

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

October 23, 2007

9:05 a.m.

MEMBERS PRESENT

Senator Charlie Huggins, Chair
Senator Bert Stedman, Vice Chair
Senator Lyda Green
Senator Gary Stevens
Senator Lesil McGuire
Senator Bill Wielechowski
Senator Thomas Wagoner

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

SENATE BILL NO. 2001

"An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to the issuance of advisory bulletins and the disclosure of certain information relating to the production tax and the sharing between agencies of certain information relating to the production tax and to oil and gas or gas only leases; amending the State Personnel Act to place in the exempt service certain state oil and gas auditors and their immediate supervisors; establishing an oil and gas tax credit fund and authorizing payment from that fund; providing for retroactive application of certain statutory and regulatory provisions relating to the production tax on oil and gas and conservation surcharges on oil; making conforming amendments; and providing for an effective date."

HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: SB2001

SHORT TITLE: OIL & GAS TAX AMENDMENTS

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

10/18/07	(S)	READ THE FIRST TIME - REFERRALS
10/18/07	(S)	RES, JUD, FIN
10/19/07	(S)	RES AT 9:00 AM BUTROVICH 205
10/19/07	(S)	Heard & Held

10/19/07 (S) MINUTE(RES)
 10/20/07 (S) RES AT 8:00 AM BUTROVICH 205
 10/20/07 (S) Heard & Held
 10/20/07 (S) MINUTE(RES)
 10/21/07 (S) RES AT 1:00 PM HOUSE FINANCE 519
 10/21/07 (S) Sponsor Presentation:
 10/22/07 (S) RES AT 11:30 AM BUTROVICH 205
 10/22/07 (S) Heard & Held
 10/22/07 (S) MINUTE(RES)
 10/23/07 (S) RES AT 9:00 AM BUTROVICH 205

WITNESS REGISTER

JOHN P. ZAGER, General Manager
 Chevron North America Exploration and Production
POSITION STATEMENT: Spoke in opposition to the tax increases in SB 2001.

PAT FOLEY, Manager
 Land and External Affairs
 Pioneer Natural Resources, Alaska, Inc.
POSITION STATEMENT: Spoke in opposition to the tax increases in SB 2001.

KEN SHEFFIELD, President
 Pioneer Natural Resources, Alaska, Inc.
POSITION STATEMENT: Spoke in opposition to the tax increases in SB 2001.

MARK HANLEY, Manager, Public Affairs
 Anadarko Petroleum Corporation Alaska
POSITION STATEMENT: Spoke in opposition to the tax increases in SB 2001.

MARILYN CROCKETT, Executive Director
 Alaska Oil & Gas Association
POSITION STATEMENT: Spoke in opposition to the tax increases in SB 2001.

TOM WILLIAMS, Chair AOGA Tax Committee, employee of BP
 Anchorage, Alaska
POSITION STATEMENT: Spoke in opposition to the tax increases in SB 2001.

PAUL LAIRD, General Manager
 Alaska Support Industry Alliance

POSITION STATEMENT: Spoke in opposition to the tax increases in SB 2001.

JOHN SHIVELY, President
Resource Development Council

POSITION STATEMENT: Spoke in opposition to the tax increases in SB 2001.

DONALD BENSON
Palmer, Alaska

POSITION STATEMENT: Spoke in favor of SB 2001.

JERRY MCCUTCHEON
Anchorage, Alaska

POSITION STATEMENT: Spoke in favor of increased petroleum taxes.

LOWELL HUMPHREY,
Anchorage, Alaska

POSITION STATEMENT: Spoke in opposition to tax increases in SB 2001.

CHRIS HUMPHREY
Anchorage, Alaska

POSITION STATEMENT: Spoke in opposition to tax increases in SB 2001.

DAVID LAWER, Senior Vice President and General Council
First National Bank of Alaska
Anchorage, Alaska

POSITION STATEMENT: Spoke in opposition to tax increases in SB 2001.

JOE MATHIS, Owner
Montana Creek Campground
Anchorage, Alaska

POSITION STATEMENT: Spoke in opposition to tax increases in SB 2001.

WILLIAM HARVEY
Anchorage, Alaska

POSITION STATEMENT: Spoke in favor of a gross tax.

RANDY SELMAN
Wasilla, Alaska

POSITION STATEMENT: Spoke in favor of the PPT.

TOM LAKOSH

Anchorage, Alaska

POSITION STATEMENT: Suggested an alternative taxing method.

MARY NORDALE

Fairbanks, Alaska

POSITION STATEMENT: Spoke on past auditing problems with the oil and gas industry.

CHUCK LOGSDON, Alaska Oil and Gas Association (AOGA),
Palmer, Alaska

POSITION STATEMENT: Spoke in opposition to SB 2001.

MAYNARD TAPP, Founder

Hawk Construction Consultants

Anchorage, Alaska

POSITION STATEMENT: Spoke in opposition to SB 2001.

TOM WALSH, Oil and Gas Industry Consultant

Anchorage, Alaska

POSITION STATEMENT: Spoke in opposition to SB 2001.

JOSEPH HEGNA, Vice President

Oil and Gas Sector, MWH, Inc.

POSITION STATEMENT: Spoke in opposition to SB 2001.

LYNN JOHNSON, CEO and Co-Founder

Dowland-Bach Corporation

Anchorage, Alaska

POSITION STATEMENT: Spoke in opposition to SB 2001.

ACTION NARRATIVE

CHAIR CHARLIE HUGGINS called the Senate Resources Standing Committee meeting to order at [9:05:38 AM](#). Senators Huggins, McGuire, Green, and Wielechowski were present at the call to order Stevens. Senators Wagoner and Stedman arrived soon after.

Also in attendance were Senators Davis, Thomas, Hoffman, Elton, and French and Representatives Gardner and Buch.

SB2001-OIL & GAS TAX AMENDMENTS

CHAIR HUGGINS announced the consideration of SB 2001. He noted a memo from Kevin Banks correcting earlier statements.

JOHN P. ZAGER, General Manager, Chevron North America Exploration and Production, said it is a pleasure to represent

the independent producers. He said Chevron is the fourth largest producer and the third largest operator in Alaska. Chevron is the largest operator in Cook Inlet, operating 10 platforms with 8 producing, he said. "We are mostly 100 percent...working-interest owners at Granite Point with ExxonMobil owning 75 percent of one platform." In McArthur River, Chevron partners with Pacific Energy Resources and has about 52 percent ownership. Chevron also has gas fields that it operates on the east and west sides. It is a joint-venture owner with Marathon on the Kenai Peninsula. There are about 500 employees or contractors and most are on the Kenai Peninsula, he noted, so Chevron is one of the largest private employers on the Kenai. Chevron is unique in having a balance of production in Cook Inlet and the North Slope. Production in Cook Inlet is about 23,000 barrels of oil equivalent--two thirds is gas. Most of the people work supporting the oil production. He said the platforms are continuously staffed with 10 to 15 employees. Production in Cook Inlet is about 15-16,000 barrels per day. Costs are very high because of the percentage of water, he said. On some platforms, the direct operating expense is over \$40 per barrel.

SENATOR WIELECHOWSKI asked the lifting costs on the legacy fields for the North Slope.

MR. ZAGER said he believes it may be in the teens. Chevron also has interest in the North Slope--about 15,000 barrels per day through the small working interest in Prudhoe Bay, Kuparuk, and Endicott. Chevron is in the early stages of dramatically increasing its capital investment in Alaska. If prices were to drop, those assets would be severely challenged to operate profitably, he stated.

CHAIR HUGGINS asked if he was talking about oil or gas.

MR. ZAGER said the gas production is primarily onshore and more profitable. The cost challenges are about oil.

[9:12:57 AM](#)

MR. ZAGER said Chevron is beginning a wide-spread exploration program this winter on the North Slope. It is the first exploration there since the early 1990s, and he envisions a two-winter exploration program in the white hills.

CHAIR HUGGINS asked about Chevron's decision to invest.

MR. ZAGER said, "These decisions were made to invest using PPT [profits-based petroleum production tax of 2006] as our tax

assumption." For some projects, Chevron took initial steps in 2005, "but when we actually made the go/no-go decision sometime in the last 10 to 12 months, we were assuming that PPT was our tax regime."

9:14:32 AM

CHAIR HUGGINS said if the decisions were spurred by the PPT, it seems like a short decision cycle.

MR. ZAGER said Chevron has an annual capital budget, and it develops projects over a period of time. Generally it uses "a three-year plan that is pretty firm and then we extend it out for a period beyond that just to get a longer look." As projects come into the inventory, Chevron has a five-stage process. Stage one is identifying viable opportunities. Stage 2 is comparing and selecting the options, and the third stage is refining the option and being ready for investment. Stage 4 is execution, and stage 5 is looking back. In 2005, the North Slope project was in stage 1, and during the last 12 months it was put into stage 3, so it is in the budget and ready to be approved.

9:16:04 AM

SENATOR WIELECHOWSKI asked when Chevron requested the permits for the North Slope exploratory wells.

MR. ZAGER said he doesn't have the exact date, certainly within the last 12 months or so.

SENATOR WIELECHOWSKI said that DNR and DOR said the PPT had little to do with Chevron's decision on those new wells.

MR. ZAGER said "a nucleus" of those leases was acquired seven or eight years ago. Some dry holes were drilled by others and it made Chevron rethink those projects. Since then, Chevron needed to decide whether to drop the leases. "We decided that we would keep holding on to them because another concept had come that was different than the one that was condemned by the other wells. So, I believe our first significant additional lease purchases then were around...March 1 of 2006." Chevron picked up a lot of acreage then, and it has picked up additional acreage since. The last round has been since PPT was in place. "So that is spending the capital to acquire the lease acreage, which was really just the down payment, if you will, on that play." The real investment was six to eight million dollars acquiring those lease positions, he said, and that money will be dwarfed by the amount Chevron will spend drilling over two seasons. The real

investment decision is committing to get the rig and mobilize all the people and resources to evaluate the leases.

9:19:14 AM

SENATOR WIELECHOWSKI noted that DOR and DNR said PPT did not impact those decisions. He requested a verification of the timeline.

MR. ZAGER said he doesn't know how the agencies would know when Chevron made the decision—"maybe from the fact that we took some of those leases prior to the passage of PPT." They may surmise that Chevron had made the drilling decision then, "but that was not the case; that was only made in the last several...we committed to the rig probably a year ago because of long lead times. So they may have said, at that point, we're committed to drilling. But usually when you make a rig commitment, you have fallback provisions; you can do other things with that rig, you can get out of your lease, so you're trying to, all the time, stay on the timeline, make what commitments you need to, but also have off-ramps along the way. And so when we finally...committed to the full thing was certainly within the last three to four months—where we got internal approval all the way up to our board of directors to make that investment."

9:20:51 AM

CHAIR HUGGINS said the committee is interested in Chevron's perspective and if its activity is relevant to the PPT. Exploration investment was the idea behind the PPT. In his estimation, the challenge of exploration and production is the future challenge to cut down the decline in production.

9:21:30 AM

MR. ZAGER said the PPT was used in making Chevron's final investment decision. It is hard to say what it would have done if the PPT had not been there. It probably would not have made it uneconomic but would have moved it down the queue of world-wide opportunities. It is a real challenge to convince a company that has been successful internationally that it is time to come back to the North Slope—"where we've left a lot of money over the years without too much to show for it." Now is the time to come back and test the waters again.

SENATOR WAGONER asked how many wells are proposed.

9:22:39 AM

MR. ZAGER said Chevron is permitted for 15 or 16 locations, but "that was done largely to provide optionalities as we move

forward." He said he expects 6 to 9 over the next two seasons. The first wells may cause Chevron to make changes.

[9:23:14 AM](#)

CHAIR HUGGINS asked how much it costs to drill a well.

MR. ZAGER said because of the infrastructure it would be hard to determine cost per well, but the total commitment for the two seasons is about \$150 million.

CHAIR HUGGINS asked what the North Slope labor force will be.

MR. ZAGER said it is hard to say, but probably 100. There are probably 20-30 people now. Getting the right people is "a real constraint." Chevron is staging and waiting for snow to fall. He showed a graph entitled "Chevron is increasing investment under PPT," and it showed the increase in capital investments of Chevron. He said most of it is in Cook Inlet gas. In 2007 begins the increased efforts in the oil business and North Slope drilling. In 2008 there will be a full program on the North Slope with investments of over \$300 million along with adding a full rig line in Cook Inlet. In 2009, Chevron is planning to bring a second rig line into Cook Inlet. Individual wells aren't drilled; "you've got to get a rig; you've got to get a queue of opportunities lined up in front of it so that crew can keep working." In today's world, a hiatus means people may not be there. The way to operate efficiently and safely is to have a crew that has worked together.

[9:26:11 AM](#)

SENATOR WIELECHOWSKI asked if Chevron is looking for oil or gas in Cook Inlet.

MR. ZAGER said both. Chevron intends "to flatten and then hopefully increase the production on the oil side," and it has strong market commitments for gas. To fill them, Chevron must spend a lot of money on exploration and development of those resources.

SENATOR WIELECHOWSKI asked if there are a limited number of arctic rigs for drilling.

MR. ZAGER said he is not the best person to ask, but there are a limited number. One rig does not fit every well, he added. Chevron had a new rig built in Canada, and it is now drilling gas prospects in Cook Inlet. It is drilling today and it will head north in November. Anadarko may have the same small mobile

rig, designed to drill and move more efficiency. The common enemy is production decline. Not that long ago "we were here slugging this through." Chevron believes it is too early to tell if the PPT is working. Chevron investments show that it is working. A review has been scheduled for 2011, and that doesn't give him comfort, he said. He asked what Chevron is supposed to assume. He expressed concern about the White Hills prospect drilled in 2007-2009, with delineation work in 2009 and commissioning in 2010.

[9:29:41 AM](#)

MR. ZAGER said knowing that there is a review of PPT in 2011 could influence the timing if taxes are expected to increase. A spike in oil prices or an election between then and now may give Chevron the confidence to go forward.

CHAIR HUGGINS said Senator Wagoner made that same comment.

SENATOR WAGONER said the administration said it will leave gas at 25 or 22.5 percent, and then take care of it in three years. He asked if that has the same kind of effect as the review in 2011. It will open up the tax policy of Alaska if gas prices are not addressed at this time. He said he understands the nuance of the gas line contract and negotiations.

MR. ZAGER said anything that opens the discussion brings concern to people who are investing potentially billions of dollars.

SENATOR WAGONER said, "We might be rushing to judgment."

CHAIR HUGGINS said, "What we're doing...I characterize as a knee-jerk—that we can't qualify why we're doing it."

[9:32:26 AM](#)

MR. ZAGER expressed the desire to balance taxes with an optimum investment climate. Corporations should operate safely, protect the environment, and increase value to shareholders. Managing cash flow determines accumulated value. Cash is used for operating costs; investment for upstream, downstream, technology, or acquisitions; paying down debt and cash buildup; dividends to shareholders; and buying back stock. He noted that there are always more opportunities and not enough capital to go around. There is always a ranking process of projects where some get cut off at the bottom.

[9:36:45 AM](#)

MR. ZAGER said investment decisions in Alaska consider the government take, but it isn't the most important thing. Alaska has an asset that Chevron wants to lease out in the market. To value it, one first looks at the geology and the reserve potential. The crown jewels have been found, and now Alaska state land is "fair to middling." The oil industry spends a lot of time studying rocks. The cost of operation is another factor, and Alaska is on the high end. Even Cook Inlet lacks a large infrastructure—at times a tool has been flown in from Nova Scotia. Time is a factor. On the North Slope, it takes eight to ten years before revenue comes in. Risk and probability of success are important. The fiscal regime defines how much revenue the investor keeps.

[9:41:35 AM](#)

MR. ZAGER said he sometimes gets lost in the minutia of why people are so fixed on government take when there are so many other things. The product needs to be priced appropriately in the market. He said investment decisions are made on the after-tax net present value. That means that the future cash flow is discounted back, and opportunities are ranked, and certain ones will get funded and some will not. Great rocks can trump poor fiscal terms, he stated. Pricing a Chevrolet like a Cadillac won't work. He showed a graph of Alaska lease sales since 2002 compared with the Gulf of Mexico. It is a good example, he said, "because these are the exact same companies you want bidding on the North Slope." They are large companies that can operate in the deep water, and they are the major producers here in Alaska and the large independents. If this were baseball, the score would be 72 for the Gulf of Mexico and 1 for Alaska.

SENATOR STEDMAN said the Gulf of Mexico is under a different tax structure and he asked for a comparison of near shore versus being out in federal waters. "Could you elaborate on that because we've had Gulf of Mexico conversations numerous times here, and I still have a conceptual difficulty in drawing a real tight correlation between the federal deep water in the Gulf of Mexico versus the Arctic?"

[9:46:00 AM](#)

MR. ZAGER said he doesn't have all the details of the leasing in the deep water. They are federal sales, and state waters have different terms. From the investors' point of view it is how much they can keep. It doesn't matter, and this is the competition that Alaska has. "This is the league we are playing in...in terms of attracting investment to Alaska."

SENATOR STEDMAN said he has a conceptual challenge. A lease in the Arctic on state lands comes under the state, property, corporate income taxes and the royalty system versus going offshore that only has the federal environment and no state financial burdens. Wouldn't it lead to higher bonus bids to stay competitive?

MR. ZAGER said that is correct. Industry is actually bidding that government take up with upfront money going to the government. The rocks are so attractive and the fiscal terms leave money on the table, so they put \$2.9 billion upfront to make sure they get a bite of the pie. Alaska used to attract bonus rounds in the 1980s, because the rocks were that good. Times have changed, he stated.

SENATOR WIELECHOWSKI said he sees it differently. The rocks have not changed from 2002 to 2007, and yet the number of leases has increased. The fiscal terms were lower in 2002-2005, and there was less investment. "Now that we've raised the fiscal terms, we've actually had more investment. A person can come to a lot of conclusions, but Alaska raised taxes and got more investment."

[9:49:23 AM](#)

MR. ZAGER said that oil prices have a lot to do with it. He said to look at government take in the Gulf. If Alaska's rocks were that attractive, why didn't it attract at least a few hundred million? Libya got over 100 bids in the first two rounds. People were bidding on an excess of 90 percent government take—it's what you've got left at the end of the day that drives those decisions, he stated.

SENATOR WAGONER said the Gulf of Alaska has been little explored. He asked if anyone will go back there in the future.

MR. ZAGER said he has not heard any talk about that. It is not on the top list of basin potential, but he does not know. But, generally, a company wants to get a concept that another company doesn't have and be the first in to capture the opportunity.

SENATOR MCGUIRE asked how other things factor in. She said she doesn't discount the value of basic geology. The stock market is based on reality and perceptions. She asked how perceptions play a role on deciding to invest in Alaska. Maybe Alaska is the fallback, because Libya-type places are unstable and need to be got while they can.

[9:52:42 AM](#)

MR. ZAGER said he disagrees. There are hundreds of energy companies scrambling for opportunities, so Alaska won't be deferred if the opportunities are good. The oil business has a herd mentality, and everyone follows success. That is seen in Angola and West Africa now. If Anadarko and similar companies are showing great returns in Alaska, several other companies that size would follow. "We follow success." He doesn't think Alaska is being mothballed, because it is too competitive of a business.

SENATOR STEDMAN asked if a gas line would spur more activity from firms the size of Anadarko, since the two big oil pools have been tied up for several decades.

[9:54:46 AM](#)

MR. ZAGER believes that is right. "We are fighting an oil and gas business with a hand tied behind our back, and basically the gas hand is tied behind your back." He said access to the gas is required before anyone will invest.

CHAIR HUGGINS said he likes that comment because it "appeals to my strategic mindset."

SENATOR WIELECHOWSKI asked if a gas line will spur a lot more drilling and then more gas and oil will be found.

MR. ZAGER said geologists sometimes think they know more than they do. The conventional wisdom is there is more gas to the south. At times, the industry has drilled for oil and found gas. Putting more wells in the ground will lead to serendipitous discoveries, which happens frequently, he said.

[9:56:42 AM](#)

SENATOR WIELECHOWSKI said it seems that the gas line is really critical, and herd mentality will shift to Alaska because there will be 10 percent of the U.S. supply of gas pumped down that pipeline. Are incentives and tax breaks really needed?

MR. ZAGER said it is a presumption that there will be a gas line before declining oil creates fiscal problems. The assumption that the tariff of such a pipeline will leave competitive returns for grassroots exploration on the North Slope should be studied if not challenged. Costs will be high, the tariff will be several dollars, and prospects are remote. Unless there are world-class reservoirs, it will be a challenge to attract a lot of capital for a gas drilling frenzy on the North Slope.

SENATOR WIELECHOWSKI said your company has plopped down 15 wells looking for gas.

MR. ZAGER asked who said they are looking for gas.

[9:59:14 AM](#)

CHAIR HUGGINS said he is a cheerleader for a gas pipeline. "Contract doesn't equal gas pipeline," and that scares him.

MR. ZAGER showed a "risk (or decision) tree," which is a way to value a future investment opportunity and the probability of success or failure. Some of Chevron's models have hundreds of variables, but his example uses four. He gave an example of the decision to drill an exploration well with an 85 percent probability of failure, which would cost Chevron \$20 million after taxes. "Then how you figure the expected values, you multiply by the probability of failure, so that gives you your value. Your expected value at that point is minus 17." The success side gets more complicated, because success means oil was found but volumes vary. "There is a P10 discovery," means there is only a 10 percent chance that the accumulation will be smaller than that. A P50 is "kind of the middle of this whole distribution of outcomes from virtually nothing to something very big." The P90 is "the upside case—that's kind of how big you think it can be." 90 percent of the time the amount will be smaller than that. The chance of getting a P90 discovery is 15 percent times 10 percent, or 1.5 percent. "We take the average of this distribution and we multiply it by 15 percent and you come up with an expected value of 20.625." To get the expected value for Chevron's decision, he adds those values and gets a positive 3.6, "so the answer would be, yes, drill the well." Some people see those as excess profits and want a bigger take from the state. But he said look what happens if he changes the "300' to "200" because of taxes: the expected value goes to minus 0.9, and the well doesn't get drilled. "You can drive something from positive to negative simply by changing the tax rate on the most successful outcome." If taxes are expected to change, a risk factor needs to be added, which could cause a change in an investment decision. Most likely a tax would move it down lower in the queue of opportunities.

[10:05:35 AM](#)

SENATOR STEDMAN said the legislature spent a lot of time on forecasting and progressivity. One concern is that the tax regime didn't "start taking off some of the higher end too early." There were price ranges used in the models, including

optimistic and stress values. "We set some of these triggers above the optimistic arena so the industry would not use the progressivity in their financial modeling." "We spend quite a bit of time...to try to insulate the industry from that but still put the state in a position that if we had excessively high oil prices, the state would not have their percent of the pie diminish."

MR. ZAGER said there are many other uncertainties used in the model besides oil prices. If there are good rocks, the oil price could stay the same, and Chevron would end up with more profits. It is just a risk factor.

CHAIR HUGGINS said he is concerned about the unintended consequences of the knee-jerk of failing to look at all aspects of a proposal. The luxury tax on boats to get money from affluent people didn't work because it put people out of a job.

[10:09:21 AM](#)

MR. ZAGER showed a model of the investment needed to maintain production at reasonable levels. The blue line shows a 6 percent decline, and the model assumes development costs to be \$15 per barrel. It assumes \$1 or \$2 billion additional annual capital spending. It assumes spending keeps going and that there is adequate inventory. "So you kind of look at the kind of capital you'll need to attract, in order to keep decline at a more reasonable--or almost a flat--decline for a number of years."

SENATOR WIELECHOWSKI asked if the PPT is left in place, what assurances will Chevron provide to continue substantial investments in Alaska?

MR. ZAGER said oil companies put money where the best returns are, and the more attractive Alaska is, the more money will flow there. No guarantees.

SENATOR WIELECHOWSKI asked if the PPT will keep the graph at the green line.

MR. ZAGER said he can't say that.

SENATOR WIELECHOWSKI said, "And you can't tell us that if we went to ACES, we're not going to stay at the green line?"

MR. ZAGER said he can only talk about probabilities.

SENATOR WIELECHOWSKI said, "But you can tell us that if we do go to ACES, there is going to be more money coming into the Alaska treasury."

MR. ZAGER said ACES will likely increase tax income in the short term, but "in the year 2010 to 2015, I think that's probably not a probability and you'll see less money coming into the Alaska..." He said Chevron will not run away from Alaska production, and there is no doubt that short-term state revenue will go up. For the next two to three years, that would be the way to go, he said. For future generations and "some reasonable level of production, then you need to be more circumspect in your answer and think long term about how do we maintain production." Take care of your goose that laid the golden egg.

[10:13:45 AM](#)

SENATOR WAGONER asked if Mr. Zager's model has the current tax structure, with credits, figured in.

MR. ZAGER said no, he looked at a couple of reports to get a feel for where current finding and development (F&D) costs are running. Fifteen is about as good a number as he could pick, but it is not necessarily for Alaska. It is more of a North America number. F&D is "how much it takes to explore for, and then develop, the oil and gas resources." It includes drilling, infrastructure and whatever is required to get to production. A lower number is better for both the state and producer.

SENATOR STEDMAN asked Mr. Zager to discuss the impact of a credit on that number.

MR. ZAGER said it would lower the after-tax F&D. The credit is a partial return of the capital investment.

SENATOR STEDMAN asked if the industry considers the number after all the taxes and transaction costs are taken out.

MR. ZAGER said it depends on the source. His numbers came from a report of industry-wide surveys. It is public data. Internal investment decisions would be looked at on an after-tax basis, and F&D costs would just be one of several parameters in that decision. The next chart is from the Wood Mackenzie Government Take study, and it ranks fiscal attractiveness against fiscal uncertainty. Alaska is at the bottom of fiscal certainty, but that is not why he is showing the slide. He said there are government takes of up to 90 percent, and those countries that have high government take have the best rocks in the world and

they are OPEC members. They generally have national oil companies. The terms are pretty onerous for international companies. Libya is one of the least attractive places in the world, but there was a rush to get in there. The rocks are good enough. Countries with less than a billion B.O.E [barrels of oil equivalents] want to attract investors. The others can afford to turn them away. The gulf coast apparently has something going for it because industry voluntarily increased the government take. Alaska is in the middle, he said, and it can move to compete with the best rocks in the world or move the other way to attract investment. "Do we want to make Alaska even less fiscally attractive?" It will be hard to attract more investment, he concluded.

10:22:09 AM

SENATOR STEDMAN noted that Alaska is put in the lower quadrant [fiscally uncertain]. He said both the state and the industry agreed to change the ELF [economic limit factor] system. If the state didn't change ELF or adopt the PPT, he asked if Alaska would be next to Saudi Arabia on the chart.

MR. ZAGER said maybe.

SENATOR STEDMAN said the legislature is like a board of directors and in charge of maximizing the wealth of shareholders—the people of the state. Alaska had to come to the table with industry to change the tax structure under ELF. Industry and the state agreed to move on the chart. He suggested that is different from "a scenario where a state may just happen to create a tax structure...for whatever reason."

10:25:01 AM

MR. ZAGER said the changes to date are understandable, "but if this gets to be an annual trend, then we've got a real problem." Gas taxes will be looked at in 2010. He suggested sending a signal that Alaska is disciplined enough to see if PPT works before changing it. Investors went into countries with high fiscal terms with eyes wide open—they ran the economics and the deal hasn't change since they got in.

SENATOR STEVENS noted that ELF was advantageous to industry and "there was still precious little exploration and development. Why would that be?"

MR. ZAGER said ELF didn't have the credit incentive. The reward is smaller because of the tax increase, but the risk is smaller. The super majors can take on any size project, but the smaller

companies are concerned about exposure, so the investment incentives are more important.

10:27:36 AM

SENATOR STEDMAN spoke of another chart he would like to see: "Global state take versus pre-take...at ten."

MR. ZAGER said he needs permission to use the graphs. Energy companies have the responsibility to invest where there is the best risk/reward ratio. He has heard people say that oil companies are threatening to withhold investment in Alaska, but "that is absolutely not true." He said he will work hard to get as much money for Alaska as he can, "but you're making the job a lot more difficult if you increase government take--lower the returns." "It's not that we're threatening to withhold investment, it's just a fact...that if the state takes more, they're less attractive investments." He has 500 people working with him who want the company to keep investing in Alaska. Investment is the only way to stem decline. Sell Alaska's Chevy as a Chevy, and don't price it like something else, he said.

10:32:04 AM

SENATOR WIELECHOWSKI said obviously raising taxes costs Chevron, but every world-renowned, independent expert hired by the state has said raising taxes will not substantially impact investment.

SENATOR GREEN said, "I would somewhat question the fervor with which you've made that statement, because I think there were other things to balance that that would have offset the increase." It wasn't that carte blanche, she stated.

SENATOR WIELECHOWSKI said he will be happy to recount the testimony. Pedro Van Meurs said the state could increase the tax to 25 percent, plus 8.5 progressivity at \$50 per barrel--0.25. Dr. Johnston, another world-renowned expert, said it can be increased to 30 or 35 percent, plus 0.25 at \$30 or \$40 a barrel; Gaffney Cline & Associates said ACES would not have a substantial impact. Dan Dickenson and Steve Porter agreed with the experts. "Do you disagree with that?"

MR. ZAGER said we are only arguing about the order of magnitude. No one has said that increasing taxes will increase investment. The commissioner of DOR said it won't attract more investment; in fact it will hurt investment in Alaska. If you are perfectly happy with current investment, and if you are in it for the short term, "by all means."

10:34:40 AM

SENATOR STEDMAN asked how spent Chevron spent money to create their credits. He asked about Chevron's ability to use the credits and how they are handled from Cook Inlet to the Arctic.

MR. ZAGER said Chevron has been drilling oil and gas wells to generate credits. Operating expenses are high in Cook Inlet. The tax is based on the ELF system, which is good and justifiable. Gas storage wells are not deductible for credits. Chevron has sufficient cash flow to use its own credits, so it doesn't trade them.

SENATOR STEDMAN asked what impact Chevron would be subjected to if the credits were split so that only 50 percent could be used in the year they were created, which would give the treasury more predictability.

10:37:29 AM

MR. ZAGER said it would be far down the list of financial impacts, because it is only the net present value of half its credits for one year. It may be a bigger issue for smaller companies, he surmised.

CHAIR HUGGINS asked about the claw-back provision.

MR. ZAGER said it is a justifiable provision. It is a fairness issue to the people investing over the years. The taxes changed in the middle of the game. "We went from no tax to taxing basically cash flow." Federal income tax is on income. For income tax purposes, companies can depreciate their assets, so even investing in 2005, they are still recognized as offsets in 2008 or 2009. PPT is a tax on annual cash flow, so if it was spent last year, it doesn't count for this year. It is probably an advantage to do it on an annual basis since it can be done immediately, but during the transition period of going from one system to another, companies that invested heavily get the short end of the stick. "There are also provisions put in where you've got to earn that capital back again through double the reinvestment rate." There was a lot of discussion around this, he said. PPT had more sense of partnership between the state and the industry by sharing in the upside and risking in the downside. That has been eliminated by putting a floor in, so the state is running away from the risk and continuing to take on the upside. The clawback provision is about fairness. There has to be recognition that the cash flow now is largely the benefit of the investments that were made over the past five years.

10:41:59 AM

CHAIR HUGGINS asked about "the floor".

MR. ZAGER said the floor was put in to mitigate the state's risk, so when things get bad there is some minimal assurance by getting 10 percent of the gross. It moves the risk to the producers, he said. Cook Inlet is not included because it is heritage fields, but someday the heritage fields will have high lift costs. Putting a floor in will shorten the life of those fields. He said to think what the incentive is. A gross tax is regressive, like a flat tax, and is not a good tax policy. The poor fields end up being taxed a higher percentage.

10:43:53 AM

SENATOR WAGONER said, in terms of the clawbacks, the company still amortizes the costs against federal taxes. The state does not disallow the deduction at the federal level.

MR. ZAGER said it would not.

SENATOR WAGONER added that if the state allows it to be deducted from production taxes, then it is a two-for-one. They continue to get the amortization for federal taxes.

MR. ZAGER said that is the way the system works. "You net out state taxes and that takes the bite out of the federal tax, so essentially by eliminating this deduction, you're taking a partial bite out of the federal taxes as well.

SENATOR WIELECHOWSKI said he agreed that the rich fields shouldn't be taxed the same as the poor fields. Chevron's goal is to maximize the money for shareholders. The state needs to maximize income, investment and Alaska jobs. He said that can be accomplished with a two-tiered tax system that taxes legacy fields higher than the more expensive exploration fields.

10:47:03 AM

MR. ZAGER said his statement is that a gross tax would tax one higher than another. "I don't think I said they should be taxed differently." He thinks he was implying that a net tax would take those differences into account.

SENATOR WIELECHOWSKI asked if a multi-tier system makes sense.

MR. ZAGER said the PPT system handles it with its net system. A less-profitable field will be taxed at a lower rate. There are also exploration credits. A viscous oil credit was considered

but not added. The net-tax system is designed to take those differences into account.

[10:48:56 AM](#)

CHAIR HUGGINS said this was one of the most engaging conversations with an oil company. Slide 6, 9, and chart 14 revealed a number of elements that haven't yet been presented coherently.

The committee recessed from [10:49:48 AM](#) until [11:03:52 AM](#).

PAT FOLEY, Manager, Land and External Affairs, Pioneer Natural Resources, Alaska, Inc., said Pioneer is still a relatively new player in Alaska. The Oooguruk project is Pioneer's North Slope cornerstone. The PPT program provides a modest incentive for future investment and achieves the goal of increasing state revenue. He asked for no negative changes to the PPT for this special session.

SENATOR WAGONER asked if ACES made any positive changes.

MR. FOLEY said some are positive, but most are not.

[11:06:38 AM](#)

KEN SHEFFIELD, President, Pioneer Natural Resources, Alaska, Inc., said Pioneer is a large U.S. independent operating around the world. It doesn't have any production in the state, but he hopes to see that change. He spoke of a growing gas business in South Africa and oil in Tunisia. Company production is a little over 100,000 barrels per day of oil equivalent. Pioneer's assets are focused in North America, with over 90 percent of production and reserves there. "That is our primary competition for capital," he said. Each fall, the Pioneer business units present opportunities to the senior management committee. Pioneer and most of the independents prefer Lower 48 projects because they are lower risk and lower cost. The cycle times are shorter, creating cash flow in the same year as investment. He said his team advocates for Alaska budget dollars. From all the investment opportunities around the world, the committee picks projects that meet the corporate goals.

MR. SHEFFIELD said some of the drivers for that selection include production growth, with a ten percent growth each year. Pioneer wants to replace 100 to 150 percent of what it produces each year. The management team looks at economic and financial metrics, and the probabilistic range of outcomes.

11:11:58 AM

MR. SHEFFIELD said, looking at the budget for 2008, about 75 percent of the projects that were put forth for consideration will get funded, and the balance will either be deferred or... Rising oil prices have improved the margins, but rising costs have taken a bite out of that. "The tide for new projects is still lifting all boats," he said. That has raised the profitability of lower-risk opportunities in the Lower 48, so budget dollars are flowing to coalbed methane, tight sand reservoirs, and shale gas, thus there has been less emphasis on high-risk exploration. The current commodity cycle allows Pioneer to have a less aggressive portfolio.

CHAIR HUGGINS asked where Alaska projects fall.

MR. SHEFFIELD said Pioneer explores around the world, "and we do have some high-risk opportunities here in Alaska, as well as down in the Lower 48. We've drilled, over the last decade, wells in West Africa." Five percent of Pioneer's projects are high risk, and some of that money has been allocated to Alaska.

CHAIR HUGGINS said Alaska's objective is to double Pioneer's production in Alaska.

11:15:50 AM

MR. SHEFFIELD said Pioneer's projects in Alaska are competing against low-risk, short-cycle projects, including oil and gas drilling in Texas, shallow-gas drilling in Colorado, high-margin gas in South Africa, and successful oil drilling in Tunisia. Pioneer also has a business development group that scours the lower-48 looking for new resource plays. So Alaska is competing with existing and new projects. The government take in Alaska is somewhere in the range of the mid 60s, "and people said it's kind of in the middle of the road in the scheme of the whole world of opportunities." But for Pioneer in Alaska, the primary competition is the Lower 48, with lower costs, shorter cycles, and lower [government] take.

SENATOR WIELECHOWSKI asked about Oooguruk with 30 million to 90 million barrels, and if it is one of Pioneer's larger fields.

MR. SHEFFIELD said, "Our Oooguruk project at 70 to 90 million barrels is a number that we've made public, is toward the higher end of new projects that Pioneer's undertaking world wide." It is a significant step out for a company the size of Pioneer. The company looks at economics and puts together a swat analysis—a tool to weigh the strengths, opportunities and threats of any

new business decision. Alaska,, in 2002, had a great petroleum system—"geologists just love Alaska because of the petroleum system." Pioneer saw a potential for high-impact opportunities and liked the state's fiscal policy. The state was courting the independents with the ELF regime, saying there would be low severance taxes unless "you hit a home run, and then you would pay significant severance taxes." The exploration incentive credits were in play at that time, and the combination of those factors was a plus for Pioneer.

11:19:58 AM

SENATOR WIELECHOWSKI asked if "prolific petroleum system" means the same as "good rocks."

MR. SHEFFIELD said yes, and the North Slope petroleum system is charged with hydrocarbons, "which means...that most anywhere you drill a well on the North Slope, you have a really good chance of finding some hydrocarbons. Maybe not in commercial quantities, which is a real challenge, but there are hydrocarbons in the system, and that contrasts to many other petroleum systems in the world where you have a hard time finding..."

SENATOR WIELECHOWSKI said the majors say the rocks in Alaska are not good. He asked if the rocks are good for independents. Is this the elephant for independents like Pioneer?

MR. SHEFFIELD said that is not a fair assessment, because the rocks are the same for everyone. He said Pioneer found that the rocks aren't as good as was thought. There are large accumulations, but the oil quality is low. There are large fields, "but they're on the margin." Rocks are a challenge to the economics and the recovery in those reservoirs.

11:22:08 AM

SENATOR WIELECHOWSKI asked if he is talking about heavy oil.

MR. SHEFFIELD said, "Yes, the oil quality has something to do with it, but I think our experience through the drilling that we've done--and we've participated in a number of wells across the slope--has been just low rock quality."

CHAIR HUGGINS asked when the state courted independents.

MR. SHEFFIELD said it was under the Murkowski administration, and Mark Myers was the Director of the Division of Oil and Gas.

In 2003 or 2004 he recalled having some informative meetings with DNR and DOR, talking about how to do business in Alaska.

CHAIR HUGGINS said he would like to continue that practice. It is more important than ever to Alaska's future.

[11:24:29 AM](#)

MR. SHEFFIELD said business opportunities are opening up to Pioneer; larger companies are looking for partners. The downside is high operating and transportation costs. The long project-cycle times are nearly unacceptable to independents, he added. Pioneer wouldn't put serious money into something with a long lead time. At that time there were thoughts that the tax policy might be changing. In a frontier area, project delays and potential for cost overruns needs to be considered. The reservoirs turned out to be at the lower end of what was expected. The regulatory process has been more time consuming than was expected. Costs came out higher as well. Pioneer is about half-way through with the spending on the Oooguruk project and, to date, it is over budget by 25 percent, or \$70 million. Most of Pioneer's 11 exploration wells have come in significantly over budget.

[11:27:45 AM](#)

SENATOR WIELECHOWSKI asked if the increased cost was particular to Alaska or worldwide.

MR. SHEFFIELD said it is a combination. The price of steel has gone through the roof. The logistical challenges of the North Slope can snowball because of the short winter season and the transportation challenges. It is true of any remote area.

CHAIR HUGGINS asked about the expanded days for exploration.

MR. SHEFFIELD said that is generally good for the industry. The expanded drilling season allows for more work and amortizing over more wells. A rig on the North Slope can drill more wells and get more value. "Five years later the tax policy is still being discussed." Pioneer drilled three exploration wells in the shallow waters of the Beaufort Sea in 2003, which became the Oooguruk project. An extended-reach appraisal well was drilled on the Kenai Peninsula near Anchor Point, three miles under Cook Inlet. It is called Cosmopolitan and is a known oil discovery. Over the last two years, Pioneer took over as operator and increased its interest to 100 percent. "We upped the ante on this project based upon PPT." It is a challenged resource and the company thought it had a decent chance under the PPT.

Maintaining that tax structure is critical to the project. If the project is successful, it could be similar to Oooguruk.

[11:32:47 AM](#)

MR. SHEFFIELD said Pioneer owns an interest in 1.5 million acres in Alaska, and most is in the North Slope, including Prudhoe Bay and the NPRA. Pioneer has participated in 11 North Slope wells over the last 5 years, but it doesn't have a lot to show for it. Pioneer has 35 staff in Anchorage.

SENATOR STEVENS asked about Cosmopolitan.

MR. SHEFFIELD said if the appraisal well is successful and it meets the economic criteria, it likely will result in the construction of an onshore facility near Anchor Point, a dozen wells, and a long-life oil field. There will be significant economic activity during construction and drilling, and then Pioneer will need two or three operators per hitch.

[11:35:07 AM](#)

CHAIR HUGGINS said Cook Inlet is an important basin.

SENATOR WIELECHOWSKI asked how Cook Inlet projects were affected by PPT or would be affected by ACES.

MR. SHEFFIELD said the PPT established incentives—a 20 percent tax credit--that significantly affected Cook Inlet.

SENATOR WIELECHOWSKI asked if that is changed by ACES.

MR. SHEFFIELD said he thinks Cook Inlet is being left alone.

CHAIR HUGGINS said one exception is "you can't take Cook Inlet factors and transfer them to your northern operations."

[11:36:49 AM](#)

MR. SHEFFIELD said Oooguruk is near the end of its construction phase, and it is the largest single capital project in Pioneer's history. Pioneer is the operator with a 70 percent working interest, at a cost of over \$0.5 billion. First production may be in 2008, with 15,000 to 20,000 barrels per day by 2010.

SENATOR WAGONER asked if the facility access agreement is final.

MR. SHEFFIELD said it is nearly completed, with only minor legal nuances left.

SENATOR WAGONER asked the length of that negotiation.

MR. SHEFFIELD said Pioneer sent a formal request to the KRU [Kuparuk River Unit] owners in May of 2005.

MR. FOLEY said two years is the time frame. It is complex and this is the first time that the owners have contracted production with a third party, so they are cautious. He suggested that the agreement will be the basis for many future agreements, so there is a huge desire to get it right.

[11:39:44 AM](#)

SENATOR WIELECHOWSKI said facilities access is critical for bringing in more independents. He asked if that is a weakness and if there could be some legislation on facilities access to better open up exploration in Alaska.

MR. SHEFFIELD said Pioneer is quite experienced at dealing with it. Usually there is sufficient commercial incentive for the facility owner to bring in the third party production and make some money off of it. The North Slope is more complicated as it is a secondary and tertiary operation, and most of the facilities are being operated to the maximum extent. The new players need to provide enough incentives to actually displace some of the facility owner's own production. That is the complicated part that took so long to work out. He has run into facility access issues on both sides, and the free market has always been able to work things out. Once this deal is made, others will follow in an easier fashion.

CHAIR HUGGINS asked if Pioneer is being tortured by the process.

[11:43:09 AM](#)

MR. SHEFFIELD said Pioneer's oil from Oooguruk will be displacing production from KRU, and that makes it a fairly unique agreement. The KRU ownership has been reasonably fair. The facility is full, so obviously they want the proper incentives in order to displace its own production. He said he has been on the other side of it. Without the infrastructure that the KRU provides, Pioneer couldn't move forward.

SENATOR WAGONER asked if Pioneer would have other choices.

MR. SHEFFIELD said the obviously option would be to build a stand-alone facility, but the economics wouldn't support it. Most of the systems within the KRU are at capacity, but there are other systems—gas lift, injection water, oil handling, water

separation—"we need all those things to operate our field, and some of the systems within KRU are not at their capacity." It is a complex sharing arrangement.

[11:45:33 AM](#)

SENATOR WAGONER asked the feasibility of expanding the existing unit and creating more capacity.

MR. SHEFFIELD said that is an option in the future, as well as building a facility owned by Pioneer. He wants to see how the wells produce before committing more capital. It may make sense eventually, he explained.

SENATOR WIELECHOWSKI said North Slope is declining, and he asked about displacing 20,000 barrels instead of adding to 2
..it.

MR. SHEFFIELD said it will only displace a few hundred barrels a day. The gross production coming into the facility is maxed out. The KRU will have to shut in some wells that are making 99 percent water, but it will displace a small amount.

CHAIR HUGGINS said there is a lot of water.

MR. SHEFFIELD said marginal wells in the KRU have greater than 95 percent water.

CHAIR HUGGINS said the cost of doing business is exceptional—a little bit of oil and a lot of water coming out of some wells.

[11:48:46 AM](#)

MR. SHEFFIELD said Pioneer has come a long way from its first well in 2003. It has evaluated and sanctioned a major offshore project in the Arctic in less than three years; permitted a complex project with government agencies and stake holders; constructed a gravel island offshore in 2006/7, installed a complex sub-sea flow line bundle, fabricated and installed the facilities in a remote setting, and at peak construction, Pioneer had over 600 workers on the North Slope. Pioneer looks forward to seeing its first oil production in 2008. Oooguruk is a precedent-setting event for Pioneer and for Alaska. "We're poised to become the first independent oil producer in the state, and...the first to enter into a third party processing agreement with the existing fields." Other investors are watching, he surmised. The benefits to the state are the royalties, 30 percent of the net profits, PPT revenues, state

income tax, property tax, and the construction and contractor benefits to the economy.

11:51:20 AM

SENATOR WIELECHOWSKI asked if DNR provided royalty relief or incentive credits.

MR. SHEFFIELD said Pioneer was shooting for a big Kuparuk play, but ended up getting a lower quality reservoir in the Jurassic. So DNR pointed out that it was the kind of resource that the law was intended to help.

SENATOR WIELECHOWSKI noted that DNR has other tools that aren't going to be changed.

MR. SHEFFIELD said, "No I don't believe that there's any talk of changing the royalty relief law."

CHAIR HUGGINS asked what tools he was talking about.

SENATOR WIELECHOWSKI said DNR has the ability to give small independents royalty relief and to create other terms to make a project more attractive. "We're not changing that with ACES."

CHAIR HUGGINS asked if Pioneer has received royalty relief.

MR. SHEFFIELD said yes, in early 2006.

MR. FOLEY said the DNR royal reduction application was a one-year process, and DNR concluded that the project was challenged and royalty relief was granted. Prices were significantly lower at that time, he stated. Some leases at Oooguruk are 1/8 royalty and some are 1/6. The 1/8 royalties have an additional component of a 30 percent net profit—"they are some of the most heavily-burdened leases in the state." The state did grant the relief down to five percent until pay out—and pay out is the same time Pioneer begins making payments under net-profit share leases. Over a three-year period, it starts phasing up, he said. "Even in light of a royalty, Oooguruk is the highest government-take project that we're aware of in Alaska."

11:55:24 AM

SENATOR STEDMAN said prior to PPT there were royalty relief mechanisms, and after PPT there was the stimulus of a 20 percent credit. Since ELF, the calculations of attractive projects have changed, and the state will take that into account.

CHAIR HUGGINS asked if there were no investment incentives, only royalty relief.

MR. SHEFFIELD said that is correct.

SENATOR WIELECHOWSKI said it is important that royalty relief is still available for independents, and it is a good thing. This project probably wouldn't have happened without it, he added. ACES isn't affecting any of that.

CHAIR HUGGINS said ACES does something to the clawback, but Alaska has enhanced making "profitability work for you."

[11:57:41 AM](#)

MR. SHEFFIELD said PPT was rolled out without any consultation with Pioneer, which had already committed to Oooguruk and had significant exploration commitments in the central North Slope and the NPRA. After the "initial shock of seeing the rates going from basically zero to over 20 percent, we worked through the PPT mechanics and...found it to be a balanced system where the investment tax credits helped to offset the higher tax rates." The PPT is a modest incentive, encouraging development of the abundant lowered-tiered resources that are challenged by low quality or location. Looking at a wide range of investment opportunities, PPT is fair and sustainable because the net-profit aspect levels the playing field, whether it is an exploration investment, a new satellite field, or heavy oil project. It is not perfect, but it is fair and balanced. In the long term, PPT will grow the pie and give Alaska a bigger slice.

CHAIR HUGGINS said some see Pioneer as the type of company Alaska needs in order to flatten the curve of production.

MR. SHEFFIELD said Pioneer sees Alaska as a business opportunity. There were few operators and not much competition when Pioneer arrived. Historically the role of independents has been to commercialize the smaller opportunities.

CHAIR HUGGINS said Alaskans needs to hear what Pioneer is saying—with a caveat that it has a business interest. Companies like Pioneer will likely lessen oil production decline.

[12:02:33 PM](#)

MR. SHEFFIELD said ACES erodes some of the modest incentives of PPT. The cumulative effect of the tax-rate change, the aggressive progressivity, and the TIE [transitional investment expenditures] results in significant erosion. "Prior to

yesterday, we were of the opinion...that we would not be able to recover the roughly \$100 million that we sunk into Alaska prior to the initiation of PPT. We now think that maybe we will be able to...Maybe we've made it just under the wire." He said he will need clarification. "That \$100 million that we got sunk...we spent that money prior to PPT, but since that time we've spent over \$200 million, and we think we'll spend over \$200 million prior to the end of 2007, I guess, which is the next cut off date." With a little bit of clarity, perhaps the clawback provision won't adversely impact Pioneer, he stated.

MR. FOLEY said Pioneer is striving to clarify when it earned the credit. He said it spent transition capital and expended over \$200 million under the PPT, "so under the interpretation of the PPT and under ACES, we would be allowed to utilize that credit. Now the reality is, because we don't have production, because we're not paying taxes, we haven't actually monetized that credit." So Pioneer wants to clarify if it has earned it and if it can retain it even though ACES repeals the TIE.

SENATOR STEDMAN asked if Pioneer will sell its credits.

MR. FOLEY said Pioneer has about \$80 million in credits and has sold all of them at a price it was comfortable with.

[12:06:38 PM](#)

SENATOR STEDMAN surmised that Pioneer could sell its credits at a good enough price and did not feel it needed to hold on to the credits until Pioneer had the production to use them with.

MR. FOLEY said Pioneer has sold them at a value that was higher than the value that would be received under ACES.

SENATOR WAGONER said he doesn't understand because the ACES offers 100 percent of the value of the credits.

MR. FOLEY said, under ACES, only half the credits can be used in one year and the other half the next year. "So a very simple cash flow analysis, the value of those credits on a net present worth basis is about 95 cents on the dollar if you discounted it 10 percent."

SENATOR WAGONER said Pioneer got more than 95 percent of the value.

MR. FOLEY said that would be a reasonable deduction.

SENATOR WIELECHOWSKI said that Chevron wasn't concerned about the two-year split in using the credits because of its size. He asked if it is a bigger impact on the independents, and suggested that it be required for some fields and not others.

[12:09:00 PM](#)

MR. SHEFFIELD said it has a significantly higher impact of the independents. But Pioneer might be a bit different because it has a significant volume of credits, "which gives us maybe a little more clout than some of the other guys that just might have \$5 million or something like that."

The committee recessed from [12:09:40 PM](#) to [1:17:25 PM](#).

CHAIR HUGGINS reconvened the hearing. All members were present.

[1:17:39 PM](#)

MR. SHEFFIELD showed slide 12, and said increased taxes jeopardize lower-tiered projects. That is not good for the state. He also expressed concern about the returns on Oooguruk. "Our lease has a 30 percent net profits on top of the royalty," and Pioneer is concerned that ACES will lower those returns and make similar projects less likely. ACES does retain the net tax framework for the non-legacy fields, and that is the only thing that makes sense with tax rates as high as 20 percent. Also, the feature in ACES that allows the credits to be monetized at full value is a positive thing, although the delay would probably more than offset the par value of cashing in credits.

CHAIR HUGGINS asked for perspective on information sharing.

MR. FOLEY suggested that he was referring to information a taxpayer must provide to the state to help it with forecasting. That is not a problem; Pioneer will provide any information that's helpful, assuming it will be kept confidential.

SENATOR WAGONER asked if Pioneer would like the bill to allow it to sell credits immediately "or have the option of going to the state over two years."

MR. SHEFFIELD said that sounds like best of both worlds.

SENATOR WAGONER said it wouldn't cost the state any more. He then asked which changes are the most egregious of the five that Pioneer has listed.

MR. SHEFFIELD said the top two are the tax rate and the change in progressivity. The change in TIE credits would be third.

SENATOR WAGONER said the administration wants to make it a more defined system of allowable deductions.

MR. SHEFFIELD said the tax increases are more onerous than providing more information. He discussed the slide on ACES' impact on new projects. Taking it in aggregate of the four projects, the net present value is decreased by about 50 percent. "If these projects were in our portfolio, we believe they would have much less chance of being funded with that deterioration in value." ACES reduces competitiveness of Alaska projects and will make it more difficult for Pioneer to build a business in the state.

[1:23:47 PM](#)

SENATOR STEDMAN asked what stress oil price was used in analyzing PPT. He suggested it was below 40.

MR. SHEFFIELD didn't recall the prices then.

SENATOR WIELECHOWSKI said this doesn't take into account the potential for DNR giving upfront royalty relief, which would make it more profitable.

MR. SHEFFIELD said that is true if the risk had already been taken. But that's not going to be a driver on the front end because the company is not hoping for that scenario.

CHAIR HUGGINS said he will ask DNR how often royalty relief is used.

[1:27:05 PM](#)

MR. SHEFFIELD reiterated that Pioneer's Alaska projects compete primarily with the low-risk ones in the Lower 48. It has been an aggressive investor to date. It sanctioned the Ooguruk project under the ELF system, and it "anted up and significantly increased our position in the Cosmopolitan opportunity under PPT." For Pioneer to take the next step, it will need more fiscal stability. PPT provides the balance and stability to grow Pioneer's Alaska business. It works across all investment types. The cumulative effect of ACES erodes incentives put in place by PPT. Raising taxes jeopardizes lower tiered investments.

SENATOR WAGONER said everyone is asking for tax stability, and this regime will be in place for 10-15 years, like ELF. "At the

end of ELF, we should have...changed ELF long before we did, cause we had Kuparuk coming up paying no production tax, so...what I'm looking at is where do we set the tax so we don't have to go back short term and change the tax system again if the world changes--if the price of oil goes up dramatically." A 2.5 percent increase could stabilize Alaska's tax system for 10 to 15 years--"maybe that isn't a bad thing."

MR. SHEFFIELD said it is a tall task, and "you have to kind of strike a balance." Stability for independents is very important. He doesn't see that a higher tax makes it more stable.

SENATOR WIELECHOWSKI hypothesized if ACES passes and Pioneer finds a field that is marginal, there is still the ability of DNR giving royalty relief.

MR. SHEFFIELD said the field in Oooguruk isn't the one Pioneer was looking for. "It didn't provide the incentive for us to take that exploration risk. We were looking for a completely different target. So really the way I see it, the royalty relief is a safety net if you get not what you're looking for and it's down near the bottom--something that you can't commercialize otherwise." It is more of a safety net rather than an incentive. It won't attract investment dollars.

SENATOR WIELECHOWSKI asked if he is saying that Oooguruk is a crummy investment with a low rate of return.

MR. SHEFFIELD said if oil prices had remained low, Pioneer would not have moved forward with it. It wasn't willing to take the risk without the royalty relief, which protects them on the downside. "But if prices are higher, it will pay out more quickly and the state's interest will revert. It will get its full royalty back plus a 30 percent net profit. So, it was, I think, a win-win for Pioneer and the state."

CHAIR HUGGINS expressed concern that the data used for any assumptions must be accurate and reviewed by multiple people, and he isn't convinced that's the case. "What we're being asked to do will not be durable." PPT was passed last year and a new person--the governor--came in, who was not involved in the process, and said to redo it. Commissioner Galvin is also new. "The temptation to put your fingerprints on something just because you're the new person, or because there's a perception that it's not doing what it should do, if that's, in fact, the case, then we need to see the data that...substantiates that. And my concern is that what we're looking at, may be part of the

data...and we should, in all good faith, be able to look you in the eye and be able to give you some semi-assurances there's going to be some durability involved, understanding that part of the statute right now says a review period in 2011. My concern is we're not going to be able to do that."

[1:37:16 PM](#)

CHAIR HUGGINS said he has requested transcripts of what Mr. Van Meurs said.

At ease from [1:37:58 PM](#) to [1:42:09 PM](#).

MARK HANLEY, Manager, Public Affairs, Anadarko Petroleum Corporation Alaska, said Anadarko is a large, worldwide independent based in Houston. Independents explore and produce. They are not integrated and typically have no pipelines, tankers, refineries, nor gas stations. There are niche markets for everyone. In Alaska, Anadarko is exclusively on the North Slope. He showed a map showing where it has interest. It owns 22% at Alpine and is a partner in NPRA with ConocoPhillips. In the foothills and to the east, Anadarko is the operator with partners including BG, Petro-Canada, and ASRC—an equity partner. Anadarko has lots of acreage, plays, and opportunities. He noted that about 300,000 acres of leases in NPRA was relinquished recently—that was the Anadarko, Pioneer and ConocoPhillips partnership. "We bought the leases, we did research, and we give some of that up. Sometime you just don't think it's prospective." Returns on some fields must cover losses on others.

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SENATOR WAGONER asked which acreage was given up.

MR. HANLEY said it's in NPRA. Alaska is a world-class petroleum basin and has significant remaining resource potential that tends to be in smaller fields. Anadarko believes there are some legacy-type prospectivity—or anchor fields. It is looking at the Alpine-sized, which there should be a few left to be found. "We tend to be far away from infrastructure; we're looking at what we call higher-risk, but potentially higher reward." The past risk is often discounted if nice returns are made.

SENATOR WIELECHOWSKI asked if the world-class basin refers to the future or past.

MR. HANLEY said both. He referred to an Econ One presentation from April 5, 2006 during the PPT debate. He showed a United

States Geological Survey chart of undiscovered technically-recoverable oil reserves. The mean estimate of reserves on the Central North Slope is 4 billion barrels of oil. There are no fields over 1 billion barrels, and 2 percent are fields over 500 million barrels, and 51 percent are smaller than 64 million. "We have a lot of oil out there...but it's in a lot of small fields." A field with 50 million barrels is not economic if there is no infrastructure within 10 miles.

MR. HANLEY said there are not many 500 million-barrel fields, but he thinks there are Alpine-sized fields yet to find, which could spawn satellite fields. He said a tax hike has to have an impact on recoverable oil. He said there is huge potential in gas as well. Big companies have to find new places, and he asked if they will go after a 50 million-barrel field when they really need the production out of a billion-barrel field. He said it takes the same number of geologist to look for the big fields. "But you get Pioneer looking for...100 million-barrel fields," and others that he listed.

[1:58:13 PM](#)

SENATOR WIELECHOWSKI noted that much of the acreage where Anadarko is looking for oil and gas is further than 10 miles out. He asked how to do that economically.

MR. HANLEY said that is exactly the point. Anadarko is focused on those larger fields. "We're not looking for 50 million-barrel fields out there." BP wouldn't be interested in such a small field. Anadarko drilled a well by Barrow last winter, and "if you found 500 million barrels, I suspect it's not economic because it's way out there." There may be ways to get the infrastructure closer. He said he is optimistic, but it has to be put in perspective. Regarding tax policy, "800 tcf of discovered gas, pretty close to tide water, costs are not as expensive to drill as they are here, that's not a significant factor. But honestly, you've got 800 tcf. If we had 800 tcf sitting at Prudhoe, I think government could extract a little higher rent."

[2:01:54 PM](#)

MR. HANLEY said there is a lot of gas, but no transportation network, and that is a real challenge. The new entrants and partnering opportunities are very positive. Each learns from the other. He noted a company that spent \$100 million in NPRA for one well drilled and then gave up the leases and left. "That tells us something." Nothing was moving west until Alpine, he added. There's good prospectivity but the fields are smaller.

The long lead time and seasonal restriction—"that's a killer." Doing business in Alaska takes much more time and thus costs more. There's a lack of infrastructure and competition. The PPT credits have been helpful because they reduce costs. "In the end, we're going to pay a higher tax rate; we don't get to use those credits against that production later on. But just because you have so much capital stranded up front, it can really affect your net present value economics, and that has really helped with the issue that you can't do much about, which is the winter drilling and the longer seasons." A gross system that raised the same money isn't as good. "It helps us with our front-end costs and helps our net present value even though you're getting the same amount of money."

[2:06:22 PM](#)

MR. HANLEY said Anadarko got hit with a tax increase at Alpine and didn't get to use the credits. "The existing fields got hit hard." New fields were slightly improved by the PPT, he added. "We started off with a 20/20 [tax rate/credit rate in the PPT]...and we were comparing it to the old ELF system. People said there wasn't enough investment under the old ELF system. And that's why I said that the gross system was not getting the investment. The PPT helped with these credits, even though you might have got similar amounts of money. But for us...20/20 was an improvement; 25/20...the economics for exploration were worse under the old system, and that was before the progressivity was put in." It ended up in the middle with progressivity, and Anadarko found it to be a slight incentive. "It did help with our NPVs on some of our prospects, so we were supportive in the end of the overall system that's out there."

MR. HANLEY said he'd already touched on the net profits approach. He appreciated that the administration let Anadarko talk to them about sticking with the net system. "We did pitch, if you're going to go to a gross system...and we appreciate the fact that I think they did their own analysis after listening and came to somewhat of the same conclusion that the gross system does not encourage the investment, and frankly, if you're going to have it, to get to the kind of investment that you want, you're going to have to have credits with a gross system." Capital credits need to be differentiated. He spoke of four categories: existing large fields, satellites, heavy oil, and frontier exploration. A gross system must understand the economics of each. A net tax works it out. A gross doesn't encourage development, and there are taxes even when you're not making money. The royalty is a gross tax, and property taxes are the value of the property.

[2:12:26 PM](#)

MR. HANLEY said negatives outweigh the positives in ACES. The positives include: expanding the time to qualify for exploration incentive credits—but that is diminished by the extra administrative processes and getting good auditors that understand the industry. He said stability is a factor. He said the rates are a problem for gas and will need to be addressed later--and then everything will be open again. The progressivity escalator is a stability factor in making it less likely that government will raise taxes when prices go up. He sees that as positive.

CHAIR HUGGINS said, "We would have been much wiser to have combined oil and gas at a future date that has some rationale." It is important to know when gas will be addressed.

[2:19:03 PM](#)

CHAIR HUGGINS recognized that Senator Therriault had arrived.

MR. HANLEY said he hopes to come back in two or three years to address the gas issue, and thus oil will be discussed again.

MR. HANLEY said the tax rate increase is of most concern, escalator is second, and the transition credits are third. On the eve of the PPT coming out, Anadarko sanctioned a satellite project around Alpine. It was less economic than a stand-alone field. "We would have much rather done it under the PPT model, but we got hit with the higher tax rate." He said developing that satellite was deferred because of the governor's aggregation decision at Prudhoe Bay, because Anadarko had to negotiate how the state was going to deal with the satellites. He said the "two for one—you've got to spend two dollars to bring a dollar forward that you spent in the past to create that pool, effectively you get a 10 percent credit for every dollar you spend." He said that has an impact. For the next two years there's an extra ten percent credit on money that Anadarko spends. It was one of the things pitched regarding the foothills project, and getting the extra ten percent was a positive." But prices make more of an impact, but he can't control prices. "So on the TIE credits, I would just say our view is that it was a fairness issue...and we rather they not be eliminated."

CHAIR HUGGINS asked about the ten percent floor.

MR. HANLEY said the floor doesn't affect Anadarko directly at this point. Some have suggested calling Alpine a legacy field. A

floor is a concern because if it's a 10% gross, "the way we read the bill...clearly you can't use credits from that field to lower that tax rate." But if Anadarko is drilling like mad everywhere else, it can't use those credits either, which is a real problem because Anadarko essentially ends up with a 22.5 percent gross tax with an escalator on what it's exploration drilling.

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MR. HANLEY said that when he reads: notwithstanding any contrary provision of law, he highlights it, "because basically that says it doesn't matter what anybody else says anywhere else in the statute, this is what's controlling." He noted the base floor language is Section 16, page 11. It doesn't directly affect Anadarko, "but I expect some of the same stuff might occur with the guys at Prudhoe...they might have other income against which to offset things, but they could be affected the same way." He read: "a producer may not apply tax credits to reduce its total tax liability under (e) of this section...for oil or gas produced from all leases or properties within the unit or non-unitized reservoir below 10 percent of the total gross value at the point of production of that oil and gas." It appears tax credits can't be used, so it's problematic and could have unintended consequences. ELF was regressive, but one of the benefits of PPT is its more progressive system. The 10% floor takes away the low side risk to the state, so it is regressive on the low end and progressive "as it gets up above whatever that number is." When the crash hit in the 1990s, "companies got hammered...we were not quite as aggressive on our expenditures."

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MR. HANLEY showed a chart of different field models from the administration where the gross system with capital credits "has less npv [net present value] than raising the same amount of money." From that perspective, he liked the chart, but for project economics, "it's hard to argue that a 50 percent reduction in the economics of the field doesn't have an impact. You can argue there's still enough left there, but as I pointed out, at some point there's always something on the edge, and it's gotta have an impact."

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SENATOR WIELECHOWSKI asked what kind of npv Anadarko needs.

MR. HANLEY said it depends on the geologic and commercial risks. Every field and circumstance is different. Risks are assessed and a "percent chance of commerciality" is determined. Cash flow analysis is another consideration. Risk for heavy oil is

different—it is more of a commerciality risk rather than a geologic risk. A gross tax should look at the economics of every single field. Net doesn't necessarily address risk, but it takes care of a lot of those issues.

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CHAIR HUGGINS asked if the unknowns of heavy oil could make the state revisit this issue.

MR. HANLEY said he thinks it's challenged, but he hasn't done the economics on the North Slope. "If it's not getting developed at the rate you think it is at the prices...This is where you get some experts...and figure out what is the challenge and is there anything you can do about it?" Tax credits may or may not be enough. The tax and progressivity increases outweigh the potential benefits of the program. The progressivity is taken from a monthly to an annual calculation. Averaging is a benefit to the companies because it reduces amount the state would collect. He finds it to be a significant increase in taxes, even though it is expected to be neutral to the state. "If our view is right...this will raise quite a bit more money than is being projected."

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SENATOR STEDMAN asked about marketable credits.

MR. HANLEY said Anadarko uses its own credits and has not bought any either. The problem, he said, is Anadarko can't reduce its tax liability below 80 percent of what it would normally pay. "We have partners that have credits...that's our direct experience. So we haven't had to go out into the market to try and sell them." It gets complicated because Anadarko has to predict what credits of its own it will use in a year.

SENATOR WAGONER said there have been discussions on whether annual or monthly would be best. Dan Dickinson showed the large up-kick and down-kick in one month, and when that is averaged over a year, it wouldn't mean much to the state. But three or four of those would. It is difficult to predict. He said he's conflicted on whether it should be done annually, monthly, or quarterly.

MR. HANLEY said that is one issue and the rate is another. He gave an example of "at \$40, the new system is a 2 percent higher tax." "At \$50 the proposal goes to 39, and then the old system would have been at 27.5, and...they cross...at \$80 they become the same." Above \$80 net, it's better for the companies and worse

for the state. Oil prices are high now, "but we still are not planning our capital projects based...on \$80 a barrel." He said it doesn't matter the price today, it is the prediction 10-30 years from now. Anadarko won't divulge what it bases its economics on, "although there's usually a price that you think is going to be out there and then people do sensitivities kind of above and below just to see how it goes."

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MR. HANLEY said people are looking at accounting models, but risks and potential are also factors.

CHAIR HUGGINS asked about not being held accountable for progressivity under the annual system.

MR. HANLEY said, "I guess you're right...we don't have the error rate—we're going to know more what it is after the fact, but it is what it is." The annualized aspect has a benefit, but with the tax rate increase over the \$50 to \$60 to \$80-net range, the annualized issue doesn't help near as much.

The committee took an at-ease from [2:51:30 PM](#) to [3:02:36 PM](#).

[3:02:47 PM](#)

MARILYN CROCKETT, Executive Director, Alaska Oil & Gas Association (AOGA), said her company represents 17 member companies—the instate refiners, Alyeska Pipeline, Agrium, explorers, and producers. It provides a forum for members to adopt industry positions on legislative and regulatory proposals. A position requires a 5/6 majority vote of members present. Tax proposal positions require unanimous support. "What I'm going to be telling you today has the 100 percent consensus of our tax committee members with no dissent."

MS. CROCKETT said the ability of the DOR to use joint interest billings as a tool for audit is an important provision to retain. There have been inappropriate changes to the interpretation of the statute of limitations on production tax assessment, which would make it retroactive to matters currently being litigated. There are also challenges with extending the statute of limitations from three to six years.

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TOM WILLIAMS, Chair, AOGA tax committee, and an employee of BP said he worked for the state in the Attorney General's office in litigation over royalties from Cook Inlet. In 1975, the DOR put him in charge of running the oil and gas tax laws. He came up

with the idea for ELF but not the formula. He made the separate accounting tax work and made the temporary reserves tax work. He did the property tax for the pipeline after it was finished. He was commissioner of DOR under Governor Hammond. There are parts of his legacy that are good and parts that "have come back to haunt me."

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CHAIR HUGGINS asked when Mr. Williams left DOR.

MR. WILLIAMS said he left at the end of 1982 and then he worked for Cook Inlet Region for almost four years before joining BP.

MS. CROCKETT said Alaska's greatest challenge is the decline of oil production even with massive investments. There will be a major challenge when the North Slope production gets down to 300,000 barrels per day. The minimum mechanical capacity of the pumps is at that level. She showed a graph of that happening at 2022 if the rate of decline remains the same. She said it is not a prediction.

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MS. CROCKETT said the difference in a six percent decline rate and a three percent rate, works out to fifteen years. Exploration, investment in existing fields, and investment in technology and new infrastructure for heavy oil can slow the rate of decline on the North Slope. There are three major areas of significant oil and gas potential on the North Slope: central, National Petroleum Reserve-Alaska (NPRA), and the coastal plain of the Arctic National Wildlife Refuge (ANWR). In the NPRA there have been 300,000 acres of lands recently relinquished because of disappointing exploration results.

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MS. CROCKETT said it is unwise to depend too much on investment as a solution to production decline. There is no assurance that spending a dime will get you a dime. Even with the discovery of a commercially viable field, it will take years to production. Investing in exploration can make a significant contribution in the longer term, but results are needed in the short term. Heavy oil is a solution in the long term as the first test well was drilled only this year at Milne Point, and it is still being evaluated. Until then, West Sac will be the only commercial viscous opportunity. There are investments in existing fields that can be made to slow the decline. This infield drilling will accelerate the drainage of the oil from the rock below the existing wells. Last year, the development wells that were

drilled resulted in an additional 70,000 barrels a day from the Prudhoe Bay field.

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MS. CROCKETT said if that were a stand-alone field, it would be the fourth largest oil field on the slope. There are investments in the renewal of surface facilities for existing fields. The gathering centers and flow stations for Prudhoe Bay have been in service for over 30 years and need to be overhauled or replaced. Heavy oil will require modifications too.

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MS. CROCKETT said that will add to the cash flow risk. An incentive effective for initial development is also effective for renewal. "The harsh reality is that we find ourselves in a declining production mode that we have to grapple with." Massive new investments in the three aforementioned categories are the only way to deal with it.

MS. CROCKETT said, regarding ACES, a tax must do the things it is intended to do; enforcement of a tax should be consistent and efficient; and a taxpayer must be able to calculate the amount of tax due. Most new taxes are designed to bring new revenues to government, but in the PPT, things were not so simple. Partly it was to bring in revenue because legislators viewed the ELF system as outdated and unduly generous to producers. But Pedro Van Meurs explained that PPT was also designed to provide incentives for investment. No one disputes that PPT has brought in more revenue than ELF would have. According to DOR, the increase was more than \$800 million in the last 9 months of 2006. DOR also said that the March 31 payments were about \$137 million less than projected. But her point is that PPT has outperformed the ELF tax.

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MS. CROCKETT said it has been suggested that Alaskans were promised that the PPT would generate \$800 million additional this year than was being projected, so it necessary to raise the rate. That is flawed because DOR has said it can't forecast PPT accurately because it has so many variables. "If they can't forecast accurately then why should so much reliance be placed on its current forecast that shows that the prior forecast was off by \$800,000,000.00?" The purpose of PPT was also to create incentives, and it provided significant incentives for investing in capital assets. Current capital expenditures generate a 20 percent tax credit in addition to being immediately deductible

as lease expenditures. Such front-end benefits have the greatest effects because of the time value of money.

MS. CROCKETT said the incentive to invest sooner is increased with the transitional investment expenditure (TIE) credit. Taxpayers only have until 2013 to use those credits. The 20 percent tax credit for carried forward annual loss particularly benefits explorers and those bringing new fields to production but don't yet have the production to deduct costs against. The Section 024(c) credit of up to \$12 million per year for producers with less than 100,000 barrels a day is an incentive for independents. The \$6 million annual credit is incentive in areas outside of the North Slope.

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MS. CROCKETT said these incentives have worked under PPT. The administration has stated that capital investment for FY08 are 80 percent greater than previously estimated despite the fact that operating costs are up by 101 percent. There's a question of whether the inability of explorers to sell credit certificates near face value has been a problem, but they aren't serious enough to amend the PPT.

CHAIR HUGGINS asked if anyone has had problems.

SENATOR STEDMAN asked Ms. Crockett to repeat her position.

MS. CROCKETT said SB 2001 will generate more revenue in the short term.

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MS. CROCKETT said the two chief objections to the PPT are the difficulty in forecasting revenues and that the DOR auditors are hopelessly outgunned. The dramatic difference in forecasts and what the PPT brought in puts forth the question that the legislature made decisions based on inappropriate information. Also DOR needs cost information about spending from the operators, producers, and explorers, which allegedly has not been forthcoming from them. When the DOR staff sought information about expenditures, they chose not to rely on the 2006 costs but looked at the partnership tax returns. Federal partnership returns are not due until October of the following year, so the most recent returns available were from 2004.

CHAIR HUGGINS said the 2004 date is used by the administration.

MS. CROCKETT said yes. She showed a graph of increased costs for field machinery.

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MS. CROCKETT said AOGA is not privy to what taxpayers are reporting to the department as they make their monthly installment payments and their annual true-up payments. DOR's second objection to PPT is the audit challenges. "It is not for us to comment...on the proposal to put auditors in the exempt service, but what we can address is the dimension of the PPT audits," which has to do with the source or starting point for determining how much a producer's deductible lease expenditures are. The PPT allows DOR a choice of starting with a joint interest billing and invoices that operators bill to other participants in an oil and gas field venture or start from the comprehensive set of accounting rules that DOR prepares. That choice will determine the success or failure of PPT or SB 2001.

MS. CROCKETT said it is like have a tax based on your financial book income and choosing between your audited financial statements or starting with generally accepted accounting principles and finding the right answers. From the taxpayer perspective it means a near certainty of continual assessments for more tax, interest, and penalties, and, depending how litigious a company is, it may mean a long series of lawsuits. From the state's perspective, incentives for investments will be seriously eroded. The taxpayer's recourse is to discount the face value of the incentives in deciding to invest. The other choice that DOR could make is to start with the operator bills. Anything that is non-deductible would have to be backed out. The central concept of lease expenditures under 165 (a) is that they must be direct, ordinary, and necessary. "It would be most surprising if anything in those billings would go outside that standard." Alaska can be sure of this because the participants do not give the operator a license to waste their money.

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MS. CROCKETT said the non-operating participants don't want to pay any costs that are not related to the exploration of that prospect. It is reasonable to rely on the non-operator's self interest to police. In the context of PPT, DOR ought to audit the audits to verify that the non-operators do audit operator invoices. Once it is confirmed that these are arms length, DOR should not spend additional time to redo the company audits. Daniel Johnston praised the expertise of joint-interest auditors and the ability for the state to use unit accounting. This approach will be inapplicable for those with operations with no

audits. Section 64 would repeal DOR's authority to require or authorize the operators' joint-interest billings as a starting point for computing the amount of the other producers' deductible lease expenditure for that unit. We expect that DOR will testify that they will still be able to require the use of these billings anyway, but AOGA doesn't think so.

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MS. CROCKETT asked the committee to delete the last two sentences on page 10 of her written testimony, which she is reading. The reason she is spending time on this issue is: "Consider the situation that a non-operating participant faces. All of the information it has about what's being spent for that operation is what it gets from its billings from the operator plus whatever it may learn by auditing those invoices. But if such a non-operator cannot start from those invoices, how can it figure out what to report as a lease expenditure for that operation?" It is not feasible for a non-operator to be auditing the operator month by month, yet it will have to pay installments month by month. Even with the true-up, it is unlikely that the audit will have begun by that date. There are penalties of up to 30 percent for negligence that can be assessed on any underpayment after the true-up date. "If a non-operator cannot rely on its billings from the operator as a starting point for those purposes, what is it supposed to use?"

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CHAIR HUGGINS asked if it was discussed with the administration.

MS. CROCKETT said no; AOGA has not had an opportunity.

SENATOR WIELECHOWSKI asked if AOGA was declined an opportunity.

MS. CROCKETT said there have been scheduling difficulties. "We did not, however, have any contact as an association from the administration about sitting down to walk through the bill and answer any questions until about a week and a half ago."

SENATOR WIELECHOWSKI asked if the administration is intentionally refusing to see AOGA.

MS. CROCKETT said no.

CHAIR HUGGINS said he will remind the DOR that it's important. It is for the betterment of the state because AOGA is a business partner. It's mandatory.

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MS. CROCKETT asked why a provision in Section 1 dealing with confirming the interpretation of the limitation of assessments is there. She said AS43.05.260 is the existing statute of limitation for auditing all state taxes and she asked what is being confirmed. The new section has two parts, and one addresses decisions that retroactively change the parameters for calculating the tax, and the second requires producers to report decisions to DOR within 60 days. The curious thing about the existing statute of limitations in AS43.05.260 does not pertain to either. She pointed to her testimony that includes subsection (a), which sets three years as the period for the DOR to audit and assess any additional tax. It bars suits to collect additional tax if it is not assessed within the three years. (b) says that if a taxpayer files a return early, the three-year period starts running before the due date. (c) has three exceptions including false returns to evade tax, failure to file a tax, and for extensions that are mutually agreed upon. "Which of these provisions have anything to do with tax effects for a retroactive decision? Which has anything to do with having to report such decisions to DOR in filing amended tax returns?" She believes that it is a stealthy attempt to legislate an outcome to matters that are already being litigated. In 1999, DOR amended one of its production regulations so that it reads like that being enacted in the bill.

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MS. CROCKETT showed a side by side on page 13. The regulation deals with "decisions of regulatory agencies, courts, or any other preemptive authority" while the proposed statute addresses "decision of a regulatory agency, court, or other body with authority to resolve disputes." The regulation deals with retroactive adjustments in costs of transportation, sales price, prevailing value, or consideration for quality differentials relating to the commingling of oils or of oil and NGLs. The proposed statute addresses a retroactive change to the very same things, plus any change to a lease expenditure. The interpretation is when interest begins accruing on a tax increase or decrease that results from one of these retroactive decisions. The Director of the Tax Division told AOGA that DOR was interpreting the amendment to mean interest would start to accrue as of the original due date of the tax, not the date of the retroactive decision. The administration intends to have this interpretation confirmed in the bill. "Do you really want to confirm this?" she asked. Confirming it would set a destabilizing precedent because it will mean that laws can be rewritten to deal with subjects that they did not originally

deal, and this can be done clandestinely by confirming such interpretations and determining the outcome of judicial matters. She questioned the separation of powers and Alaska's sense of justice and fair play.

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MS. CROCKETT said another confusing thing in SB 2001 relates to the new statute of limitations for production tax only. She questioned the extension to six years, when the three-year period can be extended multiple times. She said auditors' work will expand to fill the time allowed. The longer the audits run, the greater the accrued interest. After six years, interest goes up to \$0.92 for every dollar of additional tax. The longer limitation periods will make it easier to justify litigation. The purpose of a statute of limitations is to bar claims that are so old that the records are lost. The old statute of limitations has worked for many taxes, including separate accounting, which involved income from interest in oil and gas pipelines and was more complicated.

3:46:12 PM

SENATOR STEVENS asked if the extension has to be agreed to by both parties.

MR. WILLIAMS said usually the auditor has more questions or the taxpayer asks for more time. It is a document signed by both parties. It can be renewed again.

SENATOR STEVENS asked if that has happened.

MR. WILLIAMS said he believes it's common.

SENATOR WIELECHOWSKI noted that the state said it had to negotiate for more time.

MR. WILLIAMS said both must agree, but if there's a jeopardy assessment to disallow everything, it's in the taxpayer's interest to grant the extension.

SENATOR WIELECHOWSKI suggested that a jeopardy assessment can't be issued unless there is something to back it up.

MR. WILLIAMS said no, the state can make a jeopardy assessment because the taxpayer has been stonewalling.

SENATOR WIELECHOWSKI asked what companies ask for in the extension negotiations.

MR. WILLIAMS said if it involves material that his company can still find, it asks for more time to look for it. More often it is requested from the auditor. He said that BP has given auditors up to five extensions.

SENATOR WIELECHOWSKI asked if companies ask for financial compromises.

MR. WILLIAMS said interest can't be compromised. If there is any compromise, it comes after the assessment. The attorney general has to approve it.

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CHAIR HUGGINS said there was some reason the administration put this in and he was suspect of it. Going from 38 cents to 92 cents on the dollar is a powerful inflation. What could you do to avoid the administration from taking the six years?

MR. WILLIAMS said the law is very clear about interest, and it starts accruing from the date the payment was due for the tax. That is a simple matter of 11 percent compounding each calendar quarter. After six years there are twice as many compoundings, and the rate is accelerating as it grows.

SENATOR WIELECHOWSKI said the money will be in the company's possession and could be invested, so it's not like it's a complete loss to the company.

MR. WILLIAMS said he is not complaining about the interest rate. The question is whether six years as a starting point is necessary.

CHAIR HUGGINS said he is concerned because the consequences of "what we're doing" are unknown.

[3:55:50 PM](#)

MR. WILLIAMS the state could be wanting it for pending disputes or if anything like that arises in the future. "I think they're hoping that this legislature would grant them the authority to go back to the first due date when you had no idea that there was going to be such a decision, rather than the date when the decision actually came out. And if you give them that, then they would like to have six years...because once a period closes and the statute of limitations has run, everybody agrees that that's it. If there's anything later turns out that was not paid--unless there was fraud--it can't be reopened."

CHAIR HUGGINS said, "We owe you an answer."

SENATOR WAGONER said, "That's the exact scenario explained to us yesterday."

MS. CROCKETT continued with her conclusion on page 15. She said SB2001 fails two of the three standards for evaluating the tax, while PPT passes two of them and would pass the third if the agency adopts the appropriate regulations. SB2001 worsens the overall tax climate; can't be administered efficiently; and doesn't allow a taxpayer to pay the correct amount of tax when it becomes due, which will destroy the value of the remaining tax incentives. If investors cannot tell what they owe, they cannot put a reliable figure on the value of the incentives. Production has declined and she has shown the committee the purely mathematical results about how long it is before hitting the TAPS mechanical threshold. Alaska is fortunate to have the Oooguruk project on the horizon. Half of Alaska's production will come from new oil needing additional investment. AOGA's 17 member companies unanimously agree that SB2001 does not provide a framework for encouraging that additional investment.

4:00:10 PM

SENATOR WAGONER referred to Steve Porter's testimony where he said companies were not as worried about the tax rate as they are worried about increased state spending with no fiscal plan.

MS. CROCKETT said he's half right. Business is concerned that the state doesn't have a fiscal plan, but "we're worried about both," she said.

SENATOR WIELECHOWSKI asked if she's seen modeling for the projected production decline under PPT vs. ACES. He stated that he understands the argument that increasing government take decreases the incentives for investment, but he asked for a model that would show how the decline would speed up.

MS. CROCKETT said it is impossible to prove what future projects won't be taken. It's the decision making that is impacted by the tax rate. "The correlation isn't there."

SENATOR WIELECHOWSKI said that's the problem; he is making a decision in a vacuum. "If the decline would be instead of 6 percent, maybe it would be 7 percent, but the take to Alaska increases substantially. That would be something I would want to know." He suggested that any producer would want that analysis.

MR. WILLIAMS said the 6 percent decline was under ELF; that's the empirical evidence. Large projects in this decade flattened that out, but from 1990 through 1999, it was 6 percent, and now it's back to 6 percent. It's 8 percent for Cook Inlet.

SENATOR WIELECHOWSKI said it was 6 percent under ELF, and PPT was designed to increase investment.

MR. WILLIAMS said the 6 percent decline is there. The PPT appears to have increased the level of investment to slow the decline. People are hoping to add barrels to the production and slow the decline rate from 6 to 5, 4 or "whatever they are able to do." You see investment is up, but it's too early to see barrels coming out of the ground, he stated. The PPT is new.

[4:06:18 PM](#)

SENATOR WAGONER said at 700,000 barrels a day, a 6 percent decline would be 42,000 barrels. Ms. Crockett said last year in-field drilling was bringing another 70,000 barrels.

MR. WILLIAMS said the decline for Prudhoe Bay is 9 percent, so adding satellites slows the decline.

SENATOR WAGONER said he is dealing with total numbers, so a 6 percent decline would mean only 42,000 barrels. He asked for an explanation.

[4:08:13 PM](#)

CHAIR HUGGINS asked him to figure it out later and said AOGA's collective voice will add some efficiency to the administration's communications.

[4:08:30 PM](#)

PAUL LAIRD, General Manager, Alaska Support Industry Alliance, described the alliance as a trade organization that represents companies and individuals providing goods and services to Alaska's oil, gas, and mining industries, including small local contractors, Native Corporations, and subsidiaries of multi-national service companies.

MR. LAIRD said alliance members don't make the multi-billion dollar investments in oil and gas development—they make the investments work. He said his members are deeply concerned about constant changes in fiscal policy that put some investments at risk. He doesn't know what tax rate, escalators, and credits is the right balance to ensure that the state gets its fair share

of oil revenues and encourages long-term investment. He said nobody knows. The first returns of the current tax haven't been audited so there is no evidence that it is broken.

MR. LAIRD said there was little proof behind the many projections. The PPT has generated an additional \$1 billion in revenues. The increase that's proposed would be the third major severance tax increase in three years. "Every dollar in additional taxes is a dollar that won't be invested in sustaining production, in creating business opportunities for Alaska companies, like alliance members, in generating good-paying private sector jobs for Alaskans." He said through-put in the trans-Alaska pipeline has declined by two-thirds despite multi-billion dollar investments by the industry. Without the investments, TAPS will reach its economic threshold in the next 15 or 20 years, instead of the next 50 or 60 years.

MR. LAIRD said his members want to be here long after the administration's consultants are gone. "They'll be the ones to bear the consequences if higher taxes and higher costs really do result in less investment—a novel economic concept to be sure." The tax will do nothing to encourage new oil production and construction of a gas project. He suggested this discussion should be about ensuring "our fair share of long-term jobs and business opportunities for Alaskans, rather than how much more money we can extract from the private sector without further risking our long-term future." The PPT calls for a review in 2011 to see how and if it is working. It will take several years to responsibly make that determination. He suggested hiring more auditors to make the PPT work and authorizing the state to buy back more credits, but, on behalf of his members and Alaska's economic future, he told the committee to reject changes to the PPT that will increase taxes that jeopardize the economics of critical long-term investments and put production at risk.

4:14:46 PM

CHAIR HUGGINS said there are 35,000 of them who have high-paying jobs, "and I thank you for the verbiage here because I think it's one of those that each of us need to read more than one time and realize that we just can't blindly go doing something, extracting money...we know that bureaucracies and taxes can be onerous and sometimes just for the sake of...we extract money out of the private sector and we just spend it willy-nilly...like drunken sailors...but I will read this again, and I respect you very much for your perspective...and I hope that the rest of our legislative body does that."

[4:16:08 PM](#)

JOHN SHIVELY, President, Resource Development Council (RDC), said the RDC includes businesses, Native corporations, unions, local governments and individuals.

CHAIR HUGGINS asked about his previous experience.

MR. SHIVELY said he was chief of staff for Governor Bill Sheffield and the commissioner of natural resources under Governor Tony Knowles.

CHAIR HUGGINS said it is important to recognize the Mr. Shively has served Alaska in multiple capacities.

MR. SHIVELY said this tax review has ramifications beyond the oil industry. He senses growing pessimism from the business community about Alaska's future. That is because virtually every major resource industry is under attack. He noted forestry and then said to look at what's happening with Kensington [mine]. He said there is a mining initiative that would assure that there would be no more mines. The environmental community says no to coal. The fishing industry is facing some of the same challenges. Environmental groups have closed vast areas to fishing and they provide misinformation about Alaska fishing to try to reduce the income of Alaska's fishing industry. "Does it sound familiar to you?" His own industry, the cruise industry, is still assessing the economic impacts of an initiative by Alaska voters. These things worry the business community.

[4:19:37 PM](#)

MR. SHIVELY said there were 102,000 students in Alaska's schools in 1988 and 133,000 in 1999—a respectable growth. But from 2000 to 2006 the number flattens or declines. "That's not a sign of growth." In the last 11 years, out-migration prevailed for 8 years. Juneau has a huge inventory of houses on the market and value is decreasing. Anchorage has an increase in inventory and a decrease in building. Agrium closing is another thing that worries the business community. The gasline, which is a huge part of Alaska's economic future, was recently described as uneconomic by a consultant. "Many people are looking for a bridge, right now, to get us from being reliant primarily on oil to having gas that also helps support our economy and our government."

MR. SHIVELY said he was told that geology was in the rocks, and you can't do anything about the rocks. "And unfortunately for us, the rocks haven't been very kind recently." "We haven't

found a lot of oil, so we're looking at trying to deal with the existing fields and putting substantial investments into those fields." Even with those investments, there has been a decline. He said to think about the time Alaska had a personal income tax. If it was still the primary driver of state revenue and provided a surplus, he asked if the legislature would be in special session to raise the tax. "I suspect not." That is an issue "that's often lost here, and it's one of the things that's really bothered me about the debate on this tax, and that is the fact that tax is not the way you show ownership, otherwise local governments would own all of our houses. Tax is a sovereign's right to get a fiscal benefit to pay for government." He said he believes there is suppose to a tension between raising revenue and providing services.

[4:23:58 PM](#)

MR. SHIVELY said this discussion is happening without a fiscal plan for the state. He has things he believes the legislature could do to start giving the business community confidence. "The easiest being the establishment of the percent of market value approach to distributing money from the permanent fund, but we don't hear any discussion at all, anywhere, about that." It's wrong, he said, and it makes the business community nervous. The tax debate is amusing because the perfect tax will never be found. Taxes are just one variable. From a public policy point the legislature must decide how to approach it. He said to decide on the conservative side since there is a surplus.

SENATOR STEDMAN said Alaska has a fiscal plan. There are \$40 billion in the Alaska permanent fund, and he hopes it will be more when the state needs to rely on it. There is about \$2.5 billion in the CBR [Congressional Budget Reserve] to cushion the state through the fiscal gap. "We, in the last couple of years, put \$400 million forward for future capital budgets so when we have an implosion in the oil prices we can have a capital budget to push the economy through the dip." There is \$300 million or maybe \$1 billion in surplus in 2008 that will be appropriated into forward budgets. "We've put \$930 million forward for school funding." It is accurate to say the legislature has not made a decision between income tax, sales tax, and drawing on the permanent fund, but it is a premature decision. If assets are administered prudently--the problem is the growth of the operating account--with luck the gap to the gasline can be bridged without an income or sales tax. If Alaska can get there without taking from the permanent fund, it will be the first state "to be sitting on a virtual endowment that would allow us

to run in perpetuity." Saying Alaska doesn't have a fiscal plan is a nice sound bite, but it can't be further from the truth.

[4:28:32 PM](#)

MR. SHIVELY said Alaska has assets, which is another reason not to raise taxes. There are problems with all those assets, and the business community doesn't know how they'll be spent.

SENATOR STEVENS asked how to come close to a fair share.

MR. SHIVELY said finding a fair share is not the way to determine tax policy. That's an ownership issue and that's where the debate has gotten off center. Government generally raises taxes for services it needs to pay for. "Here, we sorta almost do it backwards; we try to go out and get as much revenue as we can...and then we go out and figure out how we can spend the money and if we're going to save any."

[4:30:55 PM](#)

SENATOR WIELECHOWSKI said he appreciates the dialog, but the constitution requires the maximum benefit to Alaskans. "That is what our mandate is." It's called a tax, but it's what the market bears for Alaska's oil. If the market should bear a few hundred million more or less, "then, to me, that's what the constitution means: maximum benefit for Alaskans."

MR. SHIVELY said maximum benefit can be defined in a number of ways. The benefit traditionally comes from the royalties. It is debatable whether the constitution considered taxes to be part of that. If the legislature makes a mistake, then there isn't maximum benefit from the resources.

SENATOR WIELECHOWSKI noted that the mistake could be made in the other direction, and the state could end up in a \$3 billion deficit in 2015.

SENATOR WAGONER said Alaska also has a lot of debt. "We owe \$5 to \$6 billion to the CBR and another \$8 to \$10 to the PERS/TRS problem. A list of assets and liabilities isn't a fiscal plan.

SENATOR STEDMAN relayed that the finance committee will review the amount of debt the state is carrying next session. The PPT was about getting a fair share.

[4:35:22 PM](#)

SENATOR WAGONER said the intent of PPT was to get a pipeline with a certainty on oil and gas taxes--not to get a fair share.

MR. SHIVELY said just because two administrations have used the term "fair share" doesn't mean it is the right term.

CHAIR HUGGINS noted that Mr. Shively said the timber industry is gone. "I recall in finance we allocated money to ocean rangers with the assurance it would be paid back...and I read in the paper today...not going to make it—revenue's not going to meet the bill." Governments don't get things right most of the time. The permanent fund is one it got right. He said this administration is at the helm when Agrium and Mat-Maid are going away. He mentioned a fish processing plant in Anchorage that is now owned by a church. "The point—it appears in retrospectively, if you look at the wisdom exercised by the state, you could be suspect on a number of occasions. There are probably some great success stories." He said PERS is a huge problem. The state is facing a dilemma for power generation. He said the legislature has a very compressed timeframe to come to a conclusion without durability. He said he is wasting time because it can be done later, and he would rather work on a gasline.

The committee recessed [4:39:13 PM](#).

[6:17:12 PM](#)

CHAIR HUGGINS called the meeting back to order. Senators Green, McGuire, Stevens, and Huggins were present at the call to order. All other members showed up shortly thereafter.

DONALD BENSON, Palmer, said the oil and gas tax needs to be reexamined to restore the public trust and to bring a fair share for future generations. He said 72 percent of the public polled by a news service said Alaskans weren't getting their fair share. The public lacks confidence. Everyone needs to work together. The current corruption cases have smeared all of the good names of hardworking legislators. Their confidence should be restored by revisiting the PPT. Legislators' decisions should be based on what is best for Alaska, rather than private interests. Alaskans are ready to take back Alaska to the days before the oil companies influenced some of the legislature. Follow the will of Alaskans by passing ACES, he concluded.

[6:19:56 PM](#)

SENATOR STEVENS asked if he wants taxes raised on the oil industry.

MR. BENSON said he listened to petroleum representatives and the administration, and he feels that oil companies have the best

accountants in the world. ACES gives them even more of a chance to write off their North Slope expenditures, so he isn't saying this is a tax increase.

6:21:03 PM

CHAIR HUGGINS said the legislature is wading through it seven days a week.

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JERRY MCCUTCHEON, Anchorage, said taxes are far too low. Increasing the state's percentage will decrease federal take. He said that Dr. Van Meurs testified that the state should take more, and that the revenue from PPT and ACES declines with increasing oil prices. "And they thought that was stupid; the state's percentage should increase." Dr. Van Meurs said government take of 75 to 85 percent is usual and customary, and a take of 90 to 95 percent is not unusual. Some countries take 98 percent, and still the oil companies show up. The gross take from Alaska's oil should approach 90 percent. A contract on North Star was a little over 90 percent when oil was \$18 a barrel. "Those were willing bids--nobody held a gun to their heads." Both Van Meurs and Johnston pointed out that the threat of the oil companies leaving Alaska may not be a bad thing. It might be in the state's best interest if some of the oil companies did leave. He remarked that the FBI hadn't completed its investigation. He urged them to adopt a gross tax and modify it after the investigation is completed. [The end of this testimony was not decipherable.]

6:25:23 PM

LOWELL HUMPHREY, Anchorage, said he is opposed SB 2001. He said the proposed changes will not increase oil production. It punishes the industry for the investments it has made under the PPT. It dramatically increases the taxes for the third time in five years--"and for what purpose?" He said he has six children and is concerned about their future. For the state economy to prosper, production must be encouraged. It's not wrong for the oil industry to make a lot of money; the state is also gaining. He said the increased revenue from ACES will not be saved for the future. Increased production increases job opportunities and saves for future generations.

6:28:02 PM

CHRIS HUMPHREY, Anchorage, said he is the son of the previous testifier and he has three children. Now is not the time to raise taxes. We must encourage production. PPT might need adjustments in the operating mechanics to make sure there are no

loopholes. The review in 2011 is the appropriate time to consider major modifications based on performance data. More will be known about the gas pipeline as well. The bigger focus should be on making the PPT perform and making the gas pipeline a reality. No matter how it is packaged, increasing taxes will impact future investment. Without billions of dollars in annual investments, oil production will decline. The state should pay its fair share for developing the resources with a stable and competitive tax structure as one way to share in those costs.

[6:29:54 PM](#)

DAVID LAWER, Senior Vice President and General Council, First National Bank of Alaska, Anchorage, said his bank has 750 full-time employees. It is self-insured, pays retirement benefits, and donates to charitable and community organizations. It paid \$4 million in state corporate taxes and more \$1 million in other taxes. It serves small businesses, not oil producers. But the bank's success and the employees' well-being are directly tied to the economic development that comes with the oil producers' development in Alaska. Shell Oil's exploration and development activities were halted by the Ninth Circuit Court of Appeals, which caused it to postpone investment in a facility of one of his customers. "That's money our customer expected to use to repay money he borrowed from First National Bank." Another customer had arranged construction financing to pay for a building to lease to Shell Oil who decided not to commit the lease. The same thing will happen if the other producers voluntarily halt exploration by reasons of increased costs and taxes. No one is saying that raising taxes will cause the major producers to abandon Alaska, "but all of us can come to the logical conclusion that an increase in taxes...combined with ongoing increase in the cost of exploration and production will have an adverse impact on investment decisions." No one can say if the PPT will increase exploration in Alaska. "The policy decision to be made is whether the current tax regime, PPT, should be given time to operate to see if it encourages investment in oil exploration and production in Alaska or whether it can be amended in such a way to ensure that result."

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SENATOR STEVENS asked if he preferred a gross or net tax.

MR. LAWER said a gross tax has no advantage in promoting development, but a net tax offers that possibility.

[6:34:52 PM](#)

JOE MATHIS, Owner, Montana Creek Campground, Anchorage, said he and his wife have seven employees. They also manage a state park. A business owner needs certainty in taxes. He had a damaging flood and has faced a high cost of fuel. He has seen a huge decline in travelers to Alaska arriving from the Alcan Highway. These risks are nothing compared to what the legislature is contemplating. Alaska can't afford the risk of discouraging future investment when 50 percent of production in ten years will come from new oil. More information is needed on how PPT is working. He doesn't recommend making decisions based on emotion and rhetoric. Alaska should be focused on increasing oil production. If investments are slowed, the decline in production will increase to 15 percent. Increased taxation will not stimulate the economy. It will not improve the business in his campground. In the past year there have been more than enough negatives that have consumed the public process and diverted energy from long-term economic issues. He would rather be testifying on a long-term fiscal plan. It is a good time to encourage small independent oil companies to come to Alaska. "I'm sure that they now have a wait-and-see attitude. If you start changing the rules again, it will be a long, long wait." He doesn't think the state can survive this third change in taxation.

[6:39:22 PM](#)

WILLIAM HARVEY, Anchorage, said he built roads years ago in Savoonga where contractors talked about how the legislature was controlled by the oil industry. He spoke of the high oil industry profits and suggested simply putting a meter in Valdez and then taxing the oil by volume.

[6:41:07 PM](#)

RANDY SELMAN, Wasilla, said he worked on the North Slope when he came to Alaska in 1983. It has been very good to him. The PPT is not tainted. All taxes are a burden on every capital project, and projects need to compete with every other project. The PPT may need some administrative improvements, but he is against an increase in taxes. Alaska can't afford to lose a single future barrel, and raising taxes jeopardizes that potential. Keep taxes as low as possible in order to compete on the world oil market.

[6:43:51 PM](#)

CHAIR HUGGINS said he and Senator Green wish they were in Wasilla with him.

[6:44:16 PM](#)

TOM LAKOSH said he is an Alaskan citizen representing himself and he read from the following written testimony:

My alternative to ACES is called TRIPS, Taxes, Royalties and Infrastructure for the Petroleum Sector. There are some, albeit few, sections of ACES that would be useful but the basic principles at work that require a wholesale reworking of the Bill are:

- Virtually all oil bearing structures on state lands have been explored so there's little reason to provide incentives to the industry to explore where they have already exploited everything they could. BP made this clear in their statement that 70% of their future investment would be in the greater Prudhoe area where they are obligated to wisely extract the hydrocarbons pursuant to the applicable leases and AOGCC guidelines. If producers don't provide full and efficient extraction in the operation plans submitted to the Division of Oil and Gas, leases may be subject to revocation and "there's always other fish in the sea". We should not give existing producers kickbacks where they're obligated to do the job properly and within technological feasibility and economic limits under their existing lease contracts and applicable law. With the price of oil above \$80 there should be little left to recover in our legacy fields and we must demand that the ADOG conduct the mandated evaluations of the economic feasibility of heavy oil extraction now while we still have light oil to mix into TAPS shipments and the price is still high enough to warrant extraction without subsidy.
- If absolutely necessary, we can subsidize production of hydrocarbons that are difficult to develop by adjusting royalty rates instead of taxes. This would allow for lease by lease evaluation that is clearly more sensible than the broad subsidies to all operations. The royalty rates apply to gross production so the 19% range I've suggested has more than enough value available to provide incentive for development of heavy oils and remote gas should existing lessees submit, or new lessees sign on, to the new adjusted royalty rates that express the relative accessibility and marketability of specific lease types at specific distances from established infrastructure.
- The testimony clearly enforced the principle that "if you build it they will come". Angola got a \$1 billion for its leases and rabid global competition because the oil co's knew there was oil to develop. If there's oil/gas to be found, the state should find it and define the field before

it puts out leases so it can garner the highest bids among many competitors. The state would also be better able to predict development, classify fields to establish proper royalty rates and determine appropriate deadlines for relinquishment. The more we improve information on prospective fields and insure access, the less we need speculators that demand high rates of return. When we eliminate the discovery and access impediments we essentially only need contractors to build the production facilities and pump the oil as regulated by ADNR and AOGCC.

- If we have to subsidize the industry we should do it in a way that benefits other businesses and public interests. Taking money from royalties to improve transportation to the fields/pipelines floats everybody's boat. The heavy lift helicopters and low impact transport would also reduce tundra impacts, allow a longer exploration season and year round deliveries to isolated drilling/production pads. They would also be extremely effective tools for getting spill response equipment to remote sites and help repair global warming damage in remote areas that is directly caused by the oil we peddle.
- Our economic future through 40 - 60 years depends on our ability to market gas and the gas will not be marketable until the relative BTU value of gas approaches the price of oil BTUs, (PVM said it was at 40% of oil because Northern Tier coal companies successfully marketed their coal to power plants). The relative BTU value of gas can only be increased by de-valuing coal as a power plant fuel with a federal carbon tax. The carbon tax would also likely save us as much in damages to infrastructure from global warming as we would make on oil exports, billions and billions in prevented damage that we wouldn't have to spend our revenue on to mitigate.
- Providing tax incentives to explore on federal land will mostly provide returns for the federal gov't, leaving us with enormous development bills and not much revenue to show for it.
- The least impact to exploration on federal land/OCS can be accomplished by increasing the corporate income tax on hazardous operations because an increase in state corporate tax is used as a direct offset to federal income taxes so there's no net increase in taxes on the oil co's. This tax will affect new fields and existing fields that we've been getting a raw deal on, (i.e. the 90/10 vs 50/50 split, justice w/o a court).

- If we allow the oil co's to write off their Alaskan expenses it would tend to increase the price of our hydrocarbons and make them less competitive on the open market. Taxes do have an effect on corporate behavior and only taxing the gross at the point of export or in-state delivery will serve to keep a market check on expenditures in-state and therefore keep our hydrocarbons as cheap as possible in the market. We would surely have a strong case for upholding the gross tax where it measured value IN ALASKA. Both PPT and ACES are inviting fly by night wildcatters that will sell their credits and leave. The majors will be just as susceptible to the notion that spending controls are less of a priority given that they can sell the credits for marginal projects if they fail. Why not just take the money we'd spend on credits and provide the needed oversight to exploration contractors we hire on a competitive bid?
- The whole TRIPS scheme is designed to enhance certainty of development, (pre-defined leases and improved access), while alleviating risk due to low prices but eliminating any windfalls to industry, (the progressive production tax spanning a \$190 price range). Although I haven't done a precise analysis of the total government take, I strongly suspect that these rates would keep us below the Norwegian standard of 78% up to about \$70-\$90/bbl and I would suggest lowering the base production tax and/or raising the new class of corporate income tax until this parity was reached. I'm sure that the Norwegians never anticipated the blistering oil market we have today and so did not include progressivity. The gas problem can only be rectified with a carbon tax and then all else will be controlled by the high, stable gas value generated by a proper valuation of this external cost of our hydrocarbon economy. More stringent particulate regulation would also likely help gas prices.

Production Taxes: The gross tax on hydrocarbons produced in Alaska shall be set at the value of the hydrocarbons at the Alaskan terminus of export or point of sale within Alaska, (e.g. Valdez Marine Terminal for TAPS oil, Drift River or KPL Dock for Cook Inlet oil and gas, at the Canadian border in the case of gas transport by pipeline, at any in-state refinery or point of sale), in order to provide a market check on production costs and pipeline tariffs in furtherance of the relative competitiveness of Alaskan resources. This tax system would also encourage export of value added petrochemical and refined products. The tax rates for crude oil are as follows:

1. There shall be a minimum PT of 15% of gross value for oil prices between \$0 and \$20/bbl;
2. At \$21/bbl the PT increases to 15.5% and increases by a rate of 0.5% for each \$1/bbl increase in price to \$30 ;
3. At a price of \$31/bbl the PT shall be raised to 20.2% of gross value and shall increase at a rate of 0.2% for each \$1 in value per barrel until a price of \$110/bbl at which point the tax will have accumulated increases to provide a rate of 36% of value;
4. At a price of \$111/bbl the PT shall be assessed at 36.1% of value and shall increase at a rate of 0.2% for each \$1 in value per barrel until a price of \$210/bbl at which point the production tax will have reached its maximum rate of 46% of value.

Corporate Income Tax: A distinct class of Alaskan corporations shall include those operations that handle substantial quantities of hydrocarbons and other hazardous materials, as classified by the ADEC, and be subject to a corporate income tax of 14%. The safety and security issues presented by these operations require significant oversight, security and public safety assets that warrant an enhanced level of corporate classification in such regard.

Royalty Rates: Lease bidders will proffer a signing bonus payment and a bid above an adjustable royalty floor/minimum established between 1% for the least marketable hydrocarbon, (e.g. inaccessible, undefined gas fields), to a maximum of 20% for the highest wellhead value hydrocarbon, (e.g. well defined, light and accessible liquids such as those at Point Thompson). Each lessee shall consent to an adjustment of its royalty rate every 5 years after production startup that reflects any increase or decrease in the market valuation of the BTU content of the hydrocarbon(s) under development and/or by a substantial improvement in accessibility of leased properties as generated by state efforts. Lessees shall provide all necessary information needed to assess the relative BTU values of Alaskan hydrocarbons.

Hydrocarbon Exploration, Production and Transport Lease Provisions: All new leases shall have relinquishment provisions that reflect the realistic development timelines given the difficulty perfecting necessary permitting and development tasks. All lessees consent to regulation and assistance by the ADEC to effectively utilize and otherwise abate or sequester greenhouse gases released by exploration, production, transport, power generation and refinery operations associated with its leases. Lessees shall proportionately supply all necessary fuel

for state aircraft and vehicles used to assist and administer lessees' operations.

Exploration Commitment: In order to exact the highest signing payments and royalty bids and to provide for a most efficient and predictable development of Alaska's hydrocarbon resources, the ADNR will commit to obtaining the services of exploration experts, whether contracted or employed, with the most advanced geologic mapping and analysis capability to define hydrocarbon resources to their greatest practicable extent prior to leasing of hydrocarbon fields to enhance "prospectivity".

Infrastructure Commitment: The ADOT in an MOU with DNR shall employ all due diligence in coordinating interested state and federal agencies to develop, subsidize or otherwise facilitate transportation of exploration and production materials to proposed leasing areas and for access of gas by Alaskan communities. A dedicated 4% portion of total royalty payments shall be set aside for this Safe Transport Development fund. The ADOT shall minimally provide heavy lift helicopters and other low impact vehicles to advance preservation of sensitive areas, enhance spill response, protect wildlife and maintain security in leasing areas as training for their primary public safety and security duties that shall include repair and prevention of Global Warming impacts across Alaska. The ADOT shall also advance planning and construction of ports, port services, rail systems and pipelines necessary to promote efficient materials transport along established Alaskan transport corridors and extensions along the AGIA certified ROW(s).

Carbon Conservation Commitment: The state shall employ all due diligence with appropriate funding of legislative and regulatory efforts to establish in state and federal law establishing a transferable carbon tax and to additionally advance CO sequestration and secondary utilization, methane capture and abatement, and Arctic-appropriate carbon-neutral energy generation technologies using a dedicated 4% portion of total royalty payments. The ADEC shall develop regulations establishing a carbon tax, appropriate emissions standards and/or other carbon limiting constraints upon hydrocarbon lessees. The ADEC shall conduct the necessary analyses to establish abatement technology standards and pursue advancement of the best available technologies with a bi-annual \$3 million grant funding that may accumulate beyond the \$3 million level to ensure appropriate funding of appreciably superior and effective technologies.

CHAIR HUGGINS asked him to fax his proposal to the committee.

6:52:40 PM

MARY NORDALE, Fairbanks, said one of her concerns with PPT stems from when she was commissioner of the Department of Revenue (DOR) from 1983 to 1986. The 12 years of unresolved audits representing about \$8 million were the biggest problem. Auditing was overwhelming because DOR and the Department of Law were under staffed, under equipped, and not well enough trained. PPT is far more complicated and would require adequate resources in the agencies to insure it generates the appropriate revenue.

6:55:36 PM

CHUCK LOGSDON, Alaska Oil and Gas Association (AOGA), said he is concerned about falling production and increasing taxes. He spoke of the ELF being regressive, and now it is still regressive at the low prices but more progressive at the high prices. "Heads--revenue goes up; tails--revenue goes up." A serious problem with the proposed changes is the ring-fencing of the legacy fields. It creates administrative inefficiency. The legacy fields have the most challenged resources and the high floor rate will be counterproductive. Basically every dollar of tax reduces a dollar of producer investment. The PPT made the system more sensitive to the upside. High profits are significant incentives to reinvest in Alaska. He urged them to be careful in weighing the balance between picking up state revenue now and future economic development.

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MAYNARD TAPP, Anchorage, said the state will raise more taxes by increasing production. The state gets 75 percent of the 12.5 percent royalty. The fair share to Alaskans is the other 25 percent paid into the permanent fund. He has a consulting firm and much of his work has to do with the trans-Alaskan pipeline, and he and his employees benefit from new production. He said raising the tax would give the state money that the corporations could use for three new production wells. He would rather see the tax lowered to 10 or 20 percent to make Alaska more competitive with Canada and the Gulf of Mexico. He recognized that we are partners with the producers. He said the bill should be a development bill not a tax-generation bill. "Alaska is big oil. We are partners with the producers." Alaska's fair share is created by jobs. His company is Hauke Consultants.

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TOM WALSH, Oil and Gas Industry Consultant, Anchorage, Alaska, said his clients include major oil companies, independents,

Native corporations, and government agencies. "We provide a wide variety of services." He is worried about his employees and about the future of oil and gas business in Alaska. The proposed tax increase is a threat to oil and gas development. His company does commercial analysis of oil and gas opportunities, "and we've been doing this a lot lately." His clients say the tax structure is a key factor in marginalizing their prospect economics, and the legislation will worsen the situation. The companies are doing their homework on looking at plans and economics, and they are finding their projects don't work with escalating costs and tax increases. He has recently lost two clients who were discouraged by the business climate in Alaska. "This trend, we believe, will continue and will accelerate as we continue to be burdened by greed and paranoia rather than by rational management of our resources."

MR. WALSH said spending or saving taxes is not a clear strategy and he implored the committee to develop a fiscal plan to determine what services the state should provide to Alaskans. The current tax structure is working, he said. A company report of the impact of liquid production on the major fields of the North Slope pointed out that the declining liquid hydrocarbon production would likely become sub-economic before a gasline could be built. This would be disastrous for the industry and the state. We are headed in a direction of suffering greatly. "We should be trying to compete for more interest in our resources rather than for a greater share of a shrinking pie."

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SENATOR WIELECHOWSKI asked if he thought the PPT was working if his clients are leaving the state under the current tax structure.

MR. WALSH replied that he thought PPT is too burdensome, "and I think the reason for that is that I don't believe we really know what level of taxation is required to provide services, and I just don't think that we ought to be taxing to create a surplus simply for the fact that we can tax at a higher rate."

SENATOR WIELECHOWSKI noted that there is conflicting testimony, and he is concerned that companies are leaving under PPT.

MR. WALSH said he knows of two companies that have left because the tax is too burdensome. "I don't know whether they feel that there's a way around that in the future, or what, but it is a huge concern to them...their number one concern."

SENATOR WIELECHOWSKI asked who they are.

MR. WALSH said one company was looking at a marginal prospect in the interior basin and there was no help available with incentives. The tax structure was driving the project to be sub-economic.

SENATOR THOMAS joined the committee.

[7:12:11 PM](#)

JOSEPH HEGNA, Vice President, Oil and Gas Sector, MWH Americas, Inc. said his company is a global construction company with over 6000 employees in 30 countries, including Anchorage. "We're very bullish about the oil and gas business," and the company intends to invest in Alaska, Calgary, the Front Range of the Rockies, and the Gulf of Mexico. It will follow investment dollars. He said he is excited to grow his sector of MWH, and he has four sons getting into the professional world. The PPT was put together to fix problems with ELF and enable a gas project. We don't have a gas project and yet the tax is being changed. One reason is the cloud [of political corruption] and the other is that PPT needs to be fixed. "I think honestly that you do have to step forward and remove that cloud; you do need to restore trust." He doesn't know how to do that. He doesn't believe [the PPT] is broken. He has 35,000 employees that are members of the Alliance and he is proud of Paul Liard's testimony. PPT has already generated \$1 billion in state revenues - "That's a lot of money, folks." The Trans Alaska Pipeline throughput has declined by two thirds. So, there isn't enough investment and that won't be fixed by fooling around with the tenets of PPT.

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LYNN JOHNSON, CEO and Co-Founder, Dowland-Bach Corporation, Anchorage, said his corporation is an Alaskan-based niche manufacturing company with 25 employees. He said 71 percent of its revenue is derived from the oil and gas industry. He said his payroll spins off about \$1.6 million per year into the Anchorage economy. He said Dowland-Bach got the 2002 exporter of the year award. He said he is the past president of the Alliance and a staunch RDC member. He said he is president of the board of the Alaska's Red Cross. He said non-profits depend on the oil industry for donations. He urged the committee to proceed cautiously and give PPT a little more time to see if it works. He said the tweaking of taxes sends a bad message, and it is hard to know when they go too far. The gas line is further away, and federal funding is on the decrease. He has two kids and he would like them to return to Alaska after college.

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MR. JOHNSON said people in Southeast and Kodiak think they are not affected by the industry. He said a lot of revenue from the oil industry goes to the state. "If our tax revenue drops to zero, I would say that the marine highway system...is obviously at risk." He said to take the long view and don't look for immediate gratification. Businesses with shareholders can't do that, but he has been fortunate to be able to do that in his business. He suggested bridging the decline in oil until the state can get to the gas pipeline with continued investment. "We do have a surplus—that's been stated many times today—take the long view—encourage investment—our future depends on it."

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CHAIR HUGGINS said he appreciates the reminder to take a long-term perspective. Americans' natural tendency is to deal with things when bumped into, and what the committee is doing now is a knee-jerk reaction based on questionable data, at best. He said his son is going to demolition school and will be going to Iraq.

The committee took an at-ease at [7:24:37 PM](#) until [7:27:07 PM](#).
The committee adjourned at [7:27:12 PM](#).