

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

February 27, 2006

3:49 p.m.

MEMBERS PRESENT

Senator Thomas Wagoner, Chair
Senator Ralph Seekins, Vice Chair
Senator Ben Stevens
Senator Fred Dyson
Senator Kim Elton
Senator Albert Kookesh

MEMBERS ABSENT

Senator Bert Stedman

OTHER MEMBERS PRESENT

Senator Gretchen Guess
Senator Gene Therriault
Senator Hollis French

COMMITTEE CALENDAR

SENATE BILL NO. 305

"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: SB 305

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

02/21/06	(S)	READ THE FIRST TIME - REFERRALS
02/21/06	(S)	RES, FIN
02/22/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/22/06	(S)	Heard & Held
02/22/06	(S)	MINUTE(RES)
02/23/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/23/06	(S)	Heard & Held
02/23/06	(S)	MINUTE(RES)
02/24/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/24/06	(S)	Heard & Held
02/24/06	(S)	MINUTE(RES)
02/25/06	(S)	RES AT 9:00 AM BUTROVICH 205
02/25/06	(S)	-- Reconvene from 02/24/06 --
02/25/06	(H)	RES AT 10:00 AM SENATE FINANCE 532
02/25/06	(S)	Heard & Held
02/25/06	(S)	MINUTE(RES)
02/27/06	(S)	RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

BRIAN WENZEL, Vice President
Finance and Administration
ConocoPhillips Alaska

POSITION STATEMENT: Presented company position on SB 305.

MARIANNE KAH, Chief Economist
ConocoPhillips Alaska

POSITION STATEMENT: Presented company position on SB 305.

DARREN JONES, Vice President
Commercial Assets

ConocoPhillips Alaska

POSITION STATEMENT: Presented company position on SB 305.

ACTION NARRATIVE

CHAIR THOMAS WAGONER called the Senate Resources Standing Committee meeting to order at [3:49:06 PM](#). Present were Senators Kookesh, Elton, Dyson, Seekins, Ben Stevens and Chair Thomas Wagoner.

SB 305-OIL AND GAS PRODUCTION TAX

[3:49:06 PM](#)

CHAIR WAGONER announced SB 305 to be up for consideration and that the committee would hear stakeholder presentations.

BRIAN WENZEL, Vice President, Finance and Administration, ConocoPhillips Alaska, said ConocoPhillips has been working in Alaska for 45 years and it is the state's leading oil producer, its leading explorer and its leading champion for the gas pipeline. It also has been the leading investor in Alaska and this year, alone, is reinvesting over \$700 million in Alaska capital projects on core legacy fields and new development. Over the past 10 years it has invested over \$5.8 billion in capital and another \$6.8 billion in expenses in this state. It is among the state's largest employer of Alaskans and it pays more than any other entity, a total of \$1.6 billion, to the State of Alaska in royalty and taxes.

ConocoPhillips has approximately 1,000 employees in the state and approximately 90 percent of them are Alaskan residents. They are competent, motivated and active in the communities where they live and operate. They care about Alaska and they believe that the work they do makes Alaska a better place to live. Through subcontractors and support industries, employment is generated for thousands of additional Alaskans. He stated:

The past, present and future of ConocoPhillips and the State of Alaska are inextricably linked. As we move forward as partners for perhaps the next 50 to 100 years, we believe there must be a mutual recognition of and respect for the interests of each of us. We have to try together to answer the question, 'How do we balance the factors that affect each of our interests in a way that makes us both successful.'

MR. WENZEL said that unfortunately the balance in SB 305 is decidedly in favor of the state and at the expense of established investors like ConocoPhillips. It sets an aggressive level of state-take when take is considered in conjunction with other corporate income tax obligations, property tax obligations to the state, the property and sales tax to the state, and other tax obligations to the state municipalities - royalty obligations to the state and the various oil and gas surcharges imposed by the state, plus additional fees and costs that apply in the permitting process whenever a development moves forward. This is all on top of its corporate income tax obligations to the federal government. It is no surprise that this layer upon layer of government take has a negative impact on investment, job creation and growth in Alaska.

He said that ConocoPhillips reluctantly supported the bill even though it thought the tax increase was too high to achieve the state's goal of increasing investment. It punishes companies that have made long-term investments and are returning dividends to the state in the form of jobs, royalties, corporate income taxes and property taxes. He would oppose the bill except for the fact that it has enabled all the companies to come together with an agreement to advance the gas pipeline under the Stranded Gas Development Act and advancing the gas pipeline has been one of ConocoPhillips' top priorities.

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He began discussing ConocoPhillips' long-term investments and its role in minimizing North Slope production decline and the impacts ELF has had on those developments.

He said that ConocoPhillips has been involved with the exploration and development of 14 satellites that have resulted in new production on the North Slope (slide 2). They were predominantly marginal developments, 50 million barrels (MB) per day to 150 MB per day, and were developed as a result of the favorable fiscal treatment given under the ELF (economic limit factor). Development of those satellites played a significant role in reducing North Slope decline and enabling 1.9 MB of oil to be produced compared to 1989 predictions. This is equivalent to discovering a Kuparuk-size field and has added more than \$5 billion in revenues to the State of Alaska (slide 3).

In addition to the satellite developments, ConocoPhillips continues to explore and drill and has drilled more than 40 exploration and appraisal wells in the last five years and it is committed to continuing exploration.

MR. WENZEL said the ELF did what it was supposed to do - put oil in the pipe and grow Alaska's economy. He understood the state's view on the limitations of the current ELF-based severance tax system, particularly at high prices. He believed that a wise and enduring tax policy could be developed and that the Governor's proposed production tax that is intended to reflect profits from that production and includes incentives to encourage investment in the future and fair transition provisions that recognize the cost of investments already made was such a policy. Nevertheless, he said that SB 305, as proposed, would result in an additional \$1 billion per year to the state at today's prices. This unprecedented increase would more than double the existing severance tax payments for ConocoPhillips.

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MR. WENZEL displayed slides that illustrated different fiscal structures. His view was that a balanced fiscal structure was critical to future investment in both oil and gas - and the future of oil production in Alaska is primarily dependent on existing fields. He emphasized that SB 305 differentially and adversely impacts ConocoPhillips' production from its legacy fields and a significant transition plan was necessary to allow an equitable conversion from the old tax system to the new tax system. He also added that a new PPT would impact Alaska's global competitiveness for investment.

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MR. WENZEL said there have been many questions about the relationship of the PPT to the fiscal contract negotiations under the Stranded Gas Development Act (SGDA). The purpose of the Act was to encourage new investments and to develop the state's stranded gas resources by establishing fiscal terms in advance with as much certainty as the Constitution of the State of Alaska allowed. However, he said the line between gas and oil production is not clear-cut. They exist together in reservoirs; the wells that are drilled produce them both. Many of the investments necessary to develop gas will also develop oil. Ultimately this means that the fiscal certainty provided by the state under the SGDA will be inadequate if only applied to gas. He elaborated:

The Administration has recognized the need for the Legislature to approve any agreement that included fiscal certainty for oil, but that Administration was unwilling to consider fiscal certainty for oil under the terms of the current production tax statute. It

was, instead, willing to propose to the Legislature a new oil tax that is before you that could become part of a fair and durable fiscal regime for both oil and gas. But the Administration's position has been clear. The new production tax has to stand on its own. In other words, it had to represent something that the Legislature, itself, would accept as wise tax policy in the absence of a deal on the natural gas pipeline.

For our part, this oil tax increase, on the average of \$1 billion for the industry at today's prices, is not something that ConocoPhillips would have found acceptable if we didn't think it would progress and ultimately result in an agreement to move forward on the gas pipeline project.

So, once again, the proposed oil tax increase by the Administration is a balance. On the one hand, it provides a foundation for fiscal stability for the oil and gas-related businesses of the producers in the Alaska. This stability is essential for the future investment including investment and the development of the gas pipeline project. On the other hand, the producers must pay substantially more in taxes than they would under the current regime.

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MR. WENZEL moved on to discuss the future of North Slope oil production in Alaska (slides 10 - 13) saying:

Even with the proposed incentives, the state's consultant has acknowledged that production resulting from wildcat exploration will only play a small role in increasing revenues under the PPT. The core legacy fields, such as Prudhoe and Kuparuk, would still produce over 80 percent of the total North Slope production in 2015 providing the base infrastructure on [which] these smaller fields will depend.

The already discovered heavy oil resource will play a much more significant role in the future of the North Slope. However, the state's consultant acknowledged that technology limitations and development costs will constrain heavy oil in the near term and it could be many years before this production reaches its potential. Yet this heavy oil resource base - it's huge - and published data suggests that in-place

volume are greater than 20 BB. This is a key resource for Alaska and the Legislature should consider a structure that would best enable its development.

MR. WENZEL said the bill has been designed to encourage new investors to come to Alaska and ConocoPhillips fully supports that and believe they would be beneficial to both the state and the industry. ConocoPhillips has already made partners of several of them. But, he said, the terms that attract new investors come with a cost and the Governor's tax increase mainly targets ConocoPhillips' legacy production assets - Prudhoe and Kuparuk. The increase is unprecedented for those who have invested tens of billions of dollars to develop the North Slope and stayed in Alaska through difficult times, including periods of very low prices.

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He cautioned that any time the government raises taxes, it takes money away from the private sector that could be used for investment and continued job growth. He also thought that higher rates would not be in the long-term best interests of the state either. He explained that new field sizes in Alaska are small and Arctic operating and development costs are high. ConocoPhillips spends a lot more time and resources assessing upside potential and downside risks. Hopefully, it is right more than it is wrong.

As we bear the greatest risk, it is fair that we should be appropriately rewarded. We acknowledge that the presence of tax credits reduces downside for the investors, but conversely, higher tax rates significantly reduce the upside potential, which is a prime driver in our investment out.

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HE opined that hitting the right balance between tax rate and the credits for reinvestment was critical to future resource development in Alaska. ConocoPhillips reluctantly supported the Governor's proposal in order to move forward, but the Legislature must wrestle with the question of whether it will attract long-term investment with a tax rate of 20 percent.

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MR. WENZEL began to comment on the importance of the transition plan. Under the bill, a fraction of the producers' expenditures for exploration, appraisal and development capital incurred over the past five years may be deducted for purposes of calculating

a producer's monthly profit tax obligation. ConocoPhillips supported that plan because it provided an equitable transition to the new tax system and is an essential piece of the overall balance reflected in this bill.

He related how their Fjord Field was developed as a stand-alone satellite (and wasn't aggregated with Alpine for severance tax purposes.) As a small satellite, it had a low ELF. Once the decision was received from the Department of Revenue, ConocoPhillips and its partners sanctioned the project and moved forward. Fjord will be an 18-well roadless satellite with first production in late 3rd or 4th quarter this year and production would peak in 2007/08 at about 17,000 barrels per day. Total capital costs are expected to be around \$300 million and while oil and gas prices have significantly increased over the last few years, so have material and labor costs, and ConocoPhillips is expecting it to cost \$30 million than when originally sanctioned. He explained further:

A majority of costs associated with developing the Fjord project will have been expended prior to the bill becoming effective. Without the transitional investment expenditure plan, only costs associated with 2007 and 2008 winter drilling programs would be eligible for the PPT. As previously discussed, the project was sanctioned on the letter ruling from the Department of Revenue, assuming the field would pay full state corporate income tax, full royalty, property tax, but little or no severance tax. However, under this new bill, the development would now be subject to a 20 percent PPT rate. Without the transition plan, the increase in the fiscal terms will result in a reduction of \$100 million in the gross value of this project and a 6 percent reduction in our average return at a \$40 ANS West Coast price.

ConocoPhillips is currently working on two other satellites in addition to Fjord - these are Nanook, due to start up in 2006, and West Sak 1J, which came on line late 2005. All of these projects will have similar value-loss impacts without the transition plan. In addition, there are several other projects undertaken in the last few years, which are now almost fully developed and will have value eroded as a result of the PPT. Our view is in order to insure these past investments are equitably treated, the transition plan is essential.

I would now like to ask Marianne Kah, again, our Chief Economist from ConocoPhillips, to spend a few moments discussing how this proposed tax change might impact Alaska's competitiveness and from the perspective of a global investment.

4:12:04 PM

MARIANNE KAH, Chief Economist, ConocoPhillips, said she is also part of the corporate planning department at its headquarters in Houston. She wanted to talk with them about ConocoPhillips' view of Alaska's competitiveness on a global basis. She started out saying that she was sympathetic to the state's position on this issue.

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MS. KAH turned to slide 18 to show the average capital and operating costs for Alaska and other locations around the world over the last decade (excluding exploration and appraisal). It included the TAPS tariff, but not additional costs for Alaska that would reflect the high cost of the Jones Act tankers. Even without those costs, Alaska has higher capital and operating costs than other regions ConocoPhillips invests in. She explained:

Cost needs to be taken into account when we set our tax take. The countries with the lowest cost can afford to have higher tax rates while remaining competitive and similarly, higher cost countries need to offset these conditions with lower tax takes.

4:15:54 PM

The next slide showed a graph of total costs and total government take of revenues. She said the most competitive quadrant is the low cost/low tax quadrant of the graph she was showing. Entities in that quadrant were not trying to offset their lower costs with higher tax rates. They were trying to remain very competitive. The Gulf of Mexico was in that quadrant and the UK was almost there. A lot of U.S. states would be in that quadrant.

4:16:09 PM

CHAIR WAGONER asked what taxes the Gulf of Mexico has. "Isn't the reason the Gulf of Mexico is so profitable is because there are hardly any federal taxes; there are no state taxes. So, that in all reality, that should be in the low cost/low tax."

MS. KAH agreed and said that was the intent - to get investors to the Gulf.

CHAIR WAGONER asked if the feds were seriously thinking about raising taxes in that area.

MS. KAH replied that the only reason the feds were thinking that way is because prices are high now, but that discussion would go away if prices went down.

[4:17:28 PM](#)

SENATOR DYSON asked if her chart says that under the ELF the government take is 60 percent of revenues.

MS. KAH replied yes, including state and federal.

SENATOR DYSON asked if under the PPT it would go up to 67 percent and change.

MS. KAH replied yes. The state's consultant said it was a 6 percent increase, but ConocoPhillips number was slightly higher. She surmised that was because the consultant had used the wrong royalty number.

Back to the quadrant, Ms. Kah, said that clearly the low cost/low tax places are trying to make themselves very competitive. The low cost/high tax countries are still trying to attract investment. The high cost/low tax countries have lower tax rates because they offset higher costs. The high cost/high tax areas on the graph don't get as much investment because they are not trying to offset their higher costs with a lower tax rate. Norway is an example of a country in that category.

[4:19:23 PM](#)

SENATOR ELTON asked if she was including royalty as part of the tax structure and, if so, why. The royalty is the state's oil and is part of the lease condition.

MS. KAH replied that royalties were in her number and she was trying to show the numbers the way an investor would look at them. "And, you know, the dollars are dollars."

SENATOR ELTON said he understood her point, but one thing that has consistently bothered him is that it is very easy for her to chart what the costs may be for ConocoPhillips, but it doesn't show him anything about what the risk might be. For example,

ConocoPhillips doesn't have to worry about employees because they are working in Alaska, but if they were working in Nigeria, it would. Likewise, if they were working in Saudi Arabia, compounds would have to be built, but not in Alaska. "How do you factor those risks into an investment scenario?"

MS. KAH replied that he was beating her to the punch and those costs were considered.

When it comes to political risk, we view Alaska very favorably, which is why we've been here so many years. Yes, we definitely take that into account. What I'm saying is you need to take into account the cost, the prospectivity and the political risk and look at all of these factors, not several in isolation....

SENATOR ELTON asked if she had a chart for that.

MS. KAH answered that she didn't have a chart for that because there were no numbers to show. Although some people can do political risk ratings, her concern would be that their view of political risk, even in the United States, is going up because they are hearing talk about things like windfall profits tax. "That is actually changing our view of the political risk in what traditionally we have thought as an extremely low risk country."

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SENATOR SEEKINS asked if she was talking about all government taxes in trying to illustrate what was being left over for ConocoPhillips.

MS. KAH replied that was correct.

SENATOR SEEKINS asked why she chose 1994 through 2003 as the "slice of time" to chart.

MS. KAH replied that Wood Mackenzie did a study in 2004 where they looked at every tax regime in the world and they had very good data.

SENATOR SEEKINS asked if it reflected accurate data other than for the PPT.

MS. KAH replied yes.

[4:23:18 PM](#)

SENATOR THERRIAULT explained the pressures government in general was getting to raise taxes and the difficulty in trying to come up with a tax structure that was stable. Other countries with a progressive system of taxation were not having to change their structure right now - and that was a form of stability.

So, we should be moving to a system that has some progressivity to it with regard to price so that we can get that long-term stability or a better chance at long-term stability even if it's not locked in under the terms of a contract. I'm wondering if you can make some comments on that and it's my understanding that in the back and forth between the Administration and the companies there was a proposal by the companies that did have a degree of progressivity to it.... It did reflect an upward take for government as prices moved up.

MS. KAH replied:

We really would be perfectly happy with a progressive price structure. Our issue really is the overall take level and the fairness in terms of the investments we've made over the last five to ten years expecting a certain risk payout that would suddenly be taken away. But in terms of moving to a better system, we'd be happy to have Alaska move to what they thought was a fairer and better system - as long as we were treated fairly in the process.

[4:25:34 PM](#)

SENATOR BEN STEVENS remarked that regardless of the difference between ELF and PPT, he noticed that only three other areas under the Wood Mackenzie study have a higher cost structure than Alaska and nothing has changed in terms of the cost structure. One is the Canadian Arctic and he asked what the others were.

MS. KAH replied Eastern Canada and Morocco. Only three areas have a higher cost structure than Alaska. She said the slide includes arctic conditions and transportation costs, but it does not include Russia. Arctic Russia, in particular, would be an equally high cost.

[4:27:46 PM](#)

Her point in slide 20 was to show that Alaska under ELF is in sort of a middle of the road position and has moved up into the high cost/high tax quadrant with the overall tax take level of

the PPT. She noted that peer areas, such as the Gulf of Mexico and the UK North Sea, even if recent tax increases were taken into account, were still significantly more favorable regimes. "The high cost in the Arctic and the types of fields that are likely to be found suggest that the proposed fiscal regimes could detract rather than encourage significant investment."

She said commercial discovery size is what ConocoPhillips thinks of as prospectivity and she illustrated those areas with a graph. Areas with high prospectivity can generally assess higher tax rates while maintaining investment. The Alaska North Slope, however, has limited prospectivity as compared to other parts of the world ConocoPhillips is exploring in. ConocoPhillips believes tax rates should reflect that.

MS. KAH said the state's consultant assessed the competitiveness of Alaska's tax rates by comparing the different regimes around the world based on similar field sizes, but she pointed out that that is not the way investors look at it. When they compare an investment in Russia, for example, versus Alaska, they compare the prospects of a 750 MB field versus a 50 MB to 100 MB field that they might find in Alaska.

So, you really can't compare fields of the same size. You have to take into account the higher prospectivity in terms of the tax rates that that project will be able to support.

Any greater prospectivity in Russia may compensate for the higher tax rates. When you add political risk in, you know, it may change that picture, but I think you need to take that higher prospectivity into account. I also want to point out that it's not really meaningful to compare the competitiveness of Alaskan tax terms with Russia, Azerbaijan and Angola at similar field sizes. It's just not a meaningful comparison.

[4:29:29 PM](#)

MS. KAH talked about Norway, specifically, because the state's consultant stated that it was comparable to Alaska, both in its wealth of natural resources and its cost structure. But, she did not believe it was a good comparison, because Norway does, in fact, have a lower cost structure and better prospectivity. However, she pointed out that it has significantly higher taxes than Alaska. Another reason she didn't think that model was helpful to them was because true production in Norway has declined by 17 percent since 2001 in a fairly high price

environment. In her view, Norway was not getting enough investment, because its tax structure was not in line with its cost and prospectivity position.

4:30:26 PM

Slide 22 looked at petroleum industry reinvestment rates. MS. KAH said that investors needed stable fiscal terms with tax rates that are commensurate with the cost structure and the size of the opportunity. Alaska's tax regime has offered that in the past and that is why ConocoPhillips has found it an attractive place to invest. But with recent tax increases in locations around the world, she was becoming concerned that global tax takes were reaching a point where private companies were finding it challenging to invest. She thought one of the main reasons the reinvestment rates in the green bars of the graph had not moved with the oil price was because the tax rates were reaching a point where companies are not finding enough investments that were attractive and meet shareholder returns - along with other considerations. Prices were expected to cycle down to lower more normal levels, so companies are not anxious to invest with prices this high. She also noted that there is a lag time in developing projects creating a delay in supply response.

MS. KAH said she believed that tax rates around the world were playing a key role in lagging reinvestment rates, because companies were worried they would make investments and governments would change their tax rates afterwards. Longer-term, she was concerned that private oil companies were being pushed out of the conventional oil business and being forced to invest in alternative energy supplies and things that have more favorable tax terms.

4:32:04 PM

CHAIR WAGONER asked how conservative companies would stay if crude oil prices remain high.

MR. KAH responded that she has long since given up trying to forecast oil prices. Several factors suggest that prices are exaggerated today. The first is that there was extraordinary global economic and demand growth in 2004, which is not being repeated. China had unusual factors that year - a power shortage during which it used diesel generators and an extra 300,000 barrels per day temporary need - and that is now gone.

They are now seeing a price response to higher prices in terms of demand growth. The year 2005 had a demand growth rate that was under the 10-year average, about 1 MB per day. Another

reason prices are staying where they are is that financial investors were moving money out of equities and bonds and into commodities, including oil.

I believe that money is overwhelming our oil markets now and keeping the forward price curve at a very elevated level - out five years. We've never seen them invest five years out in the curve before.

[4:34:24 PM](#)

CHAIR WAGONER replied that he understood what she said about China, be he was just in China and saw that they were building a tremendous number of new roads and were getting ready to produce their own cars.

They're back where we were probably in the 1920s and they are getting ready to get rid of all their bicycles and everybody with an income that allows them will have a car. So if that does take a dip, I would say it's not going to dip very long.

MS. KAH agreed and said that she also thought prices would come down, but to a higher number.

[4:35:03 PM](#)

SENATOR ELTON referenced slide 6 that indicated Alaska's take was \$60 a barrel, but Ms. Kah was saying to not count on prices staying and that they are artificially being held up. He asked where she thought prices would cycle down to and why that wasn't reflected in slide 6.

MS. KAH reiterated that she doesn't try to forecast oil prices any more. They look at their projects through a range of prices. The financial community consensus seems to be \$40 a barrel. Industry has to have the most conservative view on this, because it takes the risks.

She emphasized that when people talk about price, they need to talk about cost structure, too. It is really high today. Goldman Sacks believes replacement costs today are \$50 per barrel. The service industry has not kept pace with the spending level, but eventually it would make the investment and costs would come down. People think a big windfall is taking place when, in fact, a lot of money is being absorbed by higher costs.

[4:37:13 PM](#)

SENATOR ELTON asked for the same graph of the state's nominal take out to 2025 at \$60 oil (shown on slide 6) to be done for \$40 a barrel oil - if that was what ConocoPhillips based its decisions on.

MS. KAH replied that she did not say that was how its decisions were made.

I said we're more conservative than the financial community and that's all I can say. This is really competitively sensitive information and we wouldn't want our competitors hearing how we base our decisions because we bid against them in auctions around the world.

SENATOR ELTON asked to have the Department of Revenue prepare that chart.

[4:38:10 PM](#)

MS. KAH said another concern from a major company's point of view was that she sensed a bias in the proposed tax regime in favor of the new versus the legacy investors.

I believe there's a common misperception that smaller and medium sized petroleum companies have lower return requirements than the majors. As an economist, I'd like to point out that they have a higher cost of capital than we do. It's because they're less diversified and, therefore, they are viewed as being more risky - both by the bond community and the equity investors. So they have a higher cost of capital and, therefore, should have higher return requirements than we do.

Companies that don't invest and return adequate returns to their shareholders are no longer with us today. So, I don't think you want companies to come in here who aren't going to invest conservatively and return sufficient money to their shareholders. I would imagine - and I don't want to speak for the independents - but I would imagine that they would be comparing Alaska's tax regime to the Gulf of Mexico, the United Kingdom, Canadian oil sands. Those are common areas where they would be frequent investors. But the state's consultant concluded that tax rates in these locations were more competitive than existing and proposed rates in Alaska.

What I worry about if countries decide that they are going to have high taxes today, it's possible that only government controlled oil companies with different objectives like energy security are going to be willing to invest in conventional oil - getting back to the point I said before. I fear that we are all collectively being pushed out of conventional oil into LNG projects or into coal to liquids or something that is not conventional oil - because tax rates are getting too high in several locations around the world.

And there's another concern created by the high tax in favor of new versus legacy investors. As partners, we think about what will it be like to have a large number of small players active in the environmentally sensitive North Slope. The costs associated with environmental protection are really high and I know ConocoPhillips has very high standards on environmental protection and as well as state and federal governments and local governments - have the same standards. And this level of environmental sensitivity may be new to many of these players. That's something that we worry about.

[4:40:35 PM](#)

MS. KAH made a case for why the state should want ConocoPhillips to stay and what it has to offer the state. ConocoPhillips has been a long-term investor in Alaska - it has the size and financial strength to carry out project of any size. It has the skills to manage large and complex projects and has substantial experience in both developing and operating in the Arctic region. ConocoPhillips, in particular, has substantial experience in heavy oil production, both in Venezuela and Canada, and has leading technology that processes the heavier crudes. It has the second largest refinery in the United States that can be upgraded to handle heavy crude. It also has strong commercial acumen and access to markets, which allows projects to be designed to maximize the full value of the resource.

ConocoPhillips is the second largest gas marketer in the United States. It has strong risk management skills and a long-term investment horizon. This means they invest year-in and year-out and won't leave when market conditions get tough.

The last point Ms. Kah wanted to make was why the majors should be viewed as desirable investors by showing the committee their three-year average upstream spending in billions of dollars versus the spending of various independent petroleum companies. Majors can bring a lot of investment dollars into the state provide the terms were competitive. She concluded saying:

The tax proposal as introduced is the upper bound of what we believe is reasonable given the totality of the deal. I thank you very much for your attention and I'm going to turn it back to Brian to finish.

[4:42:23 PM](#)

MR. WENZEL said he had identified some language changes to clarify and improve the bill. Among other things, the changes concern how eligible deductions and credits are identified and the value at point of production and how that value should be calculated. He hoped to be able to offer that language shortly.

He said he wanted to summarize several key messages from today's discussion. One was that the proposed production tax results in a more than doubling of the effective tax rate over the current system.

In isolation, we would not view this change as reasonable, fair or appropriate, particularly given the state's current budget surplus. However, as a foundation for oil and gas fiscal stability that facilitates future investment in Alaska, the balance proposed in this bill is something that ConocoPhillips will reluctantly support.

Second, the North Slope has a huge heavy oil resource that is already significantly disadvantaged from a technology, quality and cost perspective. Incentivizing this resource will be key to increasing production levels in Alaska.

Third, a transition plan from the current production tax system to the new system is essential to insure equitable treatment of our legacy investments. Many of these investments were associated with the development of marginal assets that were justified on the basis of the prior ELF system. Qualifying these legacy investments for deduction against the PPT is an essential part of the balance reflected in this bill.

Finally, the tax rate associated with this bill pushes Alaska into a high-cost, high-tax bracket as compared to many other regimes around the world. This will affect the risk/reward balance the companies will evaluate before deciding to invest here. Before you accept the rate reflected in the Governor's bill, you must first be comfortable with the potential risks of future investment that such a high rate imposes. I would like to reiterate that Alaska and ConocoPhillips are aligned as partners on many very important goals - increasing investment in Alaska, increasing Alaska's oil and gas production, increasing Alaska's competitiveness, developing long-term relationships with proven partners for long-term mutual benefit.

In closing, many factors have to be considered by a government in choosing the appropriate tax rate for an industry as complex as the oil and gas industry. Cost structure including distance to market, prospectivity, potential field size, reservoir quality, regulatory constraints and the desired level of investment are perhaps but a few of the factors that need to be considered. Today, Alaska is challenged in each of these areas and the fiscal regime needs to recognize this. Thank you for considering our views.

4:45:50 PM

CHAIR WAGONER said that ConocoPhillips was the first of the big three companies to sign an understanding with the Governor that it accepted certain terms on the gas pipeline and he asked if the PPT was being discussed at that time or did ConocoPhillips request it or did it come up after.

MR. WENZEL replied that the PPT had been discussed prior to that date, as early as last July. It is typical for an administration to approach potential taxpayers about a change in the tax system. ConocoPhillips found the base terms of the contract acceptable in October.

CHAIR WAGONER asked if ConocoPhillips didn't at least consider that the Legislature would discuss fixing ELF or going to a different tax structure in the near future.

MR. WENZEL replied no, their investment analysis doesn't typically look for a change in a tax regime in Alaska - in other

countries perhaps - and certainly not a doubling of the production tax rate.

SENATOR ELTON asked him to clarify what he meant by "doubling" pointing out that the tax doubles only if the price of oil stays at \$60 a barrel. It doesn't double if it's at \$40 a barrel. "It's certainly a loss to the state if it's less than \$27 a barrel."

MR. WENZEL apologized and agreed that the doubling happens at current prices, not at all price levels.

SENATOR DYSON clarified that when he asked the question earlier, it's only a 6 or 7 percent change from government's total take now.

MR. WENZEL replied that was correct.

SENATOR DYSON continued by pointing out that at least some of that may be offset by the credits.

MR. WENZEL responded that the tax credits were built into that analysis.

SENATOR DYSON asked if he figured in how much ConocoPhillips would invest in exploration and development in Alaska when he made the chart.

MR. WENZEL replied yes; it was his best estimate for both ConocoPhillips and the industry.

SENATOR DYSON remarked, "That's fascinating when we all have difficulty predicting oil prices, but you're able to predict the investments for not only yourselves, but the industry."

MR. WENZEL replied that ConocoPhillips felt it was necessary to make an estimate and show what it felt was a dramatic impact in terms of where the state of Alaska is moving on its overall tax regimes.

[4:51:04 PM](#)

SENATOR GENE THERRIault referenced the tax credit mechanism and the ability for them to be sold in SB 185 [from the 23rd Legislature] and asked if ConocoPhillips could purchase tax credits in Alaska under the existing system.

MR. WENZEL replied that he didn't think so, but he couldn't say for sure.

SENATOR THERRIAULT requested that information along with what is paid for \$100 worth of credit. He thought it might be advisable for the state to have some limits on what credits could be bought for even though the consultant advised to let the free market set that rate.

[4:51:46 PM](#)

MR. WENZEL replied that the trading of the credits was structured for the benefit of the state.

The alternative is to simply write producers a check. I believe the state actually structures the system with credits such that in a scenario where prices are low, they don't have to cut those checks - rather those credits remain out there.... I would have the same view that you should allow the free market system to work and value those credits as appropriate.

SENATOR THERRIAULT responded that he thought Mr. Wenzel was right, but he thought the value had some "leakage."

[4:53:31 PM](#)

SENATOR BEN STEVENS asked to go back to slide 19 based on the Wood MacKenzie 10-year study from 2004 and said, "I find it fascinating that no matter what we do, we're in the high cost portion of production on a global scale." He asked if the tax credits would move Alaska left on the horizontal scale, why wouldn't the tax credit in the PPT cause it to move to a lower tax structure.

MS. KAH replied, "It's because the overall tax rate is higher and that has more than offset the additional tax credits."

SENATOR BEN STEVENS responded that this was another way to demonstrate what Dr. van Meurs said - that the tax credit has low sensitivity and the high sensitivity is in the tax rate.

MS. KAH replied, "It's less sensitivity than the overall tax rate."

MR. WENZEL agreed.

SENATOR BEN STEVENS said he still couldn't fathom why the state hadn't moved down the cost structure with tax incentives.

MS. KAH explained that that graph charted costs with no government take factored in.

SENATOR BEN STEVENS repeated that if tax credits were factored in, "We still don't see a movement."

MS. KAH replied they wouldn't put the tax credits in that graph. Those would be represented on the chart in the lower government take.

SENATOR BEN STEVENS remarked, "But it should if it had a significant impact. It should still move us down more towards the center."

MS. KAH agreed saying:

Right, it should have moved you to lower overall tax rate, but the increase in the absolute tax rate from 13 percent in ELF to 20 percent in what's being proposed more than offsets the improvement in the tax credits.

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SENATOR STEVENS said he thought the chart illustrated the overall insignificance of a tax credit in the scheme of things - in terms of what Legislators can do to make Alaska more competitive.

[4:56:53 PM](#)

DARREN JONES, Vice President, Commercial Assets, ConocoPhillips replied:

I think the way you think about that is that the increased tax rate would raise that Alaska ELF higher than even that circle is. The tax credits bring it back down a little bit. The other way to look at it might be the way you're suggesting is. You'd just have a tax increase, the rate increase, and you could say the tax credits lower your effective costs. Then you might move it to the left a little bit. In that case, you would be higher up on that scale.

[4:57:55 PM](#)

SENATOR BEN STEVENS added, "We'd be higher on the scale, but maybe further to the left."

MS. KAH agreed and added that depended on where those numbers were accounted.

CHAIR WAGONER commented that it didn't much impact ConocoPhillips, but it might hugely impact an independent.

MR. WENZEL agreed.

SENATOR BEN STEVENS switched direction to Standard and Poor's recommendations that highlighted capital expenditures for ConocoPhillips were about \$11.6 billion globally last year.

MS. KAH replied that sounded right.

SENATOR BEN STEVENS asked how much of that was in Alaska.

MR. WENZEL replied about \$700 million.

SENATOR BEN STEVENS asked if ConocoPhillips has budgeted about \$10 billion for capital expenditures in 2006.

MS. KAH replied that sounded right.

SENATOR BEN STEVENS asked how much of that was budgeted in Alaska.

MR. WENZEL replied roughly \$700 million again.

SENATOR BEN STEVENS asked if ConocoPhillips had spent \$700 million a year consistently regardless of its global percentages.

MR. WENZEL replied that ConocoPhillips' investment over the last five years was closer to \$2.5 billion, an average of \$500 million per year and stated:

No, I can't say that we hold \$700 million as our capital expenditure level year-in and year-out on a go-forward basis. It's dependent on the projects we see and the economics of the projects.

SENATOR BEN STEVENS asked of the \$700 million allocated for expenditure in 2006, how much was for exploration and how much was for maintenance and development.

MR. WENZEL replied that it was in the neighborhood of \$100 million.

SENATOR BEN STEVENS asked for a breakout of ConocoPhillips' exploration, development and production figures. He said he found a 1999 quote from a former chairman that said:

'When we look beyond 1999' - and you remember what 1999 was - it was \$12 oil - he says - 'The future of Alaska will be shaped on four factors: the availability of the resource base, our cost structure, oil price and the state's fiscal and regulatory polices.' The question I have to ask is how would you rank those?

He said that they have shown the committee that the availability of the Alaska resource base doesn't compare on the global perspective - at the most 50 MB to 100 MB field, maybe a 400 MB field and the cost structure won't change. The only thing the state can change is its fiscal regime. "So, when you're talking to us, you want to tell us that the most number one important thing is the thing that we can change!"

MS. KAH replied, "I think I've said that is really why we've stayed in Alaska all these years - because we viewed Alaska as having a stable fiscal regime.... And our people aren't getting shot at here either."

SENATOR BEN STEVENS said, "The one thing that has the flexibility for change is what is before us and the flexibility to skew that one way or another off the global competitiveness is the tax rate and the credit rate. No matter what we do here in Juneau, we're not going to change the cost structure of the North Slope. No matter what we do in Juneau, we're not going to increase the probability of finding the next 500 MB field. He emphasized that the tax change only occurs every 17 to 25 years and that is why Alaska is viewed as a stable regime.

He further noted that the \$40 a barrel figures Senator Elton was requesting were in the Department of Revenue's fiscal note.

SENATOR ELTON said he would check the fiscal note.

SENATOR BEN STEVENS said he thought the number one issue was fiscal stability.

[5:06:35 PM](#)

SENATOR THERRIAULT asked what the crossover point was between the status quo and the PPT.

[5:07:15 PM](#)

MR. WENZEL replied that their estimate is around \$25 under the PPT.

SENATOR THERRIAULT asked what the crossover point was at 25/20.

MR. WENZEL didn't have that number.

CHAIR WAGONER asked if there were further questions. There were none. He thanked everyone for their comments. There being no further business to come before the committee, he adjourned the meeting at [5:08:27 PM](#).