

ALASKA STATE LEGISLATURE  
JOINT MEETING  
SENATE RESOURCES STANDING COMMITTEE  
SENATE FINANCE COMMITTEE  
February 14, 2012  
1:03 p.m.

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CALL TO ORDER

Senator Bert Stedman, Co-Chair called the Senate Finance Committee meeting to order at 1:03 p.m.

SENATE FINANCE COMMITTEE MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Johnny Ellis  
Senator Dennis Egan  
Senator Joe Thomas

SENATE FINANCE COMMITTEE MEMBERS ABSENT

Senator Lesil McGuire, Vice-Chair  
Senator Donny Olson

SENATE RESOURCE COMMITTEE MEMBERS PRESENT

Senator Bill Wagner, Co-Chair  
Senator Wielechowski, Vice-Chair  
Senator Bert Stedman  
Senator Hollis French  
Senator Gary Stevens

SENATE RESOURCE COMMITTEE MEMBERS ABSENT

Senator Joe Paskvan, Co-Chair  
Senator Lesil McGuire

ALSO PRESENT

Dr. Pedro Van Meurs, President, Van Meurs Corporation,  
Consultant, Legislative Consultant; Senator Cathy Giessel;

SUMMARY

^PRESENTATION BY PEDRO VAN MEURS ON ARCTIC AND ALASKA OIL ECONOMICS: SESSION FOUR

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DR. PEDRO VAN MEURS, PRESIDENT, VAN MEURS CORPORATION, CONSULTANT, LEGISLATIVE CONSULTANT, provided members with two PowerPoint presentations: Policy Options for Alaska Oil and Gas; and Addendum to "Policy Options for Alaska Oil and Gas" (copy on file). He explained the presentation would consider how the architecture for existing oil and new oil discussed in previous sessions could be applied to heavy oil, shale oil and natural gas.

Mr. Van Meurs observed that the major heavy oil development may face significant challenges, due to difficulties assuring the total gravity in the TAPS line was adequate for transportation. Major heavy oil development might have to be stimulated in conjunction with expansion of light oil projects, with possible condensate and liquid stripping projects from gas fields (such as Point Thomson) and/or construction of GTL plant(s) (with subsequent cracking of waxy components). Heavy oil production needed to part of a broader plan.

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Mr. Van Meurs stressed the need for special terms for heavy oil with a lower government take. He observed that 40,000 barrels of oil per day (bopd) heavy oil was being produced on the North Slope. He stressed the difficulty in determining a fair decline curve and pointed out the small volume of heavy oil. He proposed that heavy oil not be separated by class.

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Mr. Van Meurs recommended terms for heavy oil production based on the Petroleum Profits Tax (PPT) as follows:

- PPT based on a flat rate of 25 percent;
- 20 percent tax credit; and
- A 15 percent allowance based on the gross value of the heavy oil as special deduction for the determination of the PPT.

Mr. Van Meurs advised the severance feature start at a higher price of \$160 per barrel to protect government take at higher levels.

Mr. Van Meurs explained that government take could be brought down without creating problems through a 15 percent allowance based on the gross value of heavy oil. At \$100 per barrel of oil, \$15 would be deducted before PPT was calculated; PPT would be based on \$85 per barrel of oil. There would be one more line on the tax return for the number of barrels multiplied by 15 percent of value.

Mr. Van Meurs addressed the issue of a negative PPT. A floor price would be initiated for the purpose of calculating PPT at a price that would never be lower than \$55 per barrel escalated with inflation. He observed that the calculations might need fine tuning due to their sophistication. Problems with negative PPT would occur if the tax credit were greater than 20 percent.

Mr. Van Meurs summarized that the system would only need two adjustments for new oil production for heavy oil: a 15 percent allowance and a floor price.

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Senator French asked where heavy oil would be measured; oil was measured downstream of production facilities. Heavy oil would join the production stream somewhere above the production facility. Mr. Van Meurs explained that the measurement would be field by field. The Department of Natural Resources would designate fields as "heavy oil" There might be difficulty measuring some fields precisely. A methodology would be needed to calculate holdings since ownership would be different for different fields. The worldwide practice was to establish a simple test separator for field tests to extrapolate, which would require additional investment. He believed that Alaska had sufficient technological advancement.

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Senator French observed that heavy oil deposits on the North Slope might overlay different viscosities. He asked how often fields overlay and comingle. Mr. Van Meurs did not suggest that gravity content be tracked as oil was produced. Any reservoir could have layers of heavy and

light oil. He recommended that entire fields be labeled based on described criteria and classification. He did not see any problem establishing criteria.

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Senator Wielechowski referred to previous statements by Mr. Van Meurs, which he felt were in conflict.

Proposal for a Profit Based, Production Tax for Alaska, February 14, 2006, by Dr. Pedro van Meurs, page 138:

"The fiscal proposal of a 25 percent tax rate and a 20 percent credit rate will provide a strong stimulus for heavy oil developments through the considerable downside price risk protection this system provides and the significant improvement in IRR and NPV@10 percent under current long term price projections. There is no need for further incentives. Such incentives would unreasonably lower the revenues of Alaska for no significant added benefit in economic stimulus."

North American Report, Recommended Fiscal Changes for North American jurisdictions:

"For large unconventional or high cost resource projects it can be recommended to introduce profit sharing royalties or taxes, similar to the Alberta royalties for oil sands, the net profits interest for shale gas in Northeast British Columbia, the royalties in Newfoundland and Nova Scotia offshore, or the petroleum profits tax in Alaska."

Mr. Van Meurs explained that the PPT structure was entirely suitable for development of heavy oil and ideal over a fixed royalty structure. He originally recommended the PPT structure in 2006 because it was the proper architecture for development of heavy oil. He emphasized that he had not changed his recommendation regarding the architecture, but emphasized there was a different competitive environment in 2012. Competition with Alberta required a greater competitive environment than 2006 when costs were lower. The allowance was introduced in light of greater competition and higher costs. He concluded the structure was still viable if it were kept simple.

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Co-Chair Stedman spoke to of capital expenditures and asked if they were included in the 25 percent credit. Mr. Van Meurs did not recommend any changes to the capital structure imbedded in PPT.

Mr. Van Meurs reviewed recommendations for ultra-heavy oil, which would be more aggressive: PPT based on a flat rate of 25 percent. He thought government take would still be somewhat higher than Alberta but advised that government take and even royalties might need to be reduced if there were no takers. He stressed that the market should be tested before any reductions.

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Mr. Van Meurs discussed slide 92 and indicated that ultra-heavy oil could present problems in the pipeline. Alberta used an up-grader to create a mixture of light product called synthetic crude oil and coke. The synthetic crude oil was equal in quality to West Texas Intermediate (WTI) and could be put directly into the pipeline. The coke would be used to fuel the plant. He recommended that Alaska upgrade ultra-heavy oil, which would solve the pipeline issue with additional quality oil.

Mr. Van Meurs observed that Alberta permitted a "feed price" into the up-grader. The value of ultra-heavy oil or Alberta oil sands would be equal to 65 percent of the value of the synthetic oil that would be produced. The feed price would be the basis for royalties and PPT and would only pay corporate income tax on the upgrader, since this was in fact a mid-stream type operation. The same concept was applied in Alberta for oil sands and recommended for refineries in Alaska.

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Senator Wielechowski referred to Alaska's corporate tax provisions and questioned if the lack of separate accounting allowed the write-off of bad investments made outside of Alaska. Mr. Van Meurs felt that Alaska's system of taxation was a little cumbersome and complicated the formula used above.

Senator Wielechowski asked if Mr. Van Meurs would recommend separate accounting in Alaska to allow companies to write-off investments and level the playing field. Mr. Van Meurs affirmed that he has always been a strong supporter for calculating state corporate tax based only on costs and revenues attributed to development or production in Alaska. He felt that Alaska's ability to provide incentives was impaired by the tax system.

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Mr. Van Meurs reviewed slide 93, which was an overview of all the terms for oil. He stressed that a wide range of government take could be created with simple allowances, within PPT and without changing the royalty or corporate income tax. He concluded that Alaska had flexibility to attract investment to "just about every resource that Alaska has." Royalties could be lowered if the market demanded over time. Alaska would compare favorably with other major producers such as Columbia. He recommended testing the market first.

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Mr. Van Meurs observed that shale oil was risky and could be given the same terms as the terms for ultra-heavy oil. However, there was a small probability that the shale oil operations might turn out to be rather profitable if fracking operations were very successful and primarily light oil was produced. He suggested that introduction of an R-factor in the case of shale oil would be wise to allow adjustment if it was unusually profitable. The R-factor would automatically correct.

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Mr. Van Meurs spoke to slide 95 and recommended that natural gas be separated into two groups: new fields that needed to be explored (Point Thomson) and associated fields (Prudhoe Bay) where the drilling and field development costs had been spent. He acknowledged that Governor Parnell preferred to wait for discussions with major oil companies, but recommended terms were established for both types of gas. He advised a more aggressive approach and pointed out that Alaska did not want to be dependent on major oil companies for development. Announcing terms would enhance the state's bargaining position. New gas needed to be very

attractive. The only way to export gas was as LNG. He observed there were two concepts for development: develop LNG directly from the North Slope, competing with Russia through tankers, which would be economically feasible, but not necessarily political acceptable; or through a pipeline, which would be acceptable politically but not necessarily economical. Taking new gas on-stream would be a major undertaking that needed to be aggressive to be competitive. He suggested a 25 percent allowance [of the gross value of the gas revenues]. The severance feature was tougher, starting at a net-back of \$8/MMBtu. A floor net back gas price would be necessary.

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Mr. Van Meurs suggested a 15 percent allowance would be sufficient for Prudhoe Bay gas. He reiterated that the state would be in a difficult and competitive position in terms of gas development. He recommended that PPT be modified as a first step; and that legislators test the market.

Senator Wielechowski asked for a breakdown of government take. Mr. Van Meurs promised to provide the breakdown for each recommendation.

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Mr. Van Meurs noted that the proposed fiscal terms could be provided for a simple to administer overall system and would set terms for all possible oil and gas investments. All resources would have 25 percent PPT and 20 percent tax credit, which would allow consolidation of all resources into one tax return. The base price, increment, change price, next increment and maximum value would change, but the concept would remain the same for each resource. An allowance and floor price would be introduced for heavy oil. Shale oil would also receive an R-factor as the only resource capable of a huge variation in profitability. The system would be simple, easy to implement and deal with all systems.

Senator Wielechowski asked if industry had indicated that the proposed system would result in increased investment. Mr. Van Meurs had no indication from industry but believed in the market. He stressed that if the terms were clear to investment groups around the world that the state would

know relatively quickly (days to a year), if the terms were well set. He was confident that investors would come with competitive terms, even if they were not the major companies. He pointed out that major oil companies were in an extreme harvesting mode.

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Senator Wielechowski observed that the number of companies doing business in Alaska had tripled, with all-time highs in investments. Different consultants had recommended different concepts. The concept adopted by the state of Alaska was depicted in a number of presentations by Gaffney and Cline and Associates. The philosophy of "portfolio blending" was used to encourage production in heavier fields since investors would lower their overall tax rate. He did not think it was completely accurate to call ACES a net profits tax; ACES encouraged reinvestment through cash flow. He suggested that Mr. Van Meurs' recommendations moved away from a portfolio blending philosophy.

Mr. Van Meurs agreed and acknowledged that investment was occurring in Alaska, but at a modest level compared to other nations. He agreed that PPT was developed with barrel of oil equivalent (BOE) concept in mind and with combined price and tax value concept to encourage heavy oil production. He was not in favor of the BOE concept, but he was in favor of the tax value. His analysis showed a need for wider differences in government take than could be achieved with ACES. He added that new investors attracted to the resources would not benefit from the portfolio blending. He concluded that the terms for heavy oil itself would need to change in order to attract new producers; not because it was cross subsidized from light oil.

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Senator French asked if the lower rate should persist in the future or be timed to the recapture of investment. Mr. Van Meurs responded that both could occur as long as the system that allowed consolidation. He did not recommend different tax rates were included in HB 110. The allowance could be stronger for the first five years then be reduced as a variation of the same concept. He explained he had recommended a flat rate because it was simpler. He did not think it was a major issue and noted that he had not had

time to optimize the system, but variations could be put in place to optimize the economics.

Senator French asked if recommendations were made for other areas. Mr. Van Meurs responded that different cultures required different structures. A similar structure was working successfully in Trinidad and Tobago. The same system did not work in all areas of the world. Details of fiscal terms were different from country to country. Severance structure was also used in Kazakhstan.

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Senator Wagner questioned what the Repsol Company would say to a similar tax structure. Mr. Van Meurs felt that Repsol would find the terms advantageous since the government take on development would be significantly less. He suggested further adjustments could result in a simple system that would work for every resource in Alaska, which would result in further production.

Senator Wielechowski asked if any of the proposals could hurt Alaska, such as cuts to credits, or a move away from resource blending. "Was there any downside?" Mr. Van Meurs stressed that companies and investors would be invited to comment and identify any problems during the development of a new system. He acknowledged that removal of the 40 percent [portfolio blending] would take away the "massive help for exploration" but felt that there would be more exploration in the end. He maintained that exploration was reduced because companies could not see their way through a totally profitable operation, including development. He saw an enormous incentive for companies that had the cash and incentive to explore through to development. He emphasized the need to restore balance between attractive development and somewhat less attractive exploration, which he maintained would attract more business from major oil companies.

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Senator Egan asked if the proposed new fiscal terms would be enough to get the state out of harvest mode. Mr. Van Meurs stated that it would be very difficult to get the producers out of harvest mode because devolvement was so competitive elsewhere. He furthered that the state needed to provide a sense of fiscal stability. He acknowledged

that it would be very difficult to change perceptions but stressed that his proposed changes were a good start. He maintained that Alaska remained valuable in the long-term and new investors would react favorably.

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Mr. Van Meurs observed that if Alaska did not achieve its goals and production kept declining the market would have indicated that something needed to be done; a valuable benchmark would be established as to how fiscal terms may have to be further changed in order to eventually attract investment. He maintained that with the appropriate fiscal and contractual framework Alaska could achieve 1 million barrel per day throughput through the TAPS line, and significant LNG exports. However major political and fiscal change was required, which would be difficult. The sooner the process started to encourage changes the better the future of Alaska would be secured.

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Mr. Van Meurs reviewed the Addendum. He acknowledged that his recommendations represented massive change and might be a "bridge too far" in the short term. He provided proposals in the case that Alaska only wanted to make minor modifications to ACES through the following changes:

- Decrease .4 to .35
- Decrease \$92.5 to \$90
- Start at 0.1 percent increases to a maximum additional rate of 25 percent at \$ 130 per barrel, which prevent a government take of more than 75 percent,
- Establish a 20 percent of gross revenues allowance for new oil production, and
- Limit tax credits to 20 percent on exploration and development.

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Mr. Van Meurs reviewed slide 3, which showed government take under the proposed terms. He noted that the green line on slide 3 should be 2 percent higher.

Mr. Van Meurs observed that it was possible to test the market with a modest change from ACES. He reiterated that

his proposals would not create a "give away" from existing production; would provide stimulus for new production; would not require ring fencing [a protection-based transfer of assets from one destination to another]; and solve four of five deficiencies in ACES.

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Mr. Van Meurs acknowledged that the proposal would not solve all the deficiencies. He asserted that it would be a modest step, but a good step that would solve problems with BOE cross subsidization. The proposal would not create an "architecture" to which new Alaska resources could be added, such as heavy oil, shale oil and natural gas, or provide the stimulus of investment in these resources. He concluded that his proposals was a superior concept to HB 110 and would better protect Alaska with a start in encouraging new oil production.

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Co-Chair Hoffman asked for a breakdown of impact in dollars for slide 3. Mr. Van Meurs agreed to provide the data.

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ADJOURNMENT

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The meeting was adjourned at 2:15 PM.