

SENATE FINANCE COMMITTEE

March 5, 2013

1:33 p.m.

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CALL TO ORDER

Co-Chair Meyer called the Senate Finance Committee meeting to order at 1:33 p.m.

MEMBERS PRESENT

Senator Pete Kelly, Co-Chair
Senator Kevin Meyer, Co-Chair
Senator Anna Fairclough, Vice-Chair
Senator Click Bishop
Senator Mike Dunleavy
Senator Lyman Hoffman
Senator Donny Olson

MEMBERS ABSENT

None

ALSO PRESENT

Scott Jepsen, Vice President, External Affairs, ConocoPhillips; Bob Heinrich, Vice President, Finance, ConocoPhillips; Todd Abbot, President, Pioneer Natural Resources Alaska; Ed Kerr, Vice President of Land and Business Development, Armstrong Oil and Gas; Ken Thompson, President, Alaska Venture Capital Group; Senator Hollis French; Senator Cathy Giessel.

PRESENT VIA TELECONFERENCE

Ken Thompson, President, Alaska Venture Capital Group.

SUMMARY

SB 21 OIL AND GAS PRODUCTION TAX

SB 21 was HEARD and HELD in committee for further consideration.

#sb21

SENATE BILL NO. 21

"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."

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SCOTT JEPSEN, VICE PRESIDENT, EXTERNAL AFFAIRS, CONOCOPHILLIPS, discussed the PowerPoint, "Senate Finance Committee CSSB21" (copy on file).

Mr. Jepsen displayed slide 2, "Topics."

- Alaska Challenges
- CSSB21 vs. ACES (Alaska Clear and Equitable Share Act)
- Observations

Mr. Jepsen spoke to slide 3, "North Slope Investment Challenges."

- Challenged oil remains
- Complex, high cost wells
 - Smaller reserve targets
 - Fault blocks, flank oil
 - Satellites, viscous oil
 - Facilities handling ~ three times as much water as oil
 - Significant resource

- ACES tax structure
- High average & marginal tax rates
 - Progressivity eliminates upside

- Tax credits attempt to offset high tax rates and high costs. Applies to both new and legacy fields

BOB HEINRICH, VICE PRESIDENT, FINANCE, CONOCOPHILLIPS, stated that ConocoPhillips saw many impediments to investment under ACES. He remarked that ACES had high marginal tax rates, and had a negative impact on investment. He pointed out the chart on slide 3, which showed the state, federal, and industry share across a range of prices on a marginal basis. He also noted the progressivity surcharge, which eliminated the upside that was traditionally seen at higher oil prices. He looked at the graph on the bottom right corner, which showed ConocoPhillips per barrel earnings since the time that ACES was implemented. He noted the changes in crude oil prices that had an almost 100 percent swing upward since ACES was implemented. He noted that the ConocoPhillips Alaska net income per barrel only moved from \$22 to \$25, which was a less than 10 percent movement. He stressed that the extra money went to the state, because of the progressivity surcharge in ACES.

Mr. Heinrich addressed slide 4, "Changes to ACES to Improve Alaska's Investment Climate."

Eliminate progressivity

Create a flatter tax rate over a broad range of prices
-Producer and State share proportionately as prices fluctuate and margins change

Create a flatter tax rate over a broad range of prices
-Producer and State share proportionately as prices fluctuate and margins change

Issues

- Tax increase at lower prices - base rate too high
- GRE will have minimal impact on legacy fields.

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Mr. Heinrich discussed slide 5, "ACES vs. CSSB 21." He stated that the graph represented ConocoPhillips modeling work the comparison on a producer-share basis across a

range of prices. He explained that the "producer-share" meant the percentage of available cash after cost and taxes that were retained by the producers. He felt that the representation was an inverse of what the state's consultant had presented when discussing the state or federal take. He remarked that the producer-share calculations depended on many factors including the assumed cost structure for both a capital and operating costs. He stated that the Fall 2012 Revenue Sources Book was used in determining the calculations for FY14. He explained that the graphic represented the result of FY14 only, as if CS SB 12 were in effect for the full FY14. He explained that the first year was used, because the data became less reliable in forecasting. He felt that the one-year snapshot reflected a better view of what was actually expected in the results. He pointed out that the resulting producer share was represented by the blue line, which was basically flat across a range of prices starting at approximately \$60 per barrel. He stressed that ConocoPhillips liked the range of the curve, because it represented a consistent split of results across a wide range of prices. He explained that the gross minimum tax would kick in under both ACES and CS SB 21.

Mr. Jepsen spoke to slide 6, "Gross Revenue Exclusion."

GRE targeted primarily at new fields and extensions of existing fields

- Extensions identified as participating area (PA) expansions

- Legacy field PA expansions included

- Increase to 30 percent is an improvement, but less effective than tax credits

GRE will likely not have significant impact on legacy fields

Legacy Fields are...

- Greatest investment opportunity resides inside existing legacy PAs

- About 90 percent of North Slope 2012 production

- Lion's share of estimated future production

- Key to offsetting ANS decline

Mr. Jepsen addressed slide 7, "Observations."

CSSB21 an improvement over ACES

- Provides relatively flat tax rate with slightly progressive nature over a broad price range
- Elimination of progressivity solves the high marginal tax problem
- Makes Alaska more attractive for investment at \$100+ prices
- Increase in gross revenue exclusion (GRE) positive

CSSB21 changes for an improved investment climate

- Reduce base tax rate
- Create incentives for both new and legacy fields
- Few legacy field projects would qualify for GRE
- Consider tax credits associated with production

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Co-Chair Meyer noted that the intent of the legislation was to incentivize more oil production. He felt that the GRE process already encouraged greater oil production, but pointed out that GRE currently only applied to new oil fields. He wondered if there would be a greater incentive to pursue development and production, if the GRE also applied to the legacy fields. He further queried if it were better to maintain the capital cost credits, and attach the credits to actual drilled wells. He felt that capital credits were too expensive, and were projected to be almost \$900 million in the following year. He remarked that the capital credits did not result in greater production, but noted that ACES was not an incentive to produce anyway. Mr. Heinrich responded that GRE increased cash flow over the long term for a particular investment. He pointed out that long-term cash flow was key to ConocoPhillips' investment. He furthered that ACES decreased the long-term cash flow. He felt that the issue could be resolved in the base tax structure, rather than creating a separate tax structure for a different class of investment. He remarked that a tax credit tracked investment, but felt that the credit could be focused on associations with production. He stressed that the combination of the base tax rate and investment incentives were impacts on ConocoPhillips willingness to invest in development and production in Alaska.

Mr. Jepsen added that tax credits helped the capital-intensive projects. He remarked that some projects would need new roads, new pads, new facilities, and new

pipelines. He pointed out that the GRE was much less effective for those projects, than the capital credits. He stressed that the legislature needed to find a balance between the GRE and capital credits.

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Co-Chair Meyer remarked that progressivity was not included in the legislation. He wondered if ConocoPhillips would like to see bracketed progressivity at very high prices. Mr. Jepsen replied that a flat tax rate over a broad range of prices was most important, because the state and industry would share equitably as the margins fluctuate. He furthered that there would be an extreme amount of revenue for the state at the \$200 per barrel price level with a 65 percent share. He

Senator Dunleavy wondered if ConocoPhillips would invest in Alaska to develop the oil that proposed to exist in the ground, with the proposed policy change. Mr. Heinrich replied that the chairman of ConocoPhillips recently stated that if the investment climate in Alaska were to change to the point where it would differentiate itself, ConocoPhillips would invest more money in Alaska.

Mr. Jepsen furthered that Alaska published extensive information about ConocoPhillips operations in Alaska, so its changes in investment and behavior would be very transparent.

Co-Chair Kelly referred to a previous presentation regarding reimbursement of the royalty. He asked for ConocoPhillips' opinion regarding that presentation. Mr. Jepsen agreed to provide that information.

Senator Bishop inquired how much it cost to drill per well. Mr. Jepsen responded that the cost was variable, but that it was around \$13 million.

Senator Bishop queried how much the cost would be for a standard well, without any lateral attachments. Mr. Jepsen replied that ConocoPhillips had a plot that showed how well costs had increased, on average, over the prior ten years. He agreed to provide that information.

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Senator Bishop requested some theoretical examples of what ConocoPhillips might do to increase production. Mr. Jepsen replied that ConocoPhillips was advancing and progressing current projects, and furthered that longer term projects could look attractive and they were already doing work with viscous oil.

Co-Chair Kelly remarked that there were current discussions throughout the state regarding the opinion that tax policy could not reverse the decline in oil production. He wondered how ConocoPhillips felt about that perspective. Mr. Jepsen referred to back up material, not on file, that reflected the activity over the ten years prior. He pointed out the new fields that came on production since 1997, and the graph used DNR data. He noted a significant amount of investment and production from new fields. He explained that the decline rate was fairly significant, but, on an absolute basis, was slightly more manageable than ten years prior. He felt that there was currently an opportunity to level the decline, under the right tax framework, and right set of opportunities. He did not want to make promises regarding decline rates, because there were various factors that contributed to oil production. He stressed that approximately 270,000 barrels had been produced from the new fields.

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Co-Chair Kelly queried the intent of the graph. Mr. Jepsen replied that the graph represented all the various fields that have been brought on stream since 1997.

Co-Chair Kelly inquired if there was a policy that prompted the increase. Mr. Jepsen responded that during this time, ELF was trending toward zero, and many of the fields had zero severance tax. He stated that there was a reasonable tax policy in the state, which was a royalty regime that provided both an upside and downside to producers.

Co-Chair Meyer requested that the slide be provided for committee members.

Senator Hoffman directed the presentation back to slide 7 and wondered if the first bullet referred to a reduction from 35 percent or from 25 percent base rate. Mr. Jepsen stated that the comments were in regard to the 35 percent

base rate, which was outlined in CS SB 21. He stressed that the 35 percent base rate was too high.

Senator Dunleavy queried how ConocoPhillips felt about 20 percent. Mr. Jepsen replied that at the end of the day, it would depend on what the overall tax structure looked like.

Mr. Heinrich interjected that the 25 percent rate was a point at which Alaska could be considered competitive.

Vice-Chair Fairclough requested an explanation of the gross revenue exclusion (GRE) versus the capital credits. She inquired how dollars versus production related to the gross revenue exclusion. Mr. Jepsen asked for clarification.

Vice-Chair Fairclough wondered if ConocoPhillips would rather have a GRE or a capital credit. Mr. Jepsen responded that tax credits probably provided the biggest "bang for the buck." In terms of addressing the high cost in Alaska, the capital credits were a better mechanism.

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Vice-Chair Fairclough observed that many thought that capital investment and employment were high on the North Slope, and asked if that point of view was accurate. Mr. Jepsen replied that there was a lot of work going on the North Slope, and stated that the work was associated with rebuilding the oil fields. He stated that most of the fields were expected to have been fully depleted and abandoned, but were still active. He stated that the work was also related to maintenance and radial work. He stressed that most of the employment was related to renewal. He stated that the capital investment was high, because of inflation. He referred to a slide (not on file) that was presented to the House Finance Committee. He stated that the slide showed capital investment by year, and then showed the capital investment on an inflation adjusted basis. He remarked that the capital investment was constantly in motion, because investment depended on various factors.

Vice-Chair Fairclough inquired if the dotted line was the actual investment. Mr. Jepsen responded in the affirmative.

Vice-Chair Fairclough wondered if the spike in investment was relative to the price of oil or whether there were

other factors. Mr. Jepsen replied that the spikes were a result of large projects and expanded projects.

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Mr. Heinrich interjected that the grey shaded area reflected the price at the particular time. He pointed out that ConocoPhillips' capital programs had expanded over several years.

Vice-Chair Fairclough queried what the inflation adjustment would like in ten or five year increments. She specifically wondered how much money was lost over inflation from price or costs. She shared that steel costs were rising, and wondered if the inflation represented new increases in capital investment, or if it only referred to retrofitting and refurbishing. Mr. Jepsen responded inflation impacts on investment were a mixture of capital investments and refurbishing.

Senator Bishop referred to Mr. Jepsen's earlier comments regarding the material impact of GRE and wondered where the capital credits should be applied. Mr. Jepsen understood the sensitivity regarding the capital credits. He felt that the capital credits should be targeted towards well-work related issues.

Senator Hoffman observed that ConocoPhillips's camps were full with workers. He wondered if there was a breakdown for the numbers of rebuilding and repair, versus potential development and new field development. Mr. Jepsen responded in the negative.

Senator Hoffman wondered if the vast majority of expenses related to rebuilding and repair. Mr. Jepsen related that the information could be determined by extrapolating the age of the fields, and inferring what the activities may have been. He remarked that, during the particular timeframe, there was not much work related to replacement of pipelines, etc.

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RECONVENED

TODD ABBOT, PRESIDENT, PIONEER NATURAL RESOURCES ALASKA, began his displayed the PowerPoint, "Senate Finance Committee Testimony re: CS SB 21(RES)" (copy on file).

Mr. Abbot discussed slide 2, "Looking Forward Statements."

Except for historical information contained herein, the statements, charts and graphs in this presentation are forward-looking statements that are made pursuant to the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements and the business prospects of Pioneer are subject to a number of risks and uncertainties that may cause Pioneer's actual results in future periods to differ materially from the forward-looking statements. These risks and uncertainties include, among other things, volatility of commodity prices, product supply and demand, competition, the ability to obtain environmental and other permits and the timing thereof, other government regulation or action, the ability to obtain approvals from third parties and negotiate agreements with third parties on mutually acceptable terms, international operations and associated international political and economic instability, litigation, the costs and results of drilling and operations, availability of equipment, services and personnel required to complete the Company's operating activities, access to and availability of transportation, processing and refining facilities, Pioneer's ability to replace reserves, implement its business plans or complete its development activities as scheduled, access to and cost of capital, the financial strength of counterparties to Pioneer's credit facility and derivative contracts and the purchasers of Pioneer's oil, NGL and gas production, uncertainties about estimates of reserves and resource potential and the ability to add proved reserves in the future, the assumptions underlying production forecasts, quality of technical data, environmental and weather risks, including the possible impacts of climate change, and acts of war or terrorism. These and other risks are described in Pioneer's 10-K and 10-Q Reports and other filings with the Securities and Exchange Commission. In addition, Pioneer may be subject to currently unforeseen risks that may have a materially adverse

impact on it. Pioneer undertakes no duty to publicly update these statements except as required by law.

Mr. Abbot addressed slide 3, "Presentation Overview."

- Pioneer overview
- Importance of a healthy industry
- Competition for capital
- CS SB 21(RES)
- Incentives for Alaskan investments
- Closing thoughts

Mr. Abbot discussed slide 4, "Pioneer Natural Resources."

Corporate overview:

- \$19 Billion enterprise value
- Member of the S&P 500
- Investment grade rating
- ~3,500 employees
- \$3 Billion capital budget
- \$2 Billion cash flow from operations
- Leading performer in peer group

Alaska Operations Overview:

- 1st independent operator on North Slope
- 70+ full-time Alaska employees
- \$14+ million in annual wages (employees)
- 150 - 300 Alaska contract workers
- ~\$180 million 2013 capital budget
- ~6,000 BOPD gross production
- Net investor in Alaska

Mr. Abbot stated that Pioneer spent more money than it made in Alaska.

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Mr. Abbot addressed slide 5, "Pioneer Alaska Profile: Ooguruk."

Exploration:

- 11 exploration wells '02 - '05

- 1 commercial project

Oooguruk Quick Facts:

- 70 percent Pioneer (operator) : 30 percent Eni
- ~\$1 billion capital invested
- 12+ million barrels produced
- ~\$270 million in credits received
(~7percent of total credits issued by the state)

Mr. Abbot discussed the timeline at the bottom of the slide. He related that the proposed changes represented a fourth change in fiscal structure for Pioneer since it had been in Alaska.

Mr. Abbot spoke to slide 6, "What's Next?"

Nuna Project:

Nuna-1 well drilled in 2012

1~50 MMBO of resource potential

Nuna-2 drilling underway

Phase I development overview

- Q3 2013 sanction decision
- ~\$1 Billion capital required
- 2015 first oil
- 14 MBOPD peak production
- Jobs and economic impact

Potential for 2nd drill site

Must compete for limited capital against low-risk, fast-cycle projects in Lower 48

Mr. Abbot stated that the projects were currently in appraisal. He shared that Pioneer had recently completed the drilling of their second appraisal well. A frack fleet was currently mobilized to complete that project, and there would be a production test, once the project was complete. He stressed that the resource was a 50 million barrel type of resource, with 14,000 barrels per day at peak production. He stressed that there would be \$1 billion worth of capital, and provide many jobs for the state. It was a relatively near-term project, and had potential for upside with a second drill side. He remarked that the

project needed to compete with other projects in the lower 48 states.

Mr. Abbot discussed slide 7, "Pioneer Competitive Resource Opportunities." He stated that Pioneer was planning to spend \$3 billion in capital in the upcoming year. He noted that most of the share would go to Wolfcamp/Spraeberry, which was an old and mature basin. It had continued growth thanks to technology and new ideas. He shared that the Pioneer chairman had recently declared that he felt that it would become the largest oil basin in the world. He stated that the 2013 production growth in that basin would increase by 75,000 to 80,000 barrels per day, which was a 15 to 20 percent production growth for a very mature field. He stated that the Eagle Ford Shale would see approximately \$575 million in investment, and the Barnett Shale would see continual aggressive drilling. He stressed that there was a deep inventory with 20 percent and above growth rates.

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Mr. Abbot spoke to slide 8, "CSSB 21(RES) Comments."

Governor's Guiding Principles:

- Tax policy must be fair to Alaskans
- Any changes to oil taxes should, when taken together, be geared to foster new production
- Changes should result in a more simple tax system and restore balance to our fiscal system
- Tax policy must make Alaska competitive for the long-term

Positives:

- Elimination of progressivity
- Small producer credit extension
- Gross revenue exclusion (GRE)
- Escalating loss carry forward credit
- \$5 per barrel tax credit

Negatives:

- Loss of capital credits
- Increased base tax rate
- Complicated carry-forward loss calculation
- Disadvantages new entrants

Mr. Abbot discussed slide 9, "Relative Rankings and Policy Consideration." He stated that the slide represented the

big companies that contribute to the industry in Alaska. He pointed out that there was a broad array of people and companies. He remarked that each company was a driver in the financial market. He stressed that traditional independents were rewarded for production growth and debt management. He stated that while the smaller independents' production may not seem significant, they have a significant economic impact. He stressed that many companies may have moved their investment to North Dakota, if the small independents were not a part of the industry.

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Mr. Abbot spoke to slide 10, "Eagle Ford Operators and Companies." He stated that the slide showed a list of all of the different investors in the Eagle Ford Shale in Texas. The companies that were highlighted in red and blue were also businesses in Alaska. He pointed out that there was a large number of independent businesses on the list, and furthered that independent businesses drilled over 90 percent of the wells in the US in 2010. He remarked that the large resource plays were driven by small and midsize companies that were becoming innovative and attempting to challenge some of the harder assets. He stressed that many of the fields were not driven by the large companies taking a dominant position.

Vice-Chair Fairclough directed the presentation to slide 9 and inquired why the three companies were in red. Mr. Abbot replied that those companies were considered "small" and "independent" companies.

Mr. Abbot discussed slide 11, "Typical New Project Profile." The red bars were the facilities under construction and were usually a multi-year process; the green bars reflected drilling activity; and the dotted line was project production.

Mr. Abbot spoke to slide 12, "Mid-Sized Producer." He stated that the slide depicted how Pioneer would evaluate a new project. He explained that the hashed bars showed the discounted, after tax cash flows for each year under ACES. He furthered that the red and green bars reflected what would occur under the current proposal. He stressed that the loss of the credits would result in greater capital up front. He stated that Pioneer was a net investor, and had not yet turned a profit, so their taxes would be due in the

future. He remarked that the benefits of the current proposal would not occur for many years down the line.

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Mr. Abbot discussed slide 13, "New Entrant-Stand Alone Project." He pointed out that a new entrant would face a worse situation than a company like Pioneer, under the new proposal. He remarked that the proposal would be more beneficial to a large producer that had a current tax liability, than to a smaller company.

Mr. Abbot spoke to slide 14, "Industry Spending on North Slope." He stated showcased the impact of credits directly. He stated that the slide showed a five year history on capital expenditures by category, and where the credit were applied. He pointed out that 43 percent of the credits were directed at new wells, and 42 percent of the credits were directed at facilities to allow those wells to produce. He stressed that the production was declining, but that did not mean that the credits did not have a positive impact.

Mr. Abbot discussed slide 15, "Fostering New Production: Why Credits Matter."

Benefits to State

- Credits directly encourage activity in Alaska
- Jobs, direct and indirect (9x multiplier)
- More wells
- More oil
- More royalties, taxes and throughput

Benefits to Developer

- Reduces investor risk
- Improves small project economics
- Improves financial performance
- Doesn't increase debt
- Builds healthy industry
- Strengthens competitiveness

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Mr. Abbot spoke to slide 16, "CSSB 21(RES) Closing Thoughts."

Pros

- Eliminates progressivity

- Shares upside potential
- Improves competitiveness
- GRE reduces tax for new oil
- Extends small producer credit

Cons

- Elimination of credits increases investor risk
- Requires more upfront capital
- Increased base tax rates
- Does not simplify tax calculations
- Complex carry-forward loss calculations
- Does not strongly motivate additional investment

CS SB 21(RES) suggestions

- Targeted credits for new facilities/well related costs
- Allow targeted credits to be redeemable/ transferable
- Allow credits to be taken against any payment to the state

Mr. Abbot stressed that credits were important for the smaller oil companies. He stated that a healthy debate needed to be held regarding how the credits were targeted and added that the credits should be transferable.

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Co-Chair Meyer pointed out that capital credits had gotten the desired result in the past and asked how the committee could make sure that a similar mechanism would get more oil in the pipeline. Mr. Abbot responded that for a company to claim the credits it had to be moving forward with new development and production.

Senator Bishop noted that, according to slide 14, 42 percent of the credits were for facilities. Mr. Abbot agreed.

Senator Bishop inquired what those percentages equated to barrels of oil produced. Mr. Abbot did not have that data.

Senator Bishop noted that was the important question and thanked Mr. Abbot for Pioneer's effort to hire Alaskans.

Co-Chair Meyer asked if Pioneer had built their own processing plant. Mr. Abbot replied that Pioneer shared a facility with KRE.

Co-Chair Meyer recalled that there were five producers in Pioneer's location.

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Senator Hoffman inquired if Pioneer was suggesting that there should be changes to the way the credits currently apply. Mr. Abbot responded that some of the credits for projects encouraged new production, but some were not. He felt that the focus for credits should be on new wells and facilities.

Senator Hoffman stated that the goal should be new exploration and that without exploration there would be no new oil. He inquired if exploration was a priority among the three categories. Mr. Abbot replied that exploration was extremely risky and that a large amount of capital was spent on a project.

Senator Hoffman observed that the purpose was to get more oil in the pipeline. He acknowledged that the costs for explorers was high and noted that the governor's goal was to get new barrels of oil on the line. He inquired if the credits were more valuable to Pioneer than the other options in the resources committee. Mr. Abbot responded that the credits were more valuable to Pioneer. He opined that development, and not exploration, would get new oil in the pipe line.

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Senator Hoffman wondered if the well drilling and development dollars add more oil to the pipeline. Mr. Abbot replied in the affirmative.

Senator Hoffman asked how facilities encouraged new oil in the line. Mr. Abbot replied that he was unsure, but noted that a large investment applied to most projects.

Vice-Chair Fairclough observed that new exploration could put new oil in the pipeline eventually. She stressed that the most immediate oil was in currently fields, but felt that it was merely a short-term solution. Mr. Abbot responded that slide 11 showed that the capital cost was post-sanction dollars. He remarked that the capital cost did not include the exploration or appraisal phase. He

remarked that there were many years of appraisal and exploration before the investment return could be obtained. He felt that the credits should be focused on the near-term, mid-term, and long-term.

Vice-Chair Fairclough noted that there were different investment strategies for different forms of oil production.

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ED KERR, VICE PRESIDENT OF LAND AND BUSINESS DEVELOPMENT, ARMSTRONG OIL AND GAS, read from a prepared testimony (copy on file):

Thank you for giving me the opportunity to speak with the Senate Finance Committee today about the oil and gas industry on the North Slope. We are a strong supporter of SB 21 we believe that the passage of this bill will not only result in significant investment on the North Slope, it will serve as a catalyst to increasing production as well. Some of you may have heard Bill Armstrong make a presentation to the Senate Resources Committee a couple of weeks ago. If you heard that presentation you probably already know that it has been our opinion that you in the Senate have been inundated with so much information that I cannot begin to imagine how you can process it all. I have been in this business for more than 30 years and have experience in numerous states and some various other regions in the world and I have to tell you, it is incredibly difficult to keep up with all of the information that is being provided with regard to SB 21.

For this reason I will not have a power point, I would rather talk to you and see if you think I have anything to add with respect to how Alaska can increase its production in a manner that is fair to Alaskans and is something that the oil companies can work with. Today I would like to keep things pretty simple and keep to the fundamentals. The only thing that really tells the story on the North Slope is what does its production profile look like and is there anything on the horizon that will help it.

As I was trying to get ready to talk with you about this I had an internal fight with myself. It reminded me of my high school English class when we read the Dickens classic, A Tale of Two Cities. The first part of opening line of the book is "It was the best of times, it was the worst of times." Guys this describes the oil industry on North Slope and where it is at this point in time better than anything I can think of.

I know revenues to the State have been up over the last few years and I know that you as members of the legislature have an important duty to make certain that the State gets its fair share and maximizes the state's fiscal position. The hard part of the story is when you look to the future and the fact that while the North Slope is one of the most remarkable petroleum provinces in the world, it is the only petroleum province in the US that is not enjoying the benefit of the amazing technological advancements in horizontal drilling and stage frack technology. I know you have seen the same graph in probably ten different presentations of the North Slope's production decline while Texas and North Dakota have production increases. Last Friday the ADN reported on the front page that Texas has doubled its production since 2010, doubled its production in 3 years, amazing (especially given the fact that Alaska has experienced about a 6 percent annual decline during that period), and we all know North Dakota passed Alaska last year to become the second largest producer in the United States. I never thought I would see that. I know someone can look at that data set and feel that this is the worst of times because as we all know the states revenue is only as good as the production and if the production keeps dropping at this rate, soon the state will have big issues with its budget.

I don't know how long TAPS can last at the current decline rate and frankly that's not the question anyone should be asking, we should be asking, "How in the heck can we have one of the greatest petroleum provinces in the world and get beat out by North Dakota in daily production. Guys as a petroleum system North Dakota is a Jr. High team and Alaska is Professional team, there is no way this should happen, but it has and we have to ask ourselves how did we get

to this spot and what will it take for Alaska to take its rightful spot as the top producing state in the nation.

Before I give you any more of my thoughts I should probably take a second to tell you a little about Armstrong Oil & Gas and what we have done in Alaska. We are an independent oil and gas company headquarter in Denver, Colorado. We would probably be considered a bit of new type of company for the North Slope as we are privately owned, we carry no debt and as such we do everything out of our own pockets, every decision we make is based on the bottom line and not what some stock analyst on Wall Street thinks or says.

I am a minority owner in Armstrong and have been involved in Alaska since the beginning. We began studying the North Slope diligently in the late 90s, we made our first lease acquisition in the early 2000s. Our business model is to establish significant exploration and development projects through the utilization of all of the technology available to our industry. It is our opinion that we have the best scientist in the world these scientists have an extremely broad and diverse experience level that affords us a perspective that most people do not have. Most of our Geoscientist spent their early years with Exxon.

At any rate the first concept we pulled together on the North Slope was what is today the O3 field. We initially established the concept through acquisition of leasehold and technical data and then we brought in Pioneer to help us develop the field. Subsequently we brought a company called Kerr McGee into to help us define and develop what is today known as the Nikaitchuq field that is operated by ENI. We currently operate the North Fork Gas Field in South Central Alaska and on the North Slope we are partners with Repsol E&P USA where we currently have 3 rigs running on the North Slope.

If I can I would like to take second to apologize for the lack of a polished presentation for you today. The fact is I am not that good of a public speaker and I didn't know I was coming here until a few days ago, so my apologies. What you will hear from me are

observations of what we as a company have found is the number one critical attribute any area needs in order to have a successful thriving oil and gas industry that will either sustain itself or grow even larger.

The most critical barometer for the health of a producing region is the rig count (it is the canary in the mine). Depending on the week, you see Alaska's fluctuate between 6 and 14. Let me put that in perspective, the Permian Basin not all of Texas, just the Permian Basin is at 430. That is around 43 times greater than all of Alaska by itself. Assuming each area drills and completes a well in a couple of months that means in one year the Permian Basin brings on an additional 2580 wells while all of Alaska would bring on about 60. With this metric in mind it is easy to see how Alaska is drifting the wrong direction with its production. You can apply this metric to any basin or state and you will get the same answer (North Dakota is at 178 rigs, Oklahoma has 190), in order for Alaska to continue to be considered relevant in the petroleum industry something must be done to make it competitive with the other states and regions of the world.

When I look at some of the public companies I see such amazing results. Pioneer recently reported it had over 36,000 net resource locations with potential in excess of 8BBO. EOG Resources has had oil production growth of 35 percent in 2010, 52 percent in 2011 and 39 percent in 2012, they have a drilling inventory that will keep them busy for the next 15 years even if they do no new business. My point is that this story is occurring in tons of companies all through the lower 48, states like Pennsylvania are on the rise and the state of Alaska needs to do something to make itself more competitive. We feel like SB 21 is a great start to getting Alaska competitive with the rest of the world.

I think it is important to note that SB 21 needs to be passed as it is and possibly with some minor improvements in order to make certain Alaska becomes competitive with the rest of the world. We need to make certain the GRE stays in place as it is and is not limited to the first 7 years. A study of the new fields on the North Slope show how time consuming and

difficult it is to bring fields on line and as such you need the GRE to be effective throughout the life of the field. The monetizing of the EIC will serve to continue to encourage new entrants with new ideas to come to the North Slope.

The fact is the North Slope is remote, cold, expensive, with tremendous regulatory issues and SB 21 is needed or Alaska will not be considered competitive with the rest of the world. It is next to impossible to convince a substantial company to come to the North Slope to develop new fields when the states own experts rate the state of Alaska worse than Kazakhstan for new field development. It is important to note that by supporting SB 21 as a new entrant we are actually helping the state's fiscal position. We are walking away from the cash reimbursement from the state of the LCF and QCE, so that we can have a stable tax regime. At the end of the day the state has only upside with regard to the new field portion of SB 21.

We do think SB 21 simplifies the tax code, we think it is fair to Alaskans, that it is durable and that it makes Alaska competitive. I believe that you need all parts of SB 21 for the state to be successful. The state needs the legacy field provisions of SB 21 to pass so that the fields like Prudhoe Bay and KRU can provide quick immediate barrels into TAPS and keep the transportation costs on TAPS from increasing.

The state also desperately needs SB 21 to pass so that new entrants will be encouraged to come to the NS and invest, this is the future of the North Slope. Currently 92 percent of all production from the North Slope comes from 2 operators, I know of no other significant petroleum province in the world that has this fact set. As a comparison the top 20 operators in Permian make up 47 percent of the basins production and when I asked our research guys how many make up 92 percent, I was told that the number was so high that it would take a tremendous amount of time to figure that out. On the North Slope the top two operators drilled 86 percent of all of the wells in the basin, in the Permian Basin the top 20 operators make up 35 percent of all wells drilled.

None of this is the operators fault they are doing their job, but it does show that there is a desperate need for more players on the North Slope and in order to have any impact this change needs to be done now. As an example from the time we started working on O3 until the first production came out of the field it took 10 years, so as you can see something needs to be done right now.

Further evidence of the North Slope not being competitive can be found within its lease sales. Since we made our first bid in Alaska in 2001, a very successful sale would be one that is considered to bring in around \$10MM with around 6 successful bidders, compare this against the GOM sales that have more bidders and as an example on the last Central GOM sale had one tract that brought in \$157MM that one tract being well in excess of the last 10 state North Slope Lease sales. This is evidence of a system that needs fixing.

So enough about the negative news. The good news is I can tell you from the perspective of the company that brought Pioneer, ENI and Repsol to the North Slope that there are a lot of companies that would desperately like to do business on the North Slope but they have shied away because of the ACES tax system. To be sure the costs concern them and I believe we need to work hard to streamline the permitting of projects on the North Slope, but I believe the primary thing that keeps them away is the current ACES tax system.

SB 21 is a huge step in the right direction to getting new entrants on the North Slope as well as getting production from new fields up and running, increasing the life of TAPS and providing high paying jobs for Alaskans in the process. There is an incredible step function change in our industry that is going on right before our eyes and if Alaska doesn't make the changes provided for in the Governor's bill this revolution has the potential to pass over Alaska. So these are my thoughts, but I would really like to talk about this with all of you. This is an amazing time in our business and I want to make certain that you guys ask any question at all that you feel should be discussed. I love this business and think that is the best way to

get the heart of the discussion so please ask me any questions you want about taxes, permitting, potential of the North Slope (it is huge) or anything else you want to talk about.

[3:31:38 PM](#)

Senator Dunleavy wondered how the landscape of the North Slope would look like in 5 years, if the bill were to be adopted. Mr. Kerr responded that Armstrong would move forward with new projects, if the bill was adopted.

Senator Dunleavy inquired if Armstrong would be producing more oil if the bill passed. Mr. Kerr responded in the affirmative, but stressed that there were many permitting issues that must be addressed.

Co-Chair Meyer noted that the state was trying to deal with permitting issues.

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Senator Bishop wondered if the Baakan or Eagleford had any tax credits. Mr. Kerr responded that they did not have tax credits. He remarked that those locations had quick turnover time, and made money relatively quickly. Conversely, the North Slope presented challenges, because of its remoteness. He furthered that Armstrong would rather forgo the credit in favor of a more reasonable tax rate.

Senator Bishop queried the turnaround time in North Dakota from the deal with the landowner to the drilling time. Mr. Kerr replied that the turnaround time could be as short as three months.

Senator Bishop requested slide 4 of Econ One's presentation and offered that he felt that the committee substitute made Alaska competitive with the other states.

Co-Chair Kelly requested a description of Texas' oil tax regime. Mr. Kerr replied that that it was a flat tax rate. He stated that Armstrong did not currently have any production in Texas.

Co-Chair Kelly queried Mr. Kerr's opinion about a 63 percent government take. Mr. Kerr asked for further clarification.

Co-Chair Kelly wondered how he felt about replacing ACES with a flat government take across all prices and production. Mr. Kerr stated that it would be inappropriate for him to respond, because he did not have the parameters in order to form a responsible opinion.

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Senator Dunleavy inquired if Armstrong was saying it accepted the committee substitute. Mr. Kerr responded that if he had to choose between the proposal and ACES, he would choose the proposal. He stated that pioneer had 40,000 locations and that he looked through Alaska with a different lens.

Vice-Chair Fairclough inquired if the bill had a positive effect on "wildcat" companies. Mr. Kerr replied that the proposal was better than ACES. He furthered that Armstrong was trying to plan for long-term full-cycle economics.

Vice-Chair Fairclough queried if Armstrong was currently producing in Alaska. Mr. Kerr responded that Armstrong was producing in Southcentral Alaska, with approximately 13.5 million cubic feet per day.

Vice-Chair Fairclough wondered if Armstrong usually saw development and production through, or if Armstrong sold locations. Mr. Kerr responded that Armstrong did both of those things.

Vice-Chair Fairclough inquired what the best component under CSSB 21 (RES) compared to ACES. Mr. Kerr replied that it was the elimination of progressivity and how the tax was calculated.

Co-Chair Meyer wondered if Armstrong or Repsol was the operator on the North Slope. Mr. Kerr replied that Repsol was the operator on the North Slope.

Co-Chair Meyer stated that Armstrong was the operator in Cook Inlet, and therefore was an operator and a producer. Mr. Kerr agreed with that summation.

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AT EASE

3:48:45 PM

RECONVENED

KEN THOMPSON, PRESIDENT, ALASKA VENTURE CAPITAL GROUP (via teleconference), introduced himself.

3:50:37 PM

Mr. Thompson spoke to slide 2, "Why Consider Our Company's Perspectives?"

- 1) Most active exploration company exploring and developing sole on North Slope state lands
 - a) Drilled 10 of 36 exploration wells on state lands in 2007-12 (more than COP, BP, XOM, ENI, Repsol, Armstrong combined)
 - b) 105,000 leased acres in 3 core areas in JV partnership with Ramshorn Exploration (affiliate of large Nabors Industries)
- 2) ~\$200 MM invested to date in Alaska North Slope projects...3 discoveries, acquired discovery
- 3) Mustang development project under construction...\$577 MM capital, 44 MMBO
- 4) Three other development projects in permitting/conceptual engineering stages. >\$1.5 billion capital
- 5) First production and cash flow to state and our companies...startup of Mustang in 3Q 2014
- 6) On investment of \$200 MM, received refunded tax credits totaling \$69 MM but State will receive back this amount in the first year of Mustang production, and \$1.2 billion over field life.
- 7) Experience in bringing other independents to Alaska and in raising capital for Alaska

Mr. Thompson discussed slide 3, "North Slope Drilling Results and Success." He explained that the slide showed the activity since 1999, which was the year of the first lease. He shared that most of the drilling had occurred during the recent three to four years.

Mr. Thompson spoke to slide 4, "What Difference can Our Company make?" He shared that it was interesting that the smaller fields could add up to over 50,000 barrels of oil a day. He pointed out that the developments he was showing on the slide could offset decline. He stated that if the major companies had incentives in legacy fields, the Alaska curve would turn upward. He opined that Alaska needed exploration and production.

[3:59:10 PM](#)

Mr. Thompson discussed slide 5, "We See Positives in SB 21 CS to Help Grow Production."

1) Increases "Carry Forward Loss Credit (CFL)" from 25 percent to 35 percent and interest on unused credits.

Positive: incrementally more future cash flow to re-deploy into facilities and drilling

2) Extends "Small Producers" credits from 2022, reduces small producers' tax bill by \$12 MM/yr.

Positive: more cash flow for small producers to re-deploy into facilities and drilling

3) Specifies 20 percent QCE tax credit certificate payment in single year vs. 2 but does eliminate QCE on 12/31/13

Positive: more immediate cash to put into Mustang development facilities and drilling 2014

Negative: no QCE payment in 2015 to re-deploy into Mustang development drilling

4) Eliminates progressivity factor, increases base tax rate from 25 percent to 35 percent but provides \$5/bbl produced bbl credit

Positive: Eliminating progressivity simplifies tax calculation and will be a public relations plus for AK

Negative: Increase in base tax rate from 25 percent to 35 percent not expected, but partially offset by...

Positive: \$5/bbl produced bbl credit better balances relative state/producer takes at low oil prices

5) For new oil, increases "20 percent GRE" to 30 percent GRE and amends definition of leases that can be included for this GRE

Positive: Should incentivize new oil production on more leases, also help during low oil price cycles

6) Removes old distance limitations and allows for a 30 percent "Exploration Incentive Credit" for exploration wells drilled that target new oil discoveries regardless of location

Huge Positive: For exploration companies like ours-will result in more companies and more oil on State lands

7) Overall, thanks for the changes in the CS, this should help in attracting new capital and leveling oil production

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Co-Chair Meyer wondered if the \$5/bbl was a good offset against the rise from 25 percent to 35 percent. Mr. Thompson replied that it only partially offset the decrease, but furthered that the CS was more attractive at oil prices.

SB 21 was HEARD and HELD in committee for further consideration.

#

ADJOURNMENT

[4:08:32 PM](#)

The meeting was adjourned at 4:08 p.m.