

HOUSE FINANCE COMMITTEE
March 30, 2006
2:07 P.M.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [2:07:46 PM](#).

MEMBERS PRESENT

Representative Mike Chenault, Co-Chair
Representative Kevin Meyer, Co-Chair
Representative Bill Stoltze, Vice-Chair
Representative Richard Foster
Representative Mike Hawker
Representative Jim Holm
Representative Reggie Joule
Representative Mike Kelly
Representative Beth Kerttula
Representative Carl Moses
Representative Bruce Weyhrauch

ALSO PRESENT

Representative Ethan Berkowitz; Richard Owen, Alaska Production Manager, ExxonMobil; Jim Bowles, President, ConocoPhillips-Alaska; Marianne Kah, Chief Economist, ConocoPhillips-Houston, Texas; David Bramley, Consultant & Specialist, CRA International Associates

SUMMARY

HB 488 An Act repealing the oil production tax and gas production tax and providing for a production tax on the net value of oil and gas; relating to the relationship of the production tax to other taxes; relating to the dates tax payments and surcharges are due under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the treatment of oil and gas production tax in a producer's settlement with the royalty owner; relating to flared gas, and to oil and gas used in the operation of a lease or property, under AS 43.55; relating to the prevailing value of oil or gas under AS 43.55; providing for tax credits against the tax due under AS 43.55 for certain expenditures, losses, and surcharges; relating to statements or other information required to be filed with or furnished to the Department of Revenue, and relating to the penalty for failure to file certain reports, under AS 43.55; relating to the powers of the Department of Revenue, and to the disclosure of certain information required to

be furnished to the Department of Revenue, under AS 43.55; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the oil and gas production tax; relating to the deposit of money collected by the Department of Revenue under AS 43.55; relating to the calculation of the gross value at the point of production of oil or gas; relating to the determination of the net value of taxable oil and gas for purposes of a production tax on the net value of oil and gas; relating to the definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making conforming amendments; and providing for an effective date.

HB 488 was HEARD & HELD in Committee for further consideration.

#HB488

HOUSE BILL NO. 488

An Act repealing the oil production tax and gas production tax and providing for a production tax on the net value of oil and gas; relating to the relationship of the production tax to other taxes; relating to the dates tax payments and surcharges are due under AS 43.55; relating to interest on overpayments under AS 43.55; relating to the treatment of oil and gas production tax in a producer's settlement with the royalty owner; relating to flared gas, and to oil and gas used in the operation of a lease or property, under AS 43.55; relating to the prevailing value of oil or gas under AS 43.55; providing for tax credits against the tax due under AS 43.55 for certain expenditures, losses, and surcharges; relating to statements or other information required to be filed with or furnished to the Department of Revenue, and relating to the penalty for failure to file certain reports, under AS 43.55; relating to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue, under AS 43.55; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the oil and gas production tax; relating to the deposit of money collected by the Department of Revenue under AS 43.55; relating to the calculation of the gross value at the point of production of oil or gas; relating to the determination of the net value of taxable oil and gas for purposes of a production tax on the net value of oil and gas; relating to the definitions of 'gas,' 'oil,' and certain other terms for purposes of AS 43.55; making conforming amendments; and providing for an effective date.

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Co-Chair Chenault convened the meeting of the House Finance Committee noting that producers for ExxonMobil and ConocoPhillips would provide testimony.

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EXXON MOBIL:

RICHARD OWEN, ALASKA PRODUCTION MANAGER, EXXONMOBIL & VICE PRESIDENT OF EXXONMOBIL ALASKA PRODUCTION, discussed ExxonMobil's concerns with the committee substitute, CS HB 488 (RES). [Testimony on File].

ExxonMobil has had a presence in Alaska for over a half century, investing more than \$11 billion dollars in the State's economy. Currently, ExxonMobil has working interests in Prudhoe Bay, Kuparuk, Endicott and Granite Point. ExxonMobil's current working interest oil production is approximately 180 thousand BD and is the largest owner of the discovered gas resource.

Mr. Owen noted they are proud of the role they have played in Alaska through:

- Exploration
- Initial Field developments
- Construction of Trans-Alaska Pipeline System (TAPS)
- Development of new technology
- Promotion of efficient reservoir management practices

Today, ExxonMobil's production from Alaska represents approximately 4% of the worldwide oil and gas produced, primarily from Prudhoe Bay and nearby satellite fields. Prudhoe Bay, along with Point Thomson, has significant remaining potential.

Changes in the taxation regime for oil directly impacts how ExxonMobil views stability of the Alaskan fiscal environment, which in turn, impacts the evaluation of ongoing investment decisions. Tax systems need to be designed to ensure the desired objective of resource development. Quality of resources means the size and nature of the oil and gas reservoirs, the cost & technology required to develop those reservoirs, the distance to market, as well as the tax and royalty system that applies including long-term stability of the system.

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Mr. Owen continued, HB 488 as proposed by the Administration, represents a significant tax increase on the industry. ExxonMobil is concerned that a higher tax rate could prevent some of Alaska's remaining resources from being developed. He reiterated, too high a tax rate discourages investment. When the State limits or reduces the benefit that companies can achieve from upside factors, the State reduces the attractiveness of those investment opportunities. ExxonMobil recommends the focus of the bill be encouragement of investment and the growing production.

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Mr. Owen pointed out the committee substitute elimination of transition provisions. The benefits from a typical oil and gas investment need many years to be realized. Satellite and territory recovery investment decisions by the company during the last five years, were made under the Economic Limit Factor (ELF) structure, anticipating a lower tax relative to that proposed under the Petroleum Production Tax (PPT) bill. The original proposal of HB 488 recognizes it is not appropriate to increase taxes on investments without providing some form of consideration to the Industry. The provisions in HB 488 contain a 5-year transition period into the proposed PPT system. That is reasonable.

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Mr. Owen said ExxonMobil was prepared to move forward under the original proposed system, HB 488, as it seeks to provide a balance of revenues to the State and producers across a range of oil prices, providing sufficient incentive for producers to undertake exploration and development risks; it also includes reasonable transition provisions for past investments.

He commented the quality of the resource, the risks undertaken by a producer, and the impact on the State's overall investment climate, should be factored into the design of a tax system. While the industry needs predictability and durability from which to gauge investment decisions, the attractiveness of that predictability and durability is lost if it comes at too high a cost.

Mr. Owen urged support of the bill as proposed by the Administration.

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Representative Hawker asked if ExxonMobil would support CS HB 488 (RES) if it were the version passed out of the House Finance Committee. Mr. Owens replied that when the bill was changed, there were implications, which need further

consideration & negotiation. He maintained that increasing the tax structure undermines the health of the Industry.

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Representative Holm asked about the removing the transition provision. He asked what price oil the provisions were based upon. Mr. Owen replied that they were based on investments made, in which the company anticipated a revenue stream, which the tax structure was in place. The Petroleum Production Tax (PPT) legislation proposes to change that structure. He argued that revenue streams from those investments will take many years from start to return, and that some of the actual oil expected from the enhanced recovery projects has not come to fruition.

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Representative Holm asked how ExxonMobil responds that the people of Alaska have waited seventeen years for a Court resolution for consequences of the spill. Mr. Owen said it was not his intent to discuss that; he only intended to discuss the PPT bill and the future of oil and gas development throughout Alaska.

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Representative Joule inquired about the transition phase, as it exists in other parts of the world. Mr. Owen acknowledged some, noting five examples. He offered to make the information available to the Committee.

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Representative Kelly inquired about the investment "crawl-back" being considered by the Senate. Mr. Owen said it is difficult to determine how that will work. On the Senate side, it is a plan to tie the transition to future spending. The revenue stream is not obvious at this time and the proposed legislation creates a change from one system to a new tax system. The original bill made the transition based on calendar years, which was an effective mechanism.

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Vice Chair Stoltze referenced the dead-end response from the query made by Representative Holm. He asked if there would be further consideration regarding the spill litigation.

Mr. Owen replied that this meeting was not the appropriate forum for that discussion.

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Co-Chair Chenault asked when the actual negotiations began on the PPT with the Administration. Mr. Owen advised that from the beginning, ExxonMobil made it clear both to the public and the State that predictability & durability were necessary for the gas pipeline to move forward. As soon as negotiations started, ExxonMobil began to talk with the Administration about the "stability" surrounding oil terms.

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Co-Chair Chenault asked when if Alaska to date has been a stable environment for ExxonMobil to work. Mr. Owen responded that he did not have a personal history with the entire industry. During the period of the Economic Limit Factor (ELF), there was stability in the year round oil taxes; however, nearly every year, there is discussion to change it.

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Co-Chair Chenault agreed, however, in the worldwide arena, there must be similar conversations occurring. He thought that during the past six years, there has been continued stability. He emphasized that the State of Alaska has been stable in how they have treated the oil industries. Mr. Owen agreed, and asked that his comments were not reflective of the current situation but what could happen over the next ten years in relationship to predictability, durability and stability. He indicated that ExxonMobil was looking at a huge initial investment over the next ten years; for that to be possible, it requires a guarantee of large returns over the next fifty years.

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Representative Kerttula reiterated the emotion of statewide disappointment from ExxonMobil, resulting from their behavior with the oil spill and the lack of settlement over the last seventeen years.

Mr. Owen replied to comments made by Representative Kerttula that there are different tax structures that could be put in place. The Administration has testified about the structural issues associated with the existing system. There are many different systems that could be put in place and the one made by the Administration could work in Alaska and it would be appropriate.

[2:34:01 PM](#)

Representative Kerttula pointed out the lack of definition contained in the Governor's legislation. She believed both groups could better define it.

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Co-Chair Meyer referenced the heavy oil existing on the Alaska North Slope (ANS) and asked if the best way to access it would be by keeping the tax rate down or raising the credit portion. Mr. Owen said both are important, but ultimately, the tax rate is the most important. The tax credit is a way to reduce the barrier for investment. ExxonMobil attempts to get a guaranteed revenue stream for that investment. A tax rate could impact the revenue stream for the entire life, while a credit rate only eases the investment. Ultimately, they must be balanced. The investment credit has the ability to impact the rate of return, reducing up-front investment.

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Co-Chair Meyer pointed out that the House Resource Committee (HRC) version of the bill uses the West Texas Intermediate (WTI) gauge rather than the ANS. He asked how ExxonMobil felt about that. Mr. Owen explained that WTI has a different crude mix to the ANS. It is not representative of the ANS crude. It is more appropriate to make the tax based on the mark attempting to actually be taxed. The market is based on sale contracts, based on price. ExxonMobil does not discuss price or price outlooks with any of their competitors. The West Coast market is more of a refinery market; where crude is sold is a real market. He did not believe that there had been manipulation of that market.

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Representative Kelly asked about the progressivity aspect added by the HRC. Mr. Owen stated that he did not like either option or the 25% tax rate. ExxonMobil only supports the 20% rate with no progressivity. Representative Kelly thought that a 25% rate would be better for "bad times" in Alaska.

[2:42:09 PM](#)

Mr. Owen replied that the 25% rate was damaging for the Industry. He urged a base tax rate, stating that progressivity does not work for the Industry. As the cost of oil rises, the State continues to receive a higher share.

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Representative Joule pointed out that ExxonMobil is the "long range fiscal plan" for the State of Alaska and that it does not leave the State many alternatives to finding a healthy balance.

Mr. Owen recommended that the idea of the long-range fiscal plan, including the Industry, would be a helpful discussion for the State to have. Ultimately, the tax system the Legislature is attempting to come to terms with needs to be one that addresses resources that exist in Alaska and that will provide a long-term health for the Industry. Also, the prize for the State would be getting volumes, royalties and taxes.

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Representative Hawker commented on progressivity. He counseled Mr. Owen that nothing would pass out of this Body that does not contain a progressive structure. He noted that the Governor's proposal would not happen and that the progressive mechanism proposed by the House Resource Committee was a preferable alternative at this time. Mr. Owen replied, ExxonMobil encourages the House Finance Committee to explore something progressive, reasonable & desirable. Representative Hawker said that since the PPT was designed for profitability, the aspects of that principle must be considered.

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Representative Hawker argued that the account receipts do not factor in inflation. He requested comments for a net base scenario.

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Mr. Owen responded that discussion was hypothetical and that moving to progressivity brings a whole new range of issues and does not take into consideration implications. He warned that it should be addressed carefully.

ATEASE: [2:50:02 PM](#)

RECONVENE: [2:56:53 PM](#)

CONOCO-PHILLIPS:

JIM BOWLES, PRESIDENT, CONOCOPHILLIPS-ALASKA, commented that ConocoPhillips supports the bill proposed by the Governor as it brings a fair balance to the table, which effectively doubles tax for the oil companies. Mr. Bowles noted concern with the bill from the House Resource Committee (HRC), pointing out that nearly every component had been changed. He listed the negative changes:

- The base tax rate changed with the escalation of the porgressivity;

- The WTI pricing presents a negative change;
- The transition is a negative change.

Many people think that there would be only a 2-3% change in government take; however, the proposed changes result in substantial dollars removed for each Industry involved.

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Mr. Bowles referenced the handout. (Copy on File). The first slide indicates the government take represented in billions of dollars. The bottom of the slide illustrates the amounts for each of the following:

- * The current ELF system,
- * The original bill,
- * The HRC version, and
- * The Senate version.

He pointed out that the proposed bill indicates the doubling of taxes - extra \$20 billion dollars over a 20-year period for the State of Alaska. HRC version proposes basically a tripling of those taxes; the Senate Committee substitute would impose 3.5 times taxation.

Mr. Bowles emphasized that the base effective tax rate is the key component of the business.

[3:02:07 PM](#)

Mr. Bowles referenced Page 2, which demonstrates how the link works for making decisions - Investment beats Tax. He stressed that tripling taxes on Alaska's #1 economic engine is not a winning move. He commented on the State taxing Industry to a breaking point and then backing off just below the breaking point, actions which "trouble" ConocoPhillips and the overall Industry. Any tax change has an incremental effect on how business is done.

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He agreed that there should be a competitive government take with respect to business around the world; however, he warned that the competitive peer group should be investigated very closely.

Mr. Bowles acknowledged that Industry profits are high but the State needs to consider the amount of investment costs associated with getting the royalty, State taxes and statewide charity and educational program contributions.

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Mr. Bowles acknowledged that ConocoPhillips-Alaska has a vested interest in what comes out of the tax bill. They are the largest oil and gas producer in the State. He pointed out that they employ 500 statewide employees.

ConocoPhillips is:

- Alaska's #1 oil producer
- Alaska's #1 gas producer
- Alaska's #1 explorer
- Largest owner of State and federal leases
- Largest industry-community supporter
- Largest royalty and taxpayer
- Key employer in the State

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Representative Weyhrauch asked if ConocoPhillips could quantify their total investment under the original HB 488. Mr. Bowles could not. He noted they could provide a better insight regarding how investment decisions were made. The assurance is looking at their track record in Alaska.

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Representative Hawker inquired about the tripling of taxes, as indicated on Slide 1. Mr. Bowles responded that at the \$40 dollar rate, taxes would be doubled and that would be a substantial change.

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DAVID BRAMLEY, BUSINESS CONSULTANT & ASSOCIATE, VICE PRESIDENT - CRA FOR INTERNATIONAL ISSUES, acknowledged his history with ConocoPhillips and CRA International, a business firm specializing in economic strategizing. Understanding the application of the E&P fiscal systems and their business implications is fundamental to his work.

At the request of ConocoPhillips, CRA International has analyzed Alaska's proposals for fiscal change in comparison with the fiscal environment in other Organization for Economic Cooperation and Development (OECD) regions that are also mature and are significant oil and gas producers. They identified a comparable group of international oil and gas producing areas and compared those fiscal systems in context with underlying economic potential and current levels of investment. Through the comparisons, they sought to illustrate how well Alaska's fiscal system is aligned to the economic realities of the region.

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Mr. Bramley explained that the proposed changes to Alaska's fiscal system support new investment. He spoke to the impact of the fiscal changes on investor decisions making. All potential investors in the Alaskan oil and gas business make their decisions on capital allocation in the context of a larger portfolio of choices about where to invest, covering a range of competing options.

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Mr. Bramley compared Alaska's fiscal proposals in relationship to overall government take of net cash flows from investing in new opportunity areas. The analyses provide an effective high-level view of the impact on the investment of current and proposed fiscal terms. Comparing Alaska's fiscal proposal to other mature OECD producing areas is the basis for a realistic appraisal of the impact on investment.

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Mr. Bramley reviewed Slide 4, indicating Alaska's production decline by 6% between the years 2000-2004. Petroleum is an extractive industry and the overall economic potential of an area is a function of the hydrocarbon reserves present and the technical and operational costs required to bring oil and gas to market. The relative level of maturity and remaining prospectivity of Alaska versus the other OECD areas is therefore an important factor in defining the context for comparisons of the fiscal regimes. Overall production of oil and gas from an area rise to a peak and then undergo a long steady decline. There are exceptions to that pattern, in which the United Kingdom (UK) is one.

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Dr. Bramley reviewed Slide 5, the remaining oil and gas reserves and their size relative to past production from an area is a fundamental measure of maturity. The figures reflect gas in the tank, although any Industry insider would acknowledge how elusive and verifiable reserve figures are. The bar chart indicates historic oil and gas production & estimates of remaining production of remaining reserves.

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Mr. Bramley highlighted Slide 6, the reserves and reflecting how successful an area is in replacing its year-by-year production with proved petroleum reserves. The chart shows the comparison group. Only Alaska has failed to replace production on a proved reserve basis over the past 10 years.

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Mr. Bramley referenced Slide 7, which indicates the pattern of new field developments in an area giving another measure of potential to add to the producing base and arrest long-term production decline. The chart shows the number of new fields brought on stream in each of the comparison areas and the average size of those new fields. Alaska has the lowest number of new producing fields with the smallest size amongst the whole group.

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Mr. Bramley spoke to Slide 8, looking at exploration activity. Alaska clearly lags behind the other conventional oil and gas areas in the comparison group both in terms of number of exploration wells drilled and success rate. Canadian oil sands were excluded from the comparison since exploration there does not make good business sense with the major resources already discovered but undeveloped.

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Mr. Bramley commented on Slide 9. Based on recent development history and the available set of forthcoming opportunities, seeks to develop a profile of a "typical field" in each area. It is a helpful way of characterizing an area's economic potential and a good base for later calculations of government take in economic terms. The results are shown in the tables.

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Mr. Bramley continued, Slide 10, draws together all of the observations of maturity and indicates the overall trends. Alaska emerges in a predominately red category. Alaska has little remaining economic and resource potential. It does have areas under review, ranking low in that group. Maturity analysis raises concerns about the impact of Alaska's existing fiscal terms.

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Mr. Bramley highlighted Slide 11, which provides a direct comparison of total government take throughout field life for the representative fields of each area. To calculate involved determining a relevant fiscal system dividing the cash flow from a new field between the government and the company investor. Overall government take is a good measure of the share of the economic value of a field that is captured by that fiscal system. The chart shows overall government take for each region, plotted against the unit technical cost of representative fields.

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Mr. Bramley continued, Slide 12, adds a color code to reflect relative levels of maturity and suggests Alaska's positioning is problematic - a mature region with a high cost base and with relatively high government intake.

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Mr. Bramley continued, Slide 13, points out that Norway is the only country in the comparison group with levels of government take higher than the Alaska proposals; used as an example, since Norway has been cited in previous testimony as an area with strong similarities to Alaska. Norway is significantly less mature than Alaska for conventional resources. There are a number of structural and policy factors that are relevant:

- Norway has chosen to give incentives for exploration
- Norway's upstream petroleum industry remains highly concentrated and is led by largely government-owned companies
- Norway has pursued a policy of 'measured development'

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Mr. Bramley spoke to Slide 15, indicating the fiscal response to changing oil price is an important consideration. The base price considers oil at \$35 dollars per barrel. He urged that both a higher and lower scenario be considered to reflect the way investors make decisions, and in order to capture the full range of possibilities that may affect future investment in Alaska. The chart illustrates the regressive nature of both the current and proposed fiscal systems. The regressive feature of the Alaskan regime is not helpful in supporting positive investment decisions.

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Mr. Bramley continued, Slide 16 observes the regressive nature of the Alaskan regime and manifests itself in the context of changing costs. The chart provides an examination of the effect of higher and lower capital and operating costs on total government take. As the costs increase, so does the total government share.

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Dr. Bramley explained that is not a helpful combination in supporting investment decision-making.

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In response to a question by Representative Hawker, Mr. Bramley explained that the point of inflection rests at the \$35 dollar per barrel price; three points have been modeled also including \$40 & \$50 dollars. There is always a continuous curve.

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Representative Kerttula pointed out that Dr. Van Muers came up with an opposite conclusion, indicating that Alaska was highly enticing for new entrance; she asked the difference. Mr. Bramley did not believe there was a difference in interpretation of the roles or the cash flows. The conclusions could be different because of the way they were basing their judgment of fiscal competitiveness on the total government take, which is important to investors. They were more detailed on their expectation of economic potential in Alaska in terms of field size and the unit cost in basic analysis.

Additionally, ConocoPhillips has a different view on the investment behavior. Other consultants have based their models on threshold comparisons. ConocoPhillips bases theirs on the market and the affect of fiscal take. If the price goes up, the tendency to buy will go down, which might result in a migration of capital.

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Representative Kerttula asked if factors for including small companies had been added. Mr. Bramley affirmed and pointed out the significance of price breaks for those smaller companies. There are important questions regarding the growth of those portfolios.

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Representative Kerttula questioned if ConocoPhillips had factored in access to the facilities and the pipeline corridor. Mr. Bramley affirmed that those elements had been factored as part of costs doing business in Alaska.

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Dr. Bramley stated that Slide 18, considers the impact of the new proposals on future investment; it is essential to consider where Alaska future potential actually lies. The table indicates that Alaska is in the unusual position of having the majority of its resource potential in the form of known but undeveloped hydrocarbons, currently, the uneconomic heavy oil and gas resources. There is major potential in incremental and improved recovery from producing fields. Each element is larger than the resources

available through new exploration and undeveloped conventional oil. Conclusions from the study of Alaska's investment attractiveness within the OECD group, is that new proposals will inevitably reduce future investment.

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Representative Hawker questioned how any increase in taxes [including PPT] could provide an incentive toward production. Mr. Bramley acknowledged that the increase in tax goes directly to the overall government take. The difference rests between the original and the proposed HRC version.

Representative Hawker observed the PPT paradox. Mr. Bowles commented there was no difference between ConocoPhillips and the other companies. He spoke to the credit uplift, which masks the underlining problem against the tax rate. Credit cannot offset the underlining issues. ConocoPhillips can only move the needle so far on the credit side and that the underline, base investment will come from the larger fields. The key driver is the base tax rate.

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Representative Kerttula asked which was the more important factor:

- Entrance
- Tax rate

Mr. Bramley replied that they could not provide a definitive answer one way or another. Each situation has issues of access, and is not unique to Alaska. Mr. Bowles added that there is full access capability to the pipeline and with respect to facilities; Pioneer is the new entry player. There is no facility access question.

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Representative Kerttula inquired how other places around the world tackle these concerns. Mr. Bramley responded, there is no indication that Alaska is not working.

Representative Kerttula pointed out the number of so few new fields. Mr. Bramley responded that the infrastructure is the complex networks created. It is difficult to draw analogies from that; the Alaskan situation is not fundamentally different from the others.

Mr. Bowles added, the lack of field size prospects is a key driver. The availability of large structures, facilitate

new field developments. New field capability creates a better environment for small developers to enter.

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Representative Kerttula observed the attractiveness of Alaska; she asked if the profit rates had been considered over proposed costs. Mr. Bramley replied that is inherent in the manner in which the analysis is done.

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Representative Foster mentioned the boost to Alaskan economy & the "golden egg" potential and how those things affect marginal fields. Mr. Bowles agreed. ConocoPhillips hopes for a clear and fair tax rate to help drive new players into the State.

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Representative Kelly addressed credits versus progressivity. Mr. Bowles replied that all companies have indicated that the base tax rate is the most important consideration. Progressivity moves the tax rate up, which has an impact on investment decisions.

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Mr. Bramley pointed out Slide 19, suggests an appropriate level of government take. Based on the analysis, the Industry believes that the balance of the current proposals is slanted towards short-term revenue collection over the stimulation of new investment.

Slide 20, highlights that increasing Alaska's oil and gas taxes comes with a price:

- The dilemma of balancing revenues and investment
- Alaska is mature, but has undeveloped potential
- Current fiscal proposals do not help competitiveness in the OECD peer group

Mr. Bowles recognized the dilemma of balancing revenue and investment and the work has focused on the question of investment. Alaska is mature and has enormous remaining potential, but the challenges to access that are huge. Current fiscal proposals do not help competitiveness.

[4:01:12 PM](#)

Representative Kelly asked if there was a way to analyze the shape of the curve. Mr. Bramley did not think so.

[4:03:40 PM](#)

MARIANNE KAH, CHIEF ECONOMIST, CORPORATE CONOCOPHILLIPS-HOUSTON, TEXAS, spoke to the investment criteria used and how the tax bill would appeal or not appeal to ConocoPhillips.

Typical investment criteria components are:

- Prospectivity
- Costs
- Cycle time
- Taxes
- Legal regime

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Ms. Kah continued - Slide 2, the investment criteria in relationship to Alaska's rating:

- Small expected field size & lower value heavy & high sulfur crude
- High exploration, development and production cost and high transportation cost
- Long lead times
- High tax rates given prospectivity & cost
- Recent concern about stability of fiscal regime
- Strong rule of law/political stability
- Concern about changing tax rate without grand fathering recent investment

[4:07:06 PM](#)

Ms. Kah noted Slide 3 - the global average commercial discovery size in comparison to other countries around the world. The Alaska North Slope (ANS) has limited prospectivity and the tax rates need to reflect that.

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Representative Holm pointed out the presented investment criteria does not indicate a return of investment. Ms. Kah explained that the value, which comes at the end of the criteria, is the return on investment. All of those items are the components.

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Representative Kerttula referenced stability & the tax rates. She suggested it be considered that Alaska has maintained the same tax rate for fifteen years. She assumed that whatever is put in place at this time will likely be

working for many years. Ms. Kah stated that they do give Alaska credit for the stable fiscal terms, acknowledging there had been no major change for more than thirty years. The corporate world wants to guarantee that if there is transition, the Industry is treated fairly.

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Ms. Kah continued, Slide 3 provides a chart, indicating that exploration is important. ConocoPhillips will continue to explore in Alaska. She pointed out that the core fields still produce over 80% of the total North Slope production into 2015. Significant capital is needed to maintain the infrastructure as well as for drilling and well work. It could be many years before the full potential is reached. Technology to develop resources requires huge capital and resources. She warned that if members were interested in Alaska's future, they should be interested in keeping the major Industry investors in the State.

[4:10:36 PM](#)

Representative Weyhrauch referenced benefit "grand fathering" of costs. Ms. Kah stated that "grand fathering" implies that if you invested under the old regime, you keep those terms; she realized that was not possible so the alternative is transition credits.

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Representative Joule asked if that concept was true for the effective date. Ms. Kah said that was a different matter, regarding whether past rules apply. It would be consistent that the principle of no retroactivity should be applied to things moving forward. Representative Joule understood, but did not agree.

[4:12:49 PM](#)

Representative Kerttula maintained that during the five years, surely some costs could be amortized. Ms. Kah advised that when ConocoPhillips makes investments, they factor in price risk. She referenced Alaska attempting to "punish" companies. Investments take many years to pay off. It is not fair to use the new tax regime with expectation and price risk included.

Mr. Bowles pointed out that last year when the tax structure changed, ConocoPhillips was in the process of making satellite investment decisions. They were unable to make the decision on the premise that those fields could be aggregated. They sought out State assurance that they would not be aggregated and went forward with development

decisions based on the tax at that time. Those fields have not yet produced.

[4:16:05 PM](#)

Representative Kerttula pointed out the incredible profits that they have received in Alaska over time. She did not understand why those considerations had been made. Ms. Kah advised there have been years of good profits, which offset the years when there were none. It is hoped that on average, they earn above the capital return. The truth is that the Industry over the past 20-years has not earned a higher return than many others.

[4:17:24 PM](#)

Representative Hawker emphasized that profit is not a bad word and acknowledged that there have been poor returns for some years.

The Governor's version contains a five-year transition look-back; the original HRC version had a three-year look-back but what actually passed was a three-month recovery. He asked what the Industry wanted. Ms. Kah replied that five-years is relevant because that is the amount of time it takes on the slope from the time of the initial capital investment to the time the revenues actually start to come in. Mr. Bowles indicated his respect for the HRC version, however, the Senate version recognizes transition and incentive investments in the future. Representative Hawker was troubled with the 5-year option.

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Ms. Kah referenced Slide 4, which indicates increased production costs and that Alaska is the highest cost region in the portfolio. Costs in Alaska are rising at a greater rate than other areas, because of the aging infrastructure and the declining field size.

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Ms. Kah continued Slide 5, showing Alaska with high costs and high taxes. Countries with no costs and no taxes are the ones that are really trying to attract investment. The quadrants are as follows:

- Low Cost - Low Tax
- Low Cost - High Tax
- High Cost - Low Tax
- High Cost - High Tax

She foresaw Alaska moving into the quadrant with high costs and high taxes, which discourages development.

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Ms. Kah highlighted Slide 6, which shows Alaska with high cost, high tax and low prospectivity and development indicating that only the government takes.

[4:24:20 PM](#)

Representative Hawker referenced the MacKenzie projections. Ms. Kah disagreed with the Daniel Johnson testimony. She understood him to say that if the government participates at all, it should be a government take. From the point of view of ConocoPhillips, if the government is paying their way as an investor, why should that then be a government take. She agreed if the government was being carried through the exploration; that is why some countries were removed. MacKenzie is more representative of the industry and is more mainstream.

[4:26:36 PM](#)

Representative Kerttula asked about "carried equity". Ms. Kah explained that sometimes the government has the right to "back-in" to a development prospect once discovered; in that scenario it becomes a form of government take. The main point is it does not change the answer, merely the details.

[4:27:25 PM](#)

Representative Kelly noted that Alberta is not shown on the slide. Ms. Kah replied they have substantial royalty relief and attractive fiscal terms.

[4:28:03 PM](#)

Representative Hawker asked what "development only" meant. Ms. Kah explained it does not include exploration or lease bonuses.

[4:28:31 PM](#)

Ms. Kah noted Slide 6, which adds bubbles; the size of the bubble indicates the prospectivity.

[4:29:24 PM](#)

Ms. Kah disagreed that taxes can be raised without affecting investment, as some consultants have suggested. She noted three reasons that it will affect investment:

- Reduces after-tax cash flow available for investment
- Adversely changes risk/reward balance
- Capital goes elsewhere to:
 - Other countries
 - Other energy sources
 - Other industries

[4:32:46 PM](#)

Ms. Kah reviewed the major upstream projects for investment from 2005 through 2011+ being considered by ConocoPhillips. Investment in Alaska must attempt to compete with the other areas around the world. A tax rate needs to be comparable.

[4:33:31 PM](#)

Ms. Kah discussed Slide 9, clarifying what is wrong with windfall profit taxes. Windfall profit tax introduces a lot of distortion, decreases investment and doesn't achieve the goal intended. She observed opposition to the tax by elected officials and the 250 economists. She noted that a non-partisan congressional research service concluded that windfall profits tax on domestic crude oil removed \$79 billion dollars in gross revenues from industry, reduced domestic oil production by up to \$1.6 million dollars and generated 20 percent of expected gross revenues.

[4:36:17 PM](#)

Representative Hawker observed that Ms. Kah had made a strong argument against windfall taxes. He noted that progressivity is inevitable and questioned if ConocoPhillips concerns could be alleviated by the net profit tax. Ms. Kah responded that neither alternative is attractive as it would not be inflating the base. To attract investment, that would not work.

[4:37:55 PM](#)

Ms. Kah reviewed Slide 10, project economics in development. (Impact of Progressivity on Risk/Reward Balance). She observed that a "tornado chart" was created in order to see the range. A series of simulations were run to see the expected value of the project. If a windfall profit tax is introduced, the upside is taken away and both the up and downside are taken into account.

[4:40:25 PM](#)

Representative Hawker questioned if the profit tax remained on the net, would the bar remain balanced. Ms. Kah observed

that inflation would be reduced, but the upside would still be reduced.

Representative Hawker questioned if progressivity started at \$50 dollars on the net, and escalated to \$120 dollars, taxing at 80 percent. Ms. Kah responded that the upside would be 80 or 90 percent. The company never sets one price. She estimated that it would still be 90 percent.

Representative Hawker observed that the State of Alaska is attempting to take a bigger chunk of the profits. He questioned if a plateau were established if the results would not be as eschewed. Ms. Kah responded that there would then not be an investment. ConocoPhillips counts the upside price risk and gives it a 25% weigh in; ConocoPhillips is in the business of managing risk and the upside is essential in the project value.

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Representative Hawker requested more information on the definitions of "upside".

[4:45:05 PM](#)

Representative Holm observed that if the price analysis had been done 14 months ago, what would the highs & lows be. He guaranteed that ConocoPhillips would not have achieved the current level and maintained that the models for the investment had been made on a reduced level. The State government does not own the oil; the citizens of Alaska own that oil. A different climate exists today. The State is not taxing the industry. He felt that as the value grows, the profits should also grow.

[4:47:24 PM](#)

Ms. Kah observed that Slide 11 illustrated finding development and production costs. Some of what is seen, as a windfall tax is actually higher reserve replacement costs. Development costs have doubled. She maintained that \$25 dollars a barrel needs to be added up-front in terms of investment. No compensation is included in the cost of capital. Replacement cost is usually stated in terms of WTI and that crude is not as valued as WTI, which increases costs. Replacement costs today are over \$50 dollars a barrel. There are estimates of replacement costs of \$50 - \$60 dollars. Spending levels and costs continue to rise, as does inflation. ConocoPhillips is facing high replacement costs. There have been increases in steel prices. The industry is investing in prospects that are smaller, more complex and more remote. Costs are not going down. She was concerned that the windfall would only be used for the higher replacement cost environment.

[4:50:53 PM](#)

Ms. Kah summarized Slide 12:

- Current tax rate is already uncompetitive given cost and progressivity;
- Proposed tax increase will reduce investment and production in Alaska; and
- U.S. federal windfall profits taxes lowered production and failed to produce expected revenues.

Ms. Kah concluded that ConocoPhillips has been a long-term investor in the State and wants to be part of Alaska's future.

[4:52:21 PM](#)

Mr. Bowles recognized the difficult task of the Legislature, but emphasize the key points:

- Higher taxes have a direct impact on investment,
- The 20 percent tax rate strikes a good balance, and
- Windfall profits tax do not encourage investment.

[4:54:08 PM](#)

Representative Hawker summarized previous testimony [from the Administration] that stability is needed and PPT is the key. He questioned if ConocoPhillips would be willing to move forward on the gas line without a PPT bill. Mr. Bowles said they reached agreement with the Governor, without the PPT legislation. ConocoPhillips is now more nervous regarding the climate of the State, given the current PPT proposals.

[4:57:03 PM](#)

Representative Kelly did not understand why the proposal was considered a tax given the contract of cost of goods sold and how the value changes.

[4:59:17 PM](#)

Representative Holm observed a handout he distributed. [Copy on File]. The handout indicates that ConocoPhillips made \$11 million dollars yesterday [3/29/06]. He commented things are not as bleak as the information being presented. He wanted a guarantee that the value for the people of Alaska was realistic.

[5:00:59 PM](#)

Representative Hawker asked if the accountants for ConocoPhillips had been consulted about the possibility of a major tax date change without regulations promulgated by the State. Mr. Bowles agreed with the complexities and acknowledged the concerns. He urged a reasonable timeframe. Representative Hawker recommended regulations are in place first.

[5:02:33 PM](#)

Representative Joule spoke to a process, supported by the Industry, excluding the Legislature. That bothered him. He asked everyone to keep an open mind in the negotiation process. Mr. Bowles recognized that and the role of the entire State. The initial intent was to layout the Industry's process in relationship to the formation of taxation.

[5:04:42 PM](#)

Representative Foster commented on comparison with aviation business and how the net profits work seasonally. He was outraged with proposals submitted by the Committee.

Representative Weyhrauch agreed that profit is important. He added that any law could be amended down the road.

HB 488 was HELD in Committee for further consideration.

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[5:06:47 PM](#)

ADJOURNMENT

The meeting was adjourned at 5:06 P.M.