

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 27, 2006

12:48 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

Representative Jim Elkins

COMMITTEE CALENDAR

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."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 488

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

02/21/06	(H)	READ THE FIRST TIME - REFERRALS
02/21/06	(H)	RES, FIN
02/22/06	(H)	RES AT 12:30 AM HOUSE FINANCE 519
02/22/06	(H)	Heard & Held
02/22/06	(H)	MINUTE(RES)
02/23/06	(H)	RES AT 12:30 AM HOUSE FINANCE 519
02/23/06	(H)	Heard & Held
02/23/06	(H)	MINUTE(RES)
02/24/06	(H)	RES AT 12:30 AM HOUSE FINANCE 519
02/24/06	(H)	Heard & Held
02/24/06	(H)	MINUTE(RES)
02/25/06	(H)	RES AT 10:00 AM SENATE FINANCE 532
02/25/06	(H)	Joint with Senate Resources
02/27/06	(H)	RES AT 12:30 AM CAPITOL 124

WITNESS REGISTER

BRIAN WENZEL, Vice President
for Finance and Administration
ConocoPhillips Alaska, Inc. (Conoco)
Anchorage, Alaska

MS. MARIANNE S. KAH
Chief Economist
ConocoPhillips Alaska, Inc.
Planning, Strategy and Corporate Affairs
Anchorage, Alaska

MR. DARREN JONES, Vice President
for Commercial Assets
ConocoPhillips Alaska, Inc.
Anchorage, Alaska

ACTION NARRATIVE

CO-CHAIR RALPH CO-CHAIR SAMUELS called the House Resources Standing Committee meeting to order at [12:48PM](#). Representatives Ramras, Samuels, Seaton, Olson, Crawford and Seaton were present at the call to order. Representatives Kapsner and LeDoux arrived as the meeting was in progress. Representatives Berkowitz, Kerttula, Gardner, and Guttenberg were also present.

HB 488-OIL AND GAS PRODUCTION TAX

CO-CHAIR SAMUELS announced that the only order of business would be 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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BRIAN WENZEL, Vice President for Finance and Administration, ConocoPhillips Alaska, Inc. (Conoco), said Conoco is the leading oil producer in Alaska and has invested over \$5.8 billion in capital in the last 10 years and \$6.8 billion in expense and it

pays \$1.6 billion to the state every year. He spoke of Conoco's employees who see themselves as playing a role in building Alaska's future. He said the company generates direct and indirect employment. He said there needs to be mutual respect between the state and the company so they are better off than if they pursued their short-term interests.

MR. WENZEL said the governor's bill is balanced in favor of the state with an aggressive level of state take. He spoke of other taxes to the state as well as surcharges and fees paid during the permitting process. That is, of course, on top of federal corporate taxes, he noted. He spoke of layer upon layer of payments to the government; investment will be impacted and job growth will be affected. He said he sees that the state cannot adopt tax policy that only seeks to maximize the robustness of the participants in the economy. The government provides essential services to the citizens, and must turn to taxing powers to pay for them, he added. He said Conoco reluctantly supports the passage of the bill when the government is enjoying a budget surplus. The tax rate is too high to guarantee increased investment over the long term, he stated. It punishes companies that have made investments in Alaska and have created jobs, royalties and property taxes. He said he would oppose this bill except it allows parties to come together under the Stranded Gas Act to move the gas pipeline to the next phase. Advancing the gas pipeline is a key priority for Conoco.

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MR. WENZEL said since 1989 Conoco has been involved with 14 satellite [oil fields], which are marginal developments that the state is targeting with HB 488. They were able to be developed in the favorable treatment under the ELF system. It made an additional 1.9 billion barrels from the North Slope, he said, which is equivalent to a Kuparuk-size field. He said the company has drilled 40 other appraisal wells in the last five years.

MR. WENZEL spoke of a graph shown to the committee. He said the ELF increased barrels in the pipeline and the state was able to collect taxes on those developments, and the Alaska economy was able to grow. "There is no such thing as a perfect tax system." He said the governor's tax is a wise policy, but HB 488 will cost the industry \$1 billion at today's prices. "This unprecedented increase will more than double the existing severance tax payments," he said. He showed a graph under the proposed profits-based Petroleum Production Tax (PPT) system.

He said the future of oil production is dependent on existing fields. He said HB 488 adversely impacts production from existing fields, and the transition plan is necessary. The new PPT will impact Alaska's global competitiveness. The purpose of the Stranded Gas Act was to encourage the development of the gas pipeline by establishing fiscal terms for certainty. Oil and gas exist together, which means the fiscal certainty under the Stranded Gas Act could be inadequate if it only applied to gas, he opined. The administration was unwilling to consider fiscal certainty on oil under the terms of current statute, but it was willing to propose this legislation that could become part of a fair and durable fiscal regime for both oil and gas. The administration made it clear that the new tax had to stand on its own in the absence of a pipeline deal. He said Conoco would not support the bill if it didn't think that it would result in an agreement to move forward on the gasline.

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MR. WENZEL said the administration's proposed tax is balanced to facilitate future investment, including a gas pipeline. The producers will pay substantially more in taxes than under the current regime, he noted. He showed a slide of oil production. The heavy oil resource will play a more significant role in the North Slope, but technology limitations will restrict heavy oil. "It could be many years before the resource reaches its potential."

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CO-CHAIR SAMUELS asked the view of Conoco regarding incentives for heavy oil. He mentioned the royalty reduction program, and predicted an allocation nightmare for the state and the industry, including litigation. He said that instead of a separate tax system for different geographical locations, "would it be beneficial to instead address the problem through the royalty reduction...If you think you need more money to develop the heavy oil, and the costs are high, the profit is less, and there's just not going to be enough even potential profit to move forward with heavy oil...instead of having the nightmare scenario of cost allocation arguments, is to instead move forward with a royalty reduction argument, where you still can push more money into your column." He asked the benefit of having two tax structures.

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MR. WENZEL said Conoco is willing to work with either mechanism, but he assumes it would be more palatable for the state to look at a differentially lower tax rate or higher tax credit for heavy oil production. He said he understands the challenges of allocation expenses. "In terms of doing it with royalty reduction, we have not had a lot of success getting royalty reductions in the past, but if that is the preferred path forward from the state, I think we can easily work with that."

MR. DARREN JONES, Vice President for Commercial Assets, ConocoPhillips Alaska, Inc., said the issue with royalty reduction is that it can't be depended on because it is negotiated, unless the law is changed. In the new system, if it's not paying royalty, then it will be subject to the PPT, "and if we're already getting credits for PPT investments, and all that means is the new oil would get taxed at 20 percent." He said the company would have to think more about the ramifications of royalty reduction.

REPRESENTATIVE SEATON said if all costs are subtracted before taxing, what is the problem of developing higher-cost heavy oil. The PPT would act the same, he noted, and all the higher costs would be subtracted.

MR. WENZEL said he agrees that all the costs would be captured under the PPT, but because of the technology leaps that are necessary to extract heavy oil, it requires more motivation than simply the current tax system.

MR. JONES said light oil fields tend to have pretty high initial rates with decline over time, and "the heavy oil fields, like West Sak that we are developing now, we're drilling more wells to build it up more slowly over time, so there is sort of a rate of return impact issue of the heavy oil. It takes longer to get the production up." He noted that the wellhead value of heavy oil is significantly less.

MS. MARIANNE KAH, Chief Economist, ConocoPhillips Alaska, Inc., said in a high price environment, "you would think that heavy oil becomes more economic, but what we've seen happen, because we produce a lot of heavy oil in Venezuela and Canada, is that the differential of heavy oil to WTI [West Texas Intermediate] widens. So, I remember at the end of last year we actually had to write off all of our [indecipherable] reserves, even at the high price environment because there was like a \$17 a barrel discount to WTI, making it appear to be uneconomic. When, of course, it came right back on our books the year later when we

started producing it. So there's a problem, even in a high oil price environment because of the discounting. And that occurs because there isn't enough upgrading refinery capacity to process that crude, even after you get it out of the ground. And it take years for that market to get back in balance. So every time the oil price goes up, you see the discount of heavy sour crude to WTI widens. Today it is about \$16 a barrel." She added that it will be a much bigger discount in Alaska. That has to be taken into account, she said.

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REPRESENTATIVE SEATON asked if a widening difference at high prices is because more heavy oil is produced without enough facilities.

MS. KAH said that is one thing, the other is that Saudi Arabia is replacing crude that is lost on the market and their crude that is shut in tends to be heavy sour crude. She said there is also strong demand, so the light product has a higher value and heavy oil goes down in price. It is cyclical, she said. The world's crude is going to get more heavy and more sour, and sulfur regulations are getting more stringent. "So over time, I would expect to see a gradual widening—not from where we are today, after it gets back to normal—I'd expect to see a gradual widening over time just because there's going to be more of this in the global crude slate."

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REPRESENTATIVE BERKOWITZ noted that Mr. Wenzel said that past investments have led to an additional \$5 billion of revenue to the state, and he asked how much of that came from Conoco and what profits did the company show for its Alaska investments.

MR. WENZEL said he doesn't think he has profits for that period, but Conoco's profits were \$2.5 billion in 2005.

REPRESENTATIVE BERKOWITZ asked if that was in Alaska.

MR. WENZEL said yes.

REPRESENTATIVE BERKOWITZ asked about the timeframe where Alaska received an additional \$5 billion.

MR. WENZEL said he believes that has been in the past 10 years that Conoco has spent \$5.8 billion in capital and \$6.8 billion in expenses.

REPRESENTATIVE BERKOWITZ asked how much of that came from Conoco investments.

MR. WENZEL said it is all from Conoco.

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REPRESENTATIVE GATTO addressed the heavy oil that Mr. Wenzel showed on a graph and asked if it refers to heavy oil reserves or oil that "you can get to." He noted that there is heavy oil at Prudhoe Bay that is impossible to access.

MR. WENZEL said the blue bar is the heavy oil that is possible to develop with today's technology.

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REPRESENTATIVE BERKOWITZ asked for the [profits for the last ten years].

MR. WENZEL said there are over 20 billion barrels of oil in place. There is potential that can't be extracted today. The technology will require huge expenses and therefore heavy oil should be given a differential consideration in the form of a lower tax rate or additional credits. The bill has been designed to attract new players, and Conoco encourages new investments, which can be beneficial. He said Conoco has already made partners of several of them. The terms of attracting new investors come with a cost. The governor's tax increase mainly targets large, legacy investments including Prudhoe Bay and Kuparuk, and will result in perhaps "the highest severance tax burden...anywhere in the United States. This is an unprecedented fiscal increase," he said. He told the committee Conoco has stayed in Alaska during difficult times, including times of low oil prices. Such an increase could undermine investor confidence, he opined.

MR. WENZEL showed a slide of the effective tax rate of the core versus satellite fields. Core assets represent 65 percent of the North Slope production and they will experience a much higher effective tax rate.

REPRESENTATIVE SEATON asked how much of the difference is because of the \$73 million allowance.

MR. WENZEL said the \$73 million is included in the graph lines, but it's a relatively small impact.

REPRESENTATIVE SEATON said, "So the difference between satellites with the new PPT, versus core assets...the \$73 million has very little relationship to the differential between those two lines?"

MR. WENZEL said that is correct and it is mainly driven by the higher level of investment relative to production and revenue on those new satellites. "You've got essentially all of the capital to develop those resources and the tax credits come in related to that, bringing down the effective tax rate. Whereas on the core fields and known resources, much of that capital has already been expended and there's no resulting impact."

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CO-CHAIR SAMUELS said the \$73 million is a competitive disadvantage over companies that pay no taxes. He asked if Conoco would like to keep the provision in the bill.

MR. WENZEL said it was put in place to bring small players into the state and assist small companies. It has a larger impact on those players; as such it is much more appropriate to speak with the independents on that issue, he said. Conoco pays \$1.6 billion in tax or royalty to the state. He said Conoco has a desire for equal treatment.

MS. KAH said without equal treatment, partners have misaligned interests, which is a problem with developing fields.

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REPRESENTATIVE SEATON asked if the \$73 million allowance is equal treatment or not.

MR. WENZEL encouraged the legislature to consider another alternative that is applied equally.

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REPRESENTATIVE GATTO asked the return on Conoco's investments.

MR. WENZEL said he doesn't have the public return on investments and can't disclose the return on particular projects.

REPRESENTATIVE GATTO asked for the two most recent annual filings.

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MR. WENZEL said the huge rate increase in the bill is supported reluctantly by Conoco. The state is enjoying a budget surplus. The PPT rate would be 13 percent instead of 20 percent in order for Conoco to pay the same taxes. Some suggest that the rate should be 25 percent, but that would take money away from the private sector and is not in the long term best interest of the state. New fields are small and costs are high, he stated. Conoco spends a lot of resources assessing the upside potential and the downside risk. "When we invest we fully understand that there is a chance that we may not get a return on investment, but also acknowledge that results could exceed expectations." He said Conoco bears the greatest risks and should be appropriately rewarded. He said tax credits reduce the risks, but high tax rates significantly reduces the upside potential. If credits are too high, the state will take too much downside risk, and if taxes are too high, investors look for better opportunities elsewhere. He said, "Moving upwards from 20 percent will seriously disrupt this risk-and-reward balance."

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CO-CHAIR RAMRAS spoke of the public testimony a few days earlier, and he said he was struck by the debate being focused on the tax rate and tax credit rate. Representative Kelly has asked why the increments are in fives. His concern is the severance rate for ELF. He noted a presentation called "Current Production Tax and Why it is a Problem," by Dan Dickenson. He said the current production tax is at 15 percent, and applying the ELF brings it down to about 7 percent. Going up to \$60 a barrel, the effective tax rate is about 14 percent. "We are increasing the taxes on the industry enormously, because right now the effective tax rate is...6 percent." He said a member of the public assumed that a 20 percent tax was offset by the 20 percent credit, so people are thinking that there will be no taxes. "We are taking the actual tax up for the benefit of the State of Alaska from its current rate of 6 to 14." He said he wants to make it clear that the rate is going up. He stated that the rebate of the credit is the issue of progressivity

because as the price of oil goes up, the effective tax rate goes up.

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CO-CHAIR SAMUELS said the effective tax rate is now closer to 4 percent after counting all the incentive programs.

MR. WENZEL said it is important to be very careful when speaking about the effective tax rate and be sure to understand what the denominator is. He said he is showing the effective tax rate relative to revenue. The ELF was a revenue-based system, and it was a 15 percent tax multiplied by an ELF factor that brought the tax down to around 7 percent. He said the new system is based on profits instead of revenue, so it is important to be careful in comparing the two.

CO-CHAIR RAMRAS expressed that tax credits are not widely understood by the public.

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MS. KAH said the tax credit would be subtracted from costs, but the tax applied to the profit can't be compared to the current tax system.

MR. WENZEL said the 20 percent base tax rate in the PPT is applied against profits, and the 20 percent tax credit is applied against capital and exploration expenditures, which is probably a smaller number than profits at today's prices. For example, in 2005 Conoco had a profit of \$2.5 billion and capital expenditures were about \$700 million. The credits come from a smaller number and do not reduce all of the tax that is calculated.

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CO-CHAIR RAMRAS said it is good to work with real numbers. So 20 percent tax on \$2.5 million is \$500 million, and if it is a \$700 million expense, the 20 percent credit will be \$140 million to subtract from those taxes. He stated that the effective tax would be \$360 million, which is 13 or 14 percent. The committee will debate the combination of tax and credit, and he said he will suggest higher exploration credits because "exploration will drive the state more than development." He said credits are poorly understood. Under the new system he worked out the difference in taxes, and said, "We're going from \$160 million to

\$360 million when we go into the next year. That's the nature of what we're talking about by making this shift in real life terms. Which is why this is a considerable paradigm shift for the producers to concede." He said he really wants people to understand that it is "not 20 in and 20 out."

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REPRESENTATIVE BERKOWITZ said the PPT is deductible against corporate income tax. He said there is another fund, the 470 fund or oil spill prevention fund, that's not included as part of the tax bill. He asked how much of an impact that would be on the numbers that Mr. Wenzel is showing.

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MR. WENZEL said the PPT will be deductible for corporate income tax purposes, and the numbers displayed don't include those effects. The deduction at the federal level will decrease Conoco's tax burden but it won't account for all the increase of the PPT.

REPRESENTATIVE BERKOWITZ asked how significant it will be.

MR. WENZEL said the effective tax rate line on the graph would shift down.

REPRESENTATIVE BERKOWITZ said the 470 fund will be removed as a tax burden. He asked how much of an impact that would have and if the PPT makes other changes to Conoco's benefit.

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MR. WENZEL said he will have to get back to him.

MR. WENZEL spoke of the transitional provision in the bill, where expenses in the past five years may be deducted from the taxes owed in the future, and Conoco supports that provision. He said it is an essential piece of the bill.

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REPRESENTATIVE BERKOWITZ asked if the impact of the transitional plan will lower Conoco's effective tax rate.

MR. WENZEL said his chart includes the transitional plan.

REPRESENTATIVE SEATON said he was interpreting the "core" as already having the capital expenditures, versus satellites, so there would not be a 20 percent capital [deduction] in core areas. "Is that the difference between these two?"

MR. WENZEL said historical capital is already expended, but maintenance capital is definitely included as part of the effective tax rate.

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REPRESENTATIVE SEATON asked about the difference between the two dotted lines, the new fields and the satellite fields, "if that's not mainly explained by the capital tax credit, what is mainly explaining the difference in those two lines from the solid effective tax rate?"

MR. WENZEL said, "It is explained by tax credits, just not exactly the tax credits on maintenance capital. The investments in the satellites and the new fields are much larger. You have large investments early on to put all the holes in the ground, put the facilities in place, and then ramp up with production. The yellow dotted line here at the top only includes a smaller level of maintenance capital, not the original capital to actually put the facility in [and] the wells on line." He spoke of a chart showing the capital profile of a particular project. "The lower effective tax rate on new and satellite fields would represent all this capital plus the revenue that comes off of it, whereas the orange line up on the top would instead only include a smaller level of maintenance capital. It wouldn't include all the early capital to put the fields in place."

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REPRESENTATIVE CRAWFORD noted that depreciating capital expenses is accelerated and most of the benefit is gotten up front.

MR. WENZEL said not to confuse depreciation deductions for state corporate income tax with a production tax. "These are two totally different taxes." For state corporate income taxes, yes, "you'd appreciate assets to recognize the value of those assets over time, and try to line that depreciation up with your revenues. On production taxes, under the ELF-based system, it's a tax simply based on revenue. The new system...is based on profits." He said the capital is recognized when it is spent instead of depreciating it over time.

REPRESENTATIVE CRAWFORD said he was referring to the claw back provision.

MR. WENZEL said, "The rationale for looking back, under a production tax, to those prior investments is that those investments were put in place at a time prior to this new PPT, did not receive any credits, and yet the profits off of those investments will be heavily taxed as we go forward...So we have an unfair treatment of these recent capital expenditures, which are very much contributing to our revenues the day this tax goes into place. If we don't look back and capture some of those very recent capital expenditures for the last five years, we end up with a higher tax rate under this new PPT than is really appropriate relative to our true profits and cash expenses, if you will."

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REPRESENTATIVE GUTTENBERG said that most people think of capital investment as pipes, pumps and similar things. He asked if finance charges are built into those costs.

MR. WENZEL said, "No, we are not including any capitalized interest or things of that nature in those capital costs. I think that will be driven by the definition of those terms in the bill."

CO-CHAIR SAMUELS asked what is spent every year to keep production going, and how its behavior would have changed if Conoco had known about the PPT. Of all the money spent in the last five years, how much of that was meant to increase production and how much was spent to keep production going? He said there were expenses that Conoco would have had to spend even if it was taxed at 100 percent. He questioned how the legislature should judge, as policy makers, what Conoco would have spent anyway. "How much of it was to bump up production and how much of it was the way of the world?"

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MS. KAH asked if he was talking about administrative costs.

CO-CHAIR SAMUELS said he is talking about the money that will be considered for the transitional provision.

MS. KAH said it is hard to separate "because the natural decline rate, production would be in steep decline if you didn't spend

what you're probably thinking of as maintenance capital. But that counts. It's keeping the decline rate from dropping."

CO-CHAIR SAMUELS said, "And what would you have spent no matter what the tax rate was?" He said it was somewhat of a rhetorical question, but he is struggling with it.

REPRESENTATIVE GATTO said it may be a good idea to go back five years, but to go back the same amount for each of those years does not seem reasonable. "Wouldn't you suggest that we should ladder all the way back?"

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MR. WENZEL said, "There's actually another argument here that we should go through...It's related to the expectations we had when we decided to make those investments...No, we would not recommend a ladder approach going back over time. Rather...we invested in the past based on expectation of future profits. That's how we make our decisions about whether to invest or not. It's based on maintaining production. It's based on new production. Those expectations were based on an ELF system." He said suddenly that expectation was very wrong. "Now our effective tax rate on the production tax side has doubled."

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CO-CHAIR RAMRAS said Conoco's expectation of the value of oil was wrong too: \$62 a barrel instead of \$30 a barrel. He said Conoco made an investments thinking oil would be at \$30 per barrel, and "you have been the beneficiary of a terrific economic cycle." He said Conoco was lucky and "it doesn't wash with me. You're going to have a damn hard time getting all of this claw back/transition provision by me. I'm not buying it."

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MS. KAH said, "When we look at projects we price risk them. We take both the upside and the downside into account when we look at projects." She said Conoco makes investment decisions for 10 to 20 years. "We are not thinking of a five year investment." She said people think \$60 is a very high price, but people don't realize that Conoco's costs are high. She spoke of the increases in steel price. She said, "The service industry has just not kept pace with us." She said that needs to be taken into account. "We definitely did not consider a change in the basic tax structure when we made that investment decision."

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CO-CHAIR RAMRAS asked how much is the depreciation life of the \$700 million. He further asked, "How much of it is 5-year goods, how much of it is 15-year goods, and how much of it is 39.5-year goods? When you say it's 20-year replacement, how much of that \$700 million is 5-year goods? I don't want to sit here and listen to a bunch of baloney." He said much of the testimony is impressive, but when he feels he is not being told the truth, "I'm going to call you on it. Because I am not going to sit here with producers and just rubberstamp disingenuous testimony. A great deal of that \$700 million is maintenance material that's going to be replaced on a 5 to 7-year lifecycle and not based on a 20-year investment horizon. I am not going to accept that."

MR. WENZEL said there is a mix of capital expenditure, but he doesn't have it broken out. He added that depreciation lives are set for income tax purposes based on deductions. He said when Conoco makes an investment it looks at prices and takes the risks of upsides and downsides. The fact that prices are high is not getting lucky but is an offset when estimates were off in the other direction. He said Conoco stockholders expect stock to increase in value when oil prices go up. He said Conoco recognizes that there are upsides. There are many other years when Conoco sees a downside. "It does look like, and it is true, we are being very profitable at the moment because of oil prices being high." He said costs are up also, but not as much as the price of oil. When looking at all of Conoco's investments, it is imperative that Conoco passes the oil price risk to stockholders. It is inappropriate for Alaska to come in and actually take away part of this upside that the investor should get. He said Conoco did not expect a change in taxes. He said the company expects something much more stable. "As we change taxes this dramatically in the State of Alaska, we are actually affecting investor confidence in the state."

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REPRESENTATIVE OLSON asked what price Conoco is budgeting for next year.

MR. WENZEL said Conoco doesn't disclose that.

REPRESENTATIVE OLSON said Alaska is predicting oil to be \$45 to \$50 per barrel, and one of your competitors is in the same range. "Apparently they didn't have a problem with it."

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REPRESENTATIVE SEATON said the State of Alaska is taking a considerable downside risk under the PPT, and it takes away the oil companies' risk on the downside by taxing profits. At \$20 per barrel the state will only be getting a three percent tax instead of six. He said the PPT gives the state the downside risk while taking more profit on the upside.

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MR. WENZEL said it is a profits-based tax, so the burden of the tax comes down as profits decline. When the tax is imposed, Conoco will build it into its expectations.

REPRESENTATIVE SEATON asked about Conoco's investment strategy when ELF was aggregated. He asked if Conoco stopped putting in capital investments when that happened.

MR. WENZEL said Conoco continued to invest with new expectations. He added that the change was inappropriate because it was a change in the tax law on a particular day when investments had been made under other expectations. He said Conoco paid its taxes on that basis, but it affected future projects. He said Conoco has requested clarification from the state that their Alpine field would not be aggregated so the economics would allow the project to go forward. Conoco proved to the state that the project was not economic under the ELF system in an aggregation. The Department of Revenue said it understood, so it gave them a letter saying the field would not be aggregated with Alpine. So the project proceeded and added production to the State of Alaska and royalties and taxes.

[1:58:37 PM](#)

MR. JONES said, "At Prudhoe we were planning to move ahead with part of the development of the Orion heavy oil resources that overlies Prudhoe Bay reservoirs, and we had a plan...but because of the change in the ELF aggregation that the governor put forward, we delayed that work."

REPRESENTATIVE SEATON said heavy oil was excluded from aggregation.

MR. JONES said it wasn't excluded and the project was delayed because the incremental impact of the ELF on that field is in the range of 20 percent.

[1:59:35 PM](#)

REPRESENTATIVE BERKOWITZ said Conoco keeps indicating that the state has benefited from everything that Conoco has done, "but I'd also like to remind you...that Conoco has also reaped some pretty handsome profits over the last couple of years." Not everything done by the state is just for the state's benefit. He asked if Conoco has recouped the transitional expenses, and if not, "What is your internal schedule for recouping those expenses? What do you consider to be price risk?"

[2:00:25 PM](#)

MR. WENZEL said he sees this as a partnership and both the industry and the state benefits from a healthy oil industry today. The transitional expenditures have not been recouped. "They were part of our expectation." They have probably been recouped for corporate income tax and largely depreciated. But he said this is a different tax. The ELF doesn't provide any credits; it was a revenue-based tax.

REPRESENTATIVE BERKOWITZ noted that Conoco has already expensed them for corporate income tax purposes, and with the PPT it can expense them against profits retroactively.

MR. WENZEL said that is correct and it is a different tax. "We have taken the benefit of those to reduce our state corporate income tax according to the tax code." He said that it appears there will be a new tax that is a proxy for profits so it is appropriate to deduct them on this side.

REPRESENTATIVE BERKOWITZ noted that one expense will get deducted twice.

MR. WENZEL said yes because it is two different taxes.

REPRESENTATIVE BERKOWITZ said Mr. Wenzel mentioned a price risk, and he asked him to explain it.

[2:02:21 PM](#)

MS. KAH said oil prices are "mean reverting", but she doesn't know what the mean will be, and part of the price risk is "we don't know what the average sustainable price is going to be, but we also don't know where we're going to be in the price cycle when we bring our projects on." She said she uses a decision and risk analysis. The company puts price risk into project economics weighted by probabilities of future prices. It is a sophisticated process. She stated the concern that the government loves to take on the upside but not help on the downside.

REPRESENTATIVE BERKOWITZ assumed a price risk analysis was done and he asked where Ms. Kah thinks things are headed.

MS. KAH said it is only done at the project level, not for the Alaska business unit.

REPRESENTATIVE GATTO said Conoco answers to its stockholders. He said the risk/reward ratio changes over time. Prices may go up or down, and he said to be responsible to stockholders, unexpected changes should have been already calculated. This tax change was already priced into Conoco's overall calculations. He said he would be surprised if it wasn't. "It can't be a complete surprise to you that sooner or later something would have had to change, and you've already had the good changes, the enormous bump in prices." The increase in the tax rate would have been anticipated, he surmised.

[2:07:14 PM](#)

MS. KAH said Conoco takes political risks into account and views Alaska very favorably. Some countries are viewed as risky in terms of changing their tax rates, "but we don't expect it of the State of Alaska." She said that makes it more likely that Conoco will invest in Alaska rather than other places.

[2:07:47 PM](#)

REPRESENTATIVE GUTTENBERG said the ELF has been in place for a number of years and was expected to change. He said everyone knew there was a gasline on the horizon, adding to expectations of a change of policy or attitude. He noted that Conoco builds political risk into its equations. The state constitution requires maximizing the benefit of resource development to Alaskans. He said roads are going out and schools are being closed [indecipherable] and Alaska "brings you back to the table, just as you bring us back to the table to reevaluate the

policy. And I think this is just the point that that's been out there in the future and now we're there. And that's been built into the equation."

2:09:42 PM

MR. WENZEL said he disagrees. He said Conoco staff who are running projects every day would not have had a doubling of the tax rate built into their expectations. He said it undoubtedly must be done in other countries with political risk, but in Alaska his analysts are not told to expect a change in taxes. "We are willing to support this bill with its tax increase based on the overall balance of where we're going in the future, our desire to move forward on large investments--gas pipeline and other." He said the company is reluctantly supporting HB 488 but it never expected a tax increase in Alaska.

2:11:11 PM

REPRESENTATIVE CRAWFORD noted that Ms. Kah said Conoco has not projected its future in Alaska except on a project basis. He asked them to take the projects and give the committee a projection over the next several years. He asked where Conoco thinks the equilibrium price for oil is, so the legislature can get an idea of the best tax policy.

MR. WENZEL said he would do that and he continued to read his testimony. He said a field was discovered in 1992 prior to the discovery of the Alpine field, and it was not possible to develop it by itself. With the expansion of the Alpine facilities in 2004, it is now possible. He said the project began in 2003 and was faced with ELF aggregation. In 2005 the administration allowed it to be stand-alone and thus pay little severance tax, so Conoco went ahead with it. It will be an 18-well roadless satellite with 17,000 barrels per day. He said capital costs are \$300 million. Oil and gas prices have increased, so labor and material costs have increased. He said costs will be \$30 million higher than anticipated.

REPRESENTATIVE KERTTULA asked what the production tax on that field would have been.

MR. WENZEL said he doesn't have that figure, but he can get it. He said the costs were expended before the PPT. The project was decided based on the premise of paying little or no severance tax. It will be now be subject to a 20 percent tax rate, "and without the transition plan, the increased fiscal terms will

result in a reduction of over \$100 million in gross value and a six percent reduction in our average return at the \$40 West Coast price."

CO-CHAIR RAMRAS asked what the West Coast price is today.

MR. WENZEL said it is about \$60.

[2:15:53 PM](#)

MR. WENZEL continued reading his testimony. He spoke of two other satellites that will have similar losses of value. There are several other projects undertaken in the past few years that will have full value eroded as a result of the new tax. He said a transition plan is essential.

CO-CHAIR RAMRAS noted opening remarks that said Conoco would reluctantly accept this 20/20 plan. He asked Conoco to work on a finer transitional plan. "This transition plan will not survive in its present form." He said Conoco should look at a variable to reduce the credits, "because to get 100 percent of the last five years, I think, is an unrealistic expectation."

[2:17:05 PM](#)

MS. KAH said her job is to describe to the committee how Alaska is viewed versus other locations. She read from written testimony. She said Alaska has higher capital and operating costs than in other places.

CO-CHAIR SAMUELS asked how much of the price is the Trans-Alaska Pipeline System tariff.

MS. KAH answered about \$3.50 per barrel.

REPRESENTATIVE BERKOWITZ said the tariff is scheduled to be reassessed, and he wondered if it will come down.

CO-CHAIR SAMUELS said the realistic question is what the industry is assuming will happen in 2009 when the Trans-Alaska Pipeline System settlement methodology [TSM} comes to play again.

MR. JONES said he is supposed to talk about tariffs, but his company will have to renegotiate the TSM. He said the other factor is how much oil is in the pipeline, because with less oil the tariff could be higher.

[2:21:03 PM](#)

MS. KAH said her slide does not include the fact that Alaska crude does have a lower value because it is not at the Gulf Coast, "where we set WTI." She said it adds another couple of dollars to get it to the WTI basis. She said her only point is that costs need to be taken into account when setting the tax rate. Countries with the lowest cost are able to have the highest tax.

CO-CHAIR SAMUELS asked if Conoco looks at the percentage of the Trans-Alaska Pipeline System that it is paying to itself through Alyeska when looking at the economics of a project.

MR. JONES said it is looked at both ways.

[2:22:47 PM](#)

MS. KAH said places with high cost and low tax are favorable places to operate. High cost and high tax places are not getting sufficient investment, she stated. There is a relationship, as costs go up, tax rates go down. Alaska, under ELF, is in high cost, low tax, but under the PPT, Alaska's position will rise to the high cost, high tax quadrant, and she warned Alaska to consider that.

[2:25:11 PM](#)

CO-CHAIR SAMUELS said that in Norway taxes are high and credits are high, and they do have a lot of exploration. He asked if Conoco invests in Norway, how much, and why, if Norway is in the quadrant of high tax and high cost.

MS. KAH said Conoco invests in Norway because their field is so large it is attractive to maintain investments. She said Norway is not getting enough investment.

[2:26:17 PM](#)

REPRESENTATIVE BERKOWITZ said he has been hearing that cost and tax are critical components for investment, but he is not hearing about the effects of the market, which is a much bigger determinate of investment than "these relatively incremental amounts of cost or tax." If Conoco predicts high oil prices, that should be a bigger determinate of investments than tweaking a tax rate.

MS. KAH said Conoco price risks all its projects, but it doesn't know how to take all the political risks and tax rate changes into account. "What amazes me is that Norway has not seen more activity despite the fact that we have been in a high price environment the last three years." She said they will have to lower tax rates to get that.

REPRESENTATIVE BERKOWITZ said Alaska has concern with stability, and it can't forecast whether mergers are going to occur. "I would argue that there would be no Conoco profits in Alaska whatsoever had the State of Alaska not interceded to protect you so you could continue to make profits here." He said that needs to be considered.

[2:28:26 PM](#)

MS. KAH said she looks at her chart from the bottom line of net importing countries, which generally want to maximize their production and minimize imports. She said Norway is a net exporter, so it is not as desperate for production. Her next slide is about "prospectivity." Areas with higher prospectivity can assess higher taxes she said. The Alaska North Slope has limited prospectivity compared to countries like Kazakhstan, she noted, and tax rates need to reflect that. The Alaska consultant compared competitiveness of Alaska's tax rate, but he addressed something that is not important to companies. "If you want to understand how an investor would look at it, you should look at the net present value." She said the consultant provides both.

CO-CHAIR SAMUELS asked about the net present value.

MS. KAH said, "The net present value is king even though we do look at all available indicators."

[2:30:38 PM](#)

REPRESENTATIVE OLSON asked if political or tax stability is more important.

MS. KAH said both are factored into the equation, but political risk is not as quantifiable, but the company would require higher returns to be willing to be in a higher risk country. She noted that Pedro van Meurs tried to compare Russia, Azerbaijan and Angola to Alaska, and it is not a meaningful

comparison because of the field size. The risk of a 700 million field in Russia is not comparable to a 50 million barrel field in Alaska. So tax rate needs to be a lot lower in Alaska before Conoco would be equally interested.

REPRESENTATIVE GARDNER asked about Russia.

MS. KAH said she does not have data, but Conoco is looking at investing in arctic Russia.

[2:33:08 PM](#)

REPRESENTATIVE BERKOWITZ said Ms. Kah made the comparison of the 700 million barrel field in Russia and the 50 million barrel field in Alaska, and he asked if Conoco can get investors for Russia, "shouldn't we be able to get someone to come in here and invest for our 50 million barrel fields?"

MS. KAH said she will be talking about the independents later. She said she has a sense that the new tax law is designed for new players, and she will address that later, but the state needs the major producers.

REPRESENTATIVE BERKOWITZ said the majors have been fine partners, but the state is reaching a maturity in the North Slope; the state needs to make sure Alaska's fields get developed. "We don't have the option of going to another place."

[2:34:34 PM](#)

MS. KAH said her point is that the tax rate needs to be commensurate with prospectivity, field size and costs.

CO-CHAIR SAMUELS said Ms. Kah said Conoco doesn't quantify political risks, but in Azerbaijan or Nigeria it has to be far more risky than what the legislature comes up with, which will be reasonable. "We are not going to nationalize you and we are not going to blow up the pipeline and we're not going to execute your workers."

MS. KAH said there is risk in those places, but there have been very few nationalizations. She said they have seen incremental tax changes, and Venezuela has given them substantial payback; it has been an attractive place to invest in spite of political risk. Alaska has been attractive because of low political risk, she noted.

[2:36:52 PM](#)

MS. KAH said the state's consultant said Norway is comparable to Alaska, but Norway has a lower cost structure and better prospectivity. It has unique circumstances of a large field, so Conoco will continue to invest there. Norway has significantly higher taxes than Alaska, and it is not a helpful comparison. Crude production has declined in Norway since 2001.

REPRESENTATIVE GATTO asked if all production in Norway is in the North Sea.

MS. KAH said it is in the North Sea.

REPRESENTATIVE GATTO said the risk in the North Sea must be high expenses.

[2:38:22 PM](#)

MS. KAH said that on the United Kingdom side, the costs have gone up, but it was one of the lowest cost regions before that because they did a lot of work on getting joint facilities between the competitors. The UK has been low cost and Norway has been more expensive.

[2:38:49 PM](#)

MS. KAH said investors need stable fiscal terms, that is why Alaska has been an attractive place to invest. "I am truly becoming concerned that global tax takes are reaching a point where private companies...are finding it challenging to invest and meet our shareholders' return requirements." She said that is the reason industry reinvesting rates are not keeping up with oil price increases. "I believe one of the major reasons is that we are finding it increasingly difficult to invest [in a way] that meets our shareholder requirements."

MS. KAH said investment may be declining because there is an expectation that prices will cycle down, and because there is a lag time in developing new projects to invest in. She said the oil industry is afraid countries will change tax rates, and "we did not have that fear five years ago." She is concerned that private oil companies will not be able to invest in conventional oil and be forced to invest in alternative energy supplies, with more favorable tax terms. She said she has never seen in the

last 20 years oil companies being pushed out of the conventional oil business.

[2:40:51 PM](#)

REPRESENTATIVE SEATON asked if slide number 22 represents Alaska only.

MS. KAH said it was worldwide total spending. This is a global trend, she noted. She said major oil companies are concerned that there is a bias in favor of new investors, smaller investors instead of the "legacy" investors. She said there is a common misperception that small petroleum companies have lower return requirements than the majors, but she doesn't think that is true. Independents have higher costs of capital and they are less diversified and have higher risk, and therefore they need higher returns.

[2:41:57 PM](#)

REPRESENTATIVE BERKOWITZ asked what Conoco's targeted rate of return is.

MS. KAH said she can't tell because it is competitively sensitive. She stated that oil companies are not happy in this economic environment. "We are worried about the future."

REPRESENTATIVE BERKOWITZ asked if she could tell him what the expected rates of return would be for Alaska independents. "You made the statement that they need higher rates of return, and I need to be able to quantify that."

MS. KAH told the committee to look at other investments the independents might be considering. They will look at the Gulf of Mexico and the United Kingdom as alternative investments, "and I might say that all of those tax rates are in that lower left hand quadrant of the chart we looked at earlier." She said their alternative investments have a much better cost position than Alaska. She said she would think independents would want a higher return than they are getting from their existing lower 48 production to invest in Alaska.

[2:43:25 PM](#)

REPRESENTATIVE BERKOWITZ said that is just an assumption. He said the legislature is trying to set concrete numbers for tax rates, and it is very difficult to be told it is proprietary

information. "You're asking us to make a concession to you without you telling us what it is that you are trying to achieve, and that to me is problematic."

MS. KAH said she feels uncomfortable talking about what the independents want. There does seem to be a bias for newcomers. She said, "Well what about us, the legacy investors who have been investing here year after year?"

REPRESENTATIVE BERKOWITZ said, "We are not forgetting you; you have been making handsome profits for a good long period of time, and we hope you continue to make handsome profits for a good long period of time. But when you're making internal investment decisions that force you to choose between an Alaskan investment and a Russian investment, we want you to go ahead and make whatever investment you want to make, but we also want to make sure that the Alaskan investment comes to fruition somehow. Because we don't have a choice. Our money comes from Alaskan oil; it doesn't come from Russian oil."

[2:44:50 PM](#)

REPRESENTATIVE SEATON said other than the \$73 million, won't Conoco be getting exactly the same capital credits and allowance for operating costs as the smaller companies?

MS. KAH said the committee told her that Conoco was going to have problems with the transition program, and that is how Conoco would be treated unfairly.

REPRESENTATIVE SEATON said in trying to stimulate new investment, Conoco's investments are treated the same.

MR. WENZEL said that is correct, for new investment the bill is equal for small and large producers. He said Conoco's issue is around the fact that it already has a lot of investment, which does not receive some of the benefits from the new program.

[2:46:37 PM](#)

REPRESENTATIVE KERTTULA said Conoco gets a deduction both under the current system and the new one on the corporate income. Conoco doesn't get the credit, but it didn't get it under ELF either, so "I don't see the change there."

MR. WENZEL said that is correct, there wasn't a tax credit under the ELF system, but the system was based on revenue and it wasn't appropriate to have a tax credit there.

REPRESENTATIVE KERTTULA said, "It didn't exist then, it doesn't exist now, and you did get the corporate income tax. So I know we're putting a new tax onto the revenue but the other things have not changed."

MR. WENZEL said there is a dramatic change in the tax rate.

REPRESENTATIVE KERTTULA said she doesn't see the change in terms of the deduction.

[2:48:02 PM](#)

CO-CHAIR SAMUELS referred to a statement that independents' money might go to the UK, where taxes have gone up 50 to 60 percent in the last couple of years.

MS. KAH said the UK has no royalties, but the UK is still in the lower left hand quadrant. She said they went from 30 to 50 percent tax, and now it is viewed as a risky place to invest. She guaranteed that the UK will now get less investment.

CO-CHAIR SAMUELS asked if other countries are changing taxes because profits are so massive. "If they all switch that way, the competition for capital will be on an even playing field."

[2:49:33 PM](#)

MS. KAH said she is very worried about the future of the oil industry because "I feel like the entire oil industry is being pushed out of conventional oil investment." She said some of that investment is continuing, but it's national oil companies from consuming countries who are still willing to make investments with lower returns than a private company. "My worry is the future of the industry is pushing the oil industry out of oil and into unconventional oil and LNG...and other things.

MS. KAH said she wishes "you would like us to stay in this country." She spoke of the environmental sensitivity of the North Slope and said Conoco has a good track record with strong standards put in place. If Alaska replaces Conoco with lots of small companies, there may be environmental problems. She is particularly worried if Conoco is partnering with "these

people". Conoco wants to continue to have a significant role in Alaska and has the skills and experience for all projects under arctic conditions. Conoco has, in particular, experience and technology for heavy oil, and it is the second largest refiner in the United States, so it can allow the refineries to take more heavy crude. Conoco has access to markets that allows it to maximize the value of the resource. Conoco has strong risk management skills with a diversified portfolio. Conoco has a long-term investment horizon, which means that it invests year in and year out regardless of market conditions.

CO-CHAIR RAMRAS asked Ms. Kah to talk about exploration credits. He said he is fascinated that development and exploration costs are approached with the same credit. "What kind of change do you think would be enjoyed by the State of Alaska if we lessened your concern on the exploration side and participated more in the risk side with oil companies and increased significantly the exploration credit?"

[2:54:01 PM](#)

MR. WENZEL said Conoco would view that very favorably. He said Conoco continues to explore in Alaska and is using current exploration credits.

REPRESENTATIVE CRAWFORD said that the governor's advisor said everything in this "so-called" oil tax relates to gas too, in a ratio of 6,000 cubic feet of gas to one barrel of oil. He said he asked him how this ranks Alaska in the world, and was told not to worry because the gas tax part will be changed within two or three weeks, "but we may never get to that part--this may be the only stage that we deal with." He asked what Conoco says as to where Alaska will be in the range of gas tax if this is the gas tax that we are faced with.

[2:56:02 PM](#)

MR. WENZEL said with respect to Alaska's gas tax, "I think we will definitely tell you...without that fiscal stability and those provisions of that stranded gas fiscal contract that will come out, there is not sufficient incentive to develop that gas and bring it to market today, under the current system or under this PPT."

MS. KAH said the investment contemplated for the pipeline is \$20 billion and has a ten-year lead time, and is much more risk than Conoco is comfortable with. "It would need better treatment

than even an LNG project that's \$5 billion because it's just too big a risk for a company even our size to contemplate without making sure we had good enough fiscal terms and stability of fiscal terms."

[2:57:21 PM](#)

REPRESENTATIVE CRAWFORD asked if Conoco would be adverse to someone else using the \$18 billion worth of loan guarantees and building a pipeline that Conoco could put its gas through.

MS. KAH said she has not been involved in the issue.

MR. WENZEL said, "We don't view that as the most economic answer. We believe our project is viable and doable. Sure, we will look at any possible way of monetizing that resource, bringing it to market for the full benefit of both Alaska and ConocoPhillips. If there are other alternatives better than the one that we've come up with, we're happy to consider those."

[2:58:07 PM](#)

MR. JONES said controlling the risks is one of the big challenges.

CO-CHAIR SAMUELS asked how the PPT looked for Conoco in Cook Inlet.

[2:58:39 PM](#)

MR. JONES said there is a difference between oil on the North Slope and gas in Cook Inlet. He said people may ask why there hasn't been more exploration for gas in Cook Inlet. "And as you probably know, it has been a stranded gas market, where there has been a lot more gas resource than market that needs the gas. So just changing the credit system to try and get people to just produce more gas, other than very small amounts...you won't get people going out looking for half a TCF or TCF-sized fields because once you find it, it's now stranded again." He said he hasn't thought through the ramifications of the PPT, and it is a big change that may have unintended consequences. "What kind of happens is that profits from the existing assets get used to incentivize new development, so what may happen is that profits from Cook Inlet get used to incentivize new developments on the North Slope, since it's...around all of Alaska. So I think that's a challenge that you may want to consider."

3:00:02 PM

CO-CHAIR SAMUELS said he has worked hard to not have this be a forum on any proposal that may or may not ever be brought forward by the producers on a gas pipeline. He noted that this is complicated enough without that overlay. "You guys have been very careful not to say that if the oil tax regime does x, y, or z, that it has a direct impact on any potential gas pipeline. Now, I am still not convinced I understand how they're politically attached. I understand how they're attached obviously in geography, but economically-speaking, I am thinking the gas deal has to stand alone on the gas deal, and the oil deal has to stand alone on the oil deal. And I fully understand why you want fiscal stability so that we don't bait you in and half way down the project, and we go: 'Well, just kidding, we want more money out of our hydrocarbons in general.' So I understand the fiscal stability you're looking for, but what I don't have a grasp on yet, or I guess I disagree with, is how the economics are so completely tied together that you can't divorce the discussions and do what is best for oil and oil development and oil exploration, and then hopefully, sometime soon, do what is best for gas, gas development, and build a gas pipeline." He asked Conoco to say how the two are so economically interlinked.

3:02:00 PM

MR. WENZEL said he cannot give more comfort in terms of an economic linkage. He said it is very much about fiscal stability and knowing that taxation on the gas side will not result in instability on the oil side. "They are definitely linked that way." He said there is no doubt that allowing the gas project to move ahead will further enhance oil production; it will extend the life of the pipeline. He stated that for Conoco the key part of where it stands on HB 488 "is the fact that we want that gas pipeline to go ahead. We see this bill and the balance it provides as sort of a maximum we can accept as a balance and move forward and stay aligned with the other sponsors of that project." He said it is a difficult balance, but Conoco sees HB 488 as the most expedient way to go forward.

3:03:11 PM

REPRESENTATIVE BERKOWITZ said Conoco jumped first and signed an agreement on gas prior to any understanding or discussion of oil. He asked why Conoco was willing to go ahead at that point and now, all of a sudden, linkage is important.

MR. WENZEL said Conoco did step out and reached a point where the terms of the gas project were sufficient to move ahead. He said that even then Conoco recognized that if the project was going to be moved forward on a reasonable and expedited basis, "the other two sponsors needed to come to that same recognition, and I think they've come there now in the last couple weeks." He said they are continuing to work with the administration to find the right balance that "gets everyone on the same page." He said he can only reiterate that fiscal certainty on gas and oil are now critical to all three sponsors for moving the project forward.

REPRESENTATIVE BERKOWITZ said there was introduced legislation on oil taxes, "and even then you were still willing to go on gas. I'm just trying to understand why."

MR. WENZEL said from Conoco's perspective, it reached that point where the terms on the gas deal were sufficient to move ahead, and Conoco announced that.

REPRESENTATIVE SEATON stated that he wants to set aside the pipeline and consider this bill as involving oil and gas. He said, "So we have a whole different relationship here with a whole different set of tax credits, a whole different tax rate and tax system." He said he asked the administration for charts showing the effect on gas under this PPT. He said he doesn't think the data show that there has been a conjoining of gas and oil on a BTU basis. He thinks they have been quite disparate. He wants to understand if Conoco thinks gas needs to be in this PPT, and whether it complicates or simplifies the structure. "We were considering this PPT as an oil tax bill, and now it's an oil and gas tax bill." He asked if it is beneficial for this oil tax to also apply to gas.

[3:07:53 PM](#)

MR. WENZEL said in moving to a PPT, it would be important to combine the taxation of oil and gas together in order to simplify the process. He said that trying to separate all expenses and revenue between gas and oil might be very difficult, because they are often produced out of the same area. Gas is a smaller piece of Conoco's business, and Conoco has been more focused on the taxation of its future gas business under the stranded gas fiscal contract.

REPRESENTATIVE SEATON said he is also concerned that the state hasn't looked at the tax ramifications of this proposal on gas and gas production, and whether gas becomes more favorable or less for Conoco's business.

MR. JONES said Conoco has not run economics on all of its projects for the new bill, but initial estimates are that the PPT will double the severance tax in Cook Inlet. These tax increases will be passed on to the consumers in South Central Alaska. He said some independents may say that the PPT will increase investments, but you need a market to sell the gas.

[3:10:55 PM](#)

REPRESENTATIVE OLSON said assuming there is fiscal certainty on gas and oil in the next few months, what impact will that have on the 2009 export license renewals?

MR. JONES said Conoco's current LNG export license ends in 2009, and "we're looking to...extending it assuming we have the gas, assuming South Central demands are met and that it's the right thing to do." He said the PPT will make it less profitable, and that may impact it.

REPRESENTATIVE SEATON said he represents that area and is very concerned that nobody has done an economic analysis on that, and it may be good to just throw [a gas tax] in, but if it means that the export license doesn't make any sense with world markets on LNG, "that's a huge deal to us on the Kenai peninsula." He said he would sure like Conoco to run some numbers on the other effects of the PPT, and not just look at the North Slope.

[3:12:30 PM](#)

REPRESENTATIVE KERTTULA asked if Conoco has thought about crediting its gas costs against its oil profits and how it plays into HB 488.

MR. WENZEL said gas costs, including capital and expense, go into the formula and affect the overall taxation.

[3:13:08 PM](#)

MS. KAH said large producers are desirable because they have large investment spending capacity. She said the tax proposal is the upward boundary of what is fair.

[3:13:53 PM](#)

MR. WENZEL said Conoco has suggestions for changes in the bill, including how eligible deductions and credits are identified and how the value at the point of production should be done. He noted that the proposed tax will more than double Conoco's effective tax rate. In isolation it is not reasonable or appropriate, particularly because the state has a budget surplus, but to facilitate future investment the company reluctantly supports HB 488.

[3:15:14 PM](#)

REPRESENTATIVE BERKOWITZ noted that Mr. Wenzel doesn't want a tax increase when the state has a surplus, but when the state has a deficit, the industry opposes a tax increase.

MR. WENZEL said if the state was running a deficit, investors would be more understanding, but if the state has a surplus, it is important to consider the message the state sends when the money is not needed.

REPRESENTATIVE BERKOWITZ said a progressive structure has been discussed for a long time, with oil companies suggesting it. "We have been locked into a regressive structure, which hurts industry at low prices and didn't help the state at high prices, and that's why you're seeing the change today...It's really about getting a more equitable share."

MR. WENZEL said he doesn't dispute moving to a PPT; it could work very well. But his point is the state is increasing the tax burden.

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REPRESENTATIVE BERKOWITZ asked if Mr. Wenzel would favor a tax that is more progressive.

MR. WENZEL said he would be happy to consider some step levels depending on the price. "We are very much focused on the base tax rate and the ability to look at that base tax rate and figure out what our upside is in the future. So for us, this balance works, but to the extent that the legislature, this committee, had a proposal along the lines of a stepped series of tax rate, that could work also. Again, it would be key to look

at the base rate that's appropriate at more commonly expected prices as opposed to setting it at today's prices."

REPRESENTATIVE BERKOWITZ asked if he would share those commonly expected prices with the committee.

MR. WENZEL said there are a number of forecasts. But he will not divulge Conoco's forecast. He said Ms. Kah is concerned about where oil prices are headed.

MS. KAH said she reads the external forecasts of prices not staying at the current level. She said it is uncertain how fast prices will drop. Inventory is extremely high, so there is a potential for a collapse. She said there is concern about supply disruptions, so historically, at the current level of inventory, the price of oil today should be \$35, but it is not, it is \$60 per barrel because of insecurity. She said the question is whether the price will decline slowly or bounce. She said most forecasts are between \$30 to \$50 per barrel, but oil companies are more conservative.

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REPRESENTATIVE GATTO noted that the tax is doubling under HB 488, but Conoco stated there will be a 200 percent increase, which is a tripling.

MR. WENZEL said Conoco was inappropriate in saying 200 percent.

CO-CHAIR SAMUELS asked why the state should give a tax credit for abandonment expenses. He asked how many abandonments there have been during the claw back provision.

MR. WENZEL said he doesn't have those numbers. Those expenses are simply related to abandoning individual wells. His view is that those are appropriate expenses that should be incorporated in any profits-based tax. It is a cost of doing business. Those expenses do not receive a capital tax credit because they are operating expenses. There won't be many profits to take the credits against for abandonment of large fields like Prudhoe Bay. They have to be taken against production tax, and can't be moved. He said the company could turn them into a tax credit by virtue of having a loss, but they could only be used against other production tax.

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REPRESENTATIVE GATTO asked if there is a "removal and rehabilitation" for when the last barrel of oil flows through the pipe. "Don't we already put that as upfront expenses?"

[3:24:11 PM](#)

MR. JONES said the TAPS settlement methodology includes a factor for dismantling and restoration of the pipeline, and that is the only context for that allowance.

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REPRESENTATIVE BERKOWITZ said the removal and rehabilitation has the industry setting aside money to accommodate that. It should have been expensed in already.

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MR. WENZEL said, "We need to remember we're talking about a profits-based tax on production. The fact that those costs are usable either in tariff methodology or elsewhere, doesn't change the fact that if you are going to do a tax for production based on profit, you need to bring in expenses."

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REPRESENTATIVE BERKOWITZ said you need to remember that there is a deal that has already been struck that shouldn't be part of another bite of the apple. He said the removal and rehabilitation is a done deal, and if it's not, he would surely like to know. There should be billions of dollars there at this point. "I'd like to have that money if we are going to renegotiate it."

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MR. JONES said the TAPS investors/owners have received reimbursement for that expense as part of the TAPS tariff. That money is what is set aside, there is no similar account for the North Slope oil fields.

[3:26:10 PM](#)

REPRESENTATIVE KERTTULA said that will work under the TAPS settlement; that isn't something that's covered by this bill.

[3:26:25 PM](#)

REPRESENTATIVE OLSON said he thought that 30 years ago there were open-ended bonds posted to handle that.

MR. WENZEL said he would get back on that.

MR. JONES said it is likely there were bonds, but there is not a similar TAPS mechanism for the North Slope oil fields.

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REPRESENTATIVE CRAWFORD asked if Conoco would be expensing for that all along.

MR. JONES said in Conoco's financial books, clean-up is taken into account.

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CO-CHAIR SAMUELS said that having the gas tax in the bill doesn't bother him much because gas from the slope will be locked into a contract. He said his concern is with the tax credits for Point Thompson where there is very little exploration risk, so why should the state have a tax credit? The state doesn't need incentives, and this issue at Point Thompson is where his red flags go up when he sees gas included in this bill. He said Cook Inlet will be a separate issue.

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MR. WENZEL said Conoco's view on tax credits for Point Thompson is not different from its view on all other tax credits. "We believe the tax credit should apply uniformly across all investments in a basin, at the very least. We would not recommend creating some differential treatment for a very specific asset in this bill." He said it would set a precedent.

REPRESENTATIVE SEATON said the \$73 million allowance was to give stability and to not over-tax production of less than 5,000 barrels. He said he is concerned that that number was arrived at for oil prices of \$43 per barrel, so the state is giving a pass for \$23 a barrel oil for a field producing 20,000 barrels a day. He asked if it is reasonable that that size of a field would pay no tax.

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MR. WENZEL said that base allowance is worth \$15 million to Conoco, so it is appropriate to discuss it with others where it represents a larger cut.

REPRESENTATIVE SEATON noted that the monthly tax bill will have a 10 percent holiday, and no interest owed on that money. He asked if Conoco pays interest on the underpayment for federal taxes and why not have that same system.

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MR. WENZEL said there is no interest as long as the taxpayer meets that 90 percent threshold, and he doesn't know about federal taxes.

REPRESENTATIVE SEATON said if it is normal, will Conoco do it for the state?

MR. WENZEL said Conoco will pay interest if that is what the legislature wants.

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CO-CHAIR SAMUELS said that Dan Dickenson testified that the point of production was going to change, and he asked what the advantages or disadvantages of changing it is to Conoco.

MR. WENZEL said he is not up to speed on the point of production. He said the North Slope is a large heavy oil resource that is significantly disadvantaged in technology, quality and cost. He said it will be key to incentivize heavy oil to increase production. The transition plan is essential to ensure equitable treatment. Many investments were marginal and only justified under the ELF system. The tax rate pushes Alaska into a high tax bracket, so the state must be comfortable with the risk that such a high rate gives the state. He concluded that many variables need to be considered in a tax regime.

[HB 488 was held over]

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ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at [3:38 PM](#).