

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

March 1, 2006
12:38 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

OTHER LEGISLATORS PRESENT

Representative Ethan Berkowitz
Representative Eric Croft
Representative Les Gara
Representative Berta Gardner
Representative David Guttenberg
Representative Beth Kerttula
Representative Vic Kohring (via teleconference)
Representative Mark Neuman
Representative Norman Rokeberg
Representative Woodie Salmon
Representative Peggy Wilson

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
02/27/06	(H)	Heard & Held
02/27/06	(H)	MINUTE(RES)
02/28/06	(H)	RES AT 12:30 AM CAPITOL 124
02/28/06	(H)	Heard & Held
02/28/06	(H)	MINUTE(RES)
03/01/06	(H)	RES AT 12:30 AM CAPITOL 124

WITNESS REGISTER

JOHN ZAGER, General Manager - Alaska
Chevron Corporation
Anchorage, Alaska

POSITION STATEMENT: Expressed concerns with regard to HB 488.

KEVIN TABLER, Manager
Lands and Governmental Affairs
Chevron Corporation
Anchorage, Alaska

POSITION STATEMENT: Answered questions about HB 488.

MARK HANLEY, Manager
Public Affairs for Alaska
Anadarko Petroleum Corporation
Anchorage, Alaska

POSITION STATEMENT: During hearing of HB 488, related Anadarko Petroleum Corporation's views.

PAT FOLEY, Manager
Land, Commercial
Regulatory Affairs
Pioneer Natural Resources
Anchorage, Alaska

POSITION STATEMENT: Testified in support of HB 488, but requested that the tax credits be refundable.

JIM WEEKS, Alaska Operations Manager
Ultra Star Exploration LLC
Anchorage, Alaska

POSITION STATEMENT: Testified in support of HB 488.

ACTION NARRATIVE

CO-CHAIR RALPH SAMUELS called the House Resources Standing Committee meeting to order at [12:38:58 PM](#). Representatives Ramras, Samuels, Gatto, Olson, Seaton, Crawford, and Kapsner were present at the call to order. Representative LeDoux arrived as the meeting was in progress. Representatives Berkowitz, Croft, Gara, Gardner, Guttenberg, Kerttula, Kohring (via teleconference), Neuman, Rokeberg, Salmon, and Wilson were also in attendance.

HB 488-OIL AND GAS PRODUCTION TAX

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CO-CHAIR SAMUELS announced that the committee would continue its discussion of 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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JOHN ZAGER, General Manager - Alaska, Chevron Corporation ("Chevron"), said his the company has had a relatively short time in which to review the proposed profit-based petroleum production tax (PPT), and therefore some of the conclusions are preliminary. He then familiarized the committee with Chevron's asset base, which was formed when Chevron acquired Union Oil Company of California (Unocal) in August of this year. Both companies, he noted, have been active in Alaska for several years. In fact, both companies were active in the early discoveries at Cook Inlet. Currently, Chevron is the fourth largest producer in the state, although it's far below the state's third largest producer in terms of total production. Chevron is large enough that it would be treated similar to the

producers with regard to the PPT, but the company isn't small enough to reap the benefits aimed at the smaller producers. Mr. Zager informed the committee that Chevron has 382 full-time employees or contractors, of which 272 are located on the Kenai Peninsula and the remainder in Anchorage. With the aforementioned staff and a more than \$45 million payroll, he opined that it's obvious that it would have a large impact on the economies of the earlier mentioned areas. The company also contributes to the economy by serving customers such as Tesoro, ENSTAR Natural Gas Company, Chugach Electric, Agrium, and Aurora.

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MR. ZAGER highlighted that Chevron is unique in that it's the only producer in the state with a relative balance of production between the Cook Inlet and the North Slope with production in the amount of 60 percent and 40 percent, respectively. Either stream of production alone is large enough to trigger the PPT. Because of this, Mr. Zager opined that Chevron's Cook Inlet assets are uniquely positioned to suffer from the PPT, in terms of its low margin of business and difficulty to support an additional tax. He then reviewed Chevron's assets on the North Slope, as illustrated on slide 3, which are as follows: Alpine - 1 percent; Greater Prudhoe Bay - 1 percent; Greater Kuparuk - 5 percent; Endicott - 11 percent; and Point Thomson - 25 percent. Additionally, Chevron is one of the owners of the currently leased land within the Arctic National Wildlife Refuge (ANWR). Chevron also has exploration acreage on the North Slope as well as a fairly extensive lease interest in the foothills. He acknowledged that Chevron did participate in a lease sale in Anchorage in which it spent approximately \$7 million acquiring 42 leases, for a total of some 480 square miles of new leases in the area from Kuparuk down south.

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MR. ZAGER, in response to Representative Gatto, explained that the reference to "ORRI" stands for overriding royalty interest and means that the company doesn't pay any of the cost but receives 1 percent of the production. He likened this to the royalty the state has on certain leases.

REPRESENTATIVE BERKOWITZ surmised that if Chevron just spent \$7 million to acquire 42 leases, it wouldn't seem to be concerned with the implementation of a new tax regime.

MR. ZAGER reminded the committee that originally the lease sale was scheduled for October and Chevron had decided to participate in the lease. However, the lease sale was delayed until today, which led the company to discuss whether it should change its plans due to the possibility of a new tax regime. The company decided that due to the many unknowns at this time, it's hard to evaluate the company's economic position based on what might be the final form of HB 488. Since the state has always seemed to establish reasonable tax regimes, Chevron decided that it was in the best interest to proceed with the lease sale.

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MR. ZAGER then turned the committee's attention to slide 4, which relates Chevron's more complicated Cook Inlet position. He reiterated that Chevron, which is the dominant operator in the Cook Inlet, operates 10 of the 15 platforms in the area. He noted that eight of its platforms in the Cook Inlet are producing while two platforms have been shut in. He then reviewed Chevron's onshore and offshore assets in Cook Inlet. Mr. Zager highlighted that Chevron is 100 percent owner and operator of the Swanson River field, which is the location of the Kenai gas storage facility where the gas is stored in the summer months until needed in the winter. The gas storage facility has proven to be very instrumental in meeting the peak needs of the Cook Inlet area in the winter months. He then mentioned that Chevron is constructing a new storage facility at Pretty Creek field. He then highlighted new exploration at the Ninilchik Unit, which is operated by Marathon and in which Chevron has a 40 percent working interest, and the Happy Valley field, which is a 100 percent Chevron asset. Chevron's total production in the Cook Inlet is about 25,000 barrels per day of net oil and about 16,000 barrels per day of net production on the North Slope.

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MR. ZAGER, in response to Co-Chair Samuels, reiterated that of the 10 platforms, eight are currently producing and two are shut in and not producing. He then shared a photograph of the Trading Bay Unit [on slide 5] and reminded the committee that the North Slope isn't the only location with difficult operating conditions in the state. The Cook Inlet also has its challenges with its high tides and ice floes. Mr. Zager acknowledged the notion of bringing in new producers to the state, and requested that the committee consider the implications/risks of a much smaller and perhaps thinly capitalized company behind these

assets. He highlighted that these operations require a lot of maintenance and integrity because no one wants an environmental incident.

MR. ZAGER moved on to the graphs on slide 6, which is a logarithmic scale that plots time/years against production rates. He informed the committee that in the 1970s Alaska was just at 200,000 barrels per day of production as compared to today when there is about 13,000 barrels per day of production. Although the aforementioned illustrates that production is a small fraction of what it used to be, operating costs have not decreased at all, which is illustrated with the water cut line that specifies that today a little over 90 percent of the fluid being moved is water. The aforementioned adds to the expense of the Cook Inlet.

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MR. ZAGER turned the committee's attention to similar graphs on slide 7, although they only refer to the Trading Bay Unit. The graph illustrates that the peak production was about 120,000 barrels a day, which has decreased to about 7,000 barrels per day. The water cut is up to about 95 percent of the production. Mr. Zager informed the committee that Cook Inlet is a very high-cost area in that its direct lift costs are \$20-\$25 per barrel, and therefore including the transportation and indirect costs, it amounts to more than \$30 per barrel to operate in the inlet. Therefore, the breakeven on a cash flow basis is a bit more than \$30 a barrel.

CO-CHAIR RAMRAS asked if those figures include depreciation.

MR. ZAGER replied no. He noted that this entire discussion is focused on profit as defined by the PPT, which he referred to as free cash flow. However, in business, earnings are very important and it means that another depreciation line would be added. For the Cook Inlet [holdings], that amounts to about \$10-\$12 a barrel of additional noncash expense that is reported for earnings purposes. He pointed out that large corporations are especially graded on their earnings per barrel, the priced earnings ratio. Therefore, a company generating barrels in production but not earnings is an issue that would need to be addressed in the portfolio of that company.

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REPRESENTATIVE GARA reminded everyone that until a few years ago, oil was at \$18 and \$20 per barrel. Therefore, he questioned whether Chevron was losing money on its Cook Inlet operations at that time.

MR. ZAGER answered that in certain parts of the Cook Inlet, Chevron was losing money, as evidenced by the closing of two platforms. The other platforms were basically breakeven or in a slightly positive position, but given the uncertainty in oil prices and that things could get better, the company decided to continue to operate those. He noted that once the decision is made to cease production, it's irrevocable and "you really can't go back and decide to start those platforms up again." At this point, the decision to continue was the right decision because at current prices Chevron is obviously making some profits. However, when one reviews the amount of operations, resources, capital, and expense that go into it, one must question at what point is that amount of profit irrelevant to the operations. He explained that although the PPT will not take Chevron's profits negative, it will reduce them to the point at which the company may decide to say, "enough is enough." Furthermore, the PPT will tend to drive Chevron's earnings per barrel into the negative range. The aforementioned would all be considered in deciding the future of the operations.

KEVIN TABLER, Manager, Lands and Governmental Affairs, Chevron Corporation, interjected that one must also remember that production is continuing to decline.

REPRESENTATIVE GATTO inquired as to the cost to shut in a platform.

MR. ZAGER explained that to shut in a platform means to cease production on the platform permanently, which is an expensive proposition. There is an initial cost to the platform during the initial closure because the platforms are cleaned thoroughly. The cost to cease production and clean the platform is several million dollars per platform. However, if the platform is abandoned, it could amount to a million dollars per well. He noted that ultimately the platform would have to be removed, which would be an expensive process. In further response to Representative Gatto, Mr. Zager explained that once the platform is shut in, it moves into the lighthouse phase and it will continue to have power in order to maintain the lights and avoid the platform becoming a navigational hazard. The aforementioned alone costs hundreds of thousands of dollars per year per platform. He noted that the company also periodically

checks the shut in platforms to ensure that there aren't problems.

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MR. ZAGER related that if production continues to decline at the rate that it will without additional capital spending, the life of [Chevron's] platforms will be fairly limited. Moreover, there are significant operational risks to merely maintain these platforms in Cook Inlet. Although the risk of having a large incident in Cook Inlet is very low, it could have a very high impact if there was an incident. He reminded the committee that two platforms are shut in. He then explained that the platforms are codependent and share overhead and the onshore facility is located in Nikiski. When one platform becomes economic, the remaining overhead and fixed costs must be shared amongst the remaining platforms, which makes it more difficult for the remaining platforms to be viable. "So, once one starts to go, there's going to be a cascading effect," he related. Therefore, the Cook Inlet is very challenging and can't afford an additional production tax.

MR. ZAGER then updated the committee with regard to what has happened since Chevron acquired Unocal, which occurred on August 10, 2005. At the time, there was speculation that Chevron would divest the Alaska assets, especially the Cook Inlet assets. The thought was that a company of Chevron's size wouldn't see much financial benefit in retaining those assets. From October to January, Mr. Zager said that he and his staff spent time with Chevron's management to familiarize them with Unocal's operations and opportunities in Cook Inlet. Through that process, it was determined that there are incremental investment opportunities in the Cook Inlet, although they amount to the lowest part of Chevron's portfolio in terms of reinvestment opportunities. There was another list of projects that didn't make the list, and thus at the end about 35-50 projects made the list while a similar amount didn't. In February, Chevron decided to retain all of [Unocal's] Cook Inlet assets, with the intent to begin a multi-year investment program. He related that on a gross basis, spending with Unocal's partners, the company envisions spending about \$200 million over a four-year period. He noted that the aforementioned spending is only in the oil portion of the business.

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MR. ZAGER informed the committee that Chevron will retain the current office locations and all its employees. In fact, the company anticipates that six months from now it will have a larger in-state staff than currently. He noted that over 99 percent of the employees are in-state residents and the company anticipates that six months from now there will be an even larger in-state staff base. However, there's a bit of a problem in that the company performed its analysis several months ago with the current severance tax paid to Cook Inlet, which is essentially zero for these assets. When modeled under the proposed PPT, it was determined that the proposed PPT affected the economics of the company's projects. He explained that the economics for the best projects in the portfolio became less attractive. He attributed that effect to the fact that the projects were generating lots of profits and would have to pay the additional PPT. However, the projects on the bubble benefited under the proposed PPT because the projects weren't generating quite as much income on which to pay taxes while benefiting from the capital credit part of the investment. However, the benefit doesn't makeup for the increased tax on some of the other investments.

REPRESENTATIVE BERKOWITZ inquired as to which projects were positively affected and which were adversely affected.

MR. ZAGER posed a hypothetical example in which a project had a 30 percent internal rate of return (IRR) and after running through this proposed model, the additional taxes and the capital credit would cause the IRR of the project to drop to 25 percent. However, under the proposed PPT, a project with a 12 percent return that wouldn't normally meet the cut would see an increase in IRR to about 15-18 percent. When all those are added together under the 20/20 PPT, the entire package is degraded somewhat.

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REPRESENTATIVE BERKOWITZ characterized [HB 488] as a one size fits all approach. Therefore, he inquired as to how Mr. Zager would tailor it, if allowed.

MR. ZAGER opined that there are two components that would benefit, such as the upfront 20 percent that takes MPV [market place value] away from the project in the out years. For incremental investments, the ratio is going to be very important, he said.

REPRESENTATIVE BERKOWITZ asked if Mr. Zager felt that there might be a better taxing regime than the proposed PPT.

MR. ZAGER surmised that the economic limit factor (ELF) is off of the table. He informed the committee that Chevron hasn't analyzed other possible taxing scenarios. He highlighted that the current taxing regime is one under which Chevron can live with.

REPRESENTATIVE GARA inquired as to the IRR that Mr. Zager felt would be necessary on an oil and gas project in order to proceed with it.

MR. ZAGER answered that he couldn't provide those numbers because they are held close.

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REPRESENTATIVE GARA surmised then, based on Mr. Zager's earlier testimony, that a 12-13 percent IRR peaks Chevron's interest.

MR. ZAGER commented that Representative Gara may be reading too much into the earlier hypothetical investment. Mr. Zager continued by reminding the committee that under the proposed PPT, the portfolio overall was slightly degraded. Therefore, by lowering the tax rate or increasing the tax credit or some combination of the two would improve the situation. The other issue with regard to the PPT is related to the alignment of partners. Although the current partners in the Cook Inlet can already find ways in which to be misaligned, this proposal will create a direct financial misalignment because the partners will be in different tax positions depending upon whether the credit is received and the amount of capital invested elsewhere in the state.

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MR. ZAGER moved on to the production profile for the Cook Inlet, the Cook Inlet offshore production as presented in the graph on slide 11. The graph relates the effects of the four-year capital investment program. He explained that the green area represents the base production with no additional capital investment. The graph shows a decrease from 2,000 barrels a day to about 4,000 barrels a day. "Even at current oil prices, I'm pretty sure that that would be under water on a cash flow basis," he opined. The modeling demonstrates that with four years of capital spending, production could be maintained at a

flat level for four years. The hope is that during those four years of capital programs, Chevron could identify other programs. Furthermore, more tax credits could help place some of the projects just below the threshold of investment quality over that threshold. Therefore, with capital investment, he predicted that Chevron should be able to maintain current production for that four years.

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MR. ZAGER then turned attention to slide 12 regarding the reasons to spur Cook Inlet investment. Since the gas is running out there needs to be a plan to meet the energy needs of Southcentral Alaska. On the oil side, oil redevelopment will maintain and add new jobs and will extend field life. Another reason to spur Cook Inlet investment is new exploration. Currently, there is a lack of real significant exploration and there seem to be a limited number of players looking for gas.

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MR. ZAGER concluded by relating that HB 488 is a huge increase in taxes. "When we model it, it looks like a minimum of a two times tax severance tax increase. And depending on some of these other levers ... as changing the tax rate, taking away the transitional capital, it could be up to a four times increase in severance tax," he opined.

REPRESENTATIVE BERKOWITZ inquired as to Chevron's effective tax rate under the current system versus under the PPT. He also requested that the answer distinguish between Cook Inlet and the North Slope assets.

MR. ZAGER said that he may be able to only answer parts of the question because Chevron and Unocal's financial systems have not been integrated yet. On a statewide basis, the Unocal portion was about 1 percent. He recalled that on the Chevron side, it was much higher, perhaps more than 10 percent.

REPRESENTATIVE BERKOWITZ asked if Mr. Zager felt that 1 percent for the Kuparuk [River Unit] is fair.

MR. ZAGER said that he didn't want to speculate regarding what is fair. However, he acknowledged that it's a big oil field that generates significant profits under the current system.

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CO-CHAIR RAMRAS inquired as to what Chevron gives back to the communities of Alaska each year.

MR. ZAGER said that he didn't have a specific figure. He related that Unocal has been very active relative to its size. He noted Unocal's involvement with the United Way. He opined that Unocal is doing its fair share, if not more. He estimated that for this year there is about a \$300,000 budget as well as other funds that come from the "corporate." In further response to Co-Chair Ramras, Mr. Zager estimated that [Chevron's] profits, as defined under HB 488, are in the amount of approximately \$300 million in 2005.

REPRESENTATIVE KOHRING asked if Mr. Zager believes the restructuring is a good concept, although the tax level in HB 488 is too high. He inquired as to Mr. Zager's recommendation as to how to modify HB 488.

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MR. ZAGER said that would be answered momentarily. In summary, Mr. Zager agreed that HB 488 proposes a large tax increase. He reiterated that the better projects in a company's portfolio will be degraded and the poorer projects will be enhanced. Therefore, the legislation is increasing incentives to invest in marginal projects or projects with a high risk. The aforementioned will impact each company differently on a portfolio basis. He expressed the need to review how those projects compete worldwide and domestically.

REPRESENTATIVE GATTO inquired as to how much of the approximately \$300 million Chevron made in the state would HB 488 deduct.

MR. ZAGER estimated that a 10 percent deduction would not be unreasonable, although it could be less than or more than that.

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MR. ZAGER, in response to questions, related that production is about 40,000 barrels a day. The bill, as presented by the governor, is something that [Chevron] can support. However, he expressed concern that there are four major levers, which he anticipated would be changed/modified to move into the state's direction. If all those levers move simultaneously, it will be a very different position than currently. Chevron, he opined,

believes those to all be material levers. For the larger producers, the standard deduction is small to the company's total business. For those companies that don't produce oil or haven't invested in the state, the transition capital is an irrelevant number. Mr. Zager opined that Chevron, for its size, has been producing and investing heavily or more heavily than anyone in the state.

CO-CHAIR SAMUELS inquired as to the credits Chevron expected from the transitional money in HB 488, as it stands now.

MR. ZAGER answered that Chevron has spent in the range of \$400 million over the last five years.

CO-CHAIR RAMRAS inquired as to how much [Chevron] has spent over the last two years.

MR. ZAGER estimated that [Chevron] spent in the range of \$150 million.

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MR. ZAGER said that [Chevron] has a few ideas. He explained that Chevron is the only company in the state with a relative balance of production between the Cook Inlet and the North Slope. He explained that Chevron views the standard \$73 million deduction will be eaten up on Chevron's North Slope production and thus leave the Cook Inlet production to bear the brunt of the petroleum tax. However, Chevron's joint venture partners and competitors in Cook Inlet are under the umbrella of the \$73 million exemption. He opined that the state would want to encourage investment wherever possible in the state. Therefore, Mr. Zager proposed that whatever standard deduction applies, it could be narrowly applied to the Cook Inlet offshore oil or as broadly as south of the Brooks Range in order to encourage those who haven't had production in the North Slope to explore and develop elsewhere in the state and to be on equal footing as those present.

CO-CHAIR RAMRAS said that he didn't disagree with regard to drawing a line south of the Brooks Range in order to address Cook Inlet. However, he questioned how he could explain to those in his community to allow [Chevron] \$146 million before the state takes a single dollar in severance tax.

MR. ZAGER clarified that it would only be 20 percent of \$146 million. He opined that it's in the economic best interest of

the state to keep the production on line in Cook Inlet. He reminded the committee that it receives the severance tax as well as the royalties, the property tax, and the economic benefit of the jobs and the jobs associated with them.

CO-CHAIR RAMRAS asked if it's in the best economic interest of Chevron.

MR. ZAGER replied yes.

CO-CHAIR RAMRAS asked if it's in the best interest of the Fairbanks Northstar Borough School District.

MR. ZAGER answered, "To the extent they're part of the state of Alaska, I think it's in the best interest of the state to encourage as much production everywhere in the state as possible, and encourage investment everywhere in the state as possible because that benefits the entire state and ... I assume they receive money from the state to support the school district."

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REPRESENTATIVE GARA inquired as to Mr. Zager's view of a proposal in which the tax rate is reduced below \$20 a barrel and the same equivalent for gas while raising the tax rate above \$30 a barrel in order to protect the company on the low end and provide the state with a larger share on the high end.

MR. ZAGER responded that the idea of a tiered system is going to add a lot of complexity with regard to tracking. In fact, he suspected that it would create the need for additional staff to monitor it. Therefore, he viewed keeping it simple as a definite advantage. Although he said he wouldn't rule it out, he suggested the need to achieve a single rate for which everyone could agree.

MR. ZAGER clarified his first proposal, which would take the standard deduction and apply it not only to the North Slope but to another area where there is a distinct and separate operation such that everyone is on the same playing field. The second proposal is around the rates such that the front-end rate is lowered or the capital credit is increased to encourage investment, or a combination of the two. He highlighted the importance of taking down the front-end rate because it will come out of the base operation. He noted that additional

credits on the back side will certainly help on incremental projects.

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REPRESENTATIVE ROKEBERG related his belief that if HB 488 worked for Chevron, it could work across the state. He inquired as to the affect the PPT has on the Cook Inlet gas. He related his assumption that under HB 488, Chevron would pay PPT on the gas only portion of the company's portfolio.

MR. ZAGER noted his agreement, and explained that when Chevron reviewed the basis for the company's recommendations with regard to the Cook Inlet oil, which is a low margin business, it couldn't make the same arguments for the Cook Inlet gas. Therefore, it led to the earlier suggestion to provide relief to the Cook Inlet oil segment.

REPRESENTATIVE ROKEBERG related his pleasure in hearing that the leases brought \$7 million [in bids].

MR. TABLER commented that the decision to bid on that was a leap of faith for which only time will tell whether it was a good decision or not.

REPRESENTATIVE ROKEBERG recalled testimony that the Chevron board had approved or there had been a suggestion to make substantial investments. He inquired as to the type of investments being reviewed to boost the company's production.

MR. ZAGER reminded the committee that Chevron had 35-50 individual projects that were wells off of existing platforms.

REPRESENTATIVE ROKEBERG related his understanding that one of Mr. Zager's recommendations is to raise the tax credit for CO2 reinjection.

MR. ZAGER continued, and related his recommendation that there be an additional 5 percent incentive for certain types of projects that are challenged, such as the heavy oil development. He noted that recently there has been discussion with regard to using CO2 in the Cook Inlet for tertiary projects. He emphasized that it's a very expensive proposition to take an old field and turn it into a CO2 project, although there could be millions of barrels of additional resource. He then expressed the need to have absolute clarity with regard to the terms and definitions.

CO-CHAIR SAMUELS related that there have been discussions with the three major producers regarding having a plan for royalty reduction rather than having the conflicts that arise with the cost allocations for a certain type of oil.

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MR. ZAGER acknowledged Co-Chair Samuels concerns and related that in a large area, an oil field could have several different qualities of oil and lead to conflicts. Therefore, he suggested that perhaps an area could be designated as a heavy oil area beforehand. He then commented that other mechanisms should be considered, in terms of how to approach the heavy oil or the CO2 projects.

REPRESENTATIVE ROKEBERG asked if the measurements of the center coil of gravity could determine what is heavy oil and what isn't.

MR. ZAGER replied yes, but expressed concern that in an area with a thick "pay" interval there could be different gravities of oil in the same well or field. In further response to Representative Rokeberg, Mr. Zager related his understanding that those in Alaska use the terms viscous and heavy oil interchangeably, although technically they aren't. He specified that he is referring to viscous oil development in which the reservoir temperature is relatively low and it's difficult to flow the oil.

REPRESENTATIVE ROKEBERG related that he has reviewed carving out the Cook Inlet sedimentary basin for different treatment in order to enhance the investment. He announced that he would be willing to suggest that the state default to the ELF for oil in the Cook Inlet. However, he inquired as to how one would account for gas production in Cook Inlet. He pondered whether the PPT would be left in place for that. He then inquired as to what would happen if a larger field was discovered.

MR. ZAGER said that he didn't have a silver bullet for that, and noted that some of Chevron's fields produce both oil and gas. Therefore, he suggested that perhaps it will have to move to a field-by-field basis designation.

REPRESENTATIVE ROKEBERG interjected that the legislature has done that in the past.

1:42:48 PM

REPRESENTATIVE GATTO turned attention to slide 2, which specifies the number of employees and the company's payroll. From that he extrapolated that the average payroll for each employee is \$125,000 per year. He asked if that's a typical industry standard.

MR. ZAGER opined that Chevron offers a competitive pay with its peers. However, he noted that the figure presented may include benefits and thus may not be the actual take-home pay.

REPRESENTATIVE GATTO recalled the testimony that Chevron's production is 40,000 barrels per day, which amounts to 14 million barrels per year. The reported \$300 million in profits would come out to \$20 per barrel, which is of concern because \$20 per barrel at these high prices would mean that a \$20 drop in price would place Chevron at the "break over point." He asked if that's reasonable.

MR. ZAGER clarified that the [\$300 million] in profit was defined by the net profits tax, which means that the capital would need to be added in. Doing so would increase the price per barrel by \$5 or so. The point, he said, is that Chevron is significantly more challenged than those operating exclusively on the North Slope.

1:45:18 PM

CO-CHAIR SAMUELS asked if Mr. Zager believes that the state should offer incentives for the removal of a platform that has sellable tax credits for that particular function.

MR. ZAGER highlighted that the state has benefited greatly from the platforms or the facilities on the North Slope in that the state has built an envious financial position. Therefore, he indicated that when it comes time to cleanup, the state should [pay] its fair share.

CO-CHAIR SAMUELS inquired as to whether Mr. Zager believes that all of the royalty owners in the state should be treated the same.

MR. ZAGER said he couldn't answer that question.

REPRESENTATIVE GARDNER reminded everyone that over the course of this week, all of the major producers have come before the

committee with concerns, but ultimately in support of HB 488 as written. However, Chevron supports the legislation with stipulations. She inquired as to Chevron's position were HB 488 to pass as written.

MR. ZAGER informed the committee that since Chevron first heard about the proposed PPT tax, it raised concerns with regard to the Cook Inlet. The company has constantly been ensured that the Cook Inlet will be taken care of. However, the proposal doesn't seem to do so, from Chevron's perspective. Therefore, Mr. Zager said that he would be very disappointed if the legislation doesn't include something to help the Cook Inlet, and thus the company put forward two ideas for consideration. In further response to Representative Gardner, if the legislation doesn't provide additional consideration for the Cook Inlet, he said that he would have great difficulty supporting HB 488.

[1:48:07 PM](#)

CO-CHAIR SAMUELS asked if Mr. Zager believes that the \$73 million would make a difference if the company is only in Cook Inlet. He noted that it has been argued that the \$73 million has addressed Cook Inlet, but Chevron, with its involvement in both Cook Inlet and the North Slope, has a unique situation.

MR. ZAGER specified that if Chevron didn't have any North Slope assets, its Cook Inlet severance taxes would double under the proposed scenario. Mr. Zager said:

I guess if I own a Cook Inlet company, I would then certainly take some comfort in the \$73 million deduction as being fair, relative to the other producers. I still think we would have - and it's in the best interest of Chevron, but it's also in the best interest of the state ... to encourage everyone to expand investment opportunities in the Cook Inlet. So, I would still be a proponent of considering ... adjusting either the tax or the credit rate for the Cook Inlet.

REPRESENTATIVE SEATON said that he has been concerned with the inclusion of gas in the oil because the two are taxed at different rates and receive different credits. He asked if Mr. Zager was saying that HB 488 would have the same impact on gas and oil and thus he sees no difference in the two.

MR. ZAGER replied yes, and explained that since it's a net profits tax when one makes a profit on gas, a profit is also being made on oil. However, he said that he does draw a distinction in Chevron's portfolio with regard to its Cook Inlet assets and the cost basis between its oil and gas operations. Mr. Zager related that from Chevron's perspective, the most critical aspect is the oil operations. If the [legislation] were expanded to include the gas operations, he said he wouldn't object.

REPRESENTATIVE SEATON surmised then that Mr. Zager didn't view the difference in the oil tax rate and the gas tax rate on the production tax as significant.

MR. ZAGER said that [Chevron] actually didn't do that analysis and merely reviewed Chevron's current severance tax without breaking it down between oil and gas. Then, it was reviewed on a combined basis afterwards.

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MR. ZAGER reminded the committee that Chevron has been in Alaska for a long time and, as indicated by the results of the sale today, Chevron hopes to operate in Alaska for a long time. However, that will depend, to some degree, on the measures taken on the new petroleum tax. Mr. Zager opined that the state would benefit if it could establish a formula to attract additional capital.

[1:53:58 PM](#)

The committee took an at-ease from 1:54 p.m. to 2:03 p.m.

[2:04:03 PM](#)

MARK HANLEY, Manager, Public Affairs for Alaska, Anadarko Petroleum Corporation ("Anadarko"), began by informing the committee that Anadarko is a large independent, which means that it explores for and produces oil and gas. Generally, Anadarko doesn't have refineries or gas stations. He further informed the committee that Anadarko is a \$23 billion market cap company with a little over 3,000 employees. Mr. Hanley related that Anadarko is one of the larger independents.

[2:06:00 PM](#)

MR. HANLEY highlighted that Anadarko is operating in Alaska exclusively on the North Slope, as illustrated by the pink and yellow areas on the slide entitled "Anadarko's Alaska Acreage Position." He noted that Anadarko partners with ConocoPhillips Alaska, Inc. and Pioneer for which ConocoPhillips Alaska, Inc. is the operator. However, Anadarko also has interests in which it's the operator in the amount of 2.2 million net acres, which results in ConocoPhillips Alaska, Inc. and Anadarko operating about the same net acreage. However, that will shortly decrease because Anadarko brought in a new partner, BG, that is a large worldwide gas player. Anadarko, he opined, has multiple opportunities and has developed a regional model in order to model various areas. For the purposes of this PPT discussion, Mr. Hanley characterized Anadarko as a bit of a hybrid. He noted that although Anadarko doesn't have interests in Cook Inlet, it does have production there.

[2:08:20 PM](#)

MR. HANLEY related that Anadarko views the North Slope as a world class petroleum basin in which much oil has been found and much remains to be found. Anadarko, he further related, tends to focus on legacy or anchor field opportunities that would support stand-alone facilities. Furthermore, Anadarko views Alaska as a favorable political environment. In response to Co-Chair Samuels, Mr. Hanley clarified that Alaska is a favorable political environment because it's a western democracy in which the risks aren't the same as in other areas. Moreover, the State of Alaska views development positively. Also, Anadarko views the abundant new entrants as partnering opportunities.

CO-CHAIR RAMRAS asked Mr. Hanley if [Anadarko] views the State of Alaska as a partner or merely a taxing agent.

MR. HANLEY answered that generally, [Anadarko] views the state as a partner, and mentioned that the company has been able to work collaboratively with the state.

CO-CHAIR RAMRAS related his fascination with the exploration credits and the opportunity to bring down the cost for explorers and be in partnership financially.

MR. HANLEY said he would address that at the appropriate time during his testimony.

[2:11:39 PM](#)

MR. HANLEY continued and added that Anadarko also views the new entrants as a positive in order to explore the basin. "The fact that there's new players with different ideas from us is a positive for us," he stated. However, [the challenge] is that it's a maturing basin with high costs, a lack of infrastructure in some respects, limited access at times to facilities and pipelines, extremely long lead-time exploration, and short operating windows. Therefore, there is a cost and the proposed credits help to recover some of those costs faster thereby reducing the cost of the development.

[2:14:14 PM](#)

REPRESENTATIVE GARDNER pointed out that although Anadarko views new entrants and partnering as opportunities, it is competition, which is a challenge.

MR. HANLEY clarified that the reference in the presentation to competition is the lack thereof. However, he noted that one of the reasons Anadarko looks for anchor fields is because it doesn't necessarily want to access existing facilities and have to deal with the satellite issues. It's a factor that Anadarko considers, he said.

CO-CHAIR SAMUELS turned attention to the challenge, as specified by Anadarko, of limited access to facilities and pipelines. With regard to the TAPS [Trans-Alaska Pipeline System] settlement methodology (TSM) reopening in 2009 or 2011, he asked if Anadarko has a methodology to [predict] the result of it. He asked whether Anadarko factors in the aforementioned reopening or has to utilize the economics of the current tariff when running the economics.

MR. HANLEY said that currently Anadarko is using the numbers as they are. He expressed hope that the state won't have to deal with TSM because Anadarko is before the Federal Energy Regulatory Commission (FERC) challenging those rates. He opined that well before 2009, there should be a decision. A judge will determine who is in the right in this case, and Anadarko is fairly confident that interstate rates will also decrease. Therefore, the state may be able to reopen TSM because the FERC may have set a just and reasonable rate.

CO-CHAIR SAMUELS mentioned that the TSM will play into the \$73 million and the tax credits.

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MR. HANLEY continued with the challenge relating to the lack of a gas market. He specified that Anadarko is very supportive of getting a gas line built in Alaska because it will improve both oil and gas economics. In regard to Anadarko's view of the PPT, Mr. Hanley opined that the administration did a good job balancing the issues and the priorities. He related that from Anadarko's perspective, the higher prices it might pay from its Alpine production are offset by what the company generally views as improved economics for exploration and development as well as protection on the downside. Therefore, overall Anadarko views [this proposal] as a positive balance because it improves the company's exploration economics and for that reason Anadarko supports it.

REPRESENTATIVE GARA related, "It seems to me that, as I've heard from your company in the past and others, the prospects of major gas finds, assuming there is a gas pipeline and ... an open season that lets you get gas into the pipeline, ... are so great that nobody was talking about the need for these additional credits before." Therefore, he inquired as to what Mr. Hanley could say to convince him that the companies really need the proposed credits in HB 488.

MR. HANLEY related that Anadarko believes there's tremendous gas potential, although it's not a sure thing. He then highlighted that there is a difference between finding a lot of gas and whether that gas is commercial. Compared to the economics of the existing gas, "ours is less economic," he opined. Anadarko has exploration risk, development risk, et cetera. He informed the committee that there would have to be very large field sizes that flow fairly well because Anadarko, in this high price market, can't afford to drill many wells to obtain the gas. Anadarko, he opined, believes there's potential, and the credits, particularly the exploration incentive credits, have helped.

[2:21:42 PM](#)

MR. HANLEY pointed out that Anadarko has had the concept for a couple of weeks and the legislation for a week. Therefore, he said he would like to reserve the right for Anadarko to change its mind because the company isn't sure how HB 488 affects gas economics. Under the old system, the maximum tax on gas was 10 percent and there was a different ELF. He explained that generally Anadarko, on both its oil and gas prospects, will pay a high ELF because Anadarko is looking for fields such as Alpine

and large fields on gas. Moreover, Anadarko's modeling is generally based on high severance taxes.

MR. HANLEY then turned the committee's attention to the slide entitled, "New Small Oil Development," which specifies that it would have an ultimate recovery of 47 million barrels. He then turned to the graph on the slide entitled, "Small Oil Development - Rate of Return." He specified that the red line is the value of the \$73 million. If one views the [small oil development], one can see the improvement in the rate of return in comparison to the current case. He then highlighted that the green line is the same model, without the \$73 million. The aforementioned, he said, is Anadarko because it would use the \$73 million against Alpine. "It gives you an idea of the relative value between an existing player on this particular oil development and a new player who has the ability to use that \$73 million as part of their economics." Therefore, there's a fairly good delta there. He pointed out that the graph [with the maroon line] assumes an existing producer at the 25/20 PPT. The green line illustrates that Anadarko would have an improvement in its economics. If the tax is raised to 25 percent, it actually reduces the economics below the current system. He pointed out that Dr. Van Meurs' 11.6 chart for a 50 million barrel field for which Dr. Van Meurs predicts that at a 25/20 PPT without the \$73 million still improves the economics. Therefore, the differing model results needs to be addressed. If the goal is to have more wells drilled on the North Slope, and not enough are being drilled under the current system, one would think the [state] would need to improve its economics. However, raising the tax to 25 percent brings "it down to the same level," then that goal hasn't been achieved.

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CO-CHAIR RAMRAS requested that Mr. Hanley explain the graph on the slide entitled, "Small Oil Development - Rate of Return." He pointed out that the graph doesn't specify what happens if the price of oil reaches \$60 a barrel. He also requested that Mr. Hanley explain where Anadarko is with the production tax, under the ELF.

CO-CHAIR SAMUELS also requested that Mr. Hanley define what Anadarko considers to be small oil development in terms of the number of barrels per day.

MR. HANLEY reminded the committee that the small oil field is a 47 million barrel recoverable field with a maximum of 15,000

barrels of oil per day. Again, these are all variables and thus the maximum doesn't mean it's the average. Furthermore, how fast the field comes on line and how quickly the company can produce it make a difference in the economics. He informed the committee that Anadarko did try to utilize some of [the elements] used by Dr. Van Meurs. Although Anadarko didn't totally succeed in that respect, Mr. Hanley related that the trends presented by Dr. Van Meurs are correct. For instance, Dr. Van Meurs used the West Texas intermediate (WTI) oil price while Anadarko used a wellhead price, which Mr. Hanley said Dr. Van Meurs had to establish in order to determine the impacts. Therefore, he opined that everyone should be placing the wellhead oil prices at the bottom of the graphs in order to compare apples to apples without the need for a conversion figure.

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MR. HANLEY then addressed effective rates, and informed the committee that currently at Alpine Anadarko is paying just under 13 percent. Last year Anadarko was paying in the "low tens," which he explained is because under the current system the first five years of production a company has the ELF multiplied by 12.5 percent and after that it's multiplied by 15 percent. He characterized the current ELF that Anadarko pays as high and suggested that the ELF for Prudhoe Bay may be the only field with a higher ELF. He explained that under the PPT as it exists today, if were it applied in 2005, Anadarko would actually pay \$13 million less than under the old system. Part of the reason that Anadarko would pay less under the proposal in HB 488 is that it had a lot of capital investments, which offsets those. In further response to Co-Chair Ramras, Mr. Hanley specified that over the last five years, Anadarko has invested in the \$90 million range. He offered to determine how much the company has invested in the last two years.

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REPRESENTATIVE GARA, referring to the lines on the graph that represent the existing ELF tax and the 25/20 PPT, noted that the two are very close. However, according to Wood MacKenzie the rate of return in Alaska, under existing law, is higher than most places at \$25, \$35, and \$40 per barrel. Therefore, he questioned whether, under existing law, too much money is leaving the state and thus he further questioned why something better than 25/20 shouldn't be adopted if it also leaves Anadarko with a high rate of return.

MR. HANLEY said that he couldn't comment on the Wood MacKenzie study. However, he related that most of the small oil field developments are very challenging and thus not many are drilled. He said he didn't believe the contention that a lot of money is left on the table that the state could tax more under the current system and still have investment.

REPRESENTATIVE NEUMAN highlighted that Anadarko's graphs seem to stop at the \$45 to \$50 per barrel range. However, the reality in recent times has been that oil prices are \$60 per barrel. Therefore, he inquired as to what the graph would look like at \$60 per barrel oil.

MR. HANLEY offered to provide a graph with \$60 per barrel oil. However, he pointed out that the graph he provided is based on a wellhead to about \$43 per barrel of oil. He noted that Dr. Van Meurs' graphs went to a \$40 WTI, which equates to about a \$32 wellhead price.

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MR. HANLEY continued his testimony by highlighting that the rate of return is just one measure. He then referred to [the graph on the slide entitled "Small Oil Development - Net Present Value"], which includes a 12 percent discount rate on the after tax net present value. Generally, the discount rate changes the crossover points, but not necessarily in a relative manner. In regard to what Anadarko uses for a hurdle rate, Mr. Hanley said that it isn't something that the company discloses. However, the numbers can be run at various hurdle rates and he opined that the legislature's consultants could do so and present a tight range of the numbers that companies will use. In concept, the graph relates that at the high end, the state gets more while at the low end, the [state] takes some of the risk [and takes less]. Compared to the current system, at the high prices there is less net present value.

MR. HANLEY, in providing clarification, pointed out that the graph discounts the value of the money in the future at some rate. The [after tax net present value] is another way that companies look at measuring their return. He offered to get the committee a better explanation.

[2:39:18 PM](#)

CO-CHAIR RAMRAS surmised that the graph entitled "Small Oil Development - Net Present Value" isn't about the state's take but questioned what it is actually addressing.

MR. HANLEY explained that this graph is discussing the same case as before, just on a discounted basis. "If you value the cost of money into the future and the relative value of that as you go forward, not just on a rate of return basis," he further explained.

CO-CHAIR RAMRAS related his understanding that Anadarko is supposed to be speaking as the representative of small producers, and therefore "what's good for Anadarko is good for the whole PPT theory." He related his further understanding that Anadarko, under the PPT system, would pay \$13 million less. Therefore, PPT incentivizes small producers to explore more. He asked if the graph entitled, "Small Oil Development - Net Present Value" is showing four different scenarios a small explorer who wants to enter the Alaska market, as Anadarko believes, may face if the net present value is utilized. He then inquired as to the difference between the green line, which refers to an existing producer for which the exemption is applied elsewhere, and the red line, which refers to a new entrant for which the exemption is applied to the evaluation.

MR. HANLEY explained, "It's a relative impact on us looked at from a different way." He [turned attention to the graph entitled "Small Oil Development - Rate of Return"] which illustrates that "they all were either better or about the same as the current system ... [for] a small field, I guess you would say."

CO-CHAIR RAMRAS related his understanding that the discussion is in regard to the profitability for [the company] that is drilling.

MR. HANLEY stated his agreement and mentioned that it could be a small producer or a large producer. He specified that the difference between the green line and the red line is the \$73 million in the green line is applied elsewhere with an existing producer that won't have that exemption to help the [particular field's] economics. However, [as illustrated by] the red line, a new entrant would be able to apply the \$73 million in its economics with regard to how the particular field is valued.

CO-CHAIR RAMRAS posed a situation in which Chevron says that it used the \$73 million in the Cook Inlet, but the \$73 million

wouldn't be available to use in another field unless the company is allowed to apply it twice.

MR. HANLEY indicated his agreement and said that Chevron, in the aforementioned case, would be the green line. Therefore, the company would say it couldn't use the \$73 million to evaluate whether a prospect is of value. He said that Anadarko would probably view it that way on this particular prospect because Anadarko has used the \$73 million elsewhere. However, another company without production would use it and the \$73 million would be of value to them.

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CO-CHAIR RAMRAS surmised then that the red line appears to be more desirable because it's a higher rate of return, which is why it refers to a new entrant.

MR. HANLEY replied yes.

CO-CHAIR SAMUELS posed a situation in which TOTAL E&P USA, INC. (TOTAL) wants to partner with BP. However, once they run the economics on the same project, they would have different results. The major producers pointed this out and thus the argument can either be that it's philosophically unfair or that there will be more problems with joint ventures. With the \$73 million, there is also the argument that the state will get what it asks for and thus there will be many [players], all with the \$73 million exemption and the ELF revisited.

MR. HANLEY remarked that [the \$73 million] is also an enticement. He recalled testimony relating that Norway is actually giving people a check for \$78 for every \$1 [spent] to every new entrant. Generally, the companies coming to Alaska, after their first exploration, become an existing player.

CO-CHAIR SAMUELS, in regard to the 12 percent discount rate, asked whether that's what Anadarko uses.

MR. HANLEY reiterated that Anadarko doesn't inform others of the discount rate it uses, although [consultants] could inform the committee how discount rates are used.

CO-CHAIR RAMRAS asked whether the lines would shift down if the discount rate is 10 percent.

MR. HANLEY said that if the discount rate is decreased, the lines will shift up. Therefore, the higher the discount on the dollars, the less the value overall.

CO-CHAIR RAMRAS related his understanding that under the net present value one looks at the return six years from now, such that the dollar is discounted back. Therefore, at 12 percent per year, that dollar would be worth \$.28 in today's dollars.

MR. HANLEY said he agreed with Co-Chair Ramras' understanding. However, he suggested that others could better explain this. He pointed out that under "this model, the higher the price, more of the people ... are underneath as far as the return based on this method of evaluating it, compared to the current system." Therefore, at higher prices, the state receives more and "you see under this system some of those better prospects they had get taken down at the high prices."

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REPRESENTATIVE CROFT returned to the chart entitled, "Small Oil Development - Rate of Return," which illustrates that all of the lines have the same curve. Although there is a difference between the lines in terms of the rate of return, it doesn't seem to fluctuate by oil price. However, the curves produced by the net present value discount causes radically different curves and thus there are different results for different oil prices. Representative Croft inquired as to what curve is desirable if the goal to have a small oil development with a good net present value. He assumed that one would want a good net present value at a range of prices and a relatively flat curve in order to ensure that there is a good return at \$20 and \$40.

MR. HANLEY pointed out that if the tax rate is reduced, then the economics will be approved, even under the net present value. If the credits are increased, the same can be accomplished. Combinations of what one does under the system will have different impacts and the question is regarding what is [the state's] goal. If the desire to have all the scenarios produce a better net present value than the system, then at all prices the state would take less money. He reminded the committee that Anadarko believes that while the company may pay more on its production in the future, it will be balanced by the fact that the state is taking more at high oil prices and it's a balance under some measures. If the goal is to obtain more money at high oil prices, balancing that off against the economic indicators that allow the companies to take more at the low end

while there is an improvement in the economics [counter] balances paying more, he said.

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REPRESENTATIVE SEATON surmised that these graphs are presenting [the take] from Anadarko's view. He related his understanding that at \$25 there is a crossover breakeven point. He asked if the sensitivity calculation is merely a different set of numbers.

MR. HANLEY clarified, "This is this proposal, the PPT, based on those numbers."

REPRESENTATIVE SEATON further surmised then that with the PPT at 20/20, the red line, no matter the price, the company has a higher after tax present value than under the current system. Under the 20/20 proposal with higher oil prices, the state is supposed to receive more. He asked if the aforementioned is a function of change in money from the federal government to the state government. He inquired as to how the company makes out better in every scenario while the state does so as well.

MR. HANLEY attributed [the difference in the green and red lines] to the \$73 million deduction. As [the prices increase], it gets closer to the existing system, he pointed out. Therefore, eventually "all of those" will crossover and at a certain high price even the red line will fall under the existing system, he opined.

REPRESENTATIVE SEATON posed a situation at \$50 Alaska North Slope (ANS) price and surmised that the graph illustrates that the company has higher profits, although that doesn't necessarily mean that the state is receiving less money than under the current ELF. He asked if the graph illustrates that in the development of a small oil development at \$50, it's absolute that the red line specifies that the oil company will make more money in comparison to the state.

MR. HANLEY said he didn't know the answer because it would be a cash flow analysis versus the net present value. Mr. Hanley then moved on to the graph entitled, "Medium Oil Prospect - Risked Rate of Return." The aforementioned presents a similar type of approach based on a larger field. He explained that it's a risk analysis and thus there is a certain chance of success. He pointed out that the graph illustrates that for a larger field, the PPT improves the after tax rate of return line

for all the cases. Furthermore, the difference between the red and green lines isn't as significant as in the earlier graphs.

2:56:48 PM

CO-CHAIR RAMRAS inquired as to what it would take to support the same line, increase credits, and reduce the \$73 million. He then inquired as to whether the \$73 million could be in place for a few years and then sunset it and place the company under the 20/20 proposal. If the aforementioned is an option, then he inquired as to the number of years that a credit would need to be provided and still enjoy new entrants who are then phased into the regular PPT plan that is applicable to the majors.

MR. HANLEY opined that in one view the \$73 million credit is equal across the board because everyone gets it. However, companies without production don't receive the credit, although it helps the exploration economics. He specified that 20 percent multiplied by \$73 million is \$15 million in value, regardless of the size of the producer. Therefore, in that respect it's a level playing field. In regard to the relative value, he posed a situation in which a company has 20,000 barrels per day of production and, for the sake of argument, the \$73 million is equivalent to 5,000 barrels per day at \$40. Therefore, 25 percent of the aforementioned company's production would be tax free whereas a company with 250,000 barrels per day would receive 2 percent tax-free production. Mr. Hanley then provided the following example:

If you want to get rid of the \$73 million and use the tax rate, I don't have a tax credit. If you want to use the tax rate to keep them whole ... effectively ... for the 20,000 barrel a day person you get rid of the \$73 million you've got to lower the tax rate from 20 percent to 15. That keeps them whole. For the guy with 250,000 barrels a day, if you lower it a half a percent, it keeps them whole.

MR. HANLEY surmised that it was all part of a package to come to an overall dollar amount in which the tax rate was figured in with the \$73 million. He related his belief that if the larger companies receive a 1 percent rate reduction in the tax or could prevent a 1 percent increase those companies would give up the \$73 million. However, if a company gives up the \$73 million and can't decrease 5 percent, there is an adverse impact on the smaller players.

3:01:07 PM

MR. HANLEY related that there seems to be an assumption that there's a level playing field already. He suggested that to the extent there is a tilted playing field, [under HB 488] it's still heavily tilted away from some of the smaller, newer players and toward the larger players. Mr. Hanley pointed out that this is a net back approach in which one would normally be able to deduct expenses. He explained that if Anadarko puts oil down the pipeline and it costs the company \$4 to send it to Valdez, that's what the company pays. However, an owner has a return on that and will, under the proposed system, be allowed to deduct a profit as an expense. He characterized the aforementioned as an unlevel playing field. Therefore, Mr. Hanley said he wouldn't argue that it unfairly tilts the playing field against the large players, although it does have an impact. He suggested that even without this there may be different companies in the same fields paying different tax rates under this proposed system. He reiterated that whether a company is exploring or not impacts the value of the credits under the proposed tax structure.

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CO-CHAIR RAMRAS surmised then that if the \$73 million were reduced while continuing to incentivize small entrants, the tax rate could be lowered or the amount of credits could be raised. However, he opined that lowering the tax rate and reducing the tax credit would [be received] poorly in many of the districts.

MR. HANLEY, in response to Co-Chair Ramras, informed the committee that Anadarko has over 3,000 employees [worldwide] and market capital of over \$23 billion. Mr. Hanley acknowledged that Anadarko is a large company.

CO-CHAIR RAMRAS pointed out that Anadarko would be the largest company in Alaska were it based in Alaska, although it's being referred to as a small company.

MR. HANLEY mentioned that the view one takes of this proposal depends upon whether the company has production and what it's looking to find. Again, the difference, under HB 488, for a new entrant versus an existing producer is less for a [medium oil prospect as illustrated on the graph entitled, "Medium Oil Prospect - Risked Rate of Return"]. Therefore, there is less of an impact on the company's economics as it goes forward.

3:05:29 PM

CO-CHAIR SAMUELS recalled Mr. Hanley's testimony that if the \$73 million is eliminated, Anadarko would want to have a lower tax on a certain amount of barrels or revenue. Still, the company would effectively end up at the same place in that the benefit would still be given to the large companies.

MR. HANLEY said, "To the extent that you want to incent new companies, this is a much bigger issue and much more valuable to the companies." He suggested that many companies, particularly those without production, would view the elimination of the \$73 million with a 1 percent decrease in the tax rate to be a much worse system.

3:07:17 PM

REPRESENTATIVE GARA surmised that on one hand Mr. Hanley's and Dr. Van Meurs' presentations say that at a 25/20 PPT at \$40 per barrel, the state would take more money than it does currently. On the other hand, Mr. Hanley's graph shows that under the 25/20 PPT the company's rate of return is higher at \$40 per barrel than it is currently. Therefore, he inquired as to how the company and the state can be making more money at the same time.

MR. HANLEY offered to provide the committee with an explanation [at a later time].

REPRESENTATIVE CRAWFORD related his understanding that the after tax rate of return axis is the return to the company. The existing ELF is lower in all cases on the graph, although the committee has been told that this is a tax hike. However, the companies receive a larger after tax rate of return regardless of the proposals presented on the graph.

MR. HANLEY explained that the graph views the field as a new prospect such that the company is allowed to use all of its credits against the prospect. The tax increase, he further explained, comes from the existing fields. He related that a company would have past capital that's invested and thus if a company were to do a new Prudhoe Bay, its economics would change because the company has a higher tax rate. Furthermore, there would also be the many credits against the capital. The aforementioned is why there is reluctance from the existing producers. He opined, "It's essentially hammering existing production." In some respects, under the 20/20 proposal, the state is paying for 40 percent of the cost of development, which

more than offsets the higher tax rate. Therefore, the dollars are coming from the tax increase on existing production.

[3:11:10 PM](#)

REPRESENTATIVE CRAWFORD characterized this as a "scary proposition" because if the state is very successful with this, the state could receive a lot less in the future.

CO-CHAIR SAMUELS related his understanding from economists that getting many new entrants with the lengthy necessary exploration lead time will result in the \$73 million losing its value over time.

REPRESENTATIVE GARA opined that the early tax credit is important in achieving a higher rate of return and more taxes under the analysis. Therefore, he surmised that the early tax credit is almost more important to a new developer than the tax rate once a field becomes profitable. He then posed a situation in which the 25/25 system that was raised to 30/25 such that the company is protected on the downside and receives a larger tax credit when the situation is riskier. Therefore, it would be worth the extra tax the company pays when the situation becomes profitable. He asked whether he can assume that by raising both 5 percent, a new developer would be better off than if neither were raised.

MR. HANLEY related his understanding that if there is a 5 percent increase, there would be a decline in the economics because the tax rate is more valuable than the credit increasing. In regard to the crossover point, Mr. Hanley said that it's based on many variables. He offered to model it.

REPRESENTATIVE GARA said that if the answer isn't clearly in the affirmative, then such a model isn't necessary.

[3:14:14 PM](#)

MR. HANLEY opined that there would have to be significantly larger incentives on the back end to make up for tax increases. He stated that Anadarko absolutely prefers a lower tax rate because it improves the company's economics. This is a policy call for the legislature.

REPRESENTATIVE GATTO commented that it doesn't matter what the tax rate is if the company is paying zero. However, under some scenario it's possible to take the credits and pay a tax rate

that's higher and do better, although he wasn't sure that most of the companies would fit such a scenario.

[3:15:19 PM](#)

MR. HANLEY related his understanding that it seems that there's concern that people made decisions based on low oil prices. However, the prices have been higher and [the companies] have been able to pay back their capital such that one would question why the lookback should be allowed. In response, he highlighted the Alpine field in which a project, two satellites, was sanctioned in December of 2004 during a high oil price environment. The satellites are due to come online this year and thus there hasn't been a decrease of dollars coming in to offset those. Therefore, one could argue that they are taking the high side from Anadarko. With regard to an earlier comment that price is what drives many of the issues, he acknowledged that the price is a variable and the tax needs to be fixed.

[3:17:49 PM](#)

MR. HANLEY clarified that some have said that the tax rate is insignificant compared to the swings in the price of oil. However, Mr. Hanley reiterated that the price is the variable and everyone has to deal with that. Therefore, he said he wouldn't encourage a 40 percent tax rate because if the price increases to \$60, one has to review the variable price, which if it decreases, will have a larger impact. With regard to prices, Mr. Hanley indicated that without being able to determine the price of oil between 2014-2034 or have protections on the price during those times, [Anadarko] would be conservative, particularly in an environment in which production in Alaska takes longer from startup to production. Therefore, he opined that companies are probably more conservative with price estimates in Alaska. Despite the fact that prices are up, from a company's perspective, companies could argue that the state has been receiving higher than it should for a while. Mr. Hanley informed the committee that one of the reasons Anadarko can support HB 488 is because there is some protection in some cases and some downside protection. Depending upon the model, the state is going to take less money than under the current system. However, "if we think that 10 years from now when the price goes down, they're going to change it back and take that ... that hasn't helped us." He noted that such wouldn't be modeled.

[3:21:30 PM](#)

REPRESENTATIVE BERKOWITZ, in regard to modeling conservatively, opined that it must mean that Anadarko has some estimates as to what the company believes the price will be in the future.

MR. HANLEY agreed that is the case. He said that on internal rates of return, hurdle rates, discount rates, and prices one can put those on graphs in order to review the ranges. The consultants can provide the committee with ideas as to what companies might use.

[3:22:45 PM](#)

MR. HANLEY commented that independents are sensitive. In one respect independents don't have as broad a portfolio, but independents tend to want to "confirm and condemn." Therefore, things that the legislature does will impact independents, and perhaps to a larger extent than some larger companies.

REPRESENTATIVE BERKOWITZ recalled that one of the earlier presenters suggested that independents need higher rates of return than the majors. He asked if Mr. Hanley agreed.

MR. HANLEY opined that each company's different. He suggested that the committee ask its consultants to determine the cost of finding versus the cost of capital. He highlighted that those who are looking for new oil and gas on the North Slope are the independents and new entrants, which he attributed mainly to the internal hurdle rate on the size of the field. For some of the larger companies, the expected size of fields aren't in Alaska. However, he further opined that it does take a mix that one needs "to balance that off." He expressed the need to have the investment in the existing fields in order to have the infrastructure and the pipeline in order to move oil down it. Still, some companies will not look for things that others will and thus the committee should be aware of the mix of heavy oil as well as small fields and frontier fields.

[3:25:40 PM](#)

MR. HANLEY then discussed the credits that aren't. He noted that Anadarko would be able to utilize credits since it has income, and therefore he said that he would speak in regard to companies that don't have existing income against which they could use these credits. To the extent that the aforementioned is the case, the new companies have to discount the credits. Therefore, it's not a level playing field if companies with

existing income can use the credits at 100 percent while the newer companies cannot. In fact, the new companies would have to sell the credits to the [existing companies] and thus the [existing companies] will take 10 percent more and the newer companies will receive 10 percent less. Furthermore, the state incents the same amount of money. Mr. Hanley then suggested that a refundable credit should be considered. If it's costing the state the same, he questioned "why not just cut the check." The aforementioned would level the playing field for the new entrants. To the extent the committee views refundable credits as a problem, he suggested expanding the taxes and payments against which companies can utilize those. He further suggested that it could be utilized against corporate income taxes and bonus bids. In fact, there is a precedent for such, as demonstrated by the broader incentive credits under the Department of Natural Resources (DNR). Mr. Hanley emphasized the need to keep the tax credit level for the players that don't have production, which he opined is best accomplished with a refundable credit.

[3:29:02 PM](#)

REPRESENTATIVE GARA expressed his discomfort with the \$73 million. To that end, he inquired as to why a lower tax rate during the first few years of production wouldn't be continued versus the free \$73 million credit in profits.

MR. HANLEY clarified that the \$73 million is an allowance deduction. Although the state can structure this any way it wants, it will be difficult for the newer players to replace the \$73 million because of the relative value, as described earlier.

REPRESENTATIVE BERKOWITZ pointed out that although there has been discussion with regard to incentives, there hasn't been any real discussion in the way of punishment for the failure to perform. He asked if Mr. Hanley has any thoughts on the aforementioned. He suggested that perhaps a "use it or lose it" provision could be utilized in terms of whether a lease is developed or not.

MR. HANLEY said the aforementioned can be done because there is already a process by which the state can increase or decrease the length of term of a lease. However, he said that incentives are a better way to encourage development.

[3:32:47 PM](#)

REPRESENTATIVE CRAWFORD recalled the charts the committee has been given that relate the state's oil production if there isn't a gas line by 2012 to 2015. He related his understanding that the state's oil production is enhanced if it has a market for its gas. He suggested that it would be best if a gas line is built and producing during that timeframe.

MR. HANLEY commented that for Anadarko's purposes, the sooner the gas line is built the better. He then continued with his presentation in regard to the state needing to be careful in regard to what it asks because what the legislature decides will drive behavior. Anadarko would like to drill more wells and to have more exploration economics as well as more shareholder value, all of which he didn't believe to be mutually exclusive from the state's goal. He then expressed the need to review how much the economics decrease if the tax rate is increased. He also expressed the need to review how much the minimum economic field size for certain areas increase as the tax rate is increased. All things being equal, Mr. Hanley opined that as the tax rate is increased the economics decrease, which can be offset by certain credits or incentives. Drawing to conclusion, Mr. Hanley urged the committee to do what it wants and mesh that with what [the companies] want. Furthermore, he expressed the need for all the players to talk in order to come to a common understanding of the legislation otherwise the policy call and impacts can't be reached.

[3:36:50 PM](#)

MR. HANLEY then recommended using some type of a work session during which a range of the various elements can be chosen in order to model for the various players and scenarios. He related his belief that currently there will be unintended consequences because the models being presented vary because of the differing assumptions. Although Mr. Hanley said that he seems to understand the intent of HB 488, it doesn't seem to be clear in the statute.

[3:39:55 PM](#)

REPRESENTATIVE GATTO related that it would be fair to assume that the large oil companies would really enjoy a very complex system because they have a lot of certified public accountants (CPAs) and attorneys. Therefore, he questioned whether the course to take should be to forget the incentives, specify the tax, and specify the percentage the state will give the company that looks for a well.

MR. HANLEY acknowledged that such a course could be taken and the companies could model it. However, the problem is that one size doesn't always fit all. Mr. Hanley echoed his earlier comment that the proposal encompassed in HB 488 is a "decent mix." Again, the question is in regard to what the state is trying to incent. From Anadarko's perspective, while it may pay more, the legislation as it's written actually seems to improve the companies economics and improve the downside. Therefore, he suggested that some of Anadarko's prospects are more likely to be drilled than they were before the legislation.

[3:43:11 PM](#)

The committee took an at-ease from 3:43 p.m. to 3:48 p.m.

[3:48:35 PM](#)

PAT FOLEY, Manager, Land, Commercial, Regulatory Affairs, Pioneer Natural Resources ("Pioneer"), paraphrased from the following written testimony [original punctuation provided]:

Pioneer began its investment in Alaska in early 2003 with the drilling of 3 exploration wells in the shallow waters of the Beaufort Sea. Pioneer significantly expanded its Alaskan inventory at the October 2003 Alaska State Lease Sale where it was the largest participant and successful bidder on approximately 150,000 acres. We opened an office in Anchorage in early 2004 and now employ 26 persons in Alaska. In 2004, Pioneer concluded exploration agreements with ConocoPhillips and Anadarko across a vast portion of NPR-A. In 2005, Pioneer acquired a 10 percent working interest and the option to acquire up to an additional 40 percent working interest and possibly succeed ConocoPhillips as the operator of the Cosmopolitan Unit located in the Cook Inlet. Pioneer has significantly invested in the state and has assembled a substantial portfolio with an interest in approximately 1.6 million acres of leasehold.

On February 6, 2006, Pioneer announced that it approved and is commencing the development of Oooguruk field on the North Slope of Alaska. Pioneer is the operator of the field, which is in the shallow waters of the Beaufort Sea approximately eight miles northwest of the Kuparuk River Unit. Pioneer has

commenced operations to install an offshore gravel drilling and production site and we expect to complete gravel hauling activities by the end of winter. Following construction of the gravel drilling and production, a subsea flowline and facilities will be installed during 2007 to carry produced three-phase liquids to existing onshore processing facilities at the Kuparuk River Unit.

CO-CHAIR SAMUELS turned attention to the transitional phase, and inquired as to how much Oooguruk is going to cost Pioneer to develop in the last five years and two years. He also inquired as to whether Pioneer has any other major developments.

[3:51:21 PM](#)

MR. FOLEY answered that currently Pioneer is exclusively focused on the Oooguruk project. However, he related that this summer Pioneer is likely to make a decision regarding what it will do to continue work on Cosmopolitan. He highlighted that Pioneer is heavily involved in exploration and has drilled five wells to date. This winter Pioneer has been involved in three exploration wells. He said that on a long-term basis, Pioneer would expect to have a capital program similar to the last several years. In regard to Pioneer's investment in the state to date, he estimated it to be roughly \$100 million over the last three years. He returned to his testimony and paraphrased from the following written testimony [original punctuation provided]:

Pioneer plans to drill approximately 40 horizontal wells to develop 50 million to 90 million barrels of estimated gross oil resources. Total gross capital to be invested in drilling and facilities is expected to range from \$450 million to \$525 million.

MR. FOLEY added that Pioneer has a 70 percent interest in Oooguruk and is a partner with Eni on this project.

REPRESENTATIVE GATTO inquired as to whether there is any connection between Evergreen Resources and Pioneer.

MR. FOLEY replied yes, explaining that Pioneer acquired Evergreen Resources in 2005.

[3:53:14 PM](#)

MR. FOLEY returned to his testimony and paraphrased from the following written testimony [original punctuation provided]:

The wells are expected to be brought on production as drilling progresses, with peak rates of approximately 15,000 to 20,000 barrels of oil per day expected by 2010.

For independent companies like Pioneer, the challenges to building a business in Alaska are formidable. The remaining North Slope resources are nothing like the billion barrel fields that opened the Slope. The new wave of developers are working to commercialize: a) smaller, lower quality oil reservoirs, b) viscous oil resources, c) remote resources in NPRA, the foothills and offshore and d) natural gas resources, which will not have a market until the next decade. All of these resources are challenging to commercialize, but it is a challenge that must be met to insure new sources of supply for the state.

The North Slope is one of the highest cost areas in the world. Remote geography translates to some of the highest capital, lease operating and product transportation costs in the world. Additionally, North Slope projects have comparatively long cycles [sic] times. From buying a lease to selling oil takes 5 to 10 years depending upon drilling success and distance to existing infrastructure.

MR. FOLEY interjected that Pioneer's Ooguruk development will be at the shorter end. However, he reminded the committee that Ooguruk was a resource that was discovered in the late 1970s and early 1980s and remained undeveloped until now. He then continued his testimony and paraphrased from the following written testimony [original punctuation provided]:

The largest challenge independents face on the North Slope is arguably uncertainty. To be successful, we must properly assess and make provision for a number of uncertainties related to exploration risk, future oil and gas prices, fiscal policy, regulatory processes and access to infrastructure.

[3:55:59 PM](#)

The long cycle times for Alaska projects require that we make our investment decisions based upon a long term price projection. Although current prices exceed \$50 per barrel, the 10 year average price for North Slope crude is approximately \$25 per barrel. For Pioneer's Alaska Projects, the price of oil in 2006 is irrelevant. The prevailing price in the next two decades will determine future cash flow for new projects.

MR. FOLEY, in response to Co-Chair Samuels' query, related that Pioneer, in general, has an aggressive view toward price. He then returned to his testimony and paraphrased from the following written testimony [original punctuation provided]:

Accurate assessment of risk is critical to the success of an exploration portfolio. Will the value of the fields we ultimately discover offset the cost of dry holes, land, seismic data and development costs? For many of the remote exploration areas in Alaska, it is difficult to project acceptable full cycle returns.

[3:57:37 PM](#)

In 2003, the state initiated exploration incentive credits for certain qualifying exploration expenditures. These incentives encouraged Pioneer to invest significantly in infrastructure challenged areas such as NPR-A.

CO-CHAIR SAMUELS noted that Pioneer has taken advantage of some exploration tax credits already; and asked if those are also available for development tax credits. He further asked if Pioneer would benefit from the proposed provisions in the transitional money.

MR. FOLEY clarified that Pioneer has yet to be issued a tax certificate and the [exploration] credits were derived from work that was performed last winter. Therefore, the company has not yet monetized those credits. Mr. Foley said that a company like Pioneer would benefit from the transitional capital.

REPRESENTATIVE SEATON inquired as to the rate of credit for which Pioneer has applied and believes it qualifies.

MR. FOLEY specified that the wells Pioneer drilled last winter should qualify for the 40 percent tax credit rate. He mentioned

that this winter Pioneer is drilling one exploration well that the company believes will also qualify for exploration incentive credits, which should be creditable at a rate of 20 percent.

4:00:08 PM

MR. FOLEY again returned to his testimony and paraphrased from the following written testimony [original punctuation provided]:

When Pioneer was considering its first investments in Alaska, state officials were promoting the resource merits of Alaska basins. Alaska certainly contains world class petroleum systems. Additionally, the officials promoted the fiscal policy including the ELF formula and exploration incentives. Under the ELF formula, only very large new fields would pay severance tax and qualifying exploration expenditures in remote areas would receive exploration incentive credits at either a 20 or 40% rate. With this fiscal system in place, Pioneer invested heavily in the state over the last several years. When we learned that a new severance tax policy was under development, we were quite concerned that any new system would be detrimental to our future investments and a departure from the fiscal system promoted to the independents by the state.

We recognize that the existing severance tax policy, as it applies to the large fields on the North Slope, is likely not sustainable and we are pleased that the proposed PPT taxes profits rather than revenues. Given that the state collects royalties right off the top, it makes sense that any additional government take should be assessed after costs have been recovered. This concept is important to the smaller, lower productivity and remote resources which are critical to future production growth. Although the proposed production tax rate of 20% is quite large when layered upon the other burdens of royalty, ad valorem tax, state income tax and federal income tax, the impact of the large tax rate is tempered by the allowance of cost recovery, investment tax credits and the proposed taxable income threshold.

CO-CHAIR SAMUELS turned the committee's attention to the tax rate at Oooguruk, and related his understanding that Pioneer

received a royalty reduction on that particular field and after cost recovery Pioneer will pay 30 percent in that particular field. He then inquired as to what Pioneer would consider its effective tax rate.

MR. FOLEY said that he doesn't know Pioneer's total effective tax rate. When Pioneer made its investment decision on Oooguruk, it was with an expectation that the severance tax would be zero. He informed the committee that some of the leases at Oooguruk were a one-sixth royalty flap and others were a one-eighth royalty with a 30 percent net profit component. The 30 percent net profit component is preserved and the royalty reduction has taken all of the royalties down to 5 percent until payout at which point they would increase linearly over a four-year period to reach the rates today.

4:04:15 PM

MR. FOLEY continued with his testimony and paraphrased from the following written testimony [original punctuation provided]:

Pioneer is pleased to see the provision included in the proposed legislation regarding the deductibility of transitional capital. The provision serves to compensate those companies, including Pioneer, who have made significant capital investments over the past five years based upon the fiscal terms in place at that time.

We have reviewed the testimony of the administration and agree that the PPT, as proposed, will provide incentives for new investment by all companies. Economic metrics for new investments will improve under the PPT versus existing tax law. This should encourage the development of marginal fields and will reduce the minimum economic size for exploration prospects, thus prompting more exploration and increasing the chances of finding commercial-sized fields. In addition, it should encourage reinvestment in existing fields. We believe the PPT as proposed will entice more companies to Alaska and increase competition. More companies and more ideas will lead to smarter field development methods, smarter drilling and production equipment, which will further reduce the minimum economic size of exploration prospects and grow the resource pie.

4:05:42 PM

The tradable tax credits are a particularly effective incentive for the exploration and development of new resources. Under the proposed PPT, the higher risk, higher cost and long project cycle times associated with new resource exploration and development are partially offset by the ability to monetize these credits shortly after investment. In an exploration portfolio, the large majority of projects are not successful resulting in a total loss from all lease acquisition, seismic and drilling costs. The tradable tax credits would lessen the negative financial consequences of the inevitable dry holes explorers will drill.

A significant concern to Pioneer is the potential for a lack of liquidity for the tradable tax credits. Pioneers' outlook is to continue with very large capital expenditures in the state over the next several years. With only a handful of very large producers as potential buyers for the credits, and the proposed limit that a company may utilize purchased credits to offset no more than 20% of its tax, we are concerned that the market for the credits may not be competitive.

4:07:02 PM

CO-CHAIR SAMUELS surmised then that Pioneer's concern with regard to the credits is that the three [major producers] will buy enough of the credits and the value of each individual credit will decrease. In that scenario, the [three major producers] become the driving market force.

MR. FOLEY indicated that to be the case as well as the imperfect nature of a market with so few buyers.

REPRESENTATIVE SEATON asked whether Pioneer views oil prices below \$40 per barrel as untradable without a significant discount. He asked if the aforementioned has been considered in relation to the credits.

4:07:53 PM

MR. FOLEY said Pioneer has not considered the consequences of that.

REPRESENTATIVE SEATON said that he might be mixing things because the tradables are down to 20 percent and the investment clawback is at \$40.

CO-CHAIR RAMRAS clarified that the transition provision has a \$40 threshold while there is no threshold for the use of the credits.

[4:08:31 PM](#)

MR. FOLEY returned to his testimony and paraphrased from the following written testimony [original punctuation provided]:

New investors could face selling credits at a discount to taxpayers who would in turn cash them in to the state at full value. We appreciate that a buyer of tax credits should recover its transition costs, but we are concerned that the required discount might be substantially greater. We respectfully ask the legislature to consider implementing refundable credits with appropriate limitations to protect the state's cash flow in the event of low oil prices. The program could provide that credits be refunded at a modest discount to face value. This would allow the State, and not a third party producer, to benefit from any discount that a seller would be willing to accept.

[4:09:24 PM](#)

CO-CHAIR RAMRAS inquired as to what a modest discount would be.

MR. FOLEY said it would be close to 100 percent; and the closer, the better. He related that during his career he has been involved in purchasing and selling several credits, which often sell at a discount of only a few percentage points.

[4:10:13 PM](#)

MR. FOLEY continued with his testimony and paraphrased from the following written testimony [original punctuation provided]:

We believe that the PPT as proposed improves Alaska's competitive position with respect to other investment opportunities around the world. Mr. Van Meurs' testimony indicated that the proposed PPT would improve Alaska's competitiveness versus a number of

mostly large, international investment opportunities around the world. To attract companies of Pioneer's size and smaller, we believe that Alaska must effectively compete with U.S. lower 48 opportunities as well. With higher prevailing natural gas prices in the lower 48, gas resource plays (tight sands, shales and coalbed methane) are attracting huge amounts of capital due to the relatively low risk, low cost and short project cycle time relative to exploration. The size of some of these resources is quite large resulting in increased competition in the U.S. for independent's capital. If Alaska wants to improve its competitive position and attract new investors, we believe that the legislature should take great care in making changes to the administration's proposal that would make it less competitive.

[4:11:36 PM](#)

For new investors to Alaska, particularly smaller companies, exempting the first \$73 million of cash flow from taxation is a valuable feature of the PPT. The obstacles to new investors are high. Most new investment opportunities in Alaska are either small, infrastructure challenged, risky (exploration) or some combination of these factors. New investors are also handicapped by not owning the existing infrastructure and they lack the economies of scale enjoyed by the large operators. To be an effective operator in the state requires a huge commitment in highly compensated personnel to effectively navigate the regulatory and operational challenges that are unique to Alaska. Under existing law, it is unlikely that an explorer would pay significant production tax unless a huge field was discovered. A number of new companies were recruited to Alaska by the state and made substantial investments based on the existing tax law. Under the proposed PPT, exempting the first \$73 MM of cash flow from taxation will help deliver an investment climate more consistent with the system that initially encouraged Pioneer to explore in Alaska and will help offset the high "start-up" costs.

In general, we believe the proposed PPT is a balanced program with appropriate incentives to encourage new investment in the state. We encourage the legislature to carefully evaluate the proposal and take care to

insure that it results in fiscal policy that makes Alaska more competitive. We also respectfully request your consideration to make the tax credits in this bill refundable to allow the new investors the full intended advantage of the tax credit program. Thank you for this opportunity to express Pioneer Natural Resource's views on HB 488.

[4:13:41 PM](#)

CO-CHAIR RAMRAS inquired as to Mr. Foley's view if the state offers to [make the tax credits refundable], but will not refund the credits for a specific amount of time. In such a situation, the state would benefit from the time value of the money, while [delaying the refund] acts as a backstop. Therefore, the company could determine whether to redeem the credits for production, sell them to a major producer at a discount, or wait the specified amount of time and redeem them with the state for 98 percent face value. He asked if that would be an attractive approach.

MR. FOLEY replied no, pointing out that if a company doesn't realize the value of the credit for two or three years, the MPV of that credit would be less. He opined that the [discounted] credit could be sold into the market sooner and would be discounted less than the program Co-Chair Ramras described.

CO-CHAIR RAMRAS noted that he didn't disagree.

MR. FOLEY said the fundamental concept is that money is being left on the table. In other words, a seller might be willing to sell its credits at a discount, and therefore it seems appropriate for the state to take advantage of that discount.

[4:15:57 PM](#)

CO-CHAIR SAMUELS posed a situation in which the state offers to provide the company a 100 percent [tax credit] if it continues to reinvest those funds into capital in Alaska. If not, the company could take its chances with selling it privately [to the major producers].

MR. FOLEY said that anything better than what is expected from the market is an improvement.

[4:17:32 PM](#)

REPRESENTATIVE SEATON opined that Pioneer is in an interesting position due to its Cosmopolitan holding, which he presumed will be a gas play. He asked if Mr. Foley has analyzed the PPT on the sole gas operation that Pioneer has in Cosmopolitan versus an oil play on the North Slope. He further asked if the differing tax structures and credits mean that the relationship and advantage or disadvantage is different for the two resources or are the two considered the same.

MR. FOLEY related his understanding that the Cosmopolitan development has both oil and gas potential. Pioneer has considered Cosmopolitan in a hypothetical success portfolio and doesn't differentiate the value of a gas molecule or oil molecule other than to make them (indisc.) equivalents.

[4:18:38 PM](#)

REPRESENTATIVE SEATON said this is a concern for him in the Cook Inlet where there are a number of gas plays that are strictly gas. He expressed concern that there hasn't been any review of any differential effect of the changes from the gas tax structure, which differs from the oil tax structure, to the unified tax structure. Therefore, he requested that Mr. Foley review that and determine if there is a differential impact or not.

REPRESENTATIVE GATTO highlighted that the smaller the player, the more excited they are about going to the PPT.

REPRESENTATIVE SEATON noted the \$73 million credit.

REPRESENTATIVE GATTO pointed out that when Pioneer acquired Evergreen, Evergreen held leases know as Pioneer that he recalled were coalbed methane leases. He then asked if Pioneer is going to drill for anything else in that Pioneer unit.

[4:20:12 PM](#)

MR. FOLEY clarified that the Pioneer Unit held by Evergreen that was acquired by Pioneer was named the Pioneer Unit because of [the proximity to] Pioneer Peak. Mr. Foley informed the committee that Pioneer has surrendered all of its leases in the Matanuska-Susitna Valley. All of the leases held by Evergreen were focused on coalbed methane, and that was a project that Pioneer decided not to pursue. In further response to Representative Gatto, Mr. Foley explained that Pioneer, the

parent corporation, acquired Evergreen for which the vast majority of its assets were in Colorado.

[4:21:07 PM](#)

JIM WEEKS, Alaska Operations Manager, Ultra Star Exploration LLC, paraphrased from the following written testimony:

Mr. Chairman, distinguished members of the House Resources Committee. My name is Jim Weeks, and I am here today representing UltraStar Exploration LLC, a very small all Alaskan owned independent explorer, with strategically located leases on the North Slope. UltraStar is based in Anchorage, with offices at 3111 C Street, Suite 500. The Company was formed in 2002 by me, John Winther, and Dale Lindsey, for the primary purpose of exploring and developing leases on the North Slope. UltraStar is 100% owned by Alaskans. I am Managing Member, and moved to Anchorage in 1984 with ARCO, and have had a presence here ever since. Dale, whom most of you know, was born and raised and still lives in Seward. John, whom most of you also know, was born in Fairbanks and raised in Juneau. He currently lives in Petersburg. Thanks for the invitation to testify on this important legislation.

First of all, I'd like to commend the Governor and members of the Administration for addressing this issue, and your Committee for the timely and thorough review it is being given. During the last several days, I've listened to a lot of testimony on the proposal. Some witnesses wanted the Committee to delay decisions on this issue. There should be no delay, nor should there be a rush. This is a very important piece of legislation, and you need to get it right, less it results in unexpected and/or un-desired outcomes. You are doing it right, giving the bill a thorough and fair hearing in a timely fashion.

I will now offer a few specific comments on the bill. You've heard lots of testimony supporting the 20-20 tax and exploration/development incentive split, and the arguments in favor of these provisions have been articulated very thoroughly and clearly, and I certainly cannot embellish on them, so I won't even attempt to. I'll just add UltraStar's strong support

for the positions of the existing producers and independents and explorers on these issues.

John Winther testified to the Joint House and Senate Committee hearing last Saturday, echoing UltraStar's support for the 20/20 provisions, and the \$73 million deduction allowance in the bill. Since then, we've learned that the \$73 million allowance, granted to all companies in Alaska regardless of the size of their cash flow streams, may be a difficult pill for you and your colleagues to swallow. Thus, you may want to eliminate it from the bill. I encourage you not to jettison it entirely, but consider an alternative that will provide incentives for exploration and development of small fields.

It's generally agreed that the big Prudhoe Bay and Kuparuk sized fields have been found. The big structures have been drilled, and what remains are the 10-100 million barrel accumulations. These are modest by North Slope standards, but can add up to significant amounts of oil and related economic activity. The stock market rewards reserve replacement. The current producers are huge, publicly traded companies that have become so large that their reserve replacement needs cannot be met by chasing small satellites on the North Slope. For instance, ExxonMobil produces 20 million barrels in 10 days. We'd do jumping jacks in downtown Juneau if we found that much oil on our leases.

But smaller accumulations can be attractive to small independents like us, provided the right incentives. Rather than the \$73 million allowance for all companies, I suggest you consider establishing a ceiling above which large companies would not get the \$73 million allowance, and below which smaller companies would. There is a precedent for this in the "Charter for Development", a 1999 agreement between the State, BP and ConocoPhillips that made the combination of ARCO and BP possible. There are many provisions in the Charter, but none of them requires BP and ConocoPhillips to give preferential treatment to small producers, called "qualified producers". The Charter defines qualified producers as those with worldwide assets of less than \$1 billion dollars, and establishes 5000 barrels per day as a maximum amount

of crude oil that a qualified producer can produce to receive the preferential treatment.

MR. WEEKS, in response to Co-Chair Samuels' question as to how UltraStar would define large and small companies, opined that it would do so by calibrating a company by size and a threshold amount of oil per day.

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MR. WEEKS then continued with his testimony and paraphrased from the following written testimony [original punctuation provided]:

I realize that the provisions of the Charter were developed for a different purpose, but certainly it distinguished between "little guys", and "big guys", and established a maximum production level for which the benefits apply. Whether \$1 billion dollars or 5000 barrels per day are the appropriate ceilings for the PPT is subject to more debate, but such a two-tiered approach will accomplish what I believe you want: to provide incentive for entry by small newcomers without giving an un-deserved windfall to the established players. Please don't throw the baby out with the bath water by eliminating the \$73 million allowance altogether.

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My last issue is pretty specific, but could be significant for small independents. It regards the exclusion of "amounts paid for purposes of indemnification." on line 15 of page 14 of the bill. Small independents like UltraStar will need to indemnify facility owners and operators who will process our oil through their facilities. We will need to purchase real, third party, arms length insurance to satisfy these requirements. We will also need insurance to meet the bonding and financial responsibility requirements of the Department of Natural Resources and Environmental Conservation, and the Alaska Oil and Gas Conservation Commission. Depending upon the circumstances, membership in an oil spill clean up cooperative may also be required. All these costs can broadly be characterized as costs for the purposes of indemnification, and could arguably be

excluded when direct costs are calculated, as defined at line 21 on page 13.

Nearly 15 percent of the cost of the Winstar exploration well at Oliktok Point in 2003 was for insurance premiums, so these indemnification costs can be significant for the little guy, and should clearly be deductible to determine direct costs. In his letter transmitting this legislation to this committee, the Governor said that a number of indirect costs are listed in the bill, and are to be excluded from the calculation of direct costs. Indemnification is one of the indirect costs listed. Trust me, Mr. Chairman, there was nothing indirect about the \$370,000 check I wrote for the insurance premium on our last well. The money went directly from our bank account into theirs. I urge you to clarify your intent on this issue, and allow real, invoice supported, arms length indemnification costs to be included.

Thanks for the opportunity to testify at this important proceeding.

REPRESENTATIVE KERTTULA thanked Mr. Weeks for reminding the committee about the charter, which she said he is correct about.

MR. WEEKS related that UltraStar holds the view that the charter enables his company to look for small satellite accumulations.

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REPRESENTATIVE SEATON recalled that the \$73 million [credit] was based on a 5,000 barrel field by \$40 [wellhead]. Representative Seaton related his understanding that Mr. Weeks is saying that although the 5,000 might be an adequate distinguishing production value, perhaps a more long-term projection of price should be used to arrive at a lesser figure.

MR. WEEKS said it would not be related to price. He suggested that the 5,000 barrel a day was in the charter and it may be a coincidence that the same figure was used to calculate the \$73 million. Mr. Weeks opined that there should be a threshold in the maximum level that's excluded until new entrants can start a business and build a production stream from which they can begin to pay taxes.

REPRESENTATIVE BERKOWITZ asked Mr. Weeks if he believes the ELF is broken.

MR. WEEKS replied yes. For example, the leasehold that UltraStar now holds that abuts the western boundary of the Point McIntyre participating area can be drilled from a deviated well from Point McIntyre No. 1, which is in the Prudhoe Bay unit. Currently, UltraStar is negotiating with BP, as the operator of the unit, for access to the drill site and the production facilities that would process any oil found. Before the governor's reinterpretation of the ELF in 2004, Mr. Weeks said that his economic model/assumption was that any pool under UltraStar's lease would be a separate reservoir from an ELF standpoint and carry little or no severance tax. However, after the reinterpretation to include the satellites with the facility pools, the aforementioned became unclear. Therefore, Mr. Weeks changed his assumptions such that any pool held by UltraStar, since it would be produced and processed by Prudhoe Bay facilities, would attract the crude oil. Mr. Weeks said that the proposal in HB 488 is a cleaner method.

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REPRESENTATIVE BERKOWITZ asked if Mr. Weeks knows of any mechanism besides the ELF and PPT that would be better.

MR. WEEKS said he hadn't given such any thought, but would do so and share any ideas on that.

[HB 488 was held over.]

[4:36:12 PM](#)

ADJOURNMENT

The committee recessed at 4:36 p.m. to March 2, 2006, at 12:00 p.m.