HOUSE FINANCE COMMITTEE
AND
HOUSE RESOURCES COMMITTEE
March 6, 2006
12:38 p.m.

CALL TO ORDER

Co-Chair Samuels called the joint meeting of the House Finance Committee and the House Resources Committee to order at 12:38:00 PM.

MEMBERS PRESENT

Representative Mike Chenault, Co-Chair
Representative Kevin Meyer, Co-Chair
Representative Bill Stoltze, Vice-Chair
Representative Mike Hawker
Representative Jim Holm
Representative Reggie Joule
Representative Mike Kelly
Representative Beth Kerttula

Representative Jay Ramras, Co-Chair
Representative Ralph Samuels, Co-Chair
Representative Carl Gatto
Representative Gabrielle LeDoux
Representative Kurt Olson
Representative Paul Seaton
Representative Harry Crawford
Representative Mary Kapsner

MEMBERS ABSENT

Representative Carl Moses
Representative Bruce Weyhrauch
Representative Richard Foster
Representative Jim Elkins

ALSO PRESENT

Daniel Johnston, Legislative Consultant, Daniel Johnston & Co., Inc.; Representative Norm Rokeberg; Representative Berta Gardner; Representative Mark Neuman; Representative Peggy Wilson; Representative Ethan Berkowitz; Representative Les Gara; Representative John Coghill; Representative John Harris; William Corbus, Commissioner, Department of Revenue

PRESENT VIA TELECONFERENCE

None

SUMMARY

OIL AND GAS PRODUCTION TAXES

12:38:06 PM

DANIEL JOHNSTON, LEGISLATIVE CONSULTANT, DANIEL JOHNSTON & CO., Inc., referred throughout his presentation to a handout entitled "Alaska's Proposed Production Tax – PPT 20/20/%" (copy on file), which analyzes issues related to SB 305 and HB 488. He explained the services he provides: consulting, teaching, and expert witness work. The past 15 years his work has been equally divided between oil companies and government work. He shared that his philosophy is that mineral resources are a gift from God and this work is a sacred trust.

Mr. Johnston shared his mandate in the analysis and discussion of PPT 20/20%. He stated an objective to share analysis, research, discussion and recommendations, to help design a fair production tax system, and to avoid a punitive arrangement. He opined that future generations would ask questions about the design, negotiations, and management of this policy.

Mr. Johnston pointed out that on page 5 of his handout is a disclaimer about some of the restrictions and limitations of his presentation. He noted the report should be viewed as a preliminary indication of things that will be addressed when there is more time.

12:47:21 PM

Mr. Johnston shared conclusions that Alaska has every right to change its current regressive, inefficient tax system. The new system should increase revenues to the state and enhance exploration activity. Those objectives are not mutually exclusive. Increasing taxes on existing production is relatively inelastic. Proposed incentives can work and there is solid justification for having credits.

Mr. Johnston related that the new system would be a well-designed, modern system that is flexible, progressive, simple, and transparent. Trying to craft one system to fit all situations in Alaska may be impossible. The producers want "fiscal certainty".

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Mr. Johnston discussed the debate regarding government take. With the gas pipeline project, a government take statistic is much less meaningful. It is time to address this issue. Crafting language to avoid "leakage" deserves appropriate terms on the front end. He suggested that Alaska should get the deal right the first time. There are several issues of

critical importance: relinquishment provisions, abandonment provisions such as site restoration, cleanup, and dismantlement, and the proposed "linkage" with the gas pipeline deal, which is risky.

12:55:36 PM

Mr. Johnston related other perspectives on ELF; the alignment of interests is not good because the tax is based on production not profits. He referenced the Indonesian story and its fiscal device where the oil companies had five years of royalty-free living, which resulted in a strong incentive for the oil companies to produce the oil quickly and to obtain separate field status. He discussed problems with separate field status. He shared the California story where the state lost in two ways: lower royalty and lower taxes. He suggested that with new elements it often takes 10 years.

Mr. Johnston discussed what criteria should be used if the system is going to be changed. He emphasized that the system must be progressive. When comparing times with low and high oil prices, with progressive systems the government take increased on an average of 10 percent. The system must have a fair division of profits, have no unhealthy dis-incentives, and be simple and transparent. One critical issue centers on whether or not raising or lowering taxes has an effect on investment activity in the petroleum sector. He opined that the proposed PPT system, as it is currently designed, would not be a problem.

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Mr. Johnston spoke to the uniqueness of Alaska's needs. There are boundary conditions and high costs with being land-locked. There are high transportation costs. High costs exist in the Arctic, and there are field size distribution expectations relative to Arctic conditions. He opined that exploration in northern Alaska is not a place that most of the major oil companies would be interested in. The fields are not big enough to attract a large amount of capital. Independent oil companies may express interest there.

Mr. Johnston referred to page 11 as the balance sheet - things to consider about fiscal system analysis and design relating to prospectivity and contract terms. He pointed out the importance of expected field size distributions, the petrophysical characteristics of the rock, the delivery rates of an oil well, estimated success rates, if the province is gas or oil prone, and the quality and quantity of the oil or gas. Other factors are exploration drilling costs and costs after the discovery is made. Exploration

drilling is more expensive. He discussed transportation costs, water depth, climate, and political risks.

Mr. Johnston highlighted contract terms as the other side of the equation. He pointed out that government take, one of the elements, has weaknesses. One country's government take may have better terms than another's. There are many factors regarding government take, some with immediate implications. The most important is the limit to the number of barrels.

Mr. Johnston related that the type of tax system is very important to oil companies. Most provinces with the kind of field size distribution Alaska has, use production-sharing contracts, which have some implications unfavorable to oil companies. Most companies would prefer royalty tax arrangements. Work programs, seismic data, and drilling are important contract terms. In the area of timing, relinquishment, and guarantees, Alaska distinguishes itself. Unlike in many parts of the world, Alaska is able to hold onto substantial acreage, which may weaken Alaska's bargaining position and is something to consider for the future.

Mr. Johnston stated that royalty rates are average in Alaska by world standards. By changing the severance tax to a PPT as proposed, the royalty is reduced to 12 percent. He suggested that 20 percent is an acceptable royalty rate. "Entitlement" is the number of barrels a company is physically, legally able to lift and report to shareholders. He defined "ringfencing" as an important issue regarding trading credits. The PPT proposal is outstanding in terms of ringfencing. Alaska does not qualify as high risk regarding "Crypto" taxes. Contract stability is an area worth looking closely at. "Allocation strategy" is the method of allocating licenses to the oil companies. Alaska uses area-wide leasing, which is painless to oil companies. There are a variety of issues where Alaska has advantages.

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Mr. Johnston related that comparing Alaska to an appropriate peer group is important. He took issue with some of the peer groups that have been mentioned so far in other presentations. The proposed PPT is trying to accommodate the legacy assets in Prudhoe Bay and Kuparek, and in Arctic Frontier explorations, which are vastly different. It is difficult to find a peer group with a similar situation.

The United Kingdom is not a good example of an appropriate peer group for Alaska. It has a government take of 50 percent, but also a government take of 75 percent for the old legacy fields. Picking a peer group that fits the exploration of Alaska's legacy fields is quite another

matter. Angola falls into the same category with a 75 percent government take. He suggested that there is work to be done to provide better examples of peer groups because of the bi-modal distribution quality found in Alaska.

Mr. Johnston mentioned that another problem is how government take is calculated. He referred to the Wood Mackenzie Report from 2004, which excludes one of the four main means by which governments "get a piece of the pie" called government participation. The government can take up a working interest in a commercial oil company discovery, called a risk-free government carry. Oil companies do not like this form of government participation because it is inefficient for them. The Wood Mackenzie Report excludes this in their analysis. He suggested a hearing with Wood Mackenzie in attendance. If the government take is factored in worldwide, 5 percentage points would be added to the Wood Mackenzie Report because Alaska does not have government participation.

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Mr. Johnston discussed if increasing tax rates would reduce investment in Alaska and result in job loss, as implied in a presentation last week. He pointed out that the PPT system is designed to both take and give. He referred to page 14, a BP graph of production tax vs. the tax rate in the UK sector of the North Sea. He argued that the graph is not a fair representation of what the result of lowering the tax rate would be. He pointed out that the government take was around 85 percent until 1993 when it dropped to 33 percent, a dramatic reduction. The graph shows that investment increased at this point, but it does not show prior years of extensive exploration, which would have affected investment increases.

Mr. Johnston showed, on page 15, that the actual investment activity in the UK contradicts the idea that production after 1993 was strongly influenced by the tax reduction. The graph depicts, by year, the royalty rate, the supplementary petroleum duty, the petroleum revenue tax, corporate tax, and marginal tax rate on old and new fields. The term marginal take and government take are the same, but statistics vary by report, depending on who writes the report. He highlighted annual expenditures for exploration and development throughout the years 1974-2005. He noted that in the 1980's, the UK sector of the North Sea instituted a policy similar to that which is being proposed in Alaska – a credit system. He referred to it as a two-dimensional change that kept the investment activity very high. He suggested that the graph is a bit misleading. He referred to the BP presentation and a disaster in 1988, when many were killed and the industry had to spend an extra five billion pounds over five years. Exploration drilling after

1993 decreased. He suggested that the committee obtain more information on this topic.

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Mr. Johnston referred to page 16, UK drilling activity history. It confirms the fallacy of the claim that the reduction of government take from around 85 percent to 33 percent enhanced investment activity in the UK in 1993. Exploratory drilling was quite high in the 80's. He related that the North Sea was maturing at this time, also.

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Mr. Johnston referred to the "risk vs. reward" in the PPT credit plan on page 17. He spoke in favor of a credit plan that would allow companies direct credits that could be sold or traded. He provided as an example, grass roots oil exploration in Indonesia. He explained the process for cost recovery and how much the government would pay for dry hole costs. Countries would take the risk because new discoveries are profitable. Norway is the best comparison; it partly justifies the high government take. It is a new system so it is too early to tell.

Mr. Johnston mentioned that in the 1980's, the UK's North System government take was 85 percent. He maintained that in the North Sea you could not take advantage of the "credit" unless there was sufficient new production. This illustrates that these credits work, and the industry will find a way to "soak it all up". Canada's Petroleum Incentive Payments (PIP) Grants is another example of a credit plan that worked. They only risked 20 cents on the dollar. The Alaska's PPT proposal risks 39 cents on the dollar and could go lower in order to incentivize exploration, and the government take could be higher.

1:32:09 PM

Mr. Johnston summarized the key fiscal elements of PPT 20/20%. The PPT rate is 20 percent, and the PPT base is company cash flow, which is greater than capital expenditures. The tax credit rate is 20 percent and tax credit base is capital expenditures. TLCF or Net Operating Loss is another component of PPT. Mr. Johnston recalled two quotes by Dr. Van Meurs: "Negative Cash flow can also be converted into a tax credit by taking the 20 percent tax value of these yearly losses." "A loss in any year can be converted into a tax credit by taking the 25% tax value."

Mr. Johnston reported that the base allowance rate is a standard deduction of $73 million, and the base allowance base is the same as the PPT base "deductible" for PPT calculation purposes. The transition provision is past

capital expenditures from July 2001 to June 2006, to be amortized over 6 years and deductible for tax purposes.

1:36:47 PM

Mr. Johnston summarized the key fiscal elements of PPT 20/20%. The proposed structure shifts some of the risk from the industry to the State of Alaska. The shift is multi-dimensional. By shifting the tax base from "net production" to "profits" it takes some of the risk away from the oil companies and puts the burden on the government. It is sometimes called a "proxy for profits" because no depreciation is required. The shift applies a 20% credit on capital expenditures and allows credits to be traded. He addressed the $73 million allowance and noted that it is difficult and awkward. It is difficult to design a one-size-fits-all system. He said he is still uncomfortable with it. PPT also has no ringfence.

Mr. Johnston addressed the "lookback" provision. He noted that there is a fairness issue. He suggested that it would be politically difficult to sell to the public and deserves further consideration.

1:40:18 PM

Mr. Johnston briefly mentioned, on page 21, the hierarchy of arithmetic one would expect in any given accounting period. He provided information about government take on page 22, depicting a simple royalty/tax system with a 15% royalty and a 50% tax. He described several scenarios to explain a regressive fiscal system. Column C can be viewed in several ways, as the difference between $20 per barrel and $60 per barrel, or windfall profits. Marginal government take assumes that there are no costs.

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Mr. Johnston explained the variations on government take calculations on page 23. This scenario involves a royalty/tax system with a 15% royalty and a 50% tax, but also a 30% government participation element, which Mr. Johnston included in all calculations, as did the administration. He mentioned Azerbaijan as a country that deals with government participation "heads up" from day one. He agreed with Dr. Van Meurs with his treatment of Azerbaijan. He mentioned that contractor take is significantly different in each scenario. Much money is involved and a mistake could be very costly. He noted the similarities between Azerbaijan and Alaska's proposed PPT system.

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Page 24 depicts the definition of the Wood Mackenzie treatment of government participation. In calculating the government take, all elements of the fiscal regime such as royalty, income tax, production sharing contract profit shares, and additional profits taxes have been included. Cash flow that would be derived by the government, or a national oil company having an equity interest in a field, was not included. He referred to it as the government participation controversy.

1:48:15 PM

Mr. Johnston referenced page 26, take calculations with and without factoring in participation. The examples show for a "world average" system with government participation of 13.5%, which should be close to world average for all systems, and how different the take statistics look regarding government participation. The graph on page 27 is a reproduction of a graph from Conoco Phillips indicating four cost/tax scenarios. The lines shift up by 5% when including government participation. Countries are more likely to have government participation when the costs are low and the tax is high.

The credit system would make it appear that the costs are lower and that they would not have to put the amount up front, but that was already factored in.

Representative Kapsner asked for further explanation of page 27.

1:51:21 PM

Mr. Johnston explained that the graph indicates the government take on the left scale relative to the costs in a given country. He spoke to countries with high government take and low cost. When there are high costs there is a downward trend, as shown by the scale on the right. In this case, the government take is artificially off by 5%. The credit system makes it appear that costs could be reduced, which makes Alaska look less "painful".

1:53:05 PM

Mr. Johnston continued by highlighting pages 28-30 on government participation. The government participation at 30% could cause financial pain for oil companies. He noted the financial "painometer" on page 30.

Page 31 highlights efficiency and flexibility in fiscal design systems. A flexible system can accommodate a wide variety of circumstances such as high and low prices. An efficient system gets a fair share for the government. The

theory is that a progressive system will be more stable and prices will triple.

Page 32 is a graph that shows a typical regressive system and regressive signature. When systems are evaluated, several different field sizes are shown, and three different cost assumptions and three price scenarios are evaluated to show the government take. As profitability increases, the government take declines. Government take for such a system would be approximately 65%.

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Mr. Johnston highlighted, on page 33, the regional distribution of petroleum fiscal systems. He addressed the highlighted box:
* ROR systems
* "R" Factor
* +Price-based formulas
These systems are the systems that are most likely to be progressive. The rate-of-return-systems have some heavy baggage.

1:57:28 PM

Mr. Johnston addressed page 39, indicating industry statistics. Page 40 highlights the weakness of the government take statistic, which is not a perfect statistic. It is important to know the strengths and weaknesses. It does not adequately capture signature bonuses, does not address the "how" of government take, says nothing of timing, and the scope of the material is too narrow as it does not indicate benefits such as jobs. The government take statistic also says nothing of ringfencing, or the ability to tax deduct costs incurred in one area against other license areas. It does not measure contract stability, nor account for reserve/lifting entitlements and ownership. It does not differentiate between diverse work program provisions, and crypto taxes don't get captured. Finally, the government take statistic is not relevant in some important situations such as exploration and development.

2:01:10 PM

Mr. Johnston stated that Alaska is low on the painometer. He spoke to government risk and said that Alaska is not a risky place on the planet. He referenced the statistics on page 42. He addressed the difference between oil and gas exploration. Gas discoveries are not nearly as valuable as oil discoveries for the same volume of reservoir rock.

Mr. Johnston highlighted statistics from various companies regarding deepwater projects on page 43. He said that 72

of the systems were regressive, 23 were progressive, and 5 were neutral. He pointed out the 5 points of increase on government take.

2:03:30 PM

Mr. Johnston spoke of international petroleum exploration and contracts as shown on the graph on page 44. It is close to a statistically significant sampling. It is not appropriate for Alaska because of North Slope requirements. He cautioned members to be wary of a graph like this. He pointed out that government participation, as seen in the left hand column, is factored in. On either side of Azerbaijan are two countries with no government participation

The graph on page 45 is based on cash flow analysis. Most systems are regressive and government take has dropped some. The left side shows government take increases in progressive systems. On page 46, graph 3 is not conclusive, but it depicts what has happened to the government take in the UK during the last five years. It is not appropriate as a comparison to Alaska's legacy fields. He said he had to mention that the government take in the North Sea was 75 percent, but he warned the members to be careful.

Mr. Johnston also warned against page 47, graph #4. He hoped to assist in determining what a fair share would be. He asked what kind of terms would yield the same economic benefit at $60 per barrel that was obtained at $20 per barrel. He referred to the article about Libya and the company's bid terms, which are consistent with the graph.

2:09:34 PM

Mr. Johnston spoke to contract duration. He said he does not believe that contracts should last about 50-60 years. He clarified that most contracts are much shorter and are two-dimensional: exploration years and production years.

Mr. Johnston looked at the graph on page 51, the expected value theory or risk analysis. He showed how rewards balance the risks. He analyzed the estimated probability of success. Credits are now structured in such a way that the average field size is lower and risks are lowered by half.

Mr. Johnston contradicted BP's presentation from February 28, 2006 on the proposed PPT. He highlighted Sonangol to explain that if non-associated natural gas is found, there are re-opener clauses in place. "Always" is not the appropriate word.

2:15:54 PM

Mr. Johnston defined ringfencing on page 53.

Co-Chair Samuels asked about the $73 million figure. Mr. Johnston responded that it won't work for many companies in this state and needs to be replaced by something.

Representative Gatto asked about the relationship between "backing in" and getting a royalty. Mr. Johnston responded that they are not the same in the industry's language. From a financial point of view, they are similar because when the government receives a royalty the oil companies have paid for everything right up to the point of production and the government gets something that they did not pay for.

Representative Gatto referred to page 20 and asked if the lookback should be layered 80/60 and then 40/20/0, or not even considered. Mr. Johnston replied that it is a complex issue dealing with how far back to go, and with fairness and expectations. The issue is that Alaskans are behind and have not been receiving their due. He said he is not comfortable with elements of the lookback and is not happy just saying five years.

2:20:15 PM

Co-Chair Ramras asked how long Mr. Johnston would be available. He asked for the optimum rate: 25/20 or 20/20 or something else. Mr. Johnston replied that he has only two weeks available in the next few months. He said he would be in Juneau for two more days. He opined that the system that is chosen must be progressive because it would be stable and dignified. The terms must be designed now in order to be stable and comfortable. He mentioned the problem of Cook Inlet being so different than the legacy fields. Representative Ramras suggested excluding Cook Inlet. Mr. Johnston suggested he is not happy with 20/20. He hesitated to state numbers. Many sliding scales don't work well. It is nearly impossible to predict a rate with Cook Inlet involved. Representative Ramras asked how it would be to deal with everything but Cook Inlet. He wondered what would happen if exploration costs are several points higher than the tax rate. Mr. Johnston said the system should accommodate a wide variety of oil prices and encourage exploration. He said he would like to see greater credits for exploration. It has to be decided how much exploration is wanted.

2:26:51 PM

Representative LeDoux asked Mr. Johnston to state his own opinion about what system would bring the most money into Alaska. Mr. Johnston responded he would structure the system to segregate different provinces and different

classes of investors. Representative LeDoux asked if that is illegal. Mr. Johnston suggested it could be fixed.

2:29:14 PM

Representative Kapsner addressed the topic of tax credits and asked if the focus should be on exploration costs or on fields already explored. Mr. Johnston replied that it is good to ask what needs to be incentivized. He suggested that companies explore within their own fields. Pilot studies would qualify for exploratory investments. He listed, in order, how investment dollars could be spent: first in existing fields, then in exploration within existing fields, and finally in wildcatting or frontier exploration.

2:31:45 PM

Representative Holm asked how strong the legislature's bargaining position is in light of the fact that the legislature does not negotiate the contracts. He wondered how much control the legislature has over "whether they lift or don't lift". Mr. Johnston replied that it is an uncomfortable question. The legislature's bargaining position is more a function of just how much strength Alaskans have, and not quite as much a function of who is doing the negotiating. He defined bargaining power as a combination of the legislature's and the administration's bargaining power. This issue is one of the most widely published subjects in the world. Mineral resources, and especially oil revenues, contribute greatly to the nation's budget. He mentioned the strength of the lobbying power of the oil companies. He opined that Alaska is not in the strongest position he has ever seen. Representative Holm asked about walking away from the negotiation table. He said he is uncomfortable not knowing where the line is. Mr. Johnston pointed out that the problem is that walking away would lead to more loss of money to the state.

2:35:12 PM

Representative Holm asked about the difference between giving a check, rather than giving a credit, and which is better to do. Mr. Johnston responded that they are virtually identical. The credits proposed could be sold, which is tantamount to getting a check.

Representative Seaton asked about the complexity of combining oil and gas in the PPT system. He wondered if gas should be taken out of the mix or left in. Mr. Johnston replied that it is premature for him to say because he does not know enough about it. PPT will influence future exploration of gas because gas discoveries bring in less money. He suggested providing additional gas exploration

incentives. The credit system needs more attention. Representative Seaton requested future feedback on this consideration.

2:38:43 PM

Representative Kelly asked about tax and credit sensitivity on the profit side overshadowed by the credit side, by possibly ten times. If that is the case, he wondered how the credit side could be fine-tuned. Mr. Johnston said the working number is five to one. It is the tax that is the most sensitive. Representative Kelly agreed that the progressive system is the way to go, but asked about providing a safety net, such as ELF, so it does not bottom out. Mr. Johnston thought Alaska would be protected, but that a number should be determined so it would never do worse than what ELF yielded. He suggested calculating the tax in two ways: calculate ELF and the new PPT and take the higher of the two.

Representative Kelly asked about boundary concerns. Mr. Johnston said the biggest boundary condition is one-size-fits-all. He referred to Dr. Van Meurs' presentation and stated that a credit system is necessary, and it is important to get the tax right, also. He continued to explain that Cook Inlet could not sustain a tax increase - 73 percent is an attempt to separate the different provinces. He remained skeptical.

2:44:50 PM

Representative Kerttula asked if any other countries group all of the credits together up front, all at once. Mr. Johnston said no. She asked if incentives are allowed, should the legacy and newer fields be broken apart. Mr. Johnston replied yes, but that has its problems, too. He related problems in Pakistan and Algeria - offshore terms and onshore terms. Representative Kerttula asked if any countries allow dollar for dollar credits – gas against oil or any other mineral. Mr. Johnston said that many countries allow "credits to cross the fence". When governments have different terms for gas, the statistics show that the government take is about 67-70 percent. The world average government take for oil, as reported by Wood Mackenzie, is 71 percent and for gas, 61 percent. There are problems if the tax system is not the same for both oil and gas.

2:48:39 PM

Representative Olson asked how to address both the companies in Cook Inlet and those up on the slope. Mr. Johnston responded that in the 80's many companies invested at $60 per barrel. He related the pain felt at $40 per barrel. He suggested that exploration should be encouraged. North

Slope producers are smiling now, but in the 80's and 90's exploration was discouraging.

2:50:32 PM

REPRESENTATIVE ETHAN BERKOWITZ asked about elasticity of production for legacy fields. He asked Mr. Johnston to quantify an increase in tax rates and how it would affect production decisions. He wondered if legacy fields should be treated differently. Mr. Johnston said he was speaking about the elasticity of investment, relative to fluctuation in taxes. Research and experience has shown that it is not extremely elastic, but when the tax was dropped from 85 to 30, investment activity in dollars really slowed down. He noted that the three years prior to 1993 and the three years after, there were a few more wells drilled, but the change was only 3 percent. If taxes are raised there will be a change in production on the North Slope. It is a tradeoff. The question is what would be reasonable. He suggested increasing taxes would be beneficial.

2:54:18 PM

REPRESENTATIVE NORM ROKEBERG asked about the variability of different provinces. He wondered about making distinctions between fields. He noted possible legal issues. He wondered if legal issues are taken care of, what an ideal structure would look like. He also inquired about tax credits for heavy oil. Mr. Johnston noted the flexibility surrounding a heavy oil field, and the means by which to reduce the royalty. He deemed it appropriated to provide a means of fiscal relief. He suggested Alaska seek that kind of flexibility on an area-wide basis. He spoke in support of such an idea.

2:57:51 PM

Representative Gatto referred to predictability and durability in earlier presentations. He asked if PPT provides for those more than ELF. Mr. Johnston said those terms go beyond contract terms to stability provisions, which are very predictable and durable, but high risk.

2:59:48 PM

Co-Chair Ramras asked for an opinion on number ratios. Mr. Johnston related the question to predictability. He suggested a sliding scale based on prices, which would influence a production-based tax.

3:01:54 PM

Co-Chair Samuels noted that there is auditing of fields around the world. He asked about cost recovery and "games

playing". Mr. Johnston replied that it is a huge issue. Many companies have a strong incentive to keep costs down. If they keep costs down, they get to keep a percentage, say 41 percent. 59 cents on a dollar is a high incentive compared to Indonesia where it is only 15 cents. One practice is to procure a vendor for goods and services through a bidding process. He addressed cheating and how it is measured. He mentioned severe penalties, AFE in the budget process, and working industry partners, as ways to provide transparency. One difficulty for governments is administrative overhead charges, which are more difficult to measure.

3:07:15 PM

Representative Seaton asked about the $73 million allowance and how it was constructed. He wondered if a different formulation would work. Mr. Johnston replied that there was a bit of art involved by Dr. Van Meurs when constructing the formula. $40 per barrel, times 5,000 per day, equals $73 million. But that allowance is applied against cash flow, not gross revenues. He suggested that the number 5,000 is a realty check. He said he is not comfortable with $73 million, but it worked for Cook Inlet companies.

3:10:09 PM

Representative Seaton wondered about progressivity based on a production model, rather than a profits model. Mr. Johnston said he preferred that levies are profits based. Under the proposed system, with a sliding scale, if there were a tax rate change, the credit rate would also change. It would be regressive. Representative Seaton asked if it is necessary to have the change in credit. Mr. Johnston said it would take another formula to accommodate that. It would cause more problems.

3:13:03 PM

REPRESENTATIVE LES GARA requested a range of fair tax rates on the legacy fields. Mr. Johnston replied that he is uncomfortable answering that question. At $20 per barrel the producers would be feeling pain; at $60 it would not be so bad. He suggested that a sliding scale would accommodate the down side and the up side. The take should be a function of a flexible sliding scale and require some modeling. He stated comfort with a flexible system.

3:16:01 PM

Representative Rokeberg referred to an earlier comment regarding a progressive system, and reverting to ELF if the price drops. He voiced concern with that idea. He wondered if other countries do that. He also asked about the "two

knives" system. Mr. Johnston replied that there is "no going back" language in some sliding scales. The "knives" terminology came from Kazakhstan, which has three sliding scales.

He summarized that he would not want to see a system with maximum flexibility because "if you want to go the full distance with a truly progressive system", the government take is greatly reduced. He emphasized that he does not want to see Alaska under worse circumstances. A sliding scale has a high likelihood for unforeseen circumstances. He suggested that if PPT drops down below what would have been earned under ELF, reverting to ELF is better than nothing.

ADJOURNMENT

The meeting was adjourned at 3:20 PM.