

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

March 18, 2005

3:35 p.m.

MEMBERS PRESENT

Senator Thomas Wagoner, Chair
Senator Ralph Seekins, Vice Chair
Senator Ben Stevens
Senator Bert Stedman
Senator Kim Elton
Senator Gretchen Guess

MEMBERS ABSENT

Senator Fred Dyson

COMMITTEE CALENDAR

SENATE BILL NO. 50

"An Act relating to the oil and gas properties production (severance) tax as it applies to oil; establishing a minimum rate of tax for certain fields of five percent; providing for an adjustment to increase the tax collected when oil prices exceed \$20 per barrel and to reduce the tax collected when oil prices fall below \$16 per barrel; and providing for relief from the tax when the price per barrel is low or when the taxpayer demonstrates that a reduction in the tax is necessary to establish or reestablish production from an oil field or pool that would not otherwise be economically feasible."

HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 50

SHORT TITLE: OIL SEVERANCE TAX

SPONSOR(s): SENATOR(s) FRENCH

01/12/05	(S)	READ THE FIRST TIME - REFERRALS
01/12/05	(S)	RES, FIN
03/18/05	(S)	RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

SENATOR HOLLIS FRENCH
Alaska State Capitol

Juneau, AK 99801-1182

POSITION STATEMENT: Sponsor of SB 50.

DEBORAH VOGT

Haines AK

POSITION STATEMENT: Supports SB 50.

JUDY BRADY, Executive Director
Alaska Oil and Gas Association (AOGA)

POSITION STATEMENT: Introduced Tom Williams.

TOM WILLIAMS, Chairman

Tax Committee

Alaska Oil and Gas Association (AOGA)

POSITION STATEMENT: Opposed SB 50.

ACTION NARRATIVE

CHAIR THOMAS WAGONER called the Senate Resources Standing Committee meeting to order at [3:35:43 PM](#). Present were Senators French, Ben Stevens, Elton, Stedman and Chair Wagoner. Senator Seekins arrived at 3:39.

SB 50-OIL SEVERANCE TAX

CHAIR WAGONER announced SB 50 to be up for consideration and said he did not intend to move the bill today.

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SENATOR FRENCH, sponsor, reviewed an outline of oil taxation in Alaska by narrating a slideshow for the committee. There are four main taxes the oil industry pays - the royalty at 12.25 percent (which varies a little from lease to lease), a property tax of 20 mils per dollar (2 percent), a corporate income tax of about 9.4 percent and the production tax of about 12.5 percent for the first five years of a lease and 15 percent afterwards.

In general, the production tax is 15 percent when the Economic Limit Factor (ELF) comes into play. The 15 percent production tax varies because of the ELF.

At its simplest, the ELF is simply a number between zero and one. You multiply the production tax of a field by the field's ELF and that always works to lower the field's tax burden.

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SENATOR SEEKINS arrived.

SENATOR FRENCH calculated some examples on a slide. ELF was designed to encourage small field development, but what was small in 1989 is different from what most people mean when they say small. Back in 1989, Prudhoe and Kuparuk were the largest and second largest fields in North America. Small meant something less than giant.

Now people take a much different view of what small means. This is one of the fundamental assumptions that allowed for the ELF to be constructed the way it was. In 16 years of hindsight that was not a perfect assumption.

There are twenty separate fields on the North Slope and even after the Governor put the satellite fields in with the same tax structure as Prudhoe, there are still nine operating fields on the North Slope that pay no production tax.

In 2003, the state took in about \$599 million in production taxes. The average price that year was \$28 per barrel; the average ELF was about \$.50 - meaning the production was .5 percent.

He presented a slide showing the Kuparuk, West Sak and Tabasco fields. This bill would exempt West Sak and Tabasco because they are both heavy oil (less than 28 p.i. gravity). There are two satellite fields near Kuparuk - Tarn and Meltwater. Tarn made about 22,450 barrels of oil per day or about 65 million barrels total of oil to date, making it one of the 30 largest oil fields in the United States. It has a tiny .013 ELF - meaning it will pay .2 percent production tax in 2005. Its ELF will go to zero in 2007.

SENATOR FRENCH said another thing that wasn't considered in 1989 is what kind of production facilities would be needed for satellite fields. Those fields are piggybacking on to existing infrastructure. Tarn is produced using Kuparuk's facilities.

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SENATOR GUESS arrived.

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Tarn is produced basically by two drill sites and three 10-mile pipelines. That's what it took to bring the Tarn field on line - a fairly modest capital outlay by the oil industry - compared to the huge

expenditures that a new field startup requires. The Meltwater field, which was also one of these satellites, is produced through Kuparuk's facilities. It required one drill site only and in 2003 it produced about 5,800 barrels of oil per day and paid no production tax. This rather modest field will make the producers two million barrels of oil this year - at \$50 a barrel, that's \$100 million.

A drilling supervisor for Schlumberger, a leading oilfield services provider, said he charges between \$2 million and \$8 million for drilling a well on the North Slope.

SENATOR FRENCH said that the Meltwater field had four to six wells. Using the high figure of \$8 million to drill one well, it would cost \$48 million for all the drilling for a field that's making \$100 million a year. "Chances are the wells costs less. It's hard to find out."

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SENATOR SEEKINS asked what the state's share of that \$100 million per year.

SENATOR FRENCH replied that the state gets the 12.5 percent royalty and 9.4 percent in corporate income tax and the North Slope Borough would get its 2 percent property tax.

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He said that SB 50 sets out two principal reforms. The first establishes a minimum 5 percent production tax for all fields. In January 2004 the Department of Revenue estimated this provision alone would raise \$75 million at \$22 per barrel.

The second major reform bases the ELF on the price of a barrel of oil. As the price of oil rises or falls, so does the ELF. The bill sets a \$16 - \$20 range of oil as the norm and allows this range to increase with inflation to recognize that prices rise over time. At lower oil prices, the production tax will be reduced. He felt that it is only fair to lower taxes at lower prices so the state doesn't tax the oil industry out of existence during economically hard times.

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SENATOR SEEKINS asked how he established the norm.

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SENATOR FRENCH said it's impossible to predict oil prices.

The real key is not what the prices are going to be; the real key is preserving the economic viability of the companies and the fields that are in place. It's our belief that the \$16 - \$20 range establishes that.

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SENATOR SEEKINS remarked that it was a fair assumption that oil wouldn't get that low for the long term.

SENATOR ELTON said he thought they would want to establish that "tipping point" on, not the price of oil, but the price of producing it.

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SENATOR FRENCH said if oil prices fall below \$10 a barrel as they did in 1984, the bill would waive half the production tax and defer the other half until prices rise above \$16 a barrel. The bill doesn't allow the production tax to ever exceed 25 percent. The bill also exempts heavy oil.

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CHAIR WAGONER why he capped it at 25 percent.

SENATOR FRENCH explained that he was trying to be fair. If oil prices go to \$100, the formula would produce an unusually hard bite. "[The calculation] produces roughly equal share of profit between the industry and the state."

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CHAIR WAGONER said it seemed excessive to require 25 percent when the state has no risk and no upfront investment with venture capital. "I could understand increasing taxes if the state had some risk here...."

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SENATOR SEEKINS asked what the maximum production tax is now.

SENATOR FRENCH replied 15 percent, although no field pays that.

SENATOR SEEKINS said it looks like the maximum is being raised by 65%.

SENATOR FRENCH replied yes.

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He continued explaining that SB 50 allows tax payers production tax relief, much like the royalty tax relief that passed a couple of years ago.

If the tax payer can demonstrate that the field would be economical, but for the production tax...by clear and convincing evidence to the Department of Revenue, then the department has the power to waive the tax for that field - to make certain that the truly marginal fields - the fields that are truly on the cutting edge of development and exploration - don't get lost, don't fall off the table because of this bill.

SENATOR FRENCH sought to answer why a change is needed. Dan Dickinson, Director, Division of Tax, said a year ago in the Petroleum News that:

Despite its name, Economic Limit Factor - the current ELF ignores the biggest single economic determinant, which is price. That's the missing link in the current ELF formula.

He said we may be at the end of cheap oil. Current oil usage each day is about 80 million barrels and he cited publications on the issue. Conoco-Phillips made \$15.2 billion in profits in 90 days - after deducting all the costs one can imagine, including bonuses and lobbying fees.

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SENATOR STEDMAN asked if he knew their rate of return on equity.

SENATOR FRENCH he couldn't quote a number, but said his data came from the Charles Schwab Website.

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SENATOR ELTON said it was 24 percent for Exxon.

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SENATOR FRENCH reminded the committee about a book written by Governor Hickel called "The Crisis In The Commons: the Alaska Solution" in which about how the oceans are owned in common. He wrote that few world leaders were thinking about how the commons should be used for the benefit of the total. He also wrote that the Mineral Leasing Act of 1920 recognized that the commons belong to the public and required the income from their development to be paid to the public's government. He said our statehood act was modeled on that act. "The subsurface energy

resources were specifically designated to the new State of Alaska."

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SENATOR FRENCH said that recently, portions of a Wood Mackenzie Study were released and the thrust is that Alaska is a more profitable place to do business than the average of 60 other oil and gas producing regions worldwide. "We have higher than average costs with lower than average government take at prices above \$16 a barrel."

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SENATOR SEEKINS asked if the study was just talking about the take for government.

SENATOR FRENCH replied that it talks about everything after expenses including government expenses - in other words, profitability. Other countries, like the UK, are increasing their take according to Petroleum News.

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SENATOR STEDMAN asked if SB 50 would tie tax into something like inflation proofing.

SENATOR FRENCH explained the normal range is set between \$16 and \$20. A higher taxation scheme would kick in at a higher price.

SENATOR STEDMAN said he didn't think historically that inflation and oil prices are correlated.

SENATOR FRENCH responded that costs of doing business are basically the same for both government and industry. "It costs just as much to insure an oil field worker as a government worker.... All their costs over time just tend to go up."

CHAIR WAGONER stated that Conoco Phillips just announced it was putting Orion on hold.

That's a direct affect of when the Governor announced his changed to ELF. So, how many more Orions are out there and how many more times are the oil companies going to take their money that they had programmed for Orion, for instance, and taking it elsewhere? That's the hit I see Alaska taking. Right now these companies are investing billions of dollars a year and it's going to take a lot of money just to stay level on the

amount oil we got coming down the TransAlaska Pipeline System.

If you change the tax structure now and we lose that production to keep that level on the flow down the pipeline, even if you increase the taxes, what's going to be the difference in those two lines as far as income to the state of Alaska?

SENATOR FRENCH agreed and said the state must find a sweet spot. "The idea is to let industry and the state have equal portions of the oil revenue...." - as Hugh Malone said when the original ELF was crafted.

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DEBORAH VOGT, Haines resident, said she served the state between 1978 and 1999 as an assistant attorney general and senior hearing officer and deputy commissioner for the Department of Revenue. She dealt with oil taxes for most of her career. She supported raising taxes and finding the sweet spot to keep Alaska competitive for new investments. "But, I submit that under today's statutory scheme we are a long ways from that sweet spot."

She said that last year Sir John Brown with British Petroleum announced that his company could meet all of its needs for operations and investments with \$20 oil. At that time, it was his intent that revenue above that amount would be returned to the shareholders. She asked the committee to think about the fact that ANDS crude was going for \$52.50 earlier this week and that's a long way from \$20.

MS. VOGT challenged:

So, where is the additional \$30 a barrel going? These are Alaska's resources. This is private industry, but they are producing oil that is leased from the state. It's our oil. They have the right to produce it, but it's different from other private industry like Alaska Airlines or somebody.

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She didn't know who the BP shareholders are, but deducted that that its excess revenue is not staying in Alaska. She asked the committee to compare using \$7 million from the state's annual budget to support gasline activities to making \$30 million a day like oil companies do.

MS. VOGT said that the long-term forecast when she was in state government in 1999 was \$16 to \$18 oil. In the fall of 2004, that number was \$25.50 and every indication is that the number will go much higher.

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She explained a little bit about the state's overall petroleum picture. Royalties are the state's ownership interest in oil. Royalties are not general fund money; they go straight into the Permanent Fund. The second thing about royalties is that the state is not always the "farmer" in the equation. The federal government passed legislation to reauthorize drilling in the Arctic Wildlife Refuge, but the state would get only 50 percent while the U.S. would get the other half.

She explained that aside from the property tax, there is the corporate income tax, which is 9.4 percent. It is very poorly designed for taxing natural resource production.

Because of this, the oil industry has never paid anywhere near the 9.4 statutory effective tax rate. Their effective tax rate has never come anywhere near the 9.4 percent rate.... It is not sensitive to economics of Alaska. Because we tax on a portion of worldwide basis, what's happening in Alaska affects the corporate income tax very, very indirectly. I just want to emphasize [indisc.] severance tax rates, it's very, very important.

Think about it. None of these other revenue sources is a very good tool for funding that sweet spot between not discouraging investment, but getting the maximum benefit for Alaskans from their natural resources.

MS. VOGT said that oil and gas corporations, like every corporation, have a fiduciary responsibility to their shareholders to maximize profits. They are not going to tell you about any changes that will cost them money. "They are not going to make it easy for you to find that spot."

She said the Chairman of the committee and other members of the Legislature have a fiduciary and a constitutional duty to the people of the State of Alaska to maximize their natural resources. She agreed with the Wood MacKenzie report shows Alaska might be a little over the sweet spot with low oil prices, but at high prices, "We are giving away way too much."

SB 50 addresses both high and low prices and draws intelligent solutions.

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SENATOR SEEKINS asked Ms. Vogt to repeat what she said about the royalty share going to the Permanent Fund.

MS. VOGT related that by constitution, 25 percent of the state's royalties go directly to the Permanent Fund and statute mandates another 25 percent.

CHAIR WAGONER said that HB 11 changed the statutory 25 percent for newly discovered oil fields. Ms. Vogt acknowledged the correction.

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JUDY BRADY, Executive Director, Alaska Oil and Gas Association (AOGA), introduced Tom Williams to make its presentation. She said he was director of the Division of Petroleum Revenue from 1975-1979 and was commissioner of the Department of Revenue from 1979-1982. He was in private practice and then went to work for British Petroleum. He has degrees from Harvard, Stanford and Princeton and knows a lot about oil and gas tax.

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TOM WILLIAMS, Chairman, AOGA Tax Committee, speaking on behalf of AOGA, said he is employed by BP Exploration. He presented a slide show of Alaska's oil revenue picture. This current fiscal year, 88 percent of the unrestricted general fund revenue would come from petroleum and 12 percent from non-petroleum sources. Historically, it's been closer to 80 percent. According to the Department of Revenue projections, oil revenue will continue to provide three-quarters or more of the unrestricted general fund revenues through 2014.

Two elements are critical to that situation; one is price and the other is volume. There isn't a lot anyone can do about price, but volume is a result of investment, which the state has some influence over.

He reviewed the four elements of the state's fiscal system - royalty from land ownership, which was \$1 billion last year and almost \$500 million to the Permanent Fund; production tax was \$652 million. Production tax is where the ELF comes into play. The property tax, with the state as assessor, is at 2 percent or 20 mils. The same property tax is also paid to the municipality where the field is located. A credit is granted to the municipal

tax for the state tax. This system was created by the state in 1973 in a special session.

The oil and gas corporate income tax was just under \$300 million last year. He pointed out that taxes that go to municipalities don't show up in calculations of the revenues that go to the state, but it still is part of the cost of doing business in Alaska for gas and oil companies.

MR. WILLIAMS stressed that the ELF is only affecting production tax.

Even if the ELF makes the severance or production tax zero, a field still pays for royalty to the state, for property taxes on its facilities, contributes fully to the owner's income taxes....

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He said that the fields are creating Alaska jobs even if they are not paying production tax.

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MR. WILLIAMS explained that the netback is gross resource value to the point where the oil is leaving the field and going into the pipeline. The costs of running the field are not counted for the purposes of this tax, but transportation costs are. The ELF depends on two parameters - how many barrels per day a field produces and the average rate per well.

The larger a field is, the more productive its wells, the higher its ELF and the higher its tax rate. The thought is it's more profitable and can afford to pay more.

He pointed out that this methodology applies regardless of what the price is.

If you started with the West Coast price, say, of \$10 and you subtracted...\$5 for transportation.... That leaves me a netback of \$5. If the West Coast price triples to \$40, my transportation cost remains \$5. Now I have a netback of \$25. It's quintupled. That's how Alaska is leveraged by price. The ELF does not have price as a specific parameter in it, but ELF, a tax, has price in it in its overall composition.

Now, why do we have an ELF? I have to confess that the ELF is an idea that I thought of when I was the director of Petroleum Revenue for the state back in 1976. In December, I wrote a memo suggesting the idea behind the ELF.... We wanted to have a high rate production tax. We didn't want to have the consequences that a high rate production tax would have later in a field's life - which is what the department said in 1977.... As operating costs rise, the profit margin shrinks during the life of a field. Production tax contributes to the total costs and tends to hasten the time to avoid the consequence of high production tax in the later stage of field's life.

He presented the committee with a graph showing the four stages of a field's life. The first stage is when the field first comes on to production and costs are as low as they are ever going to be. Stage 4 finally shows a loss.

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SENATOR ELTON asked if the graph assumes the price of oil is the same in stage 1 as it is in stage 4.

MR. WILLIAMS replied no. It will happen regardless. It will happen in every field. "That's how fields end. They go through this evolution.... The point is to illustrate what happens with respect within that value." He said that's why fields get shut in. "Those costs keep going up and up as more and more of the oil that is extractable gets produced. It gets harder and harder to get the next one out - and more and more expensive."

SENATOR ELTON asked if the period of time between stages 1 and 4 would be extended.

MR. WILLIAMS replied, "Absolutely. There is no time dimension to this graph."

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He said the wildcatters who come up to Alaska need a stage 1 picture or they are not going to explore.

The response to this evolution over a field's life.... The first one is do nothing. Stage two - the gray area - is starting to get squeezed between the red coming off the top and the rise in costs at the bottom. Now, producers start saying we're going to have to be more

efficient. We're going to have to streamline our operations. We're going to have to debottleneck. We're going to have to eliminate unused facilities or consolidate facilities....

Another thing that they do is, as these margins are getting squeezed, it gets harder and harder to find reinvestment opportunities in the field. There are still going to be competitors with opportunities elsewhere. So, we start having some economic casualties - projects that are technically possible, but don't make economic sense. As this stage advances, which can take years, it could even take decades. You will have increasingly these things - more drastic measures to try to save costs and also higher casualties in terms of things that just don't make the grade in being competitive for investment.

When you reach the point that there is nothing left - that is competitive to invest in for that field, you fall into, what I call, a harvest stage. That's what you have illustrated here - is stage 3 - where you have such a narrow band. It may be possible that you'd still find some capital investments in a field like that would pay out of that little thin margin, but I'm saying for purposes of discussion here - let's say there isn't. So, that represents the situation where you've gone into harvest mode.

Then you have the running in the red stage. That's phase 4. Now, why are you running in the red? Well, you can run in the red - at Prudhoe Bay in December of 1998, that's \$8.16 - because you don't believe it's going to stay there forever and it didn't, thank goodness. The other thing that you'd stay in the red for sometimes is because there's a cost to wrap up your operations. You can't just turn the field off and walk away. You have to plug in and abandon the wells; you have to remove all the surface facilities and restore the land. That's in the contract for the use of the land - whether it's the lease or the right-of-way to whatever. There's never going to be a return on that cost. That's just a cost. So, you may be willing to operate in the red, because that's less expensive than incurring the cost right now. Why go to death if you can only have pain and agony for now?

CHAIR WAGONER remarked, "Death's going to come some time."

MR. WILLIAMS conceded that point. He went on to explain the ELF's inception. The department wanted to know how many barrels of oil were needed to cover the costs of getting the production out of the ground or production at the economic limit (PEL). He showed the committee how to calculate the operating margin, the ELF. It was scaled so that if the operating margin was high, the ELF would be high and the tax would be closer to the full 15 percent (12.25 percent at first). As the margin gets squeezed the ELF gets smaller and disappears. As the margins get squeezed, the severance tax disappears. He inserted that the state had a stair step tax regime before the ELF was enacted.

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MR. WILLIAMS said the ELF was his idea, David Knutsen, a petroleum economist for the department, came up with the actual formula. The reason industry did not want the ELF is because it raised the rate at Prudhoe Bay without the consequences at the end of field life.

In 1977, Prudhoe Bay did go from a 7.8 percent rate to approximately 11.7 [percent] under the ELF and that's a 50 percent increase in the tax rate. That's why industry didn't like it.

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He said that legislators were told that smaller fields would pay less tax for the same well productivity and that was the intent. The reason it was okay is because the state would get more money. "The giveaway to the small fields was estimated at \$200 million.... So, the state was a net \$2.69 billion or \$2.7 billion ahead."

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He said the ELF has worked the way it was supposed to - Prudhoe and Kuparuk still have a higher production tax.

Kuparuk is still paying at a higher rate of tax with the 1989 formula than it would have under the prior formula. That will change because Kuparuk is closing in on the 300 barrels a day per well threshold where the tax goes to zero - and Kuparuk is getting smaller. The two things are going to take Kuparuk smaller, but it hasn't reached that yet.

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He reflected that the state is ahead by \$2.7 billion net and has met its target before 2010. ELF was enacted over the strenuous opposition of the industry for three years. He said further:

No one said that investment in the big fields would stop altogether. What they said is that that you will have production that falls off the edge, because we'll cease to compete successfully with the others. The black area of the curve is what the natural decline rate would be in these fields - the existing fields from '89. The yellow area that gets added on top, that the actual production that did result from ongoing investment....

MR. WILLIAMS said that new fields were discovered like Alpine and North Star. Instead of being down at 300,000 barrels a day with the natural decline, production is close to one million barrels. However, more investment is crucial. The Department of Revenue has said that it is going to have to double or triple from its present level over the next decade.

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Different kinds of investment have different economic profiles. Wildcat exploration spends millions of dollars up-front.

You have it exposed at risk for years before you see a dime come back on it. When it does come back, you'd better get it as fast as you can. On the other hand, you have drilling more wells in Prudhoe Bay and they can be turned on right away.

Most of the expenditure on heavy oil has been on research and development. Hundreds of millions of dollars - not for any specific well or field - but in trying to crack the nut, solving the problems of the viscosity of the oil and the fact that silt comes out with it. Because the profiles are different, any given tax change promises to have a different impact on each category of investment. He urged the committee to make sure there are no unintended consequences, which combines with Murphy's law to put you behind from where you thought you were going to be. He cautioned that the fiscal notes on this legislation do not assume that there is a response in the level of production over the next 10 years if HB 63 or SB 50 becomes law.

The Governor's ELF decision lumps six small fields together with Prudhoe making them one larger size because field size is the dominant factor where the ELF goes up. Some were paying no tax

and now they are paying 13 percent. Two of the fields that got aggregated, Orion and Polaris, are West Sak viscous oil.

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MR. THOMPSON said AOGA doesn't like SB50 for a number of reasons. It is a structural tax increase. The Department of Revenue's expected price forecast is \$25.50 in the long term. It's a 27.5 percent increase across the board if DOR's price forecast comes true.

Second, the maximum tax right now is 15 percent, although no field is paying that. That would increase to 25 percent. The 5 percent minimum is a heavy burden on satellite development and maybe on the viscous oil development, too. "In fact, it uses the wrong standard for judging viscous oil. West Sak oil is not best measured by API gravity, but by centipoises, which is the unit to measure how thick it is."

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MR. THOMPSON said:

An analysis of the consequences on investments and whether in fact you're really going to get all the oil in the coming years that the Department of Revenue assumes - so, it makes Alaska less competitive; in fact, threatens that investment, because the funny thing is about \$50 oil. It's \$50 in Russia, too. It's \$50 in Trinidad; it's \$50 in the United States, Gulf of Mexico, in Oklahoma, wherever it may be. The competition doesn't change because of the price of oil; all the boats rise and fall with the tide together. That's the important thing that's overlooked. That's the end. I'd be glad to try to answer any questions.

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SENATOR GUESS asked if production tax is a function price through the netback.

MR. THOMPSON replied yes.

SENATOR GUESS asked if price is a function in the ELF.

MR. THOMPSON replied no. Price is a parameter in the netback.

SENATOR GUESS asked regardless of price, if the ELF is zero, the production tax is zero.

MR. THOMPSON replied that is correct.

CHAIR WAGONER thanked him for his testimony and said he would hold the bill.

There being no further business to come before the committee, he adjourned the meeting at [4:59:52 PM](#).