

SENATE FINANCE COMMITTEE

April 6, 2012

1:04 p.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 1:04 p.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Lesil McGuire, Vice-Chair
Senator Johnny Ellis
Senator Dennis Egan
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Senator Cathy Giessel; Damian Bilbao, Head of Finance, Developments and Resources, BP; Tom Williams, Senior Tax and Royalty Counsel, BP; Senator Tom Wagoner; Bob Heinrich, Vice-President, Finance, ConocoPhillips, Alaska; Scott Jepsen, Vice-President, External Affairs, ConocoPhillips, Alaska; Representative Les Gara; Dale Pittman, Production Manager, ExxonMobil, Alaska

PRESENT VIA TELECONFERENCE

Todd Abbott, President, Pioneer Natural Resources, Alaska, Anchorage

SUMMARY

SB 192 OIL AND GAS PRODUCTION TAX RATES

SB 192 was HEARD and HELD in Committee for further consideration.

SENATE BILL NO. 192

"An Act relating to the oil and gas production tax; and providing for an effective date."

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DAMIAN BILBAO, HEAD OF FINANCE, DEVELOPMENTS AND RESOURCES, BP, introduced himself.

TOM WILLIAMS, SENIOR TAX AND ROYALTY COUNSEL, BP, introduced himself. He noted that he worked as the Commissioner for the Department of Revenue (DOR) for the State of Alaska thirty years prior.

Mr. Bilbao displayed the PowerPoint Presentation, "British Petroleum (BP) Testimony to Senate Finance."

Mr. Bilbao looked at slide 2, "Key Messages."

CSSB 192(Fin):

- is a tax increase that will cause us to re-evaluate existing activity plans.
- is not meaningful and will not lead to more investment.
- likely to create misalignment between producers that slows/stops activity.
- creates more disincentive than ACES to invest in the long-term.

Co-Chair Stedman requested a definition of the range of reference. Mr. Bilbao replied that he would address it in a later slide.

Co-Chair Stedman looked at the word "misalignment", and requested further explanation. Mr. Bilbao replied that by having a different target from each producer could potentially direct investment to a field that could better achieve that project. He stressed that the producer would shift to a field that would better achieve its target.

Co-Chair Stedman agreed that a tax increase was a disincentive. He stressed that there were issues related to cost and "full-cycle" economics. He referred to earlier testimony related to the analysis of full-cycle economics. Mr. Bilbao replied that a tax increase would cause BP to re-evaluate production and exploration activity.

Mr. Bilbao discussed slide 3, "CSSB 192 (version T) Will Not Draw More Investment." He remarked that CSSB 192 (version O) was not attractive. He stated that graphs were provided by PFC Energy, and felt that there was not enough production incentive in CSSB 192.

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Co-Chair Stedman noted that each tax structure increased tax flow to the companies. Mr. Bilbao responded that CSSB 192 would be a larger tax increase than the Alaska Clear and Equitable Share Act (ACES).

Senator Thomas wondered if a meaningful incentive would be a \$2 billion addition to the price of the current oil price. Mr. Bilbao replied that achieving a level of meaningful tax change would return money that would otherwise go to the State to the producers to incrementally invest back into production.

Co-Chair Stedman remarked that there were three entities that were the focus when engaging in tax discussions: industry, federal government, and the state. He stressed that a \$2 billion shift back to the industries, as outlined in HB 110, would also be contributed to the federal government. He noted testimony from consultants that stressed no need for significant change. Mr. Bilbao replied that the assumptions were based on how the costs were modeled. He stated BP took a different perspective, and felt that tax change would encourage and enhance competition in Alaska.

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Mr. Williams looked at slide 4, "CSSB 192 (version O) is a Tax Increase." He stated CSSB 192 was a tax increase at oil prices that affect project economics. He remarked that over time, the resources would deplete. He stressed that oil fields stop producing, before all the oil is taken from the ground. It stops because of substantial cost increases to obtain the resource as the resource is depleted. He stressed that eventually the cost of getting the barrel out of the ground, is the same as value of the oil once it is out of the ground, so money would be lost. He explained that the graph showed curves that assumed that the cost per barrel is maintained, but stressed that costs would not

remain the same per barrel in real terms. He noted that between \$70 and \$130 per barrel there was a "dolphin fin", because there was a gross tax impact on revenue. He pointed out that 20 to 30 percent of industry production costs were not deductible under ACES, because of the 21 categories of costs that were disallowed in statute.

Co-Chair Stedman looked at the value in the FY 13 projections, which was \$22 billion gross. He understood the issue of declined production and increased costs, but pointed out that there was a \$2 billion increase related to a volume problem. Mr. Williams replied that the costs for the new production of heavy oil would be higher than the current costs.

Co-Chair Stedman furthered that there was some analysis of incremental production with a lower progressivity charge, and conversations related to incentivizing heavy oil. He stressed that the industry was not ready for heavy oil incentives, because the industry did not know what financial burdens heavy oil extractions would incur. He expressed concern regarding the industry's refusal to disclose its target range; therefore the legislature was incapable of determining the economics for the individual oil companies. He stressed that the consultants were willing to work with the companies to analyze the economics, but understood that there were disagreements regarding the imbedded cost issues. Mr. Bilbao replied that BP was attempting to provide a range of costs, but was careful about disclosing their confidential planning price. He felt that the range was accurate, and what was represented was starting point.

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Co-Chair Stedman referred to a "hypothetical amendment" stating that the profit level should just be split, and the government take should not level out. Mr. Bilbao replied that any shift above \$120 per barrel would not affect the way BP looked at their business. He stated that BP was basing their assumptions on experience and planning. Mr. Bilbao furthered that it would be premature for BP to determine incentives for heavy oil production, and noted that the focus was on efficiency. He remarked that the only way heavy oil could be produced is if there was enough light oil to dilute the heavy oil to efficiently flow along the Trans-Alaska Pipeline (TAPS).

Mr. Williams added that progressivity was becoming a tax on the gross value, without regard to the cost of oil extraction. He felt that the problem with the gross tax was similar to the problem with the gross royalty, because there was no recognition of the change in the margin per barrel, which could result in zero profits in an older field.

Co-Chair Stedman stated that the projection in FY 13 was \$5.8 billion in total costs, with \$22 billion in gross revenue, and \$7 billion in transportation, at \$110 per barrel. He felt that the analysis needed to be run in dollars, because there were blended costs and broad legacy field calculations. He reiterated that a full-cycle economic analysis needed to be run to determine the rate of return to net present value. He pointed out that the analysis of ACES was currently different than when it was passed, because the price of oil had almost doubled. He stressed that Alaska had the second largest oil field in North America, and wanted to be sure that there was a severance tax.

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Mr. Williams stated that the legislature had originally created a presumption that could not be rebutted: 300 barrels a day were needed to break even, and 1989 legislation changed that problem.

Co-Chair Stedman stated that he would like to focus on dollars, rather than barrels. He pointed out that he did not want the state to be placed at a disadvantage. Mr. Bilbao suggested that there be an analysis of the economics below \$125 per barrel. He stressed that if there was a fixed cost per barrel, and production decreased, costs were going to decrease. He felt that there should be an analysis run of the low base-cost from an industry perspective.

Co-Chair Stedman understood, and noted that there would be a factoring of the inflation index. He stated that his current numbers showed that operating expenditures (OPEX) were running flat, with declining volume.

Mr. Bilbao discussed slide 5, "Unintended Consequences." He noted the Incremental Production Incentives:

Issue: Economic Risk. Concept: Existing production from the legacy fields is the foundation for North Slope present and future; SB 192 penalizes the base business. Impact to the state: Weakens the foundation of the Alaska economy.

Issue: Likely misalignment between operators. Concept: SB 192 provides each producer with a different production target; creating misalignment around projects. Impact to the state: Delay of short-term projects.

Issue: Short versus long-term focus. Concept: SB 192 provides a financial incentive to shift effort and resources away from long-term projects in support of short-term rate. Impact to the state: Delay of long-term projects.

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Co-Chair Stedman noted some work by Senator Wagoner regarding an amendment in the Senate Resources Committee related to incentivizing incremental production. After the consultants analyzed the benefit, it was determined that the incremental benefit was very short-term. He stated that there should not be an increase to the complexity of the current structure. Mr. Bilbao replied with slide 6, "What does meaningful look like." He stated that efficiency, technology, and tax change would collectively result in production growth. He explained that no alternative proves meaningful tax change with a 25 percent base rate. He remarked that there should be one system for legacy fields and new fields. He felt that if there were too many separate tax groups, there was risk of misalignment between the groups. He stressed that there should be no distinction between legacy fields and new fields. He pointed out that most production would be from the existing legacy fields, but the natural decline of the legacy fields was about 15 percent per year. He stated that billions of dollars were spent to maintain the decline at 6 percent per year. He felt that providing incentive for production somewhere other than a legacy field, failed to recognize a misalignment with other producers. He proposed a similar structure to CSSB 192, with a base rate of 22.5 percent, a minimum tax of 5 percent, and the base rate would be in effect until \$80 at which point the progressivity would initiate at 0.2 percent. The 0.2 would max out at \$130 per

barrel at 10 percent, at which point the progressivity rate would rise to 0.1 percent and max out 50 percent at \$180 per barrel. He felt that this proposed structure would provide a meaningful impact in the price per barrel horizon that BP used to look at the projects in the base business.

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Mr. Williams stressed that the base tax rate had "gone too far." He felt that the challenge was to fix the future of oil development.

Co-Chair Stedman would like to focus on the cash flow, and wondered how much cash would be moved around in BP's proposal. Mr. Bilbao replied that the proposal was very similar to HB 110.

Co-Chair Hoffman looked at slide 4, and felt that there was a contradiction in slide 6. He wondered why there was a concern regarding progressivity change, if the company did not feel that progressivity had an impact in their decision making process. Mr. Bilbao agreed that there was not a substantial concern regarding progressivity, but there was an attempt to create something that could enhance what the committee had already constructed.

Co-Chair Hoffman wondered if BP would ask for additional tax rate reductions if the price of oil reached \$170 in the next five years per barrel. Mr. Bilbao replied that he would be surprised to see the price of oil rise to \$170 per barrel, but felt that \$170 per barrel would be good for the industry and the State. He stressed that BP would encourage Alaska to remain as competitive as possible in the international market. He stressed that Alaska was currently one of the least attractive destinations for investment on the planet.

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Co-Chair Hoffman remarked that discussions in structuring ACES used projections of \$30 to \$70 per barrel, with no concern regarding progressivity percentages above \$100 to \$110 per barrel. He felt that the industry would continually come back to the legislature suggesting tax rate restructuring, due to continually price per barrel increases. Mr. Williams replied that in order to avoid

continual industry recommendations, BP proposed a permanent shift in market prices.

Co-Chair Stedman wondered if the company would be pleased with this recommendation. Mr. Bilbao replied that the numbers were looked at a quarterly basis, and the recommendation was consistent with the change.

Senator Egan wondered if the misalignment would foster competition. Mr. Bilbao stressed that the misalignment would provide challenges around short-term decisions. He felt that the current misalignment impacted budgetary decisions.

Senator Thomas wondered who needed to agree for the big projects and investments. Mr. Bilbao replied that the three major producers in Prudhoe Bay needed to agree, before advancing projects. He explained that BP made decisions unilaterally related to the independent fields.

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Co-Chair Stedman wondered how much incremental investment was needed to flatten the decline curve in Prudhoe Bay. He stated that there had been testimony in the Senate Finance Committee that showed an investment of roughly \$3 to \$5 billion annually. Mr. Bilbao responded that \$5 million dollars a day would be needed to offset the decline to 4 to 6 percent.

Co-Chair Stedman asked if \$2 billion would be enough to offset. Mr. Bilbao responded that the \$5 million investment a day was reflective of the next ten years.

Co-Chair Hoffman noted that CSSB 192 would give \$1.25 billion to the industry, and wondered what BP's proposal would give the companies. Mr. Bilbao replied that BP's estimation would be consistent with HB 110.

Co-Chair Stedman wondered if an incremental analysis should be run on the current economics. Mr. Bilbao replied that anything that could the state could do to better understand investment in Alaska would be beneficial.

Co-Chair Hoffman noted that if BP's proposal was close to HB 110, the benefit would be closer to \$2.4 billion as

opposed to the CSSB 192 \$1.25 million return to the industry.

Co-Chair Stedman pointed out that \$277 million would be going out of the state treasury, but that the proposal would decrease government take by \$2 billion.

Mr. Bilbao encouraged the committee to consider the increased revenue and production, if there was substantial tax rate restructuring. If there was additional production, there would be additional government take that would not reduce, minimize, or entirely offset government take from a tax decrease.

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AT EASE

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RECONVENED

BOB HEINRICH, VICE-PRESIDENT, FINANCE, CONOCOPHILIPS, ALASKA, introduced himself.

SCOTT JEPSEN, VICE-PRESIDENT, EXTERNAL AFFAIRS, CONOCOPHILIPS, ALASKA, introduced himself.

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Mr. Jepsen displayed the PowerPoint Presentation, "CSSB 192 Observations." He looked at slide 2, "CSSB 192-Observations."

- Tax rate on base still too high.
- New oil incentive insufficient to offset high base tax rate.
- Floor represents a tax increase at low prices
- Indexing is a positive step.
- CSSB192 insufficient to improve the investment climate and attract capital necessary to stem the decline.

Mr. Heinrich looked at slide 3, "Government Take Comparison vs. ACES." He stated that the graph addressed a range of prices. He declared that government take included state production taxes, royalties, property taxes, state income tax, and federal income tax. He stated that the analysis was conducted prior to the modeling of the progressivity

trigger point indexation, but that progressivity had no impact on FY 13. He explained that the red line represented ACES, the yellow line represented CSSB 192, and the blue line represented HB 110. He stressed that the high minimum gross revenue tax, at 10 percent, had a significant effect on the government rate. He looked at the current price range, \$80 to \$100 per barrel, ACES was highly unattractive competitive with minimal benefit from a reduced government take to incentive additional investment.

Co-Chair Stedman noted the proposed shift of \$142 million loss to the state in FY 13 that was represented in the chart. Mr. Jepsen replied that the State's revenue would actually increase to \$1.5 billion, so the share that would return to the producers was a small share of the government take.

Co-Chair Stedman noted the freezing of the split of profit oil, queried ConocoPhillips' position regarding the profit split. Mr. Heinrich replied that the progressivity aspect of ACES was not beneficial at any cost per barrel. The benefit should be moved to the lower end of the scale. Mr. Jepsen furthered that ConocoPhillips would like a tax framework that had a sufficient split of share between the producers and the state in any price environment. He stressed that there should be a homogenized system, that did not split different fields, projects, new, or old oil; rather one that provided incentives to make investments under any price environment for the best economic projects for the companies.

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Co-Chair Hoffman noted that there were many consultants who had declared that there were no problems with ACES, and industry always commented that ACES need to be fixed on the high end. He wondered why the consultants would be wrong with the current prices at \$100 to \$110 per barrel. Mr. Jepsen replied that the consultants were not investing money. The producers were looking at opportunities in the Lower 48 and other locations around the world, and Alaska was not attractive for the incremental capital investment in other jurisdictions.

Mr. Heinrich reiterated that Alaska was not able to attract the investment it needed.

Mr. Jepsen stressed that the industry was currently in the high price environment, and there was no change in the investment climate.

Co-Chair Hoffman pointed out that Alaska was in harvest-mode for many years. Mr. Jepsen replied that the production in Prudhoe Bay was in decline since 1989. He felt that Alaska was not currently in harvest-mode.

Co-Chair Stedman noted the recommendations from consultants that there should be 70 to 75 percent government take for legacy fields. He noted that the chart did not have the government take exceeding 75 percent. Mr. Jepsen replied that the consultants were not making the investment decisions.

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Co-Chair Stedman wondered how the decline would flatten out in Kuparuk. Mr. Jepsen responded that ACES was not allowing ConocoPhillips the opportunity to devote the resources necessary to devote money to specific projects. He stated that the geologists, geophysicists, engineers, and drillers felt that Kuparuk was "opportunity rich." However, Alaska did not provide an attractive enough investment climate to develop those projects. He felt that HB 110 would encourage investment.

Co-Chair Stedman looked at the graph on Slide 3, and noted the \$2 billion negative spread to the State under HB 110. He stressed that if \$2 billion was taken from the treasury, he wanted to be certain that the industry was going to invest. Mr. Heinrich agreed.

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Co-Chair Stedman wondered what it would take to stabilize Kuparuk. Mr. Jepsen replied that increased drilling was required to revitalize Kuparuk. He noted that increased investment would provide more revenue for the State.

Mr. Heinrich discussed slide 4, "State/Industry Share." He stated that the data was from the current Department of Revenue Sources Book. He stressed that there was no representation of the benefit from the indexation of the trigger points, and only represented the base progressivity elements of the gross tax. He stated that the x-axis was

the Alaska North Slope crude oil price; the solid red and green lines represented the Alaska and producer share at the industry under ACES; the diamond-marked lines represented the Alaska and producer share under CSSB 192; the triangle-marked lines represented the Alaska and producer share under HB 110; and the dashed lines represented the severance tax structure, which was a 25 percent net margin tax under CSSB 192. He stated that the Alaska share represented royalties, production taxes, property taxes, and state income tax. The producer share had a deduction of federal income tax. He pointed out that CSSB 192 was virtually "on top" of ACES in the low price environment below \$105 per barrel.

Co-Chair Stedman requested a restatement. Mr. Heinrich stated in CSSB 192, there was very little improvement as prices increased in the \$120 per barrel price range, making industry earnings "essentially flat."

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Mr. Jepsen looked at slide 5, "Production Incentive."

- New production incentive insufficient to overcome high base tax rate.
- All new production investments challenged by costs and smaller targets.
- Maintaining base decline will require more investment over time.
- Increases complexity.
- Production incentive does not go as far as HB 110.

Co-Chair Stedman wondered if there was something wrong with the economics that the legislature was analyzing. Mr. Jepsen replied that there were not simple variables related to hypothetical projects. He stated that the industry analyzed margins and potential upsides. He stressed that ACES and CSSB 192 did not provide the same kind of "upside" that was available in other jurisdictions.

Co-Chair Stedman felt that he did not have the same information that ConocoPhillips used to present their opinions. Mr. Jepsen stressed that the analysis was similar to the Department of Revenue, but financial projections within the company were confidential.

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Senator Thomas wondered if ConocoPhillips had utilized local contractors and sub-contractors. Mr. Jepsen replied that Alaska Hire would continue to be a focus. He agreed to provide more detailed information regarding Alaskan hiring statistics.

Senator Thomas noted that PFC did not reference Alpine, and wondered if ConocoPhillips considered Alpine to be Colville River. Mr. Jepsen affirmed that ConocoPhillips considered Alpine to be Colville River.

Co-Chair Stedman noted that the magnitude of the spread at \$120 per barrel, HB 110 would provide a cash increase to the companies to approximately \$1.3 billion. He stressed that there was a significant difference between HB 110 and CSSB 192 that needed to be reconciled. Mr. Jepsen replied that CSSB 192 needed to be recalibrated.

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RECONVENED

DALE PITTMAN, PRODUCTION MANAGER, EXXONMOBIL, ALASKA, recognized the work of the committee's work in organizing SB 192. He stressed that the current tax system was not designed to incentive significant increases in investment. He felt that CSSB 192 was an improvement over ACES, but still fell "far short" in creating the kind of significant changes in development investment that was needed by the state. He encouraged the committee to look at all oil fields, especially the legacy fields. He felt that the long-term and near-term future was in the legacy fields. He continued to thank the committee for their work in analyzing the tax system restructuring.

Co-Chair Stedman requested a discussion regarding the needed capital investment to stabilize the production decline. Mr. Pittman felt that there needed to be encouragement to continue to invest in legacy fields. He could not address an exact tactic to stabilize the decline.

Co-Chair Stedman referred to the incremental policy discussion, and pointed out how the producers were separated in CSSB 192 according to a calculated decline

curve and a lower progressivity on the incremental production above the forecasted decline curve. Mr. Pittman stressed that there were some unintended consequences when determining tax incentives. He felt that the principle for new volume investments was good policy, but added that there would be some disagreement in how to incorporate that policy.

Senator McGuire referred to testimony from PFC Energy regarding setting a decline curve. She wondered if there were concerns from ExxonMobil regarding a set decline curve in other jurisdictions. Mr. Pittman was not aware of any jurisdictions in ExxonMobil's business that had set decline curves.

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Co-Chair Stedman pointed out that there was a \$180 million shift to the industry in CSSB192 at \$120 per barrel. Mr. Pittman felt that \$200 million was a large sum of money, but encouraged the committee to understand that ExxonMobil was a large company and \$180 million was small on the broad scope.

Co-Chair Stedman felt that there should be a positive insurance from the industry that there would be a return, if there was a significant tax change.

Co-Chair Stedman queried Mr. Pittman's thoughts related to incentivizing a specific carbon stream. Mr. Pittman replied that cost allocation could be intensive, but felt that there would be some consequences to the industry, and would be detrimental to the state.

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TODD ABBOTT, PRESIDENT, PIONEER NATURAL RESOURCES, ALASKA, ANCHORAGE (via teleconference), thanked the committee for the work regarding SB 192.

Mr. Abbott noted that Pioneer Natural Resources entered the Alaska market in 2002. He pointed out that Pioneer was the first independent operator on the North Slope in 2008. He stated that Alaska was less competitive now than it was in 2002, because of the lower risk high margin project elsewhere in the United States. Alaska had many geographical, logistical, climate, and financial

challenges. He declared that Pioneer had a large inventory of opportunities in the Lower 48, and those projects were easier to execute and bore a lower tax burden than the Alaska projects. He stated that Pioneer had invested \$2.1 billion in Texas oil production, versus \$135 in Alaska. He stated that the cost of logistics for finding, developing and producing the North Slope projects, put those projects at an immediate disadvantage. He explained that the current tax system and the proposed version had widened the divide with the Lower 48, and Alaska's disadvantage was growing as oil prices increased.

Mr. Abbott addressed the gross progressivity feature of SB 192 was counterproductive, and did not make Alaska competitive with the domestic partners. He did not feel that CSSB 192 encouraged investment behavior. He felt that the three tier progressivity system made some reductions in the government take, but did not make Alaska competitive with the domestic alternatives in the Lower 48. He believed that the proposed structure inherently discouraged investment on the higher cost, more difficult opportunities that remained on the North Slope; therefore, lowered the probability of new fields coming online. He stated that Pioneer had supported meaningful and significant production tax reform since the adoption of ACES. While some features of the current proposal were attractive, the progressivity remained "broken."

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Co-Chair Stedman wondered what would be beneficial in order to enhance investment. Mr. Abbott replied that the environment was difficult in Alaska, and there were difficult challenges. There needed a larger accumulation in a more productive well in Alaska, versus smaller wells in Texas, even before taxes. He felt that given the risks and disadvantages in Alaska, there needed to be a more generous tax structure than one in the Lower 48.

Co-Chair Stedman noted that the small producers faced some issues facing a marginal spread, and wondered if Pioneer's profit would balance out in the processing facilities. Mr. Abbott responded that Pioneer produced into the ConocoPhillips station, and ConocoPhillips had a fair working relationship with Pioneer.

SB 192 was HEARD and HELD in Committee for further consideration.

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Co-Chair Stedman discussed housekeeping.

ADJOURNMENT

5:11:41 PM

The meeting was adjourned at 5:11 PM.