

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

October 25, 2007

10:10 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)	Heard & Held
10/21/07	(S)	MINUTE(RES)
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
10/23/07	(S)	Heard & Held
10/23/07	(S)	MINUTE(RES)
10/24/07	(S)	RES AT 10:00 AM BUTROVICH 205
10/24/07	(S)	Heard & Held
10/24/07	(S)	MINUTE(RES)
10/25/07	(S)	RES AT 10:00 AM BUTROVICH 205

WITNESS REGISTER

WAYNE STEVENS, President and CEO
 Alaska State Chamber of Commerce
 Juneau, Alaska
POSITION STATEMENT: Commented on SB 2001.

KEVIN MITCHELL
 ConocoPhillips
 Anchorage AK
POSITION STATEMENT: Commented on SB 2001.

KEN THOMPSON, Managing Director
 Brooks Range Petroleum
 Anchorage Alaska
POSITION STATEMENT: Commented on SB 2001.

CRAIG HAYMES, Production Manager
 ExxonMobil Alaska
 Anchorage, Alaska
POSITION STATEMENT: Commented on SB 2001.

RICK RUGGIERO
 Gaffney Cline and Associates
 Representing the Administration
POSITION STATEMENT: Commented on SB 2001.

MARK HANLEY
 Anadarko

Anchorage AK

POSITION STATEMENT: Commented on SB 2001.

ACTION NARRATIVE

CHAIR CHARLIE HUGGINS called the Senate Resources Standing Committee meeting to order at [10:10:30 AM](#). Senators Huggins, Wagoner, McGuire, Green, Stevens, Wielechowski, and Stedman were present at the call to order.

Senators Davis, Hoffman, Thomas, and French were also in attendance.

SB2001-OIL & GAS TAX AMENDMENTS

CHAIR HUGGINS announced the consideration of SB 2001.

WAYNE STEVENS, President and CEO, Alaska State Chamber of Commerce, Juneau, Alaska, said the Chamber is concerned about the proposed changes to the recently enacted petroleum production tax embodied in ACES. The Chamber believes changing the tax structure so quickly will have long-term negative impacts on the future of Alaska's economy. They also believe the consequences of adopting ACES have not been fully considered with regard to all business in Alaska.

He said the Chamber is a business advocacy organization whose mission is to drive positive change for Alaska's business environment and to improve its member organizations by providing leadership, advocacy and support. The State Chamber members have a strong commitment to ethical business conduct and understand the legislature's commitment to ethical conduct among elected and public officials. Because the legislators have heard from Alaskans' that their faith in the current PPT is shaken, they understand the desire to review it again. However, they also believe this comes with great risk.

MR. STEVENS said they urged caution in the rush to find a fix for something that is not broken. The concern is that while the governor and legislature work to restore public faith, outcomes based more on emotion than economics will further chill the oil investment climate.

He said a second concern is the stated goal of generating more revenue for the treasury, but Chamber members fear that Alaskans will confuse the outcome of higher tax revenue with the goal of fair share. Members believe tax debate creates unwelcome risk

and stalls investment planning and decisions. Taxes are a key consideration in all business decisions and anytime tax law is debated, investments can be delayed; the wrong tax rate can end all consideration of investment. He said that working to induce investment such as the pipeline full of oil at \$80 plus per barrel would generate more revenue at the current tax rate than would a dwindling quantity of oil at a higher tax rate.

Most members of the Chamber do not understand the finer details of petroleum exploration and production. However they all understand two major trends in Alaska's oil patch. Taxes on the oil industry have increased at a rate no other business segment could survive. But despite billions of dollars invested by the oil industry on the North Slope and Cook Inlet, production continues to decline at an alarming rate. Many have noted this decline and think that proposing a new increase to the production tax is a risky policy given the desire to encourage increased production.

He said that a decade-old tax regime in Cook Inlet is encouraging very limited investment and recent investments on the North Slope were committed under the significantly lower economic limit factor tax (ELF) and historically high oil prices. Yet this exploration activity pales in comparison to that taking place in Canada and the Gulf of Mexico. He stated that raising production taxes in light of limited investment is counter intuitive. Instead of referring to fiscal notes and revenue projections, he urged them to set the policy outcomes they desire in the oil patch and then debate language to achieve those outcomes. He suggested: "Adopt an oil tax regime that will generate reasonable revenue for state government while encouraging maximum utilization of oil reserves."

He said the State Chamber had advocated for decades for a state fiscal plan and willingness to check spending. A clear plan however is not guiding spending or revenue collection or the question of how the state can invest new revenue in projects that will render a return on investment. Given today's oil prices, the taxes the ACES proposes to collect go to revenue for a fiscal system that results in increased spending, but lacks a strategic business plan for the state. This policy outcome does not warrant worsening the investment environment.

He said the State Chamber members have a strong commitment to ethical business conduct and this includes many members from the oil and gas industry. Given the daily headlines and investigations their concern is that many Alaskans now view

business negatively. This impression is further fueled by the implication that the oil and gas industry has somehow slighted the state through its accounting practices. He encouraged them to consider this dynamic and to avoid making unfair accusations that fuel this distrust.

He said at the end of the day differences of opinions exist and reasonable people can disagree. He offered the Chamber's assistance in boosting the state tax audit capabilities saying they are confident that if industry can hire talent to administer a wide range of complex tax regimes throughout the world, Alaska can recruit the best and brightest to administer its single tax regime. This expertise he said would be found in a combination of state employees and private contractors. Although they are concerned with the proposed minimum tax on certain fields, they thanked the legislature for recognizing the wisdom of a profits tax. He commented, "So many today illogically condemn petroleum industry profits. Alaskans should cheer since those profits will allow the same companies to make the world class investments Alaska needs to monetize our oil and gas."

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SENATOR WIELECHOWSKI said he is glad Mr. Stevens brought up the idea of profits, because all the oil companies have made huge profits. However, he said, they are not spending these profits increasingly in Alaska, but rather giving it back to their investors. He wanted to encourage them to explore in Alaska with more of their profits because there are global shortages of both oil and gas. He asked how the Chamber thinks the producers could be encouraged to develop the fields on the North Slope that are profitable because they are not doing it now.

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MR. STEVENS responded that in looking at the one line item of billions in profit, you lose perspective of the costs and how they relate to each other. He thought it was important to focus on an overall balance sheet - the percentages of income, expense, assets, liabilities, equities et cetera - so that they don't stray too far away from what other industries like banking and national retail industries fall under.

He stated that Alaska is a significant shareholder and on one hand it slaps the industry around and tries to get more revenue from them; yet the managers of our investment funds - retirement funds or the Permanent Fund - if they didn't reach a certain level of return on investment from those holds, would be selling

them off with vigor because they weren't producing the kinds of returns they want and that the citizens of Alaska share in as a part of their dividend. Isolating a single item or shareholders without acknowledging that the state is a shareholder with a significant portion of its portfolio invested in the oil industry is not the right thing to do. However, the PPT was designed with this premise.

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SENATOR WAGONER said they have heard over and over again that Alaska has the highest oil tax regime in North America, but he doesn't buy into it. His studies have shown him that Alberta has a 25 percent royalty - 24 percent of which is forgiven until the companies recoup their investment costs - then it goes back to 25 percent - in addition to other taxes. Alberta is now looking at revamping its tax structure and their head advisor was Dr. Pedro van Meurs. They are now looking at a three-tier tax structure for oil, gas and oil sands. The figure he saw was taxing the oil sands at 33 percent royalty. With figures like that, he didn't think Alaska was the higher of the tax regimes. Everyone else in the world is changing their tax structure to take what they see as more of a fair proportion of the revenues from their resource. He said he used to be a retailer, so he understood where the Chamber was coming from, but he still thinks the state needs to take its equitable portion.

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MR. STEVENS responded that he reads a lot of different numbers and depending on how they are portrayed, Alaska ends up in the higher end of comparable tax regimes. What doesn't get talked about is the higher cost of doing business on the North Slope of Alaska versus Alberta and the cost of an 800-mile transportation system to get to tidewater that Alberta or other Gulf of Mexico entities don't have. It is difficult to compare them with Alaska without filling in the complete picture. He thinks it is good to review the tax structure as a business person would to make sure it is right. They need to keep the pipeline full. It is designed for 2.1 million/barrels a day and it is only using a third of that capacity with a 6 to 12 percent annual decline. It doesn't take very long to work the math down to get to that point where it is not feasible to run the pipeline. That window of time diminishing before a gasline starts that would increase some of that production is "pretty scary."

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SENATOR WAGONER cautioned:

Don't get too scared about that, because a lot of the information being put out that that pipeline won't be operational at 300,000 barrels/day is pure just information that is not factual. Because all they have to do is change the mechanical makeup of that pipeline and it can carry 300,000 barrels/day through chokes and changes and pumping systems and things like that.

He said people in the oil industry have assured him that that is not a consideration at this time, but it's being made a consideration in several presentations.

CHAIR HUGGINS commented that he saw it as their task to avoid seeking the answer to that.

SENATOR STEVENS summarized Mr. Stevens' comments that we haven't really given PPT a chance and we don't really know the answers yet and don't have the data to decide whether it's the right or wrong approach. He was saying to give it a little more time to see if it works or not.

MR. STEVENS responded that was correct.

[10:29:54 AM](#)

SENATOR WAGONER offered him a copy of the Alberta proposal.

SENATOR STEDMAN said the last round on the PPT discussions spent quite a bit of time comparing oil basins and the difference between oil and gas and other production. What we are dealing with is a natural life-cycle of an oil basin where it peaks, in this case, at 2 million barrels/day and now is substantially below that at less than 50 percent. What they are trying to do is extend the lifecycle. He didn't want the people at home to think that if they create the magic combination of taxes and incentives that would bring production back up to 2 million barrels per day. The odds of that happening are near zero unless they find another Prudhoe Bay.

MR. STEVENS agreed and added that the oil industry would like to move east from Prudhoe Bay where there may be some opportunity for that, but it has restrictions on it. Offshore has other restrictions and other considerations that drive up costs and restrict access. They should try to strike that balance of an appropriate tax structure that encourages people to take the risk. He remembered that the producer at Milne Point spent a year exploring and found nothing but a dry hole. "Any good business person would try to balance risk and reward."

CHAIR HUGGINS said the one thing he liked about what Alberta has done which Alaska is not doing is taking the time to come up with a solution. This is a special session and they have only 30 days. He said even the administration had to contract with an outside contractor to write the bill because people were doing other things. Alberta has a very deliberate process over a time span to look at the ramifications of what they are being asked to do. He admonished:

Good for them and shame on us, because we're doing just the opposite. We're essentially saying - bring those guys to Juneau, give 'em 30 days and we want an answer. My concern about that is the validity of what we do and the durability of the results. And we know there's going to be a gas pipeline proposition that's going to ask us to look at gas. And my concern is the timeframe that we're being asked to answer the questions will not allow us to get to the questions that will stand the test of time.

CHAIR HUGGINS said he is concerned about the direction Alaska's economy is heading and it is an understatement to say Alaska's real estate market is soft. Agrium with its 100-plus jobs has closed its doors, and in Palmer, the administration is helping Matanuska Maid to close its doors. He knows that Alaska has a power generation challenge and Enstar has difficulty in getting natural gas. The dynamics of things that are coming together about the state's economy are concerning to him along with state spending habits - whether they like it or not, the Public Employees Retirement system is looking for \$8 billion to \$10 billion. He asked Mr. Stevens if he should be concerned from the State Chamber's perspective or not because of the magnitude of the assets the state has.

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MR. STEVENS responded, "You should be very concerned." There are a number of very troubling trends. Alaska has enjoyed a largess from a number of sources like federal funding that is coming to an end in the near future. Alaska has tremendous fish, mineral, oil and gas resources at its disposal and at every turn business is thwarted by those who don't want to allow the state to develop them. The tourist industry seems to be strong, but that can change at a moment's notice. He said the state is facing a number of issues including where its future employees will come from. People are reaching retirement age, but there is no mechanism to keep young people in Alaska or encourage them to

avail themselves of vocational opportunities. He said Alaska has done little about it.

MR. STEVENS said there is no fiscal plan and the state doesn't have a common goal; it has created a system that pays everyone to just be here and that payment is going to increase; yet we're not attracting businesses that challenge us to create an economy beyond government and distribution of common wealth. "And that's troubling. That's very troubling."

10:38:58 AM

KEN THOMPSON, Managing Director, Brooks Range Petroleum, Anchorage Alaska, read the following testimony [this is not verbatim, however]:

I am the Managing Director for Alaska Venture Capital Group, or AVCG LLC, an independent oil exploration company formed with a sole focus on the North Slope of Alaska. AVCG is a privately held member LLC comprised of private equity investors made up of 15 independent oil and gas companies and individuals from Kansas and me as an owner/member partner from Alaska. AVCG has a technical and operational services' subsidiary company called Brooks Range Petroleum, with offices and staff in Anchorage. In Alaska and on the North Slope, we operate under the name Brooks Range Petroleum.

AVCG has lease holdings and explores currently only in Alaska...and nowhere else. AVCG/Brooks Range Petroleum likes to think of our company as 'Alaska's Independent Oil and Gas Company.'

AVCG LLC has been very active in the past seven North Slope areawide lease sales and active in acquiring acreage held by other companies where we see potential. We and our partners currently hold over 300,000 acres of exploration leases in five exploration prospect areas on the Slope. Our exploration strategy is to explore in the central part of the North Slope for fields in the 10-100+ million barrels range, fields that may be too small for the giant producers but satisfy as niche fields that can be 'company makers' for a small independent. We believe there are hundreds of millions if not billions of barrels of oil left on the central North Slope in smaller fields of this size for small independents

like ours that want to take this type of exploration risk.

Last year, AVCG LLC announced joint venture agreements with two Canadian independents, TG World Energy and Bow Valley Energy, and with a private exploration company from Houston, Ramshorn Exploration. Together, as working interest co-owners we are exploring the central part of the North Slope.

In the winter of 2006, AVCG participated with an ownership interest in the Cronus exploration well about 10 miles southwest of the Kuparuk Field, operated by Pioneer Natural Resources. Unfortunately, that well was a dry hole.

This past winter for the first time, our operations subsidiary, Brooks Range Petroleum, operated the drilling of two exploration wells for our working interest partners in the Gwydyr Bay area of the North Slope, just northwest of Prudhoe Bay. One well, the Sak River #1, was a dry hole, but we were excited to announce earlier this year that our Northshore #1 well northwest of the Prudhoe Bay Field did strike oil. We plan to complete and test this well this winter. In addition, we ran a 130-square mile 3D seismic survey over our acreage and surrounding area in the Gwydyr Bay area on the North Slope. In total this past drilling season, our JV Group invested over \$44 million on land, seismic and drilling activities.

This winter our Joint Venture Group will be among the most active of explorers as we plan to shoot over 200 square miles of new seismic data on the extreme western and eastern sides of the Central North Slope and to drill up to four exploration wells. We plan to test the Northshore #1 well and also drill one or two other exploration wells nearby to see if we can discover a sufficient volume of oil to warrant a commercial development at Gywdyr Bay. We will drill our Tofkat #1 well south of the Alpine Field and also drill a fourth exploration well on a prospect to be named. In total, our group will spend over \$40 million in seismic and exploratory drilling in winter 2008. If our Northshore oil completion test is as suspected and one of the wells strikes oil close by, we may proceed

with Northshore development with more substantial capital investment in the second half of 2008.

My comments today represent the perspectives of a small, independent exploration company that is actively exploring on the North Slope with a good level of activity, generally on prospects that because of smaller size no longer interests the major companies. At the end of next drilling season, AVCG since 1999 and our partners since last year will have jointly invested over \$100 million in Alaska even though none in our group have generated any revenues yet from Alaska oil, so we sincerely appreciate being listened to. We think in the long run we can bring substantial, incremental value to the State of Alaska. Please wish us good luck.

Many of you also know me as the past President of ARCO Alaska, Inc. from 1994-1998. I also served as Executive Vice-President for ARCO and head of global oil and gas exploration for ARCO. I do have exploration and production experience in 10 U.S. states and in over 20 countries throughout the world, so I'll also share my perspective in how I see the ACES bill in the context of competitiveness in the United States and in the world.

General Comments on ACES Legislation

At this point, I would like to address various key points in the ACES legislation. First, our company prefers that the PPT be allowed to run its course in the next few years, and that ACES not be approved with its current provisions. I agree with Dr. Pedro van Meurs that in the light of declining oil production in the state of Alaska and prospectivity trending to smaller field sizes, the State should not once again increase its taxes after having done so last year. I will tell you that when recruiting companies to join in our Alaska ventures in 2005 and 2006, many were concerned about the threat of tax increases in Alaska. PPT proved tax increases were not a threat but a reality. Adding yet another tax increase via the ACES bill this year shows instability in Alaska's tax policy which results in uncertainty and risk when making investment decisions.

I heard that consultant Daniel Johnston differed strongly from Dr. van Meurs and urged the oil industry to understand the "cloud of corruption" over the existing Petroleum Profits Tax, or PPT, and that this alone provides a good reason to change PPT. I challenge Daniel Johnston that the bushel should not be thrown but because of a few bad apples.

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In fact, last year during the PPT debates, I recall those who are guilty of paying bribes and some who are accused of taking bribes actually supported a 20 percent base tax rate, not the 22.5 percent base rate that was finally adopted. In fact, I'd like to think that the almost all in the legislature and in industry were honest, that they could be trusted in their deliberations last year, and that the final answer of PPT was a good answer and an honorable answer.

It is also very important to keep in mind that the progressivity tax was added at high oil prices to drive the real tax rate to even higher levels than 22.5 percent, with a range exceeding 30percent now possible at certain prices. And let's not forget to tack on the royalty, the corporate tax, the ad valorem property tax, and environmental and permitting fees. It appeared to me that the checks and balances in the system worked in the Legislature last year, and I applaud the honesty of the legislators who in the end made a positive difference.

But I sit here feeling as if the honest and trustworthy investors in this industry are being punished alongside the guilty. I personally think this will have negative consequences for Alaska in the long haul in relationships and even in sustainable increased value. I am politically astute enough to know that the ACES train is moving fast down the track, so I can stand out of the way or jump on board and try to make the ACES bill better before we reach derailment in the long-term relationships between this industry I love and this State I love. So, I have some suggestions of things not to change and things to change in the ACES proposal.

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- 1) Keep the exploration and development investment tax credits. For a small explorer startup company like AVCG LLC, the exploration economics with the exploration tax credits ranging from 20-40 percent as provided by PPT and with ACES are more favorable with an improvement in the investor's rate of return as compared with Alaska's old severance tax system. Near-term cash flow because of the investment tax credits is higher which improves the return on investment. Plus refund of cash to companies like AVCG and our working interest partners via the credits mean that we can apply that cash to our capital budget the next year to run adequate seismic and do additional drilling that increases the chance of more oil production and reserves for us and for the State.

Likewise, the credits for losses for a startup company like ours while we establish production - and also the development investment credit - can take substantial risk out of development of smaller fields that our company is focusing on. Many of these smaller fields can add up over time and provide significant incremental revenue to the State.

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- 2) Keep the standard tax deduction/exemption for smaller companies. The small producer tax credit that exempts up to the first \$12,000,000 in production taxes for smaller companies can allow us to return a larger share of our annual cash flow for exploration and investment while we build the company to a critical mass of reserves and production necessary to expand staffing and have a routine level of major capital spending each year.

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- 3) Keep the new ACES tax credit allowance for qualified delineation wells. A new proposal in the ACES bill that was not in the PPT law is the possible tax credit allowance for the investment in up to two delineation wells following a discovery. This would be very helpful to small explorers as well as for large companies on the North Slope where often one well is not enough to determine if field size is large enough to warrant development.

A real case in point is that should we have a discovery this coming winter at our Tofkat exploration well on the western side of the Slope, we will have to drill one or two delineation wells to confirm if field size is sufficient to develop the resource at this remote location. Often, due to the nature of these complex stratigraphic traps where sands unpredictably come and go, the delineation wells can be almost as risky as the initial exploration well. Having a credit where the State, in a real sense, is sharing in the risk will - I think - expedite delineation of new fields and advance development for revenues.

- 4) Keep the revised progressivity tax rate at 0.2 percent per dollar increase in oil price. The PPT tax law had an incremental tax rate of 0.25 percent per each dollar increase in oil price above a trigger price while the new ACES reduces this incremental tax rate to 0.2 percent per dollar increase in oil price at a trigger price. While we can debate all day long the competitiveness of Alaska's tax rate with other countries' fiscal systems, giving some reduction in this surcharge keeps the government take at more reasonable levels. However, as I'll outline below, I would change the ACES trigger price back to \$40 per barrel net and not the proposed \$30 per barrel net if Alaska wants to better balance revenues with industry capital investment at low prices as I'll more fully discuss.

- 5) Do establish the Oil and Gas Tax Credit Fund for the purposes of purchasing certain tax credits from explorers and producers. This ACES provision would establish a procedure and standard for appropriation into this fund and management of this fund. Having a clear and transparent way for small explorers to receive their credits at full value is extremely important for AVCG to then be able to plow those credits back into seismic and exploration on the North Slope.

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- 6) Change the recovery of tax credits from two years as proposed in ACES back to the recovery of credits in one year currently provided for in the PPT law. In the PPT law, a company could file for the various credits,

and if approved, would receive those full capital credits not to exceed credits of \$25 million per company. In the new ACES law, while the cap has been removed which is very positive, the credits are refunded over two years instead of over one year; for example, 50 percent of qualified credits can be applied for in the first year once a well is completed or abandoned and 50percent in the following year.

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For a small company like ours, this will definitely affect our capital spending in a given winter as we plow all the credit refunds back into seismic or exploration drilling. As a very real example, AVCG and our working interest owners are projecting to spend \$41 million in seismic and exploration drilling this coming winter and likely around the same in 2009. We calculate that we could receive \$16 million cash in qualified credits in mid-year 2008. So essentially, our working interest owners are planning to provide cash out of pocket of \$25 million for the 2009 drilling season; this is a fixed number based on cash availability in these small companies to spend toward the Alaska portfolio. If the State refunds only one-half of this credit in the first year, or only \$8 million instead of \$16 million, AVCG and our partners will still provide \$25 million out of our pockets as now planned and budgeted...meaning our overall spending in 2009 will be \$33 million, not \$41 million, i.e. \$25 million from our available funds and only \$8MM from the State. This would mean one less well that will be drilled by our group in 2009. And one less chance for another discovery that eventually could provide revenues to us all.

[11:00:46 AM](#)

With small companies, this is just the way our cash flow situation works. And for some of our AVCG investors like me, when I say "out of pocket," I mean "out of pocket." So, we hope the full credit can be applied for and refunded in a given year. We hope this happens for all of industry. As an innovative compromise, however, the legislature may consider a small company refund provision that allows for companies that meet the no production or low

production measures in the small company tax credit provision of the PPT law - that remains in ACES - to receive tax credit refunds that are fully refunded in the first year for qualified costs. Once a company grows in production beyond this 'small company' measure with more substantial cash flow, perhaps refunds of 50percent each year would apply as outlined in ACES.

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SENATOR WAGONER asked if those credits only apply to the smaller explorer and not much to the majors, because they have the production to write it off against - including Chevron. When they are talking about purchasing back the credits, they are only talking about the smaller producers. Instead of being more complicated, it would be simpler for the state to just buy them back at 100 percent, because that's what it would pay anyway.

MR. THOMPSON replied that would help for Brooks particularly if it were in one year instead of two, because that is capital that is put back into the business. For his size program, that would mean one more well he could drill in every winter. Major producers can deduct the credits off their tax bill and this would affect their capital profile, but it's just less cash flow for them.

MR. THOMPSON continued reading his comments on the PPT tax rate:

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Change the base tax rate in ACES from 25 percent back to the PPT tax rate of 22.5 percent, and re-review again in 2011 after some time has passed as allowed for in current law. As I mentioned in my introduction, I felt the 22.5 percent base tax rate was reasonable. And the real tax rate is much higher with the tax progressivity factor. But what is fair, and how exactly is 'fair' determined?

I saw a copy of a presentation entitled 'Guiding Principles For A New Production Tax System' by the Department of Revenue urging the changes in ACES, arguing that the average government take in various international countries averaged 67 percent for all types of fiscal regimes. So that the ACES government take, at an oil price of \$60/barrel net, is 68 percent. So these principles argued that that was fair for Alaska to take 68 percent when the international

average is 67. Somehow, the Department of Revenue representatives concluded an average of 68 percent as provided for in ACES would be close to the average of 67 percent for all types of regimes internationally.

11:06:45 AM

On that same slide show the DOR broke the fiscal regimes into two types: production sharing agreements where the government take averages 74 percent, but in tax and royalty regimes like Alaska's, for those international companies that had tax a royalty regimes, the average take was 55 percent as shown by the DOR.

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First, the average recommended to Alaska is the average of all regimes, i.e. the averaging of government take from tax and royalty regime countries and government take from production sharing agreement (PSA) regimes.

In the years I was with Arco and I managed a research center and worked in 20 countries or so and also when I was executive vice president and also in charge of global exploration working in over 20 countries, I'm very familiar with different types of production sharing regimes, and actually the risk profile for capital development was often much different than in regimes that use a tax and royalty system like Alaska. In some of the PSA countries where I worked, it was not unusual for a producer on capital projects to have a very low initial tax burden until the capital investment was fully recovered plus a negotiated rate-of-return was achieved. So we would literally get all of our money back up front, pay out was often only two or three years, unlike Alaska being 4 or 5 or more - in terms of payout. We'd get our capital back and we'd get a preferred return. Then the government would increase the take to the 74 percent. I'll take that deal any time.

11:08:55 AM

SENATOR WIELECHOWSKI asked what the general negotiated rate of return was.

MR. THOMPSON replied that it would differ by whatever a company could negotiate. A major corporation would calculate its cost of

capital based on how much the debt would cost and the cost of issuing it and maintenance of equity. That might be an average of 8 to 10 percent. Investors that hold stock want more return than that from you because otherwise they could just invest in the market. So often the rate of return might be 12 to 15 percent above the weighted average cost of capital. Some companies, like exploration ventures with higher risks, often were successful in negotiating a better preferred return and sometimes for those kinds of interest that might be 15 to 20 percent after all taxes and burden. Once your capital is paid back and you have your preferred return, then the high take of 74 percent was taken. He further stated:

I don't feel what ACES does to me is equitable and fair because it's averaging in those types of regimes that pay back the capital and get a return along with the tax and royalty. And again, international countries shown by the Department of Revenue on the Governor's website for a tax royalty regime, the take is 55 percent. And ACES says 68 for a similar type system.

SENATOR WIELECHOWSKI said he was intrigued by the profit sharing concept. He asked how investors would think if the state had more of that type of system - it maximizes investments and the take for the government, because it assesses each field. Both sides negotiate so both sides know they are making money. He asked, "Why don't more developed nations do that and would that be something that would be acceptable to do in Alaska, do you think?"

[11:12:16 AM](#)

MR. THOMPSON replied one of the things that makes it difficult for Alaska to switch to purely that type of system is when you're getting the capital paid back and the preferred return of 12 to 15 percent, the government take is very low - maybe only 10 or 15 percent (not the 68 percent). So if Alaska wanted to immediately switch to that system, which he thought would generate a lot more investment than either ACES or PPT, it would take a few years for it to work out and they would have to fund government from other sources like the Permanent Fund.

[11:13:27 AM](#)

SENATOR WAGONER said the state already has the ability to do a reduction in royalties - like Alberta does with the oil sands - until the companies recoup their capital investment, and asked if that would be doing the same thing.

MR. THOMPSON replied that could be a compromise. He thought if Alaska switched to the other system it would get more capital projects going, but the problem is that the state would have less revenues for a few years. For small fields like his it would make an impact.

11:15:16 AM

SENATOR STEDMAN recalled the previous discussions on PPT that covered the American tax and royalty regime and outside-America profit sharing and rate of return scenarios. He urged them to focus on the system at hand unless they wanted to spend a year here in committee working on something else. He said they are working on refining the PPT and he personally wasn't interested in going back and starting over. They are talking about changing the government take number.

CHAIR HUGGINS said he concurs and he asked Mr. Thompson to proceed. He asked if Mr. Thompson does something in spruce bark beetle work.

MR. THOMPSON replied he is a drummer in a band called the Spruce Bark Beetles and quipped that he does it on the side pending revenue from new discoveries. He went back to the subject at hand and said it is hard for Alaska to change to a different system. It should compare to other countries, not lumped into a unique world of production sharing agreements with special arrangements made for capital payback and return up front. He stated:

Another distinction in regards to ACES is that most of the individual people and company investors specifically in AVCG do not consider international regimes as areas to consider as competition for investment dollars with Alaska. The main competition for most AVCG Owners' cash is in other states in the U.S. I found it astounding and concerning that the average of 67 percent for all international regimes did not consider weight-averaging in a little more strongly the major American producing states. As examples, the current government take in the Gulf of Mexico offshore - one of the main competing areas for Alaska investment dollars - averages 45 percent. This is under consideration by the U.S. government for increase, but it is highly doubtful with the boom going on in deep water exploration and development that the U.S. government would increase the government

take from 45 percent to ACES' 68 percent. Although I think the government will increase the 45 percent.

[11:18:57 AM](#)

Now let me give you some astounding figures as of this week. Yesterday we participated in the North Slope area wide all acreage held by the state - on the North Slope was up for bid - anything not yet taken. There were a lot of bids and his company won six tracts. The total of all bids is a little over \$2 million. October 3, just a few days ago, at the Gulf of Mexico sale 205, and that was just one area of the Gulf of Mexico, the bids were \$2.9 billion - 45 percent tax burden. The State of Alaska right now is going to 68 percent? The bids were \$2 million!

[11:20:01 AM](#)

SENATOR WAGONER asked what would be the government take if Shell is allowed to proceed and strikes oil on their leases in federal water on the North Slope.

MR. THOMPSON said those are federal leases and he didn't bid on those. Most federal leases have a 12.5 or 16.7 percent royalty and other federal taxation. It may trend slightly higher than 45 percent with the higher royalty.

[11:21:07 AM](#)

MR. THOMPSON continued:

In other producing states that compete for investment by our AVCG investors, the state and federal combined government takes in 2006 were as follows and averaged 45-57 percent:

U.S. Gulf of Mexico	45 percent
Colorado	51 percent
Wyoming	52 percent
Kansas	53 percent
Texas	53 percent
New Mexico	53 percent
Oklahoma	53 percent
California	53 percent
Louisiana	57 percent

To my knowledge, these states do not have the added progressivity surcharge tax, which further separates

Alaska in government take from these competing states. I would argue that Alaska should have a government take of 55 percent to maintain long-term competitiveness with these other states for investment dollars. Having said that, some of these states are examining their own tax structures and the Department of Revenue was to have obtained current figures for 2007 for these states as some have changed their tax rates. That would be good for the committee to look at when that's available. But I don't think it'll be the 68 percent of ACES. In fact if we were to just step back a bit and look at tax and royalty regimes internationally, have a government take of 55 percent, the Gulf of Mexico is 45 - headed upwards some and then these other states average in the 50s, if Alaska set a government take at 60 percent and 40 percent to the investor, the ACES legislation should be amended to allow for a base tax rate of 22.5 percent, not 25 percent, should be amended to allow for a trigger price of \$40 per barrel and not \$30, and then the incremental progressivity tax rate increase should be 0.2 percent per dollar. I calculated that by hand - that the state yield would be 60 percent take and that can be verified by having the DOR run some of their models for those examples that I gave.

I think the 60 percent would be competitive with states; it would increase above PPT slightly, but it would also be something that doesn't stop investment when people look at things like the Gulf of Mexico or even federal waters offshore Alaska for investment dollars.

[11:23:33 AM](#)

SENATOR WAGONER asked what if the tax rate went to 25 percent on both sides - tax and credits.

MR. THOMPSON answered that wouldn't be as competitive as some of these other total take tax burdens, but it could be looked at with the new data DOR will collect.

[11:24:26 AM](#)

MR. THOMPSON said his final two points were on changing the trigger price to \$40 per barrel:

In particular there, if oil prices fall, many of the small and medium size fields that our company is

looking at simply would not pass muster below \$40 if we did have the higher tax rate. And hopefully prices do not fall that low, but it would make a big difference if the trigger was \$40 instead of \$30. There is a whole other wedge of smaller fields that could be brought on stream, we think, if that trigger price is left at the more reasonable \$40 net.

Then my final point 4 on the last page of my comments is it would be great if the state in my opinion could consider some type of "Transitional Investment Expenditure (TIE)" tax credit. This provision that was in PPT was repealed in ACES. And this benefit or provision does not greatly benefit our company, AVCG, because we did not have large seismic or exploration drilling costs between March 31, 2001, and April 1, 2006. In fact most of our drilling was this last winter in 2007, but it is important to other major investors in Alaska.

As an example, the largest explorer and developer in Alaska, ConocoPhillips, now with the ARCO heritage assets, was hardest hit in tax exposure with the change from the old severance tax law to the PPT and now once again to ACES. I think just allowing a good steward who is the largest explorer in Alaska some transition allowance to ease the pain of greatly increased taxes is the right thing to do and can only build better, more trusting relationships. Again, this provision does not greatly benefit our company, however.

This concludes my remarks. I tried to share the perspective of an independent exploration company that only invests in Alaska. My ultimate wish would be for the state to leave PPT alone and re-review it under the law as planned in 2011 or perhaps even in 2010. But if the ACES train has left the station and cannot be stopped, I urge you to at least consider the five things our company would not change in this bill and the four things we would change.

The above comments are offered with a hope that there can be an eventual win-win solution to this complex subject of the State realizing more revenues at higher prices while attracting exploration and development investors who can also realize upside at higher prices

for the substantial risk they have taken in the remote and harsh environment of the North Slope. In the end, I hope both sides get a fair and equitable share at all price levels.

11:28:03 AM

SENATOR WAGONER asked the feasibility of a company his size or bigger exploring and producing a field of 25 million or 50 million barrels when it's marginal. He asked:

What effect on a marginal field will the upcoming TAPS settlement have in the tax tariff case that's before FERC? Would that have a positive effect on your ability to go out there and produce one of those fields that are marginal right now?

MR. THOMPSON replied that the TAPS tariff increase that happened last year was the largest increase of burden of any type that he faces as a smaller explorer to ship oil down the line. He declared:

We have no interest in that line. We have no interest in the tankers or refining profits on the other end. So we feel the full brunt in that that TAPS tariff somehow could be reduced would be very significant in developing marginal fields.

Having worked for years at ARCO, Mr. Thompson said he saw the thing that most lowers the tax tariff per barrel is more production in oil down the line. So, whatever ACES does to encourage investment in exploration or allow fairness in development projects increases the chances of more oil down the line. And that's fewer tariffs per barrel on everybody. His company is not involved heavily in the settlement, but the increase last year was very discouraging.

11:30:10 AM

SENATOR WIELECHOWSKI asked what impact he saw on people coming back to Alaska to look for gas if a gasline contract goes forward.

MR. THOMPSON replied that they would most likely see more activity in the foothills area of the North Slope. The largest reserves would be the existing reserves at Prudhoe and Pt. Thomson. Companies have been taking position over the last few years hoping that the gasline deal moves ahead. ARCO felt there was some significant gas potential in other interior basins in

Alaska - a couple hundred miles from Fairbanks, for example. He hoped there would be more exploration in some interior basins as well. He also pointed out that smaller fields can be more economic when they have two revenue streams - gas as well as the oil. He hopes a good contract is turned in and that the state moves ahead with it.

SENATOR STEDMAN said they were talking about the Nenana basin.

SENATOR WIELECHOWSKI stated that they should consider that the state is likely to see a significant amount more of investment and exploration in Alaska with an impending gasline contract and when they are thinking about loading up investment credit and tax breaks, there's probably going to be a surge of investment coming in anyway.

[11:33:06 AM](#)

MR. THOMPSON responded that he has worked big oil and natural gas projects all over the world. At the time Arco merged with BP in 2000, it was the third largest holder of natural gas reserves in the Pacific Rim Basin. If Alaska does things right on the investment tax credits on encouraging additional oil exploration not only on state lands, but also offshore in federal waters and the NPRA, there are still a lot of big oil fields and production to come. He thought that would start up much sooner than a gasline. "In my view, you need them both."

[11:35:03 AM](#) recess [11:42:27 AM](#)

CRAIG HAYMES, Production Manager, ExxonMobil Alaska, Anchorage, Alaska, read the following statement:

Good morning. For the record, my name is Craig Haymes. I am the Production Manager for ExxonMobil in Alaska, a position I have held since January 2007. I have the pleasure of living in Anchorage with my family. Prior to January this year I was involved with Arctic oil and gas projects on the East coast of Canada for almost five years. I want to thank the committee for the opportunity to express ExxonMobil's views today regarding the Administration's proposed tax increase.

Let me state upfront ExxonMobil believes the current PPT tax rate and the increase proposed by the Administration will have a negative impact on resource investments in Alaska. ExxonMobil does not support the proposed tax increase by the Administration.

We believe that Alaska needs to focus on a long-term resource development policy. The policy should encourage increasing investment that is needed to maximize the development of Alaska's resources. Alaska is rich in undiscovered resource potential, yet oil production continues to decline from mature basins. Oil production today is one third of the peak of over 2 million barrels per day in 1988. Alaska faces a significant challenge. We have a common goal to maximize economic resource development and need to work together; Government, industry, and the people of Alaska, to enhance the development of Alaska's rich resources and the future.

EXXONMOBIL IN ALASKA

ExxonMobil invests all over the world to meet the growing need for energy. Over the last 20 years we have invested close to \$280 billion dollars to search for new supplies of energy, build new production facilities, expand refinery capacity and deploy new, environmentally sound technologies.

ExxonMobil believes technology innovation is the key to meeting the world and Alaska's energy challenges. Technology is the lifeblood of our industry. ExxonMobil currently spends close to \$1 billion per year on research and technology. We have consistently applied our technology in Alaska to unlock and develop resources. We have significant arctic experience around the world.

Some examples of technology applications that we have contributed to Alaska are:

- The installation of the ice resistant Granite Point platform in Cook Inlet, which is still producing oil
- Significant research and engineering for the Prudhoe Bay completion designs for permafrost
- The installation of the first Concrete Island Drilling System (CIDS) to drill exploration wells in ice covered waters in the Alaska Beaufort Sea
- The first full-field 3-D simulation model of Prudhoe Bay, leading to many enhanced oil recovery and development drilling programs that are still being pursued today

The application of technology will continue to be a key to the future of Alaska's resource developments.

ExxonMobil has had a presence in Alaska for over 50 years and has been a key player in Alaska's oil industry development, spending and investing over \$20 billion dollars. We hold the largest working interest at Prudhoe Bay (36.4 percent) and our current working interest share of oil production in the state is approximately 150,000 barrels per day. We are also the largest owner of discovered Alaska gas resource.

We are currently active with our co-owners at Prudhoe Bay, Kuparuk, Duck Island, Granite Point and Point Thomson. Over the last two years we have participated in the drilling of over 70 percent of the wells on the North Slope - over 130 wells were drilled at Prudhoe Bay alone - this drilling will add 50,000 B/D of oil production in 2007, an important contribution to help mitigate production decline.

We are proud of the role that our company has played in Alaska, which we believe has benefited both the State and the industry, and we look forward to working with Alaska for many years to come.

ALASKA RESOURCE POTENTIAL IS SIGNIFICANT

I would like to take a few moments to discuss Alaska's resource opportunities. Alaska has significant oil and gas resources. According to the US Geological Survey and the US Minerals Management Service, Alaska's undiscovered technically recoverable resources are 53 billion barrels of oil. This is in addition to the Department of Natural Resources estimate for known remaining oil resources of 6 billion barrels. To date Alaska has produced close to 17 billion barrels of oil - this is a world class result - but is less than one fourth of the potential total of 76 billion barrels. That is, Alaska still has the potential to produce another 59 billion barrels of oil. The gas resource potential almost doubles this undiscovered potential on an oil equivalent basis.

Whilst Alaska's resource potential is high, the Oil and Gas Journal and Energy Information Administration report that its world ranking of proved reserves has declined from 14th in 1977 to a position closer to 30th today.

ALASKA'S FUTURE OIL PRODUCTION

Today Alaska is producing approximately 750,000 barrels of oil per day from the North Slope, one third of its peak production. The Department of Revenue's production outlook, from their Spring Revenue Sources Book, shows that they estimate a 9percent annual decline in Alaska's current base production. As the chart illustrates, at this decline rate, over the next ten years Alaska's current base production, shown in green, will drop to around 360,000 barrels per day. That is a production level of less than half of today's.

The Department of Revenue also forecasts that this base production decline will be partially mitigated with the development and production of oil in categories called "Under Development and Under Evaluation", shown in blue on the chart. These categories include future investments, such as development drilling, satellite developments, and enhanced oil recovery from existing fields. Based on this forecast, over 50percent of the projected oil production in 10 years will come from new investments. Let me say that again, 50percent of future oil production in 10 years is not even developed or producing today. Considering that most new projects take at least 5-7 years to bring to production on the North Slope, investment decisions for these activities, particularly in the near term, will be critical to underpin the future of Alaska's oil production.

As I mentioned earlier, the Department of Revenue forecast is based on a 9percent annual decline in Alaska's current base production. However, this decline assumes that production enhancement investments at the core Prudhoe Bay, Kuparuk and Alpine areas continue. The Department of Revenue forecast, as shown, does not highlight that this activity requires investment decisions that are no different from the "Under Development and Under Evaluation" categories. As such, a more accurate representation of the future oil production and investment levels required to achieve the Department of Revenue forecast is illustrated in the following chart.

As this chart shows, Alaska's oil production from the North Slope could be as low as 150,000 barrels per day within 10 years, (assuming 15percent decline, which is typical for large oil fields such as Prudhoe Bay), without ongoing and increasing investment. Based on this forecast, within 10 years, 75 percent of production will come from new investments.

Conservatively, we estimate that at least \$30-40 billion of investment is required within the next 10 years to achieve the Department of Revenue forecast. This does not include the billions of dollars of additional operating expenditures that would be required to support the developments once they are producing. This is a significant level of future investment and spending.

The high tax rate in PPT and the proposed tax increase put this investment at significant risk. Alaska needs to encourage the increasing investments required, not only in exploration activities, but also in the ongoing development of existing and new fields.

[11:52:41 AM](#)

SENATOR WIELECHOWSKI said ExxonMobil's annual report recognized that the easy stuff has all been found and from now on huge investments are required all over the world. He asked if that was a fair statement.

MR. HAYMES replied that it is fair to say that the challenge of finding new oil and gas resources is becoming more and more technically challenged, but there probably is still some of the easy oil out there. "We're all looking for it. There is no doubt the level of capital investment that's required to explore and develop the future resources for the generations to come is going to be very, very high."

SENATOR WIELECHOWSKI asked if there are huge resource costs all over the world. "It's not just isolated to Alaska is it?"

MR. HAYMES replied, "Alaska has some very unique aspects that I'll talk about almost immediately in my testimony."

[11:53:56 AM](#)

SENATOR WIELECHOWSKI said regarding government take that a chart by Chevron on the Alberta Royalty Review Panels shows that every jurisdiction is raising oil taxes.

MR. HAYMES responded that it is useful to look at what others are doing and learn from it, but they need to decide what the right take for Alaska is to encourage more investment.

SENATOR WIELECHOWSKI said his point is if costs are going up in every jurisdiction in the world, ExxonMobil is not going to leave every jurisdiction in the world. The cost of getting oil is going up for industry all over the world, not just in Alaska and oil take by government is going up everywhere in the world as well. "So, it's not just [in] Alaska that this is happening."

MR. HAYMES said there is no doubt that there is increased cost in inflation and costs have doubled. Costs go up when oil price goes up, so it is fair to say that all regions are seeing cost increases. He said they have to look at what makes Alaska a high-cost area.

[11:56:23 AM](#)

SENATOR WIELECHOWSKI said it is also an extremely profitable region.

MR. HAYMES responded that production has declined to a third of the peak. He said there gas potential doubles the remaining production and these resources aren't being explored or developed at a prudent pace. He said that government and industry don't control all of the variables, but there are some things that can be controlled, which he would talk about later.

SENATOR WIELECHOWSKI said ExxonMobil made \$40 billion last year and asked him how much of that was made in Alaska.

MR. HAYMES answered that ExxonMobil does not report its earning on a state by state basis.

SENATOR WIELECHOWSKI said he knows that, but someone surely has calculated that figure.

MR. HAYMES responded that ExxonMobil is a global company and reports its earnings on quarterly summaries and in the annual report.

SENATOR WIELECHOWSKI asked the question one more time and got the same answer.

CHAIR HUGGINS said they would move on.

[11:58:22 AM](#)

SENATOR MCGUIRE digressed to say there is a question on where Alaska sits on his company's investment timeline and ExxonMobil, in particular, has been criticized for "warehousing" in Alaska. She asked him to explain how Alaska fits into ExxonMobil worldwide portfolio timeline. She invited him to mention alternative energies it is looking into also.

[11:59:35 AM](#)

MR. HAYMES replied that ExxonMobil will always look at every opportunity in the world to pursue energy. Its demand is significantly increasing. It looks at many factors: the resource potential, the technology required to develop that resource that includes exploring appraising and developing, marketability, and costs to develop the facilities.

They look at cost for an investment over the entire life of the project - decades. The decisions are made. He said the most important thing is the fiscal policy including predictability. Because the investments are capital intensive and take quite some time to generate a return they need to look at things over decades. Alaska is an area ExxonMobil constantly looks at and evaluates. The future of Alaska is not just gas, but oil and gas. According to federal studies, half is oil and half is gas. Currently they do not have a way to get the gas to market. That's a challenge, but ExxonMobil continues to be active in looking at ways to commercialize Alaska's gas.

[12:02:53 PM](#)

SENATOR MCGUIRE remembered a presentation she heard in House Resources when she first started serving in the legislature in 2001 or 2002 that a representative from ExxonMobil said the price of gas at the time didn't make development of Pt. Thomson economic. Clearly today the price makes it economic. She asked him to illustrate their decision making over that period of time and explain why those leases aren't being developed.

[12:03:57 PM](#)

MR. HAYMES said he didn't mention price earlier in his assessment and the reason is because ExxonMobil doesn't control it. It is a commodity that goes up and down all the time. The gas market is far more volatile than crude. Crude has gone up recently and gas has gone down. When ExxonMobil looks at economics for any project they look at sensitivities around price, but focus on the aspects they can control like costs, project execution, assessing the resource, the technology needed

to develop it and ongoing operations required. The government is in control of the fiscal policy.

With respect to Pt. Thompson, he said, it is a gas field and it needs a gas pipeline to commercialize it. He repeated that ExxonMobil continues to evaluate ways to commercialize Pt. Thomson and is currently working off-take studies with the other owners and the AOGCC. They have continued their technical work and have complied with all of the lease agreements, the statute, regulations and the Pt. Thomson agreement. It is unfortunate there is a dispute, but they will continue to do what is necessary to move that along.

SENATOR MCGUIRE said that's the legal answer, but she wanted to know why they don't want to get that gas in a line and get it going.

MR. HAYMES replied:

We are absolutely keen to commercialize Pt. Thomson. We have invested over \$800 million and drilled 19 wells in the field. We are as keen as anybody to seek a return on that investment. Pt. Thomson has a lot of significant challenges - high pressure, reservoir quality challenges; the technology required to develop it is leading edge and of course it needs a gas pipeline to produce the gas.

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SENATOR WAGONER said it is interesting that ExxonMobil won't disclose profits they make in Alaska because BP and ConocoPhillips did. He came down here with an open mind to come up with a solution to the difference between PPT and ACES. The fact that he is not disclosing their profits leads him to be suspect when all oil companies come before the legislature and say they are partners in producing and marketing Alaska's oil and stated, "I don't think that's the way a partner acts."

[12:07:40 PM](#)

MR. HAYMES responded that Alaska is a high-cost region. Many factors contribute to that including the severe climate, sensitive environment, remote location and current restrictions for future exploration opportunities. Alaska has two large oil fields: Prudhoe Bay and Kuparuk. They have accounted for over 70 percent of the North Slope oil production. Assuming exploration and investment activity continues in these fields, they could remain at this level of production for the next decade. The

legacy fields require continuous investment to keep the oil flowing. This is the same for any oil field in the world. During the production phases there are many changes in operating parameters such as reservoir pressure changes, oil, gas and water production changes and changes in operating conditions and on-going technical challenges. He said in order to keep the oil flowing, these changes require additional investments, such as the addition of water and gas injection and gas compression facilities, which are historically significant investments at Prudhoe Bay.

MR. HAYMES continued:

Currently, the owners spend over \$2 billion dollars to optimize and enhance production from Prudhoe Bay and Kuparuk. These spending levels are in addition to the capital investments pursuing new wells, projects, and enhanced oil recovery opportunities. These operating expenditures are essential to mitigate production decline at these significant fields, which are critical to the future of Alaska's North Slope oil production.

Many of today's exploration and development activities are occurring in and around Prudhoe Bay and Kuparuk. As an example, since the year 2000 there have been multiple Prudhoe Bay satellite fields developed - Aurora, Borealis, Midnight Sun, Polaris, and Orion - which are currently contributing over 40,000 B/D of oil production. These developments would not have been possible without the infrastructure and facility sharing of Prudhoe Bay, which reduced the development and operating costs of these satellites. As satellite fields are developed it reduces exploration and development costs for future new projects, as the infrastructure on the North Slope expands. If the major Prudhoe Bay and Kuparuk developments did not exist, these satellite fields would not have been economic to develop.

As another example, for the past seven years over 900 new wells have been drilled in Prudhoe Bay and Kuparuk. The drilling of these new wells has slowed the overall production decline from 12-15 percent to an estimated 6-9 percent. Almost 40 percent of Prudhoe Bay's production today is from these new wells.

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SENATOR STEVENS said he keeps hearing about reduction of oil flow on the TAPS and that 300,000 barrels/day might not be optimal to keep it going. He assumed that was an enormous part of ExxonMobil's costs. He asked, "Can you just give me a little insight as to how you decide what volumes you want to have moving through that pipeline? And what would be optimal?"

MR. HAYMES replied that any oil field in the world similar to Prudhoe Bay typically declines at 15 percent plus if you do nothing. So they pursue as many opportunities as they can. He said the decline rate is a challenge for everybody because as it goes down, the unit operating costs go up. Typically a certain amount of those costs are fixed and while technology can help reduce those costs, "that decline is constantly against you." He said the ExxonMobil looks at every investment on its own merits and the full life cycle.

SENATOR STEVENS asked what factors ExxonMobil takes into account in getting the volume up or allowing it to go down.

MR. HAYMES replied that the full life cycle of a field includes different operating costs, capital investments, and different sensitivities. It's a little like chasing your tail, when costs go up they need to produce more oil. Each investment decision rests on its own merits.

CHAIR HUGGINS recognized Senator Thomas in attendance.

[12:16:26 PM](#)

MR. HAYMES continued:

For the past two years, development drilling at Prudhoe Bay has achieved the equivalent of the important Oooguruk development. This example highlights the importance of exploring for and developing new oil in and around the Prudhoe Bay and Kuparuk fields - all are important to the economic benefit and future of Alaska.

Let me re-emphasize that Prudhoe Bay and Kuparuk have the potential to continue to be critical contributors to Alaska's oil production. They have the potential to remain key hubs and enablers for exploration and development of heavy or viscous oil, light oil and gas. Encouraging increasing investment at these key fields is as important as encouraging investment in

exploration and development of new fields. Without these two hubs, Alaska will be severely challenged to realize the full potential of its resources.

Progressing a tax policy that singles out and penalizes these fields will discourage investment not only at these fields but will also impact future investment attractiveness to explore and develop other Alaska oil and gas resources.

PROPOSED TAX INCREASE MORE COMPLICATED

In analyzing the Administration's tax proposal, we found that virtually all of the provisions are simply tax rate increases or further increases in complexity.

As an example, under the Administration's proposed tax increase the two so-called legacy fields, Prudhoe Bay and Kuparuk, would have a separate 10 percent gross minimum tax and be segregated from each other and all other North Slope fields. This gross tax would be in addition to the base royalty payments. With this minimum gross tax the state would be insulated from price and cost risks, whilst retaining the upside potential from the progressivity element. The Administration is simply proposing to increase its take while shifting the development risks to the producers. Essentially, at low price, producers are penalized.

Companies are willing to accept the risks of long-term, capital intensive investments when there is a corresponding opportunity for upside potential and a sharing of risk should prices fall. Under the Administration's proposed tax increase, investors will need to assume a higher economic risk when making funding decisions for future investments and spending.

The Administration has also proposed that all revenues and expenses for the Legacy Fields will have to be accounted for separately, with separate taxes paid for each unit and their satellites. This would include Alaska's heavy or viscous oil reserves produced from those Legacy Fields - a resource that already has significant economic and technical hurdles to overcome. No other fields, units or regions within the state would be subjected to these administrative burdens.

The ring-fencing of the Prudhoe Bay and Kuparuk Units makes the tax proposal more complex than the existing PPT.

EXXONMOBIL POSITON ON THE ENACTED PPT

I believe it is important that I clarify ExxonMobil's position on the current PPT. ExxonMobil did not support the PPT that was enacted last year. As we testified last year, we supported the concept of a net based tax but stated that the proposed 20percent tax rate, in the original PPT bill, would not encourage the full development of Alaska's resources. We agreed with the 20percent tax rate in order to support the progression of a gas pipeline project.

The PPT that was ultimately enacted increased the already high 20 percent base tax rate to 22.5 percent with progressivity - more than doubling industry's taxation. Alaska's current PPT tax rate is too high. When combined with the gross royalties and the high development and operating costs, it makes Alaska one of the most expensive regions to invest.

There has been a lot of discussion recently on PPT revenues and forecasts, which has been used in part to support the Administration's proposal to increase taxes. PPT has only been in existence for slightly more than one year. The Department of Revenue has not completed its PPT regulations or started any PPT audit. ExxonMobil, like a number of the other producers, met with the Department of Revenue several months ago to discuss ways to help the State better forecast its expected PPT revenues and we are willing to continue those efforts. We are also willing to work with DOR auditors to improve their understanding of joint interest billings.

[12:21:39 PM](#)

FISCAL PREDICTABILITY IS IMPORTANT

I would now like to address another important element of the business environment - fiscal predictability. ExxonMobil and, I believe, the industry values a predictable fiscal environment in which to make long term investment decisions. Our investments are capital intensive and are evaluated over timeframes of decades. Any change in the fiscal regime has a direct impact on how we view predictability of the Alaskan

fiscal environment, which in turn directly impacts how we evaluate on a risk basis future investment decisions. Let me reemphasize this point. Because of the nature and magnitude of the risks associated with any oil or gas investment, coupled with the amount of time required to recoup that investment, fiscal terms that are predictable are key to any investment decision.

The Administration's proposed tax increase would represent the third significant change to Alaska's fiscal terms in the past three years. Changing the fiscal environment for capital intensive projects, that can take many years to generate a return, can only reduce the attractiveness of future investments. Each time taxes are raised, the attractiveness of any prospective well or project diminishes and the likelihood of it not being funded increases. For every well or project not progressed, additional production and State revenues are lost. As mentioned earlier, to mitigate oil production decline Alaska needs to increase investment. The Administration's proposed tax increase will reduce investment.

ExxonMobil expects to be involved in Alaska for many years to come. The policies established today and in the future will impact the attractiveness of future potential projects and the future of Alaska.

ALASKA NEEDS A LONG-TERM RESOURCE DEVELOPMENT POLICY

As I mentioned earlier, Alaska has significant resource potential, but with many unique cost challenges. It will take significant resources, technology, investment and teamwork from everyone to realize the full potential. Alaska and industry collaboratively need to create a resource development policy that encourages investment for long-term production and growth. This is a complex issue and needs significant time and effort from all parties. It is beneficial to look at what others have done.

The Canadian province of Alberta has enormous unconventional crude oil resources. Alberta's oil sands represent the potential of over 170 billion barrels of crude, and, like Alaska's resources, are located in higher cost, remote arctic regions that require significant investments to develop.

Alberta adopted a resource development policy approach, designed to increase industry investment and production. Their approach has proven successful due to a number of key factors:

- Collaborative pursuit of resource development objectives
- Development of technologies jointly with industry to reduce costs, increase oil recovery, and upgrade viscous oil to marketable products
- Creation of a level playing field for all projects
- Sharing risks with the investors by maintaining a lower gross revenue based tax, that is, lowering royalties significantly
- Providing long term fiscal predictability

Alberta's success suggests that Alaska should seriously consider what other regions are doing to encourage investment.

A long-term sustainable resource development policy is required to enable Alaska to maximize its oil and gas resource. There are many factors that need to be considered. It is a complex issue. I hope that key points addressed in my testimony are considered:

- Alaska has significant resource potential, but it is in a high cost environment
- Oil production is already one third of its peak, yet we have only produced one fourth of the oil resource potential
- In 10 years, 75 percent of Alaska's future oil production needs over \$30-40 billion of new investments - investments that are needed sooner than 10 years.
- Prudhoe Bay and Kuparuk are the 'hub' of the North Slope, they represent 70 percent of North Slope oil production for the next 10 plus years, can be the backbone for future exploration and economic developments, whether it is existing production, future light oil, heavy oil, or gas. They need increasing investments to achieve their potential.
- Development drilling at Prudhoe Bay and Kuparuk over the last 2 years has added 50,000 B/D of new oil production in 2007.

We propose a collaborative approach to develop a sustainable long term resource policy that will encourage the needed increasing investments and build the future of Alaska for many generations to come. ExxonMobil looks forward to working with the Administration, the legislators, industry and the people of Alaska in the future pursuit and development of its oil and gas resources.

To encourage full development of Alaska's resources, the PPT tax rate needs to be lowered, and should not include a gross revenue based component. Increasing investment fuels the economy.

Thank you again Mister Chairman for the opportunity to testify today.

[12:27:49 PM](#)

CHAIR HUGGINS said ExxonMobil's image in Alaska has some negatives, but it continues to be the state's business partner. He heard on the radio that the number two investment return for the Permanent Fund was from ExxonMobil. He didn't think it was appropriate for everyone to ask how much ExxonMobil makes in Alaska, which could be proprietary information; rather it is important to figure out how to make ExxonMobil successful. Sometimes people take exception to the way ExxonMobil does business, but he hopes to continue doing business with them in the future.

CHAIR HUGGINS recessed the committee to the call of the chair at [12:30:04 PM](#).

[2:42:11 PM](#)

CHAIR HUGGINS called the meeting back to order at [2:42:11 PM](#) and said they would have a roundtable discussion on issues in ACES. Committee members present were Senators Huggins, Stevens, McGuire, Wielechowski, and Stedman. In addition, he said LB&A consultants, Dan Dickinson and Steve Porter; BP's Claire Fitzpatrick; ConocoPhillips', Kevin Mitchell; ExxonMobil's Craig Haymes; Alaska Venture Capital Group; Range Petroleum's, Ken Thompson; Anadarko's Mark Hanley; from the Administration - DOR Commissioner Patrick Galvin and Gaffney Cline & Associates' Rick Ruggiero were in attendance.

Roundtable

[2:43:34 PM](#)

CHAIR HUGGINS asked Mr. Ruggiero to comment on anything he wanted to highlight about SB 2001.

RICK RUGGIERO, Gaffney Cline and Associates, said the issue he wanted to make sure gets proper airing is that it is very important to have the best possible information possible and that it is very important to take care of the date of disclosure. When he first met with Commissioner Galvin and his team he was "aghast at the void of data that they had to do their job."

He said there was a lot of press about a shortfall, but what he saw as the companies came to the table is all of their data were DOR figures. This was what they were using knowing that the legislature would possibly be moving millions or billions of dollars across the balance from them to you or the other way. He was disappointed that they did not take the opportunity to come forward with the best possible data.

[2:47:20 PM](#)

SENATOR WAGONER joined committee.

MR. RUGGIERO said new data is essential to making good models and therefore good decisions. He was a bit taken aback by the way the industry gave the DOR the right cost data the last time around, although it was buried in footnote 8 of the AOGA presentation, which says you should have gotten this and that the DOR should have been able to figure out by doing the mathematics that it does in the footnote, that the real cost associated was in the \$11 to \$13 range instead of \$7 to \$8 range - a major difference in trying to do predictions. These were major differences that were known at the time that the legislature should have had at its disposal to make a good choice on how to set taxes going forward.

He said they need to have the right words in whatever they do with the ACES bill to make sure the proper data does move with violation of any SEC rules or anti trust rules. "There is information that takes place that is transferred between oil companies and governments around the world that you don't have here and that you really need to have to manage your asset."

He repeated, "You deserve to have the best data known at the time to move forward. You can't bet the bank on forecast data, he advised the committee, but you manage your business as the government the same way these companies manage their business with their one, three, five and 10-year forecast. They deserve to have the collective wisdom of the various companies in order to do that business. The beauty of getting it from multiple

players is you kind of see how they do their estimation and get an idea of what is robust and what's not.

2:53:21 PM

CHAIR HUGGINS said that's easier said than done. He is flabbergasted with how little the state's knows - especially after a special session has been called.

SENATOR WIELECHOWSKI said he is equally frustrated with the lack of information the state has to administer the system it has now - and also to decide whether the system is working and whether it needs to be improved. He said:

We can't even get the profits from Exxon from last year; it's something that I could probably figure out with a calculator and about five minutes. And we're sitting here and we have two senators asking that question. We can't get that information and we wonder why Alaskans - I mean I get emails every day, phone calls every from constituents. Go to the gross, go to the gross. You can't trust the oil industry. And when I see behavior like where I can't get simple information. That's why Alaskans are saying that. That's why Alaskans are hesitant and they are distrustful and think we should go to the gross - because they think we're getting gamed. If we can get the information, maybe there is a better way to do it, but if this is the way the relationship, the partnership, is going to be, then it's no wonder why most Alaskans want to go to the gross.

CHAIR HUGGINS asked if the DOR has the answers to what the different organizations' bottom line within the state is, but at any rate the department could come up with the figures on its own "with 15 minutes of homework."

COMMISSIONER GALVIN responded that he revealed profits for ConocoPhillips and BP as far as Alaska operations go. Most of those operations take place in partnership with Exxon and the math could be done based on ownership percentages, but he hasn't done that because the number isn't relevant to his position on this issue and nobody has asked them for it.

CHAIR HUGGINS asked if his was the appropriate agency to deduce those numbers.

COMMISSIONER GALVIN replied that probably the DNR would be the department to do that calculation because it knows the percentages of ownership.

2:57:16 PM

MR. DICKINSON said three specific questions were addressed. The first question dealt with the notion of penalties, interest and what happens when companies under declare. He clarified that the current law has two interest regimes - one deals with estimates and interest on overpayment or underpayment through March 31. The interest rates there are IRS interest rates, which means there are four. One rate is for a "large overpayment" - if the amount of tax that was underpaid is over \$100,000, it's the highest of the four rates. If the amount that is due that month is under \$100,000, then it's a slightly lower rate. If the state owes money (an overestimation in a month) there's another rate. The fourth rate is for under \$10,000 or \$15,000. There are four rates in all; all of those rates are lower than the state's rate. And on March 31 you take everything that has happened so far and that becomes a single amount of tax due - or underpaid or overpaid - typically if history is any indication - the amount underpaid. That then bears the rate found in the general tax statute. That rate is San Francisco discount rate federal funds rate plus five points or 11 percent. Typically for most of the year since that went into effect it has been at the 11 percent compounded quarterly. He said that back in the early 80's the state's rate was 8 percent simple and there was a sense that the state could be essentially used as a bank. It made sense to under declare because you could earn a lot more than 8 percent simple elsewhere.

3:00:17 PM

MR. DICKINSON said the point he wanted to make is after March 31, those rates apply to all other tax types save one. He said the same rate is applied to all taxpayers.

He said that people get confused because of the IRS that has separate and distinct civil penalties that can be levied if you purposely ignore the law or if there is misconduct and things like that. And then finally there are actually very severe penalties for fraud. Where there is an honest dispute between the taxpayer and the government as to whether a deduction was appropriate or how much tax is owed, that is the 11 percent compounded quarterly and that can go higher if market rates go above 6 percent.

He said that same question here was how that compares with other states - and it is higher than what other states have; but he didn't get a chance to compare it to other peer nations like the UK or Norway.

CHAIR HUGGINS asked if the state is using the IRS practices in its penalties.

MR. DICKINSON replied only in a year for underestimations or overestimations of the amount.

CHAIR HUGGINS asked if there are distinct statutes or provisions for people that by design or omission did something.

MR. DICKINSON replied yes and that could be up to a 25 percent penalty. He said if there's any messing around or proof of bad faith on an item, that penalty can apply to the total amount underpaid, not just that item.

CHAIR HUGGINS said it appears that it's a more wholesome task than one would want to bite into in 30 days to rejuvenate the penalty factors, because there are a lot of moving parts and the synchronization of that is such that you need time and it's best measured in months, not days, to pull that off.

COMMISSIONER GALVIN answered it depends on what their objective is. If it's to have a fairly straightforward penalty apply in a particular situation, it's simple, but if it's going to be more integrated into the entire system that would apply across other tax types, it would take more time.

CHAIR HUGGINS said the provision this bill contemplates takes the \$100 per day to \$1000, which is a tangential piece.

MR. DICKINSON replied that really applies to information so you can't take a percentage. With a six-year expanded statute of limitations that basically says monthly reporting is required, that starting six years from now in its most extreme case the state could level a new penalty of \$2 million every month (\$1000/day X 365/days/yr X 6/yr = \$2,000,000). This is a very heavy penalty for underreporting especially if you don't notify the company until six years later.

SENATOR WIELECHOWSKI said if they're paying only interest, they have that money, say \$1 million. They can take that \$1 million and invest it somewhere else and with a discount rate of 10

percent, it's basically a break even proposition. It's not costing them anything else.

MR. DICKINSON said if their discount rate is 10 percent, they are losing money.

SENATOR WIELECHOWSKI said 1 percent and they have heard profit ratios of 35 - 45 percent from all the companies.

CHAIR HUGGINS commented that didn't sound like a very good investment strategy.

[3:05:37 PM](#)

KEVIN MITCHELL, ConocoPhillips, commented that 11 percent interest is a significant rate. He would view that as "quite the penalty." So from his perspective, there is no incentive to overclaim expenditures and be subject 11 percent interest compounded.

[3:06:39 PM](#)

MS. FITZPATRICK added that with the proposal to move the statute of limitations to six years, an audit could take them out to 8 or 9 years. To be told after 8 or 9 years what you had done in good faith at the time is now wrong, then they stand the best chance of not over or under claiming, but actually doing it properly.

CHAIR HUGGINS asked if she said that BP needs regulations to comply.

MS. FITZPATRICK clarified, "I said if we're actually when we're doing our filings, knowing what the regulations are, that means we stand the best chance of knowing whether or not we are making a compliant filing or not."

SENATOR GREEN arrived - all present

[3:09:40 PM](#)

MR. DICKINSON said the request was to model a 22.5 percent versus 25 percent without a floor, but with an aggressive progressivity. On that issue, he observed that the amount of revenue available for division among the parties (whatever the rules are) when they are down in the range of \$9/barrel and the state is taking 62 percent of some profit piece from that is literally a question of cents or a dollar. When you are up at the current range of ten times that (way above the lifting cost) at that point if the state has a more assertive progressivity,

the amount that will be picked up may equal what it will give up (if you view those as a trade off) over five or six years as at low prices. It's not symmetrical to move something at low and pick it up.

And I believe that the state essential if they pick up the windfall profits or the spikes, you can do a small number of profits. Spikes will make up for many years in which you have a policy where if investments are being - the combination of investment, cost and low price leads the state to have a very very low take. So, it's my observation that the floor may have a very chilling effect when prices are low and if it's a revenue issue, that you may pick it up at the other end. If it's a sufficiency of revenue issue, the only other observation I would make and I think I made this for your committee before, and I hesitate to make it again, because it's stepping a little outside of my area of expertise, but when the state was young it maybe made sense to have a regressive fiscal system when the oil was sort of first flowing in because that really was the state's only source. As you know, three years after Prudhoe Bay started producing there was the first price spike and at that time the state repealed its person income tax and repealed its gross receipts tax on business and decided this was the new frame of reference. And I don't know that we need that any more. The state has put a significant, a quarter of all the royalties, have been put aside. You as the legislature have added certain increments to that so there's a lot of money sitting there over and above the protected corpus. There's dollars that are sitting there that could be drawn on, the CBRF is sitting there. So it may be that if I can put this in sort of betting terms, the state's risk tolerance may be such that you're willing to accept some of that high side and when prices are low and everyone is challenged we don't need to say well - as I believe you can show in 1999 for a couple of months, we were taking 110 percent of the economic rent. That's just an observation on those two and I know you want some more quantitative and if I have the chance I will certainly do that and present that to you.

3:12:00 PM

CHAIR HUGGINS said there's not a lot of affection amongst some on the floor because of what he just described. Somebody said it

would be like upping property taxes in the late 80s. Nobody would like that very much; nobody had much money to pay it and a lot of people were out of jobs.

[3:12:42 PM](#)

CRAIG HAYMES, ExxonMobil, said the challenge of the 10 percent gross floor is when you look at your forward investments, as investors they would need to assume that kicks in and be able to use that as a basis for economics.

And that's a significant deterrent when you look at a return on a significant capital investment that takes decades to get a return. So the problem is whilst we may not be at the floor today, because the crude price is at ridiculous levels, the dynamics of the oil fields and the costs and commodity price will change. We never know where it's going to go, but for investment decision purposes, we would need to assume that floor kicks in - given unit costs on mature fields will continue to increase - given the commodity prices. If you look at history it shouldn't be above \$40 or \$50/barrel and given currently the production is declining. So, for us it would be if it was in there, even though it may not be happening today, we would be assuming it is going to happen. So, it would reduce the attractiveness of future investment opportunities.

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KEVIN MITCHELL, ConocoPhillips, echoed those sentiments about the floor. He is concerned that the floor would be triggered in a low-price environment which makes a very regressive tax. So, they would be getting effective tax increases at the time when the industry can least afford it. The second is that the potential investment opportunities could be impacted by that floor and in testimony yesterday he outlined how they could be at the floor simply because of trying to pursue investments that will drive some growth. This is a significant area of concern.

CHAIR HUGGINS inserted that tomorrow they would get together with the administration to discuss what scenarios would activate the floor.

MS. FITZPATRICK said BP, to err on the side of caution, would be making its decisions assuming the floor kicks in. If they pursue investment to get more barrels, that might in fact trigger the floor, which means she would question the value of making the

investment in the first place - making it a viscous cycle at that point.

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COMMISSIONER GALVIN commented that their level of investment in order to kick in the floor would exceed what the state has seen in the past. He said the administration has acknowledged from the get-go is that there is a trade off.

You can take the side of wanting to protect the state's interest when prices are low and minimize the risk of having the significantly low revenues in times of low prices and we recognize the opportunity to take a greater take on the upside when prices are high. And what influenced our decision was more of a conservative view that we would rather protect the state when there are low prices. But again we said from the get-go that this is a policy call in terms of that risk/reward trade off that is up to the legislature to respond to. I think I hear the same hallway chatter with regard to the floor and we're open to discussion about the validity of that in replacement for higher on the upside, but in the end, I think it's a responsible thing for us to consider in terms of a trade off there - and make a reasoned decision that we're going to do something else.

SENATOR WAGONER said he has heard a lot of good debate on both sides. He thinks it's only fair if the state shares in the upside it should share in the downside.

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CHAIR HUGGINS said his perspective is that some parts of the bill need more airing and there are two other committees for it to go through. Its merits will continue to be reviewed.

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MR. DICKINSON said Mr. Mitchell made an interesting observation in a similar roundtable and one idea people like is the hybrid of a gross and a net and if there's some way of combining them that makes sense. Mr. Mitchell said that progressivity essentially acts like a gross, but maybe it could be redesigned to have the elements of a gross at the very high end because at that point it becomes very close.

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MR. MITCHELL elaborated he believes that the marginal basis the net structure with progressivity behaves very like a high gross rate. If you look at today's \$80-plus barrel price, costs haven't jumped by \$20/barrel over the last three months as prices have moved from \$60. So there is a bigger margin, but that entire margin is being taxed from a production tax at 27 - 28 percent rate plus the progressivity. That's in addition to the royalty and the other taxes of corporate taxes and property taxes. He said the state gets the best of both worlds by sharing on the high side and getting the investments through the tax credits.

3:21:48 PM

MR. DICKINSON said the third topic was a request to provide to the Senate Resources Committee an explanation or illustration regarding the \$800 million shortfall - what it's based on and how the DOR arrived that number. While he said the commissioner of the DOR could better explain that number, he wanted to summarize several ways of looking at the gap. He referenced a handout labeled "Summer '06 versus the Spring '07 Forecast for Fiscal Year 2008."

The fiscal note indicated for two different prices: one said at a price of \$46.90 that the state would bring in \$1.5 billion and it gave a high side estimate of \$60 and said they could expect to bring in \$2.4 billion. Eight months later in 2007 the spring forecasts came out and a number of adjustments had been made - and it said they could expect to raise roughly \$1 billion. His point is the difference between the revenue forecast at \$1 billion and the fiscal note from eight months earlier at \$1.5 billion is roughly \$500 million.

Another way of looking at it is clearly recognizing the effect that prices have. And what would the fiscal note have been if the price forecast used had been \$54.72? That suggests it would have been roughly \$2 billion in revenue instead of the \$1 billion forecast by the DOR. So there is a \$1 billion gap on this very simplistic basis. He had not doubt there are a lot of other tweaks that can account for the smaller differences between those.

MR. DICKINSON asked if the major issue that everyone is focusing on is cost, what difference would a doubling of costs from \$2 billion to \$4 billion produce. He answered:

So, we start with an incremental \$2 billion. What's the tax effect going to be? Let's further assume

really simply that \$1 billion of that was higher Opex and \$1 billion of that is higher Capex. Okay, what's going to happen? The Opex, if there's \$1 billion extra dollars, that's going to make taxes go down by \$225 million. It's that simple. If your tax rate is 22.5 percent and there's \$1 billion more in deductions, it's \$225 [million]. So you can think about your own income tax when I have \$100 deduction, I save \$22.50 in tax. You know, it's the same idea.

Capital investments, though, capital spending, starts out with the same thing because that's also deductible. Then you have the ability to take a 20 percent credit - so that gets added on - and then finally another very simplifying assumption I've made here is that in this the second year of the PPT, that there's enough TIE investment available so that the two for one match is fully utilized. So whatever credit there was essentially, TIE, to match it comes in and the net effect is you add additional 10 percent. So I added 22.5 and 20 percent and 10 percent. So the effect of an additional capital dollar is the state basically gets \$.525 less in tax or to go back to my analogy if there's \$1 billion in extra capital spend, that should knock \$525 million out of the tax receipts.... So, you take the 22.5 and the 52.5 and you combine them and it's an average of 37.5 and you multiply that times \$2 billion and you get \$750 million.

All I'm trying to do with this simplistic thing is say sitting back, the Department of Revenue has seen this \$2 billion increase and yes you'd expect everything else being equal for that to be about \$800 million. I think it's very important to distinguish that kind of analysis from the revenue's efficiency analysis - the numbers that you looked at then you pass budgets and items like that.

[3:28:45 PM](#)

COMMISSIONER GALVIN said the gap exists and Mr. Dickinson just showed them two ways that validate those numbers. The question is moving forward that acknowledging that the folks from BP and ConocoPhillips said their numbers match up with the state's.

MS. FITZPATRICK agreed and added when BP looks at current costs as an individual company, it has only part of what the state is looking at. But she felt comfortable with the 2007 numbers.

MR. MITCHELL pledged to work with the administration in sharing data.

MR. HAYMES pledged to not be so ambiguous.

MARK HANLEY, Anadarko, echoed previous comments on adequate and correct information.

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COMMISSIONER GALVIN said the nature of actually getting to that desire of sharing of information comes down to the state saying it wants this information and then it gets a reaction from the companies asking if the information is really critical and necessary. There is a different perception between the state and companies when it comes to how valuable it is. There needs to be statutory authority that information needs to be provided.

That's why it's in the bill. There needs to be very clear statutory authority that says the taxpayer shall provide this information in a way that avoids having individual conflicts over whether or not certain aspects of certain types of information are really meant to be provided in a very general statement about how they shall provide whatever information is necessary for the state and you end up with conflicts on a daily basis over whether that's really necessary or not. That's why we're trying to provide in the statutory language some clear definitions of what needs to be provided.

SENATOR WIELECHOWSKI said one of the things he's confused about in the overall argument is PPT was supposed to raise \$2.2 billion and it actually raised \$1.4 billion. But last year the industry expected to pay \$2.2 billion in taxes and it ended up paying \$1.4 billion.

COMMISSIONER GALVIN corrected that last year in FY'07 it was supposed to bring in \$2.2 billion if all the numbers were lined up; but it brought in \$2.0 billion; when you look at FY'08 with the current costs they are looking at a \$800 million shortfall.

SENATOR WIELECHOWSKI said that ACES would have them pay less than they expected to pay under PPT.

MR. HANLEY said he raised this issue upstairs as well and a lot of what was debated during PPT was how much is the right government take and for the companies to have. One thing seems to be forgotten and it's the fact that if companies paid less than they expected to pay, it was because their costs were higher and it cost them more. When everyone figured out the 22.5 percent tax rate, that was based on having a lower cost as well. Results show they had a lower return than was expected, too. "It is important to remember that while the state lost money, so did the companies - if that's the case." There is also the difference between a cost and investment and part of the reason there's \$200 million less is that people went out and spent \$500 million more in drilling new wells, not just new cost increases.

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COMMISSIONER GALVIN responded that it's important to reflect on who knew what when. The companies clearly paid less than the state expected and it's true that a company's margins are going to shrink with increased costs. From a year ago, they may have paid exactly what they thought they were going to pay, it just wasn't necessarily what the state thought they would pay. It's an important distinction.

SENATOR WIELECHOWSKI asked how much of the state's information he was relying on when the state's estimates were made and if this is one of the things ACES is going to fix.

COMMISSIONER GALVIN replied in a way. A year ago the state came up with estimates and provided them to the companies that kind of said well maybe you're a little low here or over there, but the information didn't come from the companies per se. They didn't actually report anything; they didn't sign any certificates; it's not like this year when they had actually filed returns where they certify these are their costs and provided them to the state and that's what it is basing its information on now.

SENATOR WIELECHOWSKI asked if it's fair to say the state suffered a shortfall because the department underestimated how much their expenses would be.

COMMISSIONER GALVIN replied the department underestimated what their costs actually were.

SENATOR WIELECHOWSKI said the department got its information from them.

COMMISSIONER GALVIN replied that he got its information based on a variety of sources; he then had conversations with the companies; and that they didn't correct it is probably the more accurate was of putting it - as opposed to that they didn't give it to him.

CHAIR HUGGINS said when he listened to Dan describe his old job with the Division of Tax, that the projections were surprisingly accurate.

MR. DICKINSON added that on one level it was a classic case of the division overestimating volume, which it had done 18 out of 19 of the past times, and underestimating expenses and underestimating price. The net effect of those was the number that came within 8 percent of the projected number. He added that Commissioner Galvin described the process exactly, but one step further - the information he had from companies was blended from a lot sources including partnership returns for unit investments on the North Slope. That's really the only information the companies provided. Other estimates were put together from Wood MacKenzie, for instance. Among the people who reviewed it were the companies, but also the legislators' consultants - looking at ballparks and sensitivities. "I guess I would just characterize it there was a lot of discussion about them, but no flags about whether they were way off, but you're right. Nobody put someone under oath and said do these numbers represent X, Y and Z."

SENATOR MCGUIRE remembered that there was a clear policy decision to incentivize their industry.

But the spirit I would like to convey when you think about legislative intent and the debates that went on for eight months of last year is that there was a very clear policy decision to incentivize your industry and I think you should really walk away feeling good about that. The legislature has debated taxes in my tenure on alcohol and tobacco and car dealerships and all kinds of things. And in no case have I ever heard a desire on the part of lawmakers across the state to say let's incentivize this industry. I mean we are not saying to liquor stores we're going to go ahead and give you some credits, because we would like to see more people drink. And so - but I think it's an important thing to point out that with that benefit comes tremendous responsibility. And that what we're

expecting is not - and I'm not implying it's occurring - but not a game of cat and mouse or battleship, but rather that focus on the partnership part and that we are wanting to help you incentivize your industry. And so when you're thinking about what kind of costs or investments go in, then it's really a matter of are you investing in the state? Is it something that's going to grow your industry, create more jobs, bring more profits for you, but also for the State of Alaska. And so I look forward to a better sharing of data, but if it gives you the spirit of what we're thinking about, we may not get it right every time, we may not get every word in the right spot of what we're trying to define. I think that's the difficulty of a citizen legislature; we're not economists; we're not petroleum engineers; we can't identify everything; neither can the department frankly. But the spirit is please work with us; we're trying to grow your industry for the benefit of all of us.

[3:47:07 PM](#)

MS. FITZPATRICK said everyone was collectively in agreement with each other on the principle of getting something workable.

COMMISSIONER GALVIN said that the state needs to make it clear exactly what is required.

[3:50:27 PM](#)

SENATOR WAGONER commented that ConocoPhillips' chief economist, Marianne Kah, last year sat in this same committee room and said something that was probably very important and that they didn't pursue very much - that costs were on the increase and could double. He asked her if labor was included in that and she replied probably not. He thought they needed to be more thorough on both sides when the forecasts are being made - and be a little more honest with each other because she had it pegged pretty well.

MR. MITCHELL agreed that Ms. Kah is sharp and very accurate.

[3:51:55 PM](#)

MR. HANLEY recalled that a little bit of the pressure last year is that the companies were padding their costs to make their returns look lower. So, this year, they are sitting here listening to the legislature is telling them they didn't tell them the costs were high enough.

[3:53:48 PM](#)

CHAIR HUGGINS said as he understands it there is a little bit of change in how they are going to state deductions. Instead of exclusions, the law will say what you can deduct.

COMMISSIONER GALVIN agreed and explained that the state through regulations will identify what can be deducted.

SENATOR GREEN asked if they will still have exclusions.

[3:54:36 PM](#)

MR. DICKINSON replied that the structure still starts with a high level statement (in section 165); it says it has to be a direct cost of producing, exploring for or developing oil or gas in the state and all the other qualifiers. Then section (e) sets out the current 17 (and this bill would add two more) specific exclusions - so that no matter what, those are no longer deductible. The change, as the commissioner said, is there's not going to be an intermediate step which says the department has to write regulations and unless the department's regulations allow for it, it is prohibited as a deduction. So the department is taking the general notion of a direct cost of exploring for developing or producing oil or gas in the state (with four other qualifications) and turning those into regulations.

[3:56:29 PM](#)

SENATOR GREEN recalled from the previous years that they were sort of the warned not to list too many things one way or the other for fear that something would inadvertently be omitted and therefore become litigious. She asked if the goal he was shooting for was to avoid listing too many items.

COMMISSIONER GALVIN replied that it really depends on the nature of the definitions. As Mr. Dickinson said, you can define things in the broad category and leave a lot of open room for interpretation within them. The limitation is if you try to identify all of the nits and you miss something, then there's an inverse interpretation that you intended to exclude that nit. The balance is to find things in such a way that you insure that you have maximum inclusion of what you are trying to include and minimize things that you clearly don't want to have in there. He said his regulations would be two or three steps down in that fine tuning.

SENATOR GREEN asked if that could be done with maximum accuracy and fairness or does it advantage the department to be able to define passed legislation in regulation.

COMMISSIONER GALVIN replied that the regulatory process allows more interaction with the taxpayers being able to have a discussion of the technical details in a context that allows for them to be fleshed out a bit more. It adds a level of avoiding unexpected exclusions and flexibility to have the conversations with industry before going through litigation.

[3:59:11 PM](#)

CHAIR HUGGINS followed up saying his concern was more elementary and if the department hadn't been able to do audits, how well could it do definitions.

COMMISSIONER GALVIN replied that the language of the statute and the intention of the effort is going to be based upon industry standards, not upon going into the audits and deciding retroactively what should or shouldn't be included.

[4:00:10 PM](#)

MR. HAYMES said he was concerned that the draft bill was ambiguous. He said the 30-cent allowance was objective, but any time you get into prescription it's going to be very subjective. It will create a lot of confusion and ambiguity and auditing of auditors. He was very concerned that regulations could be easily modified. "And again it kind of gets back to if there's a lot of ambiguity; then we need to assume a worse-case scenario in future investments - not knowing how it will be treated until you're way down the pipeline so to speak." He implored them to make the definitions as objective and transparent as they can.

[4:01:41 PM](#)

SENATOR WIELECHOWSKI asked Commissioner Galvin if his position has evolved in any way after hearing the testimony about credits over one year versus two years. It seems it benefits the smaller independents to go one year and the larger companies say it doesn't have that big of an impact.

COMMISSIONER GALVIN replied that his position never really evolved. He recognized that it was basically a trade off issue and the difference going from one year to two years is simply a matter of taking 50 percent and discounting it by time value of money in one year. Clearly a project would have to be fairly marginal for that to make a difference between whether you're making money or not. But it's just whether the value to the state is really offset by that. He saw value in the smoothing aspect of it in terms of blending variable costs from one year to the next for simple forecasting.

MR. DICKINSON emphasized that the value to the state is really small for a technical reason. He explained that the projections the state has to deal with are based on a fiscal year. So, as you make an investment in the later part of a calendar year and then are forced to move half of it into the next calendar year, it's still going to be on the same fiscal year plate. So, instead of half being moved forward, it's more that quarter gets moved out to that next fiscal year and three quarters of the effect of it could be in that first fiscal year.

[4:05:28 PM](#)

SENATOR WAGONER said it's the same dollars in the end to the state no matter how the pie is cut. He wanted to simplify anywhere they could.

SENATOR WAGONER said this provision only affects the explorers. The producers take those credits against their production tax.

COMMISSIONER GALVIN said they only get half.

[4:06:07 PM](#)

MR. MITCHELL said it's not a huge financial impact, but it's still a form of tax increase and an erosion in value if you look at project economics. However, the allowing credits to be deducted over two versus over one year is not a huge factor in considering whether a project gets done or not.

MR. HAYMES said the key for Exxon is that it adds a lot more administrative burden to both the investors and the DOR. If the intent is to incent more investments, this doesn't do it.

SENATOR STEDMAN said he would be considering this along with forecasting and planning the state's budget cycle in the Finance Committee. He wanted to get as much predictability into the process as possible.

CHAIR HUGGINS announced that Senators Thomas, French, Hoffman were in attendance.

[4:08:44 PM](#)

CHAIR HUGGINS went to the issue of changing from monthly to annual reporting and asked the commissioner to explain the rationale behind that.

COMMISSIONER GALVIN explained that in calculating the progressivity he realized that they are asking the companies to

do a little bit of an artificiality where they would take their anticipated annual costs and have to divide that by 12 months and calculate their income for a particular month. That would establish their net value, which would then kick in the progressivity. Thinking through the basic fairness of it with constantly changing prices and price spikes that may last a week or two, the inherent randomness of having a spike that takes place between the 10th and the 30th of the month may create a tremendous progressivity payment whereas if it took place between the 20th of one month and the 10th of the following month, it may have no impact at all. And he thought there was just a basic fairness aspect to having progressivity calculated over the entire year - have it be the annual price and have it apply basically to one chunk on an average basis.

He said when he ran the models for last few years, prices were pretty volatile and he figured the state would be out \$10 million to \$20 million per year from doing it on annual basis.

Basically given that we are increasing the progressivity across the board, it was sort of one of those trade off things that was well okay, it will make it a little bit easier to calculate and a bit more fair in its application and although it does cost the state in the end, it was from my perspective an appropriate tradeoff.

[4:11:35 PM](#)

MR. HANLEY said annualizing it generally saves the companies money, which means it would cost the state some money. And that in itself wasn't hugely significant, but it's important to point out that in his view the changes that were made to the starting point and the escalator were actually a significant tax increase at a \$60 price.

[4:13:28 PM](#)

COMMISSIONER GALVIN said it was not the intent to make these equivalent tradeoffs and he recognized the change in progressivity that would bring the state significantly more money. Going to the annual was a nod to fairness and a little bit easier calculation.

CHAIR HUGGINS asked if they agree that annualization is simpler.

MR. HANLEY replied yes.

MR. DICKINSON added in that the creation of the monthly progressivity was one of the uglier things in PPT, but having said that, one of the reasons it was done was because there was a definite focus on capturing spikes. "If that's not a concern, then clearly an annual return is much simpler than 12 monthly returns."

CHAIR HUGGINS thanked everyone for their comments and adjourned the meeting at [4:15:43 PM](#).