

**ALASKA STATE LEGISLATURE  
LEGISLATIVE BUDGET AND AUDIT COMMITTEE**

October 18, 2007

10:37 a.m.

**MEMBERS PRESENT**

Representative Ralph Samuels, Chair  
Senator Lyman Hoffman, Vice Chair  
Representative Mike Chenault  
Representative Mike Kelly  
Representative Mike Doogan  
Senator Lyda Green  
Senator Bert Stedman  
Senator Johnny Ellis  
Senator Gene Therriault  
Representative Reggie Joule  
Senator Charlie Huggins

**MEMBERS ABSENT**

Representative Mike Hawker  
Representative Kevin Meyer

**OTHER LEGISLATORS PRESENT**

Senator Con Bunde  
Senator Fred Dyson  
Senator Kim Elton  
Senator Hollis French  
Senator Bill Wielechowski  
Senator Gary Wilken  
Representative Bob Buch  
Representative Harry Crawford  
Representative Nancy Dahlstrom  
Representative Andrea Doll  
Representative Bryce Edgmon  
Representative Anna Fairclough  
Representative Les Gara  
Representative Berta Gardner  
Representative Carl Gatto  
Representative David Guttenburg  
Representative Lindsey Holmes  
Representative Craig Johnson  
Representative Wes Keller  
Representative Beth Kerttula  
Representative Mary Nelson

Representative Mark Neuman  
Representative Kurt Olson  
Representative Jay Ramras  
Representative Bob Roses  
Representative Paul Seaton  
Representative Bill Thomas

#### **COMMITTEE CALENDAR**

PRESENTATIONS BY DR. PEDRO VAN MEURS AND DANIEL JOHNSTON -- HOW PPT IN ITS CURRENT STRUCTURE COMPARES TO SIMILAR OIL PROVINCES AROUND THE GLOBE; AND A DISCUSSION OF COSTS

#### **PREVIOUS COMMITTEE ACTION**

No previous action to record

#### **WITNESS REGISTER**

PEDRO VAN MEURS, Ph.D., President  
Van Meurs & Associates Limited  
Nassau, Bahamas

**POSITION STATEMENT:** Provided comments.

DANIEL JOHNSTON, Owner  
Daniel Johnston & Co., Inc.  
Hancock, New Hampshire

**POSITION STATEMENT:** Provided comments.

#### **ACTION NARRATIVE**

**CHAIR RALPH SAMUELS** called the Legislative Budget and Audit Committee meeting to order at [10:37:01 AM](#). Representatives Samuels, Doogan, Chenault, Joule and Senators Hoffman, Ellis, Therriault, Huggins and Green, were present at the call to order. Representative Kelly arrived as the meeting was in progress. Also in attendance were Representatives Buch, Crawford, Dahlstrom, Doll, Edgmon, Fairclough, Gara, Gardner, Gatto, Guttenburg, Holmes, Johnson, Keller, Kerttula, Nelson, Neuman, Olson, Ramras, Roses, Seaton, Thomas and Senators Bunde, Dyson, Elton, French, Wielechowski, and Wilken.

^PRESENTATIONS: HOW PPT IN ITS CURRENT STRUCTURE COMPARES TO SIMILAR OIL PROVINCES AROUND THE GLOBE; AND A DISCUSSION OF COSTS

CHAIR SAMUELS announced that the first order of business would be a presentation by Dr. Pedro Van Meurs, and invited opening statements.

[The following is an uncertified verbatim transcript.]

[10:39:19 AM](#)

SENATOR ELLIS: I appreciate just being able to make a brief statement. There is something that's been bothering me, and I need to get it off my chest and at the risk of putting the damper on some of the good feelings of all of us being back together to revisit this issue and the upbeat mood this morning. I have to say that I'm upset and somewhat stunned that Mr. Van Meurs is back before us. At the outset, last year, I was impressed with his international credentials. Actually, once documents came out, I believe it was Representative Kerttula [who], on behalf of her caucus, ... showed that Mr. Van Meurs was saying, in private, things that I've found out since ... were more in agreement with my position during the PPT (petroleum production profits tax) debate, and that in public, were very different. I felt intentionally misled; the press, the public, the Alaskans. And was distraught to see that Mr. Van Meurs was basically making my arguments in private with the previous executive on the 20 percent vs. 25 percent: ... he was for 25 percent tax rate and then changed to 20 and was an enthusiastic cheerleader for 20 percent. On the issue of Alaska being treated as a banana republic, it's all in a document here that I would be happy to provide to any of the legislators who would like to see it. ... These comments are meant to be instructive, an object lesson for some of the newer colleagues among us. So, I will take Mr. Van Meur's presentation with a grain of salt, based on not just suspicions but the actual documents that show that he was giving good advice to the previous executive in private and saying something very different in public. When a legislator does that to me, and it's happened to me before that a legislator intentionally misled me, I'm done with that legislator. When a hired consultant does the same thing - I'm done with that consultant. So, we'll listen to the presentation today. I'll try to be respectful and take from it what I can, but I just want everyone to be mindful that private advice and public advice were very different in the very important PPT debate that we're back here to revisit. And we should keep that in mind.

[10:41:45 AM](#)

CHAIR SAMUELS: OK, thank you for the comments. To let the public and the members who were not in attendance at the last LB&A (Legislative Budget and Audit)[Committee] meeting, I've had requests for both Dr. Van Meurs and Mr. Johnston separately. And the agreement I made after discussion at the LB&A meeting was I would try to hire both Mr. Johnston and Dr. Van Meurs, or I would hire neither. Going from this point forward, I've had requests at various committees for one of them, or the other one of them. And as far as LB&A goes, there are plenty of other people in this building that have a budget that can hire whomever they want. As far as this committee goes, I will not hire either one or the other. And I have respect for both of their opinions. I had dinner with Mr. Johnston and Dr. Van Meurs last night, and, I want to make this absolutely clear and I told them both this and I want to be absolutely clear in front of everybody, I said 'I have no opinion on what you say. I want you to tell me what you think about the state of the world and the economics of this.' We talked about some of the memos. I'm sure that Dr. Van Meurs will be able to answer some of those questions. Everybody in this debate, ... has baggage attached to them, in some way shape or form; every consultant, probably most of the legislators, that were here. I'm hoping that for the next 30 days that all of us tend to listen to the issues again. I've gotten the feeling already a lot of people are backed into their corner already and saying 'I thought this way last time and I'm going to continue to think this way.' And I hope we get more information. So at the last LB&A meeting, the agreement that I made, and it was sheer luck of the draw that they're both available on this day .... Dr. Van Meurs is leaving tomorrow, Mr. Johnston has one extra day, I believe - where are you Daniel [identified in the gallery by a raise of the hand], and so I've got the two of them. And I still think it was best to try to get, particularly for the new members, all of the information; how we got to where we are and where we should go forward with this. So that's the balance that I tried to strike. I appreciate your comments. Are there any other opening comments that anybody would like to make? I'd like to go through the presentation and if there is a quick question to ask on clarifying a term, or something, then I think we can interrupt and go down that road. I'd rather wait until the end to ask any questions on the substantive policy. At the end of Dr. Van Meurs presentation, we'll probably take a lunch break and then Mr. Johnston can come forward and we'll just kind of see how it goes. But at the end, if there are disagreements or agreements between what their two statements are, we can have them up here together and they can try to hash out (indisc). So we have a general idea of the varying opinions we have on a

global stage. One other announcement to make is the LB&A web site, and I don't have the exact address for that web site. We've attempted to put everything from the governor's proposal, on that web site, all of the presentations that have been given to us, any memos that have come out of LB&A. We've tried to have all of that information on a kind of a one-stop-shop so you can be at both the legislative side and the administrative side, and we'll work with Ms. Davis to make sure ours is updated, we'll give her any information so if people are going to that web site. So everybody should have access to all of these presentations and any correspondence that goes back and forth between the legislature and any committees .... We'll do our best ... so that you can go to one place if you want to pick out Dr. Van Meurs presentation, the governor's presentation, an oil company or who ever, we should try to get everybody on there for ease, as best we can. With that, welcome back Dr. Van Meurs, and the floor is yours.

[10:45:42 AM](#)

DR. VAN MEURS: Mr. Chairman, what a wonderful pleasure to be back in Juneau and discuss PPT all over again; round two. That is a very interesting experience. 'Tis wonderful to reacquaint myself with all the friends and colleagues we had. I must also say, I'm very happy, as I mentioned to you, to escape from the battle of Alberta [Canada], because it is so nice to come back to a place that is so quiet and so peaceful, as we have here. So consequently, that is a wonderful experience. What I like to do is lead you through my views on the PPT. First, I like to explain why the PPT was the way it was, then I like to make some comments on the legislation ... that I understand, is going to be introduced.

[10:46:45 AM](#)

DR. VAN MEURS: Firstly, what I would like to say is I would strongly recommended not ... to make any changes to the PPT law, other than a number of very good transparency provisions that I have found in the law, that I found very encouraging and stimulating and that I think are very appropriate. Let's not forget, Governor Murkowski changed the rules Prudhoe Bay, then the PPT was introduced. If now, in another year later, we make amendments again to the PPT, quite frankly you become a basket-case of instability, and I think from an international perspective it would be ... creating a very negative image, I think, for Alaska if you are being perceived to making fundamental changes to such an important package kind of every

year. And consequently, ... I would definitely not recommend to make any changes.

[10:48:02 AM](#)

DR. VAN MEURS: Also, I would not recommend to make any changes because the legislature, in it's great wisdom, already passed provisions in the previous law that provide for a review period in the year 2011. And consequently, why was the year 2011 chosen, why was that year picked? That year was chosen because, by that time, it was felt that we would have enough information, there would have been one or two audits done, we would have maybe at least two completely audited years, we would have enough information to really know ... how the PPT actually works. And consequently, it was always contemplated that in 2011 that there would be a review of this. It was clearly spelled out how that would work ... I still believe is the right moment to do so. That is the time when we really will know what the actual costs were, that is the time when we really will know how much investments is really stimulated by this law and what the administrative difficulties and problems are. So consequently, I still believe that there was great wisdom in including that review clause, and I simply believe that is what the legislature should stick with. Let me explain what the current system was, why was the PPT introduced, what was the effect on the overall government take.

[10:49:37 AM](#)

DR. VAN MEURS: Here you see what I call a government take map. Actually, this is taken directly out of my report for the government of Alberta. As you know Alberta is currently reviewing the royalties on the oil sands, as well as the conventional oil and gas. And consequently, in particular with respect to the oil sands, the Alaska fiscal system was an important bench mark because it was a recently introduced fiscal system. And consequently, what I did is I compared say the fiscal system in the oil sands with the fiscal terms that had been recently passed in Alaska. Here you see the average government take, the figures are maybe somewhat difficult to see, but in your handout you can see that approximately the undiscounted government take is about 60 percent or so. And if you - what is very important, if you go from the top to the bottom of this chart, you've got increasingly higher prices. If you go from the left to the right, you get into increasingly lower costs. So cost level seven is about \$20 a barrel, cost level one is about \$9 a barrel, and that represents the entire

scale of cost - cost per barrel and capital cost and operating costs on the North Slope. So you see any feasible possible combination and permutation of cost and revenues on that chart. What you see from that chart, is that if you go from the top to the bottom that, once you exceed about \$60 U.S., then government take very gradually goes up and reaches about \$66. Call that, as we discussed so many times before in this legislature, a price progressive system. If you go from the left to the right, from the most costly to the least costly project, you see that the government take goes up slightly not very significantly, so the system is slightly progressive with cost. Now, the last, both features of that government take were of fundamental importance. The first fact that the government take goes up this price is an international phenomenon. And we wanted to see the costs going up. Most governments around the world like to see the government take going up at this price because it is fair for the owner of the resource to get a higher share of the wealth of that resource if the resource is more profitable as a result of higher prices. And this legislature included the price progressive feature, and by the time we get to very high prices that price progressive feature is upsetting the effect of the royalty, which is regressive in its nature and actually creates a somewhat progressive system (indisc.) price in totality.

[10:52:52 AM](#)

DR. VAN MEURS: What is more important for the understanding of the PPT is what happens from left to right. Let's not misunderstand, the PPT was designed for a very important reason: And the PPT was designed to make the next large generation of oil deposits on the North Slope, the half-year oils, economic. Now, these resources are also more costly, and consequently the concept of the PPT was to stimulate these more costly resources. And how was that done? That was done with the particular features that you approved: the 20 percent credits that we had, and the carry forward credit. And consequently, this was done by providing incentives for these higher cost fields so that these higher cost fields would become economic and could contribute to reducing the drop in production from the North Slope. That was, and as you look at this chart, what you see is that the government take is slightly less ... for the expensive fields than for the less expensive fields. Now, if you would have, for instance, just a flat royalty, or for instance as I understand some legislators also at that time proposed that maybe you would just have a 10 percent flat, say, severance tax or production tax, what would happen? Then you would create a

very regressive system and for the high cost fields the government take would ... go up, and for the low cost fields it would go down. And you would achieve exactly the opposite of what you want to achieve. That means the high cost fields will become uneconomic, and it will not be attractive to produce the heavy oils from the North Slope. So, that is why this system was specifically designed to incentivize oil companies to work on the technology and make the investments in the next generation of resources. The only generation of resources that, up to now, we know we have.

[10:55:09 AM](#)

DR. VAN MEURS: The next slide shows exactly the same table, but now at the 5 percent discount rate. Government often likes to see a 5 percent discount rate, because that reflects, kind of, the discount rate of governments. What you see here is the table looks relatively similar, ... although, in this case, the cost situation is somewhat flattered. So, consequently, what is very important is: the current system was designed to be sensitive to costs, and thereby make the investments into heavy oil develop in subtractive. It was also designed to make a price progressive.

[10:55:54 AM](#)

DR. VAN MEURS: A very important unique feature of the PPT, ... that really was unique for Alaska was the tradable credits of the 20 percent on the capital expenditures and as well the tradable credits on the loss carry forward, which made it very attractive for new companies to come in and to start working on the North Slope. Because, at the time, it was explained to me that an important objective of Alaska was to not only incentivize the new, but incentivize investment. Also, Alaska wanted to find a broader range of investors, particular investors that probably were interested in the ... smaller opportunity; medium-sized companies interested in smaller opportunities. Now, it is difficult to say after one year or one-and-a-half year what the effect is, but for sure we are already seeing some remarkable developments in the North Slope with Pioneer and others that clearly seem to respond to this kind of legislation. In order to encourage the reinvestment in further heavy oil development, an important feature of the PPT, contrary to some other profit sharing systems in the world, is that the PPT was completely consolidated.

[10:57:41 AM](#)

DR. VAN MEURS: That means you only present one PPT return for all of Alaska with the objective that it doesn't matter where you make your profits in Alaska, it doesn't matter where you reinvest in further development of the resources. Whenever you have these capital investment you can benefit from these credits, and you can use them directly against your PPT payable. Consequently, the consolidated effect of this PPT was very important, it was a very important instrument to encourage the reinvestment in Alaska. Now, as we all knew, and ... as we see today coming back after a year, it is indeed very indicative oil production is declining and, obviously, if this goes forward for another 10 or 20 years and if there is no gas development, obviously Alaska will be in very difficult shape. And consequently we, ... absolutely have to find ways of maintaining oil production at a higher rate. And that was the core philosophy of the PPT: maintaining production, creating a future by developing the technology to develop the higher-cost resources that are the only large rates resource that we know of in terms of oil on the North Slope.

[10:59:15 AM](#)

DR. VAN MEURS: As I mentioned, when I read the proposed law, the bill, I was very pleasantly surprised by a real effort that seems to go into that bill to create a higher degree of transparency, which I think is ... very important. As I said I'm just coming out of the battle of Alberta and the lack of transparency there was severely criticized by the Royalty Review Panel and consequently that is definitely something that people are looking for. They like to know how things are administered, they like to see the figures, they like to know the cost, they like to have the information on the basis of which, say, in 2011 you can then change the fiscal system. It is also good (indisc.) absolutely excellent measures being proposed in this legislation ... to make auditors an exempt class so that you really can attract the best people to administer this, this law. I personally believe that the initiatives in this bill for greater transparency, for stronger administration, for better administration, should all be strongly supported. And if the only thing you do this month is approve together stronger support for your administrators, then you've done a good thing. So consequently, that is a very important feature of the law.

[11:01:00 AM](#)

DR. VAN MEURS: And I believe those changes you can implement without making the impression that you are changing fiscal terms every year, because they don't go to the matter of fiscal terms, they go to the matter of the administration and the transparency of the fiscal terms, and, certainly, that needs to be improved. So, I think, I personally welcome enormously those very good initiatives in the bill. Senator Ellis made comments that I made comments in private that I didn't mention in public. Now, I'd like to say I published reports that were available for everybody. So, consequently, my comments, what my advice was on the PPT, [were] well documented. I have three reports that I'd like to mention here and consequently what my opinion was on the PPT was crystal clear. I not only told you about it, there are extensive reports that were submitted to legislators and to the governor for release and that are in your possession, so consequently I think you had a perfectly crystal clear view as to what my personal opinions were as far as the PPT. ... I'm not recommending making any changes - but if you want to make changes, I would simply invite you to go to my previous reports and read them, and then simply implement them. That's all you need to do, I think, to get to a good PPT. Let me go through some of the recommendations that I made in February and in March in writing.

[11:02:48 AM](#)

DR. VAN MEURS: Firstly, in my February 14 report, it was well-documented that I recommended a 25 percent PPT rate. And, then, in the discussions between the governor and the oil companies in his wisdom he decided to make it 20/20. But there is no question about it that I recommended 25/20 ..., that was my recommendation. Today, that recommendation is still up-to-date. What has happened in the world, we have seen, indeed, the tendencies that I explained to this legislature that government takes are going up all over the world, and by going to 25 percent Alberta certainly doesn't lose competitiveness - as I also testified in front of you. Therefore, today, I simply reconfirm this recommendation. If you want to go follow my recommendation that I made earlier and go to 25 percent, that is what I recommended in the first place. So, if that is what you want to do, I wish you good luck. That is perfect as far as I'm concerned. Also in my February 14 report, I did not recommend the claw back position. And I like to underline that very clearly. You can read that again. I did not recommend the claw back position. Again, in the negotiations with the oil companies, the governor decided that it was better to include the claw back provision, but I did not recommend it, that is

black and white. So, consequently, if you like to delete these transitional investment expenditure credits, I think it is a good step. That's what I recommended in the first place. I think that is a very good recommendation in the new bill, it merely crystallizes the recommendation that I made earlier. ... If you want to change the law, and if the legislature believes it is important to change the law, then scrapping these transitional investment expenditure credit is a good measure. It doesn't make any sense, in my opinion, to have these credits. You don't reward companies for past performance. You don't give Oscars for nice oil companies in the form of \$200 million here and \$200 million there.

[11:05:32 AM](#)

DR. VAN MEURS: That is not the role of government. The role of government - past investments and some costs cannot be changed anymore, and consequently fiscal systems are always based on from now forward. Now, with the help of this legislature - as you know the claw back was designed originally just as a blanket claw back because I felt strongly about the fact that companies should invest in order to earn these credits - the legislature modified this feature with the famous 2 for 1 feature, which was then accepted in the legislature, and that was a good feature ... to at least ensure that companies that would obtain these credits would do some extra work for it as a minimum. So, that was a good change. But, as I said, I never recommended the claw back in the first place; that is black and white. ...

[11:06:37 AM](#)

DR. VAN MEURS: That brings me to the progressive feature ...: As soon as the 20/20 was adopted by the governor, the governor asked me to look at the possibility for the progressive feature, and I published, on March the fifth, a report that was also distributed in the legislature and to the governor and even to my friend, Daniel Johnston, here, to make sure he had ... looked at it and discussed it with me. So, consequently, I published a report as to how to include a progressive system.

Now, it was interesting to see that a new governor says the PPT should have a gross component and a net component. Now ... my March 5 memo explained how to create a gross component and a net component. I already recommended that to the legislature. So consequently, if you want to know how to do a gross component and a net component, just go to my March fifth memo and you will find it.

What did I propose on March the fifth? I don't personally like progressive systems based on nets as were finally adopted. My recommendation was to base a progressive ... two-tier system: ... a basic production tax based on the gross, and that would be a normal windfall profit tax, plus the PPT.

[11:08:34 AM](#)

DR. VAN MEURS: So, that was my recommendation on March the fifth. What was my recommendation for the progressive, basic, production tax? Now, here you see the formula from the report, .... based on West Texas Intermediate, minus 50, times .25, ... at the price of 84, ... follow[ing] my recommendation of March the fifth, what would you receive today: 8.5 percent on the gross, plus 25 percent on net. Now, that is what I call a combination of a gross and net system. Further, proposals were circulated in the legislature that based some of the scales on gross, but basically, it was a variation on what I had here. But basically, I believe strongly in a system that consists of gross plus net; that's what I proposed at the outset. ...

[11:10:26 AM](#)

DR. VAN MEURS: As I said, today, you would be collecting 8.5 percent on gross, and then in addition, you would be collecting 25 percent on net. But I had recommended that this basic production tax would then be a deduction for the profits tax. ... That is, I think, a far better recommendation than this government was coming forward with, where they say, "We're going to combine net and gross, but you don't see the gross; the gross is just in floor somewhere down there, which only applies under certain conditions." No, I proposed a real gross, plus a real net. That is gross plus net, not some kind of wishy-washy kind of ceiling of \$10, say, only on the gross fields. That only clicks in under certain conditions. Today, with this recommendation, you would have received 8.5 on gross, plus 25 percent on net. Now, at \$84 a barrel, aren't we in good shape, and what are you getting? So, consequently, that is why I think, I still believe today this was a good recommendation. It think this is a -- personally, I believe that windfall profit tax structures work better than sliding scales based on net. So, consequently, this idea of just dropping the 40 to the 30, I don't think is very effective. This is a far more effective measure.

[11:12:09 AM](#)

DR. VAN MEURS: So, consequently, this idea of just dropping the 40 to the 30, I don't think is very effective. This is a far more effective measure. As you may have read in the newspapers, I recommended exactly the same concept as a bitumen tax on the oil sands in Alberta. That recommendation was accepted by the royalty review panel, and that recommendation is now in front of the premier of Alberta. As a result, I don't see much purpose in this proposal of simply dropping the 40 to a 30. I consider that just -- that's just a band aid measure; that is not what you call a very strong measure, particularly - and I forgot to put that on the slide - particularly if you realize that event he slope is reduced at the same time from .25 to .2.

[11:13:05 AM](#)

DR. VAN MEURS: So, consequently, you're almost gaining nothing. So, consequently, that is a very inefficient, unpredictable measure that I don't think is very strong recommendation from the current government. I still believe that I like to reiterate that I like to reconfirm my own recommendation of March the fifth as a good measure. I think that was far stronger way of combining gross and net, and a way that applies to everybody equally.

[11:13:52 AM](#)

DR. VAN MEURS: Don't try to just select these oil companies that you like to hit and not other oil companies that you don't like to hit. I mean, if you do something, always try to maintain a level playing field. That is sound; that is good policy. So, I proposed a level playing field: gross plus net for everybody. That is fair. If oil prices are \$84 a barrel, everybody can pay.

[11:14:24 AM](#)

DR. VAN MEURS: Now, I like to highlight that if I would make this recommendation again, I would probably modify it a little bit to give some better support for the heavy oils, because definitely, the gross plus net is nice concept, but you would have to, you would have to, be somewhat more mindful of the high cost of heavy oils, and consequently, you don't want the gross plus net system to destroy the opportunity and destroy the upside that may exist on these heavy resources. So, I would say, the formula that I suggested to you in the first place I think is a good formula, but, in hindsight, if I had some more

time to work on it, I would definitely suggest some further modifications in that to make it more applicable to a wider range of fields - in particular the heavy oils.

11:15:38 AM

DR. VAN MEURS: There was another important recommendation that I made in my May 1 report, which was discussed, vitally discussed, among you and was not excepted, but I still believe that if you want to change the PPT, that is a very important change to make. So, a very important change to make. I recommended on May the first the so called gross review exclusion, whereby, for PPT purposes, 64 percent of the gross value for all the gas would be a deduction for the calculation of the PPT. In other words, I feel strongly that you cannot apply the same PPT that you have for oil to gas that are entirely different resources. If you want to export gas, you should by now know that you need a very expensive transportation system, and consequently that exporting gas from Alaska and exporting oil from Alaska are entirely different challenges for any investor that likes to pursue that.

Most nations that export gas over long distances, like my client Trinidad, for instance, or like Malaysia, or like Indonesia, or like Qatar - all the nations that have been very successful in bringing gas to the Lower 48 - my client Trinidad has been extremely successful. They now supplied or in 2006 they supplied two-thirds. Just think about that: a tiny little island in the Caribbean is supplying two-thirds of the LNG imports of the United States. Just think about that. And why were they successful and why is Alaska not successful now? The reason is very simple. Trinidad and Tobago understood that gas is very different resource than oil, and if you want to be successful in the export market, your fiscal system - your government take for gas - should be less than for oil. And consequently, that is why I recommended the gross review exclusion, and that is why I still would recommend that today.

11:18:14 AM

DR. VAN MEURS: The gas project today, as we will discuss later, is obviously in deep trouble. The costs have escalated beyond belief. If you want to have any hope of exporting some time over the next 20 years some gas from Alaska, you have to become realistic about the fiscal terms for gas. And that means making the government take for gas less for gas than for oil. As I mentioned, that is why I like to reconfirm today my recommendation for the gross review exclusion.

[11:18:58 AM](#)

DR. VAN MEURS: Over the newspapers I heard much discussion about these consultants to this government - the past government - that failed to understand the enormous cost increases that were going to occur. And I had -- saw even a quote, and I don't want to attribute that directly to the governor, but I saw a quote in the newspaper that said [it is] incredible that these consultants didn't know that there were going to be cost increases.

[11:19:39 AM](#)

DR. VAN MEURS: Now, let me tell you, I provided you with ample and precise information about all the cost increases. I'm going to show you a slide that I showed you nicely in the hall down, down from here, when we were discussing the gasoline. Look at my slide. I said the economic evaluations are based on the \$21 billion project; however, costs have already escalated significantly. In particular, steel prices and regional escalation in Alberta now. So, I told you: costs have already escalated significantly. So, how can the government, the government say that nobody told us? I told you.

Now, at that time, you didn't want to believe that, because, of course, you all thought, "Oh, Pedro's just selling the gasoline, so, consequently, that's probably not true." No, it was true. Costs were escalating like crazy, and consequently, that is why I put that in front of you. In fact, I made an even stronger slide in the same presentation to you when we introduced the gasoline. I said, "The combination of gas price risk and cost overrun risk creates a possibility that the project may not be built in the next decade, even with [a] stranded contract.

Now, where are we today? I tell you: Even with a stranded gas contract today, this project is not economic. So, this has happened. When I made this presentation, Econ1 ridiculed me. They said, "Here is [Pedro]" - now we just had gone through Katrina - they said, "Here is Pedro predicting the perfect storm: cost increases and price difficulties - the perfect storm. The chance that that ever happens is 1 percent." Now, see where we are today? It has happened. The perfect storm has happened. I told you it was Econ1 who said that it was not going to happen. I told you.

[11:22:08 AM](#)

DR. VAN MEURS: Let me give the next slide when I defended myself this Econ1. I summarized the views of Econ1. Econ 1, in their presentation said last year a 50 percent cost overrun [was a] very low probability. Low gas prices: very low probability. Project uneconomic: very low probability. What did I tell you? 50 percent cost overrun: very likely. Low gas prices: fair possibility. Project uneconomic: fair possibility.

REPRESENTATIVE RAMRAS: Mr. Chairman, what does FIF stand for?

[11:22:52 AM](#)

DR. VAN MEURS: Sorry?

REPRESENTATIVE RAMRAS: FIF.

DR. VAN MEURS: Oh, that was the fiscal review finding.

CHAIR SAMUELS: Fiscal interest finding.

DR. VAN MEURS: Interest review finding.

DR. VAN MEURS: So, I definitely predicted strong cost escalation; I told you strong cost escalation has already occurred; and I foresee further strong cost escalation.

[11:23:29 AM](#)

DR. VAN MEURS: Now, my friends, you cannot have it two ways. You cannot on the one hand say the gas pipeline deal was so bad because there was no cost escalation and then say the PPT was so bad because there was cost escalation. Like, you can't have that. The new commissioner of revenue make this report, and he said to his surprise there was 50 percent cost escalation. All he had to do was look at my slides and he could have known. It was no surprise.

So, now, what was very interesting on the part of the report of the new commissioner is that he seems to except already the fact that there were enormous cost increases in the North Slope. Now, let me tell you: that's not necessarily proven. The situation is: cost increases are not the same all over the world. If you go to deep water Gulf of Mexico, yes, deep water drilling rates quadruple. In 2003, the rates were \$150,000; ... today you pay a half a million dollar a day for the deep water rate. If you go to Alberta, around Fort McMurray, labor crews

tripled in cost. But my client, Kuwait, for instance, that I did careful cost analysis for, rig rates and cost increased only 30 percent over the same period. Now, I didn't see, in 2006, great evidence of enormous stress on the North Slope, with respect to costs.

[11:25:25 AM](#)

DR. VAN MEURS: So, for me, it is not yet proven that there has been significant cost increases on the North Slope, as the commissioner of revenue already accepted. Now, normally, it is not so good to say that the cost increased already before you even do an audit. What you are supposed to do, is do an audit first, and then decide whether there were cost increases and how much they were. So, consequently, that is why I greatly admire this government for hiring better auditors. But if you cannot go out at the same time and say we are hire all these better auditors, but we already now there is 100 percent cost increases, then you don't need your auditors anymore. So, consequently, the fact that you go out and hire all these auditors is because you didn't know what the cost increases were. ... I wouldn't be surprised if four years from now suddenly there is this small announcement in the newspaper that says, "We now redid our 2005 and 2006 returns and we collected a few hundred million dollars more." ... I therefore believe that before you make these drastic conclusions, that there has been these enormous cost increases on the North Slope, ... it is imperative that you do your audits first .... That is why the date 2011 was there, because today there is no proof of anything. ... Yes, we know international[ly] [of] all kind[s] of cost increases, ... but that doesn't mean that there [are] 100 percent cost increases in the North Slope. That could very well be companies over-declared. If you start a new tax system, always companies try you out .... Let's see what they go for ... and then you have to send the auditors in and then you fight back. That's always the way it works. Now, have we already given up on the battle? Of course not.

[11:27:52 AM](#)

DR. VAN MEURS: What I'm concerned about is that ... the price for declaring more costs has been lowered by this legislature. The legislature actually lowered the interest rate applicable to late payments. ... right now you only have ... U.S. ... regular interest rate, so ... the penalty of over-declaring is not very high. And if you are going to improve the law today, apart from the good transparency measures that a new government is

proposing, and the stronger measures to create a very better administration, I think in addition you should look at the whole penalty systems. Companies should not get away with over-declaring and then letting you fight for five years ... to get your money back. So, that is something I didn't discover in the new bill; and I think it is necessary to put that in if you really want to have a strong system of accounting.

[11:29:11 AM](#)

DR. VAN MEURS: Let me then just make some few more comments on some of the other provisions on the law. As I mentioned, this 10 percent floor really ... is a political floor; it is really nothing like a real floor. It is kind of a nice feature to have, but it doesn't do anything good for you. ... if you want a gross plus net system, as I mentioned in March the fifth, do a gross and net system. I think it is a good recommendation. But don't do something that looks like a gross and net system but is not a gross system. ... either do something substantive and real or just forget this floor. This floor makes no sense administratively. We are having a tax that is consolidated. We just discussed that it is difficult enough to administer a consolidated tax. Now, if you want to start ring fencing and taking all kind of pieces out in the Arctic that should be separately accounted for with cost allocation procedures as the law says. ... You are now creating an exponential growth of the difficulty of administration, for what purpose. For no purpose. So, this whole recommendation makes no sense.

[11:31:12 AM](#)

DR. VAN MEURS: Tax credits. Under ... the PPT, we had a clear tax credit. And we said if you go after these heavy oils, in the year you invest you get your tax credit, the full 20 percent. The new law says we made this enormous improvement - now you get it over two years. What is that going to do? The government wastes the same amount of money and you lose now the whole incentive of what this tax credit is designed for. So, what good is that? This is displayed as an enormous improvement in this bill. This does nothing, as far as I'm concerned. The government get[s] the same money and you lost now all the incentive to reinvest because you only get half in the year that you invest. For small companies that's really important, particularly since this is tradable. So, now you have a tax credit with no effect or a very much reduced effect, but you still pay the same as Alaska over the two years. Why do you want to do this? This is just a bean counter's invention to

kind of ... look smart, but, really, it doesn't do anything in practice.

[11:32:43 AM](#)

DR. VAN MEURS: Then there is the corrosion issue. ... when we had the PPT debate, we all were greatly dismayed by all the news that reached us about the poor maintenance of the pipelines and gathering lines in the Arctic. And of course, I can understand the emotion and say we should not allow deductions for that because this was mismanagement. And, I feel this is great politics and I can understand the emotion, but for administrators this is very difficult to do. Just think of this poor 26-year-old that has just gone through college and has to check the forms of cost and now she ... or he has to decide whether these pipelines were properly repaired or not. Now, this doesn't work. So, consequently already when this issue came up last year I suggested, and I'm very happy that this legislature adopted this, I said, "Look, please make it easy for your administrators. Let's just deduct \$0.30 a barrel and have it over with to show our displeasure about the poor state of repair." And that was accepted and I am proud it was accepted; it was a good measure, it was an expression of the discontent about this matter. And we got our money back already. Now, you can debate the \$0.30. If you want to make \$0.50, if you want to make it \$0.50 for capital costs and operating costs, also good. Maybe the figure should be updated. But that \$0.30 was the expression of this legislature that they felt it was unjustified to deduct costs for poor maintenance, and it was easy to administer, just one little line on the form .... That is why this was introduced and I still think that is a good measure, we should stick with that. The figure was calculated very quickly because we were in the last hours of this session. Could the figure be improved, yes, maybe with all the information we have today maybe we should change this figure, or we should make it a figure applicable to five years, ... I'm highly recommendable to investigate whether this is the right figure. But, once you have established this figure I think you have expressed your displeasure about the fact that Alaskans should not pay for unjustified repairs ... that was the whole idea of the \$0.30 and it is already in there.

[11:35:57 AM](#)

DR. VAN MEURS: Extra incentives for exploration. Actually, the current PPT law already included some extra incentives, which I was never much in favor of. I told this legislature

repetitively, on certain questions, that it was my recommendation not to go much further than a 20 percent credit. And the reason is by the time you start to pay a 40 percent credit or other high credit and you give the PPT deductions and you give the tax deductions, you reach the point where the State of Alaska and the federal government are pretty well paying the entire well. And that's not leading to efficient oil companies. A very important objective of the State of Alaska should always be to promote efficiency. You don't do that by paying 80 percent or 70 percent or 90 percent of an exploration well.

11:37:06 AM

DR. VAN MEURS: Joint Administration; I was pleased to see, as I saw better exchange of information. That is just excellent. I think these are good provisions. I would highly recommend that you pass them because, yes, when I was working with DNR and DOR, there were occasional problems because of confidentiality ... we could not exchange information and, obviously, that is something that can be improved. So, I welcome those kind of provisions. However, the bill seems to tip toe into something that I would be very worried about. And that is somewhat of a joint administration of this PPT; that would be very bad. My experience around the world is as soon as you get two governments in charge of administering a single tax, it becomes all clogged up in administrative procedures. And that is not to the benefit of anybody. You don't need two government departments. Now, I'm not saying that that was the intention of the bill, but there seems to be a little bit of atmosphere of that in the bill. ... I would strongly recommend: DNR has the role to collect royalties ...; DOR has the role to collect the PPT ... and there should not be all kinds of crossovers that could result in delays and other complications. Mr. Chairman, that is all I have to report to you. ...

11:39:07 AM

CHAIR SAMUELS: ... to "capsulize" then, you don't think we should change it now so that the tradeoff then becomes the potential of being perceived by investors as unstable, versus if we do change it now, you think there's probably a little bit of money left on the table. But, the balance that is struck. ... On the big picture ... as you see it: is are you going to miss out on a couple of projects and a couple of investments because people are going to sit there and go, "Well, we'll wait, they might do it again next year. We'll see what happens with revenue figures, we'll see how much production figures, they

might do it again ... versus move ahead and move it forward. How stable will that number be?"

11:40:07 AM

DR. VAN MEURS: Mr. Chairman, that is exactly my concern. As I mentioned, I think the recommendations that I made in the past were good recommendations. Of course, you can increase your government take, particularly under high prices if you go for the gross plus net system. Particularly, if you look at today at \$86 a barrel, that seems ... attractive. Nevertheless, you start to run the risk that investors become wary of making strong decisions about Alaska. And the whole purpose of the PPT was to encourage investment, the whole purpose was to start developing the heavy oils. It will require enormous investments to develop five billion barrels of heavy oil. Much of that has to be done over the next 10 years. If you create an environment where people say, "Now, who knows, let's look what happens next year?", then you create an environment of uncertainty. And all of the benefits that you tried to grant with the tax credits, with the PPT credits ... fall by the wayside because the investors start to perceive risk in Alaska, generally. Now, some studies have been published by Wood Mackenzie ("Wood Mac") that portray Alaska at the absolute bottom pole of risk. I strongly disagree with those conclusions because I think they're highly exaggerated and the methodology of reaching that conclusion was extremely poor. But, nevertheless, yes, if you change your taxes every year, you get a bad name. ... Consequently, that will make investors hesitant to commit the big blocks of capital investment ... and all you're going to get, more and more, is small incremental investment just for this year to see how it goes next year. ... that's not, I think, the atmosphere you want to create. The PPT was a great upheaval, but ... from now on you'll like to re-establish that Alaska is a good place to invest, it is a good partnership ... there is understanding in Alaska of the complexities of developing the North Slope oil. And that is definitely a message that has to go out. So, ... I absolutely agree with your conclusion, Mr. Chairman. My ... base recommendation is don't change anything, wait until 2011, see what happens, see whether maybe some further changes need to be made. But if you want to make changes, yes I invited you to make changes .... And my recommendations from last year are a good indication of the kind of changes you can make. ... you would collect significantly more money at \$84. And that's, then, the decision the legislature has to make.

11:43:34 AM

CHAIR SAMUELS: Okay, just as a side note. The Wood Mac study that was referenced - and I've seen it in various comments by the various factions here - is between Marcia Davis at the Department of Revenue and myself. We've split the costs so the State of Alaska has bought it; similar to when Senator Therriault also purchased one. It is a confidential document. Wood Mac is a company that ... does a report, and then sells it off the shelf. So, if the first person that buys it makes it public, they're obviously going to run out of customers ... very quick.

DR. VAN MEURS: Yeah, my comments, Mr. Chairman, were because I had independent access.

11:44:17 AM

CHAIR SAMUELS: Yes, ... I wanted to make sure I clarified that. We're still clarifying also. When we first purchased the Wood Mac agreement, we were hoping that some of the Alaska-only documents would be made public. And now there appears to be some ambiguity. And we're talking to Wood Mac, ... my staff and myself will have a call with Wood Mac tomorrow. One way or another we will have the report. Legislators will have to sign a confidentiality agreement to ... read it. ... Senator Therriault and myself, I believe, probably four years ago now, hired Chuck Logsdon who had then just retired from the Department of Revenue to, essentially, explain it to us. Because to just read the document, I can tell you right now, it might have well been in Greek. This one, I don't know how readable it is. We will have somebody there to try to do the same thing: to walk us through what the numbers mean. ... it still remains to be seen whether or not we will have some of this to go public. And I appreciate the help that we've gotten from Marcia Davis and the administration on trying to get this report, and get all the information to all the policymakers that are out there right now. And we'll have more information, I'm guessing, by Monday. ...

11:45:32 AM

SENATOR HOFFMAN: ... One of the reasons that this administration brought this revision ... to PPT is that it was perceived that this tax revision was made under the "cloud of corruption." Does it matter to the investors if we change the law and use that as a reason? Does that change the environment

of uncertainty or stack the tax instability in the State of Alaska, by the investors?

[11:46:09 AM](#)

DR. VAN MEURS: Yes, Senator. Personally, I believe that it is a fundamental error to design fiscal systems based on fiscal targets, as is proposed. ...

CHAIR SAMUELS: Based on what, you think it's a mistake to base them on what? ...

DR. VAN MEURS: ... Last year, presentations were made and said under those conditions we are going to collect \$2 billion or something and then it was \$800 million short, or whatever. I believe Alaska should extract a fair share from the resources; it should not be based on ... the budget objectives. ... was less received than was anticipated, yes. Firstly, we don't know why because we still need to do the audit. And I think the audit could very well point out that another \$400, another \$500 million will be recovered. Secondly, did costs go up beyond the projections that were made. Yes, as I told you, these costs were in strong inflation, strong escalation and some that was not taken into account in the forecast. But, I think it creates a bad impression on investors if you say, "We like to collect so much and we just get it out of your pocket." It is like a landlady telling you, ... "I like to collect so much ... and the rent this month is double because I need the money." ... The rent for the apartment should be a competitive ... fair commercial basis, it should be competitive whether the landlady needs money or doesn't need money or had expected more money last year. This should not be an issue. ... that is how I think fiscal systems should be designed; they should be designed of competitive fairness, not on government requirements.

[11:48:43 AM](#)

SENATOR HOFFMAN: Just a clarification. ... That was one of the reasons the administration came forward with this legislation. The other one was the rates were set under a "cloud of corruption." ... does that matter if we decide to change the rates for that reason; does that matter to the investors and how do they view that? Will they still view ... Alaska as an unstable tax structure regime?

DR. VAN MEURS: No. Of course, I'm not familiar with the details of the corruption scandal. I've heard about it and I

have heard some names. As I recall ... these were the people that voted against all the proposals that I had for a better share. ... we got the better share despite them. So consequently, I don't know how much cloud this causes on the fiscal system. The fiscal system was passed with them voting against it and it was passed by the majority. ... The law was passed by those people who felt this was a fair system, which have not been accused of anything. ... it was the best deal for Alaska. ...

[11:50:18 AM](#)

SENATOR HOFFMAN: I understand that, but ... are we still viewed ... as [an] unstable state?

DR. VAN MEURS: ... Firstly, as I said, I have not been involved in the details of this investigation. But ... the law was passed despite maybe certain things going on. So, there is no argument to begin with. Nevertheless, yes, if you say every time we discover corruption in the nation, we have the right to change the fiscal system. I mean, I can think of a lot of countries where the fiscal system has to be changed perpetually. ... I'm not sure whether that's a good philosophy.

SENATOR HOFFMAN: Thank you, Mr. Chair.

[11:51:13 AM](#)

CHAIR SAMUELS: Thank you. Representative Ramras and then Senator Therriault.

REPRESENTATIVE RAMRAS: ... Two questions that overlap with one another. For those of us that are familiar with paying quarterly taxes rather than federal withholdings from paychecks, the IRS code is explicit and it's punitive. And, I believe, if it's correct, I pay 110 percent of my last year's tax liability and that should I opt to deviate from that and I end up paying less than 90 percent of the next year's tax liability, the penalties are rigorous and ... punitive. And that's why we quarterly taxpayers abide by the IRS tax code. So, I would like for you to be a little bit more explicit ... about the penalties and where we may have failed in that regard. And then secondly, I'm familiar with the ... deep water offshore drillers. Transocean and Global Burning Santa Fe are in a merger to ... monetize the fact that they are backed up to the year 2010 or 2011 for all of their deep water rigs. They can't build them quick enough. And for those of us that live in a universe where

the CPI index is 3 percent or less, when they include food and energy - which always amuses me about Alaska because we're all about food and energy - it is difficult for lay people, for legislators to digest. To borrow Hilary Clinton's statement, "Without willing suspension of disbelief, that inflation in certain pockets of certain industries could possibly run 30 percent, 50 percent, 100, 300 percent annually." So, can you merge these two issues, which is this nature of punitive or a failure to be punitive in the interest for over reporting or underreporting of expenses along with the fact that we have this unusual inflation around the world. ... even if it is a lesser inflation than the State of Alaska, it's still extraordinarily significant compared to say, the CPI index for Anchorage or around the United States.

[11:53:47 AM](#)

DR. VAN MEURS: ... my suggestion is that this legislature could use the new law from the perspective of what happens to somebody that over declares, say \$200 million, and goes through the whole process. What are the penalties for over declaring, what are the penalties for delay, etcetera. What I recall very well was that there were actually, in the original production tax, Draconian penalties for this. And in the current tax, the current legislation, this was for a late payment; a lot of that was softened. Now, that might have been a good measure, I'm not an expert in tax administration. However, my recommendation would be that you X-ray the procedures ... in the hypothetical case of somebody over declaring \$200 million and after four years of auditing we find it and he finally pays his PPT, what happens? ... is that fair and ... is that similar to what would happen to a normal U.S. citizen that under declares or over declares his taxes. As far as the international situation is concerned, ... it is very difficult to understand these enormous swings. What I like to highlight is these swings are up and down. Rig rates come down as fast as they go up. ... the reason is that this relates to temporary shortages in the services market and in the labor market, sometimes, that cause people to simply ask for the best price. And these rig rates, therefore, and ... other service industry rates as well, have had a tendency of swinging rather wildly if there are events that cause a major shift in demand for those drilling services or other petroleum services. ... it is quite well established, normal economic behavior that that is how the market works. ... This is also one of the reasons, I typically am against the overall concept that people say, "Oh yes, if oil prices go up, costs go up." Yes, costs go up in the short term because there

is shortages of services. But in the long term there has always been a downward trend in cost in the oil industry because of the enormous progress of technology. The reason that we talk today about very extensive heavy oil production in the North Slope is precisely because technology has now made that production [a]far lower cost per barrel than it was in the past. So, the long-term trend is for efficiency, is for technology improvement. In the short term there are wild swings and they're well documented and that is not anything of (indisc.). There are wild swings in particular markets like rigs, ... petroleum services, ... certain labor crews, ... supply vessels - anything that is in short supply and has a limited kind of inventory. ... consequently if price goes up suddenly prices double, triple, or quadruple. ... all you have to do is go back to the early '80s. I still remember when I was drilling wells in Alberta. The cheapest well I ever drilled was ... in 1986 when the oil prices had completely collapsed. A driller came to me and [said], "As long as you pay for the fuel and the labor, you have my rig." And that was the cheapest well I drilled, which proves that costs come down as well, if prices decline or if suddenly there are too many rigs in the market stimulated by the high prices. ... That makes it so important for auditors to be well-trained because you sit there, and now you have to approve a half million dollar a day bill rather than \$125,000 a day bill. ... you have to understand whether that is a reasonable rate, yes or no. And that is why I really like the initiative of this government to really strengthen the auditing and put every possible power into high quality auditors so that you get people that understand these kind of movements.

REPRESENTATIVE RAMRAS: Like everyone else, I have a hundred more questions. Thank you, Mr. Chairman.

CHAIR SAMUELS: Senator Therriault.

[11:58:55 AM](#)

SENATOR THERRIAULT: ... Pedro, with regards to ... the situation in Alaska, whether it is in fact stable. In the memo that you wrote on February 1st, which has been called the "Banana Republic memo." You have a small paragraph in there that says, "Despite the boisterous politics of Alaska, the state has never adjusted fiscal terms to the producers in a way that is unreasonable, compared to international practices in developed nations. On balance, the State of Alaska has been a reliable business partner with respect to the law and with a well functioning democratic system." And then you go on to say,

... "There is absolutely no need to treat Alaska like a Banana Republic in order to get the gasline." Now, you made that statement after the governor had done his aggregation, and having in mind that PPT was going to pass. So, two changes to the system and you say, "The State of Alaska is a very fair, reasonable business partner." Now we're contemplating perhaps one more change, and with that one more change you say, "The state will run the risk of getting thrown into the category of being a basket case of instability." It just doesn't seem to me that you can write a memo that says that with the aggregation, with PPT, we're fair, we never have done anything to disrupt ... the fairness ... that we display operating with these major producers. How can this one thing throw us now into the category of being a basket case of instability.

12:00:40 PM

DR. VAN MEURS: And I absolutely agree with the memo that I wrote. The memo that I wrote was written from the perspective that Alaska really had not made any major change in it's production tax ... since ... 1989 ..., if I recall the year correctly. So, 16 years of managing a fiscal system without any major change is stability in my mind. This law proposes a dramatic further change; ... change every year is very unstable. I'm not recommending you wait another 16 years before you make your next change. I think 2011 would be, as I recommended, a reasonable date and the legislature agreed ... that 2011 would be a good date to review that. That is why, I think, 16 years of fiscal stability as Alaska had, was a very good track record. Many governments, like Britain, Norway, made more frequent changes. Alberta, where I now have been advisor over the last six months, definitely made more frequent changes. It's not unreasonable to make an important fiscal change every 10 years or so. But to make an important fiscal change one year and the next year, that is very unstable. And I still believe if Alaska wants to be perceived stable, my recommendation is to do what the legislature decided last year and say, "Let's look at all of this again in 2011." We put the companies on notice already, so if they want to make investment today, they know already we're going to look in 2011 at this whole fiscal system again. And if there is fair reasons for changing it, as I believe that may very well be at that point in time, then, I think, you should change. But, I feel very troubled by ... making such an important change after 16 years. ... most developed jurisdictions around the world make those kind of changes every ... 10 years or so. Making two very important changes, one after another, particularly because it seems to be for

politically motivated reasons rather than for other reasons - that's very troubling.

12:03:24 PM

SENATOR THERRIAULT: Mr. Chairman, ... my sense of my colleagues is we're not interested in getting into a situation where we're changing the tax every year. We're looking for that fair ... taxation system, that will give us another ... 10, 15 years of stability. But if the system is not equitable on both sides, it is internally destabilizing. If the system doesn't derive a fair share for the sovereign, then the people will clamor for a change. If the system takes too much, on the other side, then you shut down the investment. And it, again, forces a change. So, I think what we're looking for is that next system that will give us 10 or 15 years or maybe longer of stability. I don't know that promising that we won't look at it for another four years ... offers a whole lot of surety to the producers. It seems like we should come up with a system that we believe, right now, is fair for the long haul, for the sovereign, and for the producers. And I think that's what the governor has proposed here.

12:04:43 PM

DR. VAN MEURS: My view is that today you don't have the information to make that change. That is why 2011 was chosen. You haven't even done your first audit yet. How do you know how much money is missing? How do you know whether you received less than you should have? You don't. And consequently, you don't know what the impact on investors will be. You don't how much interest is going to be shown over the next four years in new drilling and new activity on the North Slope. So, you don't have the information today to make a dramatic change that will last for 15 years. In 2011 I think you will have that information. Is it fair? The reason that I believe it is fair to look at 2011 all over again: ... Alaska made a dramatic shift in structure in its production tax. And consequently, there was great concern around the legislature: will this system work; will this actually deliver; will this bring the investment; will this raise the income? So yes, if you introduce something completely new, is it good to do a reality check after a few years and say, "Did it deliver what we expected it to deliver?" That's a good policy. Then once you have all the information and once you have all of the facts, and ... you have done all your audits, and you have accurate information about the cost .... I'm very supportive of the

governor in the transparency area - if you publish good data for the public to know exactly what the costs are so that people don't have to react to rumor, now everybody in the state would have the basis for a good discussion. I do not agree necessarily that the current PPT is completely out of whack, it is not a disastrous kind of PPT. You have collected more, people are investing, the law is doing what it was supposed to do. ... I do believe that the law seems to be delivering what was intended. Could everyone be 100 percent happy? No, but it is not ... a complete discrepancy between an ideal system and what you have today. ... people may feel unhappy about the fact that certain things were not coming out for the moment. Who knows later on if we'll prove wrong, but for the moment it didn't seem to come out in revenue collection as expected. But today you don't have the information to make a major change that will last for 15 years. In 2011 you [will] have all the information to establish a fair system for Alaska, for the long term, and to regain the status of fair stable partnership between Alaska and the industry. And I think that is a fair program.

[12:07:50 PM](#)

SENATOR THERRIAULT: ... With regard to the \$0.30 per barrel deduction for the maintenance, in your memo of August 5th you talk about, it says: "(Indisc.) the \$0.30 per Btu equivalent barrel is based on reasonable capital maintenance costs for fields for which I have confidential information." It seems like the debate at the time and basically your suggestion on how to fix it was: there were going to be shutdowns. There's going to be shutdowns that stem from lack of proper maintenance, you just have to accept that and we're going to offset that by this \$0.30 per barrel deduction. But, I think, what the administration is trying to do is come up with a system where we don't just accept that there are going to be ... bad acts as far as maintaining the infrastructure as it should be. That we provide some incentive for the companies to expend money as a reasonable and prudent operator would do, so we don't have unexpected shutdowns. So, we don't have the leaking pipes. And although I've not bought off completely on the suggestion that the administration has made, it seems like if there's a way of doing that so that you don't just say, "Well, there's going to be bad actors, just get over it and live with it." - that we should investigate that possibility. But the \$0.30 just seemed to me throwing up the hands saying, "Can't help it, can't avoid it. You can't police well enough to keep bad acts from occurring."

12:09:29 PM

DR. VAN MEURS: ... as I stated, the \$0.30 was meant to crystallize the displeasure of the legislature that ... unnecessary costs were incurred and that those costs should be taken into account in the design of the PPT. ... the costs for those heavy repairs should not be paid. As I said, I'm not proud of the number, it had to be generated in a very, very short time. I'm perfectly willing to accept that a better number could've been generated with more information and maybe that is what we should do. Now, yes, ideally you should only allow companies to deduct costs that ... reflect an ideally good operation. I really don't know operations around the world that have that degree of perfection. ... does it occur everywhere in the world that certain mishaps occur? Are humans making errors? Of course, all the time. Are misjudgments being made? Are companies sometimes cutting things short? These things happen all the time. I'm not saying they're good. On the contrary, I think a regulatory system in the state, and particularly with the federal government, should be on top of enforcing the highest possible environmental and health and safety standards, .... But that is basically a regulatory task. From a fiscal point of view, you can say look we know that so much percent of your operation seems to be not justified. And therefore, we ... make the life of our administrators easy and we say that is a non-deductible expense. That doesn't mean that you accept the fact that bad practices occur. On the contrary, obviously in this case, it's primarily a federal task. Obviously, regulations should always be such to make sure that companies adhere to all of the standards. And, as I said, unfortunately around the world that doesn't always happen. But, Alaska shouldn't pay for that. I agree with that ... concept. It's just how do you implement that concept. And I believe it is easier to look at the facts, do some economic study, say now what percentage seems to be unjustified. That's the percentage we're not going to allow. And that percentage, ideally, should go down over time. And that is a practical measure that I think achieves the same -- I agree with the goal, it is just I think the way it is crystallized in this law is just very difficult to administer, will lead to a lot of court cases, will lead to a lot of stress on the administration, will ask people to do things they really shouldn't be doing as administrators. ... I'm not disagreeing with your philosophy, it is just how do you do this in practice to make this work in a way that the administrator three levels down the line can administer.

12:13:08 PM

SENATOR THERRIAULT: Mr. Chairman, is it your intent to have open question and answer later, after both presentations.

CHAIR SAMUELS: ... we've got Senator Huggins and then I've got a question. After, we'll probably take a lunch break and then Mr. Johnston has ... about an hour presentation, a little bit of Q and A and then I can have both of these gentlemen back up together. ... I'm assuming they're going to agree on some things, they're going to disagree on some things, and they can both ... give their rationale on why these things are. So, there's more opportunity. We'll be here as long as there are questions to be asked. We've got these guys for one day and we're paying a pretty penny for them.

12:13:44 PM

SENATOR THERRIAULT: One ... more question. Pedro, I think that where you, perhaps, got into trouble with your credibility amongst legislators is when it became apparent to us that you were going to issue your original report with a tax rate of 25 percent. And in my own notes I kept in my office, you and Mr. Johnston got together, on February 12th, and agreed that 25 percent, with the 20 percent credit, was fair and reasonable.

DR. VAN MEURS: That's correct.

SENATOR THERRIAULT: But then you were instructed by the administration to change your report.

DR. VAN MEURS: No.

SENATOR THERRIAULT: And where you got in trouble is you changed your report.

12:14:28 PM

DR. VAN MEURS: My February 14 report reports 25 percent rate, and that has never been changed. ... in fact, I asked the governor specifically, "You just announced 22 and my report says 25." He said, "Go ahead, publish it." So, ... my report is clear; I recommended 25, I agree absolutely with your history. I wanted to feel myself certain that my recommendation was right on the 25. So, I met with Daniel Johnston and I asked him to confirm what his feelings was and he confirmed, "Yes, that is a good number." That's why I recommended it. ... there is no

report after February 14th where I changed my personal opinion. The governor, of course, accepted 20:20. And then in the legislature a lot of debate took place whether 20:20, 25:20 would change a lot in the amount of activity. And as you recall, I kept saying "I don't see very much difference in activity between 20 and 25." I testified to that a number of times. But, yes, the governor announced 20:20, in his good judgment, after discussions with the oil industry that I was not completely part of .... A governor is supposed ... to govern and make decisions. And as a consultant, you're only an advisor. And if the governor decides differently, that that is exactly what government is all about. But that doesn't mean that my report was changed. ... I reviewed my report with Tony Finizza also, of Econ One. I felt just because I changed my own recommendation from 20:15 to 25:20, because I felt the international competitiveness justified that. And consequently, I wanted to get confirmation from the other consultants and they agreed with me that ... they felt confident about that number. So, consequently that is why I recommended it. And that report has never been changed.

SENATOR THERRIAULT: Thank you, Mr. Chairman. I'll have more questions later.

CHAIR SAMUELS: Thank you. Senator Huggins.

[12:16:57 PM](#)

SENATOR HUGGINS: Pedro, for the record, I started at 22.5, voted for 22.5 and it is 22.5. ... to be quite frank, I was not in the mix as far as really hooking and jabbing coming to the results, but I had my opinions. And based on some things that you said and other people said to synthesizing that, I feel comfortable with what we ended up with. But, number one, I would say to you you're May 10th slide, slide number 21, which you talked about the huge risk - I'm going to get back to that - was, of all the things that I've heard you say were down ... in the hall going through our educational period for a number of days, and you said that it may not be economically feasible to build this gas pipeline based on the variables. And then you refreshed my memory on that and I thank you for that; and it stuck in my mind. We were going through AGIA, I had that same concern. Now, you are here today, and I'll just say for the chairman and other people on LB&A, I sat around in a meeting and we talked about how to best spin people up. And we agreed, I think without dissent, that bringing yourself and Daniel Johnston here was probably as good as we could do because you

were the architects and the advice that we were getting. And I say on that, I sustain I supported that. And I still do today and I thank you for that.

[12:18:30 PM](#)

SENATOR HUGGINS: My question for you, though, going backwards is, back to slide number 21 - I want to make sure I heard you correctly. You then extrapolated from slide 21 that ... Alaska's gas pipeline today is not economically feasible. Did you say that?

DR. VAN MEURS: Yes .... I can give you some explanation on that.

SENATOR HUGGINS: And I will, and ... let me just say that in traveling with and talking to Representative Samuels, you are a unique character. And talking to people ... of international renowned, but doing business in oil and gas. I mean you bring two things to the table, one is international experience and the other is expertise. There are some people in here that like to hear what you had to say and some don't. But ... in my estimation the business of professionals is not whether you like what they have to say, it's about whether or not they have those two ingredients. And I can tell you, and I'll say this not to compliment you, but they're a number of people in the continental United States, some of them outside of it, that says that Pedro, doesn't matter whether you like him or not, he's one of a kind. And he has expertise that probably can't be come by. ... Once again, I get back to slide 21 and ask you again if you would just for a moment reflect on your statement of -- because in my mind, we're debating about oil taxes and what we're going to do. That's a stop-gap measure. The future of this state is with gas. I think we all agree on that. The question is ... we have agreed for some things in a structure called AGIA. I'm concerned because of your statement, and I would just like to hear from you on that.

[12:20:21 PM](#)

DR. VAN MEURS: ... I'm deeply concerned about the gasline because as you probably remember from ... the discussions in the hall, I presented to you how the pipeline was completely uneconomic at the ... cost of 2001 and the prices of \$3.25 per million Btu. Today, the costs of 2001 have doubled so you need twice the price to get the same economics back. Today, the price in Alberta is \$5.50 and Henry Hub it is \$6.50, \$7.00. So,

today we actually have the economics that I presented to you, that prove that the line was uneconomic. ... so consequently at those levels and those rates that is immensely troubling for Alaska. You may recall that ... I said gas price risk and cost overruns .... There were two aspects to this gas price risk. One: the price itself. But far more important is the structure of the current market in North America.

When I presented to you the economics of the pipeline, I presented to you a forecast of gas prices that over the 20 years was equal to 95 percent of the Btu equivalent of oil because that had been over the last two decades, the typical average in the United States. Today, we are talking about 40 percent or 35 percent. So, gas prices today have cratered relative to oil prices, on a Btu basis. ... There are many causes for that. Firstly, conventional supplies are somewhat stronger in Canada and the U.S. than expected. But, also other states in the United States have now started to realize that in an energy crisis that we face, that they like to develop their coal resources. And states like Montana, and Wyoming, and New Mexico are really strongly promoting their coal resources for their electricity generation. Now, electricity generation was supposed to be the big market for the gas. Clean coal can be produced today at \$2.00 per million Btu. That is what we are competing with. LNG can be landed for \$4.00 per million Btu and LNG imports are rapidly increasing. That is what we are competing with. So, it seems that a dramatic permanent change has taken place in the North American gas market that is far more dangerous than just an occasional low price. What has changed is the entire structure of supply and demand over the last three years. And if that change prove[s] to be true, there is no hope for an Alaska line. And consequently, that is something that is greatly troubling and that you should carefully consider. In fact, if you look at the situation today with \$5.00 or \$6.00 in Alberta and maybe \$4.00 transportation cost to get it to Alberta, the netback at the well is \$1.00 or \$2.00 per million Btu. In an environment where you have gas that is only worth \$1.00 or \$2.00 per million Btu and an oil price that is \$86, the most logical economic use to monetize gas in Alaska is gas-to-liquids because you need 10 mcf of gas for every barrel of oil. That means you can produce liquids for \$20 a barrel, in terms of input. And consequently, that is a much more fruitful avenue today ... to explore, than trying to look at [an] even more costly ... project for LNG exports that would create even a lower netback. ... is gas in trouble in Alaska? It is in deep trouble. Not because you did not approve the gas contract, ... because the world has changed. ... that is

something that, I think, Alaska needs to focus on. I think Alaska needs a new approach to how to monetize the enormous gas resources of the Arctic. You need to rethink what you're doing; that would be my conclusion.

SENATOR HUGGINS: ... I think that we have received a challenge here that the future destiny of our state economically has some question marks. And we need to answer those. And I appreciate what you said and whether ... 100 percent, 90 percent, 75 percent [is] true, the validation and the exploitation and exploration of what you said ... is important for us. So, I say thank you Pedro.

DR. VAN MEURS: Thank you.

12:26:49 PM

CHAIR SAMUELS: ... I have a question on other clients of yours. And I have been following Alberta. ... And if we think we play bloody politics, just read in the papers. We're not in their league, as far as the fight that's going on ... the royalty board, which you are the advisor to, to drastically raise the royalties in Alberta. And my question is, not only for Alberta, and I asked you and Mr. Johnston the question over dinner last night and I'm going to ask him the same question after lunch when he testifies. In most of the other jurisdictions where you deal with, where you don't have ... a production-sharing agreement, where it's - you got 85 percent and it's going to be 85 percent. You know, you've got a lot better situation or lack of (indisc.) a worse situation, as the case may be. Our economy is so small and we are so closely tied to two factors. We are closely tied to the federal government and we're closely tied to the oil and gas spending; and that money that circulates around. They just dwarf everything else in our economy. Is Alberta similar to that or are your other clients around the world ... so centered on this one industry where a hiccup, a mistake, a something, a shutdown at Prudhoe Bay because of the feeder lines. Are others as dependent where their entire economy is just so fragile and so small ... or is there a wide spectrum? ... I assume in Texas, I think I read, that it's 5 percent of their economy, the production not the refining and all that .... So if ... it imploded, then they take a little hit, but ....

DR. VAN MEURS: I would ... oh sorry.

CHAIR SAMUELS: No, go ahead. You kind of get the gist of where I'd like you to make some comments on. I'm going to ask the same question of Mr. Johnston, here after lunch.

12:29:02 PM

DR. VAN MEURS: I would say the Alberta economy or the Alberta oil and gas industry, obviously like in Alaska, has an overwhelming impact on the government budget ....

CHAIR SAMUELS: Not just the government budget. I mean the economy as a whole.

DR. VAN MEURS: The economy as a whole and the government budget. Contrary to Alaska, Alberta is not receiving many transfers from the federal government. So, they are in a stronger position. Also contrary to Alaska, there is 140 billion barrels of economic oil sands to go. And that is why the fight for the royalties, for the appropriate share for Alberta on that massive resource, equal to the oil reserves of Saudi Arabia; that is why the fight for obtaining a fair share for Alberta, on these massive resources is very vicious and very, very difficult. And as you could've seen in the newspaper, ... definitely very, very difficult time to get that fair share for Alberta. I would be happy if I got for Alberta the same what you already have in the PPT, and that is what I recommended to them. So consequently, that is only a dream for the Albertans to get that high. So consequently, that is ... the fight that we are having. Alberta, though, because of the huge resource base does not compare with Alaska. Alaska compares more to two other clients that I have: One famous Trinidad and Tobago - an island with a limited population and a limited resource base that only has a few opportunities to expand that resource base, maybe with deeper water, and interestingly also in Trinidad and Tobago the heavy oils. My other client for many years, Newfoundland, which also has a limited resource base and almost the same population as Alaska has. So, in both of these jurisdictions there is great agony about the future, just as there is in Alaska. And consequently, ... the government of New Foundland, just recently, the last months, changed the fiscal terms for oil - upped the fiscal terms for oil - and is trying to develop a new gas policy. As I said, Trinidad and Tobago is gambling on deeper prospects just as you are gambling on heavy oils. It is a very troublesome future that Alaska has based on limited oil resources, essentially uneconomic gas resources at this point in time, unless you liquefy it, and a declining great dependence on

federal funds. And consequently, it was very important for this legislature to ... honestly look in the future and ... start organizing the affairs of Alaska in a way that creates a sustainable development for this state.

CHAIR SAMUELS: Okay. If there's no more questions, I think we'll break for lunch. ... It's 12:35 right now. Mr. Johnston, ... you said you had ... about an hour presentation ... plus some Q and A, however much time you need. Why don't we come back here at let's say a ... quarter to two, give us a little more than hour. And we'll reconvene and then Mr. Johnston will give a presentation and then we'll have a chance then to have both of the presenters for questions. With that, we're at ease.

[1:49:56 PM](#)

CHAIR SAMUELS: I call the meeting back to order. ... The next presentation we'll have is from Daniel Johnston. I had the pleasure of meeting Daniel, along with Senator Therriault and Senator Steadman, and Representative Kelly, at a class he gave on petroleum economics in London that we'd signed up for during the last ... go around. And then for those of you that were here before, I don't need to go through his resume. But we're welcome to have you back. ... Any member feel free to ask a question. I'll try to use the committee members first - for the Legislative Budget and Audit Committee members - but I want to make sure that everybody feels they have a chance to participate here. ... this is for education purposes, not just for the new members, but for the old members as well. And after Mr. Johnston's presentation, we can bring Dr. Van Meurs back up and have a bit of a round table .... So, with ... that, Mr. Johnston.

[1:51:21 PM](#)

DANIEL JOHNSTON, Daniel Johnston & Co., Inc., Hancock, New Hampshire: Representative Samuels, thank you very much, and I'm pleased to be here. This is the Legislative Budget and Audit Committee here, is that who I'm speaking to?

CHAIR SAMUELS: This is the Legislative Budget and Audit Committee on this front part of the table, and then everybody else is filling in wherever they could find a seat.

MR. JOHNSTON: Well, I'm pleased to be here. ... And I'll get down to business now. When I was asked to come here 10 days ago, I was excited and horrified at the same time, because as

you may know or will soon learn, everything that Pedro and I say is subject to intense forensic scrutiny; every word, every written document is reviewed over, and over, and over. And, in fact, that's not just the words that occur here or the publications associated with Alaska; everything I've ever written comes under scrutiny very, very often. ... I think I speak for both of us when I say we really are quite careful about what we say, but having to be that careful is kind of painful at times. ... I really actually had visions of a milder, quieter little gathering, because Ralph explained that there were 13 new legislators, and that most of what this was going to be about was to bring them up to speed ... basically, "How did we get to where we are?" And so, I was a little bit surprised that Pedro had ... quite a presentation, which I thought was very helpful ..., but ... he wasn't actually talking about how we got to where we are, he was talking about the proposed legislation, which I have not reviewed. And ... until I have a chance to review that, I can't really comment on it much. But there were things that Pedro talked about that I would like to address. And I -- where are you, Pedro? I apologize in advance. Now, you know I'm capable of being rude to Pedro, too, but, let me tell you, I respect that guy, and I respect him a lot. And if anything I say here today, or ever, ruins the respect that he has for me and the relationship, the friendly and professional relationship that we have, I'll be horrified. And so, with that I got to say I do feel guilty that I'm going to go through your report, Pedro, if that's okay, and just comment page by page, just to let you know what I'm capable of commenting on, because some of those pages are not relevant to anything I've looked at or done. And so, I hope you brought that back with you. ...

MR. JOHNSTON: I didn't expect to come and make recommendations either, and I don't think I really have many recommendations - just opinions, as usual - but he starts out strongly recommending that you not make changes ... other than the transparency provisions. ... I don't entirely agree with that. If -- and I don't know how we can not talk about the cloud ... if there were no cloud, I would totally agree with that. You know, if the PPT isn't working as expected, some people are going to say, "I told you so," and some people are not. But if it's not working as expected, then in my mind - tough. If it was conducted on a level playing field, and in the kind of environment that I thought was taking place last year .... Now, by the way, I don't even know -- when Pedro said he knew how some of these people who are either under indictment or have been convicted, how they've voted, I was a little surprised

because I guess I could have looked that up and investigated that for myself, but I really don't care so much. Oh, I'm absolutely fascinated with what's going on, there's no doubt about that ....

MR. JOHNSTON: Now: page four. There is a nice and useful chart here that describes government take, undiscounted, and I just now for the first time noticed there's a parenthetical addition there that says, "income only" - so I'll have to ask Pedro what he's talking about there. I don't know what that means.

[1:58:26 PM](#)

MR. JOHNSTON: I don't think we need to worry about that right now. But it's part of my mandate to come here and tell you why we are where we are. I almost brought a presentation that was my March 6 presentation ... of last year. And because actually there's been so much debate about PPT 20/20 or 25/20, by the time I arrived, the debate had pretty much narrowed down to that range. And I'd like to talk about that. Some people thought that I came to Alaska and recommended a 25 percent tax rate with the 20 percent credit. That's not exactly the case, and in fact I was little bit horrified with what I found, and here's why: This term, "government take." Now, when I thought, before I came, that there was going to be mostly just the new legislators to get a feel for how we got to where we are, that I would spend some time talking about government take, because it's a big deal. And I find, too, some pretty good stories about people behind the scenes. The guys, you know, doing the analysis here, they're about sick of hearing about government take. And I don't blame you.

MR. JOHNSTON: In all fairness, though, when I was here March 6th, I knew it was going to come to that. And the last page in my testimony on March 6th was a quote from a Dallas Morning News newspaper article that described how the New Mexico Legislature had passed a law a few years ago requiring that when expert witnesses come to the legislature that they must turn down the lights and ring a gong and put a pointy hat on the expert witnesses before they testify. The bill, unfortunately, was vetoed by the governor. But I think everybody in this room can probably identify with that, and that resonates with me, too. But it is an important thing. Pedro used the analogy, today, a couple times of the landlady and the rent that she should receive. Now, for that landlady, the rent would probably be denominated in terms of dollars per month, or something like

that. And if she's a savvy business lady, she would know what everybody else in the neighborhood, and probably other places, too, get as rent for apartments that are either similar or roughly similar, or comparable in some way, and she'd have a feel for the marketplace and the marketplace dynamics. For you, for the oil tax, government take is a pretty good number. You've got to be able to measure it in some fashion or another. Now if you take -- and I was going to do this - I decided it wasn't appropriate with the size of this room and the number of people here, but I was going to use a flip chart ... to make sure that everybody was comfortable with how government take is calculated and what it means, and give everybody a little bit of a feel. Here's why: When I first arrived, if you were to calculate government take using a 20 percent PPT versus a 25 percent PPT, the difference in government take was only 2 percent. And I thought, "Why did they hire me with this massive ego to come up here, when they've already narrowed it down to plus or minus 1 percent?" Good grief! I was in a bit of a state of shock. And as the hearings continued and time went on, I still - and even today - cannot believe how it got locked into that strange, narrow range. And it's been very, very difficult for me then and ever since.

MR. JOHNSTON: To me, part of where we are now and how we got here is a function of things that went before. But, I worked on the gas pipeline here in Alaska the prior year. And I think the fact that the PPT 20/20 or 25/20 debate was narrowed down so quickly was probably partly because of the power and the control of the various legislators - and thank God people have power and control or at least as much as you do - but I felt it [was] also a function of the power and control of the oil companies. They're very powerful here; there's no doubt about that. And part of the problem, too, was the choice of using a single system, what I disparagingly refer to sometimes as, "the one-size-fits-all." And I've been on record and I, like Pedro, haven't changed my mind on a few things, and that's one. I'm still uncomfortable with that. And that's a type of policy-level decision that was made before my time. ... I keep trying to figure out who ... made that decision? Why ... is it in your hearts that you feel you absolutely must have one system that pretty much is going to take care of everybody. That makes the job extremely difficult. Now, the things that were done to try then and accommodate that policy-level decision - things like a credit to encourage exploration, yet an increase in the tax so that you don't ruin exploration but you still get a fair share of the profits - the one-size-fits-all system was very difficult. And I said, "Okay, if that's what we absolutely must

do, I'll go along with that." I still question why it seemed so absolute at that time.

MR. JOHNSTON: I demonstrated on March 6th, after seeing that everything had narrowed down to plus or minus 1 percent - I mean really that's a pretty good characterization of what the situation was when we would talk about 20, no, 25, no, 20, no 25 - and the whole time I'm just sick about that. It's not that precise of a science in some respects and it was so darned early in the debate. ... it was a surprise to me when all of a sudden the PPT proposal from the governor came out. And so, I was there pretty much when the proposal came and, like I say, ... still cannot believe it got to that point: plus or minus 1 percent. But then there's another problem: Plus or minus 1 percent on this thing, well, we better make sure we measure it fairly carefully. And so, ... if you looked at Pedro's work and the ConocoPhillips work and British Petroleum, all three were calculating government take differently.

[2:05:42 PM](#)

MR. JOHNSTON: ... Now, ConocoPhillips, by the way, they were using a report by Wood Mackenzie. ... I am still, to this day, convinced that ConocoPhillips didn't realize that the government take statistics quoted in that useful report - as long as you know the weaknesses of these take statistics - that there was a problem. And it's a problem that made Alaska look particularly bad. In my opinion ... it ... made ... Alaska look 5 or 6 percent worse than it should have, because the rest of the world, government take should have been higher. And then, British Petroleum had an altogether different interpretation, as well. They used ... [what] ... was called ... either "marginal government take," or ... "government take on the marginal barrel."

MR. JOHNSTON: ... I immediately knew what the problem was, but here you have three calculations of government take, plus or minus nearly 15 percent. And so, here's people using a report ... and ... nobody seemed to have noticed at that point. So, I started out my testimony on March 6th of last year with this issue that really kind of horrified me. And then it never came up again until about, oh, six weeks ago or two months ago, and some of the folks from the Department of Natural Resources or the Department -- I can't remember which one it was, but they said, "Mr. Johnston, you were quoted on March 6th as saying that the world average government take was probably between 67 and 70 percent. How do you define that statistic?" ... And so, I

started to answer those questions, and then, when I realized I was coming here I accelerated the work until I saw in the information that was sent to me eight days ago, I saw the work done by the governor's office.

2:09:31 PM

MR. JOHNSTON: They're using a statistic that I think is a government ... take of some sort, to a certain extent, but they're not using that terminology anymore. And look at me: this high-priced idiot from New Hampshire comes up here and I don't even know what they're talking about. I'm serious. I've got to ask them .... I think I ... probably have about 80 percent of it, but I've got to sit down with these guys if I want to understand what the governor is proposing, and ask them to define their terms. And ... my suspicions are that ... I'll probably be able to fairly quickly ... say: "Okay, sure. Okay, sure." There's still one I don't think it's going to be okay. I understand that. I probably am going to contest that. Something to the effect of a snapshot-type of government take. In my experience, that almost never really provides the kind of insight for which the government take statistic was developed, for all practical purposes. Now, so here I am, charged you tons of money in the past two years, and I'm sitting up here telling you I don't even know what that report says, but in all fairness, until I do, I can't claim to understand it until I talk to those guys. Now, your legislators have to make these huge decisions, the most important decisions of your life .... But it's got to be a bit horrifying if you've got people like me coming up here telling you I don't even know how to read this report, and I'm supposed to be the expert. And you're going to have to have that kind of expertise yourselves, or you're not going to feel right about the job you're going to do. Now, I think it's horrifying that it's made as complex as it is at times .... I think it can be sorted out, and ... if I'm not here, somebody can help you sort it out. And when you do get it sorted out, have them go back to my March 6th report where I use the term government take, and complain about the problem that we had even when we were all using the same terminology: government take. BP used the term government take; ConocoPhillips and Wood Mackenzie used the term government take; I did too, and so did Pedro Van Meurs. You'll be happy to know that on that issue, Pedro and I calculated government take the same way. Now, there might be some divergence between Pedro and I on the government take discussions and calculations for the gas pipeline. Now that is going to be different.

2:12:25 PM

MR. JOHNSTON: And I testified on March 6th also, that when you talk about an oil tax in Alaska, in the context of why we're here, the government take statistic, despite all of its weaknesses and the problems with it ..., is still a useful statistic. When you know the weaknesses, it will make the statistic even more useful. And there's going to be a time, I hope, when you'll be able to comfortably go down through the arithmetic and the mechanics of the system so that you know where all the moving parts are and how they move, because it truly is simple arithmetic. Now, my definition on government take ... the street corner definition to a certain extent: If you pick one of the numbers here on Pedro's page 4, see a 62 percent government take. Now, what that represents is the division of profits. And there's nothing more fundamental that goes to the heart of any business relationship quite like the division of profits. ... And ... in the industry, for the most part, we're talking about full cycle. Over the life of a field or over the life of a project, of all the profits generated, how much of it, in this case here, goes to the government? We call it government take. Sometimes we quote or discuss the company's side and call it company take. But if a government take is 62 percent, that means the oil company, at the end of the day, after having invested all that capital, ends up with only 38 percent of the profits. Your question, of course, is: Well, ... that doesn't sound like much. Are we being too greedy, are we taking too much, are we going to destroy investment in this state? Because you know the value of investment in this state, the jobs, and the potential results of exploration. It can all be wonderful and glorious, and it would break my heart if I had anything to do with destroying investment in the state of Alaska. That is not my intention whatsoever.

2:14:55 PM

MR. JOHNSTON: Now, I noticed a term that the consultants that work for the governor's office ... they don't use the term, "full cycle," they use the term "cradle to grave." Okay, fine, but at some point everybody here has got to be speaking the same language, so that you're comfortable with the statistic, and work on those weaknesses, too. The weaknesses of the statistic, and there are many, was also part of my testimony, a year ago, March 6th. So, it's all in there. And I strongly encourage you to give that a look. ... At some point you need somebody to show you ... what happens to these revenues. If revenues are generated on the North Slope, where does it all go - all the

moving parts and all those things. You can do it. It's extremely important. And when you're all speaking the same language, you can discuss it comfortably and confidently, and you'll feel good about the work that you're about to do.

MR. JOHNSTON: Now, the current system - Pedro's talking about that. I don't have much to say about the current system. I am aware of the basics of what's been proposed, there's no doubt. But I will say this: ... I should have been able to become more intimate and understand better what's being proposed by the governor than I am. But the information isn't very user friendly - and I'm supposed to be an expert. I think it can be made a little more user friendly. And at some point, too, you need a side-by-side analysis. What was the old PPT and how did it work. ... until I see something like that, I don't know how it's going to compare. I can't help people unless I see all those things and know all those things, and, in my mind, neither can you.

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MR. JOHNSTON: Now -- by the way, I agreed with most of everything Pedro said, just a couple things that we don't agree on ....

REPRESENTATIVE RAMRAS: ... What page?

MR. JOHNSTON: ... The claw back provision ... page 11. Pedro said internally he advised strongly against this, "it doesn't make sense to reward companies for past investments." And by the way, I know exactly what he's saying. I don't blame him for saying it, but I think it's important that you know I'm on record as saying that actually there was some economic justification - some economic logic and business sense that provided some foundation for that. I've said it before and I really haven't changed my mind a lot on that. I didn't see it so much as ... an attempt to reward them for past investments, but it was a situation where the oil companies had made investments without the clear understanding that there was going to be a change. Now, ... there was lots of debate back then about whether or not they should have known. And during the five-year look-back period, perhaps the farthest year back they might not have know there was a PPT coming, but a year ago, perhaps they should have. There was a lot of discussion about that. But it was an issue of fairness, I felt, that justified, to at least a certain extent, accommodating these guys for investments they made prior to the change. In my mind it goes

to the attitude of the legislature, that attitude characterized by your strong desire and the efforts to be fair, which, by the way, as you'll recall, was my mandate, as well.

MR. JOHNSTON: ... I do want to comment a little about page 15. When I arrived ... and I started to understand what was going on, just as before with the gas pipeline proposal, I was not happy that the system was regressive - full stop. And ... I really ... feel that, especially Alaska, deserves a state of the art, world-class fiscal system, regardless of where you start, what tax rate -- just there are things that you need to do and needed to do ..., that were justified by the fact it was 2006 at the time ... and we're looking to the future. And especially looking to the future when most of what was conceived in PPT was conceived in an environment where the oil companies were demanding fiscal certainty: 30 years for oil and 45 years for gas. And in that context, the issue of progressivity was, in my mind, even greater and more important. And ... that, by the way, too, goes to an issue of fairness.

MR. JOHNSTON: Progressivity means ... that if profitability goes up, your share of the profits goes up, not down. Now, I'm not so sure, although ... Pedro might contradict ... my suspicions, but one thing about royalties is ... they are regressive. ... Gee, a royalty is regressive; that sounds bad. No, all that means is when you have a system with a royalty, it's likely that when profitability goes up, the government share of profits will go down. How much? It depends on the royalty rate. Twelve-and-a-half percent royalty is not cruel and unusual - it's slightly higher than world average as far as royalties go - but then royalties aren't the only things that do what royalties do. The other family of fiscal systems in this world, of which about half of the countries subscribe to, is the production-sharing approach/production-sharing contracts. And many of those - most in fact - have what we call a cost recovery limit. And it has almost all of the characteristics of a royalty. The most important characteristic is it guarantees the government a share of production or revenues each and every accounting period. And that's one of the most important aspects of a royalty, too, by the way, despite the fact that theoretically and in practice royalties are often easier to monitor and easier to measure ....

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MR. JOHNSTON: But I felt a little bit of satisfaction seeing that my histrionics ... paid off in at least an effort to make

a system that was progressive. ... it looks more to me like we have a system that has still, of course, the regressive royalty, but the PPT tax that's slightly progressive, and they about neutralize each other so that overall the system is ... not that progressive, as far as I'm concerned. To have a system be progressive is one thing, but if it's just mildly progressive, closer to neutral - meaning if profitability goes up or down, the government take doesn't really change that much - ... that bothers me. I don't think anybody could argue, in this world, that those countries that had progressive fiscal systems in the late 1990s felt an awful lot better about their system after prices went from an average of around [\$]20 to where we are now. They had, built in, the mechanisms that would enable them to feel good when the unexpected happened. And I said so many times back in 2006, and it's the same today: Who cares what oil prices are going to be two years from now? Who cares that it might never happen that oil prices will get to \$200 a barrel? Design the system so that it can accommodate it, and don't worry about it. That's my position.

MR. JOHNSTON: So ... all these consulting firms that I was saying such nice things about get together for your new governor, and they water down the progressivity feature, which I just cannot understand. I would like to have been in those discussions, because it was such an effort bringing it about. And I was asked to come here and discuss how we got to where we are, but let me tell you, when I first started working in Alaska, one of the first things I saw was that the gasline proposal that the governor was working on in 2005 was regressive. And over the phone I said to somebody, "Good grief! This thing is regressive." And I just really was in a state of shock about that. And the response on the other end of the line: an Alaska State employee said, "Well, that's just not on the table." And I thought I knew what that meant, and it was true. That's just not on the table. I said, "What do mean, it's 'not on the table'?" ... he said, "The oil companies refused to talk about it; they refuse to discuss that." ... Are they that powerful? Now listen, I said this in my March 6th testimony and ... I'll say it again: Any time I go to a country or a state like this, one of the first things I try to get a feel for is that issue, the issue of control. And they've got ... tremendous power in this state, and rightfully so to a large extent. But that kind of power scares me and bothers me just a little bit, and my three main questions that I started my March 6th testimony on was: At the end of the day are you going to have greater control or less control? In this ... [the] Alaska ... situation is so similar to so many countries, there's no

reason you can't think of yourself as a country. You just have a few different boundary conditions, like Washington, D.C., for one.

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MR. JOHNSTON: But everybody's got boundary conditions; every country has problems of that magnitude and nature. And every government has concerns and every government has certain objectives. And one of those objectives has been ... for countries to try to gain greater control. And so that was a big thing to me, too. In fact, I think it would constitute malpractice on my part if I didn't try, in providing advise here, ... to help you obtain greater control, unless it was something you just absolutely didn't care about or want. But that's inconceivable to me, because I've seen how different it can be.

MR. JOHNSTON: In 1964, the Indonesians started to come up with what is now called the Indonesian Production-sharing Contract. It was pioneered by a guy named Ibnu Sitowo (ph) .... And they came up with a thing called a contract of work, in around 1964, and after two or three years he scrapped the contracts of work. And his main comment about the contracts of work was this: "They're just a concession with a different dress on" - meaning that the oil companies still have so much control, they basically could do what they wanted, and it just wasn't working for him. So, Ibnu Sitowo decided we're going to go with a different type of an approach, ... the production-sharing contract. And he was boycotted by the oil companies. And so, the first production-sharing contract in this world, which changed this industry and gave governments greater control ... for the Northwest Java Block has produced zillions of barrels of oil, was signed with a bunch of ... little independent oil men from Billings, Montana .... But it was almost internationally unheard of that somebody would do something like that. And then the second production-sharing contract was signed with that same group, and by then the oil companies saw ... the writing on the wall and they began to participate.

MR. JOHNSTON: I'm going to go beyond page 15 ... where I concur with Pedro. ... Page 16, softening the impact on heavy oils, ... that's been one the things that we all have agonized over. Trying to do it, though, with a single system is just, in my mind, a bit of a nightmare. Let me tell you, lots of countries in this world have more than one type of system. And if it can be done there, it can be done here. And, yes, you're going to have to hire some of those high-priced auditors. ... I've said

in the past that auditors are worth their weight in gold. If the oil company people [are] behind me, they're probably groaning, because, yeah, well they know who's gold that is, and ... they know how vicious some of these auditors can be.

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MR. JOHNSTON: I've trained probably more auditors in this world - oil industry auditors - than anybody. I helped found what was called the International School at the University of North Texas, where international auditors from all over the world came, and I taught there every year from it's inception until I moved to New Hampshire ... And, by the way, too, if they're enlightened, and understand what the relationship should be between an oil company and a government, if they understand, too, that for the most part, the interests of the oil companies and the governments are pretty well aligned, then they can do a pretty good job without getting crazy. But sometimes they don't understand and they feel the oil companies are all greedy and out to get them .... I suspect that here in Alaska, if you had auditors -- after seeing the kind of relationship that legislators in this room have with the oil industry, I have a feeling that there's going to be some rough spots, but it can work ....

MR. JOHNSTON: Now, on page 17 ... and Pedro said that the gas pipeline right now is uneconomic. I think he meant uneconomic with the existing terms, or something like that. The economics of that gas pipeline are going to be, in part a function ... of the price, and the costs ...; but what about the terms? Well, that's the issue. The only thing I've said about that gas pipeline ..., and that's this: "You're not going to be getting much virtue out of that government take statistic when you start talking that pipeline. It no longer has the currency, and it really doesn't provide the meaning." And I would be ... very, very comfortable talking about the gas pipeline without ever mentioning that government take statistic. It's about internal rate of return, not so much about government take. Oh, there'll be a government take that falls out of it, if you agree on a fair and reasonable internal rate of return.

MR. JOHNSTON: There was a presentation last year - I think the fiscal interest finding or something, published by the governor's office - that showed internal rates of return for large-scale, mega projects in this world today at \$35 a barrel and \$25 a barrel. And ..., as you know, this is all I do for a living; I'm ... a specialist. ... I looked at that ... table in

the mega projects of this world, and I was fairly intimate with a third of them. And that table showed that for comparable projects in this world - comparable to what was being proposed here in Alaska - a gas pipeline that was going to cost \$20 billion. Now, by the way, I don't remember anybody ever indicating that they believed that \$20 billion number. We all know that prices for everything have gone up. And I thought that Pedro characterized quite well the implications of costs going up, and how it's different for some countries and some provinces ...; I don't think I need to add to that very much.

MR. JOHNSTON: But I'll say this, and ... this is the strongest language I used throughout the whole of last year, and it's probably the strongest language I'll use here too, but I use the term, "intellectually dishonest" or "junk science" to that effect - with respect to that table: It was terribly misleading. If ... you guys really think that Kashagan - the big ..., high pressure, highly problematic oil discovery in the North Caspian - is going to yield an internal rate of return on the order of 30/40 percent at \$35 a barrel, then you're in trouble, because you'll never make a proper decision. Now, I've worked on that field, I'm intimate with that field, and I've worked for the government in Kazakhstan, and so, ... I start down the list and I see things like this. It was just so wrong. And so, yeah, the gas pipeline, I don't know how deep a trouble the gas pipeline is, but I'm fairly intimate with many of the dynamics that Pedro mentioned. I wasn't expecting to come here and talk about that, but it's something that will be just as difficult - if not more - than the PPT discussions, and just as important - if not more. In each case, by the way, PPT, the gas pipeline, the overall revenues, I think, you know, we're talking ... a trillion dollars each, somewhere in there - and so, the importance of it is not lost on me. Now...

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CHAIR SAMUELS: Let me interrupt you for one second, Daniel.

MR. JOHNSTON: Sure.

CHAIR SAMUELS: You've been mentioning the March 6th testimony, and my staff has made copies to distribute to everybody, and ... we'll put a copy of that ... on the web site, also. Thank you.

MR. JOHNSTON: Thank you. Well...

CHAIR SAMUELS: Could you clarify which table you're talking about - which number that you said ... was...

MR. JOHNSTON: Page 21, by the way. If anything, page 21 is as complex a table as I've ever generated in my 27 years of doing this work. But it's ... part of my discipline that until I can see the arithmetic and the mechanics and all of the moving parts, as I mentioned, then I don't really understand it, and I don't really know how the system works .... And why am I not seeing some more of these here in Alaska? We're making multi-billion dollar decisions and we don't have some of the tools we need. And I say we, because I'm being paid ... to come and talk intelligently about some of these things, and it would help me and everyone else if we could take what's proposed by the governor, ... what has been generated through PPT, what was passed last year, put down like this so that we could see them. And then a side-by-side analysis comparing them.

MR. JOHNSTON: Page 22. This'll give me an opportunity to talk about government take and the use of this - what I call "back of the envelope approach." Column A, I show \$20 a barrel, with a 15 percent royalty. You've got the \$3 per barrel comes off the top. ... I don't show any deductions for transportation costs like you are intimate with here in Alaska, so I've kept it quite simple. The net revenues, therefore, are \$17 a barrel, and the operating costs and capital costs I have assumed amount to \$8 a barrel, for this illustration. That leaves taxable income of \$9 a barrel. You subtract the taxes and you get down to the contractor's cash flow - their profits - \$4.50.

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MR. JOHNSTON: Now, when I do something like this, I always think in terms of what we call, "full cycle" or what you're seeing these days, "cradle to grave." Over the life of the field, all of the revenues generated, I'm saying here on average let's assume they were \$20 a barrel. Let's assume that all of the costs associated with getting that oil out of the ground amounted to \$8 a barrel. Typically, about half of that would be operating costs and half of that would be capital costs. If you were to take ... a detailed, cash flow model of a fiscal system like this, where the costs were \$8 a barrel, then the contractor's cash flow would come to - undiscounted - \$4.50 a barrel. In that cash flow model that they generated, then, you would be able to see corresponding numbers for every single number on this back of the envelope calculation and call them "A." Every single number here would be represented by numbers

in that economic model. So, even each of these three examples here show the same thing. Now, this example here, too, by the way, I was showing the difference between this system with the 15 percent royalty and a 50 percent tax, what the difference in government take was when you went from \$20 to \$60 a barrel. And you notice that the government take goes down. That's what I'm talking about when I talk about this regressivity that I didn't think was going to be appropriate for your situation, either PPT or the gasline in the future.

MR. JOHNSTON: Now, when you see the marginal government take statistics or ... that kind of discussion, and the BP people, when they calculated take, basically this is the assumption that's made. We assume costs equal zero. So, you're talking about the division of profits at the margin. You can think of it this way, and it's entirely fair to do this: you can ... pretend as though the difference between \$20 and \$60 a barrel ... as though there are no costs associated with that differential. A positive price shock creates this additional windfall, and that's why we call them windfall profits.... Often, especially in the early stages of a positive price shock, there aren't any corresponding costs, so this calculation yields a government take of [\$]58. And this is a typical example, although if you turn to the following page, I show another marginal take statistic; that was the type of statistic being used by BP. ... ConocoPhillips was using the Wood Mackenzie report. By the way, I liked that report ... and they didn't do one single thing wrong, but they caught a lot of heat for what I said during my March 6th testimony.

MR. JOHNSTON: When you calculate government take - and in this example ... I added one other dimension that you don't have here in Alaska, but many governments do have it. Nearly half of the countries in this world have ... government participation, and the oil companies just hate it. ... Imagine if you make a discovery and the government taps you on the shoulder and congratulates you and says, "Congratulations, thank you very much, we will exercise our option to take up a 30 percent working interest." When those occurred in these various countries in the Wood Mackenzie report, they ignored it. They didn't explain why, but ... I know why: some people prefer to exclude it. The rationale is that the government, "pays its way." Once they back in, after the oil companies risked all their money and made a discovery on their behalf, ... it's at that point going forward that they pay their way. The oil companies would love it if that option didn't exist. And from a financial point of view, there is ... absolutely a difference in

value. It can be proved mathematically and very simply. In fact, in many respects, to a certain extent, I think this really actually does it. But I was in Bolivia a couple of years ago, and there was a World Bank report where they advised the Bolivian government to not include this government participation option that exists in so many parts of the world because it was "an equity participation," it was explained, and therefore it shouldn't be included in the government take calculation. So, if they were going to compare themselves with other countries in this world, they ignored ... that thing that ... has a huge financial negative impact on the oil companies. So, here we have one simple example where the government take ranges from ... 60-64. [A] four point differential on just this one example, and yet, here the PPT discussions back in March were plus or minus 1 percent. And yet, we had calculations that were all over the place.

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MR. JOHNSTON: ... I show even two decimal points on one of these calculations, which ... applies a degree of precision that just isn't appropriate if you look at the weaknesses associated with this statistic. By the way, the Wood Mackenzie reports have changed; they now quote another statistic that goes along with their government take statistic, and I think they're calling it, "state take." And that's consistent ... with the old ... Petro Consultants reports. Petro Consultants had this big debate: should we include it, should we not include it and they decided to compromise. They quote both statistics. Now, the reason I'm harping on this so much is this: it's important for PPT absolutely, no doubt, but it's hugely important for the gas pipeline, as well. The gas pipeline, one of the things that was proposed was that the state was going to take an equity position. Fine, ... as far as it sounds. I know there's pros and cons there. But the thing about the equity position that the state was going to take was this: they were going to take their royalty and their gas in kind, ... as was part of the system even then, but they were going to have the right to pay for it to; they were going to pay their working interest share that corresponded to their royalty and severance tax share. Almost identical to what we in the industry call government participation or state participation. And yet, many people don't feel it's appropriate to include it in the calculation. And, in fact, in Pedro's own testimony, he used Azerbaijan as one example where he excluded government participation, and I agreed with him on that particular case, because they were not carrying through exploration. Now, that is identical to

Alaska's situation, in my opinion. So, here you have Pedro and me, both, would have looked at the state participation and would not have factored it into the analysis that we refer to as government take. Now, I don't think it's fair for me to throw this much at you, it's one of the biggest controversies in the industry as far as the science of fiscal system analysis and fiscal system design is concerned .... ... when experts come and testify before you, and they sometimes use the same term, government take, but they all calculate it a different way. And then, after somebody complains about everybody calculating government take a different way, the governor has a bunch of consultants come in and now they're using a different terminology. It really isn't quite the science it will probably be some day, but some day the science is going to be a little more careful, better defined, and a more standardized terminology that we and you guys can use. Okay. Oh, the cost reruns. ... On page 21, Pedro mentioned something about the ... perfect storm, and I do remember some of those discussions. No comment ... that I can think of. And ... 23. This is probably as good a time as any to talk about this issue.

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MR. JOHNSTON: I think it's the only place where Pedro and I evidently, really depart. ... Pedro said the auditors have not yet seen the increase in costs. And Pedro's thesis is, and I think it's even his first recommendation: don't change this system until you've at least seen how it's going to behave. And I can understand that .... I think I said earlier that if it weren't for the cloud, I would heartily agree. ... It's the cloud that makes such a difference. If it weren't for the cloud, hey, we fought it out fair and square ... there's a lot of people that weren't happy and everybody had to give ... up a little bit, and that's the way the system works. But I think we're finding that, well maybe the system wasn't working the way it should, in which case that's where Pedro and I depart. ... if that's the case ... you probably would have a strong justification for making a change just to let the whole world know that you don't put up with that sort of thing. ... And I'm not just talking about the oil and gas investment community. And I think Pedro doesn't give the investors enough credit. Oil company people aren't that stupid; they know what's going on here. It would be hard for me to really believe an oil company person if they said, "Oh, that shouldn't have anything to do with anything." Changing the rules two years in a row. I'm an industry person, ... half of my clients are oil companies. ... So, as I mentioned last year, I have a conflict of interest.

Pedro works mostly for governments, and so, it's a little bit different for him. ... I think people are going to understand. Now, ... I'll give you a couple examples of how understanding companies can be. After the Indonesians instituted the production-sharing concept in 1968, it was just four or five years after that that the first embargo, in 1973, changed our industry.

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MR. JOHNSTON: And they went to the oil companies and ... in regard to the contracts that they had where the oil companies were getting 40 percent of the profit, they said, "Now, thank you very much. You're now going to be getting only 15 percent of the profit." And oil companies were furious ... for a very long time, in fact. Years, years later, oil companies were still talking about how greedy the Indonesians and the Malaysians were because the Malaysians followed suit and did pretty much the same thing. Even 15 years later, I found myself defending the Indonesians. Now, let me tell you, too: some companies left Indonesia, no doubt. When ... the British government created BNOT, the British National Oil Company ... took 51 percent of all the assets in the North Sea, or something to that effect. Say, "Okay, we're going to have a national oil company now," and they need some assets, and everybody's going to cough up 51 percent. So, this happened about the same time, probably, that the Indonesians did their thing in the wake of a price shock, the likes of which we are experiencing now. And I remember ... the chairman of Mesa Petroleum at that time was extremely upset and he felt he'd been betrayed by an evil, greedy government, and he took his ball and went home. ... He ... gave them the 51 percent that he had to give, sold the rest and left, claiming he'd never go back there ever again. And that does happen, there's no doubt. It didn't cause a ripple in the UK ... in my opinion. I mean, look at the UK: yeah, a few people left, but not everybody left. And it wasn't long there was other companies coming to the UK. One of the things ... was they knew it wasn't just the UK that made this change. In Indonesia, people used to talk about how greedy they were. People were still going to Indonesia, and you never heard the Indonesians complain about the level of exploration and development activity in their country.

MR. JOHNSTON: And here in Alaska, there might be some companies when, at the end of the day, when and if there is a change, or even with the current system if you don't make a change, they're going to say Alaska's no good, and Alaska doesn't provide the

kind of opportunities that are right for them. And they're either going to not come or they're going to go away. I strongly doubt that everybody is going to say the same thing and do the same thing; I've ... hardly ever seen that happen. ...

MR. JOHNSTON: I was in the Bangladesh National Oil Company offices in 1989, after a failed license round, which we described it this way: they threw a party and nobody came. And it is horrifying after a couple years of hard work. And ... it's not the only failed license round I've ever seen. I did some work for the Uzbek government. Talk about boundary conditions: it's a landlocked country, landlocked by landlocked countries, and gas prone, and speak Russian, too. And they had a failed license round. So, we know you're a long ways from that.

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MR. JOHNSTON: And yet, many of the full-page ads that I have seen and heard about, and some of the testimony makes it seem like things are going to simply dry up and it's going to be all over. In fact, I caused a lot of grief with one of the first presentations I saw when I came. On page 14 of my March 6th testimony, I showed this graph that had been used by one of the oil company personnel. And they show how the government take changed around 1993, and it dropped precipitously. And oil production immediately increased. Actually, ... it looks a little suspicious, actually, production was starting to increase before, but it increased even more significantly after. Now, I was critical of this graph. And this is one of those rare instances where a consultant gets to come back ... and clear up a few matters ... Because the BP guys wrote a memo ... justifying the use of this graph. And they went back to a speech I had given at the World Bank four or five years ago, and quoted me as saying that the UK activity has been robust because of the tax changes that have been instituted. Absolutely. Listen, my thesis was, when I first saw this graph, I immediately knew that it was a misrepresentation. Oh yeah, they dropped the taxes, and yes, production went up. But in my opinion, most of that response that you see there was from the results of another type of fiscal device that was instituted nearly ten years before. And it was a ... famous and interesting thing. It was similar, to a certain extent, to the type of credits that ... you have here in Alaska. And the response by the industry was robust. But without knowing that, you see a correlation here that indicates taxes ... go down, production goes up, and the conclusion that we're supposed to

draw is that: "Oh, so it could happen the other way, too, couldn't it? You raise these taxes and the production's going to go down precipitously." That's an unfair characterization, and it's a misuse of what few statistics we see here. That's all I was saying. ... I did as much research as I could in the two or three days that I had to ... explain this graph, and I still feel that it was a misrepresentation. And ... that may be partly why I use the term, "terror tactics," in one of my testimonies .... I'm going to have a hard time for apologizing for using that language. Yeah, maybe it is a little bit strong, but, no, I'm not going to take it back. Those guys play ... rough. Did I, or did I not, hear about a full-page ad here in Alaska, with a pipeline and a shark chewing on it. ... We have reasons to be cautious and we have reasons to worry and we have reasons to agonize over all of these things, but let's try to keep it in balance and not get too carried away. And that was what that was all about.

MR. JOHNSTON: Now, ... I think I've said enough. ... Thank you very much.

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CHAIR SAMUELS: ... You know, we want to tax ... at a worldwide average of government take. And if you wanted to get into an average, what would you consider to be our peers ... as far as a declining fields with expensive places to operate, just, in general. ... How would you compare us to other regions? ... If you were looking at Alaska, you'd [say] it's similar to "X," "Y," and "Z." Is it similar to Alberta, or Norway, or Nigeria, or off the Gulf Coast, or those types of things? ... The government take, as long as it's calculated the same way - those are the comparisons that I want to see, but we're all over the map ....

MR. JOHNSTON: Oh, yes we are.

CHAIR SAMUELS: ... And it depends on where you come from, on what you feel about the end issue is the statistics you use. I agree that muddies the water.

MR. JOHNSTON: Exactly. ... That's similar to one of the questions that was asked when I first came, you know .... Some people here in Alaska, when I came, basically felt that Alaska was more unique than anybody else. ... But let me tell you: welcome to the club. You know, every government I've worked for has these boundary conditions that I'm talking about, and ...

they all think that they're pretty unique. So, Pedro and I get used to that, and we all work with it. As far as "prospectivity" and the place where companies would consider going, ... it's a fairly high-cost environment ... and it is an Arctic environment. The North Sea isn't Arctic, but in the UK sector of the North Sea, for legacy fields like Kuparuk and Prudhoe Bay, they take 75 percent. That's one that helps me very much when I look at those two legacy fields. ... Then, of course, there's Russia ..., how could you get any more similar: the Arctic conditions; it's remote; it's high cost. ... in addition to that, and I hate to be too rude, but you've got that Russian mentality. Those guys are a little hard to do business with. Russia, on a good day, is like 50 times worse than Alaska is ever going to be even on its worst day. And yet, their share of the profits is significantly greater than what you get here. ... I've put those statistics in front of the legislators here before. And I think the government take up there ... "front-end loaded," heavily front-end loaded. It's not regressive, though, because they've got a progressive front-end loaded export duty ... and they take a pile of money right off the top, and then they don't let you have much after that, either. And some of the companies here are investing in Russia and ... yet the take here is mild compared to Russia.

MR. JOHNSTON: And ..., you know, there's places in China. ... I'm searching my brain for the situation where you have both the legacy fields and the smaller production; that's a little bit difficult to find. I think the peer group probably should include Alberta. And Alberta, just ... fiscal-wise is kind of similar to you guys, and it's got some Arctic action .... And so, there's another one. ... I'm looking around the Arctic, but not a lot of these places have quite the potential that you have. Okay, Norway, of course. ... the government take in Norway ... people sometimes quote it as 78 percent, but there's some ... allowances similar to your credits that reduce that to maybe around ... 75 percent government take in Norway. ... though, the activity in Norway - the exploration activity - isn't as great as what you would like to see .... But then, of course, too, it's ... higher cost for some of the exploration. I think some of the exploration here would be less costly than drilling off-shore Norway, because everything in Norway is off-shore. And most of the action there, too, is getting farther and farther north into the Arctic climates .... There's a few ...

[3:07:13 PM](#)

MR. JOHNSTON: But let me say, you know, about these world averages: "Holy cow!" If you take a world average that includes more than 100 countries or even more than 80, you've got to be pretty unselective and pretty liberal to round up that many countries and you're going to end up with a few like Bangladesh, where there's not a single oil well in the whole country ... places that ... nobody would really consider to be appropriate. And that's why your question goes right to the heart of one of the key and important issues: ... find a good peer group. ... I have provided testimony where I've had more peer examples like the ones I just mentioned; I just don't know ... which testimony that was.

3:08:09 PM

CHAIR SAMUELS: ... In your clients that are governments, would you ... say that ... the petroleum industry is part of their economy .... Our economy's very small, we have the federal government, and we have the oil and gas, so, there's capital coming in and dollars circulating the economy. You've got those two factions that really, really push it. Are most of your clients that are governments similar to that or more similar to the state of Texas .... I mean the economy as a whole, where if something went sideways, what are the ramifications? ...

3:09:00 PM

MR. JOHNSTON: Most clients fall into the Alaska-type category. And let me say one thing ... about that real quickly, too. ... If in Texas the oil and gas represents, say, ... 10 percent of the gross national product - and this is true of most other countries ... - it probably represents 30 percent of ... the state budget. Now, there's two reasons for this. I first saw it in Indonesia, where at one time ... it was much less diversified and much more reliant on the oil industry, and the oil was 25 percent of the gross national product, but nearly 80 percent of the nation's budget. But that disproportionate contribution to the budget relative to the gross national product is quite common around the world for two reasons. One, the oil industry is inherently a profitable industry; it's one of the reasons why oil industry employees in this state are pretty ... highly paid employees relative to other industries .... The other reason is ... the effective tax rate - and that's what these government take statistics really are it's an effective tax rate for all practical purposes - is quite high: almost, on average in this world, easily, twice the effective tax rate for other industries. And it's for these two reasons.

MR. JOHNSTON: ... some of the countries where I have worked ... have no oil at all .... But in the past year, Nepal, how much oil do they have? ... Papua New Guinea, ... another country where, on a good day, they're 10 times worse than Alaska will ever be on a bad day. And Malaysia, ... oil is a huge part of their economy and yet, their concerns are a little bit different than yours because they have such a greater amount of control over the situation; they have production-sharing contracts. And India: India's more like Texas. Oil and gas is important to that country, no doubt. Their concern isn't so much that they're heavily reliant on the industry because it makes such a large contribution to the budget, it's their foreign currency problem that arises from the ... imports .... That's the thing that makes them more concerned. ... India ... instituted some changes to their licensing policy ... just a few small changes and had terribly unexpected results. And the industry, in the subsequent license round drove trucks through that loophole, and it was embarrassing for them, too. They ... decided to go ahead and honor those contracts. ... And, by the way, though, I would have advised that, too .... So, I'm all over the map just like Pedro, and I've worked for the Kuwaitis also. ....

CHAIR SAMUELS: Okay, thank you.

MR. JOHNSTON: Yeah, I'm all over the map on that, and their concerns are very similar to yours, oh, absolutely. ... we see the same type of rhetoric from the oil companies trying to protect themselves .... And so, I've seen the same types of the rhetoric and responses to changes in the industry many, many times, and the concerns the governments have. Yeah, you've got some concerns that are powerful, no doubt. I don't see them as being dramatically different than most of the other countries, other than the Nepal's ....

CHAIR SAMUELS: Okay, thank you.

MR. JOHNSTON: ... it's familiar to me.

CHAIR SAMUELS: Thank you. Representative Ramras.

[3:15:03 PM](#)

REPRESENTATIVE RAMRAS: ... Daniel, two questions: One - geopolitical risk. Eighty-five millionths a day ... for barrels of oil demand, 82 million barrels a day of supply. I'd like for you to address the same question that ... I asked Pedro, which

is: Tell me about oil field service inflation, as it relates to the cost of the price of a barrel rising. One of the elements that's been center to the administration's argument and discussion to bringing us to this special session, and in such a hurried fashion, in my opinion, is that there was a misrepresentation by the oil industry as to the cost of lifting a barrel of oil, and that we were not provided accurate ... facts. That it was represented, I'm trying to reflect, at \$8 a barrel, and, in fact, it's somewhere in the range of \$15 a barrel. Can you just talk around that subject matter for a little bit, then I'll ask you my second question.

3:16:41 PM

MR. JOHNSTON: Somehow, those two questions seemed [to have] merged enough that I'm a little confused, but the issue of oil field service is inflation. When the oil prices go up, people get ... more excited about some of the prospects that they had in their inventory before, when prices were lower, or they get a lot more excited about places that they've been contemplating exploring that they've held off. And it's the demand for rigs, primarily, because the bottom line is getting those wells drilled .... When ... the capacity utilization for rigs, supply vessels, other oil field services ... gets above 85/90 percent, those prices go way up, and it's almost stratospheric .... The \$500,000 a day, day rate sounded a bit rich, but it's ... not unheard of .... But that does sound like a deep water rig. A deep water rig that fetches \$500,000 dollars a day today, probably 10 years ago was ... only getting about \$100,000 a day, as a day rate. And, by the way, all of the ancillary services - the supply vessels that feed these guys and the services that go on the rigs - can typically add another 100 percent. So, if the day rate for the rig is half a million a day, the day rate for all the other services is nearly that - usually a little bit less. And so, if you're in a place where you have to bring in rigs ... it gets ... seriously vicious. Iran recently had to send out gun boats to bring back a couple of jack-ups (ph). ... My take on the story was these jack-ups were operating in Iran under long-term contracts that weren't yielding very much, and with the demand so great, they wanted to leave. The gun boats ensured that they didn't leave. And it gets that wild.

MR. JOHNSTON: ... you have a situation up here where it's not quite so inflationary. There's not so many people demanding these rigs, you have a limited supply of investors. And, by the way, too, I think Pedro can better address some of that and did earlier today. And usually what happens though, ... things do

level off for a variety of reasons, and it's very likely that costs will come down again one of these days, as we've seen them do in the past. So, day rates might be half a million dollars a day for those deep water drill ships and semi-submersibles .... You know, five years from now it could be back to a quarter of that. Those are the kinds of fluctuations we see a lot. When ... oil prices went from \$20 to \$60 a barrel ... there was truly a windfall that was created during that time. ... Still, though, even if you have prices tripling and costs tripling, profits triple, too. It's when prices triple, but costs don't move that you have an even greater increase in profitability ....

REPRESENTATIVE RAMRAS: ... The \$8 and the \$15, is that possible; is that reasonable?

MR. JOHNSTON: ... \$15 a barrel, ... lifting costs off the North Slope; that wouldn't surprise me right now.

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REPRESENTATIVE RAMRAS: ... the second ... question that I wanted to ask is: If the ... price of oil is the same this year as it was last year, ... or forecasted for 2008 as it was in the fiscal year of '07, ... in order to pay less taxes to the treasury, wouldn't you have to impute that, in fact, the PPT was working because there was more investment into the oil fields. Wasn't that precisely the intention behind the PPT to begin with, ... to encourage more investment. And the only way to get to less money coming to the treasury would be through more investment, hence, more deductions and more credits, if the price of oil stayed the same from last year to this year. In fact, the price of oil's gone up.

MR. JOHNSTON: Actually, [that] sounded more like a statement that I agree with than a question.

REPRESENTATIVE RAMRAS: Well, that would be okay if you agree with it ....

MR. JOHNSTON: ... that's absolutely the case. That type of devise, those credits, were intended to encourage exploration. Those exploration dollars get spent, and the effective tax rate goes down. And we've seen a lot of graphs to that effect ....

REPRESENTATIVE RAMRAS: So, it's working?

MR. JOHNSTON: ... I don't know ... I can't say that it's working or not working right now. I've heard these things, but remember, I haven't worked up here in a year and a half, and then ten days ago I get a call ....

3:22:52 PM

CHAIR SAMUELS: ... So, next ... up we've got Representative Doogan, then Senator Therriault.

REPRESENTATIVE DOOGAN: ... I'm one of the 13 members of the legislature who wasn't here last year, and I feel the necessity to ask a couple three questions .... Mr. Johnston, you testified that you thought that the ... percentage range of the net profits tax that was under debate when you arrived, struck you as being too narrow. What should it have been?

3:24:25 PM

MR. JOHNSTON: ... Well, plus or minus 1 percent ... in my mind was too narrow, and I also, at the time I knew of a situation similar to what I described ... just a little while ago. I knew of the situations where governments got substantially more, and I haven't used some of the unbelievable examples, of which there are plenty. ... The UK, 75 percent to those legacy fields - it's a fact of life. And Norway, ... they're not getting the kind of exploration that ... you would like to see, but ... I don't think your exploration is quite like drilling off-shore in those Arctic waters of Norway either. So, that's why I knew ... for the legacy fields here and the UK, the PPT could have been 30/35 percent, and it wouldn't even change a thing ....

MR. JOHNSTON: ... Let me make one clarification on that. You have a Prudhoe Bay and a Kuparuk field right now that are producing over 600-650,000 barrels of oil a day. And ... Marilyn Crockett (ph), who I think was quoted recently as saying that without doing anything, unless we get exploration up, it's going to decline at about 6 percent per year. If you take that production from just those two fields and assume that it's going to decline at 6 percent per year, you're going to get about ... 1 to 1.5 billion barrels of oil from those two fields, without doing anything. And if you just added an extra layer of tax, a profits based tax, it really, in my mind, wouldn't substantially change the ultimate economic limit hardly at all. Oh, it will change it, but it wouldn't be a change that had a lot of drama associated with it. Now, changing a royalty does change that economic limit more dramatically, no doubt, but that's a long

ways off. And that billion to 1.5 billion barrels of reserves, in ... what other countries call base production, ... probably represents 75 to 80 percent of the ball game here, as far as revenues that the state of Alaska's going to receive through this government take thing. But government take doesn't measure all of the means by which governments benefit; ... those other dimensions, one of which is jobs ....

MR. JOHNSTON: Now, the BP folks made a good analogy for the legacy fields, in my opinion, to exploration. If you're going to get that decline rate off of 6 percent and up, they've got to do things in the future that they're not doing now. And the types of things you do with a mature field ... like water floods, enhanced recovery techniques, implementation of new technologies .... And that can be risky sometimes where the outcome might be unclear. In fact, the outcome might turn out to be a financial disaster for that particular investment. The water flood might cost \$200 million, with an internal rate of return, ... unexpectedly, of 1 or 2 percent, which means they really lost money in the long run. ... I agree that there are certainly characteristics of exploration for adding to that base production. And that's where the other dimension to the PPT was to come in and to help encourage ... whatever enhanced recovery techniques are used. But also exploration in other parts of Alaska. And, so I'm thinking you've got a tax here that has got to address that base production ... and those other things, too. Now, it's the other things, too, that makes it quite difficult. But I knew one thing for very, very sure: That huge and important component, the base production from the two legacy fields, is something that other countries have dealt with successfully. It's almost business as usual, but that would be an exaggeration.

[3:29:06 PM](#)

MR. JOHNSTON: When we talk about the universe of fiscal systems that exist in this world ... and we do these analyses that come up with these averages and stuff ... Now I forgot where I was going with that darn thing. You know, repeat the question again, because I think I've gotten off track just a little bit, Representative Doogan, I apologize.

REPRESENTATIVE DOOGAN: That's okay. I was just asking if the range of ...

MR. JOHNSTON: Oh ...

REPRESENTATIVE DOOGAN: ... was, yeah.

MR. JOHNSTON: It would ... be in a plus or minus range, because you were awfully low, in my opinion. It ... could go up, especially for the legacy fields. The other fields it was going to be a little bit tricky, and that's why we spent so much time agonizing over the claw-back or the look-back. It would be \$73 million exemptions, and all those funny, peculiar, odd, little things that you heard us talking about so much. But ... there was plenty of room.

REPRESENTATIVE DOOGAN: Mr. Chairman, if I might.

[3:30:29 PM](#)

CHAIR SAMUELS: I'll clarify one thing: the \$73 million that he just talked about, the original bill that was dropped into the ... legislature essentially had a tax holiday. The first \$73 million that you made, and it ... had the intent ... to make sure that the explorers really primed the pump, so when they started making money you didn't penalize them. In the legislature, we eliminated that from the big three producers. So, ... we turned it into a tax credit; it ended up the same way. But just so you know, through the process that changed, so the \$73 million isn't a factor in the ... Prudhoses and Kuparukus anymore. We eliminated the big three from that particular tax credit ....

REPRESENTATIVE DOOGAN: ... Mr. Johnston, you also testified that one of the ... inherent problems with the PPT is that it's a sort of a one-size-fits-all tax. And we've heard testimony from the administration that ... as they were coming up with this proposal they had difficulties figuring out those trade-offs .... The difference between oil that's coming out of the ground regularly in predictable amounts, qualities and grades is different from oil that, if you poke a hole in the ground might be there and might not. So, if we didn't have a one-size-fits-all tax, what would that look like?

MR. JOHNSTON: You'd have a separate situation for the legacy fields, and you'd have, a separate situation, you could almost treat it like another state; ... for Cook Inlet ... and for exploration up in the North Slope and other parts of Alaska. And, they could be dramatically different, there's no doubt about that in my mind.

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MR. JOHNSTON: And quite a few other governments are ... doing this around the world. ... Indonesia, ... they have a different type of system for oil versus gas, they have a different system for ... pre-tertiary rocks; they have different terms for deep water, ... for the western conventional basins that were known producing, and they have different terms for the eastern frontier. ... they accommodated all of these differences, and had a system that was relatively unique to each of those environments. And in my mind, that could have clarified ... almost all of the problems ... because the one-size-fits-all had enough unique, slightly different characteristics ... it made me extremely nervous. Anytime I see, in a contractual relationship between a government and an oil company, even one new thing ... I get ... very nervous, because it takes a while to figure out where that thing might go wrong. So, if I see a system that has two or three ... bells and whistles that seem fairly innocuous, then I'm even more worried. In India ... the mistake they made ... was they actually, simply disclosed a little bit more information to the industry. They simply gave them a little bit more information into how they were going to evaluate the bids. But once the oil companies saw that, they saw a way to pervert that system; it was the most amazing license round you've ever seen, and these crazy bids came in. It .. turned out that the ... crazier the bid was, the more likely it was to win because of the peculiar characteristics of how they were evaluating. So they just provided more information to the industry, that sounds innocuous, doesn't it. And yet, it was ... not only painful, but embarrassing to the Indian government. So, here you're doing things that are more significant than simply disclosing additional information. That's the problem with one-size-fits-all. Pedro deserves a moment on that.

[3:34:28 PM](#)

DR. VAN MEURS: ... Basically, around the world there are two models of how you should go about designing a fiscal system. Some nations, Norway is probably the best example, ... prove to be the extreme example with the one-size-fits-all model. And they try to design the fiscal system in such a way that it has some sensitivity to different economic conditions. Other nations, like Indonesia, ... Egypt, ... Yemen, or ... Algeria, which was one of my clients, actually try to extract from each block or each field, the maximum government take. They may do that through negotiations, or they may do that through other ways. Or in other words, one nation that ... does things block-by-block looks kind of like ... a mosaic ... of leases and or

contracts. There's different terms, and then the higher terms are in the more attractive areas and the lower terms are in the less attractive areas. That is a system that also could lead ... to optimization, ... from a government point of view. And Alaska, for the PPT, ... could basically opt for both. In fact, ... the original ELF, former ... was actually, kind of a field-by-field ... mosaic concept. ... what was concluded is that that mosaic concept ... didn't seem to work. I mean, people had nicely put the formulas together but then, even Kuparuk field, based on that formula, didn't seem to pay a reasonable amount ... of share. ... the problem with doing it block-by-block is that you have to design some kind of terms for that block, specifically, or on the basis of some formula that then tries to optimize that. Those systems ... could be out-dated, as, as what happened in Alaska. When one of the main focuses of the PPT was to enhance investments in Alaska. ... what is very important to realize is, yes, optimization of government take was important, but the other important factor was to encourage investment in Alaska. That, consolidated systems tend to stimulate re-investment better than non-consolidated systems, as they call it, this mosaic system. Because if you have this mosaic system you can typically not take a cost from one piece of the mosaic and deduct it from the other piece of the mosaic. So, consequently, you have what you call ring-fencing going on in technical terms. Ring-fencing doesn't stimulate investment. Since the main objective in Alaska was to stimulate investment, and particularly re-investment, of the companies that were already here, a consolidated system is a good solution for that particular objective. ... I'm not necessarily denying that other nations could be very successful with the ... mosaic system, as well. I think everybody recognizes that Norway has been unusually successful with their one-size-fits-all system. Today, Norway has a petroleum fund that has \$317 billion in it, for 4.6 million Norwegians, on the basis of the excess funds from precisely a tax that operated somewhat similar to the PPT.

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DR. VAN MEURS: So, can nations be highly successful with the one-size-fit-all? Yes, they can. We have many examples of that. ... It is really a choice on the part of the nations ... if your main focus is extracting optimal government take from each piece of the mosaic, ... a ring-fenced system, definitely has a lot of merit. If you want to design a broader system that ... encourages companies to look all over the state for investment opportunities and get the benefits out of it, then a consolidated system has also great merits. ... let's say, the

ring-fence system hadn't worked very well and proved to be difficult to manage from the point of optimization, let's say, this Kuparuk not even bringing in any revenues. It seemed that a one-size-fit-all concept would be a good thing to try out. ... consequently, that is what was presented to the legislature. ... but both systems could be successful. ... For instance, right now in Alberta ... I made the opposite recommendation. I made the recommendation for ... continuing the ring-fencing of the various oil sand plants. ... It depends on the situation what seems to be the best strategy in ... each case.

[3:41:03 PM](#)

CHAIR SAMUELS: Follow-up?

REPRESENTATIVE DOOGAN: Just one more question for each of you. Dr. Van Meurs, you used the term, stability, in your presentation. And Mr. Johnston, I believe you used the term fairness. These are somewhat amorphous terms ... for ... policymakers, particularly when you stop to realize that the price of stability is going to be ... somewhere north of a billion dollars ... in revenue to the State of Alaska. Do ... either one of you have any guidance for me and the other people who are going to have to make these decisions as to the question of whether there's ... some definition of stability or some definition of fairness ... that we can ... cling to as we go through this process.

[3:42:00 PM](#)

DR. VAN MEURS: No. ... Fairness for me is a very simple concept. Many people associate fairness with relevancy, ... fair to the people. I always believe that the fiscal system is fair if it ... seems to be competitive taking all factors of cost and logistics into account. Just as, if you sell your home and your neighbor gets ... four hundred thousand for the home and you have just a slightly bigger lot, maybe it is fair if you get four hundred and ten thousand dollars for your home. ... the fairness of government take depends on how you compare in a competitive world with other nations. That is why ... Daniel and myself are specialized on trying to do this government take work, because that ... helps you in making up your mind as to whether something is fair or not fair. ... I definitely believe that ... the PPT, the whole fiscal system as I presented, is in the range of fairness, as I testified today. ... I think it could be improved somewhat, but what is fair has a margin of error. ... it is not a very precise term. But, fairness is not

related to how much money Alaska needs. Fairness is related to ... Alaska being the resource owner, what is a fair price for this particular property. ... that is the fairness issue. Stability is a ... more difficult concept to define. The ... Wood Mackenzie study, which rates, I think, unacceptably and unfairly Alaska as very low in the stability, I would violently disagree with because I think they used methodology that is ... unacceptable. Their definition of stability is: Did the government change, over the last few years, the fiscal system? If the answer is yes, then there is no stability. ... That is an idiotic definition. So, ... I totally disagree, let's say with Wood Mackenzie definition of stability. I do believe that for investors instability is important. But, ... Alaska has not violently changed the fiscal terms over the last, as we just discussed, 16 years before the PPT changed.

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DR. VAN MEURS: I hope that ... by 2011 or so the system is more stabilized, ... maybe Alaska then goes through another phase of stability for maybe 10 or 15 years. Ten, fifteen years, ... for the shelf life of a fiscal system I would consider as very stable. You don't need 30, or 40, or 100 years of fiscal stability to ... be called stable. If these changes are rational, ... fair, ... in international competitive concept making changes every 10 or 15 years - even substantive changes - is reasonable. And I'm in the same defense in Alberta. Alberta did not change the terms since 1997. As you may have heard in the past I recommended significant changes for the oil sand. Of course, I am now being accused as "Chavez of Alberta," and ... ripping up contracts and things like that, all kind of unfriendly words. But, I'm absolutely convinced this is a very stable province and once they have revamped their fiscal system that will then ... last for another 10 or 15 years. That's what I call stability, so ... stability doesn't mean that you can't change. ... if I define stability in the way I just did, that means with respect to taxation systems, which in principle can be changed. Now, in Alaska your royalties are stable because it is a contractual relationship, and consequently there is never a change in royalties unless it is mutually agreed. So, in Alaska the royalty system is a highly stable system and is not meant to be changed, while the taxes is a stable system, as long as you change it every 10 or 15 years. I think you are a perfectly stable example of a good partner of the oil industry. And so, I think that should be the objective.

[3:47:56 PM](#)

MR. JOHNSTON: I'm glad that Pedro was so eloquent about the Wood Mackenzie report because I have not seen the report. ... On the issue of fairness, in my opinion, there are elements of subjectivity, ... but this government take statistic, when it's used properly and the proper peer groups are used ..., it can provide some substantial insights because the acid test of fairness is where you can look at a country and see that there is oil and gas activity. Obviously, oil companies are signing contracts and working with the government. ... in fact probably more often than not, it's the oil companies' bids that determine what the ultimate terms were in those countries. People will sometimes bid royalty rates, they'll bid the profit oil sharing rates .... So, at the end of the day, the government take is kind of the bottom line in determining which ... company gets the license .... The industry has made a clear and bold statement as to what they think is fair and reasonable in this country, and if it's comparable to Alaska, then you have some fairly tangible, and less subjective, measures to use in making your decision. Now, the issue of stability. And I disagree with Pedro on this one thing. If you were to make a change this year as a result of the "cloud," I see that as pure, perfect, understandable justification. And I say understandable in the context of what I mentioned earlier: ... I think we can give the industry a little bit more credit. ... I think it's fair to say that most of the companies represented here in Alaska today really should understand that if this law wasn't passed in the appropriate way ... if it really was undermined, ... then I think there is justification and no problemo. And in my mind, too, yes, you changed the terms last year, ... but then it's, the context, too .... How many countries are not looking at changing their terms these days? They all are. Now ... some of them might appear as though they're not going to change their terms because some governments looked just like every other government did and decided they didn't need too. And that's the thing ... that doesn't measure. There's a lot of countries in this world where the government take is so ... high, they don't feel so compelled to change. And so the guys like you, that have a relatively low take, and let's face it, you do. ... the license round in Libya not so long ago, and how ... stable can you think Libya is, they just opened their doors. You don't even have a measure of, of stability yet .... and ... the bids for some of those licenses yielded for the government a take on the order of 95 percent. Now, wait a minute. Is Libya that much better than Alaska? ... that's what you have to ask yourself. And my response is: Well, it must be, I don't know what they got going down there, but ... that's spell binding and

spectacular. And ... there is another dimension to the government take statistic and that's this issue of how up front it is and how much of a royalty they get.

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MR. JOHNSTON: ... you have a 12.5 percent royalty ... it's a high royalty by world standards, but as I said royalties aren't the only things that do what royalties do. So, in Libya, in addition to those shockingly high government takes, ... which are similar to the buy-backs in Iran and ... to a lot of the operations in the Middle East. There's a company operating a field in Abu Dhabi, and all they get out of producing that oil, 500,000 barrels a day - sounds kind like ... up here, although it is less expensive - they get a dollar a barrel. Now, \$80 a barrel, let's say it costs \$10 to produce that oil. There's \$70 in profit, and the oil company's share of those profits is \$1 out of 70. So, there's some wild stuff happening out there, no doubt. And, and, do you think the government in that contract had any incentive to consider changing that contract? No. So they get all this wonderful credit for being stable. Well, I guess so. It's things like that that don't get measured. And one of Pedro's clients, he mentioned Algeria, we didn't see Algeria on that list, did we?

DR. VAN MEURS: No, no. Wood Mackenzie forgot about that one.

MR. JOHNSTON: ... there was only three or four that ranked worse, but Algeria wasn't in there .... And Kazakhstan, ... we always compare Kazakhstan to you because that huge mega project there is pretty close to the gas pipeline project. On the issue of stability, I think in the long run, ... a few people are going to be upset. But I think the general consensus is going to be, if the cloud turns out to ... be [founded] ... I think people are going to understand. I really feel strongly that way.

[3:54:01 PM](#)

REPRESENTATIVE DOOGAN: ... The way you two gentlemen use the term government take it includes federal government taxes, royalties, all of that?

[3:54:19 PM](#)

MR. JOHNSTON: Yes.

REPRESENTATIVE DOOGAN: OK. Thank you Mr. Chairman.

CHAIR SAMUELS: O.K. I've got Senator Therriault, then Representative Gara, Representative Crawford, and then Senator Ellis.

SENATOR THERRIAULT: ... I just want to check on the governmental take and you've talked about the total life cycle cost, or ... cradle to grave. You're ... talking about looking at everything from putting it into production to the end, to the full life of the field. Is that correct ...?

MR. JOHNSTON: Yes. Full cycle, over the life of the field, or ... cradle to grave. Thank you very much.

SENATOR THERRIAULT: So, it's not just ... a snapshot, because even in ... a production-sharing contract you could take a snapshot right now. But maybe the company is still recouping its investment cost, and ... the sovereign's take is going to be impacted by that. So you can't just take a snapshot, you've got to look at the total, whole thing.

[3:55:29 PM](#)

MR. JOHNSTON: In my opinion, absolutely. It reminds me of a conversation I had with the Uzbek government folks ..., remember that they are a land locked country, talk about boundary conditions. They're gas prone and the wells there are high-pressure, very high-pressure expensive wells; the pressure is almost geostatic pressures; it's a nightmare. ... I'm thinking the terms are going to have to be pretty good and they just couldn't believe the kind of terms I was talking about, so they stopped and said no, this is the way we look at it. We feel that oil companies should get about 10 percent of the profit, until pay-out, and then, 3 percent. Now think about that. Before pay-out, what profit are they talking about? You know, until an oil company has got all their money back, there are no true economic profits. ... I make the distinction sometimes between economic profits and financial profits, until they've gotten pay off plus their cost of capital ... there's no true financial profits that have been generated. We can have, though, situations where accounting profits are generated in those years before a true pay-out occurs. Either way, though, in my opinion, it is very dangerous, and almost always misleading when we talk about a snapshot of government take .... And so, I have seen that terminology and I ... am just extremely curious but ... from what I have been provided, and from what

I've read, ... it didn't adequately explain the methodology, or the logic behind it; so I don't know what they have done. So, on one occasion ... in my career have I ever quoted take in any other context than full cycle. And that's for ... the Kah Shakan field ... and it is such an unusual contract, I felt that was justified, in that particular case. So, I'm real leery of that ... and I'm sure Pedro has an opinion on that, too.

[3:57:15 PM](#)

SENATOR THERRIAULT: So, in ... the total life cost, cradle to grave, generally who decides what costs are subtractable?

[3:57:33 PM](#)

MR. JOHNSTON: Oh, in most countries, especially the countries that use production-sharing contracts, but this is not exclusive to them, it is the contract which will specify what costs are eligible for either cost recovery, or as tax deductions, or both. And the government has the right to audit and they're pretty rigorous about [it], which is an understatement in some countries. ... In addition to that, many ... have what we call procurement guidelines in the petroleum regulations and the petroleum laws. There are specific laws about how you can procure goods and services, and it's almost as rigorous, in some countries, as the procurement requirements that you work under when you bring in consultants like Pedro and I. You have to do it a certain way. Well, for the oil companies in these countries, they have to be very careful about how they procure goods and services, and then it's all auditable and the governments have a significant amount of control. Sometimes so much that ... it costs them ....

[3:58:43 PM](#)

DR. VAN MEURS: Maybe I can add a few words there. ... in the PPT law, as it is today, there is clear mention of the kind of costs that are deductible and not deductible. So, if you have a tax system that works, say on a consolidated basis, and that is not a contractual relationship, you could, in you law, and in your regulations, specify which costs are not deductible for PPT purposes. And, in fact, you gave the example of the corrosion issue, and that the idea was to make that a cost that is not deductible. ... you don't necessarily have to have production-sharing contracts, as Alaska proved in their PPT law. You can, in the law, ... and more precisely in the regulations, describe what costs are not deductible In production-sharing contracts,

the costs that are deductible and not deductible are typically contained in what's called the accounting procedure. It's just an annex to the contract, but that is a contractual agreement. So, you sit together with the government and say: I agree that these costs are not deductible.

[3:59:59 PM](#)

SENATOR THERRIAULT: So, ... really you've got recoupment of costs, the total economic take from the project, long-term sharing of the project, the profits. It really is a net structure, isn't it? A production-sharing contract, is it net?

[4:00:35 PM](#)

MR. JOHNSTON: Oh, no. Almost all governments receive a certain amount through net. Is that what you're talking about; net as opposed to gross ....

SENATOR THERRIAULT: You've taken out the cost. The company has recouped the cost and then you're arguing about what's left.

MR. JOHNSTON: Well, some of these production-sharing contracts have royalties, too. Are we speaking, is that ...

[4:00:40 PM](#)

DR. VAN MEURS: Sorry, ... no. I would agree, very old data. The production-sharing feature itself, consisting of what you call cost oil and profit oil, subject to maybe a cost limit being in place. But, if you have the cost oil and profit oil concept, ... the profit oil is the split after ... all the cost oil has gone to the contractor, based on the recoverable cost, based on the definition of the accounting procedure. Then the remaining of the profit is split between, let's say the state and the investor. As Daniel says, these days ... more comprehensive production-sharing agreements would have other features ... like royalties whereby ... certain amounts are actually set aside directly for the state in addition to the profit share that the state receives.

[4:02:07 PM](#)

SENATOR THERRIAULT: Mr. Chairman, I think one thing that would be ... helpful for the new members, ... for all legislators to look at ... is ... the last year. The State of Alaska, we get revenue from the operation from royalty, we've got severance,

... property tax, ... corporate tax. And so, when we talk about where we've changed our system, and it's now terribly destabilize, the royalty didn't change, property tax didn't change, corporate tax didn't change. So, I think it would be helpful if we looked at ... a year's worth ... total state take from oil and gas operation. How much of it was royalty? That was stable. How much of it was property tax? ... How much was corporate tax? So, you really get down to just if there is instability because of the change, it's just in one component of the state's total tax. And I think if we look at ... a total of \$4 billion, how much of that really are we talking about? ... probably, off the top of my head I'd say a billion dollars, maybe a billion-five, something like that.

[4:02:45 PM](#)

CHAIR SAMUELS: ... again, ... the debate over ... putting the deductions in the ... statute and what the first committee of referral did last year is: We wanted the regulators to put them in ... knowing how difficult to get something to the legislative process was .... And, quite frankly, speaking for Representative Ramras and myself, we got attacked from all sides. The industry wanted it in the statutes, which kind of raises a red flag. A lot of the members wanted it in the statutes, which ... was an odd thing. ... I couldn't tell you how it'd end up. ... And I was of a mind to let the regulators do it, who are far more nimble and flexible.... ... as the debate continues over the next month, ... I'll be asking Ms. Davis the same thing: Can the regulators do these things, should some of them be in the statute or not; knowing how hard it would be two years from now to open this up again, to add something or take something away from these deductions, and two years after ..., rather than having regulatory changes ....

CHAIR SAMUELS: Do you have any follow-up questions? I've got Gara, Crawford, Ellis, and Kerttula...

[4:04:29 PM](#)

SENATOR THERRIAULT: Could we ask the LB&A staff to just get those figures for, say, ... the last fiscal year. What was the total take in royalty?

CHAIR SAMUELS: Certainly. ... We won't get them right this very second, but we will get them and distribute those.

SENATOR THERRIAULT: ... And then I've ... got a question for these two gentleman - Pedro, perhaps more to you. When you developed your model for the PPT, it was in calendar year 2005, I believe.

DR. VAN MEURS: Yes.

SENATOR THERRIAULT: Primarily 2005. You would have used actual data that would have been reported ... in 2004; cost data from the companies. Probably the most recent data was ... about a ... year's worth of lag, I would think.

[4:05:26 PM](#)

DR. VAN MEURS: ... There was a difference between what the Department of Revenue used and what I used. The Department of Revenue, for the forecast of whatever the reviews would be - one billion or two billion - ... used stylized figures that largely came out of 2004 data, largely from confidential tax returns ... My data were based ..., on a field-by-field basis, ... on extensive discussions we had with the oil industry, but the oil industry themselves ... provided the cost data to us, which I checked with other areas in the world, and I thought that at that point in time these data looked reasonable, in terms of cost structure.

[4:06:45 PM](#)

SENATOR THERRIAULT: So, that all came together in 2005 ...

DR. VAN MEURS: Yes.

SENATOR THERRIAULT: ... and then the debate ended up going much longer than, I think, anybody anticipated. At some point...

DR. VAN MEURS: ... could I interrupt? No, the data that I used for 2005 data ..., the Department of Revenue used ... were derived from 2004 data. But I actually used the data that were based on actual cash flows that were discussed with the oil industry, that I checked against other fields, similar fields around the world, and at that time I thought that were a reasonable cost.

SENATOR THERRIAULT: Okay, ... a point in time was established as you developed your model in 2005. As we went through the debate in 2006, number one for the Department of Revenue, some new cost data from operations in the State of Alaska,

confidential data, should have come in at some time in 2006. ... But the point I'm trying to get at, and this is a question that I have already passed to the administration for response: Was there a point in 2006 where we should have known that costs were going up faster than the models originally anticipated, and ... was that incorporated into the model, which would have lowered the legislature's expectations of what profit was going to spin off this new tax.

4:07:42 PM

DR. VAN MEURS: My model was not ... the statewide review forecasting model. My model was an economic analysis model. And I have in my ... model a standard feature, whereby after I have set tentative costs for a set of different fields, ... it is very easy in an economic model to do plus or minus 10, plus or minus 20, plus or minus 30 percent cost and look at the effect. And, of course, that was the kind of analysis that I also did. That ... is standard analysis. ... as you recall, during some of the debates, some people said, "Why not go to 25/25, for instance?" ... Because of my model, or because I had done cost sensitivity on the possible impacts of higher cost, it was my strong recommendation to the legislature to ... not go higher than the 20 percent, because that kind of a cost analysis showed that that could ... - and I in fact testified to that - ... expose the state revenues to risk. Now, that is a different kind of analysis than the total revenues analysis from the state which ... were based on ... trying to estimate the totality of the revenue. I was more interested in actual ... design a system for the next 15 years, you know the costs are going to be very different from what they are in 2005. I never really fall on my sword for 50 cents more or 50 cents less per barrel. What ... I'm trying to do is look at the fiscal system, look at the cost structure, do sensitivity analysis, and see how does this system perform under a wide range of circumstances. ... you know that if costs go up, then you will receive less, and if costs go down, you will receive more. Out of that analysis ... came my caution, which I strongly defended to the legislature, as you may recall, that ... I strongly recommended not to go higher than 20 percent credit. And despite the fact that there were some other proposals, with higher credit. And that was the result of my analysis.

4:10:00 PM

SENATOR THERRIAULT: And I remember you testifying to that fact, but I guess what I'm trying to get at is: If part of the rub

with the Alaska public and legislators is the expected revenues are not projected to materialize out of this new system, should we have known at some point that that ... was happening - that costs were going up higher than perhaps you had projected or ... modeled. Were they going up smoothly, or had they actually jumped up to a new plateau and then we're going up from that new plateau? Should our expectations out of PPT have been lower than what was being graphed?

DR. VAN MEURS: No ... I warned legislature, ... in ... almost every presentation I made during the gasoline debate, ... about the price increases.

[4:10:55 PM](#)

DR. VAN MEURS: So ... I think that ... there's ample evidence around the world, in 2005, ... and in fact beginning in 2004, 2005, 2006, that costs were going up, and I tried to convey that to the legislature as an additional risk factor in ... the pipeline. ... working simultaneously in different countries with different kind of cost structures, ... it was not my strong impression that the Arctic ... in Alaska had the same kind of local cost escalation as Alberta had. I mean, if you go to Alberta ... clear signs of overstress of the economy. Nothing like that happened in Alaska; nothing like that happened in certain countries in the Middle East where I work. So, that gave me the impression that, yes, there could be some cost increases in the Arctic, but I didn't have hard data as to what that could be. Certainly, it is still my view today, that these cost increases are not necessarily as high as occur somewhere else. And that is why I strongly urge the administration ... take strong measures to do proper auditing, because I can easily see how, after a proper audit, you will come to the conclusion that actually not that much money ... it's less than anticipated. And I wouldn't be surprised if that would be the conclusion two or three years from now. But in my model there was no need to adjust anything, because I do cost sensitivity anyway.

SENATOR THERRIAULT: Thank you ... , Mr. Chairman, I'll let somebody else take a turn, but put me back on the list.

[4:12:55 PM](#)

CHAIR SAMUELS: Okay. Representative Gara. I've got Gara, Crawford, Senator Ellis, and Representative Kerttula.

REPRESENTATIVE GARA: Thank you, Mr. Chair. ... Mr. Johnston, I want to grab as much information from you as possible before you leave. And one of the issues that you talked about was a different tax rate for the legacy fields. And looking at something like that, I want to make sure that we understand how to do it and how to talk about it, if we want to do it. And Representative Doogan starting asking you this, and I'm not sure if I understand that answer yet. You've got Prudhoe Bay and Kuparuk, for example, and you'd said maybe a 30/35 percent tax rate on those fields, but the caveat is in the future there might be heavy oil there that we need to extract, there might be new pools of oil that the companies have to access that aren't part of their ongoing operations. How, with a higher tax rate on the legacy fields, do we also accommodate for the fact that some of the ... new oil on those fields that we're hoping for is going to be more expensive ... -- how would we treat those sections separately within ... those units? And do other countries do anything like that?

MR. JOHNSTON: Yes, other countries do things like that. I refer to them as rehabilitation or redevelopment-type projects, or sometimes they're called improved oil recovery or enhanced oil recovery contracts. ... they're characterized by a producing field that's in decline and in need of additional work .... The negotiations focus on the fiscal terms, that's a natural thing, but the terms that are negotiated are typically two dimensional. One dimension deals with what's called incremental production: anything that is the result of additional work, enhanced recovery techniques, additional technology, and things like that. The base production in your case would be ... maybe a 6 percent decline. That's another element that's negotiated. And there's a fee that's often paid to the companies for the base production, or a different set of terms. I would be very comfortable ... looking at that sort of relationship, because it's been done so often. When we talk about the science of fiscal system analysis, and fiscal system design, and all these average statistics, they usually focus on exploration. If you're able to segregate out the portion up there that really isn't exploration, ... that's the base production, then there are example contracts all over the world that deal with situations like that.

[4:15:50 PM](#)

REPRESENTATIVE GARA: ... Just on that subject, could you have a special credit or deduction system for enhanced production also, if you did it by statute ....

4:16:06 PM

MR. JOHNSTON: Heck, no. ... I never was against the credits ... because if you're confined to a single system, you kind of have to do this juggling that we've been doing for a couple years now. If you can segregate the base production on the legacy fields, and then create fiscal terms for everything else, those fiscal terms for everything else could be an awful lot simpler. And there are standard formulas that have worked, not a lot of bells and whistles that make people confused ....

REPRESENTATIVE GARA: A couple follow-ups?

CHAIR SAMUELS: Yes.

4:16:45 PM

REPRESENTATIVE GARA: ... I forgot about the testimony that you handed out, and what I had from you from last year was this April 22nd memo, I think, that's being distributed. ... this is on the issue that you discussed of how quickly and how strongly you raise the tax rate at a certain benchmark oil price ... the progressivity factor we've been talking about. ... I think PPT is somewhere around \$55 or \$60 a barrel; you raise it by .225 percent for every dollar the price goes up. I think ACES is something like .2 percent for every dollar the price goes up a little bit earlier. ... on page 4 of your report from last year, you'd said something similar to what you're saying now, which is you don't think ... that progressivity rate is high enough, .... And you had recommended a .375 percent increase for every dollar ... on a legacy field, starting at \$40 dollars a barrel ... -- and that's a much higher number that we've been talking around, around here. Can you explain to us why that's not too much. ... if you raise the progressivity factor, to something like you recommend, is that fair to the oil companies; does that allow them to achieve additional profits as the price goes up, too?

4:18:29 PM

MR. JOHNSTON: ... it was one of the first issues that I bought up when I started to discuss progressivity. I was pretty adamant about the need for progressivity .... The natural question the is ... : Well, how progressive is a progressive system in this world? And there's fairly readily available statistics that I provided in my testimony ... that showed some

of those systems that are. And in this world, there's about 20 percent of the countries actually have a progressive system that responded to this price shock that we're experiencing now. ... another 10 percent of the fiscal systems in this world are ... neutral and nothing changes. It's the other 70-odd countries in this world, like you guys, that were regressive. The price goes up, but your take actually goes down. ... in this day and age, that, for me, is not a state of the art system; ... if you can change it, I recommended that you do. I looked at those countries around the world that actually had progressive systems, and ... I looked at the average progressivity, and my feeling was that ... if you look at the difference between \$20 a barrel and \$60 ... for the universe of systems in this world, the neutral countries didn't change - the government take didn't change, the regressive countries' government take went down 2-3 percentage points, the progressive countries, ... government take went up from 5 to 10 percent, as I recall. And I figured, that makes sense to me. So, if you went from \$40 a barrel to \$100 a barrel here, and the ... government take went up 10 or 15 percent, even, which is a lot higher rate than this modest little increase would yield, by the way, you ... are in a ... glorious place. And there's an acid test, in my opinion, as to ... at least one dimension of how high you could go.

[4:21:03 PM](#)

MR. JOHNSTON: ... we saw some interesting licensing here in Alaska ... during a time when prices were just as high as they are now, ... when Northstar was put out for bid. And that's one of those examples where the industry lets you know how much they can sustain. ... When the oil prices were high, Amerada Hess bid an 80 percent net profits interest. On top of that there was a 20 percent royalty. On top of that, ... it's followed by the government tax rate ..., which I think at that time even was higher than 35 percent. Northstar government take, as I recall, was over 90 percent. It wasn't legislated; ... it was a bid submitted by the oil companies .... And so, ... with prices like this, or prices like ... what they could be when you're designing a progressive element, you can go very, very high, and the oil companies have shown that they can handle that.

MR. JOHNSTON: There's more examples than Libya out there these days. When the prices are this high, there's still a lot of money to be made. In Iran, the government take on those contracts probably is 98 percent. ... I can find lots of support for some very high taxes amongst the oil industry bids around this world. ... if my mandate was to help you get the

absolute most out of the tax system here, and just beat the oil companies up, well I'd recommend that you have Pedro help you out there, because obviously Alberta ...

[4:23:09 PM](#)

DR. VAN MEURS: I'm ready to start the Bolivian revolution in Alaska, also, yes, ....

MR. JOHNSTON: ... I'm glad I'm not the only person that's compared to [Cesar] Chavez; I'm glad it's Pedro, too. So, ... there was some logic behind what I recommended, and it's that kind of logic that you have to think about, too, if you ... design or redesign the ... progressive element of the system here.

REPRESENTATIVE GARA: Just one final question?

[4:23:46 PM](#)

DR. VAN MEURS: ... Representative Gara, you asked what specific measures could you use to increase the government take on the ... legacy fields. ... broadly speaking, there are two methodologies. One is the mosaic thing, where you ... simply ... try to design a fiscal system around different size fields, as we tried to do with the ELF. ... If you opt for the PPT, as a consolidated system, then you cannot really design anything for any particular field, because you have a consolidated system. So, ... a consolidated system means it is for total Alaska, so you're not considering individual fields. If you nevertheless want to increase the government take on legacy field, then I would typically look for that outside the PPT itself. You would simply say, "Okay, for legacy fields, in addition to the PPT that you always pay, you have, say, a supplemental petroleum tax of 10 percent of gross over 50,000 barrels a day." I mean, just an arbitrary number. But ... I would not look for inside the PPT; that is a very inefficient way of trying to do that. I would look for that as a specialty feature outside the PPT. Now, what I dislike about the legislative proposal that is being made, is that they are actually trying to more or less recreate a mosaic out of a consolidated PPT by having this 10 percent floor and thereby requiring separate accounting again for each of the individual blocks. I just don't think that's worth it. If ... the goal is to achieve a higher government take out of legacy fields, there are much easier ways to do that without destroying the ... simplified accounting system that the PPT establishes.

[4:25:58 PM](#)

REPRESENTATIVE GARA: ... Finally, Mr. Johnston, after listening to you for the last year, I think I understand why you're proposing a different rate for the legacy fields, but, I mean, could you just explain why you think that makes sense, just so folks understand and so I maybe understand it better.

[4:26:23 PM](#)

MR. JOHNSTON: When we spent so much time talking about government take and how it compared up here, those government take statistics usually deal with exploration licenses around the world. And you have 700-800 thousand barrels a day of production here in Alaska that's not exploration; that's a different matter. ... the time had come to make a change for those fields and that production, but if the change was going to have to be built around an exploration system, it was going to be very, very difficult. That was the hard part for me. There is lots of room in the legacy fields for bigger changes than what I was seeing that were ... well within the zone of what I would consider fair, and I'm not talking about subjective measures of fairness. There's lots of examples ... in this world of how high you can go. And I've ... kind of broken a rule that I have lived by fairly well by mentioning some of the really intense areas around this world where the government take is shocking - like 98 percent, 97 percent - and in such wonderful, stable places as Iran and Libya. If they can handle it there, then surely you can handle increasing government take on those legacy fields by 10 ... percent, or so. ... I don't think we came anywhere close to ... creating a tax that would make the government take, here, increase by 10 percentage points; going from 40 to 80, or 40 to 100, even. I don't think even at \$100 we really increased it that much. And I'm thinking, "Holy cow, we have companies in this world that are willing to live with 90" - excuse me - "5 percent of the profit for exploration - high risk exploration." In my mind there was just so much room, and yet here we were talking about plus or minus one percent, and it's just been a mess for me. ... I was burdened by the unfortunate experience of seeing it handled more efficiently in many other countries.

[4:28:42 PM](#)

DR. VAN MEURS: ... very high government takes have been mentioned. Now, ... I worked on the highest government take in

the world in Kuwait ... 98.5 percent. And consequently, I definitely know how to negotiate and how to obtain very high government take. I would say 98.5 percent is somewhat high for Prudhoe Bay. ... we should take into consideration that this is now a field in very high status of enhanced oil recovery. It is definitely not a field in its prime years; it is a field in ... serious decline ... that still requires ... very high investment to maintain and extend the productive life. ... in the case of Prudhoe Bay, ... I would recommend some caution with respect to these matters. That is also the nice part of the PPT, whereby, of course, automatically the higher cost will ... be absorbed in the formula. But it was not necessary to criticize the existence of 98 percent government take.

[4:30:39 PM](#)

MR. JOHNSTON: Yeah, I'm not shooting for 95 percent government take.

[overlapping voices]

REPRESENTATIVE DOOGAN: How about 94 percent.

[A discussion ensued regarding the need for a break.]

CHAIR SAMUELS: ... Tell you what, we'll take 10 minutes.

The committee took an at-ease from 4:31 p.m. to 4:39 p.m.

[4:39:53 PM](#)

CHAIR SAMUELS: Let's call the meeting back to order please. Representative Crawford.

[4:40:04 PM](#)

REPRESENTATIVE CRAWFORD: Thank you Mr. Chairman. Every year we talk about oil taxes ... and I'm sure it was a big topic of discussion before I ever got here. We have two goals it seems to me. One is to get our fair share for our dwindling resource and the other is to not disadvantage new exploration and development. Those would seem to be almost ... mutually exclusive goals, but it seems that other countries are getting higher takes, we've got a low tax environment here. Certainly we had a low tax environment under ELF. We still have a low tax environment relative to a lot of places in the world, but we

don't have any investment. Historically, here there's been a real disconnect, whether there was ... lots of profit in these fields and ... the companies were getting lots ... of profit from them, but not reinvesting.

REPRESENTATIVE CRAWFORD: ... what other things that we could be doing to, to get companies competing for our oil again; ... other than maybe giving away hundreds of millions of dollars in what a lot of us feel might be a fair share for Alaska. So, if you could both give your suggestions of other things that we can do, short of just tax breaks to, to get that pipeline more full.

[4:41:47 PM](#)

MR. JOHNSTON: ... the issue of the mutual exclusivity was the thing that just is been driving me crazy ... and that's why the credits were designed to offset ... the increase in the tax. And we've seen these credits work .... And they can be relatively spectacular, it just depends on how big of a credit you're willing to give and how you structure it, because they're not all a credit system like yours. But, they can have the same characteristics, it's just slightly different arithmetic. ... you're similar to a lot of other countries who want to increase exploration activity fairly substantially, there's no doubt in my mind that that's a key objective. ... I've used this terminology before, but you guys "wanted to put a smile on the face of explorers," because you're going have to if you're going to get the kind of exploration activity you desire.

MR. JOHNSTON: And, will the credits do it or not? It's a step in the right direction and it's the right mechanics, because I know ... of no other alternative with the one main imposing boundary condition that we had: ... the one-size-fits-all fiscal system. I don't think you're going to get as spectacular exploration activity, ... not the kind that we've seen in some situations where there's been bigger changes. But I think there was a, a fair chance that you're going to get ... more. And the credit system, I thought, had worked ... well enough that people up here were familiar with it and it had been working and some wells had been drilled under the system. ... whether 20 percent credit is enough ... I don't know yet .... But, the guy that did the modeling on it is sitting next to me, so I'll turn the time over to Pedro.

[4:44:00 PM](#)

DR. VAN MEURS: ... as I mentioned earlier, I personally believe that you shouldn't ... go beyond 20. ... I already felt that the, the curve ball that exists today for the special exploration has simply gone too far. ... it is nice to attract investors, but no, you don't want to attract investors because you pay 80 percent ... of the shot; ... that doesn't make any sense. Beyond the fiscal system, there are many situations where you can definitely create a new environment of interest in the jurisdiction.

DR. VAN MEURS: ... as you well know, I've worked in almost 70 countries .... In a number of countries my task was, literally, to re-brand the country ..., to create a new image for the country. And, I honestly believe Alaska needs a new image. It is very important for the governor ... and for this legislature ... to re-brand Alaska to investors. ... although I disagree with the extreme position of Wood Mackenzie, there is no question that internationally among the developing and among the developed countries, Alaska is clearly perceived as the, the least stable.

DR. VAN MEURS: Alaska is also perceived as the most confrontational and ... that is ... a, a very serious issue. I have seen, over the last 10 years ..., many events where, where, clearly, Alaska seems to be in a confrontational mode with the industry; in a way that you wouldn't have in Britain, Norway, Alberta for that matter despite the current upheavals, or many other jurisdictions. So, I think it is good to sit down and start to look at what are the potential investors in Alaska, what would they be interested in, beyond the fiscal system what are they looking for. ... do the market research on that and ... re-brand Alaska in some kind of important way. ... in other countries I've done that a number of times by simply organizing promotional conferences. ... my toughest task in the last month was to try to re-brand Iraq. Now, ... that's a tough task. ... the oil minister of Iraq did an absolute spectacular job ... on a promotional conference in Dubai convincing the oil industry, interacting with the oil industry, ... illustrating ... the desire of the country for foreign investment, the openness that they eventually like to have. And I think it was enormously well received. ... this is probably the most difficult re-branding operation that ... you face in the world.

DR. VAN MEURS: So, can you re-brand Alaska? I think you can, and I think you should because I definitely believe you're getting less investments than you deserve, than the geology deserves. ... my feedback from the international oil and gas

community whenever I'm on conferences, or whenever I speak about Alaska, there is a negative image. And, the negative image is based on ... [a] sense of instability and the negative image is derived ... from a sense of ... confrontational attitude between the industry and ... Alaska. And I think that is an area that Alaskans can work on and I think you're going to see wonders if you do.

[4:49:13 PM](#)

MR. JOHNSTON: ... I agree with Pedro about the re-branding, ... there is almost always room for that. ... you had no control over the gift of God that we're talking about today, but you do have control over the industry's perception, or at least some control. And especially if you feel there is a misperception like Pedro does - and I agree with him - then you need to re-brand and market in a way that you can change that perception. ... this acreage in this world and opportunities are a commodity. And yet ... the Columbians use Madison Avenue marketing techniques to sell one of their important commodities - coffee. But they just can't bring themselves to quite do that for their acreage ..., although they do a little bit better than most. Here that could happen, too.

MR. JOHNSTON: But then there is one other thing: access to the pipelines. Now I don't remember -- I ... need to know ... how much of a tariff ... the little guys have to pay on the oil pipeline, and then the same issue is going to come up with the gas. I ... talked about basin mastering in my testimony in the past ... and the concept of a basin master is a big important concept in the industry, and many of the big old companies are intimate with it because they've seen how spectacularly successful a company can be, if they're the first one into a basin and they build that first infrastructure because they're in a tremendously powerful position. And depending upon how powerful that position is, you could, for all practical purposes, choke off any future exploration if you're not careful. And so that issue of access ... to the pipelines ... is interesting. I saw a letter requesting open equal access ... and the kind of tariff structure by one of the companies in this world who is a famous basin master. ... they're famous for going into countries and keeping everybody out. ... that letter made it clear to me they didn't want that happening here because they weren't the first ones in; ... they want equal access to the line if and when it is built.

CHAIR SAMUELS: Follow up? Representative Crawford.

[4:51:47 PM](#)

REPRESENTATIVE CRAWFORD: Thank you Mr. Chairman. ... it seems to me that ... when you've got absolute land rushes going into places like Libya that are ... unstable to degrees that we don't even understand -- that we've had basically three players here for a long time and ... we've had a very low tax environment ... under ELF. We've still got a low tax environment, maybe not quite as low, and we just don't see ... anything like the rushes that ... have happened ... in other areas .... It seems that we should be focusing not only on ... the economic tool that we have, but other tools like facilities' access. ... I think that suggestions along that line are ... what we need to have so that ... we can get oil companies competing for our oil again.

CHAIRMAN OLSON: Senator Ellis.

[4:52:44 PM](#)

SENATOR ELLIS: Thank you Mr. Chairman. I want to go back to deductions .... When the PPT was being worked on last, ... I was worried about the lack of specificity in the deductions. And the chairman made reference to the list and his judgment ... that specificity should be left to the bureaucrats and the promulgation of regulations. When some of us met with the governor's team ... we tried to get to the issue of why ... we were \$800 million short - why that hadn't come in under the estimates. And ... there was ... the talk of the higher cost, the escalating cost, that were not all factored in or expected. And a significant portion of that may well be true; there may be other things .... the folks at the Department of Revenue didn't, couldn't really answer our questions. And ... they -- I've been worried about a lack of auditors and it being 3, 4, 5 years before we know the answers to these questions. And so, the work on the regulations is far from complete is my understanding. What do other sovereign owners ... of hydrocarbon resources do, in terms of requiring specificity about deductions that are allowed ... so that there are no surprises .... I mean, audits are always going to be necessary and ... we are going to have to compete for talented auditors. ... are there things that can be in the statute or that must be in regulation - ... I'd like your opinion on that, too - for us to actually be in this with our eyes open and being able to know what has been deducted and not being surprised to the tune of \$800 million or whatever it might be in the future.

4:54:25 PM

DR. VAN MEURS: ... I do believe that the current PPT law broadly describes, reasonably, ... the categories of costs that should not be deductible. Obviously, what is missing ... would be more detailed regulations. DNR is, is also referenced ... in the act, actually has relatively detailed regulations with respect to profit-based royalties. And ... one of the concepts was to use that as a starting point and then improve upon it. ... I would still highly recommend it, and I'm sure that work is underway somewhere in the department.

DR. VAN MEURS: ... there are, however, a number of things that you have to understand. It is not just ... the regulations. What you need is a ... number of concepts. You need, first, a precise definition of deductible costs, and how these costs have to be classified. Secondly, you need a proper information collection system. Or, in other words, you need a proper interaction between ... an accounting system in the Department of Revenue and the accounting systems that are being used by the oil industry. These days, everything can be done electronically ... so, ... at the end of each month you should be able to get the stream of data. What is also often missing ... in many governments is ... what you call a management information system. A management information system is a system that can ... "rollup" from the accounting system whatever information you want and can spit out ... whatever data you want. That's a pretty crucial factors. So, what you need is not just regulations. You need proper regulations to describe precisely the classification of the costs that you want in terms of costs and, and of cost types, and in terms of credits against these costs and a number of other features. Then you need a proper accounting system ... with the proper chart of accounts and the proper kind of electronics. And then you need a management information system that can rollup all information that you want in order to effectively understand ... what is going on. So, unless you have those three systems you are not doing a good job at supervising, say, a profit share. So, it is three components that you need, not just one.

SENATOR ELLIS: Thank you.

4:58:05 PM

MR. JOHNSTON: Senator Ellis, you asked about how it is handled in other jurisdictions or ... sovereign states .... The spectrum of arrangements that exist in regard to this issue ...

are diverse ... and on the far end of the system are some fairly Draconian measures ... by your standards. And as awful as people might say Alaska is, as far as stability and stuff is concerned, there are elements - and this is a good example - of where Alaska is pretty mild. There's quite a few countries where the work programs and budgets of the oil companies are overseen by a management committee that is chaired by either the national oil company chairman, or somebody chosen by him, or the oil minister. ... the work programs and budgets ... go through an approvals process. ... there are ... rules and regulations for budget adjustments, ... these can be ... fairly realistic with line item limits for particular line items that can't go over budget by a certain amount and then rules for the budget itself that can't go over a certain amount. And so, they have tremendous control. ... by the way, I'm not recommending that ... - that's way out there ... but it would be a luxury at times ... because in addition to that sometimes there is this government participation element. So there are government representatives, typically the national oil company people, who sit in on the technical committee meetings and the management committee meetings; ... they're at the grassroots level seeing and participating in the development of the budget and the decisions that are made .... So, the chances of surprises the likes of which you have experiences here, in my opinion, on a system like that are much lower.

[4:59:54 PM](#)

SENATOR ELLIS: Mr. Chairman, ... we heard ... from Pedro a pessimistic view of a conventional gasline being constructed in the near to midterm for a bunch of factors and reasons that are beyond our control. And I just pose to each of you: Isn't that an argument in favor of the State of Alaska ... essentially, wising up, and moving reasonably closer to the world average in ... total government take for our oil resource, and banking that money for the hard times to come ... whatever it might be. ... I have a problem, personally, with discounting our oil resources in these intervening years ... knowing that the gasline may be ... a long haul.

DR. VAN MEURS: As you know, Alaska officially has already a mechanism to achieve that goal, which is the constitutional budget reserve fund. ... So, the concept of a stabilization fund is there; ... Alaska already approved that. ... the question now is: ... How effectively are you using this fund? I'm absolutely in agreement with you, I can only see oil production going down, even if the PPT ... is at it's most

success in attracting investment. ... I really cannot see ... something whereby Alaska regains 2 million barrels a day ..., the pipeline will never be full again. ... As a geologist, I'm an optimist and you always hope for this unexpected discovery. But, it seems highly unlikely. ... you absolutely have to start preparing for a different future, or you have to start rescheduling and rethinking the whole concept of exporting gas. ... I believe that the only way to monetize gas, that I see today, would be gas-to-liquids. That is the only practical economic way ... that could maintain a reasonable level of liquids production for ... a long period to come. So, I would recommend looking more intensively at that because as of today ... that seems to be the only economic option.

SENATOR ELLIS: ... in spite of my original comments this morning opening up, I want to maintain the legislative prerogative to pick and choose what I agree and disagree with Dr. Van Meurs, and I appreciate the answer and guidance.

MR. JOHNSTON: ... personally I've avoided the issue. But the answer is: Yes, ... I'm sure there's plenty of room there for buffering the potential pain that might be felt ... if no ... gasline were to be built. And it is that harsh, the ... natural next question then is: Is there enough room in the legacy fields ... to get more and save enough to buffer that ... pain in the future. And I think, definitely yes ... there's a lot of room there.

SENATOR ELLIS: Thank you.

[5:04:08 PM](#)

CHAIR SAMUELS: And one of the questions I'll be asking ... Ms. Davis ... the choice will be the more investment that you get ... it's going to keep declining and how much did it cost you versus how much did you stem the decline? And that's really the only question. And if you think for sure they're going to keep investing money, no matter what you do, no problem. If you think you can stem the decline a little ... by getting more investment by the tax, then that's where we're going to be .... Representative Kerttula.

[5:04:53 PM](#)

CHAIR SAMUELS: I got to go first, but I'll let you have the last word on it.

REPRESENTATIVE KERTTULA: ... we asked many, many questions to try to delineate the deductions, and we offered many amendments on the floor to limit corrosion - the other offset aside - to limit lobbying expenses ... they were not definable. And that's been one of the hold-ups in the current PPT. So, I've been wondering whether ... you could share with us some of the accounting agreements that you've seen that you think are appropriate and some appropriate standards. I know the current department is working extremely hard, but I will tell you that ... my singular foremost concern is that we not allow what we're going to get to be eaten up later on. So, ... I'd ask if ... you do have information ... that you could share with us, I think that would be helpful because we don't have good answers right now about what those deductions are going to be. ... Dr. Van Meurs described what sounds like a true hybrid, a mixture of a grosser tax. ... So, maybe you could just give us a little more definition on that idea ... and then maybe Mr. Johnston could give us ... his feelings about whether something like that ... could be a way out.

[5:06:27 PM](#)

DR. VAN MEURS: Yes, ... although I'm generally a strong ... proponent of progressive systems, I have also seen quite a bit of progressive systems ... that have been wrongly designed, created significant gold plating, created ... negative impacts on the dockets. And in fact, that's one of the battles I'm in Alberta right now, on the oil sand side. ... I'm a firm believer in that if you design progressive systems, keep it as simple as you can. Don't ... make it so sophisticated that you have to go through 20 hoops to get your extra dollar. ... the simplest systems are ... based on the gross revenues from the resource. In fact, that is why we all like royalties ....

REPRESENTATIVE KERTTULA: But relative.

DR. VAN MEURS: But relatively speaking, it is simpler than a profit sharing system. So, that was when I understood I had the task to design some progressive system ... when ... Governor Murkowski decided on the 20:20. And when we discussed it, I said, "Okay, if you ... want to back down from the 20, then we need to have something extra. Let's look at a progressive system." And out of that came, then, the memo that I mentioned. In that memo, I said ... we need to strike a balance between a system on gross that is progressive, so that means if the West Texas Intermediate price is ... 50, the feature would create zero, nothing. If the price goes up, the feature, based on the

gross revenues, collect significantly more. So consequently, think about it as a literally a traditional severance tax as we used to have ... - the severance tax of 12.5 percent, and 10 percent - ... that ... slides with price. So, it is clearly a feature based on gross. Then in order to make sure that there was not really a double counting, relative to the PPT I said okay if we ... establish such a system that, let's say, -- and that is why also called it in my memo the base petroleum tax. It was kind of like hanging on to a sliver of the original petroleum tax. And say okay, let's make that price sensitive, it's a very simple windfall profit formula .... If the price is say 90 and you use WTI 50 as a base and .25 percent as a gross factor, then at \$90 you collect 10 percent. You collect it as if it is a 10 percent severance tax, as if it is a 10 percent production tax. That then would be deductible. Of course, royalties would be deductible from this as a ... typical severance tax. Then ... you would ... make this, in turn, deductible from the PPT so that you strike a balance ... between the tax base of the PPT. Or, in other words rather than starting this 100 percent of the value for the PPT. Say, if this price sensitive severance tax would result in 10 percent, you would start with 90 percent of the basis, and then you apply the 25 percent, ... PPT rate. ... it strikes a very simple balance between a concept on gross and a concept on net, and it automatically slides with price. If the price is less than 50, it disappears. If the price goes higher, it automatically increases. Now, this was an initial memo that I wrote and, ... I'm not ... very proud of it, it was just a concept that I ... suggested to introduce; ... I would recommend refining it. As I said, bring in more recognition of the heavy oil ... so that you don't start making heavy oil uneconomic again. Maybe the sliding scale of .25 or the \$50 are not the right numbers. These are things you can debate and you can do more economic analysis on. But, I think the concept merits a great deal of ... consideration. ... in Alberta I recommended an identical system there, it was called the bitumen tax or the oil sands severance tax. ... the royalty review panel of Alberta accepted that recommendation, and put it in their royalty review report. Now, ... that would be pretty revolutionary in Alberta to get that through and it is now on the premier's desk .... But, I recommended it in Alberta because I believe it is a good system. I recommended it here because I believe it is a good system. ... this is a system that I would trust, that would absolutely guarantee that Alaska would get its extra fair share, if the price rose up. And consequently, that's what you look for in a progressive system, not a system that is so complex that you never know where you are. ... If want to have a stronger

progressive system, then go for a real stronger progressive system.

REPRESENTATIVE KERTTULA: Thank you.

CHAIR SAMUELS: Thank you. Representative Seaton.

REPRESENTATIVE KERTTULA: Could Daniel maybe comment.

CHAIR SAMUELS: I'm sorry. I'm trying to get through my list.

[5:13:34 PM](#)

MR. JOHNSTON: Representative Kerttula ,I forgot the question.

REPRESENTATIVE KERTTULA: It was ... just on the idea ...

DR. VAN MEURS: On this formula that I suggested.

MR. JOHNSTON: Whatever he said.

[5:13:49 PM](#)

REPRESENTATIVE SEATON: I was concerned about something in your testimony, Dr. Van Meurs, and that was on ... waiting until 2011 before we do anything on stability. Isn't the fact that we're discussing these items and putting them on the table, ... changing the rate, progressivity, ... and then saying we're going to address these. Doesn't that relate to what we've always been told, it takes three to four years to sanction a project so ... the oil companies are all going to know that these are the items that we're considering changing, by the time that any project that they would go forward with sanctioning would be in line and be producing. ... the difference between addressing them now, they'll have the stability of knowing ... how we're going to address that, instead of saying: ... by the time your project gets sanctioned we're going to probably change these things because we've identified them, but we're going to wait until 2011 and you're not going to know whether the tax is going to be 25 or 30 percent or whether progressivity is going to be .25 or .375. It seems to me, ... there is much more stability if we address these issues that we see as problematic now, instead of waiting to pick these items up.

[5:15:28 PM](#)

DR. VAN MEURS: ... there are many layers to the concept of stability. Firstly, ... the whole design ... objective of the PPT was to try to attract new companies to Alaska and create a medium size level of companies that would take on the smaller fields and the smaller targets. And, the problem with ... creating an international image, knowing already that the image is not that great to begin with ... they now change the tax again. Then you simply get scrap of the list of potential new investors that may wish to come to Alaska, because they are going to say, "This is just too wild up there." and "Let's lay back and see what happens." Obviously if somebody ... would want to start a multi-billion dollar investment, it would add to the stability if he would know what you're planning to do, say, in 2011. However, weighing that against ... the international image because you want to attract the new companies coming in, I think unbalance, although I think you're absolutely right. If you could tell an oil company this is what we're going to do five years from now, that would be wonderful information to have for project planning. But you have to weigh that against ... the image that you're creating internationally ..., from an image that is already somewhat negative, you simply add to ... the overall feeling in the oil industry that Alaska is just too wild a place to invest in. ... that's why I ... would greatly caution ... changing the fiscal terms again ... now. Apart from that, I think you honestly need a few years of reflection on what was done so far: ... what are the exact amount of monies that they're going to receive; what are the precise audited figures in the end; how much did we in the end receive; is it working. We need to set up the administration system that we just talked about: a good definition of cost; a good accounting system; a good management information system; a good information system, as is suggested in the bill; a good transparency system, as is suggested in the bill ... so that people have time to absorb the new system, reflect on it, and then ... in 2011 you have probably enough information to design a system that is going to be more stable for the future. I still believe ... that is the best solution that was considered ... more than a year ago. I think it is still a very good solution today.

[5:19:16 PM](#)

MR. JOHNSTON: You make a good point. I agree that there's that dimension, and it's an important one because there's not a lot of difference between 2008 and 2011. ... Pedro said earlier today ... that you don't have enough information, but I think we have a ton more information now than we did a year ago when we were doing this. ... I will just say it again, because I feel

this strongly: If the cloud turns out to be as dark as it ... could be, then I don't think any rational company is going to view this as two changes consecutively, in the ordinary sense. And it, almost, in my opinion, almost neutralizes. ... in Indonesia they had an incentive package .... They did a little bit of tweaking in ... August of 1988, and that was when they did the first trans-petroleum. And then in April of '99, just a year later, they did a little bit more tweaking. And it was generally acknowledged in the industry, that ... it took two tries but they got it. And people don't look at that in the same way that some people are looking at this. I think ... we can give the industry a little more credit, and I think that is going to mitigate quite a bit. And you don't have to make them all happy; got to make some though, for sure.

[5:20:59 PM](#)

DR. VAN MEURS: I ... like to amend my own statement, in the sense that ... if there is absolute proof that corruption led to approving the PPT system that we have today, as in a contract. If a contract turns out to be concluded under ... dishonorable circumstances, such a contract should be null and void. ... Now, the reason that I personally don't believe that ... cloud exists and that is where I'm coming from, is because my experience, intensive experience over the six months that this was discussed, or more than six months, was that precisely the people that are accused every time (indisc.) assured me that they would vote against all the ideas I had. So ... I feel very certain that one, the PPT law must pass. It was with the approval of those people that had nothing to do with any of this. And that is in, that is why I don't see a cloud ....

[5:22:23 PM](#)

REPRESENTATIVE SEATON: What I heard in your testimony was that maybe the oil companies have over deducted maybe four or five hundred million dollars.

DR. VAN MEURS: I just gave that as an example as what could happen; I have no proof of anything that happened.

REPRESENTATIVE SEATON: I understand that, but the problem is that if ... we're faced with maybe two problems. One is the tax isn't performing the way we thought it was. The other one is that it's being over deducted, and will maybe ..., four years from now, ... maybe some lawsuits and everything, we might recover some of that money. But by leaving the tax the same way

it is now, for another four years while we go through this process, aren't we just rewarding the behavior of over deducting.

DR. VAN MEURS: No, ... but one of the recommendations I absolutely made ... is anything you can do to improve ... inefficient control of the accounting system and auditing system or inefficient, kind of management of the system. I described the system that I think you need to have. You need the three factors that I already mentioned .... I think that will take some time to set up. I also think you need to review what precisely are the penalties of under declaring revenues and over declaring costs, and see whether those need to be revised. ... if that needs to be done, it would be my strong recommendation that you do that in this session. ... Once you have a good penalty system in place, if you can have a good accounting system, a good management system, and a clear definition of deductible costs, so that an administration can effectively implement it, and you take the measures that are proposed in this bill to make it easier to attract high quality auditors, I'm sure you're going to obtain your fair share on the basis of the existing law in the coming years. But ... you have a lot of work ahead of you.

[5:24:59 PM](#)

REPRESENTATIVE SEATON: Another question that I have, through the chair.

CHAIR SAMUELS: Yes.

REPRESENTATIVE SEATON: On your page 18, you're talking about the gas revenue exclusion, and I'm really troubled by that idea that is being proposed that there should be a gas revenue exclusion again proposed, because we're in a different situation, as I see it, with our gas on the North Slope, than somebody going out exploring for gas. I mean we've got gas being expensively pushed back into the ground and stored. There isn't any exploration costs. ... Sure there's some conditioning plant, but that's ... midstream, downstream. And, why, under a profit scenario, would you suggest a billion dollars made on oil would get taxed at 22.5 percent and a billion dollars made on gas, with much less costs of production, because the production in the wells and everything are already in, should be taxed at 7 percent, or 7.25 percent. I'm at a loss to find, to figure out how, with lower expenses of producing that gas, and the gas at Point Thomson already defined

and known, why we would be looking at saying that taxing profits would be at a much lower rate than taxing oil.

DR. VAN MEURS: Now this goes to the heart of ... debate that we had on the gasline a number of times. ... some persons felt that in order to judge the economics of the line you only had to do your upstream cash flows, you only had to look at the cost of production, and your price. I argued ... that in order to judge the economics of a gas project, if producers have to make commitments to use the transportation system downstream from ... the wells, or the point of production, (indisc - coughing) have to make commitments for gas conditioning, have to make commitments for gas transportation, let alone liquefaction and so on. This heavily impacts on the overall economics of the project ... for exactly the same reason that Trinidad and Tobago have successfully allowed a very strong LNG trade to the East Coast of the United States, and to Europe ... because they looked at the economics of the total project, not the economics of just the upstream. ... You have to look at the gas in exactly the same way, ... unless you find a buyer with extremely deep pockets, which is willing to buy all the gas at the wellhead.

[5:28:24 PM](#)

REPRESENTATIVE SEATON: I can understand that if we were taxing on the gross, but if we're taxing on the net profits, all those expenses are taken out. ... there is no cost of drilling the wells; there's cost incurred in ... recycling the gas now. How is it that billion dollars made on that gas that's already being taken out of the ground ... should be less than the cost for the oil.

DR. VAN MEURS: The reason is that for oil companies to make the kind of commitments to the kind of system that we are discussing, you have to have a reasonable minimum, a net present value per barrel of oil equivalent. And if that is not happening, then there is no incentive to make a commitment to such system. ... I think therefore, you have to make it attractive for those who would ... have the exclusive right to produce the gas to engage in such a project; ... that's where the issue is. The issue is not in the actual cost incurred in producing the gas up north. I agree with you. The gas is being reinjected today, and you may even save some costs by simply putting it in your gas conditioning plant ....

[5:30:31 PM](#)

REPRESENTATIVE SAMUELS: ... If the governor's bill comes up with a licensee and the legislature blesses it, you'll lock in the tax terms for 10 years, right before the open season. So we're going to have the debate on gas in three years. ... no matter what we did with gas ... it's not locked in; you're going to have that debate in three years ....

5:30:52 PM

MR. JOHNSTON: ... Representative Seaton, that's a good question, but I think I can help put your mind to rest a little. It is very common around the world, that gas terms are, from an oil company point of view, better than oil terms; ... it's a present value thing often, in addition to what Dr. Van Meurs just said. With a typical oil field, when you start producing, you might produce from 10 to 15 percent of the oil, in the first year. And then ... it will decline. If you only produce 10 percent of the oil in one year, you might produce for three or four years at that rate and then decline. With gas production, in most parts of this world, and it's just going to be the same up there, the production rate, in terms of the percentage of the reserves produced in one year, is much lower. And so in terms of present value a \$1,000 of profit for the oil, if we don't factor in the time value of money, looks the same as a \$1,000 of profit for the gas. But when you factor in time value of money, .. there is a big difference then. That is almost always one of the bigger differences between oil and gas.

CHAIR SAMUELS: Senator Wielechowski.

5:31:58 PM

SENATOR WIELECHOWSKI: Dr. Van Meurs, I wasn't here last year. (indisc. - microphone not adjusted, paper rustling)

DR. VAN MEURS: He wasn't here, yeah, last year, and that's to his great credit; a new blood ...

SENATOR WIELECHOWSKI: So when you were designing the PPT last year, you were designing it with the intent of encouraging investment.

DR. VAN MEURS: Absolutely.

SENATOR WIELECHOWSKI: And when you made your recommendations last year, for 25 percent, for no fallback, for limiting

exploration perhaps to 20 percent, ... is it safe to assume that you made those recommendations, all the ones you have in here, with the understanding that that would still encourage investments.

DR. VAN MEURS: Absolutely.

SENATOR WIELECHOWSKI: How much more would Alaska have made had we adopted your recommendations?

DR. VAN MEURS: I would have to calculate that out. ... you would have to use the review model in the Department of ... Revenue, which has a sophisticated model to calculate these things. So, I think if you wanted to ask the Department of Revenue, I'm sure they can give you those figures. ... the department has all ... the background; ... that's exactly the work we did ... a year ago. Every time the legislature was asking how much is this generating and how much is that generating, and all the options were compared on that basis. If you ask that question to Department of Revenue, I'm sure you will get an answer as to how much more will be generated on that basis. Now, I can tell you at \$84 a barrel, a lot more will be generated.

SENATOR WIELECHOWSKI: \$100 million, \$200 million?

DR. VAN MEURS: I ... would have to leave that to the department, because it is somewhat of a complex, total set of calculations. Don't forget all the companies are not the same, and the cost structures are not the same ....

[5:34:29 PM](#)

SENATOR THERRIault: I was wondering if either of you can ... comment on reserve placement ratios. There was a very interesting article, ... about a year-and-a-half ago, that many of the larger companies are having difficulty in maintaining their reserve replacement ratios. And so, they're very profitable companies at this price; but if you're not replacing the goods on the shelf, you're just a very good business going out of business. Part of that is stemming from different areas of the world ... changing the terms and kicking companies out, or nationalizing .... So, ... has the tide turned back, and the companies are doing better at replacing their reserves or it's gotten worse?

DR. VAN MEURS: No, they are more or less stable. ... as I mentioned, I think, in that same presentation of May the 10th ..., you know one of the enormous advantages of a gas project: if you actually go through the entire procedure of launching a gas project, and concluding all the deals, the amount of bookable reserves that you would get on your books is astounding. ... from a bookable reserve point of view ... the gas project would be an extremely attractive project. That is also why ... we considered ... not the exact PPT, but a severance tax kind of structure that would not be a royalty, because royalties are not bookable. So consequently, the whole thing was designed to maximize the benefit of a possible bookable reserve. I mean the gasline contract, the PPT ... doesn't diminish the bookable reserve ..., and that is an attraction of the PPT over a royalty. It has always been my belief, and I think the companies share that absolutely, there has never been a discrepancy of opinion ... that if the gas project ever would go ahead, it would be a wonderful addition, and wonderful improvement of the reserve production ratio. Now, on the other hand, I don't want to necessarily overplay the importance of that reserve production ratio. It is ... a very important ratio used by financial analysts in Wall Street and other ... stock markets in the world to judge the financial health of companies. But ... there are many other factors that result in the judgment of financial health. So, if you launch a completely uneconomic project, ... you may get a lot more reserves, but your forecast of future cash flow may be so bad that the financial community would discount it. So, ... yes, shortly would a gas project be beneficial for the reserve production ratio? Absolutely.

[5:37:45 PM](#)

MR. JOHNSTON: Senator Therriault, ... maybe I don't disagree, but I want to say it differently. And for the new legislators, I think it's important to point out how important this issue of booking barrels is. ... It began around the early 1990's, over ten years ago, that companies started to get a little psychotic about booking barrels. Now booking barrels deals with the reserves that they must legally report in the 10K reports to their shareholders. It didn't used to be a big thing in the 1980's. But towards the end of the 1980's and the early 1990's, many oil companies started realizing, ... and unfortunately much of this was driven by the analysts ... that booking barrels and maintaining ... this reserve replacement ratio was getting more difficult. So they started focusing more closely on the reserves that the companies were booking. So this issue of

booking barrels started to get very interesting during those years. And then companies truly have gotten psychotic about it. And the reason I belabor this point to a certain extent is this: A lot of times there's been mention made ... if Alaska goofs this up, the oil companies have lots of other places to take their money. Well, if that was true, then why are they spending half a million dollars a day, just on a day rate, for a rig in ultra deep water? Because the easy stuff just ain't so plentiful anymore. ... in addition to that there's another dynamic, and that's not nationalization ..., it's the national oil companies of this world. They all have seen and perceived Petronas, the national oil company of Malaysia, to be quite successful in their dramatic efforts to go overseas. And the governments of this world, and I think it's fair to say, many of them ... find dealing with the national oil companies a whole lot more pleasant than dealing with the big oil companies. And even some of the independents. And so there is much less acreage available to American oil companies, ... western oil companies, and traditional oil companies because the national oil companies, the Chinese National oil company, and the Malaysians in particular, ... and the Indians as well - they're out there beating the bush. It's hard to make a living out there in this world exploring for hydrocarbons .... It's hard to keep those reserves up and if a company is going to grow, you can't just maintain ... the reserve replacement ratio, it's got to increase each year. And they're not doing such a great job of it. And every now and then you see some big jumps, but thank God for Kashagan because the reserves are so large a lot of companies got to add barrels, and it distorted the statistics. My experience is: a lot of the reserves that are being replaced right now are paper barrels, they're not the ordinary kind of barrels that we are used to. And part of that is because there has been a lot of latitude for the oil companies to book. There's a certain amount they can't overbook, but ... a lot of times ... they have a cushion .... And there's a recent study about ... a field in Norway where some of the companies had only booked about 28 percent, others that booked up to 70 per cent of what they were entitled to book. So, ... they're going to add reserves in the coming years and that reserve replacement ratio is going to look good. It won't be from having found additional reserves during this period, for all of what they replace the reserves with ....

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SENATOR THERRIAULT: Then a second question for Dr. Van Meurs, primarily: I think when you did your modeling, you talked about

take Alaska, make it a tidewater ... and you had a \$5 transportation cost in there. But the strange dynamic that we have here in the State of Alaska is the major players that have ... major control of the basin, also control that transportation string. And now we've got a battle going in FERC, that it currently appears we're winning; but ultimately who knows what the decision might be there where \$5 of that transportation cost actually goes into their pockets. How do we take that into account on looking at the net present value and rates of return for these companies, where generally that transportation expense is a true expense; it's not a shifting of a dollar from one pocket to the other.

DR. VAN MEURS: No, that's exactly also the debate we had on the gasline ... when I advocated the state participation for the exactly the reason that you just mentioned: That if the state is 20 percent partner in the pipeline - by the way, tax free from a certain point in time - the rate of return from the state paying itself through the pipeline tariff creates a very different dynamic for the government revenue than ... if you're just delivering to a pipeline system. So, that is why, ... state participation in the line, I felt, was beneficial to the state, because it changed exactly the dynamics that you mentioned in the ... gasline for the State of Alaska. It also, of course, by assuming the commitments for the line, resulted in the higher rate of return ... for the private parties. So, yes, integrated oil companies like to be integrated oil companies, because there are huge benefits; ... not just in the ... transportation, also in the refining, also in other distribution areas. So, consequently, all the way back from Rockefeller, the oil industry discovered that there is great benefit in having an integrated oil company, precisely for the reason that you mentioned. And the way to do that is ... you can assess just upstream, you can assess upstream plus midstream. You can assess all the way down the line, and of course, particularly in LNG projects, that is how you have to do it, because it is often considered, ... an integrated operation. So, yes, the dynamics are quite different, whether you are an owner or not.

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SENATOR THERRIAULT: But, as a legislator, when the company reps comes to my office and says. "Well, you may have now gone past that tipping point." I just need to know to always ask, "Well, have you included the transportation money that you're putting in your pocket." And I understand, that that's for those companies that own the line. We want to have a lot more

companies come here and explore, and they're taking a dollar out of their pocket and they're giving it to their competitor, above and beyond what we think the FERC will allow ultimately. ... I guess we've just got to always know: ... are you one of the ones that own the line, because you're also making money and operating the line.

DR. VAN MEURS: No. ... the Alaska State Legislature passed, ... and is still kind of advocating that ... gaslines, and ideally oil lines, should be third party lines. Precisely to create a level playing field in the upstream, and there is some merit in that concept. And consequently, that was ... definitely one of the ... considerations. Now, on the other hand, I don't want to overplay it as an absolute must. But, ... yes, there are certain advantages and disadvantages in having a third party pipeline and that was well discussed ... in the past and I think that is well known, particularly from the point of creating a level playing field.

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MR. JOHNSTON: Senator Therriault ... I think you can blame the \$5 a barrel tariff, in the tidewater approach, on me. ... The reason that I recommended that we do that approach - and it's kind of an analytical approach that I felt helped put Alaska on a more level playing field and opened up the peer group - because one of the big boundary conditions here, as it was explained to me when I first started looking at the oil tax ... is the high transportation cost that you experience here, that other countries and provinces do not. ... my recommendation was this: Well, let's pretend as though the \$5 transportation cost is a part of a government rent extraction mechanism, and then see what the government take is. And it increased the government take about 3 or 4 percentage points by doing it that way, as I recall.

DR. VAN MEURS: Yeah, a little bit more, actually. Yeah.

DR. JOHNSTON: Okay. I knew at the time that there was some profit involved, I just didn't know how much. And so, I never ever changed it, and never revisited it, but I always knew that it was a little bit wrong. The analytical technique could be improved, if we had a better feel for what percentage of that \$5 is true profit and what is not. Because if the oil companies are getting a significant amount, it wouldn't be appropriate to add the whole \$5 in, in that tidewater approach. ... with that modification, even plugging in the whole \$5, I felt that the

take was still quite low for what I considered to be ... 80 percent of the action here, and that's that production up there.

DR. VAN MEURS: But ... actually the question was asked ... from the perspective of a third party company because the whole idea was to attract new investment. And we wanted to judge ... does this government take compare with what you would face somewhere else in the world. And that was really the question. So, ... the tidewater approach was done from the perspective of attracting new investment to Alaska through third party, which, as you said, had to pay this tariff as if it was an extra royalty.

MR. JOHNSTON: That's the way I understood it.

DR. VAN MEURS: Yeah.

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CHAIR SAMUELS: How difficult is it then. If you look at the ownership in TAPS right now, I believe ... Conoco's a net payer because they own more oil than they own a percentage in the pipeline, BP is the majority owner, while Anadarko ... owns none of the pipeline, and yet they all own different shares of the oil. So, to construct a system in there you would incorporate somehow that cost mechanism ... But they don't own a proportionate share. Is that?

DR. VAN MEURS: Yes, for the PPT purposes we assumed, of course, that the value they would receive is the value at the production point, as the PPT law establishes. So, for companies like Anadarko ... and for all the other companies, the economics ... determined ... the point of production methodology. It is well understood that companies that also own the line would have an extra benefit. But companies that don't are involved and the companies like Pioneer ... face the kind of economics that ... we determined.

[5:50:21 PM](#)

CHAIR SAMUELS: Okay. We've got Representative Seaton and Representative Kelly.

REPRESENTATIVE SEATON: Thank you, Mr. Chairman. A couple of questions on progressivity. Can you compare for me the idea that you had proposed in your paper ... about gross tax at \$50 WTI versus what we had proposed through House Resources, which

was increasing the net tax, that they increase by the same amount but at \$50 WTI. In other words, the same bench mark of having ... that .25 start at WTI minus 50, ... but one applying to the net tax and one being a whole new, separate gross tax. Can you ... compare the viability to those? ... by the time you get to 50 you, you've eaten up all the expenses, so basically you're talking gross anyway.

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DR. VAN MEURS: ... three broad groups of progressivity were explored by the legislature. The first one was this, which ... had the limited ... review. When I came back after I had worked on this, the legislature actually had incorporated the concept of progressivity ... related to gross value of the production. And so consequently, ... the first efforts of the legislature was to do something halfway between what I suggested here and what was ultimately accepted, which was ... a windfall profit sharing formula, but let's apply it to the gross value of the production. So, we measure it relative to the gross value of the production at the Arctic. And consequently, you ... deduct the \$5 transportation cost and that gives you the value that you work with. And that, ... at the end of session, kind of fell by the wayside. ... under the last session what was introduced was ... to ... base it on the net value whereby we deduct all the costs. And let's then, rather than taking [\$]60 as a base, ... let's now take [\$]40 as base because the difference is \$20 in cost. And that is how we ended up with that [\$]40. And then we said, okay, let's do progressivity based from the [\$]40 upwards. ... as you go from my original proposal to the proposal with respect to ... the gross value of the PPT to the net value of the PPT, the certainty that you collect goes down in the system because with the gross plus net system, no matter what the costs are, even if the costs are equal to ... \$100 barrel, you would still collect. So, with the gross plus net system ... you have eliminated the cost factor. By applying gross scales to the net production, ... -- if there is no net, then it doesn't matter; 27 ... or 30 percent of zero is still zero. So consequently, the moment you move ... from the gross plus net concept to a gross formula to adjust the progressivity of the net, you run the risk that you won't get anything. Now, if you go even one step lower and ... base it on the net net, then ... the chance that you may not get anything gets very high, because now everything depends not just on the price but also on the cost. So, the certainty of actually collecting on a progressive system with my March 5 memo is higher than on ... the intermediate step and the lower step.

REPRESENTATIVE SEATON: May I follow up?

CHAIR SAMUELS: Yes.

5:55:02 PM

REPRESENTATIVE SEATON: ... I'm trying to ... relate this to the ACES proposal that has an annualized, instead of a monthly tax, and collecting once a year with no interest. Is that something that ... either one of you would support, as far as taking the progressivity to an annualized, instead of ... a monthly payment system.

DR. VAN MEURS: Now, from the point of view of Alaska, ... if you have a monthly system or a quarterly system, particular monthly system, the chance that you collect something is much higher. Let's take ... the formula that ... I proposed. Let's say if ... you do it monthly. If you have 11 months of West Texas Intermediate price of 45 and one month of 60, you collect something in that one month because in the other months you're zero. If you take the yearly average and you blend in the one month of 60 with the 11 months of 45, you still collect nothing. So, if the goal is to collect whenever there is a high price, in whatever month, then the monthly system collects more than the annual system.

MR. JOHNSTON: And I don't have anything to add to that.

5:56:48 PM

CHAIR SAMUELS: ... I'd like to ... walk through my recollection of the various committees, and the arguments ... for the new members. In the House Resources Committee, we added the entire concept of progressivity. And you wanted the tax rate to go up after the decision making had taken place and you took a best guess, as you could, as when investment decisions got made. And I think at the time we were talking ... \$35 to \$40 a barrel; that was when decisions got made. We separated ourselves from that as best we could. I believe at the time we got to [\$]50, we added the progressive feature then. ... we ... kept it closer to the gross ...; but it was more on a gross as a true windfall profits tax in the first committee. The argument when it got switched to the net, which I would appreciate your comments on, was that as costs went up, the decision-making point no longer was between [\$]35 and [\$]40, ... it could shift up to ... [\$]55 or [\$]60 where your investment decisions are now

.... But now, you've raised your tax and affected the investment decision. ... with the net, it slid along the line a little bit better. And that was the argument for going to the net on the progressivity. When the ... choice was, as we told the folks in industry that came forward, ... you can always come forward to the legislature and change it. Well, as we have seen that is far easier said than done, to start changing technical things. We would've had a hearing just like this to change something that far. ... you can see that the two sides ... of the argument and the compromise that got reached ended up being on the net .... But you're trying to get away from the decision-making point of investment so your progressivity does not affect the investment decision. So, ... you've given the argument for the gross and so, ... what's the downside, the argument on the net where this decision making for investment is no longer at, in my example, [\$]35 to [\$]40 but the decision making is now [\$]45 to [\$]50 and you've raised your tax rate and now you are affecting the investment decisions. Setting aside that you think the rate's too low ... but philosophically, ... how do you find some middle ground there?

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DR. VAN MEURS: Now, it is a matter of risk. ... the more you move to a gross plus net system, the more you put risk on the lap of the investor, and you put certainty in the lap of the government. So, obviously, the more you go to the net system, the more risk is in the lap of the government, of not potentially collecting, and the less risk is in the lap of the company. ... it is a matter of how to allocate risk in the formula: ... the more certain Alaska wants to be about its revenue, the higher risk in investment would become. And ... now you have to start pondering, as an investor: ... can I live with this particular risk profile? There's absolutely no question that the formula that came out, from an investor's point of view, is the lowest risk formula, from the point of view of progressivity. But as a consequence for the State of Alaska, the highest risk formula. And that is then a question of judgment: Do we feel confident enough to put that risk in the lap of the companies and go for a full scale gross-based system, or do we feel, in order to promote the investment in the resources, that we're better off with a net system. And that's then a judgment to make. And I think the legislature came down on the side of promoting the investment and putting the ... risk in the lap of the state rather than the investor.

[6:01:23 PM](#)

CHAIR SAMUELS: Thank you, anything you can add to that Mr. Johnston?

MR. JOHNSTON: Well, not much in the sum of what you've described is new to me .... So the issue of gross versus net I missed some of that. I will say though, ... we compared Alaska with everybody under the sun as far as government take. If you go one step further and try to add some dimension to the government take statistic, it's an issue of how much is based on gross, the means by which governments get a piece of the pie in this world. And what's being proposed here is pretty light, in that respect. ... for countries that have the significant resources like you, in a couple of fields like yours, there's times when they're guarantee share. ... the difference between net and gross is this issue of guarantee; ... the more guarantee the government has the more risk on the oil companies, just like Pedro said. But I've seen the effective royalty rates where the government has guaranteed ... more; ... the average for production-sharing contracts ... is 30. So, I can see why there was the agonizing over going with gross versus net, but you had a lot of room to maneuver. ... not only was the Alaska take relatively low, in my opinion, but the front-end loadedness and the means by which you got a piece of the pie was fairly benign in my opinion, too. And that's why I was more bullish than most, I guess.

[6:03:01 PM](#)

CHAIR SAMUELS: Okay. And I want to follow up ... on a question that ... has frustrated me in the four years since I've been involved in learning .... ... we kind of beat our chests and say, "My God, look what they're doing in Libya." ... we need to raise our tax rate. ... There are people that when invested, they go to Nigeria, where you have this social unrest and the high taxes. So, you've got places like Nigeria, ... Venezuela, ... Russia with Putin, but people aren't investing here. So, I mean in some ways ... we can just raise the tax rate and ... "the heck with 25", give up ... and ... go to 40 ... because they're not coming anyway. Or, we can try ... the PPT as attempting to entice some of the investment. ... We hear about all these comments about "we're such a stable government", but they don't come here. They go to places where getting executed is probably just a ... cost of doing business. ... It frustrates me to see where those dollars are going; ... we thought we reached middle ground last year and apparently ... we

did not. ... They ... spend the money in these places that are ... third world countries with dictatorships.

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DR. VAN MEURS: I think there is enormous hope for Alaska because ... by the time I went in debate in Alberta, on the increases in the oil sand tax, they said they're all going somewhere else. And I said now the only place I can think of is Alaska ....

CHAIR SAMUELS: I think they were paying Pedro under the table ...

MR. JOHNSTON: See I don't think those are mutually exclusive. I mean, you can raise ... the taxes and you can put a smile on the explorer's face, it's just very difficult to do with this type of system .... It actually, in my opinion, could be easy to do if you segregate these more than even the new proposal. ... And there's the other trade-off ..., putting a smile on the explorer's face means you're going to have to have some terms that are pretty exciting. And at the end of the day, those jobs that are created in Alaska, because of your efforts to increase exploration, if we're not careful, will be some of the most expensive jobs in the world. You'll end up paying them ... a million dollars per man job per year ... whether it's successful exploration or not.

CHAIR SAMUELS: Okay, thank you. Representative Kelly.

[6:06:16 PM](#)

REPRESENTATIVE KELLY: Thank you Mr. Chairman. Just a couple of comments. ... But there is a distinction between the two [speakers] that I think is important, and ... it's not planned but I think we ... might need to do something about it. ... Dr. Van Meurs you came in with a knowledge, at least a basic knowledge, of the governor's proposed system, the bill that's before us tonight, and you (Johnston) didn't. ... getting your reaction to the governor's bill just as we got Dr. Van Meurs', would be of interest to me .... Another thing ... important to point out: ... I thought I had stepped behind the looking glass a minute ago ... when you answered a question that if we had gone with your proposals, somehow we'd have generated hundreds of millions, maybe more, in extra revenue. That is not strictly accurate because your role was ... also strongly advocacy for a 20:20 solution. A net solution, not a gross solution. And some

of these things ... are important to point out, not for contention, because ... the three areas of creating a spreadsheet, making a proposal, and then advocating, you have had to do ... a soft shoe among the three.

DR. VAN MEURS: What you're explaining to me is life of a consultant.

REPRESENTATIVE KELLY: Having done a just a little bit of that myself I understand that you did the three ... dances probably pretty well. But I think it's important for newcomers to understand that that question a few minutes ago, about your proposal bringing in more money than what happened, is not, on the face of it, the right way to state that. Because you were working for the governor, the governor was after 20:20, and if you got your way, that is your advocacy way, what you were being paid to do, the recovery would have been substantially less, I would argue.

DR. VAN MEURS: ... I was just answering a question: what would have happened if this was done and that can be calculated. I absolutely agree with you that, as a consultant, you have to be very careful not to become politician, point one.

REPRESENTATIVE KELLY: Sure, ... I just ... think it's important to point out ... the different roles that you have, and reflecting the fact that, today, you guys came in here completely differently. And that is ... a concern to me because with Dr. Van Meurs I have a sense that on my ... scorecard ..., of where you stand on some of the ACES stuff, that we've got to opine on here and push buttons shortly -- I kind of know. With you [Mr. Johnston], if I had a half an hour I could get it out of you ... but I'm not going to ... try to do that because you'll shut me down.

CHAIR SAMUELS: I haven't shut anybody down all day.

REPRESENTATIVE KELLY: ... I would ... advocate ..., Mr. Chairman, ... that we get those answers. And I would expect that ... on the rate, I'd ... check them both off as 25 guys now out in the middle of the field .... On the BP thing, we did the \$.30 cents a barrel. That may not have been the right number, but ... it was an attempt to send ... a strong signal .... When we look at the progressivity on the base cost of getting a barrel up ... into the pipe, the net is ... kind of the world system, I've heard both of you say that .... With the production-sharing type contract arrangements it's a net based

system at the end of the day. ... My question is, the governor has proposed a change to a hybrid and ... I just need to know what your reaction is to the hybrid ....

6:11:42 PM

DR. VAN MEURS: I ... I had the pleasure of studying the bill. ... one of my slides indicates that I'm negative about the hybrid .... As I said, the 10 percent floor for the legacy fields really is not a system based on gross, it is just ... a different kind of floor. So, you are not really collecting anything more, unless the conditions of the floor actually occur. So, it also doesn't seem to generate more revenues if prices are high. My concern ... is to give Alaska a fair share if prices are high. I'm less concerned to creating an uneconomic situation if prices are low. ... in other words, I see very little value in that floor. And I wouldn't even call it a hybrid system; I think it is just a somewhat more sophisticated floor. That somewhat more sophisticated floor is put in place at the cost of an enormous complication in your accounting and we have already difficulty enough to setup a good system. So, now we are going to complicate it even more, to separately account for the legacy fields, and then so that we can always calculate the floor. ... I'm extremely negative about that whole concept. I think if you want a mixture of gross and net, make a mixture of gross and net, but don't make an imaginary mixture of gross and net, make a real mixture of gross and net. That would be my suggestion.

6:13:31 PM

REPRESENTATIVE KELLY: ... one of the things that I fear ... is that the ghost of Daniel Johnston or the ghost of Pedro Van Meurs is going to hang around here after your bodies have flown, and we can't get answers. For the next month we're going to hear ... an estimate of what Johnston would have said, and we're going to hear an estimate of what Van Meurs would have said. And I'd like to know, as specifically as we can get it, what the punch-point comparisons are, whether you support them or not, and why. ... One last thing, you know we've got a very popular governor ... who supported most of us on the waiting until 2011. ... Most of us I think understood why, when the indictments came out, that she switched and said "Hey, we've got to take a look at that." That's because maybe half-a-million Alaskans were saying the same thing .... So, I was very much a person that wanted to wait till the 2011, which is where you are. I'm not there now, I don't think that we can. I think we've got a

different situation. But one point, ... your statement Dr. Van Meurs, ... that "Well, since it went to 22 and a half, I don't think that it had this cloud over it." Okay, as somebody that was in the trenches, I think that ... is a continuum, there are lots of iterations of where that damn thing could've landed that may not have been 20 or 22 and a half ...; it could have been a lot of things. But what we have ... is a trust issue. So, I just ... wanted to say that your statement about the 22 and a half, and therefore the good guys won or something doesn't solve it for me.

[6:16:05 PM](#)

DR. VAN MEURS: No, maybe I'm somewhat too simplistic on that concept. But ... I do believe that in the end the good guys won and the people that ... honestly voted for what was right at that time they felt for Alaska, they ultimately won. It was a horrendously long process, and of course I don't know all the twists and turns through that process because I was not here all that time. ... But, I take comfort from the fact that those people that really ... felt positively about and wanted to do something good for Alaska, that they, in the end, got the legislation through. So, I ... only put that from the perspective of in the end ... a good law was created and no damage, as such, in that respect was done. ... I agree with you that's a personal judgment.

REPRESENTATIVE KELLY: Thank you. Thank you, Mr. Chairman.

CHAIR SAMUELS: Thank you. And Very short questions, I've got Senator Therriault and then Representative Doogan.

[6:17:21 PM](#)

SENATOR THERRIAULT: Thank you. Dr. Van Meurs, I should've asked for a clarification earlier, now the news has been on, and they may have lead with the story saying that you've pronounced the gas pipeline uneconomic. And I'm just wondering, when you're an oil and gas advisor, but you're not a pipeline engineer, neither am I. Through the process that we've got going right now, we're going out to the open market to companies that build and operate gas pipelines and saying "Can you make this work? Come back to us with proposals." And I believe that the end of November we will have proposals, whether they ultimately ... lead to gas flowing any time real soon, I'm not sure. ... I'm just wondering what all you base your comment on. The price of steel is up, the price of workers is up, but I don't know

that knowing those and agreeing with those would lead me to ... pronounce the project to be uneconomic ... across the board. What size pipe, 52, 48, 36, there's so many variables.

DR. VAN MEURS: No, no ... I pointed out the slide that related to the specific gasline project that ... was on the discussion. I also mentioned if somebody offers ... \$5 per million Btu at the wellhead in the Arctic, I'm absolutely sure companies are happy to sell. And if that company is willing to build a pipeline, I'm sure the project will go forward. Now, I don't see those deep pockets, ... that is one issue. But, the slide that I was commenting on was the original gasline proposal. ... I don't know whether I mentioned it here in the audience, but I'm already contacted by the government of Canada. Just to give you an example of the horrendous level of economic difficulty that these pipelines have now, Exxon Mobil ... is proposing a \$2 billion dollar subsidy .. from the government of Canada, just to get the McKenzie line built. Now, translating that to Alaska would be an \$8 billion subsidy because the project would be four times as large, ... and it was always recognize that the Alaska project was less attractive than the McKenzie project. ... If you assume that between 2001 and 2007 the cost actually doubled - and I think there is immense evidence in Canada that that actually happened - then now you ... have an uneconomic project .... Now, I believe if you have similar LNG project that even result in a lower net back, I ... see that very problematical. If there is a courageous national oil company, if Petro [Indisc.] would come to Alaska and say, "We are willing to buy at Henry Hub less \$2 at the wellhead in the Arctic, and we take care of shipping all this gas to China." Yes, you have a wonderful project. Now, I don't see that happening, but who knows. If somebody comes out of the woodwork that makes an unexpected offer that happens to be attractive to the ... three major players in the gas field, then of course you have a possibility. But I'm not excluding that, I think that possibility would be very low.

[6:21:24 PM](#)

CHAIR SAMUELS: Thank you, and before we get to Representative Doogan's last question, what time do you leave tomorrow Dr. Van Meurs?

DR. VAN MEURS: Early in the morning.

CHAIR SAMUELS: ... What I'd like to try to do, if the room is available, and particularly for the new members, is allow the

new members to come in here and just have an informal gathering and talk to Mr. Johnston tomorrow at 9 a.m. ... And I'll try to get the word out to the members on the Floor tonight, and I'll talk to the Senate also.

REPRESENTATIVE DOOGAN: Is Oil and Gas meeting tomorrow morning? Do you know?

CHAIR SAMUELS: I believe that Oil and Gas is meeting tomorrow at 1:30 so at 9 a.m. .... So, with that the last question Representative Doogan.

6:22:23 PM

REPRESENTATIVE DOOGAN: Thank you Mr. Chairman. ... I find myself somewhat bumfuzzled by Dr. Van Meurs' statements about Alaska's reputation in the world as an oil province. And what I was curious about ... the statement that you made Dr. Van Meurs, that Alaska is seen as confrontational. And I was hoping that you would be able to explain that to me a little bit. ... What do you see as the cause of that aspect of Alaska's reputation in the oil patch?

DR. VAN MEURS: I think it would clearly be wrong to portray ... Alaska in some kind of heroic battle with Exxon. Yes, the world knows that there has been a horrible oil spill. The world knows that ... Alaska has been very negative about how that matter was resolved and ... consequently, some hard feelings remain about that matter. ... I think the confrontational attitude relates more to ... the details ... of the implementation in terms of money collection, in terms of attitude toward ... the oil industry. There seems to be ... somewhat of a ... frontier mentality in Alaska whereby standing up to the oil industry is a great credit for anybody that ... wants to advance in life, particularly in political life. ... some other governments approach that quite differently and ... I attribute a little bit to two factors. One, somewhat the frontier mentality of Alaska, which ... creates people that feel fiercely about their independence. Also, I think there is some annoyance ... among Alaskans to be dependent on only three companies. ... I think ... Alaskans generally ... feel their future is determined by just three companies and they are, therefore, not masters in their own house. ... whether that is 100 percent correct is difficult to describe, but I think that is how ... I personally explain that relationship. If you go to Alberta, there is no feelings of that whatsoever. If you go to Britain in the North Sea, there are no such feelings whatsoever or Norway for that

matter, or Texas, or MMS .... So, there is a little bit of a ... confrontational environment in Alaska for a whole series of probably social economic reasons that are quite unique, but that at the same time have created a little bit of a culture that I think is not perceived very positively ... by the investor community. And ... that is why I use the word re-branding ... somewhat more concerted effort on the part of Alaskans to say yes, we know are a frontier society, ... but ... we really are prepared to open our arms to newer, medium-sized companies that are willing to come to Alaska and please don't ... misunderstand our desires ... and how we see our future. I think that needs to be marketed better. And I think ... far more of a concerted effort needs to be done to smooth out relationship with the industry to overcome these ... somewhat confrontational kind of attitudes and I think that will help greatly in bringing investment to Alaska. I have seen absolute incredible changes in some nations when they started to re-brand their image. Qatar is probably the absolute stellar example, which used to be a backwater, it was pretty nasty kind of reactions to the oil industry; over-negotiating every ... little tidbit and ... fighting every little payment coming to government and ... really they didn't go anywhere. And then they re-branded themselves as the modern center of gas development in the Middle East and now they are the leaders. And ... it is more psychology than hard reality and I think something like that is necessary. Would that be a good description of Qatar?

MR. JOHNSTON: Well, I think it was partly the result of the coup, wasn't it.

DR. VAN MEURS: I'm not recommending coups in Alaska, no.

MR. JOHNSTON: Yeah, the dad left town for a couple days and the son took over and the son was a little more aggressive, shall we say.

REPRESENTATIVE DOOGAN: Thank you very much.

[6:28:41 PM](#)

CHAIR SAMUELS: Thank you both very much. I hope that it has been informative, particularly for those who didn't live and breathe for quite some time.

DR. VAN MEURS: Thank you so much, it was a great pleasure.

CHAIR SAMUELS: Thank you much and we're adjourned.

**ADJOURNMENT**

There being no further business before the committee, the Legislative Budget and Audit Committee meeting was adjourned at [6:28:49 PM](#).