

**ALASKA STATE LEGISLATURE**  
**SENATE RESOURCES STANDING COMMITTEE**

March 1, 2006

3:35 p.m.

**MEMBERS PRESENT**

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

**MEMBERS ABSENT**

All members present

**OTHER MEMBERS PRESENT**

Senator Hollis French  
Senator Gene Therriault

**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
02/27/06	(S)	Heard & Held
02/27/06	(S)	MINUTE(RES)
02/28/06	(S)	RES AT 3:30 PM BUTROVICH 205
02/28/06	(S)	Heard & Held
02/28/06	(S)	MINUTE(RES)
03/01/06	(S)	RES AT 3:30 PM BUTROVICH 205

#### WITNESS REGISTER

JOHN ZAGER, General Manager  
Chevron Corporation, Alaska  
Anchorage AK

**POSITION STATEMENT:** Supported SB 305.

KEVIN TABLER  
Chevron Corporation, Alaska  
Anchorage AK  
**POSITION STATEMENT:** Supported SB 305.

PAT FOLEY, Manager  
Lands and External Affairs  
Pioneer Natural Resources Alaska  
Anchorage AK  
**POSITION STATEMENT:** Supported SB 305.

JIM WEEKS, Managing Owner  
UltraStar Exploration LLC  
3111 C Street, Suite 500  
Anchorage AK  
**POSITION STATEMENT:** Supported SB 305.

KEN THOMPSON, Managing Director  
Alaska Venture Capital Group (AVCG)  
Anchorage AK  
**POSITION STATEMENT:** Supported SB 305.

#### **ACTION NARRATIVE**

**CHAIR THOMAS WAGONER** called the Senate Resources Standing Committee meeting to order at [3:35:01 PM](#). All members were present at the call to order. Chair Wagoner announced that today would be the last of the stakeholder hearings.

#### **SB 305-OIL AND GAS PRODUCTION TAX**

##### [3:35:01 PM](#)

JOHN ZAGER, General Manager, Chevron Corporation - Alaska, said that Chevron's Alaska presence had changed a lot in the last year. Here, Chevron is considered an independent; its asset base is comprised of assets from the Heritage Chevron organization and the Heritage UnoCal organization (UnoCal was acquired August 10, 2005).

Chevron is the fourth largest producer in the state and as such is in a fairly unique position of not being one of the big three producers or being privy to any of the contract discussions. It has 382 employees or full-time contractors. It doesn't get the scale of benefit that some of the large producers get nor the incentives the small independents get. He said Chevron is the

dominant operator in Cook Inlet and that makes it the third largest operator in the state. It impacts the Kenai economy as well as providing energy to key customers - the Tesoro refinery, Enstar, Chugach Electric, Agrium and Aurora.

MR. ZAGER related that Chevron is the only producer in the state that has a relative balance of assets both in Cook Inlet and on the North Slope. Roughly 40 percent of their barrels come off the North Slope and 60 percent out of Cook Inlet. Both of the production streams, in and of themselves, are large enough to trigger the PPT.

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He presented map of both Chevron's North Slope and Cook Inlet productions. Net production off the North Slope is 16,000 barrels of oil equivalent per day (BOEPD). He reviewed Chevron's asset position in offshore Cook Inlet at 10,900 BOEPD and onshore at 14,100 BOEPD.

In addition, Mr. Zager said, Chevron was probably the dominant player in this morning's lease sale. It spent almost \$7 million to acquire 48 tracts, 430-some square miles of new exploration land on the North Slope, mostly located south of Kuparek. Net production off the Slope is approximately 16,000 BOEPD.

In Cook Inlet, Chevron operates 10 of the 15 offshore platforms. Of those 10, eight are currently producing and two are shut in. One of its assets on the west side of Cook Inlet is a gas storage project that is being installed at Pretty Creek Field to facilitate peaking needs in the winter. Chevron owns one-third interest in Beluga Field, one of the big gas fields in the Inlet. The biggest field in the Inlet is Trading Bay Field that has five platforms, all operated by Chevron in partnership with Forest Oil. The remaining offshore production is at Middle Ground Shoals Field with four platforms. The middle two are owned and operated by XTO; the northern and southern ones are operated by Chevron and are currently shut in.

MR. ZAGER said that Chevron's Kenai gas storage facility at Swanson River has become instrumental in meeting peak day needs in the Inlet. It has met Enstar's peaking needs and sent gas to Agrium, which is having serious problems with supply.

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MR. ZAGER said that most of the offshore platforms are 35 years old and take a lot of maintenance. The last thing they want is an environmental incident. He urged the committee to think

carefully before they turn over platform upkeep to new smaller companies from down south that they hadn't heard of before or that might be relatively thinly capitalized versus Chevron with a balance sheet of \$120 billion to stand behind the liabilities in the Inlet.

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He presented an engineering offshore graph that indicated production of 200,000 BOEPD from the early 70s to the present when production is at 12,000 BOEPD.

He explained that watercut is used to define how many barrels were water compared to oil and early-on it was 100 percent oil. Now the watercut is at 90 percent. The same amount of fluid is being produced, but it's 90 percent water. The increased cost of separating the oil and reinjecting the water has to be compared to the loss of production. [He displayed a graph of Trading Bay Unit that indicated similar figures.]

He summarized that Cook Inlet oil is very high cost, primarily because it is offshore, the facilities are big and a lot of people work on them. Direct lift costs average out to \$20 to \$25 per barrel. Adding transportation, overhead and deductions for quality of the crude and Chevron's breakeven cash flow is a little bit north of \$30 a barrel.

He explained that Wall Street grades corporations on earnings, so the cost of actually getting the production on-line (the depreciation amount) has to be added when earnings are calculated. When Chevron adds depreciation, its earning break-even point is in the \$45 range. Production is very challenged from both an earnings and a cash flow perspective.

MR. ZAGER pointed out their significant operational risk because of the age of the facilities and the sensitive environmental area they are operating in. "At some point you gotta say, 'Well, with all the risks I'm taking here, am I getting a fair return on the resources and the capital I've got canoed here?'"

Another point he explained is that platforms are co-dependent on each other for their expenses. Fixed costs, like the Nikiski dock and the Trading Bay facilities, are shared among the remaining platforms. So, as a group, they all need to maintain their profitability.

The offshore component of Cook Inlet is the least able to afford an additional tax. It is hard to plan your business on \$55 or

\$60 oil. Chevron shut in its two platforms about three years ago when oil prices were in the low-to-mid \$20s, because they were losing money every day they were running. While the others were not significantly positive, they were kept open; prices have come up and they are okay for the time being.

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Update on Unocal joining Chevron. Most were glad that Chevron ended up being the primary company. In January, Chevron management made the decision to retain all its assets in Cook Inlet and has committed to spending \$200 million over the next four years. It has decided to keep its offices in Alaska and is expanding its positions here. He reminded them of the \$7 million they spent on the North Slope just this morning. When deciding this, the company modeled all the economics with the existing severance tax system, which in Cook Inlet means zero.

After seeing the Governor's proposal, Chevron's management team ran a model under it and, "It did what it was advertised to do." The best projects in the portfolio had their rate of returns (ROR) lowered. They are the ones that are generating the most profit and the tax would hurt their economics. The smaller projects had their RORs go up. He believed that was because they weren't generating such a large amount of profit that they get hit with a profit tax, but they benefit from the capital credit part of the equation. The average mean of their portfolio went down a little bit. He pointed out that the enhanced terms of the PPT could significantly expand the list of economic projects. Changing the ratio by lowering the tax to 15 percent and increasing the credit above it would also help, especially the marginal projects and potentially bring a whole other list of projects into the realm of consideration for investment.

MR. ZAGER reminded them that Chevron has partners on all their properties and because of their unique position of being on the Slope and in the Inlet, it would be in a dramatically different tax situation than its partners. This could lead to further misalignment on the economics.

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Cook Inlet has a gas supply issue, especially out a few years. Having incentive is more about making sure energy is available to run the economy and having additional gas supply that is critical to the state's economy. He liked the idea of the state sharing some of the risk up front in exchange for some of the profit on the backside.

He said the Inlet currently lacks significant exploration. Chevron has not looked for deeper pools because of the risks and he was doubtful, although hopeful, that smaller independents would come in and actually drill a well. Aurora and Forest have been participating in some exploration, but beyond that, no one has spent any money in "turning drill bits to the right."

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MR. ZAGER summarized that the PPT is a huge tax increase, but Chevron would support the bill with the following stipulations:

- Treat Cook Inlet differently by lowering the tax rate and/or increasing the capital credit
- Include an additional 5 percent capital credit (20/25) for heavy oil or tertiary recovery (CO2) projects statewide
- Keep the transition capital.
- Keep the \$73 million exemption for any producer in the state

He said they could probably tolerate one or two of those going away, but if they all go simultaneously in the same direction, they will be in a place where the bill didn't start out at all.

He recapped that Chevron is the only company that has assets that are relatively balanced between Cook Inlet and the North Slope; one is a much better asset than the other. Both of those businesses are big enough to use up the \$73 million tax credit. He didn't think that Chevron should be disadvantaged in Cook Inlet relative to Forest and Marathon from a tax perspective just because it happens to have assets on the North Slope.

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MR. ZAGER thought lawmakers could consider letting a company use the \$73 million credit more than once if it owned property in more than one geologic basin in the state if they wanted to encourage production in as many parts of the state as possible.

Another lever that could help Cook Inlet and other areas is making the credit a little higher than the tax rate to incentivized exploration and production even more - especially in selected areas of the state.

Another recommendation was to add an additional 5 percent capital credit (20/25) for heavy oil and tertiary recovery (CO2) projects statewide. Agrium's Blue Sky project has come to light in the last few months and that uses coal to generate hydrogen

to fuel its fertilizer plant. That process generates tremendous amounts of carbon dioxide, which is going to need to go somewhere. One of the ideas was to use it for enhanced oil recovery. He thought the concept was challenged technically.

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CHAIR WAGONER asked if he would use stainless steel and less corrosive products for CO2 projects - basically installing brand new systems.

MR. ZAGER replied yes; special tungsten type steels are needed. New pipelines, well borers and platform components would have to be replaced. They are basically talking about redeveloping the field.

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MR. ZAGER emphasized that his company needs absolute clarity on terms and definitions and summarized that the consequences of a tax being too high would be that people would quit coming to the lease sales. But, he was hopeful that the state would come up with something workable.

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SENATOR FRED DYSON asked if Cook Inlet had a spot market, and if it did, would that change Chevron's position on its long-term contracts.

MR. ZAGER replied that Cook Inlet doesn't have a spot market; everything is under long-term contract. A company needs to have a market to commit to an investment. It would be hard to invest if you have a pay out in three years and the Agrium plant closes next year. He hadn't thought much about how a spot market would work in the Cook Inlet.

SENATOR DYSON asked if long-term contracts there were keeping more investment from happening.

MR. ZAGER replied:

On one hand, I would argue that long-term contracts are causing more investment. It's no secret that we have a contract with Enstar, which people comment on from time to time. As a result of signing that contract and having some assurance of a long-term market, we've invested over \$160 million in the gas business since 2001 and have brought significant additional reserves to market to help meet that

supply. If there were no long-term contracts, I keep getting back to that you're going to have trouble getting a story that you could sell to management that you have a secure market. Without a market, your gas isn't too valuable.

SENATOR DYSON said it had been represented to him that Cook Inlet has a lot of gas and if that were produced, they wouldn't have to be in such a panic to get North Slope gas down a spur line - if only the market price of gas was operating.

MR. ZAGER responded that higher prices would incite more exploration and the long-term price of gas in Cook Inlet has historically been very low. Even today, it's the lowest price gas in the United States. While offshore prospects exist, the economics to drill for it haven't been there.

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SENATOR DYSON said Chevron is considering spending over \$1 billion to bring a spur line down to Cook Inlet, but if all they had to do was change the price, that would put them in an interesting bind.

MR. ZAGER commiserated that people have gotten used to cheap gas and that is not anywhere near to the market price.

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SENATOR STEDMAN asked to go back to slide 8 and asked if his well structures were weighted more towards current costs rather than previous costs from old wells where some of the production has come from.

MR. ZAGER replied that most of their wells have been located in Cook Inlet since the 60s and 70s when the fields were originally developed and his projections were not forward-looking.

SENATOR STEDMAN surmised then that if they go back a few years to when the price of oil was \$20, the major oil companies' balance sheets would be running blood red.

MR. ZAGER responded that a few years ago, they had more barrels to produce. So the breakeven point would have been lower than \$30 a couple of years ago. They were also making a little bit of money, but they also decided to shut in the Baker and Dillon platforms in Middle Ground Shoal, because those were actually bleeding cash.

SENATOR STEDMAN said the Legislature was trying to figure out what the breakeven point is so that it could establish a tax structure that would work for many years.

MR. ZAGER remarked that a 20 percent tax would basically take away 20 percent of their profits, because right now the severance tax is zero. It's hard to come up with a breakeven point under that scenario.

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SENATOR ELTON asked to go back to slide 13 and asked Mr. Zager if he was preparing a list of definitions that he wanted and what his timeframe was.

MR. ZAGER replied that Chevron hadn't had the time to get to those details together.

KEVIN TABLER responded that he struggled to just get a model from last week. It was a work in progress.

[4:27:40 PM](#)

SENATOR FRENCH asked to see Chevron's tax burden under this bill, because he thought that Cook Inlet should be exempted. It has no significant exploration now and he couldn't see how it would get more if the Legislature started taxing there.

MR. ZAGER said he supported that point of view.

SENATOR FRENCH remarked that a small company named XTO saw an opportunity in the Inlet and gambled on buying into it during times of low prices and low volumes. He asked Mr. Zager what he thought they saw and how could they make a go of it in the Inlet.

MR. ZAGER replied that it was hard to speculate about another company's motives, but he assumed XTO got those assets at a price it thought was worth the risk. They spent some money in keeping production up, but he noted that XTO hadn't attempted to expand anywhere else in the Inlet or to do any exploration.

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SENATOR STEDMAN asked if the Legislature incentivizes heavily, should it not look at having an escalating tax rate at the high end of oil prices, \$60 - \$120 per barrel, along with a large or very attractive exploration credit.

MR. ZAGER replied that would be one approach, but he strongly urged that whatever scheme the Legislature decides to use, to keep it simple. He advised that when an oil company makes an investment decision, it doesn't look at a single point, but rather at a probability distribution starting at where everything goes right and then works back to an average. If you start clipping off the top end of the distribution, that will affect the middle point. He likened it to telling another business the state was going to take 20 percent of its most profitable customers and give them a special tax.

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SENATOR THERRIAULT asked what element set the gas prices so low in Cook Inlet.

MR. ZAGER replied that Cook Inlet had a surplus of gas in the 70s. It had a 200-year supply of gas. To monetize it, the owners of the gas, Union Oil, constructed a fertilizer plant and Marathon and Arco built an LNG plant to export the gas to Japan. That gas has now been largely monetized and the Inlet is entering a phase where the gas surplus is no longer there.

SENATOR THERRIAULT asked what is preventing the gas price from coming up to the market rate now.

MR. ZAGER replied that the Agrium plant is one of the big consumers and the price that they are willing to pay for gas to generate ammonia and urea to sell in the world markets needs to be competitive within that parameter. The LNG plant is a dedicated supply and market. The remainder is to be set by long-term contracts with Chugach, Matanuska Light and Power, and Enstar that have the market and need the long-term gas supply.

MR. TABLER added that satisfying the additional market has resulted in recent increased discoveries.

SENATOR THERRIAULT asked them to explore their concern over complete understanding of terms and definitions to see if they had specific areas of concern.

MR. ZAGER replied that terms are still a work in progress and he thought the best solution was to work through AOGA for some industry consensus on terminology.

MR. TABLER added that they have an 11 a.m. AOGA meeting tomorrow and he would bring up the subject.

[4:38:08 PM](#)

SENATOR DYSON related that Agrium told him the price of fuel to all of its competitors had gone up and they can make money and sell their product at \$5.50 gas. Agrium was thinking about coal gasification at that price range, which he found surprising. It was also represented to him by another party that the problem with Cook Inlet gas price is the Regulatory Commission of Alaska (RCA).

MR. ZAGER replied that he didn't understand that comment, since the RCA only approves contracts, but it doesn't negotiate their terms.

CHAIR WAGONER said he heard that decision was because of access to the pipe.

MR. ZAGER replied that he thinks the whole access issue and its affects on price and supply have been dramatically overblown.

SENATOR STEDMAN asked if they should consider changing the \$73 million exemption for both the North Slope and Cook Inlet.

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MR. ZAGER replied that he wouldn't be here advocating that it be lower, but thought it would be an appropriate place to make an adjustment. If you want to motivate people to explore more, you should dance with the people who are already here and not the blind dates.

SENATOR STEDMAN asked if he thought the \$73 million allowance for everyone was fair.

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MR. ZAGER replied that all the companies would have their opinions about which lever they could live with. For the big producers, \$73 million is a small percentage of the money they would pay and is almost a throwaway. A company that doesn't produce here could only aspire to get to \$73 million some day and until they do, they wouldn't pay any taxes. So, it's a very important term for them. But, he said:

Chevron has done all those things. It's been here and spent the money. We're big enough to trigger the \$73 million. But we're not big enough to say it's a really small percentage of our business. So, that's why, it hits us in the Cook Inlet; it hits us on the North

Slope. We're kind of in a unique position in that respect.

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CHAIR WAGONER thanked them for their presentation.

[4:43:25 PM](#) recess [4:49:18 PM](#)

PAT FOLEY, Manager, Lands and External Affairs, Pioneer Natural Resources Alaska, started with a brief history saying Pioneer started business in Alaska in 2003 with three exploration wells and acquired 150,000 acres in an areawide sale on the North Slope. In 2004 it formed an exploration partnership with ConocoPhillips and Anadarko covering a vast portion of the NPRA. In 2005, it acquired a small interest in the cosmopolitan unit and has an option to increase the interest up to 50 percent and to replace ConocoPhillips as the operator.

Early in February it made a sanctioned decision to proceed with its Oooguruk development on the North Slope and has begun construction. It will include roughly 40 horizontal wells and he anticipates recovering 50 million to 90 million barrels of oil. Pioneer's total investment will be \$450 million to \$525 million. Pioneer is the operator and owns 70 percent of Oooguruk; the other 30 percent owner is E&I Petroleum, an Italian oil company. At peak rate, Oooguruk will produce 15,000 to 20,000 barrels per day and he expected it to peak in 2010 or a little earlier.

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He believed the challenges for new investors to be formidable because the remaining fields are smaller, lower quality reservoirs that are more remote and perhaps offshore. He reminded them:

Last, we think there will be a focus on natural gas and remember natural gas today has no market. It will be another decade before North Slope natural gas has any marketability. The North Slope clearly has some of the highest costs of anywhere in the world and the other big challenge is that the North Slope has very long cycle times - even with success.... Realistically production won't ensue for five years at the earliest and as long as 10 years down the road. It's that long cycle time that keeps many small companies away from Alaska.

The largest risk in Alaska is uncertainty in calculating all the risks accurately like oil price, fiscal policy change, regulatory process and access to existing infrastructure on the North Slope. Because of the long cycle times, they have to take an extremely long view of price. Although the price of oil is \$50 a barrel or higher, over the last 10 years, the price has been closer to \$25 a barrel on average.

For a company like Pioneer that has no Alaska production, the oil price in 2006 is irrelevant. We look totally to what oil price will be over the next two or three decades to understand whether our investment decisions today are wise.

[4:57:44 PM](#)

Under the ELF formula, only very large fields would ever pay a significant portion of severance tax. The exploration credits entitle an investor to recoup either 20 or 40 percent depending on the distance from existing infrastructure. The exploration incentive credit fiscal system is primarily what encouraged Pioneer to invest significantly in some of the infrastructure-challenged areas - such as the far west NPRA. When they learned the severance tax policy was subject to being changed, they became quite concerned that it might be detrimental to a company like Pioneer and that it would be a departure from the fiscal system that prompted it to invest in the state in the first place.

MR. FOLEY said he recognized that the existing severance tax program on the North Slope was not sustainable and was pleased that the PPT taxes profits as opposed to revenues. It makes sense that additional assessments are added after companies have recouped their investments. Pioneer is pleased to see the provision regarding deductible transitional capital and agreed with the Administration that the PPT would provide positive economic incentives for investment. It would entice more companies and ideas to Alaska that would lead to smarter field development methods, drilling and production management.

Tradable tax credits are a particularly effective incentive for exploration and development of new resources. Under the PPT the Alaska challenges are at least partially offset by the ability to monetize the credits shortly after investment. A tradable tax credit would lessen the negative financial consequences of all the inevitable dry holes that the explorers would drill.

However, he said Pioneer has a significant concern about the potential liquidity of the tradable tax credits. It would continue to invest heavily in Alaska for the next several years, but only a handful of potential buyers will be able to buy the tax credits and layer that on the fact that no single purchaser can offset their tax through using the purchased credits by more than 20 percent.

MR. FOLEY explained that the way the credit works, they would sell the credits into the market at a discount and, no doubt, the buyers of the credits are clearly entitled to recoup their transaction costs. But he was concerned that the discount would be significantly greater than the company's actual transaction costs and that an individual could use more than one.

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CHAIR WAGONER said he was told that some credits had been sold for 45 cents on the dollar - and not 95 cents. He asked if that was true.

MR. FOLEY replied that he hadn't heard that. He said he had personally sold credits that were discounted from full face value by only a few percentage points. However, will all this in mind, he suggested that the Legislature consider a refundable credit program with limitations to protect the state's cash flow in the event of low oil prices. The state could refund money at a modest discount from the full face value. This would allow the state and not a third-party buyer to benefit from any discount that a seller might be willing to accept.

[5:03:59 PM](#)

MR. FOLEY stated that the PPT improves Alaska's competitive position from the middle of the pack - according to Dr. van Meurs. But he said to attract companies of Pioneer's size or smaller, the system should be at least as competitive or more so than U.S. Lower 48 opportunities.

Today with the prevailing high gas prices, there are very, very large resource plays that are attracting huge amounts of capital. When I talk about a resource play, I'm talking about plays that specifically target tight sands, shales, coal bed methane. These are plays that again today are attracting huge amounts of capital. They are relatively low risk; they're relatively low cost and they have very short cycle-times when compared to the North Slope. 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.

[5:05:45 PM](#)

He liked exempting the first \$73 million of cash flow from taxation which would help deliver an investment climate more consistent with the system that initially encouraged Pioneer to explore in Alaska and would help offset high startup costs. The obstacles to new investors are high and include small discoveries, access to infrastructure and being risky or a combination of all three. In summary, he said:

We believe that the proposed PPT is a balanced program with appropriate incentives to encourage new investment. We encourage the Legislature to carefully evaluate the proposal and take care to ensure that any changes make the state more competitive. Finally, we would respectfully ask that you consider a tax credit program that would allow the tax credits to be refundable. A program like this would allow a new investor the full-intended advantage of the tax credit program.

CHAIR WAGONER thanked him for his presentation.

[5:08:28 PM](#)

SENATOR ELTON asked if he thought investment in Alaska was competitive with that in other states.

MR. FOLEY replied that he couldn't comment on investment in other states, but he worked in Alaska for companies that didn't intentionally explore for gas and found it anyway. He felt that there would be a way to monetize the gas assets, but that time would be a decade or more away.

[5:09:47 PM](#)

SENATOR BEN STEVENS recapped that Pioneer worked with long-term contracts and asked him if he could share the ranges of a stress price analysis.

MR. FOLEY replied that he would be reluctant to share absolute numbers that he considers proprietary. In general, in evaluating a project, people tend to oversimplify investment decisions. It's not a simple process. Pioneer considers a distribution of costs, production rates and various price scenarios.

SENATOR BEN STEVENS asked how an increase in tax rate would affect his evaluation.

MR. FOLEY replied that a modest tax increase doesn't have a big impact on a small investor like Pioneer, but the refundable tax credit and the \$73 million floor do. He quipped that the prospect of paying a large production tax is "relatively attractive" to a small company whose production is now zero.

SENATOR BEN STEVENS pointed out that elements of the proposal affect industry participants in separate ways.

[5:13:25 PM](#)

SENATOR THERRIAULT asked if he could have justified the royalty modification in the 180(j) mechanism if the PPT was in place for Oooguruk.

MR. FOLEY replied that hadn't been evaluated yet, but he explained that when the investment decision was made on Oooguruk, Pioneer's expectation was that the severance tax would be zero or nearly so at the very end.

SENATOR THERRIAULT asked if his company ran models of the four-year step back in royalty rates on Oooguruk and what the calculations were.

MR. FOLEY replied yes. Pioneer's initial request was that the royalty at Oooguruk be rolled back to a fixed 5 percent forever. The state said that was not acceptable and a bargain was made that at payout it would begin increasing and then after four years go back to one-eighth or one-sixth depending on what the lease terms were.

SENATOR THERRIAULT said he understood that the state's evaluation after the fact was \$58 million and net present value was \$9 million. He asked if he valued that particular four-year stair step the same way.

MR. FOLEY replied yes, but added that it's also likely that Pioneer's valuation would have been different.

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SENATOR STEDMAN went back to investment credits and said he hoped they could be sold into the market in the high 90s.

MR. FOLEY said his expectation is that he could sell into the market in the high 90s, but there aren't many buyers - potentially four or five. He said that Pioneer is drilling an exploration well this winter that would generate exploration tax incentive credits at a rate of 20 percent and it is soliciting bids to sell those credits, but it hasn't received offers yet.

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SENATOR BEN STEVENS said the credit is issued against a liability to the state under the concept of the state having to essentially refund that credit to its holder and asked if he knows of any system that uses that policy.

MR. FOLEY replied that he knew of none.

SENATOR THERRIAULT asked how the five-year look back would affect his company.

MR. FOLEY replied that Pioneer had only been in the state for three years, but its investment was in the ballpark of \$100 million and since the effective date of this proposal is July, between now and July, Pioneer would invest approximately another \$50 million to \$60 million.

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SENATOR STEDMAN asked if Pioneer would be better off if the effective date were moved to January 1.

MR. FOLEY replied probably better off.

CHAIR WAGONER thanked him for his presentation.

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JIM WEEKS, Managing Owner, UltraStar Exploration LLC, said that it is a small company that is all Alaska-owned and explores on the North Slope. The company was formed in 2002 by Mr. Weeks, John Winther and Dale Lindsey for the primary purpose of exploring and developing leases on the North Slope.

He strongly supported SB 305 and the positions of existing producers, independents and explorers on this issue. However he offered the a few comments. He said UltraStar supported the 20/20 provisions and the \$73 million deduction allowance in the bill. But he has learned that the \$73 million allowance could be a difficult pill for the Legislature to swallow if it were

granted to all companies in Alaska regardless of the size of their cash flow streams and it might be eliminated. He encouraged them to not eliminate it and suggested an alternative that would still provide incentives for exploration and development of smaller fields. He suggested establishing a ceiling above which larger companies would not get the \$73 million allowance and below which the smaller companies would. He elaborated:

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 one 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 and establishes 5,000 barrels per day as a maximum amount of crude oil that a qualified producer can produce to receive the preferential treatment.

MR. WEEKS said the Legislature could decide the appropriate ceilings, but he thought this two-tiered approach would provide incentive for entry by small newcomers without giving an undeserved windfall to the established players.

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He said his last issue could be significant for small independents. He explained:

It regards the exclusion of "amounts paid for purposes of indemnification" on page 14, line 15, 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 requirement of the Departments of Natural Resources and the 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.

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CHAIR WAGONER thanked him and said they would review his suggestions.

[5:34:04 PM](#) recess [5:34:25 PM](#)

KEN THOMPSON, Managing Director, Alaska Venture Capital Group (AVCG), said his is an independent oil exploration company with a focus on the North Slope. AVCG is a consortium of 15 independent oil and gas companies and individuals from Kansas with Mr. Thompson as an owner/investor from Alaska. His company has acquired over 60,000 acres of exploration leases in five prospect areas including new acreage acquired this morning. Its exploration strategy is to explore in the central part of the North Slope for fields in the 25 million to 100 million barrel range, fields that may be too small for the giant producers, but fields that can be produced profitably by smaller companies like his. He believed there are hundreds of millions if not billions of barrels of oil left on the North Slope in small fields.

He related AVCG's activities:

Our company is excited to report that the first exploration well AVCG will participate in with an ownership interest should have started drilling last night - the Cronus exploration well about 10 miles

southwest of the Kuparuk Field, operated by Pioneer Natural Resources. We plan two exploration wells next winter and two the winter after that. With success, we will continue exploring and producing.

MR. THOMPSON reported that his exploration budget for the next three years is \$46 million. He related further:

Many of you also know me as the past President of ARCO Alaska, Inc. I also served as Executive Vice-President for ARCO and head of global oil and gas exploration for ARCO. I do have exploration and production experience in over 20 countries throughout the world. So, I'll also share my perspective in how I see the new production profits tax bill in the context of competitiveness in the world.

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In my first week as President of ARCO Alaska in June 1994, our ARCO staff reviewed state policies with me to educate me about the oil and gas industry in Alaska. One of the key items they reviewed was the production tax and the very complicated policy of ELF. Our government affairs personnel told me that ELF was in jeopardy - that the production property tax was going to be changed. That did produce uncertainty in our project economics forecast. Every year since then, production taxes and the ELF have been topics and uncertainty remains. Sixteen years have passed since that meeting and every year I hear discussion about production taxes, ELF and the imminent threat of change. I welcome change and I say, "It's time to put the new system into effect and let's get on with it."

MR. THOMPSON said he supported the PPT as long as the most important terms remain as written. He supported the progressive, profit sharing type structure versus a regressive, straight tax on gross revenues. That way the state would share the gain at high oil prices, but would also share the pain at lower oil prices. This helps the smaller investors limit their downside risk in the event of price collapse.

He reminded the committee that in addition to the 20 percent production tax the state would receive from AVCG, it would also continue to receive a 12.5 to 16.67 percent royalty share of all revenues, the oil and gas property tax, corporate income taxes and other revenues.

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The investment tax credit ass another key for AVCG. It creates a very clear incentive to return that into investment for new exploration rather than take the money outside. He thought it would be attractive to other companies as well. But companies that were already planning to send their cash flow outside Alaska would probably not be convinced to keep it here.

MR. THOMPSON listed the things that should not be changed from his company's position. He thought the 20/20 was a good balance and neither should be changed. He said, "With a tax credit of 20 percent and redeployment of the tax savings back into our exploration in the state, we can essentially drill an extra exploration well for each five exploration wells we currently have budgeted."

It was also important to keep the \$73 million annual operating cash flow standard tax deduction. However, he didn't see how the public would understand and agree to that and suggested changing the exemption to 5,000 barrels a day net. That would help AVCG get its feet on the ground and it would be an easier policy for the public to understand. A large producer could also get the 5,000 barrels exemption, but still have to pay production profits tax on the other perhaps 295,000 barrels it produced.

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MR. THOMPSON then talked about the things that should be changed. While being able to sell investment credits to others in industry, if a new explorer does not yet have oil production revenues to use the credits sounds good, the major producers are the only ones who would buy the credits and, therefore, they would set the price for them. That would not be favorable to new explorers because the credits might be sold at only 70 - 75 percent on the dollar and the major producers would take 100 percent of the acquired credit against their production tax bills. He recommended that:

The state consider establishing a pool of dollars from the production profits taxes taken in to buy the tax credits from small explorers. This makes sense. The state would not be giving up anything because the major producers would otherwise use the credits to reduce their tax bill and reduce revenue to the state. But using this approach, the small explorers could turn around and reinvest the state-refunded credit into new leases, seismic or exploration drilling. In

fact, the state might want to stipulate that if the state refunded the tax credits to a company, that company must use it for exploration or development. Our company would support such a concept. Explorers who don't want to do this option and reinvest in the state, but just want the cash value of the credit could sell it to the majors at 70 to 75 percent if they prefer that option.

The section in the bill on "determination of net value of oil and gas" listed direct costs that could be deducted from gross oil revenues to calculate a profit or "net value of oil and gas" to then be taxed at the 20 percent tax rate. For a new explorer in Alaska the startup costs in the state can be very substantial, particularly for smaller players. This can include high costs for bonding, participation in the oil spill consortium, Alaska Clean Seas, indemnification insurance, etc. These types of costs should be clearly mentioned in the bill as deductible.

MR. THOMPSON summarized his presentation saying he hoped the \$73 million deduction remained and that legislators would remember how important it would be for the smaller companies to establish a foothold in Alaska. He elaborated the alternative he suggested earlier saying:

As an alternative, however, to the \$73 million profits exemption, we offer that the state might choose to use an approach that the state has already approved in the 1999 "Charter for Development of the Alaskan North Slope" between the State of Alaska, BP and ARCO. In that charter, there was a section entitled "Purchases From Qualified Producers" that guaranteed that BP and ARCO (now ConocoPhillips) would agree to offer to purchase any "qualified producer's" crude oil so that new entrants or small producers would not be disadvantaged in marketing their oil. In that section there was a clear definition of a protected "small producer." Actually, the charter called such a "qualified producer."

I quote from the charter: a 'qualified producer' means an entity with assets of less than \$1 billion (worldwide) which produces not more than 10,000 barrels of gross working interest ANS liquid hydrocarbons per day. Again, we hope the deduction

provision remains in the bill. If there is opposition in the end, AVCG does hope the small companies are protected in some way. Perhaps an innovation such as using the Charter guidelines may help.

He thanked them for the opportunity to make comments.

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SENATOR THERRIAULT asked him for an example of a market where credits would be sold at the low range of 70 to 75 percent on the dollar.

MR. THOMPSON replied that he didn't have such an example. AVCG just used that figure in its model. The past market has been at 90 to 95 percent of the credit and he hoped that continued. This is new ground and a lot more credits might be available through PPT than ever before at one time and that could affect their value. Even if the credits go for 95 percent, the majors would turn around and use the full 100 percent. He, on the other hand, as a small producer, pledged to use the full 100 percent for exploration activity.

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SENATOR BEN STEVENS asked him to expand on page 3 of his testimony where he said he panicked at a 25 percent PPT. He asked him to compare his position as a small company that wouldn't be subject to the tax rate for many years to that of Mr. Foley's of Pioneer, who said it wouldn't affect him.

MR. THOMPSON replied that AVCG hoped to be a sizeable producer in three years and at the taxation level. However, when he ran the economics for its prospects at a tax rate of 25 percent, he found that:

Interestingly, it wasn't too much different than the current system - not dramatically different, anyway, as far as an investor's rate of return. However, when we ran the tax rate at 20 percent, we found that our near term cash flow was better. The state was taking less although, after payout and after the tax credit was gone [indisc.]. The state was taking more share of the profits and we were having less cash flow. I'm okay with that, because that means we get a faster payout with a better cash flow near term and we get a higher rate of return. And when I go to Houston in the last year and try to get partners, this rate of return, this rate of return hurdle, sometimes for other

partners, particularly in the private equity markets.... I think we could attract more capital to our company for additional drilling. So, that's really why I say that the rate of return wasn't all that much different at a 25 percent rate, but at a 20 percent rate, it really did help us....

He also informed them that private equity was not as available for exploration as for development.

SENATOR BEN STEVENS commented that the mechanisms in SB 305 affect each company differently. For a company that is seeking capital, a fixed rate at 20 percent improves its ability to do that - even though it is not a ratepayer for many years.

CHAIR WAGONER asked what would happen to his company at rates of 25/25 and 25/30.

MR. THOMPSON said he would run those numbers for him, but his feeling was that 25 percent just didn't seem fair.

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SENATOR THERRIAULT said even if the tax rate is locked in for a long period of time and the state is not getting the activity it wants, it could probably be lowered without much trouble. But, the state might not be able to increase the rate as easily.

MR. THOMPSON said he understood that concept, but it would be nice to know everything up front. He repeated that the 25 percent crosses his fairness threshold.

SENATOR THERRIAULT asked what effective corporate tax rate he expects for his operation.

MR. THOMPSON replied that AVCG used a 9.4 corporate tax rate from a conservative standpoint.

SENATOR THERRIAULT also noted that when they are talking about "government take," that includes the federal government take as well.

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SENATOR STEDMAN commented that when they talk about the difference between a 20 tax and 25 percent tax, from a company's point of view, the total government take is changed only by about 2 percent.

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CHAIR WAGONER thanked Mr. Thompson for testifying and said the meeting would be recessed until tomorrow. He then recessed the meeting at 6:03:33 PM.