

HOUSE FINANCE COMMITTEE  
April 3, 2006  
1:39 p.m.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [1:39:54 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 Bruce Weyhrauch

MEMBERS ABSENT

Representative Carl Moses

ALSO PRESENT

Patrick Foley, Manager of Land and External Affairs, Pioneer; Tom Dodds, President, Andex Resources; John Barnes, Production Manager, Marathon Oil, Alaska.

PRESENT VIA TELECONFERENCE

Ken Thompson, Managing Director, Alaska Venture Capital Group.

SUMMARY

#hb488  
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 and HELD in Committee for further consideration.

J. PATRICK FOLEY, MANAGER OF LAND AND EXTERNAL AFFAIRS, PIONEER NATURAL RESOURCES ALASKA, INC., provided information regarding Pioneer's position on the bill. He referenced the company president, Ken Schoeffield, who was unable to attend due to illness. Mr. Foley explained that his company began business in 2003, and commented that they were one of the types of companies that the State of Alaska had been encouraging to do business. He stated that their portfolio had grown to approximately 1.7 million gross acres, equaling 450 to 500 net acres. He illustrated their acreage position on the North Slope and noted that ConocoPhillips was their partner in exploration. The company has two wells in the area currently, and is expecting to drill several more. He noted their development project in Oooguruk, as well as exploration wells in other locations south of Prudhoe Bay. He noted that ConocoPhillips in Antigua operated their Artic Fox drilling rig. He also mentioned their Cosmopolitan project in Cook Inlet - a known resource discovered by Arco originally. They maintain small working interest, with the option to increase to a fifty percent working interest and become the operator. This will be decided by the summer of 2006.

Mr. Foley discussed details of Oooguruk project, an offshore development with 50 to 90 million barrels of recoverable oil reserves, developed at a cost of \$500 million and a peak production projection of 15,000 to 20,000 barrels per day by

2010. He explained that if this were a simple North Slope project, it would include no processing. Processing fees were being discussed.

Mr. Foley described the project components, such as gravel placement in the winter of 2006, equipment in the winter of 2007.

Representative Chenault asked how far from shore. Mr. Foley observed that the island is eight miles from the Island and is at a depth of 4.5 feet. The pipeline at its deepest crosses 7.5 feet of water.

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Mr. Foley acknowledged the cost structure as being a challenge, some of the highest in the world. He noted the theory that the super sized fields had already been tapped, meaning that smaller reservoirs would be developed. He noted that the cycle times between discovery and production were much longer here than in the lower 48. He observed that the cycle time was shortened to 5 years in Oooguruk. He pointed out that it is close to infrastructure and that work had been done since its discovery in the 1970's.

Mr. Foley noted the investment uncertainty in Alaska, pertaining not only to exploration but also to fiscal circumstances.

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Mr. Foley commented that their initial reception from Administration was welcoming. He expressed concern over how to process smaller fields, and noted the willingness to allow access to facilities for newer companies, providing they were willing to pay processing fees. He noted the State's fiscal policies, and noted that they were still attractive compared to other places in the world. He referenced conversations with the Governor's office, and suggested that production taxes might come out to be nearly zero considering other incentives.

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Mr. Foley maintained that Alaska needs to be competitive with lower 48 and Canadian on-shore resource plays, which target tight sands, coal bed methane, and shale. These types of projects are low risk, low cost and are attracting development. Many have lower tax rates.

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Mr. Foley concluded that this was the climate that attracted his company to develop in Alaska. He reviewed the

Administration's original proposal with a 20 percent tax rate and a 20 percent credit, concluding that they believed it to be fair and balanced. He noted the tax/credit rate, \$73 million exemption, tradable credits and other modest incentives for new exploration. Large companies that are already paying a production tax can utilize the credit the next month. A new entrant would have to wait to use the credit, or sell them when their value had eroded. He explained that the credits had market value, and that the incentives allowed for no entrants and exploration, by reducing the economic size field that can be explored. Smaller, less productive fields would be economic. He concluded that the Administration's proposal would encourage new investment.

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Mr. Foley then commented on the proposed legislation. He applauded the 20% tax rate, and cautioned raising the tax rate, proposing that that it would reduce companies' incentive to invest. He pointed out that if a development existed, it would be in the State's best interest to have multiple independent companies also investing.

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Mr. Foley cautioned that if the State wished to implement a progressive tax, that they be careful in its method. He referred to the relationship between oil price rise and costs for exploration. He noted that costs for all development related services had increased recently. Pioneer's drilling cost doubled in Texas in 2005. He concluded that the profit margin does correlate to the rise in oil profits.

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Mr. Foley suggested that if a progressive tax rate were implemented, it should be based upon profits, rather than a simple tax rate. He suggested that to base the tax on profits would make it unnecessarily complex. He noted that all of the oil sold by his company would be sold as crude on the west coast and encouraged the use of ANS price if necessary.

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Mr. Foley noted that it was difficult to predict prices. He concluded that if a price were accepted, there should be some index to take inflation into account. He suggested that excess could be taxed at a higher rate, but noted that overtime that amount would be affected by inflation.

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Mr. Foley then discussed the idea of \$12 million "start up" credits to encourage new entrants. He noted that the House had converted this concept to a \$12 million credit, but stated that it was similar to a profit exemption. He suggested that this credit would give an independent company the opportunity to cover start up costs without the benefit of an existing infrastructure. He noted that his company had 26 employees housed in Alaska, and stated that it was difficult to do business in the state without personnel who actually understand the way things work here.

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Mr. Foley proposed that start up costs in the State were high, and this exemption gave a chance to smaller companies. He noted that implementing a severance tax would make business difficult for these smaller companies.

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Mr. Foley discussed the importance of monitoring tax credits. He pointed out that credits could be used in a number of ways, whether held or sold at a discount. He noted that the purchaser of credits would redeem its full value, as well as the cost to the state. He referred to the "refundable" credit of \$10 million included in the bill, and encouraged legislators to increase the amount. He observed that if a new investor spent \$100 million, that between a 20 percent credit and a 20 percent loss, \$40 million in credits would be generated. He reiterated that any number higher than 10 would be beneficial.

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Mr. Foley then addressed Transitional Capital Recovery. He noted that their cumulative investment since 2003 had been \$100 million, and expressed the need to be rewarded for this investment. He noted that in this time, they had yet to recoup their costs for development.

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Mr. Foley referenced the 26 employees of Pioneer in Alaska, and suggested that the State should make it a priority to convert all resources into revenue. He reiterated that the 20/20 proposal was balanced and fair, and urged that careful consideration be given to raising the tax rate. He noted that the start up credit seemed to have a sunset provision, and encouraged that the credits be allowed to last in perpetuity. He also referred to refundable credits, and encouraged that these be implemented. Finally, he noted that a Transition Capital look back was appropriate, especially for smaller companies.

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Representative Kerttula asked how the PPT would play into the royalty reduction already set forth. Mr. Foley responded that Mr. Van Dyke discussed Pioneer's royalty reduction and the effect of royalty reduction. He proposed that it benefited the project, but pointed out that it would not dramatically add to its success. He noted that the rates of return were not actually at the rate previously discussed.

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Responding to another question by Representative Kerttula, royalty reduction had not yet phased out, which would occur linearly over four years.

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Representative Holm referred to earlier comments about the regulatory process being a stumbling block to production, and asked for clarification. He asked if the regulatory process was as big a burden as the tax rate.

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Mr. Foley acknowledged that the resource should be protected. However, he contrasted the difficulty in regulatory climate between the North Slope and another global location, and noted that it was dramatically higher in the North Slope. He suggested that it required personnel familiar with the system.

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Representative Holm asked how long it would take to permit a well in the Gulf of Mexico. Mr. Foley noted that he knew that Oooguruk began its regulatory process on an informal basis, and it took one year to complete. He also noted that many other projects took 4 to 5 years.

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Representative Holm observed that if the State considered creating incentive for production, perhaps it might do well to adjust the permitting process as a type of incentive. He noted that perhaps if the permitting took an inordinate amount of time, the price might decline before production.

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Mr. Foley noted his personal experience with the regulatory process in the immediate infrastructure. He felt the process worked relatively well and noted that an offshore project

was permitted in a year's time. He pointed out however that more remote resources would require a more difficult permitting process, and suggested that this might be investigated.

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Vice-Chair Meyer referred to delays occurring on the North Slope relating to environment. Mr. Foley confirmed that most exploration work took place in the winter, and noted the snow road concept in working with the Department of Natural Resources, developing systems to facilitate work in late November, a month earlier than historical trends. He also noted that drilling might continue until the end of April.

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Vice-Chair Meyer expressed appreciation for the smaller companies like Pioneer, and asked how many wells were drilled this year. Mr. Foley noted that in the past year, nine explorations wells had been drilled, as compared to 3 this year. Vice-Chair Meyer asked how this compared to ten year ago. Mr. Foley noted that he had worked in exploration activities for the past twenty years, and conceded that there might have been a time when there were as many as eight wells drilled, compared to times when prices were low. He asked legislators to consider whether six wells were adequate, and suggested that incentives might increase the number of wells.

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Vice-Chair Meyer stated his belief that double the amount of wells would be more beneficial, and questioned why there wasn't more exploration with a cost of \$60 a barrel.

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Mr. Foley noted that to drill a well would cost approximately \$10 million, with a higher cost in more remote locations. He also responded that smaller companies had finite resources, in terms of equipment and personnel. He noted that the fleet of drilling tools would increase over time. He noted that other companies needed to first consider whether it was worth their while to enter into business in Alaska.

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Vice-Chair Meyer questioned whether the 20/20 proposal would be adequate to attract smaller companies if the drilling season was shorter in Alaska, and regulatory costs higher. Mr. Foley confirmed that the 20/20 proposal was fair and

adequate (without progressivity), providing a modest incentive over the current structure, and estimated that other companies would come to the State. He emphasized that it would enable small, marginal [fields] to be profitable, by only a few percentage points increase in the rate of return.

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Representative Weyhrauch asked how our drilling costs compared to Texas. Mr. Foley noted that the costs were significantly less in the lower 48 states; a \$2 to \$3 million well would be considered expensive. Representative Weyhrauch asked how independents were affected by the use of ANS. Mr. Foley pointed out that the barrels would be sold in the west coast market. He noted that it was not as simple as predicting an average \$2 dollar difference; there have been times when the spread between ANS and WTI has been great.

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Representative Weyhrauch observed that three major companies were marketing and shipping from the west coast and wondered whether it was better to separate out that the network using ANS indexing to use WTI to game the system.

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Mr. Foley stated that a company like Pioneer had no ability to "game" the system. He noted that it was not a transfer price or accounting issue, but rather a real legitimate sale.

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Representative Chenault referred to earlier comments and asked how this might affect Cook Inlet. Mr. Foley stated that Oooguruk was in a decision making process to conclude in the summer. He noted that their company included analysis of Oooguruk and Cosmopolitan in their portfolio. He stated that if a project like Cosmopolitan were separated out, the credits might prove more enticing. He thought that Cosmopolitan may be found to be marginal and a slight shift would make it profitable.

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Representative Chenault commented that some interest was not only North Slope, but also Cook Inlet, and questioned what incentives were available to bring smaller companies into these areas.

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TOM DODDS, PRESIDENT, ANDEX RESOURCES, provided information on HB 488. Andex has been invested in Alaska for approximately 6 years. Andex is an exploration leader. He observed that there has been little new exploration in Alaska. They are currently working on a gas [exploration] project of over 500,000 acres, which would flow to Anchorage and Fairbanks. Andex tries to identify projects' risk/return. Capital commitment for investment dollars is huge. He acknowledged Alaska's high cost of operation. They are ready to start drilling in Nenana, but are waiting to see the results of HB 488. He observed increases in rent of 400 percent and 200 percent in steel. There are also shortages of equipment and manpower, which were worsened by the recent hurricanes.

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Mr. Dodds observed that they were unable to find partners for the high risk Nenana project. Lower 48 companies were not interested in coming to Alaska. Three Alaskan companies were recruited as partners, none of which were normal oil and gas companies. There is a big difference between their company and others in the Cook Inlet and North Slope. They are looking for high return investments. Exploration would be affected under a PPT plan. He observed the lack of infrastructure, but pointed out that Alaska has the potential for giant new discoveries. It will take people in the interior looking for these reserves. Daily production is declining.

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Mr. Dodds expressed concern that under the PPT tax new exploration would not come to Alaska. He observed that their project is in a basin 300 miles from the nearest operations. They are between Cook Inlet and the North Slope. Production is approximately 7 to 8 years in the future. There is only a three-month drilling season, which must occur before breakup. He stressed that a pipeline must be put under a river to reach Fairbanks at a cost of \$150 million over 6 - 7 years, which the producers must finance. The project would lower the cost of fuel in Fairbanks by half and open up services in the interior.

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Mr. Dodds emphasized that they need long-term stability and pointed to the raise in oil prices. The 6 - 1 ration between oil and gas should be more like 9 or 10 to 1, and should be stand alone commodities. The incentive with any tax increase must be real. Without new investment incentives there will be little to no new exploration. He projected that the oil and gas assets of the state of Alaska will be depleted

without new exploration. Reserves must be replaced and investment encouraged.

Alaska relies heavily on the oil and gas industry. Oil is ageing but gas has a huge potential. He stressed that the gas will be a depleting resource once it begins production and emphasized the need for more exploration.

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Representative Holm observed that the project has been on hold for several years. Mr. Dodds responded that they did not anticipate drilling before the current year. They held several public meetings. Contracts with their partners were only signed two years ago. He continued to give details regarding the project's timeline. He noted that the plan to begin in the next year had been jeopardized by the introduction of HB 488. Andex is looking at acquiring rigs. He emphasized that the project is high risk.

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In response to a question by Representative Holm, Mr. Dodds observed that the same rigs could be used for oil and gas, but that size is the issue. The rigs must be light load so that they can be broken down and brought across the river.

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KEN THOMPSON, MANAGING DIRECTOR, ALASKA VENTURE CAPITAL GROUP (AVCG), testified via teleconference from prepared comments. He stated that AVCG was an independent oil exploration company with a focus on the North Slope of Alaska. AVCG is a consortium of 15 independent oil and gas companies and individuals from Kansas and me as an owner/investor from Alaska. AVCG has a technical and operational services' subsidiary company called Brooks Range Petroleum, with offices in Anchorage. He also noted that he is the former President of ARCO Alaska, Inc.

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Mr. Thompson continued his testimony.

AVCG has been very active in the past six North Slope (NS) area wide lease sales and we have acquired over 160,000 acres of exploration leases in five exploration prospect areas, including new acreage we acquired in the recent March 1, 2006, NS lease sale. Our exploration strategy is to explore in the central part of the North Slope for fields in the 25-150+ million barrels range, fields that may be too small for the giant producers but fields that can be produced profitably by smaller companies like ours. We believe

there are hundreds of millions if not billions of barrels of oil left on the North Slope in smaller fields of this size and these fields near infrastructure can be brought on more quickly. Our first exploration well in partnership with Pioneer Natural Resources - the Cronus #1 about 10 miles southwest of the large Kuparuk Field - completed drilling last week but results remain confidential.

I don't understand all the dynamics of the past three weeks in the legislature, but this I do know. The CS for HB 488 needs to be greatly simplified and it needs to move back closer to the Governor's proposal and the original HB 488 draft if a win-win solution is to be re-developed.

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I am an optimist and always have been. I personally think there is still time to avoid a train wreck in this complicated business of a major restructuring of Alaska's petroleum taxation system...if the House Finance Committee acts quickly. I, for one, have not given up hope that there is a version - easier to understand and to implement - that can be a win-win for both the State and industry. I repeat that the current draft of CS HB 488 is not a win-win. There is a simpler and better way, in my opinion, for the State to improve government take while not dampening exploration and development investment. Let me outline my suggestions for a win-win and my suggestions for simplification.

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First, however, let me say that while I am Managing Director of AVCG, our other owners disagree strongly that any change should be made to the 20/20 PPT formula proposed by the Governor. The 20% PPT tax rate and the 20% credit originally presented in the Governor's bill should be the tax rate and credit enacted. The AVCG owners representing 15 new exploration investors in Alaska are concerned enough that the current system is being revised after they have made almost \$10 million investment in North Slope leases and other costs and are planning a 3-year \$46 million exploration program with our first well recently drilled. With reasonable discovery success over the next 3 years in any of our upcoming prospects, we could see development capital spending at \$500 million to \$1 billion.

Quite honestly, the AVCG owners listened in disbelief when I told them the production profits tax rate being considered in the current CS to HB 488 draft could add a "progressive surcharge" that could place an

additional 37.5% taxation of wellhead value by the state at high oil prices on to the base PPT, the State's 12.5-16.7% royalty, the ad valorem property tax, the 3-9% corporate income tax, lease bonus bid amounts, the ongoing annual lease rental amounts, and the Federal income tax rates averaging 20-35% of taxable income. It all adds up, and AVCG Owners are saying, "enough is enough."

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Interestingly - and this is important - when I was communicating the latest CS to HB 488 details to the AVCG owners by teleconference and email recently, I felt two overwhelming emotions. The first emotion was discouragement. Under the original 20/20 proposal, I was recommending to our owners that considering the value of the tax credits, we could add a sixth exploration well for every fifth well drilled essentially at no cost to our company...this could lead to additional discoveries and production for all of us. This is good policy. However, in discussing the CS to HB 488 with its much higher taxation at high oil prices, I recommended to our owners that, in order to pay potentially higher production taxes under the surcharge concept, we sell our credits to other companies and save the cash to literally offset our higher taxes later. I suggested we not consider the additional sixth exploration well any longer...the AVCG owners concurred. This will result in potentially a new oil field that will never be drilled and lower production for all of us. This is bad policy. And this is discouraging.

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But I also found interesting another strong emotion during that teleconference which surprised me a great deal. I felt embarrassment for the State of Alaska, and I felt embarrassment as an Alaskan. Here I was, telling a group of outside investors that recently put all of their focus and personal exploration budgets on the North Slope of Alaska, and now I was telling them that Alaska was creating the most complex, confusing production tax bill ever created since the disastrous Federal windfall profits tax. And I was telling them that Alaska was levying the highest tax rate and government take in North America, much higher than the other U.S. states where they invest. I was embarrassed that the anger - or the mistrust - of the Big 3 producers and the Governor has resulted in the State crossing the line between balancing State revenues and attracting outside investment.

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Currently, the total Alaska and Federal governments' take is just over 50%. The Governor's proposal moved this to 53% or so then the original HB 488 moved the government take closer to 55%. Then the CS to HB 488 boosted the government take close to 60% with its "Progressivity Surcharge."

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My Personal Perspective

Now let me shift gears in my comments to you. Because I could not get buy-in for any alternatives from the AVCG owners except the 20/20 case, I have decided to speak out alone. As an Alaskan, I am concerned and feel I must try to share a personal perspective trying to balance what is best for my continued involvement on the North Slope in balance with how the State must change its system to be competitive in the world and realize more government share at high prices.

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I realize by stepping out like this, I could jeopardize my management status with AVCG and perhaps even jeopardize how I am viewed by the major oil companies and my friends in the independent company sector. But I have taken such personal risks in the past, and I don't mind doing so again today to simply do what I think is the right thing to do regardless of others' opinions.

So, let me turn my attention to what key changes I would make to the CS of HB 488. Again, my views are not supported by AVCG owners or others in industry; rather they are my personal views.

Mr. Thompson noted that he is okay with the tax rate being progressive, but stressed that it needed to be simplified. He continued his testimony:

When the Governor's office first announced a 25% tax rate then amended that to 20%, I could see the move by legislators to somehow bridge the gap from 20% to 25%. However, the approach used by the House Resources Committee based on their outside consultants' work is simply too complex and will be arduous to implement. I think - and perhaps all of you think - the Federal tax code is too complex...the changes to HB488 are also too complex and will lead to different interpretation, "gamesmanship" possibly by some companies because of the unwieldy progressive tax structure formula, and

future costly lawsuits when the State disagrees with a company's calculations. And the number of accountants to keep track of these complexities on both sides will balloon! I urge you to simplify, simplify, simplify...yet still have some progression that legislators seem set on.

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For my company which drills the smaller oil traps that may add up, we do not have a lot of upside potential in seeing these smaller fields grow much larger in reserves over time in contrast to the giant Prudhoe Bay and Kuparuk fields. So our main upside is in oil price escalation to offset exploration risks and to offset the cycles of oil prices downward, a reality over time for any commodity. I find it disturbing - and personally unfair - that the House Resources Committee recommended a windfall profits tax, or "Progressivity Surcharge", as high as an additional 37.5% of value in addition to the base PPT.

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I found it so interesting to see the Econ1 consultants and consultant Daniel Johnston saying the government should take more and more at high prices when not one member of the Resources Committee asked them a very important question they should have been asked: "how much are you investing in Alaska?" I was shocked to see that these consultants, when calculating the future revenues to the State at various escalating rates, used the same oil production curves. In reality, less capital will be spent by industry at exorbitant production profits tax rates (tax rates above 25% when coupled with all other payments such as royalty, corporate income tax, ad valorem tax, lease costs and rentals, etc.). With less capital spending, the production curve will be lower...an increasingly higher tax rate may not in the end yield the forecasted revenues for the State.

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On a related note, our company plans to go into the private or public equity markets to raise funds and capital for any future development. Such equity investors invest in the oil markets to be fully exposed to crude price upside. When they look at investments all over the world, and see that Alaska could tax at much higher crude prices with a "Progressivity Surcharge", they will place their capital elsewhere to continue their exposure to higher crude prices in investments without alternative taxing structures such

as the Lower 48 states, the Gulf of Mexico deep water with royalty relief, the Canadian oil sands or other countries. The consultants did not address this issue that I face month in and month out...the private and public equity markets and the desire for such investors to fully benefit from upside commodity price swings without hedging or excessive, escalated taxation at high prices.

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I could not believe the consultants did not show capital spending elasticity graphs from different countries. They did the legislature a disservice by not doing so. Their work showed a biased perspective in my opinion; by getting the House Resources Committee to adopt a complex progressive tax rate structure, or windfall profits tax, the consultants may feel they have been successful...but not one of these consultants will be around to defend their views in the future when capital spending does decline at exorbitantly high and unfair tax rates above the 25% level.

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So, what is a simpler alternative? What is an alternative to yield more revenues to the State with a balance to attract increased investment? I have followed the progression of the PPT and noted when respected global consultant Pedro van Meurs recommended a 25/20 formula, i.e. a 25% tax rate and a 20% investment tax credit. Yet the Governor recommended a 20/20 formula with a 20% tax rate. Since that controversial time a few weeks ago, it appears the House Resources Committee and the Senate Resources Committee have spent a lot of time trying to recapture the perceived "lost revenue" from the Governor not taxing at the 25% level. On the other hand, the Governor does make a good case about increased cash flow to producers and resultant increased capital investment at the lower 20% tax rate level. But consultants Econ1 and Daniel Johnston did get things way off track by proposing too complex a solution to bridge this gap and get even more...the complex "Progressivity Surcharge." Having the PPT at higher prices being a mixture of taxation of profits and a separate incremental tax on incremental revenues is unwieldy and an accounting nightmare.

Let me address a way to transition from the 20% tax rate to the 25% tax rate without getting too complicated.

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I suggest that the Finance Committee revise the bill to keep the production profits tax simply that...a tax on production profits, and not an underhanded way to further burden gross revenues with a surcharge. A simpler way getting the progressive rate from 20% to 25% without the surcharge treatment complexity is to adopt a graduated PPT that does accomplish a higher State take at higher prices, yet leaves a reasonable producer take.

I recommend the following production profits tax schedule as a suggested one to "simulate" revenue results somewhere between the Governor's proposal and the CS to HB 488 proposal. It is one that everyone could easily understand and implement with the State realizing upside at higher oil prices yet not too much upside is taken away from explorers/producers for re-investment:

Up to monthly average wellhead price of \$50/barrel for a company: PPT rate of 20%

When monthly average wellhead price is between \$50-75/barrel: PPT rate of 22.5%

When monthly average wellhead price exceeds \$75/barrel: PPT rate of 25%

By the way, if the State were to pass a complex, unwieldy windfall profits tax like that one proposed by Econ1 and favored by some on the Resources Committee with escalating production profits tax rates or surcharges, I predict Alaska will make the cover of the industry-wide influential magazine "The Oil and Gas Journal" and perhaps even a cover spot in the "Wall Street Journal." And I don't mean this media coverage in a positive way...I think all in industry will say the State is taking advantage of industry at high prices. Whether or not industry makes money or not and makes good, solid returns is not the issue with such extremes...the perceived fairness of taxation in a high cost, remote area like Alaska is the issue. This will discourage new entrants, in my opinion.

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I highly respect industry consultant Daniel Yergin who has an excellent reputation among industry personnel and government officials alike. In November, 2005, Mr. Yergin said this about a windfall profits tax: "What a windfall profits tax does is introduce a lot of

distortion. It reduces investment, it increases a sense of political risk and it doesn't achieve the goal that is intended...it will really lead to decreased supply." I urge the Finance Committee to seriously consider this simpler approach, and ask that you have the Department of Revenue run the above case to compare the State revenues to the Governor's proposal, to the current CS to HB 488 proposal, and to the existing ELF severance tax program. Please do away with the complex "Progressivity Surcharge" and simplify, simplify, simplify.

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(2) "Trigger Points" For Escalating PPT Should Not be WTI But Wellhead Value

I do not think the "trigger point" that increases the PPT tax rate from 20% should be based on West Texas Intermediate (WTI) oil price as suggested by Econ 1 and Daniel Johnston and by the House Resources Committee. The "trigger point" should be when a company's average realized wellhead price in Alaska exceeds \$50 per barrel. Some say lower, but I do think there is strong merit that those who have invested and taken exploration risk and exposure to low prices should be able to benefit from increased profits at higher prices..."share the pain, share the gain"...to this \$50/barrel wellhead level. However, I personally am fine with the State increasing the PPT tax rate eventually to a cap of 25% when wellhead prices exceed \$50/ barrel. Having said this, you need to know that I do not know anyone else in industry who thinks this; everyone I know continues to press the 20/20 formula.

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Why should the State tie the PPT calculation to a company's realized wellhead price instead of to West Texas Intermediate (WTI) price? In reality on the North Slope, not one company sees WTI prices. Every crude oil in Alaska is different in quality with viscous crude receiving less and oil produced from wells farther away from infrastructure receiving less wellhead value due to higher shipping costs. Conversely, oil in the Cook Inlet is close to actual refining or on the water to ship out of state and thus realizes on average much higher wellhead value than most North Slope crude oils, a substantial plus to Cook Inlet operators who face higher operating costs with maturing fields. Our company's crude when discovered on the North Slope will be farther west, and when we have to transport the oil via the major producers' gathering system lines to TAPS

pump station #1, we will pay the majors a certain tariff of \$0.50-1.00/barrel or more, and a facility processing fee of \$3.00/barrel or more, giving us a lower wellhead value for our crude while the major producers make an additional profit on shipping in their crude lines and processing. The majors further make profits from tariffs for shipping down TAPS and in their marine tankers.

[3:24:26 PM](#)

3) Reinstate The Transitional Deductible Allowance

Jumping immediately from the prior ELF severance tax to the PPT formula overnight wreaks havoc with a company's budgeting and their forecast of available cash flow for near-term capital investment. While this does not have a major impact on AVCG, I do greatly empathize with ConocoPhillips, who is the largest investor and most active explorer in Alaska, about having "look back" investment credits. Part of the current oil production bringing in much higher revenues to the State is due to investment over the past few years. Interestingly, the PPT will have the largest negative impact on ConocoPhillips, particularly on their production from the Kuparuk Field. ARCO used to own the ConocoPhillips properties on the North Slope, and I am concerned with the impact on Alaska's largest investor and most successful explorer. A transition adjustment of some sort is appropriate and is fair.

I recommend the Finance Committee re-institute the original HB 488 compromise to a three-year staged and tiered "look back"; while not as substantial as the Governor's proposal, the House Resources Committee's staged "look back" is fair and should be re-instated in the bill. The cost recovery allowed should be 75% of 2005 expenditures, 50% of 2004 expenditures, and 25% of 2003 expenditures to be deductible as costs for near-term PPT calculations as originally in HB 488.

[3:26:22 PM](#)

4) The \$12 Million Tax Credit Standard Allowance

The Governor proposed a \$73,000,000 annual allowance of production profits that would not be taxed by the PPT, essentially giving a \$14.6 million tax credit per company. The House Resources Committee revised this downward to a \$50,000,000 annual allowance as a reasonable compromise, or a \$10,000,000 tax credit. The CS to HB 488 further proposed that this be changed to a simple \$12, 000,000 annual "standard tax credit allowance" as a reasonable compromise.

This "standard deduction" is very important to a startup company like AVCG/Brooks Range Petroleum trying to establish a foothold in Alaska and someday contribute substantial oil revenues to the State.

I recommend the Finance Committee endorse the \$12,000,000 tax credit allowance per company.

[3:27:05 PM](#)

5) Tax Credit Repurchase Program

As protection for explorers and new entrants to Alaska, the CS to HB 488 devised a tax credit repurchasing program for those credits a company earns on expenditures up to \$10,000,000 per year for investments in exploration and/or lease purchases in Alaska.

This is important to explorers like AVCG who does not yet have production revenues. Without such a repurchase program, our company might be able to sell our annual tax credits to one of the major producers but have to accept only 90-95% on the dollar or less. On the other hand, the State would not be giving up anything to repurchase the credits at 100% of value because the major producers would otherwise use the credits to reduce their tax bill and reduce revenue to the State. But using the State repurchase approach, the small explorer could turn around and re-invest the State-refunded credit into new leases, seismic or exploration drilling.

I recommend the Finance Committee support the tax credit repurchase program outlined in the CS to HB 488.

[3:28:14 PM](#)

6) Remote Exploration Tax Credit Extension

I thank the House Resources Committee for their proposal in extending the SB 185 exploration tax credits for the next 10 years.

I recommend that the Finance Committee also endorse this proposal that will extend the 40% tax credit for remote wildcat exploration wells more than 25 miles from existing facilities.

[3:29:01 PM](#)

7) Effective Date

The State has made far more money at high prices than anyone ever dreamed. The State has, in a way, already received a rich windfall at high oil prices. The change in the production profits tax is controversial in its own right. I would not dare "pour salt in the wound" by making the tax effective on April 1, 2006, but allow the transition as originally planned to a July 1, 2006, date. This will also give all of us time to hire additional accountants to do the monthly, complex filings!

I recommend that the Finance Committee amend the effective date to July 1, 2006.

[3:30:11 PM](#)

Concluding Remarks

The above comments are my personal views offered with a hope that there can be an eventual win-win solution to this complex subject of the State realizing more revenues at higher prices while attracting exploration and development investors who can also realize upside at higher prices. I do believe the House Finance Committee can get things "back on track" and better balanced.

Importantly, many - if not most - in industry would disagree with some - if not all - my personal views expressed above. But I do feel compelled to "tell it like it is" from my perspective as an Alaskan who has worked the Cook Inlet and the North Slope oil and gas fields for over 12 years.

[3:32:09 PM](#)

Representative Kelly spoke to the complexity issue and asked tying progressivity, would address simplicity.

Mr. Thompson responded that the system will be more complex than our current system, and commended the House Resources Committee for working with the industry and state agencies to determine allowable and unallowable deductible expenses. He felt that the progressivity formula proposed by consultants created a more complex system than necessary. He concluded that while the legislation is still more complex than desirable, it was "livable".

At Ease: [3:35:44 PM](#)

Reconvened: [3:38:12 PM](#)

JOHN A. BARNES, P.E., ALASKA ASSET TEAM MANAGER, MARATHON OIL COMPANY, testified regarding creating incentives in the Cook Inlet. He noted that they focused solely on the natural gas market. Mr. Barnes commented that the discussions on PPT dealt with reaching tax parities with a world market, but pointed out that world wide opportunities did not apply to activities in Cook Inlet.

[3:39:40 PM](#)

Mr. Barnes commented on the Cook Inlet Gas Summary before PPT and noted the declining reserves and production rates, as well as high costs, and a difficult regulatory arena. He gave the State a "D" in its permitting process. He also noted the need for additional exploration and the historical price differential.

[3:41:41 PM](#)

Mr. Barnes referred to a table outlining the results of Cook Inlet Area wide Lease Sales. He noted that there had been an increase in coal acres sold. Next he referred to a graph illustrating the timeline of Cook Inlet Exploration, showing that exploration had recently begun to increase again.

[3:42:56 PM](#)

Mr. Barnes then examined three different price markers: Henry Hub, DOR PV and DNR Royalty Values. He concluded that Cook Inlet received less for its product than other locations. He also noted the extreme volatility, and suggested that it was not a good indicator to determine progressivity.

[3:44:30 PM](#)

Mr. Barnes discussed the future of supply, pointing out Enstar as working well with the supply/demand market. He compared average residential gas prices and noted that prices had benefited from Cook Inlet resources.

[3:46:03 PM](#)

Mr. Barnes ran conceptual comparisons on an average well, based on the CSHB 488 (RES).

[3:46:42 PM](#)

Mr. Barnes showed a slide illustrating a before tax comparison for various states. He commented that Alaska would realize a lower profit, unless there was price parity. He commented that there was a disadvantage in the Cook Inlet. Profit investment ratio of excess of 4; Alaska is 1.7, which accounts for poor investment.

[3:48:05 PM](#)

Mr. Barnes offered a comparative analysis as a means of considering how companies decided whether to invest in Cook Inlet as opposed to other areas. He noted that although there was good land access, there remained the disadvantage of high costs, permitting troubles, and price.

[3:49:33 PM](#)

Mr. Barnes proposed that there was nothing wrong with ELF for Cook Inlet natural gas. He commented that a higher tax rate would result in lower reserves. He suggested that there would be a decline in exploration and development in that area. He also noted that potential loss of jobs and volatile costs to utility customers.

[3:51:23 PM](#)

Mr. Barnes analyzed the PPT for \$4 Cook Inlet Gas. He concluded that as compared to Henry Hub, a consumer would see a fluctuation in Cook Inlet.

[3:52:45 PM](#)

In summary, Mr. Barnes suggested that legislators not link Cook Inlet PPT to the volatile Henry Hub price, but rather to the Department of Revenue Prevailing Value. He recommended that incentives be prioritized, including some kind of transitional investment credits. He concluded that they did not support the CS as it stands, but rather a movement back toward the bill in its original form. He conceded that the currently proposed approach was very complicated.

[3:55:00 PM](#)

Vice-Chair Meyer summarized that Marathon would like to see an exemption from the PPT for Cook Inlet. Mr. Barnes agreed. He added that there are multiple parameters that could be used.

Vice-Chair Meyer concluded that Cook Inlet is working. He stressed that Cook Inlet is a small percent of the state of Alaska's oil and gas production. Mr. Barnes agreed and estimated that it is approximately 20,000 barrels a day. Total production is approximately equal to one month of Prudhoe Bay.

[3:57:47 PM](#)

In response to a question by Representative Holm, Mr. Barnes stressed that the transaction price should be the

transaction amount. Any tax structure with progressivity should be driven by the transaction activity.

[3:59:37 PM](#)

Representative Holm asked if there is an ANS price for gas and if not what would be an average price that makes sense. Mr. Barnes noted that there is not a market price for gas that makes sense. The value the State uses to assess royalty settlements is the best marker. There is not a good market, with daily gas trades.

[4:01:19 PM](#)

Representative Holm questioned if a greater price of gas would encourage investment. Mr. Barnes responded that gas prices are starting to rise. There are a series of gas contracts in Cook Inlet tied to various market indexes. There has been a transition to contracting for gas in the Cook Inlet. He provided details of recent contracts. He noted that the consumer would benefit if the activity level de-linked the capital and push down prices.

[4:03:25 PM](#)

Representative Joule asked how much is exported. Mr. Barnes noted that half the gas is exported; 40 percent of Marathon's gas goes to the LNG plant.

[4:04:15 PM](#)

Representative Kelly referred to slide 14. Mr. Barnes referred to the price curve on slide 7 and noted that prices are curving up due to indexes in legacy contracts raising prices and competition for capital by new contracts. The gap is narrowing. He did not think it would narrow 100 percent due to the volatility. He explained that slide 14 looks at the price as linked to Henry Hub. The calculation of PPT has two key points with flattening. All things are equal at 20 percent. As Henry Hub goes up, the curve climbs and the gas gets transacted at \$4. Consumers would see an impact for contracts that pass the tax through. He concluded that the prices would be unstable with the linkage to Henry Hub and it would not make sense to implement. Representative Kelly observed that it is linked to progressivity.

[4:09:03 PM](#)

In response to a question by Representative Kelly, Mr. Barnes noted that as Henry Hub balances up and down, progressivity is increased. Henry Hub is calculated on a monthly basis. Representative Kelly summarized that the volatility only occurs at the point of marriage between

Henry Hub and Cook Inlet prices due to the link with progressivity.

Mr. Barnes returned to slide 14. The tax rate would be changed due to progressivity even if the business has not changed. He explained that business would not have changed, but the tax would have increased.

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ADJOURNMENT

The meeting was adjourned at 4:11 PM