

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 18, 2013

1:03 p.m.

MEMBERS PRESENT

Representative Eric Feige, Co-Chair
Representative Dan Saddler, Co-Chair
Representative Peggy Wilson, Vice Chair
Representative Mike Hawker
Representative Craig Johnson
Representative Kurt Olson
Representative Paul Seaton
Representative Geran Tarr
Representative Chris Tuck

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

HOUSE BILL NO. 72

"An Act relating to appropriations from taxes paid under the Alaska Net Income Tax Act; relating to the oil and gas production tax rate; relating to gas used in the state; relating to monthly installment payments of the oil and gas production tax; relating to oil and gas production tax credits for certain losses and expenditures; relating to oil and gas production tax credit certificates; relating to nontransferable tax credits based on production; relating to the oil and gas tax credit fund; relating to annual statements by producers and explorers; relating to the determination of annual oil and gas production tax values including adjustments based on a percentage of gross value at the point of production from certain leases or properties; making conforming amendments; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 72

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/16/13	(H)	READ THE FIRST TIME - REFERRALS
01/16/13	(H)	RES, FIN
02/11/13	(H)	RES AT 1:00 PM BARNES 124
02/11/13	(H)	Heard & Held
02/11/13	(H)	MINUTE(RES)
02/13/13	(H)	RES AT 1:00 PM BARNES 124
02/13/13	(H)	Heard & Held
02/13/13	(H)	MINUTE(RES)
02/15/13	(H)	RES AT 1:00 PM BARNES 124
02/15/13	(H)	Heard & Held
02/15/13	(H)	MINUTE(RES)
02/18/13	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

WILLIAM ARMSTRONG, President
 Armstrong Oil & Gas, Inc.
 Denver, Colorado

POSITION STATEMENT: Testified in support of HB 72.

BART ARMFIELD, Chief Operating Office
 Brooks Range Petroleum Corporation
 Anchorage, Alaska

POSITION STATEMENT: Testified in support of HB 72.

BRAD KEITHLEY, Partner
 Oil and Gas Practice
 Perkins Coie Law Firm
 Anchorage, Alaska

POSITION STATEMENT: Provided a PowerPoint presentation and answered questions during discussion of HB 72.

J. PATRICK FOLEY, Manager
 Land and External Affairs
 Pioneer Natural Resources Alaska, Inc.
 Anchorage, Alaska

POSITION STATEMENT: Provided a PowerPoint presentation and answered questions during discussion of HB 72.

KARA MORIARTY, Executive Director
 Alaska Oil and Gas Association (AOGA)
 Anchorage, Alaska

POSITION STATEMENT: Provided a PowerPoint presentation and answered questions during discussion of HB 72.

ACTION NARRATIVE

1:03:31 PM

CO-CHAIR ERIC FEIGE called the House Resources Standing Committee meeting to order at 1:03 p.m. Representatives Tuck, Hawker, P. Wilson, Olson, Tarr, Seaton, Saddler, and Feige were present at the call to order. Representative Johnson arrived as the meeting was in progress.

HB 72-OIL AND GAS PRODUCTION TAX

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CO-CHAIR FEIGE announced that the only order of business would be HOUSE BILL NO. 72, "An Act relating to appropriations from taxes paid under the Alaska Net Income Tax Act; relating to the oil and gas production tax rate; relating to gas used in the state; relating to monthly installment payments of the oil and gas production tax; relating to oil and gas production tax credits for certain losses and expenditures; relating to oil and gas production tax credit certificates; relating to nontransferable tax credits based on production; relating to the oil and gas tax credit fund; relating to annual statements by producers and explorers; relating to the determination of annual oil and gas production tax values including adjustments based on a percentage of gross value at the point of production from certain leases or properties; making conforming amendments; and providing for an effective date."

1:04:28 PM

WILLIAM ARMSTRONG, President, Armstrong Oil & Gas, Inc., stated the decline curve of the North Sea, which was similar to the decline of the North Slope, was reversed in 1993 by a change in tax laws. He compared the North Slope of Alaska to the Permian Basin [Texas and New Mexico] during the mid-1950s, as they both had about 5,500 wells, whereas the Permian Basin now had about 150,000 wells. He offered his belief that the North Slope of Alaska could also support a similar number of oil wells.

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MR. ARMSTRONG reported that a massive oil boom was now in progress in the Lower 48, including North Dakota, Texas, and New Mexico. He declared that he had reviewed the PowerPoint presentations by other groups, and, although he had been in the oil business for 30 years, he still found the slides to be

confusing. So, he had decided to have a discussion, rather than present a slide show. He shared that, as his was a private company, it did not make press releases or talk to the public. He said that he was talking from the heart. He opined that his company had a unique perspective of Alaska, as it had been working in Alaska for more than 12 years, and was now the most active independent company in the state. He pointed out that three of the most recent oil developments in Alaska had originated in his company's office. Ten years ago, Pioneer Natural Resources had partnered with Armstrong Oil & Gas and they were currently developing the Ooguruk Island Field, the first non-major, independent company development on the North Slope. After this, Armstrong had partnered with ENI in the development of Nikaitchuq Field. He reported that Armstrong was the most active exploration company on the North Slope, and had now teamed up with Repsol on a multi-hundred million dollar exploration program. He stated that Armstrong had three oil rigs looking for new production in new fields outside the Legacy Fields. He offered his belief that Armstrong was the largest lease holder in Alaska, outside the Legacy fields. He reported that Armstrong was a private company, and paid for its own exploration, leases, engineering, and analysis.

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MR. ARMSTRONG opined that Armstrong was one of the best oil finding companies in the world, explaining that the typical business approach was to do all the hard work, including data mining, geophysical, and engineering, to find what he described as "the next big idea." He shared that, although many of these were dead ends, if one was worthwhile, Armstrong would collect all the leases, buy the land, and then search for partners. He noted that, as things in Alaska were so expensive, it was necessary to partner with bigger, more capitalized companies. He compared his company to a Chamber of Commerce for the State of Alaska, as he was constantly extolling the benefits of the state. He reported that the common response to Alaska was that the state had issues, and it was often said to be a state that had oil but was a terrible place to make money, or that it was controlled by ConocoPhillips Alaska, Inc., or that the rules changed regularly for taxes, for permitting, or for unitization. He shared that the most important comment he heard was that the state would take most all the profits.

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MR. ARMSTRONG declared there is an absolute boom going on in the Lower 48. He surmised that it would single-handedly pull the U.S. out of the current morass. He reported that most states had similar production decline problems, but with the advancements in technology, horizontal drilling, and stimulation techniques, most states had turned around their declines. He emphasized that this "boom has completely, totally, unequivocally skipped Alaska." He stressed that there was only one number to focus on and that was the number six, which was the rig count, the number of rigs actively drilling in a region at any one given time. He reported that Alaska had 6 active rigs, whereas Texas had 819, North Dakota had 179, and Oklahoma had 190. He exclaimed that, as stewards of the state, legislators had to ask why Alaska only had six rigs actively drilling. He declared that this was pathetic and anemic.

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MR. ARMSTRONG offered his belief that the answer was obvious, that Alaska had to change on a number of levels. He emphasized that the most important change needed to be with the fiscal regime, which was why his company supported proposed HB 72. He expressed that the proposed bill was not perfect, and needed to be "tweaked in a number of ways, I think, to make it better." He pointed out that things were always going to be more expensive and slower in Alaska. He said that the message could be changed, however, and he stated "don't tell me, show me."

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MR. ARMSTRONG announced that oil and gas companies were not searching for oil and gas, they were searching for money; therefore, the more money they made and the faster they made it, the better. He relayed that "they're voting with their feet in this state, and they're goin' somewhere else." He pointed out that many opportunities still existed for oil drilling on the North Slope; however the man-made investment framework inhibited future exploration.

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CO-CHAIR FEIGE expressed his agreement that proposed HB 72 "was a good starting point." He asked what could be done to improve the proposed bill and increase the rig count.

MR. ARMSTRONG offered his belief that the proposed bill moved clearly in the right direction. He recognized that there was a

battle between the three major oil companies and the State of Alaska, expressing his belief that a state should "cozy up" to businesses that contribute 90 percent to the state revenue. He declared that, even though Armstrong Oil & Gas was a serious competitor with the major oil companies, they needed something to help them out within the existing units because that is where there would be the fastest increase in production. He shared that top personnel at the major oil companies had stated that there was not the same return in Alaska, as was currently being returned for investments in the Lower 48. He stated that there was consensus among the oil producers that Alaska's Clear and Equitable Share (ACES) "outside the existing fields is just gonna kill us." He reported that the three major oil producers were not as actively exploring for oil as Armstrong Oil & Gas, and were instead focused on production in the existing units. He remarked that, as things moved slowly in Alaska, there needed to be an improvement for production timeframes, especially for new entries outside the existing units. He offered his belief that it was necessary to make investment in Alaska "better than any other place," as there were expenses and time delays unlike anywhere else. He declared that, as the state share from oil production in Alaska was not a fixed amount, it was necessary to make the share such that companies wanted to invest in Alaska.

MR. ARMSTRONG suggested that an increase to the gross revenue exclusion (GRE), an extension of the qualified capital expenditures (QCE) tax credits for a few more years before being phased out, and a relief from corporate taxes until there was pay-out would all help induce more oil investment in Alaska.

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REPRESENTATIVE JOHNSON asked if Armstrong would invest or partner in new production if they were aware that ACES "was on the horizon."

MR. ARMSTRONG replied that most companies, when looking at an area to invest, would first determine if there was any profit. He reported that his first investments in Alaska had been during the Economic Limit Factor (ELF) tax system, which he declared was an attractive situation for new entry. He emphasized that, had ACES been in place, Armstrong would not have invested in Alaska, and he opined that the other oil companies would have had similar determinations.

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REPRESENTATIVE JOHNSON asked for a response to the comments that new companies were investing in Alaska, therefore, ACES was working.

MR. ARMSTRONG questioned who would make those statements. He pointed to the rig count as evidence that ACES was not working.

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REPRESENTATIVE JOHNSON suggested that Mr. Armstrong listen, and he would hear these comments regarding the success of ACES.

MR. ARMSTRONG offered that many things were said in Alaska by people who were nervous about reprisal. He shared that his experience had been that new producers did not invest in Alaska because of ACES.

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REPRESENTATIVE P. WILSON suggested that Alaska increase incentives for increased production, and asked whether it would be worthwhile for Alaska to also incentivize getting more oil rigs into the state.

MR. ARMSTRONG replied that production followed activity, and that service contractors followed those companies "making the action happen." He declared that a vibrant oil and gas industry would induce the services to follow, and that he was not sure how to incentivize for more oil rigs in Alaska without available work.

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REPRESENTATIVE TUCK expressed his surprise that Mr. Armstrong had not heard the comments regarding the success of ACES, and he pointed to the activity on the North Slope. He expressed his understanding that increased technology, especially for horizontal drilling, required fewer drilling rigs. He recognized that the seasonal limitations for drilling in Alaska reduced the drilling schedules. He noted that Doug Sheridan, managing director of Energy Point Research, had stated: "the vast improvement in drilling efficiency has caused rig count comparisons between now and prior periods to become less meaningful." He asked if this new drilling technology was being used in Alaska.

MR. ARMSTRONG replied that the new technology was "definitely being applied a little bit." He expressed his agreement for its increased efficiency. Referring to the testimony in support of ACES, he suggested that this support would likely focus on the credits, whereas any discussion for the take by the State of Alaska would have a very different response from producers.

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REPRESENTATIVE TUCK asked about the impact of proposed HB 72, as it eliminated almost all the credits.

MR. ARMSTRONG replied that this would have a lot of impact on some companies as they had been operating under that business strategy. He suggested that any elimination of the tax credits should be phased, as business strategies were based on these tax credits. He addressed the efficiencies of drilling, and explained that the breakthroughs currently happening in the Lower 48, long, lateral wells with multi-stage frac technology, were just getting started in Alaska. He commented on the only new technology attempt that he was aware of, a really modern approach to a well on the North Slope, which he described as "off the hook successful." He offered his belief that it was a harbinger of future technology, if companies would come to Alaska. He noted, though, that compared to those in the Bakken Field, North Dakota, this oil well would be called "Bakken Light." He opined that this was the future in Alaska, stating that it would work fantastically.

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REPRESENTATIVE SADDLER surmised that ACES had been conceived as a balance of upfront incentives and credits, with high taxes on the production. He asked about the importance of tax credits versus progressivity for the investment decision making by an oil producer.

MR. ARMSTRONG replied that the credits really helped, but that he was unsure if it had been tested, as the majority of companies operating under ACES had not yet gotten to the point of "really making big profits." Returning to the discussion of rig count, he declared that this was a clear indicator that something was wrong with the current tax system.

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MR. ARMSTRONG, in response to Representative Saddler, emphasized that ACES needed to be completely revamped, suggesting that it be deleted.

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REPRESENTATIVE JOHNSON asked to clarify that the rig counts mentioned earlier were up to date.

MR. ARMSTRONG replied that these counts were correct, although he expressed agreement that oil rigs had gotten more efficient. He reported that there had been 300 rigs in the Lower 48 four years prior, and that currently there were 1300 oil rigs. He pointed out that this was not happening in Alaska.

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REPRESENTATIVE SEATON asked for the rig count in Alaska during ELF.

MR. ARMSTRONG offered his belief that it had been higher than it was currently.

REPRESENTATIVE SEATON pointed out that there had been a very low rig count during the PPT and ACES legislation, which had led to a production tax. He questioned whether there had also been a very low rig count during the zero tax rates on many oil fields.

MR. ARMSTRONG noted that when Armstrong Oil & Gas arrived in Alaska in 1999, the price of oil was \$25 per barrel. Since that time, the technological breakthroughs had been astounding, which made it difficult to compare the current rig counts with those at that time.

REPRESENTATIVE SEATON asked to ensure that discussion of comparisons included the different parameters in Alaska.

MR. ARMSTRONG pointed out that there had been a low rig count everywhere in 1999.

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REPRESENTATIVE OLSON asked if the regulatory climate had improved, specifically for the Cook Inlet gas.

MR. ARMSTRONG replied that it was better, and he lauded Anchorage Mayor Sullivan for changing and streamlining the

rules. He declared that a change for the tax laws was not a silver bullet because the regulatory system and permitting also needed to be changed. He offered an anecdote for one project in Alaska compared to a project in Texas, declaring that Alaska had to become more competitive.

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CO-CHAIR FEIGE encouraged Mr. Armstrong to provide additional written testimony and suggestions for improvement to the proposed bill.

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BART ARMFIELD, Chief Operating Office, Brooks Range Petroleum Corporation, presented a PowerPoint. He reviewed slide 2, "HB 72 Support/Considerations." Directing attention to AS 43.55.023(a), he said that proposed HB 72 allowed the payment of single year certificates, as opposed to 50 percent in the first year, and then 50 percent again in the second year; however, this would be eliminated after 12/31/13. He proposed either an extension of this or the adoption of AS 43.55.023(l) which should be applied to the North Slope. He also suggested a redefinition of AS 43.55.025. Referring back to AS 43.55.023(l), he shared that this allowed a 40 percent tax credit for intangible well work, as opposed to subsection (a) which included the entire capital budget.

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MR. ARMFIELD addressed his support for AS 43.055.011(e) which eliminated progressivity and maintained the 25 percent base tax.

MR. ARMFIELD pointed out that AS 43.55.023(b) was a credit that his company would prefer to not receive, as it would mean that his company was losing money in Alaska. He noted that subsection (b) also expired, in its current form, at the end of the year, and that those credits could not be cashed. He stated that they would be applied, after two years, to the tax burden, and could be used to offset that burden. He declared support for the 15 percent interest on those unused credits.

MR. ARMFIELD shared that AS 43.55.024(c), which proposed to extend the small producer credit to 2022, had been suggested by his company.

MR. ARMFIELD declared support for the concept in AS 43.55.160, although the proposed language "does not contain land that was in a unit on January 1, 2003." He reported that this would cause a problem for his company as his first two projects were in a unit on January 1, 2003, and would not be eligible for this credit.

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MR. ARMFIELD directed attention to slide 3, "Reasons for Entering Alaska," which listed the reasons why his company came to Alaska in 2000. He pointed out that oil prices had been very low, and that the Lower 48 wells had struggled to break even or recover operating expenses. He noted that, as his company was very small, it did not warrant pursuit of a low oil price as the prospect reserve base was not attractive. In the Lower 48, deals coming through the office were few and far between and did not justify the cash or the risk that would be entailed. He reported that the big reserves, high production rates, and an acceptable cost of doing business finally prompted the company move to Alaska. He emphasized that the ELF tax policy was not an impact consideration in 2000, as it was a common tax structure in the Lower 48. He shared that his company had arrived under ELF, had worked through the Production Profits Tax (PPT), had been exposed to ACES, and was now preparing for a new system. He explained that another factor promoting his company move to Alaska was the expectation that industry cycles would reveal that the big companies would lessen their efforts and that the independent companies would "backfill that, as traditionally been done" in other regions. He concluded that these had been the reasons and drivers for the move to Alaska.

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MR. ARMFIELD presented slide 4, "What does Alaska have to offer??" He stated that the world class reserve base in Alaska in 2000 had been instrumental. He explained that because of the current high oil prices, the technology discussed in earlier testimony, and the advancements being made, the huge amounts of reserves in the Lower 48 were now being opened up as they were economical. He declared that the big reserves and big flow rates were now swaying this current economic environment. He noted that the Lower 48 had a more accessible infrastructure and a better cost environment for cheaper well drilling than Alaska. Referring to the relative oil price, he explained that the differential had shifted, as Alaska oil was now trading at a higher price, although developments in the Lower 48 could shift

the prices once again. He noted that he would discuss the credit structure a bit later. He declared that he was not going to debate the impacts of the tax policy, as it was the perception of tax consequence that was more widely recognized in the Lower 48. He addressed the final point on slide 4, the "confidence in a 5 to 10 year business plan," and announced that people had more confidence with investments in the Lower 48.

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MR. ARMFIELD presenting slide 5, "Why more players are not in Alaska," stated that his company looked for three key elements with new partners in Alaska. He listed an aggressive desire to be in Alaska; a knowledge base to understand geology, operations, lease administration, native relations, and politics; and the financial capacity to execute in Alaska. He declared that very few companies had all three of these prerequisites.

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MR. ARMFIELD stated that the reality was that most companies were "very content to stay in their own backyard, their core business areas." He noted that high oil prices had taken the focus off Alaska and onto the Lower 48. As most of these companies had established relationships with investors and traditional capital sources, there was not a compelling reason for them to move to Alaska. He declared that most businesses wanted to be able to plan and execute a five-year business plan, at the least, yet the current changes made the process very difficult. He emphasized that Alaska required very patient capital, noting that his company had yet to make a revenue stream in its 12 years in the state. He opined that Alaska was an educational process for all three of the aforementioned key elements, and that finding new investors for Alaska was a long process.

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MR. ARMFIELD quickly reviewed slide 6, "Credits have helped keep us in the game," which identified the four credit structures that affected his company. He explained that the Qualified Capital Expenditures (QCE) was the most relied on credit. He confirmed that the carry forward loss credits (CFL) meant that the company was losing money. He indicated that although the small producer credit (SPC) was good, he hoped that his company grew beyond the need for that credit. He expressed his

displeasure with the exploration incentive credits (EIC) and he pointed out that his company did not qualify and had never received this credit.

MR. ARMFIELD directed attention to slide 7, "AS 43.55.025 Limitations," which mapped the limits for the EIC credit. He explained that the mass of wells in the center were Prudhoe and Kuparuk, the small dots were individual wells, and the surrounding ring was a three mile buffer around each well, with a 25 mile buffer around the producing units. He noted that the Brooks Range Petroleum leasehold position was right in the heart of that, hence it would never be able to qualify for EIC. He stated that it was necessary to move quite a way from existing activity to qualify. He referenced slide 1, and reminded the committee that he had suggested a redefinition for EIC that would eliminate some of the limitations and make it more accessible to activity.

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MR. ARMFIELD said that a similar chart to slide 8, "Tax Credits History & Forecast," had been seen previously by the committee, although this was a re-creation to show Brooks Range Petroleum's share of credits that had been refunded. He pointed out that the grey reflected the refunded credits, versus credits received through a reduction to tax burden in red. He indicated that the 2013 Brooks Range Petroleum share, about \$3 million, was stated on the bottom left. He reported that the company had received \$69 million in credits, and he pointed out that, in 2011, his was the only exploration company with a well drilling on state land on the North Slope, although it was of minimal impact.

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MR. ARMFIELD provided slide 9, "Impacts to Mustang Development Funding." He reported that an ice road was being constructed in order to allow a gravel access road to the Mustang development. Referring to the bar graph on slide 9, he explained that the top section reflected the impact under ACES: the green bars were CapEx to Brooks Range Petroleum, the blue bars were the capital credit and loss carry forward contributions from the State of Alaska, and the right side was a summary of those years. He observed that the red box in the right corner showed that \$205 million in received credits had a \$1.2 billion revenue stream to the State of Alaska with royalty, base taxes, and progressivity under ACES. He indicated the lower graph, which compared these same numbers under proposed HB 72, with the applicable share of

credits for the State of Alaska eliminated after 2013. This would reduce the capital exposure from \$205 million to \$81.5 million, and would require Brooks Range Petroleum to increase its funding request by \$124 million because of de-sanctioning under ACES.

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MR. ARMFIELD moved on to slide 10, "Forecast by Development Project," which detailed five planned developments. The first was the Mustang Development, with peak throughput of just less than 15,000 barrels of oil each day, and revenue to the State of Alaska of \$1.2 billion. He expressed his hope that the peak production of all five projects would reach 55,000 barrels of oil each day, with revenue of \$4.4 billion to the State of Alaska. He clarified that this revenue included the \$561 million of credit support under ACES. He explained that the annual average was derived from the 15 year life expectancy of each field, divided into the State of Alaska revenue of \$4.4 billion, with an average return to the State of just under \$300 million each year. He theorized that 10 new entrants of similar size would replicate annual average revenues to the State of Alaska of almost \$3 billion.

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MR. ARMFIELD introduced slide 11, "Combined Development Projects and Throughput Forecast," which projected the throughput forecast of 55,000 barrels of oil per day, and the projected capital budget of \$2.2 billion. He reported that the royalty and production tax would equal \$4.4 billion of revenue to the State of Alaska. Directing attention to the right side of the slide, he explained that the projected leasehold royalty share to the state was for 1/6, however this was a 33 percent bonus over the 1/8 royalty share. He combined this loss of revenue with the loss of credits in proposed HB 72, a projected loss of revenue of \$1.1 billion for the projects.

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MR. ARMFIELD indicated slide 12, "One Size Does NOT Fit All," and offered his belief that there were four tiers of players in Alaska. He suggested that Brooks Range Petroleum was included in the Exploration and Discovery Tier, whereas the New Entrants Tier would include as yet unknown companies. He urged that the committee consider all four tiers and the effects generated on each tier, as it moved forward in reviewing tax policy.

MR. ARMFIELD concluded with slide 13, "HB 72 Support/ Considerations," which was the same as slide 2, and he asked that the committee review these considerations.

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REPRESENTATIVE P. WILSON referred to slide 11, and asked if the preference was for ACES over proposed HB 74 because of the difference in royalty shares.

MR. ARMFIELD responded that the royalty shares had nothing to do with ACES. It was "just a burden of fact that I wanted to point out," although it was not in ACES or proposed HB 72. He clarified that this royalty, in addition to the elimination of capital credits, would reduce his revenue.

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REPRESENTATIVE P. WILSON asked for more clarification.

MR. ARMFIELD explained that the royalty share was determined by his company's lease position of 1/6 on the North Slope, and, in this case, it was 16.67 percent (1/6) of revenue, which was paid to the State of Alaska. He reported that there were also lease positions of 1/8 on the North Slope, which generated 12.25 percent of revenue to the state. He pointed out that, for these projects, the revenue difference between 1/8 and 1/6 was \$542 million, which he declared to be an additional burden that needed to be considered, especially in consideration of the elimination of the capital credits.

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REPRESENTATIVE P. WILSON asked to clarify that the royalty differential of \$542 million could be used by Brooks Range Petroleum instead.

MR. ARMFIELD expressed his agreement.

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CO-CHAIR FEIGE confirmed that the State of Alaska had ways to apply for royalty relief, as the original economics of the project had been based on a previous tax regime, assuming that proposed HB 72 was passed. He asked if the existing rules for

application for royalty relief were sufficient, or would additional provisions be necessary.

MR. ARMFIELD replied that he had not yet modeled that, as everything under ACES was the one-sixth royalty. He established that an elimination of capital credits, with an increase for near term capital needs, could require reconsideration of the royalty position, if proposed HB 72 was passed.

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REPRESENTATIVE TUCK, referencing the carryforward tax credits, noted that development was seasonal due to the weather. He asked if 10 years was an adequate amount of time to reach production, in order to take advantage of these credits.

MR. ARMFIELD responded it was a project-by-project calculation. Noting that his company was currently 12 years into its projects in Alaska, he suggested that it now had momentum, which would reduce that timeframe between discovery and production throughput.

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REPRESENTATIVE TUCK asked to clarify that the 10 year timeframe was feasible.

MR. ARMFIELD said that he was comfortable with the time frame under the current credit structure; however, with the increased pressure to come up with an additional \$124 million of capital budget for one project, some of the projects would be delayed due to a need for more upfront cash to move forward aggressively.

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REPRESENTATIVE SEATON, expressing his desire to better understand the limitations of proposed HB 72, asked if the restriction on the effective use of the offered credits was a hindrance when seeking financing.

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MR. ARMFIELD, in response to Representative Seaton, said that although loss carry forward credits were important on the front side, business decisions were not based on these credits. He declared that the restrictions on credits would make it more

difficult, but that the company goal was to not qualify for those credits.

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REPRESENTATIVE SEATON asked whether those credits were meaningless for financing, as it was uncertain for qualification for the credits. He surmised that cash flow was difficult to project before the project came on-line and the taxes generated would offset the 25 percent base rate for previous investment.

MR. ARMFIELD, clarifying that the project financiers would view the loss carry forward as an assured bankable position, stated that this would present an uncertainty, although any business model that projected continued losses over 10 years was not a good funding prospect.

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CO-CHAIR FEIGE encouraged Mr. Armfield to provide additional written testimony and suggestions for improvement to the proposed bill.

[2:21:52 PM](#)

BRAD KEITHLEY, Partner, Oil and Gas Practice, Perkins Coie Law Firm, stated the importance of this proposed bill for the future of Alaska. He clarified that he was not speaking as a representative for any clients, noting that he had been working in the oil industry for 35 years and in Alaska since 1993.

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MR. KEITHLEY directed attention to the PowerPoint, titled "Comments on SB 21/HB 72." Addressing slide 3, "Five things ...", he stated that there were five things to look for in oil tax reform: competitive rates, durability, neutrality, simplicity/predictability, and alignment. He declared that the core goal for these five was to find a way to grow the pie, slide 4, "Goal: Grow the pie." He declared that there was an opportunity in Alaska to significantly improve the state's position, and he referred to the chart on slide 4, which had been taken from testimony submitted to the legislature in 2006. He explained that the chart reflected three futures for Alaska. The first of these production decline curves showed the result if no additional investment in Alaska, which was a 15 percent decline. The second curve was a 6 percent decline, which

reflected business as usual. He opined that the third curve was the future of Alaska, which depicted a 3 percent decline, and he pointed to the chart which shared the additional barrels of oil for each change in decline. He declared that it was the investment dollars that would drive each rate of decline. The 15 percent decline curve was the result of a zero additional investment, the 6 percent decline curve was the result of an additional in the ground investment for oil and gas of \$1 - \$1.5 billion each year, and the 3 percent decline curve would result from a \$2 - \$3 billion investment each year. He noted that the annual investment needed to increase in order to move the decline curve further to the right, "growing the pie for the State of Alaska."

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MR. KEITHLEY referred to slide 5, "Competitive Rates," and pointed out that Commissioner Sullivan, Department of Natural Resources, had projected a need to invest \$4 billion in the oil industry each year. Commissioner Sullivan had observed that "we're not even close to that now..." He affirmed that the five things previously mentioned, competitive rates, durability, neutrality, simplicity and predictability, and alignment were all necessary for Alaska to reach its future potential. He declared that competitive rates were necessary to attract the sustained, long term capital which would move Alaska's decline curve to the right. He emphasized that, in order to attract this capital, Alaska needed to be competitive across the full anticipated long term price range, which were the range of prices that the investment could pay out. He explained that a long term investment necessitated pay out across the full price range during the investment cycle.

2:28:02 PM

MR. KEITHLEY referenced slide 6, "Competitive Rates," pointing to the chart on the upper right which depicted the cost of oil as low as \$70 per barrel, and he repeated that the fiscal regime needed to be competitive across the entire price range. He determined that a problem with ACES was its un-competitiveness at the higher end of the price range, whereas proposed HB 72 could just reverse the problem. If it was not competitive at the lower end of the range, this would just be an exchange of one problem for another.

MR. KEITHLEY moved on to slide 7, "Durability," and announced that this was a major problem with HB 72. He explained that the

substantial long term investments necessary to move the decline curve to the right were a 15 - 25 year investment cycle. He stated that a fiscal regime which changed its economics halfway through a cycle was not a good investing scenario. He shared that some countries used contracts to establish a stable fiscal system, whereas other countries used economic stabilization clauses which balanced any increase to taxes in one area with a decrease in another.

[2:30:36 PM](#)

MR. KEITHLEY referred to the British Columbian discussions for changes to its tax structure, slide 8, "Durability." The premier of British Columbia had proposed a new tax on LNG that could potentially have a significant effect on the investments, yet the premier would not be able to discuss any of the proposals considered until after the negotiations were completed. She had stated "we have to make sure that, first of all, we are getting maximum benefit for the people of our province, and at the same time that we aren't imperiling their business case, because if we want to be competitive, we need to do that through the course of negotiations with (industry) so that's what we're working on right now." He cited this to be another means for durability, have the government negotiate with industry for the long term durability. He pointed out that this had been a significant problem in HB 72 or ACES.

MR. KEITHLEY called attention to the graph on slide 9, "Durability," and declared that durability was suspect in Alaska. He noted that these slides had been prepared for a study by the Institute of Social and Economic Research (ISER), which had analyzed the current state of the Alaska fiscal situation and had reached this conclusion: "In its 10-year fiscal plan, the state Office of Management and Budget (OMB) projects that spending the cash reserves might fill this gap until 2023." He explained that the Constitutional Budget Reserve might fill the gap between this projected revenue and the projected annually increased spending of 4.5 percent, which he assessed as less than was historically recognized. He went on to quote the ISER study: "Reasonable assumptions about potential new revenue sources suggest we do not have enough cash in reserves to avoid a severe fiscal crunch soon after 2023, and with that fiscal crisis will come an economic crash."

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MR. KEITHLEY assessed that a producer reviewing the various investments needed to move the decline curve to the right would not invest in a situation that projected a fiscal gap in the middle of the economic cycle, especially in a state which had historically taxed the industry as a solution. He questioned whether the current system was durable, offering his belief that it would lead investors to have substantial concerns for doing business in Alaska.

MR. KEITHLEY furnished slide 10 and slide 11, "Neutrality," and he offered his belief that the government should not favor one investment over another. He declared that market dynamics changed too rapidly for government to attempt to second guess the market. He endorsed that exploration and production should be treated equally, and that the government should maintain neutrality. He expressed that proposed HB 72 had better neutrality than ACES, as it expanded incentives for both exploration and production in new fields. However, the proposed bill overlooked an important area, the significant potential to realize improved recovery rates from inside existing fields. "When production started at the Prudhoe Bay field the recovery rate of the 25 billion barrels of oil in place was expected to reach 40 percent. Today, using new technologies that estimate has increased to more than 60 percent." He explained that each 1 percent of improvement in recovery rate equaled an additional 250 million barrels of oil. He referenced the chart on the top right of slide 11, which listed the expected field size, and he stated the necessity to not discourage work inside the fields to increase the recovery rate.

[2:37:12 PM](#)

MR. KEITHLEY indicated slide 12, "Simplicity/Predictability," and offered his belief that proposed HB 72 was much simpler than ACES, and that it measured well globally for simplicity and predictability.

MR. KEITHLEY presented slides 13 and 14, "Alignment." He defined this as the alignment between the state and investors for growing the pie. He reflected that too often Alaska had argued about the state's fair share rather than work to grow the pie. He pointed out that there were many worldwide examples for governments and investors successfully working together, and he suggested a review of these arrangements. He opined that Alaska relied on indirect policy tools, citing the use of the "carrot" for fiscal investment, and the "stick" for regulatory action. He offered his belief that a base rate of 25 percent would not

encourage investment. He offered an analogy that the State of Alaska was attempting to drive the industry from the back seat of the vehicle. He opined that better ways had been developed for alignment with the oil industry. He pointed to Norway as a successful example for increasing investment and growing the pie. He cited Petoro as a leader in driving industry investment and identifying new opportunities for Norway, which had resulted in a much better success rate than Alaska for growing the pie.

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MR. KEITHLEY, recapping slide 15, "Summary of Conclusions," declared that proposed HB 72 was not competitive at a full range of anticipated prices, specifically at lower prices. He announced that durability was "a huge problem" as there was not any mechanism to ensure durability with the Alaska fiscal policy. He explained that neutrality still had some tilt, which could discourage investment in existing fields to increase recovery rates. He stated that, although the simplicity had been substantially improved, the alignment was not configured with the goal for growing the pie.

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MR. KEITHLEY concluded with slide 16, "Recommendations," and offered three specific suggestions. First, he suggested adoption of HB 72, with amendments to make it competitive across all anticipated price ranges, and to provide GRE or similar incentives for investments designed to increase ultimate recovery rates in the existing fields, which he declared to be the greatest source of oil that could be developed in Alaska. He stated that it was necessary for the proposed bill to not distort the economics for this recovery. He opined that the committee "would be well served to identify fiscal policy concerns in forwarding the bill to the Senate and the House Finance Committees." He shared that, even should this become the perfect tax bill, the oil industry would still project where Alaska's fiscal policy was leading. With the projected fiscal gap in 2023, as well as the ISER analysis, the oil industry would still not want to invest in this investment cycle of fiscal uncertainty. Lastly, he urged that the House Resources Standing Committee hold hearings on a shift from the "royalty" to the "co-investment" model, as Norway had done. He reported that Norway had found the "royalty model" to be inefficient and not attractive for the levels of required investment.

[2:43:58 PM](#)

REPRESENTATIVE P. WILSON, noting that the oil companies did not have any reason to trust Alaska, asked how discussion could move to co-investment, instead of "see what we can each get."

MR. KEITHLEY, in response to Representative P. Wilson, explained that this was one of the reasons for the policy shift in Norway, that co-investment with the oil industry was the best way to get government and industry aligned.

[2:46:06 PM](#)

REPRESENTATIVE SEATON asked if the earlier witnesses would be available for questions.

CO-CHAIR FEIGE said that he would ask.

REPRESENTATIVE SEATON suggested that it would be helpful for committee, instead of individual, discussions.

[2:47:10 PM](#)

J. PATRICK FOLEY, Manager, Land and External Affairs, Pioneer Natural Resources Alaska, Inc., offered to share the thoughts and suggestions from Pioneer for what affected and motivated its business, and how they made investment decisions for the future in Alaska. He said that he would have comments and suggestions specific to proposed HB 72.

MR. FOLEY presented an overview of Pioneer Natural Resources, and stated that it had a \$19 billion enterprise value, with 3500 employees, and a \$3 billion capital budget with \$2 billion of cash flow for those operations, slide 4, "Pioneer Natural Resources." He declared that the company was a leading performer within its peer group, and initially had been a partner with Armstrong Oil and Gas, in 2002. He reported that success in the first year led to the development of the Ooguruk oil field. He shared that there were about 70 full time employees in Alaska, with an additional 150 - 300 contract workers in-state, and an annual payroll of \$14 million. He listed the contract companies that Pioneer worked with in Alaska, reported that the capital budget for 2013 was about \$180 million, and that current production was about 6,000 barrels per day, with a projection of 40 percent growth in the next two years.

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MR. FOLEY considered slide 5 "Pioneer Alaska Profile: Oooguruk," and relayed that the company had drilled 11 exploration wells resulting in 1 commercial project, Oooguruk, and that Pioneer was the operator, with 70 percent ownership. He offered that their experience had shown that there was about a one in ten success rate for drilling. He revealed that more than \$1 billion had been spent in development of Oooguruk, resulting in production of 12 million barrels of oil, and credits of \$270 million from the State of Alaska, equivalent to 7 percent of total credits issues by the state. He declared the necessity to preserve the credits, especially when modifying the proposed bill.

MR. FOLEY referenced the fiscal policy timeline on slide 5, and pointed to the changes in the last 10 years. He said that, under ELF, the expectation had been for a production tax rate of zero percent. However, under Governor Murkowski, PPT had been introduced, which was a short lived modest improvement for the oil companies. Shortly after this, the tax rate increased and progressivity was introduced under ACES, all of which made for a worsening fiscal metric for the oil companies. He declared the need for stability and favorability with a tax program in order to make investment decisions.

[2:53:17 PM](#)

MR. FOLEY indicated slide 7, "What's Next?" and explained that the Nuna Project, an onshore drill site with offshore reserves, was Pioneer's next development. This required extended reach wells, and he pointed to the map on the slide, which outlined the Pioneer leases. He reported that a second well had just been finished, and he touted the immediate production success of the first well, almost 4,000 barrels of oil each day. He reported that, a year later, the well was still producing 1500 - 1700 barrels each day. He informed that the cost to drill each well was \$50 million, as the reservoir was "tight rock, laminated, and requires very large fracture treatment." He explained that the first well had caused a shift in business to now drill long horizontal wells with large frac treatments. He noted that fracs were measured by the volume of sand that was pumped. He said that these were substantially bigger than any in Alaska, although small in comparison to the super fracs in the Lower 48.

[2:56:07 PM](#)

MR. FOLEY offered his hope to take the Nuna Project to Pioneer's investment committee and request approval for \$1 billion to move "full speed ahead with development." He reported that this project had an oil accumulation of 50 million barrels, with projected peak production of 14,000 barrels each day. He opined that these projects would not "be a needle mover for the State of Alaska" and would not solve the financial problems, although they would make a contribution. The biggest contribution would come through jobs and the associated economic impact, he said.

MR. FOLEY moved to slide 7, "Competition For Alaska - An Independent's View," and explained that this provided a comparison for key investment decisions on Alaska's competitiveness with the Lower 48, which included resource potential, geologic risk, and oil bias. He observed that things had changed since Pioneer arrived in Alaska in 2002, as the resource potential, specifically with shale, in the Lower 48 was now at least as attractive as Alaska. He pointed out that the profitability report card was all weighted toward the Lower 48, as projects had less risk, faster cycle times, faster payback, and easier execution with greater operational flexibility. He identified that Pioneer had an island development that would run 365 days a year, and that it could not be started and stopped, which was in contrast to the Lower 48 projects which could react monthly to changes in the market environment by moving drilling rigs or adding people. He declared that the Lower 48 had a lot more operational flexibility.

[2:58:57 PM](#)

MR. FOLEY provided slide 8, "Pioneer Competitive Resource Opportunities," which compared the various Pioneer shale oil projects in Texas competing for investment funding against Alaska. He reported that these areas would drill more than 300 wells, with a \$2.5 billion budget for the 40 operating drill rigs. He shared that there were 20,000 locations to be drilled. By comparison, there were about 6 wells drilled annually in Alaska. He offered this, not as a criticism of Alaska, but in the hope to craft better fiscal policy for more attractive investments in Alaska.

[3:00:47 PM](#)

MR. FOLEY reviewed slide 9, "2013E Capital Spending and Cash Flow," and stated that Pioneer had a \$3 billion capital budget for 2013; although the majority would be spent in Texas, \$190 million, about 7 percent of the total drilling capital, would be

spent in Alaska. Describing the source of the capital budget, he noted that \$2 billion would be sourced from cash flow, and about \$600 million would come from a joint venture with Sinochem, an arm of the Chinese national oil company. The remainder, \$400 million, would be raised from sales of company stock. He commented that, as Pioneer was an independent company, it was important for them to manage its debt, and even a low interest loan would increase debt. For this reason, capital credits were important to his company.

[3:03:05 PM](#)

The House Resources Standing Committee recessed until 5:30 p.m.

[5:31:49 PM](#)

CO-CHAIR FEIGE called the House Resources Standing Committee meeting back to order at 5:31 p.m. Representatives Hawker, Johnson, Olson, Seaton, P. Wilson, and Feige were present at the call back to order. Representatives Tarr, Tuck, and Saddler arrived as the meeting was in progress.

[5:31:58 PM](#)

MR. FOLEY continued his presentation with slide 10, "SB 21/HB 72," and announced that the proposed bill had derived from the Governor's four guiding principles for changes to tax policy: to be fair, to stimulate new production, to be simple and balanced, and to be competitive. He confirmed support for each of these goals, although there were some changes necessary in the proposed bill to accomplish each of these goals.

MR. FOLEY established that it was necessary for the North Slope oil producers to have a healthy industry with a tax policy that motivated investment. He affirmed that positive aspects of the proposed bill included the elimination of progressivity, extension of the small producer credit, gross revenue exclusions (GRE) for the fields outside the legacy fields, and an escalating loss carry forward. Some of the negative aspects included the loss of capital credits and the lack of inclusion of GRE for the legacy fields.

[5:34:55 PM](#)

CO-CHAIR FEIGE asked for a suggested change to the loss carry forward credit.

MR. FOLEY said the rest of his presentation will be explaining the costs and advantages, although the upside does not match the downside, at least for a company like his.

[5:35:49 PM](#)

MR. FOLEY introduced slide 11, "Relative Rankings," and reviewed the companies in Alaska. He listed Exxon as a \$400 billion market capital company, Shell, Chevron, and BP as \$200 billion companies, and finally Pioneer, a \$19 billion market capital company. He stated that the financials for private companies were not public. He suggested that tax policy to help the state move forward would incentivize all of the companies, not just some, so that all the companies were flourishing and investing in projects throughout Alaska. He reported that the development from first idea to first oil could be 7 - 10 years, as modeled by the Oooguruk development. He offered his belief that new production in Alaska during the next decade would most likely come from one these companies already in Alaska.

[5:37:36 PM](#)

MR. FOLEY addressed slide 12, "What is an Independent Oil and Gas Company?" He defined an independent company as a non-integrated oil company, which focused on the exploration and the production side of the industry, with no refining or marketing. He stated that the 18,000 independent oil companies in the US came in all sizes, drilled about 94 percent of all the oil and natural gas wells, and accounted for 2.1 million jobs. He acknowledged that independent companies had different financial motivation, in so far as investors were rewarded for growth and debt management, not for dividend or return. He referenced a quote by Doug Smith, which stated that small companies were important because they spend money, they offer jobs, and they help with the economy.

[5:39:24 PM](#)

MR. FOLEY furnished slide 13, "Eagle Ford Operators and Companies," and explained that the core business for Pioneer included heavy involvement in Eagle Ford. He pointed to the large list of companies actively involved in Eagle Ford, noting that some of them were also doing business in Alaska. He asked what could be done with the tax policy to encourage these investors to come to Alaska. He directed attention to the chart on the right of slide 13, which graphed the required Capital Expenditure per barrel and Operating Cost per barrel, revealing

that Alaska projects were more expensive than projects in the Lower 48. He reported that the Pioneer production costs in Oooguruk would be about \$15-\$20 per barrel for capital expenditures and about \$10-\$20 for operating costs per barrel. He pointed out that, in Alaska, there was a lot of water per barrel, which caused an increase in operating costs.

[5:41:07 PM](#)

MR. FOLEY moved on to slide 14, "SB 21/HB 72: Econ One Initial Project Evaluation," which represented a conceptual project for a \$1 billion capital investment for 50 million barrels of oil. The slide evaluated the project using ACES and proposed HB 72, using common operating expenses, capital expenditures, and rates. This conceptual project would be \$115 million better off using the new tax idea in proposed HB 72 rather than using ACES. He said that it did not describe the opportunities presented for Pioneer.

[5:42:27 PM](#)

MR. FOLEY detailed that slide 15, "Typical New Project Spend Profile," depicted that same project for a \$1 billion capital investment for 50 million barrels of oil with a spending profile that matched the various opportunities presented to Pioneer. He explained that there was very substantial capital expenditure for the first eight years, which was followed by the peak production, and corresponding revenue. He compared this to the previous slide, which depicted capital expenditure for four years, and then peak production, noting this difference for the typical Pioneer projects. He confirmed that this information had been shared with Econ One and PFC for their projections, and that he wanted the opportunity to share this overview with the committee to evaluate in connection with the proposed tax changes.

[5:44:13 PM](#)

MR. FOLEY explained that slide 16, "New Entrant - Stand Alone Project," was a reevaluation of the project for a new entrant, slide 17, "Current Small Producer," was for a company similar to Pioneer with small base production, and slide 18, "Current Large Producer with GRE," was for a much larger company than Pioneer, by a factor ten. He explained that the grey bars on the chart showed the negative and positive cash flow on a discounted basis, under ACES. The red bars reflected proposed HB 72, and that there was 20 percent more negative investment because there

was not the benefit of credits. He stated that the upside was for lesser tax.

[5:45:17 PM](#)

CO-CHAIR SADDLER asked for clarification to the color bars.

MR. FOLEY replied that the grey bar represented ACES, whereas the red bar was the additional negative from the loss of credits, and the green bar was the benefit of the lower tax rates. He explained that this was discounted at 12 percent, in order to exactly match the earlier Econ One data on slide 14. He disclosed that the project for a new entrant was \$92 million worse off with the proposed bill, than under ACES, as the loss of credits far outweighed the benefit of the lower tax rate.

[5:46:48 PM](#)

MR. FOLEY moved on to slide 17, explaining that this premise for a current small producer was similar to the base production of Pioneer Natural Resources. He observed that this project would be \$66 million worse off with the proposed bill than under ACES. He explained that the current small producer had better results than the new entrant because, although all the credits were gone, the loss carry forward allowed the company a lower tax rate. The current producer would have the benefit of paying a lower tax rate sooner than a new entrant, hence a greater value.

[5:48:11 PM](#)

MR. FOLEY, in response to Representative Seaton, clarified that currently Pioneer did not pay tax, as it was a profit-based tax and Pioneer had not yet made a profit. He reported that Pioneer had made investments in Alaska since 2002, that every year Pioneer was a net investor in the state, and that the company had not yet generated a profit. He projected that, depending on the price of oil and the future investments, the company would turn the corner, and pay a production tax, in a couple of years; however, the Nuna Project could push it out several more years.

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REPRESENTATIVE SEATON asked to clarify that continued projects would extend the net operating loss, and that, under proposed HB 72, the net operating loss would disappear after ten years.

MR. FOLEY, in response, acknowledged that continual investment would postpone the tax.

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REPRESENTATIVE SEATON asked to clarify if this was a disincentive for project expansion, as it was still a net operating loss with no tax due, yet proposed HB 72 allowed the loss carry forward to disappear if not used against the taxes within ten years.

MR. FOLEY replied that he would need "to think about that a little bit."

[5:51:36 PM](#)

CO-CHAIR SADDLER asked to clarify if both ACES and SB 21 [HB 72] were included in the grey bars.

MR. FOLEY suggested ignoring all the red and green bars, and to only look at the grey bars, which reflected the impact of ACES. He explained that the red bars, which increased the negative costs as there was no longer a credit, and the green bars, which increased the positive cash flow as there was a lower tax rate, reflected the impact of the proposed bill.

CO-CHAIR FEIGE asked to clarify that the cash flow was to the company, and not to the State of Alaska.

MR. FOLEY acknowledged that the cash flow was to Pioneer.

[5:52:43 PM](#)

MR. FOLEY moved on to slide 18, announcing that this was a reevaluation of the project for a large producer, defined as ten times the operating base costs of Pioneer. He declared that there was not an attempt to mimic a legacy owner, but rather a company that could enjoy that benefit of the loss carry forward sooner. He reported that this producer would only be \$13 million worse off with the proposed bill than under ACES. He emphasized that this was discounted at 12 percent, even though Pioneer projected a 10 percent discount. He acknowledged that the higher rate increased the gap, overstating the difference between the two regimes, but explained that the Econ One presentation had also used 12 percent so he was attempting to maintain a consistent comparison.

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REPRESENTATIVE P. WILSON asked if Pioneer would be included as a large producer.

MR. FOLEY replied that Pioneer would be considered a small producer. He directed attention to slide 19, "New Field: ACES vs. SB21/HB72 Summary," which was a comparison for each type of producer.

REPRESENTATIVE P. WILSON asked to clarify that the large producers were ConocoPhillips Alaska, Inc., British Petroleum, and others.

MR. FOLEY explained that those aforementioned companies were substantially bigger, and that the example was for a company with daily production of about 40,000 barrels per day, ten times the production of Pioneer.

REPRESENTATIVE P. WILSON asked if he was referring to the producers listed on slide 11.

MR. FOLEY replied that slide 11 was just an attempt to reflect "the relative size of the current players." He stated that his point had been to have a tax policy that was attractive to all the producers, as each was motivated by different things. He defined the new entrants as companies with no base production, and that it would take a long time to realize any benefit for the loss carry forward credit. The small producer was similar to Pioneer. The large producer was a company ten times the size of Pioneer. He summarized that the exact same project placed with different investors would have different financial outcomes, possibly unintended, under proposed HB 72.

[5:57:23 PM](#)

MR. FOLEY offered his belief that there were several complicated restrictions on how that loss carry forward balance escalated, and he listed that neither the first two years or the last year were counted, and that there was not any unpaid tax from the small producer credit. He clarified that not all the expenditures would grow at 15 percent, and it was truncated at the end. He concluded that the escalation of the loss carry forward did not offset the value of the credits.

[5:58:24 PM](#)

REPRESENTATIVE TUCK asked to compare the presentation by Brad Keithley for decline rates before the net present value, so no discount rate, with the Pioneer estimate without the 12 percent discount.

MR. FOLEY, in response to Representative Tuck, said that the result would be "very, very different." He explained that this presentation work was done by Palantir, an economics evaluation consultant company. He reported that Palantir had built a commercial model to exactly match both ACES and the proposed bill. He declared that the tax structure was very complicated, and not a simple cash flow analysis, as it was a profit tax based on the entire integrated business. He opined that ten model developers would each have a different result to this.

REPRESENTATIVE TUCK asked to clarify that it was necessary to have a discounted rate to compare the models.

MR. FOLEY, in response, offered his belief that it was absolutely necessary to look at it on a discounted basis.

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REPRESENTATIVE SEATON asked to clarify that slide 11 viewed the companies by their capitalization size, whereas the other slides recognized companies by production size.

MR. FOLEY expressed agreement, noting that slide 19 had nothing to do with the size of the company, but everything to do with the in-state investment and the base tax rate.

[6:01:39 PM](#)

MR. FOLEY returned attention to slide 19, and explained that the gap would be less if it modeled at a 10 percent discount, instead of 12 percent.

[6:02:11 PM](#)

CO-CHAIR SADDLER asked to clarify slide 16, that a new entrant would lose \$92 million more under the proposed bill than under ACES.

MR. FOLEY expressed agreement. He clarified that this did not describe every project in Alaska, just the projects in which Pioneer was involved.

6:03:02 PM

MR. FOLEY provided slide 21, "Industry Spending on North Slope," explaining that this was a five year snapshot of all the expenditures eligible for credits, about \$2 billion each year. The red bars reflected that amount spent on facilities, the green bars showed the amount spent on development drilling, and the orange bars showed the amount for exploration drilling. He projected that, on average, about 42 percent of all the capital expenditures was spent on facilities, with another 43 percent spent on drilling development wells and 12 percent on exploration wells. He declared that every development well had resulted in new oil, and he opined that a lot of the facilities capital was spent on new installations or to refurbish existing facilities. He endorsed that every dollar spent helped the state with its production. He indicated that, although exploration was a risky business, without it there would not be any new oil production.

6:05:06 PM

MR. FOLEY declared that the tax rate in the proposed bill was too high, and that the credits really mattered, as it minimized the capital investment. He encouraged that the tax rate be lowered. He observed that, although the Pioneer projects would not save Alaska, it was a contributor. He said that Pioneer would bring jobs, and he referred to the multiplier effect, whereby every job in the oil field resulted in nine more indirect jobs. Referring to slide 22, "Fostering New Production: Why Credits Matter," he informed the committee that credits helped with investment, as there would be more wells, more oil, more royalty, and more throughput.

6:07:31 PM

MR. FOLEY concluded with slide 23, "HB 72 Closing Thoughts." He stated that the proposed bill had many favorable attributes, including the elimination of progressivity, and extension of the small producer credit, but that the tax rate was too high. He observed that the playing field would never be level with the current players, because of the infrastructure, people, and data, but that the small producer credit did help level that playing field a little bit.

MR. FOLEY offered some suggestions and he encouraged the maintenance of a credit program, even if it meant including some targeted investments to encourage. He said that a credit for

drilling new wells, or a credit for a new project with new facilities, even for a limited time, would encourage it. He pointed out that the gross revenue exclusion did not apply to the legacy fields, so there was not any stimulation or motivation for additional investment in those fields. He opined that new production was necessary in both the existing and new fields, as "there's a ton of additional oil resource" and it was necessary to motivate the three big producers.

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REPRESENTATIVE TUCK relayed that the bar needed to be at a competitive level, in order for investment to occur, and that the existing fields had the quickest potential for putting more oil into the pipeline. He asked if bringing tax credits closer to the wellhead would enable more investment.

MR. FOLEY, in response, replied the guiding principles of the governor's bill were to incent new oil production, and that could be accomplished by giving credits for drilling wells, and developing existing facilities. He encouraged a system that was fair and balanced for all the diverse investors.

[6:11:22 PM](#)

REPRESENTATIVE SEATON relayed that the elimination of the capital credits was due to an upcoming payout of almost \$1 billion. He asked if the relationship of the percentages in investments between facilities, developmental well drilling, and exploratory well drilling was remaining steady.

MR. FOLEY replied that he was not an expert, and merely reviewed this as data produced by the Department of Revenue (DOR). He opined that this data could be used for future projections, though he had difficulty believing the capital expenditures would increase from \$2 billion to \$5 billion in the next few years. He applauded the possibility for a doubling of investment, which would lead to a greater production, and that was exactly what the state should be motivating.

[6:13:40 PM](#)

REPRESENTATIVE SEATON expressed his agreement, except that it was necessary to balance the reduction in revenue from the elimination of progressivity. He listed the aforementioned problems cited by Mr. Foley that would not stimulate new

investment, as new investors would be worse off with the proposed bill than with ACES.

MR. FOLEY commented that the information he had presented was just sharing the oil world view through his eyes. He stressed that the credits were very important to his company. He pointed out that the legislature was the policy maker and that the industry would respond to whatever policy was approved; however, if the intent was to incent new oil wells, then design a program that rewarded the behaviors to produce new wells.

[6:15:44 PM](#)

REPRESENTATIVE SEATON asked whether he was projecting that there would be a greater margin than \$30 per barrel, as a small producer. He opined that Pioneer would not be paying any progressivity in the near future on any of the expansions.

MR. FOLEY replied that Representative Seaton had hit a key point. He declared that paying a lot of taxes was desirable in a profit based system. He explained that the system encouraged investment, because, as a harvester without capital investments, there would be the difficulty of high taxes and high progressivity. He pointed out that the smaller projects were just not that profitable. With the profit based tax, and without progressivity on a new small marginal project, there was a focus on the credit rather than the reduction in the tax rate.

REPRESENTATIVE SEATON declared that he better understood the position.

[6:18:46 PM](#)

CO-CHAIR FEIGE offered his belief that the committee understood what Mr. Foley was saying about the legacy fields, that there was a lot of oil to still be gained. He recognized that the gross revenue exclusion for the new projects may not be as achievable in the legacy fields. He stated that an incentive needed to be tied to new production, and it was necessary to define "new oil," which was more difficult to define in a legacy field. He asked if there was a methodology to identify or define the percentage of new oil in a legacy field.

MR. FOLEY replied that he was not the right person to comment on this; however, he stated that new opportunities and projects existed on the North Slope, and it seemed like the same rule should apply everywhere, as it was all new oil.

6:20:46 PM

REPRESENTATIVE SEATON commented that the gross revenue exclusion (GRE) for a specific development was a "big reduction in tax rate," and, depending on the expenditures and as it came off the top, could have a big effect on profitability. He asked to clarify that the GRE for proposed specific dates and specific units was "the administration ... sitting there trying to pick winners and losers." He offered his belief that not all projects were considered the same based on their economics, but instead, whether they fit into a window created for a certain production. He asked if Mr. Foley saw that same issue for who would receive a GRE.

MR. FOLEY responded that the current proposal rewarded different players differently. Although he was unsure whether it picked winners and losers, he declared that it depended "who you are and where you are," whether inside or outside a legacy field, current tax payer or not. He stated that everyone should be treated the same. He expressed his agreement that the GRE had the effect of lowering the tax rate. He endorsed the need to grow the pie by creating a fiscal environment which encouraged incentive and resulted in new oil production. He affirmed that a lower tax rate would create a bigger tax base.

6:23:50 PM

REPRESENTATIVE SEATON expressed his understanding for the implications of the tax rate, though he considered that the GRE was very complex as it changed tremendously depending on the base economics of the project. He explained that taking something off the top related differently depending on the economics of the project. He suggested visiting the tax rate rather than the GRE, which had multiple facets dependent on the economics of each project.

MR. FOLEY expressed his agreement that this was complex. As it was a profit-based tax, the elimination of some things through GRE in the calculation of profit resulted in lower taxes. He declared the need to keep it simple by lowering the tax rate, changing progressivity, and creating credits for the encouraged investments.

6:25:38 PM

REPRESENTATIVE JOHNSON asked if Pioneer would be in Alaska, knowing what they know today.

MR. FOLEY responded that, when Pioneer came to Alaska in 2002, it had a very strict need for an oil project, and that Alaska was a perfect strategic fit. Since then, Pioneer's opportunities in Texas had exploded and he declared "without any regard for the tax system, would we be here today? I don't know." He noted that Pioneer came to Alaska under the ELF tax system of zero tax, which then became a 20 percent profit tax which was better because of the credits and the timing. However, as the tax rate went up, it got worse and worse. He confirmed that costs were higher in Alaska, and that the fiscal environment was not as attractive.

[6:27:04 PM](#)

REPRESENTATIVE JOHNSON asked whether he considered ACES to be a success.

MR. FOLEY respectfully declined to comment.

[6:27:38 PM](#)

REPRESENTATIVE TUCK asked if Pioneer had been able to use the transitional investment credit and the royalty relief during the changes in tax systems.

MR. FOLEY said that Pioneer did have investments when PPT originally came into play, and, although they were entitled to the credits which expired by a certain date, Pioneer was not yet tax positive and had not used the credits. He opined that Pioneer would not see any benefit from those tax credits.

[6:28:50 PM](#)

REPRESENTATIVE TUCK directed attention to the graphs for proposed HB 72, and asked if a transitional credit would enhance the proposed bill.

MR. FOLEY said that Nuna was the only project on the horizon for Pioneer, and that most of the expenditure would be during 2013 - 2016. He affirmed that capital credits would not make any difference to Pioneer, unless they invested in another project.

[6:29:58 PM](#)

REPRESENTATIVE TARR surmised that this reflected investments currently made under ACES, and influenced by the capital credits.

MR. FOLEY replied that it was necessary to look at the whole system. He agreed that the credits, under ACES, were very attractive, but that the tax rate was very high. However, Pioneer did not yet have a profit, and therefore was not yet a taxpayer. He disclosed that currently they were most focused on the credits; however, in the future, the tax rate would be more important.

REPRESENTATIVE TARR referred to an earlier presentation which indicated that tax credits were not influential in decision making, as bottom line cash flow was the most important. She asked if that was not as true for a small producer.

MR. FOLEY observed that there were two really important points: the credits were important for Pioneer's project economics as they reduced the capital expenditure and increased efficiency on the investment, the discounted return on investment (DRI). The credits reduced the necessary capital, and allowed funding for other opportunities. These credits allowed Pioneer to do 20 percent more than without.

[6:32:12 PM](#)

CO-CHAIR FEIGE encouraged Mr. Foley to provide additional written testimony and suggestions for improvement to the proposed bill.

[6:33:11 PM](#)

KARA MORIARTY, Executive Director, Alaska Oil and Gas Association (AOGA), declared that AOGA was the professional trade association for the industry, and that the 15 member companies accounted for the majority of oil and gas in Alaska. She declared that her comments had been unanimously approved by the member companies, and she paraphrased from the following written statement:

The greatest and most urgent challenge facing Alaska today is the decline of oil production from the North Slope. And the greatest, most urgent issue facing this Legislature is how you will address this problem.

For someone who is happy and content to see Alaska continue along the path it is headed on, the answer to this question is - do nothing; leave the present tax system alone.

But most Alaskans would disagree that this is the future they want. They hope for a robust industry on the North Slope beyond their own lifetimes. They want their children and grandchildren to have the benefits from the oil industry that this generation of Alaskans, and the one before, have enjoyed. They want the good jobs that the industry offers to continue, and they want industry to continue to support the education and skills training that are needed to qualify for many of those jobs. They want their friends and neighbors who work for the industry to stay here. They want all the volunteer community services to continue that industry employees perform, and that companies themselves do directly. They want the activity and growth in the Alaskan economy that industry stimulates to continue. And, of course, they like the fact that industry pays for a great majority of the costs of government and hope that this, too, will continue.

The role of AOGA, and of individual companies doing business here, is not to tell Alaska how much it ought to collect from oil and gas, nor should that be our role. Rather, we should tell you about how Alaska's tax regime is affecting our businesses, about the parts of the present tax laws that are not working as intended, and about ways to improve the tax structure to get more of the intended results. With that knowledge, you can then make sound, informed decisions about how much tax to collect, how to collect that amount, and when to collect it.

For several years there has been a red herring in the public discussion about oil taxes. This is the notion that any change in tax structure that reduces tax revenues below the projections in the Revenue Sources Book is a "giveaway." This reflects an assumption that those forecasted oil and gas taxes are somehow a "given" - something like money already in the bank, and all the State Treasury needs to do is wait for it to be deposited into the State's account. The fact, however, is that industry has to spend roughly \$2

billion dollars each year just to slow the production decline from what it would naturally be, in order even to approach the level of production published in the Revenue Sources Book. And just like any other investment industry makes here, these production-sustaining investments have to beat the competition elsewhere for those investment dollars: they are both not a "given."

Worse, the "tax giveaway" argument assumes the production in the Revenue Sources Book is all that will be produced. These critics factor in nothing for any additional production and revenue resulting from a tax reduction. Instead it looks only at the downside and ignores the upside. The upside, though, is real. If a tax reduction makes investments here more competitive, companies will want to make more investments here for that upside. And they will do so even though they, like the State, lack the gift of prophecy and cannot know beforehand exactly what the upside will turn out to be for any particular investment.

As you consider solutions to the momentous challenge that production decline creates, it will be wise and useful to identify the principles you want the tax system to earn, and the specific goals you want it to achieve. AOGA believes Governor Parnell's four "core principles" offer an excellent cornerstone for this:

"First, tax reform must be fair to Alaskans."

"Second, it must encourage new production.

"Third, it must be simple, so that it restores balance to the system."

"Fourth, it must be durable for the long term."

We believe a fifth such principle will be prudent as well, because the challenge facing Alaska is not that there are too many companies pursuing opportunities they see here, but that there are too few. Alaska should therefore avoid tax changes that artificially create "winners" and "losers."

With respect to House Bill 72, there are four major features in it that we wish to address, and the Bill

omits several others that we would like to draw your attention to. The major features in the Bill are the elimination of progressivity, changes to the present system of tax credits, a "gross revenue exclusion" for certain new production, and the timing for these changes to occur. Here are our thoughts on them.

1. Repeal of Progressivity. AOGA endorses the elimination of progressivity. First, progressivity directly attacks and destroys one of the few strategic advantages that Alaska has, which lies in its economic remoteness. It costs \$9.42 on average to ship a barrel of oil from the North Slope to the West Coast, according to the Fall 2012 Revenue Sources Book, Appendix D- 1b. This means Alaska starts off with a disadvantage of \$9.42 a barrel against Outside competition, so other parts of an Alaskan investment must be pretty strong in order to overcome this disadvantage. Otherwise they won't be made.

If oil prices turn out to be higher than what they were projected to be in the investment analysis, nearly 100 percent of each extra dollar in price flows directly into the Gross Value at the Point of production (GVPP) and then, after royalties and taxes, flows straight into the investor's bottom line. This, in turn, improves the economic performance of an Alaskan investment relative to an equally competitive one Outside, because the Alaskan baseline was \$9.42-a-barrel lower and an additional dollar in price is a larger percentage of that baseline than for the percentage for the Outside investment. This can be particularly significant for potential investors who are bullish on oil prices.

Currently, progressivity in conjunction with a 25 percent base tax will take half of each dollar from higher prices when the West Coast price is \$132.38 (using the Fall 2012 Source Book numbers) -a price that has already been seen, although somewhat higher than today's. So, even for investors who are bullish on oil prices, progressivity destroys half of the one strategic advantage that Alaska's economic remoteness provides. And the more bullish they are, the more this advantage is undone because they will see higher rates for progressivity at those prices in their investment analysis.

Second, progressivity brings extraordinary complexity to the tax, not only in calculating what the tax is, but also in analyzing what the amount of the progressivity is for any particular item that affects a taxpayer's Production Tax Value (PTV). This complexity exists because the tax rate for progressivity depends on the taxpayer's PTV per barrel, and then the resulting rate is applied to the very same PTV that set the rate. This circularity in the tax calculation leads to bizarre effects. For instance, simply the fact that oil prices fluctuate during a year instead of remaining perfectly flat increases the tax even though the average of the fluctuating prices is the same as the flat price - and the greater the fluctuation, the greater the tax from progressivity becomes. There is no objective economic or financial reason for the tax to go up; instead, this occurs entirely because the progressivity calculation is circular.

2. Tax Credits

In general, tax credits, whether they be for drilling a well, building a facility to gather new oil or the pipe to build a flowline, represent a direct reduction in the amount that a potential investor puts at risk by spending money on the equipment and facilities. It is important to reinforce that there is no tax credit liability for the State at all until an investor invests here. So it costs nothing to offer the credit until the investment is made here, and at that point the tax credit has already succeeded in what it is supposed to do - namely to attract investment dollars here.

A. Repeal of the Qualified Capital Expenditure ("QCE") Tax Credit.

Even while the elimination of progressivity would improve the competitiveness of Alaskan investments from the present ACES tax, the elimination of the QCE Credit would claw back a big chunk of that money and undo a significant part of that competitive improvement. This is because the benefit of the QCE Credit depends only on how much is invested here, while the benefit from ending progressivity depends on

the price of oil relative to a producer's lease expenditures. For every producer, there is a price below which the lost QCE Credit would start to outweigh the benefit from the end of progressivity, and exactly where that crossover comes would depend on factors that are specific to each individual producer, such as how much oil it produces, where it sells the oil, its costs to deliver it there, and its lease expenditures.

AOGA fears the repeal of the QCE Credit is likely to create "winners" and "losers" artificially among producers, and we see no sound tax policy justification for doing so.

B. Small-Producer and Exploration Credits. AOGA endorses the proposal in HB 72 to extend the small-producer tax credit under AS 43.55.024 from the present sunset dates at the start or middle of 2016 to 2022 and encourages the same extension the exploration tax credits under AS 43.55.025. The State had sound policy reasons for creating these tax credits, and those reasons are just as valid today as they were then.

The purpose of the small-producer tax credit was to attract new players to Alaska who might otherwise have been deterred from coming here by its remoteness, northern climate, and the resulting challenges of higher-than-average costs and expenses. The success of the credit in doing this is a fact that cannot be denied. AOGA sees this success in its own membership and in other companies that have come here and are active. The importance of having a healthy contingent of smaller producers comes from the facts, first, that they often have a different perspective about the opportunities around them, and second, that no company or group of companies can have a monopoly on good ideas and innovation. For both reasons, the continuing and increasing presence of these smaller producers strengthens and improves the Alaskan petroleum industry. We know from testimony that the small producer tax credit has made a material difference in individual companies' decisions to do business and invest in Alaska.

The purpose and justification for the exploration tax credits under AS 43.55.025 are equally plain and clear. Huge geographical swaths of this state remain unexplored for oil and gas, or have been explored in little more than a rudimentary way. If exploration is to occur in a timely fashion so any resulting production can be transported through existing infrastructure, the exploration tax credits are a direct way of bringing that exploration about and these type of credits should be extended as well. Just as with the QCE credits for capital investments, there is no exploration tax credit without real money having first been spent on exploration work that qualifies for these tax credits.

C. Limiting the transferability of "carried-forward annual loss" tax credits. We have some reservation about the proposal in HB 72 to bar almost completely the transferability of the current "carried-forward annual loss" tax credits under AS 43.55.023(b). These credits arise every year for any active explorer until it finds something and finally has production that has a tax to apply the credit against. At present explorers can only realize immediate benefit from these credits by selling them to other taxpayers or cashing them in at the state Oil and Gas Tax Credit Fund established in AS 43.55.028.

Such sales and cash-ins would stop for North Slope explorers under the Bill, who instead would be able to hold the credit for up to 10 years for possible use against tax on their own production, assuming they find something to produce. During this 10-year shelf-life the unused credits would increase at an annual rate of 15 percent, compounded annually. The same would apply for a North Slope producer with a year resulting in a "carried-forward annual loss."

The Bill's only exception to this ban would be for a transfer made in conjunction with a sale or other transfer of an "operating right, operating interest, or working interest" in a lease or property the person acquiring that interest could also acquire a proportionate share of the lease-or-property's accrual loss credits arising before that transaction.

To prevent taxpayers from deliberately hoarding these credits instead of using them in order to get the 15 percent annual increase, the Bill would deny the 15 percent increase for each year when they could use their credits but don't. We believe this would be an effective deterrent against abuse that might otherwise occur.

In general, if sales and transfers of these annual-loss tax credits are to be limited at all, then the limitations proposed in HB 72 would be a reasonable way to do it. Our major concern of the proposal is that the 10-year shelf-life for using a credit is unrealistically short. If all the stars, planets and constellations are in just the right alignment, it might be possible for an explorer to go from exploration and discovery to production in just 10 years. But that is not the norm - particularly on the North Slope, where the limitation on transferability would apply. We think 15 years would be more in line with actual experience.

The geographical limitations on where the tax credits must arise in order still to be freely sold or transferred may have unintended consequences, but because of confidentiality considerations, they are not appropriate matters to be discussed within a trade association like AOGA. We must therefore leave this for individual companies to address if there is a problem.

Of course, without the 15 percent annual increase in the unused credits, AOGA would oppose the ban on transferability because it would destroy the incentives which the credit is supposed to provide to explorers.

3. Gross Revenue Exclusion. This is the most innovative feature in HB 72, and our major substantive concern is that it is too narrowly focused.

The Gross Revenue Exclusion (GRE) would, in calculating the taxable Production Tax Value, exclude 20 percent of the Gross Value at the Point of Production of what we'll call "non-legacy" production. Bill Section 24 calls it production "from a lease or property that does not contain land that was within a

unit on January 1, 2003[,] or if it does have land that was in a unit before 2003, "the oil or gas is produced from a participating area established after... 2011 [that] does not contain a reservoir that had previously been in a participating area established before ... 2012."

What this means is, the fields that are likely to lose out on getting any GRE under HB 72 are Prudhoe Bay, Kuparuk, Lisburne, Milne Point, Endicott, Niakuk, Point McIntyre, and Alpine; as well as the Prudhoe Bay satellite fields Aurora, Borealis, Midnight Sun, North Prudhoe Bay, Orion and Polaris and the Kuparuk satellites Meltwater, NEWS, Tabasco, Tam and West Sak.

Econ One Research, Inc. made a presentation to this committee just last Wednesday entitled Analysis of Alaska Tax System, North Slope Investment and The Administration's Proposal, HB 72. In Slide 6 of that presentation Econ One showed oil and gas resources described as "Economically Recoverable @ \$90/bbl" totaling 29.1 billion barrels of oil and barrel-equivalents of gas. Of this total, the slide shows that 10.4 billion are in ANWR and the National Petroleum Reserve-Alaska, another 9.9 billion in the Chukchi Sea Outer Continental Shelf 5.8 billion in the Beaufort Sea OCS, and 3 billion in the central North Slope where all the producing fields are that I just named.

To us, the slide shows that more than half - 54 percent - of this 29.1 billion-barrel resource lies in the federal OCS, outside Alaska's sea-ward boundary and beyond its jurisdiction to tax. Current federal law does not provide for any OCS revenue-sharing with Alaska, and even though Alaska's Congressional Delegation is trying to change that, for now the only direct revenues that the State stands to see from OCS production are property taxes on the in-state portion of a pipeline linking the OCS fields to TAPS, and an increase in North Slope wellhead values resulting from the greater TAPS throughput.

Another 34 percent of the resource is in ANWR - which, again, we hope the Delegation will be able to open up, although even Ted Stevens was unable to achieve it despite four decades of dedicated effort. Another 1.7

percent is in NPRA, which - if the Interior Department gets its way - will have its best prospective acreage turned into a bird sanctuary despite being a "Petroleum Reserve".

So, of the 29.1 billion barrels of potential reserves identified by Econ One, only the 3 billion in the central North Slope has any potential to contribute significantly to Alaska's economic well-being in the near and mid-term future. In other words, of the 29.1 billion barrel resources, only a tenth of it is within the State's power to do anything about. And of this 3 billion barrels, 2.5 billion or more stands to come from Prudhoe Bay, Kuparuk and other legacy fields already in production. The Governor's second "core principle" for tax legislation is that "it must encourage new production." But, in order to get results from such encouragement, the tax legislation must reflect the opportunities that Alaska has for getting results. Maybe the present Gross Revenue Exclusion in HB 72 can get results, in some small way. But in terms of what it attempts to "encourage," it leaves out at least 80 - 90 percent of the 3 billion-barrel opportunity in the central North Slope that Econ One has identified as "Economically Recoverable @ \$90/bbl[.]"

AOGA is continuing to search for ways to adapt the Gross Revenue Exclusion to include legacy fields in a way that might be acceptable to the Administration and the Legislature. It may turn out, however, that a different approach may be necessary to "encourage new production" in legacy fields.

For now, though, all we can say is, not enough is being done in HB 72 to improve the economic competitiveness of legacy fields, and for the coming decade or so these legacy fields will be the "trunk" that supports all the rest of the North Slope "tree." Until there is significant production from the Arctic OCS, the tree cannot survive very long without the trunk production to keep per-barrel transportation costs down and necessary infrastructure in place. It would be a mistake to let that trunk wither.

4. Issues that HB 72 does not address. There are several significant problems in the present ACES tax that are not addressed in HB 72.

A. Minimum tax for North Slope production. AS 43.55.011(f) sets a minimum tax that is targeted solely against North Slope production. That tax is based on the gross value of that production instead of the regular tax based on "net" Production Tax Value. The rationale for adopting it was to protect the State against low petroleum revenues when prices are low.

The minimum tax only complicates potential new investors' analyses of what their tax would be if they invest here instead of someplace else, and consequently it has, if anything, driven investments away. AS 43.55.011(f) should be repealed.

B. Statute of limitations & statutory interest. Here we have two concerns that are interrelated, but not in an immediately obvious way.

The statute of limitations under AS 43.55.075(a) is six years from the date when the tax return was filed for the tax being audited, while the limitations period for other taxes under AS 43.05.260(a) is three years from the filing date of the tax return. Under both statutes, the period may be extended by mutual consent of the taxpayer and the Department of Revenue (DOR).

The statutory rate of interest under AS 43.05.225(1) for tax underpayments is "five percentage points above the annual rate charged member banks for advances by the 12th Federal Reserve District as of the first day of that calendar quarter, or at the annual rate of 11 percent, whichever is greater, compounded quarterly as of the last day of that quarter[.]" Currently the Federal Reserve rate is very low, so 11 percent APR is the applicable rate.

Taxpayers are required under AS 43.55.020(a)(1)-(3) to make monthly estimated tax payments for each calendar month's taxable production during a year, but the final tax amount for the entire year is reported on March 31 of the following year under AS 43.55.030(a). And AS 43.55.020(a)(4) requires any additional tax to

be paid at that time. The statutory interest under AS 43.05.225(1) starts to accrue on any underpayment from that March 31 true-up date.

In practical terms, what these various statutes all mean is this.

For each dollar of underpaid tax that the Department of Revenue may claim after an audit, statutory interest on that dollar at the end of three years would be -

$\$1.00 \times [(1 + 0.11/4)(4 \text{ compoundings per year times } 3 \text{ years}) - 1] = \$1.00 \times 1.38478 - 1] = \$0.38.$

After six years the statutory interest on the dollar would be -

$\$1.00 \times [(1 + 0.11/4)(4 \text{ compoundings per year times } 6 \text{ years}) - 1] = \$1.00 \times [1.91763 - 1] = - \$0.92.$

Thus, for each dollar of uncertainty there is in what the taxpayer reports on its March 31st true-up for a given year, there is about 38 cents of additional uncertainty due to statutory interest under a three-year statute of limitations, but 92 cents under a six-year statute.

It is the combination of a six-year statute of limitations plus a minimum statutory interest rate of 11 percent APR that is so harmful for a taxpayer and any would-be investor. Each dollar of uncertainty in the amount of tax will nearly be doubled by statutory interest after six years.

When we speak about uncertainty and audit assessments six years after the filing of tax returns, many people will think the oil companies could calculate their correct tax liability under the ACES tax if they wanted to. Frankly, so did I before I got this job. So let us take a few moments to illustrate why this is not the case.

As amended by ACES, AS 43.55.150 (captioned "Determination of gross value at the point of production") says the Gross Value at the Point of Production (GVPP) "is calculated using the actual

costs of transportation" from the field to market unless the "shipper... is affiliated with the transportation carrier[,]" or the "contract for the transportation ... is not a[t] arm's length[,]" or the "method or terms of [the] transportation ... are not reasonable in view of existing alternative transportation options." "If the department finds that" any of these situations exists, then the GVPP "is calculated using the actual costs ... or the reasonable costs of [the] transportation ..., whichever is lower."

The immediate questions about the statute are - How does the Department of Revenue get the information to make such a finding? What is the procedure for making them; is there a hearing, an investigation or what? How does a taxpayer ascertain what the Department has found?

15 AAC 55.193 is the regulation with an important part of the Department's answers to these questions. Before getting to those answers, we note that subsection (a) seems to disregard the statutory distinction between "actual" and "reasonable" costs, by declaring that "Costs of transportation are the ordinary and necessary costs incurred to transport the oil or gas" - which could get to the same result as the statutory terms, but not necessarily.

Subsection (e) of the regulation starts answering our questions. It says "a tariff rate ... adjudicated as just and reasonable by the Regulatory Commission of Alaska ... establishes the reasonable costs of the pipeline transportation[.]" So, suppose there has been full-blown tariff dispute before the Regulatory Commission of Alaska, and the RCA has "adjudicated [a tariff as just and reasonable[.]" And suppose also that a producer ships its oil through its pipeline-company affiliate and pays that RCA-approved tariff. Is this "reasonable" cost under (e) of the regulation the same as the "ordinary and necessary" cost for it for purposes of subsection (a)? Apparently so, but the inconsistent terms in the two subsections prevent this from being completely clear. Moreover, if the transportation occurs "later than five years after the end of the test period on which the tariff rate is based[,]" then even subsection (e) says the tariff

ceases to "establish [the] reasonable costs" for the transportation. But it doesn't say what the right tariff is after those five years are up, or even how to find out or calculate what it is. It is utterly silent.

The very next sentence in subsection (e) after the one speaking about that five-year period starts, "If a complaint challenging [a] tariff rate has been filed with [the RCA] and accepted for investigation" - this is not a situation involving an already "adjudicated" tariff, but one that deals with a new tariff that has been filed for RCA's approval, which is then challenged. Here, too, the tariff on file is not allowed as the transportation cost under (e) of the regulation. Instead, the cost that is allowed is "103 percent of the costs of transportation calculated by the department using the methodology under 15 AAC 55.197, for the period [while the complaint is being heard and adjudicated by the RCA.]" Note that it is the Department of Revenue, not the taxpayer that makes the calculation under 15 AAC 55.197. It is impossible for the taxpayer to know beforehand what the Department's calculation will turn out to be.

Now it is true that 15 AAC 197(m) says a taxpayer may each year "request in writing the department's determination of the applicable after-tax rate of return under (f) of this section [and t]he department will provide the department's determination to the producer no later than the later of July 1 of the calendar year or 90 days after the department receives the producer's request." But the "after-tax rate of return" that the Department promises to provide is only one of the parameters in the cost-based tariff calculation under 15 AAC 55.197. The taxpayer is left on its own to find the correct numbers for the other parameters. More importantly, subsection (m) applies only to "a producer [that] expects to produce oil or gas the actual costs of transportation of which are required by 15 AAC 55.193(b)(6)[.]" Section - 193(b)(6) applies only to "transportation of oil or gas by a non-regulated pipeline facility ... that is owned or effectively owned ... by the producer of th[e] oil or gas[.]" In the situation I'm describing, it is a regulated pipeline, not an unregulated one, so this promise in 197(m) does not apply.

We find nothing else in the calculation-methodology regulation, 15 AAC 55.197, nor in I 5 AAC 55.193(e), the transportation-cost regulation, that commits the Department to make the cost-based tariff calculation called for in 193(e) and inform the producer of that result before the producer has to report and pay estimated tax each month, or before it makes its annual true-up on March 31st of the following year. The only deadline for informing the producer of the Department's calculated tariff is the six years under the statute of limitations.

And the same or very similar unknowable answers - including tariff calculations by the Department under 15 AAC 55.197 - arise under 15 AAC 55.193 regarding tariffs for new transportation facilities that are just being placed in service, and under -193(g) - (h) regarding tariffs set under a settlement agreement to which the State of Alaska is a party.

And just to prevent any misunderstanding, although I have been testifying about proceedings and adjudications by the RCA, these regulations also apply to proceedings and adjudications by some "other regulatory agency" - which would include FERC.

There is a built-in uncertainty created by these regulations, and others that is beyond a taxpayer's allowed authority to answer and beyond its ability to know before the Department gives the answer. And to see a "Technicolor" version where essential elements of the tax calculation are being reserved for the Department to "determine" in its discretion with no specific deadline, one should look at all the crucial "determinations" in 15 AAC 55.173 ("Prevailing value for gas") that are reserved for the Department to make regarding the valuation of natural gas that would be transported to markets outside Alaska.

We are not asking for a statutory fix to the regulations. But we are asking that, if the Department chooses to defer making calculations and similar determinations that are necessary in order even to be able to calculate the correct amount of tax at all, then the doubling-up of that uncertainty through statutory interest should be lessened - either by

shortening the period for making those "determinations" from six years back to the usual three, or by eliminating the 11 percent minimum interest rate on the statutory interest rate, or both.

C. Joint-interest billings. Our concern about joint-interest billings is also primarily a problem caused by the approach the Department has chosen to take with its tax regulations. Instead of starting with the joint-interest billings that participants in a unit or other joint operation receive from the operator, the regulations reflect an assumption that each non-operating participant has information, in addition to the operator's billings to them, that allows them to determine which expenditures are deductible as allowed "lease expenditures" under AS 43.55.165 and which are not. This assumption is wholly unrealistic. And even if there were some merit to it, the regulations opt to audit each participant separately regarding that participant's interpretation of which expenditures are deductible and which are not, instead of auditing the system of accounts used by the operator and telling all participants which cost items in that accounting system are deductible and which are not. In other words, instead of one audit of the expenses by a joint venture for any given period, the Department audits each participant separately for its respective share of the same pool of expenses.

Again, we are not asking for legislation to put the Department's regulations on a different track. But there are some in the Department who believe that the repeal by the 2007 ACES legislation of AS 43.55.165(c) and (d) - which specifically authorized the Department to rely on joint-interest billings - means the Department cannot legally rely on them now. While we disagree with this position (which is also at odds with what the Department testified to during the enactment of the 2007 ACES legislation), we do think it would be appropriate to restore language specifically authorizing the Department to rely on joint-interest billings if it chooses to do so.

Conclusion. We support the proposed elimination of progressivity, but we have concerns with what the Bill proposes for tax credits - most importantly with the proposed repeal of tax credits for qualified capital

expenditures. The trade-off between repealing progressivity and losing the QCE credit is not a net benefit for industry at low oil prices, although it would be with prices that are high relative to costs.

The concept of the Gross Revenue Exclusion has considerable potential, but its narrow focus in HB 72 misses 80 - 90 percent of the opportunity in the central North Slope described by Econ One. We will continue to work with you and the Administration to find a fair and reasonable way to expand its scope, or to find an alternative that will address the central North Slope appropriately.

The reasons that led the State to create the small-producer tax credit under AS 43.55.024 and the exploration tax credits under AS 43.55.025 remain valid today. We are pleased that HB 72 will extend the sunset date for the small-producer tax credit and encourage the same extension be applied to the exploration tax credits.

Overall, the Bill as introduced represents a cornerstone for significant and crucial tax reform that move toward Governor Parnell's four "core principles" - fairness for Alaskans, encouraging new production, simplicity with balance, and durability for the long term.

I have not mentioned, until now, the North Slope decline curve that's on the slide I've showed at the beginning, and now here at the end of this testimony. I don't need to mention it. It's the elephant in the room. As I said at the beginning, the greatest, and most urgent challenge facing Alaska today is the decline of oil production from the North Slope. We believe it is up to you, the legislative leaders of our time, and the Governor, to shape a competitive oil fiscal policy that is supported by strong principles and will lead Alaska towards a prosperous future for the long-term. You have a difficult task ahead and AOGA stands ready to assist you throughout this process.

[6:57:12 PM](#)

REPRESENTATIVE TARR asked for a suggestion of balance between the elimination of progressivity and the elimination of QCE credits to encourage new investment in Alaska.

MS. MORIARTY replied that earlier testimony had indicated that no producer in Alaska was the same; therefore, the challenge to the legislature was to find the balance that did not create winners and losers. She suggested that different types of credits specifically geared toward well lease expenditures, similar to Cook Inlet, could be re-established on the North Slope. She stated that AOGA did not believe that elimination of both progressivity and QCE would have a desired result.

[6:59:41 PM](#)

MR. ARMFIELD said that Brooks Range Petroleum would become a member of AOGA once oil production had begun.

[7:00:01 PM](#)

REPRESENTATIVE SEATON, noting that some important considerations for a company when making a decision for investment in a project included net present value, internal rates of return, and cash flow, pointed out that these had also been considered regarding investment in Alaska during deliberation for PPT and ACES. He stated that testimony had now declared that return on capital was the most important aspect. He asked what metric was the most important for Brooks Range Petroleum.

MR. ARMFIELD declared that the metrics were different for every company, and that net present value and internal rate of return were viewed for the project as a whole. He reported that the key problem for Brooks Range was initiating enough cash to move a project forward. He expressed the difficulty for marketing this investment. In the current phase of development, capital credits were the most important. Any change from ACES to proposed HB 72 would impose the need to raise an additional \$124 million to move the project forward in the next few years, and he emphasized that cash up front was currently the most important consideration. He stated that net present value and internal rate of return were "end game" numbers, but capital credits were necessary today.

[7:03:38 PM](#)

REPRESENTATIVE SEATON asked to clarify that the return of capital invested was now the most important criteria, as he did

not remember that ever being a criteria during discussion for PPT or ACES. He asked if the raising of capital was the most important consideration for a small producer.

MR. ARMFIELD replied that this was correct, which he called cash on cash, the cash invested to how many multiples it would return. However, he emphasized that low internal rates of return and net present values would keep the project from progressing forward.

[7:05:08 PM](#)

REPRESENTATIVE SEATON surmised that progressivity was still "quite a ways down the road where your company would be concerned." He asked if investment attitudes and decisions would change if the top 25 percent of progressivity was eliminated, so it was capped at 50 percent.

MR. ARMFIELD expressed his agreement that any positive change would instill confidence, yet he agreed with Mr. Foley that a simpler overall structure was best for everyone in the oil industry. He pointed out that it was still necessary to convince investors about Alaska, and he declared the need for a banner to attract investors with the certainty that the rules would remain constant.

[7:08:36 PM](#)

REPRESENTATIVE SEATON asked if the proposed gross revenue exclusion (GRE), which had a highly complex set of matrixes, would have to be analyzed to figure the effect on the rest of the project.

MR. ARMFIELD said that Brooks Range had not presented the GRE to any investors; however, he opined that the 20 percent GRE was a tradeoff for the QCE, as it deferred the contribution to a production input base.

[7:10:47 PM](#)

REPRESENTATIVE SEATON reported that it was no longer tied to the investment, as were the capital credits, but to the profitability of the oil as it excluded a percentage of the revenue generated for the duration of the project.

MR. ARMFIELD suggested that his understanding was for the 20 percent to include the capital budget, and that the only

reduction from the gross revenue exclusion was for the TAPS throughput and the West Coast transportation. Then the 25 percent base tax was applied.

[7:12:28 PM](#)

REPRESENTATIVE SEATON agreed that it was complex, and he questioned whether the GRE was making the system simpler. He asked for any suggestions for improvement to the proposed bill.

MR. ARMFIELD agreed to get clarification, and he pointed out that, as his two latest projects would not qualify for GRE, he did not consider it as a benefit.

[7:13:25 PM](#)

[HB 72 was held over.]

[7:13:47 PM](#)

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 7:13 p.m.