lot of fine tuning, and that once legislators and regulators start down the road of “managing” investments through the use of the tax code, they can't resist the temptation to continue fiddling with the knobs as the tax structure fails to produce the results that they intended. As a result, complex tax structures tend to be changed more often than simple ones, making them much less predictable.

ACES, literally, is one of, if not the most complex oil tax structures in the world. (With the exception of the 1970 -80's era federal windfall profits tax, ACES is by far the most complex structure with which I have dealt.) It also is one of the least predictable. Even five years after its passage, very few, if any, audits have been completed and the implementing regulations, which at times are extremely vague, have yet to be interpreted. As a consequence, even now, five years after passage, investors are not certain how ACES ultimately will be applied to investments.

Investors understandably favor simplicity and predictability. To help improve the investment climate in Alaska, the coming changes to the Alaska tax structure should make a ***significant*** move in that direction.

5. *Alignment.* As I explain in a [recent piece](#) in the *Alaska Business Monthly*, Alaska's current oil policy is significantly out of alignment with the state's own objectives. Certainly part of that relates to the tax code. As explained above, ACES attempts significantly to tilt private investment in Alaska away from the state's largest and best defined new prospects to smaller, uncertain and unknown opportunities. By overcharging potential production from its best prospects in order to subsidize exploration of others, Alaska's policies impair the achievement of its own objectives.

But the misalignment between policies and objectives goes much further. The state's recent actions regarding the Pt. Thomson leases provide another good example.

After protracted legal proceedings, this year the Pt. Thomson owners agreed to pursue the development of the field.

Like its approach to tax credits, however, the state's efforts at directing these investment decisions have created unintended consequences. As operator, Exxon already has spent in excess of \$1 billion on the Pt. Thomson project and estimates that, before completion, it will spend billions more. At the same time, investment in the development of the oil available in other existing North Slope units has declined.

In the absence of developing a major gas market, the maximum production anticipated from Point Thomson is 10,000 barrels of liquids per day, which is significantly smaller than other potential opportunities available in the existing units and a minor offset to the anticipated net loss of 50,000 barrels per day of production projected by the state between 2011 and 2015.

As a consequence, the effect of the state's efforts at Pt. Thomson essentially has been to focus investment on one project on the North Slope, likely at the expense of others offering significantly greater potential.

The reason that the state pursues such counter productive efforts is that the state currently does not have either the ability — or, seemingly, even a compelling economic interest — in determining which projects make the most economic sense. Instead, the state's decisions are driven largely by political reasoning. In essence, the state acts as a back seat driver, attempting to steer industry investment indirectly and towards non-economic objectives.

Recently, a co-author and I proposed a means of better achieving alignment between the state's actions and objectives that has proven highly successful in other parts of the world and, I firmly believe, would have the same result in Alaska. While the proposal met some criticism, I anticipate that support will grow as others come to realize that a revised tax policy alone will be insufficient to attract the levels of investment — estimated by DNR Commissioner Dan Sullivan to be a minimum of \$4 billion/year — required to realize Alaska's full oil potential.

Any tax reform proposal should progress toward alignment.

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