

ALASKA STATE LEGISLATURE
SENATE SPECIAL COMMITTEE ON TAPS THROUGHPUT

February 5, 2013

3:33 p.m.

MEMBERS PRESENT

Senator Mike Dunleavy, Co-Chair
Senator Peter Micciche, Co-Chair
Senator Anna Fairclough
Senator Lesil McGuire
Senator Berta Gardner

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Senator Cathy Giessel

COMMITTEE CALENDAR

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."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 21

SHORT TITLE: OIL AND GAS PRODUCTION TAX

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/16/13 (S) READ THE FIRST TIME - REFERRALS
01/16/13 (S) TTP, RES, FIN
01/22/13 (S) TTP AT 3:30 PM BELTZ 105 (TSBldg)
01/22/13 (S) Heard & Held
01/22/13 (S) MINUTE(TTP)
01/24/13 (S) TTP AT 3:30 PM BUTROVICH 205
01/24/13 (S) Heard & Held
01/24/13 (S) MINUTE(TTP)
01/29/13 (S) TTP AT 3:30 PM BELTZ 105 (TSBldg)
01/29/13 (S) Heard & Held
01/29/13 (S) MINUTE(TTP)
01/31/13 (S) TTP AT 1:00 PM BUTROVICH 205
01/31/13 (S) Heard & Held
01/31/13 (S) MINUTE(TTP)
02/05/13 (S) TTP AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

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

POSITION STATEMENT: Presented information related to SB 21.

THOMAS BARRETT, President
Alyeska Pipeline Service Company
Anchorage, Alaska

POSITION STATEMENT: Presented information related to SB 21.

DOUG SMITH, President and CEO
Little Red Services and
President
Alaska Industry Alliance (AIA)
Anchorage, Alaska

POSITION STATEMENT: Presented information related to SB 21.

SCOTT JEPSEN, Vice President
External Affairs
ConocoPhillips Alaska
Anchorage, Alaska

POSITION STATEMENT: Presented information related to SB 21.

BOB HEINRICH, Vice President
Finance
ConocoPhillips Alaska
Anchorage, Alaska

POSITION STATEMENT: Presented information related to SB 21.

DOUG SMITH, President and CEO
Little Red Services, and
President
Alaska Industry Alliance (AIA)
Anchorage, Alaska

POSITION STATEMENT: Testified in support of SB 21.

ACTION NARRATIVE

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CO-CHAIR PETER MICCICHE called the Senate Special Committee on TAPS Throughput meeting to order at 3:33 p.m. Present at the call to order were Senators Gardner, Fairclough, McGuire, Co-Chair Dunleavy and Chair Micciche.

SB 21-OIL AND GAS PRODUCTION TAX

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CO-CHAIR MICCICHE stated the purpose of the meeting was to hear from the oil industry on SB 21.

He noted the presence of Senator Giessel.

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KARA MORIARTY, Executive Director, Alaska Oil and Gas Association (AOGA), explained that AOGA represents 16 companies who account for the majority of oil and gas exploration, development, production, transportation, and refining of oil and gas on shore and off shore in Alaska. She said her comments have been unanimously approved by all members of AOGA.

She agreed with Senate President Charlie Huggins' comment in the Anchorage Daily News, January 31, when he stated, "The most pressing issue facing Alaska is the downturn in oil production on Alaska's North Slope." She applauded Senator Huggins, the committee, and Governor Parnell for recognizing this as a serious issue.

She drew attention to a chart of the most recent forecast of production decline from the Department of Revenue (DOR). She contrasted it with the forecast from 2000 when everyone was focused on oil price and the state was facing a billion dollar shortfall at a time when the budget was significantly less than it is today. In the past, DOR projected that ten years from now, 50 percent of our oil production would be from new oil.

She pointed out that DOR's updated forecast includes a new risk modeling into their forecast, but noted that the forecast for currently producing fields assumes that the current level of investment in producing fields will continue, which is by no means guaranteed.

She informed the committee that Alaska's production decline rate has remained at around 6 percent per year for the last decade, or at least 40,000 barrels a day per year. She maintained that the accelerated decline is unacceptable, especially at a time of record and sustaining high oil prices over the last five years.

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MS. MORIARTY turned to a graph that showed competition at high oil prices. Production in Texas started to level off as oil prices increased. North Dakota has caught up and surpassed Alaska in production. California is about to surpass Alaska. Alaska now supplies only 8 percent of the nation's oil production. She showed how Alaska is headed out of medal contention in daily oil production.

She related that in November 2012, the most recent month of statistics on the U.S. Energy Information Agency's website, production in Texas was 2.1 million barrels per day, North Dakota was 731,000 barrels per day, and both Alaska and California were at 553,000 barrels per day.

She reminded the committee that she represents a diverse membership, ranging from companies exploring and operating in Cook Inlet and on the North Slope, to companies hoping to develop Arctic Outer Continental Shelf (OCS) resources, to three in-state refineries, as well as the Trans-Alaska Pipeline System (TAPS).

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MS. MORIARTY pointed out that current production is over 100,000 barrels per day less than when production from the North Slope began in 1977, and Alyeska Pipeline Services Company would like to see that decline change. Alyeska faces increasing daily demands and challenges related to providing safe and reliable transportation of oil to market. All members of AOGA share those concerns. Two of the three in-state refineries rely solely on North Slope crude delivered through TAPS. Low throughput increases the costs of refining, especially in Interior Alaska. For example, about 20 years ago, when the oil reached North Pole refineries, it was about 110 degrees Fahrenheit and now it

ranges in the 30-degree range. Having to heat the oil increases energy costs.

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She spoke of the challenges in Cook Inlet of attracting workers back to the area and finding enough drilling equipment for new production there.

She related that the Arctic OCS is believed to have an estimated 27 billion barrels of oil and 130+ tcf of natural gas. Even if there is a successful exploration season in 2013, it will be 12 to 15 years before production is seen from the Chukchi Sea. The pipeline needs to be healthy and viable then, as well as today.

MS. MORIARTY discussed producers of the existing non-legacy fields on the North Slope and the developers of any new fields that may be discovered there. She said they need as much production as possible flowing from the legacy fields through TAPS in order to keep the costs affordable to ship their oil to refineries. Unaffordable high transportation costs could cripple the economics of any new fields that might be found, as well as economics of non-legacy fields currently in production.

She compared the North Slope oil province to a tree, with the two great legacy fields being its trunk and with the other fields being branches rising out of the trunk. If one peels the bark off all the way around the trunk and makes it unhealthy, all the other branches will become unhealthy, too, no matter how robust they might have been if the trunk stayed strong.

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She said that Governor Parnell recognizes that as a state, Alaska needs increased oil production in all fields because the current throughput is unacceptable. He has identified four core principles that "any tax reform proposal must adhere to": the tax must be fair to Alaskans, must encourage new production, must be simple, so it restores balance to the system, and it must be durable for the long term. She said that AOGA endorses these principles.

She encouraged the committee to ask:

- What is the state's goal and desired outcome?
- Does the state's policy reflect the constitutional mandate of developing the natural resources here for the maximum benefit of Alaskans, both today and tomorrow?
- Is the policy short, mid or long term?

- Will it encourage additional investment across a wide spectrum of projects/companies?
- Will it encourage development through a fair and predictable regulatory environment?
- Will it encourage development through land sales and competitive lease terms?

She emphasized that the challenge facing Alaska is not in having too many companies pursuing the opportunities that they see here, but in having too few. To be effective, any reform measure needs to avoid tax changes that artificially create winners and losers.

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MS. MORIARTY shared thoughts on SB 21:

Senate Bill 21 takes some positive steps towards the goal of more production; such as the Gross Revenue Exclusion concept and eliminating progressivity, which has led to Alaska being uncompetitive. There are some other provisions that need further consideration in order to fully achieve the goals set out in this legislation.

We support the proposed elimination of progressivity. We have reservations with what the bill proposed for tax credits - most importantly with the proposed repeal of tax credits for qualified capital expenditures (QCE). The trade-off between repealing progressivity and losing the QCE credit is not beneficial to industry with a rising cost structure and low oil price environment, although it would be helpful with high prices.

We strongly support the GRE (gross revenue exclusions) concept but have concerns over its limited applicability to new fields only, which is further compounded by the loss of QCE credits as a driver for additional investment. We believe the GRE and tax credit restructuring proposed in the bill could and should be expanded and better tailored to fit the majority of projects for legacy fields that would increase the amount of oil and gas from them.

We also believe the reasons that led the state to create the small producer tax credits under AS 43.55.025 are also still valid today, and the bill

would be improved by extending these tax credits or making them permanent. Similarly, the bill would also be improved by addressing the upcoming end of the tax caps for Cook Inlet production and non-Cook Inlet gas sold for in state use, which will otherwise occur at the end of 2021. Addressing these known issues now, before they become imminent, would strengthen the durability of the reformed tax.

The members of AOGA desire the same outcome that the Governor and the people of Alaska want - more oil in the pipeline providing a solid future for our industry and continued revenues to the state for the benefit of all Alaskans.

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Our member companies want to do business in Alaska. Some have been exploring and producing in Alaska for decades, while others have arrived more recently. Both groups have a strong desire to be able to remain in Alaska long term for their own and the state's mutual benefit.

Overall, the bill as introduced represents a cornerstone for significant and crucial tax reform. It will take a monumental effort just to replace oil from declining fields with a mixture of new production and new stimulation to legacy fields, and bring the decline to a stop. AOGA stands ready and willing to help Alaskans, the Governor, and this legislature in the remaining work to achieve the four "core Principles." We all need to work together to make this happen.

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CO-CHAIR MICCICHE commented that everyone he has spoken to in the 28th Legislative Session shares concern about the decline of throughput. The committee was formed for that very reason and is looking as SB 21 to consider throughput issues, not tax issues. He stated that there are two philosophies in the state: those who believe production decline can be reduced, and those who believe arresting the decline is unlikely and are concerned that without guarantees, it is a giveaway of state revenue. He asked how the legislature can ensure for Alaskans that the probability of increasing throughput in TAPS is not only a probability, but a relatively high probability, if Alaska were to become more competitive.

MS. MORIARTY suggested looking at other oil producing regions. Alaska is not competitive due to its tax structure. Other regions have been successful increasing production, even in old, declining fields. She said to ask what kind of policy Alaska wants, one with more production over the long term, or to take as much as they can in the short term. She argued that the state can have more production over the long term in a competitive environment.

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CO-CHAIR DUNLEAVY asked if Ms. Moriarty proposed rolling Cook Inlet into the tax concept.

MS. MORIARTY clarified that AOGA supports the fact that SB 21 has left Cook Inlet harmless and has left the tax structure there alone. However, if the bill was to revisit tax credits, there are several tax credits in Cook Inlet that are set to expire in 2021 that AOGA believes would be good to keep by extending them or making them permanent. She suggested it would be better to make those changes now instead of right before they expire because companies make investment decisions years out.

CO-CHAIR DUNLEAVY stated that the mandate of the committee is to look at TAPS and issues related to North Slope resources.

CO-CHAIR MICCICHE thanked Ms. Moriarty for her testimony.

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THOMAS BARRETT, President, Alyeska Pipeline Service Company, introduced himself. He stated that the steady decline in oil production on the North Slope is a crucial issue for Alyeska, as the pipeline operator, and for the people of Alaska.

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At ease

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MR. BARRETT said throughput decline is a significant problem for the state. During the time the committee is meeting, throughput will decline by over 2,000 barrels. Since the legislature has convened, throughput has declined by over 725,000 barrels.

He related that TAPS is an 800 mile pipeline that runs from Prudhoe Bay to the marine terminal at Valdez. It was designed as a warm oil pipeline set to move 1.5 million barrels per day. It had a peak production of over 2.1 million barrels per day in

1988. Circumstances have changed; throughput and temperatures continue to decline. At 580,000 barrels a day, segments of crude oil in the pipe will be below 32 degrees Fahrenheit during the winter months.

He reported that, so far, TAPS has delivered over \$170 billion over the past 35 years to the state treasury. More than 90 percent of government services are paid for by oil revenue. Some experts suggest that without TAPS, Alaska's economy might be half of its present size.

He said in 2012 average daily throughput decreased by 6 percent. He showed a graph of steadily declining throughput. Declining flow increasingly challenges Alyeska's outstanding personnel who run the pipeline every day all year long.

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MR. BARRETT showed a temperature profile of the pipeline for the last two weeks. He explained as throughput declines, the temperature declines, leading to increased ice and wax buildup. He said it ideal to operate above 40 degrees. Severe cold in the interior is currently a big challenge.

CO-CHAIR MICCICHE asked about the cause of warming between pump stations 7 and 10.

MR. BARRETT replied that heat is added at pump stations 3, 4, 7, 8, 9, and just before the refinery.

CO-CHAIR MICCICHE summarized that the lower the throughput, the more Alyeska has to spend on energy to operate the pipeline.

CO-CHAIR DUNLEAVY asked who ends up paying that cost.

MR. BARRETT said it comes out of operating costs and is passed on to the state and to the owners.

He shared an example of a challenge due to decreased throughput from the point of view of an operator. He explained about scraper pigs that clean wax out of the pipeline. Wax can damage valves and cause corrosion. He gave an example of what happened at pump station 9 on New Year's Day when a pig was trapped by a large amount of wax caused by extremely cold temperatures. The operators did an excellent job of managing and solving the problem and there was no interruption in throughput. He concluded that it is a challenge to manage problems related to throughput. He stressed that adding more heat will not solve

complex problems created by decline in flow. Currently, Alyeska is experimenting with ways to remove water from the oil before it enters the pipeline.

He questioned if finding ways to move only 3,000 barrels a day is a desirable outcome for Alaska. He showed a slide that says, "Taking action today, preparing for tomorrow."

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CO-CHAIR MICCICHE talked about minimum flow issues and concluded that Alaskans, under ACES, are paying more to ship less oil every day. He asked if Mr. Barrett agreed.

MR. BARRETT said he would frame it as "the cost of moving a barrel of oil down the line as the throughput goes down, is headed up."

He noted that even though Alyeska has "true grit" - determination, ingenuity, and partnership - it needs help with increasing throughput. He emphasized that more production from fields near to existing infrastructure is highly desirable because it can come online into the pipe sooner.

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CO-CHAIR DUNLEAVY asked if OCS comes on line and the transport system is the same, will the oil have to be heated.

MR. BARRETT explained that oil comes into the line at 105 degrees; however, TAPS is half above ground where there are temperature concerns.

CO-CHAIR DUNLEAVY asked if the decreased volume of oil is the cause of the oil cooling off faster.

MR. BARRETT said the flow rate is also slowing down so there is more exposure to the cold.

CO-CHAIR DUNLEAVY assumed that TAPS could continue to run with decreased volume, but costs would increase.

MR. BARRETT agreed that there would eventually be an economic limit. He added that with the current configuration, a gravity flow, warm oil pipeline, Alyeska can manage the flow into the mid-300 barrels per day range, but it would be more costly. Alyeska is evaluating the ability to change the pipeline to a cold, dry flow. He emphasized that it is not as simple as some

might think. Adding heat will not solve the problem and adds other complications.

He reported in 2012, Alyeska operated at 99.8 percent reliability - uninterrupted cash flow - with the safest year on record and a superb environmental record. He predicted the uninterrupted cash flow would not continue into the future.

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CO-CHAIR MICCICHE asked Mr. Barrett to define a cold, dry system.

MR. BARRETT explained that currently the system is wet; the oil has water in it. In a cold, dry system, the water would be distracted from the oil before it entered the pipe. The science is being evaluated now.

He mentioned Alyeska's safety performance and environment record is very good. He shared a personal story from having read No Easy Day. He maintained the only easy day for Alyeska was yesterday, and to repeat that will be hard. He said the easy day for TAPS and Alaska was yesterday. He suggested it was time to change the paradigm or Alaska will not be able to sustain what it had in the past.

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MR. BARRETT showed a slide of a statute at the Valdez terminal that says, "We didn't know it couldn't be done." He pointed out that TAPS is Alaska's pipeline. Alyeska's personnel will continue to do its part and is determined to do a good job. He asked for the committee's support to move forward to increase production and throughput in TAPS.

CO-CHAIR MICCICHE appreciated the quote and the presentation. He said the committee would be working on some of the operational issues after passing SB 21 on to another committee.

CO-CHAIR MICCICHE introduced Mr. Smith, saying that the committee seeks to allow a cross section of people who are operating on the North Slope to testify. So far, the committee has heard from the public, industry support agencies, and the industry.

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DOUG SMITH, President and CEO, Little Red Services (LRS), and President, Alaska Industry Alliance (AIA) stated that he was testifying on behalf of AIA, representing 600 companies and

about 35,000 employees, most of whom are dependent on a successful oil tax policy.

He noted that it is early in the analysis of SB 21. The committee is focused on production in TAPS. He said that if there was an interruption in the flow of oil in TAPS, there would be ramifications felt in the North Slope. He recalled in 2011 when there was an interruption and LRS provided the freeze protection capacity on the North Slope. He pointed out that problems caused by decreased oil flow affect activity in the winter on the North Slope.

He termed increasing production a "bridge building opportunity" toward future production on the North Shore and other areas. He spoke of a goal to stem decline in order to provide a time window to get to the next resource to put into TAPS.

He related that there is pressure to move support services to the Lower 48. He mentioned the 410 wells waiting to be drilled in North Dakota and said Alaska drilled that many wells in the last three years. He said AIA must follow the investments of the companies they work for.

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MR. SMITH suggested making a fair, equitable, and durable tax policy now. He said he was opposed to too many additional consultants. He recalled information provided in 2007 by Gaffney Kline that forecast almost \$4 billion in capex for drilling up to 2012, and an incremental improvement in production of over 200,000 barrels per day by 2012. He said that prediction was very far off. He cautioned to look at the track record of experts, at what investment capital is doing, and at the market, in order to keep jobs and move the economy in the right direction.

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SENATOR MCGUIRE thanked Mr. Smith for diligently following the issue. She requested suggestions and recommendations from AIA.

MR. SMITH read four considerations:

- Ensure our tax policy adjustments do not increase taxes in the range where producers will stress test the economics of investment opportunities, thought to be in the \$80 to \$85 range.

- Ensure our tax policy does not disincentive development within existing PA's where the largest production improvement opportunities exist.
- Oil policy must support the new entrants like Pioneer and ENI who are producing oil into TAPS and spending millions in our state economy. Our policy must encourage them to continue that investment trend.
- A new tax policy must make Alaska competitive for investment but protect Alaska's interest. A fair and balanced approach will be durable.

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CO-CHAIR MICCICHE asked if LRS is expanding to areas outside of Alaska.

MR. SMITH said safety is of the utmost importance to LRS. He spoke of industries outside of Alaska that are not as focused on safety like they are in Alaska. Until that changes, LRS is not interested in going Outside. He spoke of recent efforts to encourage oil companies to have allegiance to Alaskan contractors. He said they moved LRS manufacturing from Canada to Anchorage and spent \$2 million on a hot oil unit.

CO-CHAIR MICCICHE asked how many people LRS employs.

MR. SMITH said 148, of which, 98 live in Alaska and 70 percent are Alaska hire. He said LRS works closely with NIT to identify people with CDL's, Hazmat, and tanker endorsements. Last month LRS hired two wounded war veterans.

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CO-CHAIR MICCICHE reminded the audience that Alaska has a citizen legislature and most legislators have jobs. He announced that he works for ConocoPhillips, so to avoid any appearance or perception of conflict of interest, he will hand the gavel over to Co-Chair Dunleavy who will lead the proceedings.

[4:30:18 PM](#)

At ease

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SCOTT JEPSEN, Vice President, External Affairs, ConocoPhillips Alaska introduced himself. He stated that he would be presenting on Alaska's production challenge, investment considerations and Alaska's cost environment, and ACES and SB 21.

He showed a graph depicting Alaska's oil decline while the Lower 48 continues to increase in oil production. Over the past few years there has been an oil production resurgence in the Lower 48. He addressed the causes for that: a resource of conventional and unconventional plays, improved technology, higher oil prices, and an equitable tax environment. Alaska has the resource, the technology, and high oil prices, but not a favorable tax environment. The tax environment in Alaska takes away the upside as oil prices increase. Costs for exploration are also high in Alaska.

MR. JEPSEN showed a slide that emphasizes that Alaska legacy fields still provide significant opportunity. The legacy fields are about 90 percent of North Slope production and the lion's share of estimated future production. Legacy fields are key to offsetting ANS decline.

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CO-CHAIR MICCICHE noted on the previous slide that Alaska's North Slope production is erratic compared to other areas in the Lower 48.

MR. JEPSEN attributed variable production on the North Slope to weather variation and major turnarounds. Also, some fields came on line between the dates shown - 2005 to 2012.

MR. JEPSEN discussed investment criteria, or, how Alaska rates. He looked at exploration prospectivity, costs, cycle time, taxes and legacy field opportunities. The first four investment criteria are considered unfavorable, with only legacy field opportunities favorable. He mentioned a pending well in the Chukchi Sea, which is a federal operation with a better tax environment.

He said Alaska is disadvantaged by development costs. The cycle time for drilling a well takes longer.

SENATOR GARDNER asked if the state adopts a favorable oil tax, would it offset the other four adverse investment criteria. She also wondered if the ACES credits had an impact on exploration development costs.

MR. JEPSEN believed there were some things that could improve Alaska's investment climate. Changing the tax environment is one. However, SB 21 eliminates investment credits. Alaska could offer investment credits for new production, including in legacy fields, that will level the playing field when it comes to cost

and cycle time. He noted that ACES credits have not been a game changer for ConocoPhillips.

SENATOR GARDNER asked Mr. Jepsen if he considers the credits under the current regime to be level.

MR. JEPSEN suggested if progressivity were eliminated under ACES and the tax credits kept, it would be a significant improvement in the business climate.

SENATOR GARDNER asked if that would be enough to negate high exploration, development and production costs.

MR. JEPSEN said yes, with progressivity removed.

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MR. JEPSEN stated that legacy fields have significant opportunities for investment. The state can improve Alaska's investment climate by changing taxes and putting capital expense incentives in place.

CO-CHAIR MICCICHE saw several areas the committee could address: tax rates, and the permitting/regulatory environment. He inquired if the state could have a role in decreasing transportation costs.

MR. JEPSEN said Mr. Barrett spoke of ways Alyeska tries to keep costs down. He didn't know if the state has much to say about setting tariffs and about the Federal Energy Regulatory Commission's (FERC) role.

CO-CHAIR MICCICHE concluded that increased production reduces transportation costs.

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MR. JEPSEN agreed that the tariffs are a strong function of throughput.

He turned to a graph that PFC Energy presented last week. It shows high cost and high government take challenges in Alaska as compared to the Lower 48. He said the playing field could be equalized through investment incentives in Alaska.

SENATOR GARDNER looked at Alaska's development costs on the graph and wondered if they included ACES credits. The intention of the credits was to "share the risk." She noted the state's participation was about \$1 billion a year.

BOB HEINRICH, Vice President, Finance, ConocoPhillips Alaska, said he did not know the origin of the data on the graph. He explained that ConocoPhillips includes the benefits they receive from capital credits. He said that much of the \$1 billion credit is going toward explorers, not those in the development stage.

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CO-CHAIR DUNLEAVY inquired why ConocoPhillips reports a greater profit margin per barrel of oil in the Lower 48 than in Alaska.

MR. HEINRICH replied that the ConocoPhillips' numbers are often misused. He agreed on an oil-for-oil basis, they do achieve a much better profit and cash margin in the Lower 48 than Alaska due to the lower cost structure and the access to markets.

SENATOR GARDNER asked if Alaska offers good rates of return and strong cash margins.

MR. HEINRICH explained that the cash margins ConocoPhillips receives in Alaska are significantly less than what it receives in new projects in West Texas - Eagle Ford, and North Dakota. He defined the cash margin as taking the net income per barrel and adding back depreciation per barrel. It is in the range of \$30 to \$35 in Alaska; in the Lower 48 it is in the \$40 to \$45 range.

SENATOR GARDNER asked if there are projects in Alaska that ConocoPhillips is not doing because of the current tax regime.

MR. JEPSEN recalled ConocoPhillips' testimony last year about the challenges under ACES, when Northeast West Sak was mentioned. It is a very highly challenged development that requires new roads, pads, pipelines, and over 100 wells to fully develop it. Based upon the investment climate with ACES, ConocoPhillips decided to do only part of that project.

SENATOR GARDNER asked to define "problematic under ACES."

MR. JEPSEN explained that it means ConocoPhillips will take a look at it periodically and decide whether or not it meets investment requirements.

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MR. JEPSEN related that the easy oil in the legacy fields is gone. He shared an experience from when he came to Alaska in

1982. Companies are now focused on challenged oil which requires complex, high cost wells. Most fields are faulted and the oil isolated. Multi-lateral wells have to be drilled in order to target five or six sands. Flank oil around reservoir edges is currently being pursued. In the 80's if the reservoir was less than 15 feet thick it was not economic to develop. Now it is common to develop 10 foot sands due to improved technology. He concluded that in order to stem the decline, Alaska needs a better investment climate.

MR. JEPSEN discussed costly water handling due to the abundance of water in wells on the North Slope. He said a billion dollars does not go as far as it used to. He compared a picture of the initial Alpine development, with a cost \$1.4 billion, to the CD-5 drill site, that will cost about \$1 billion, with much less capacity. He said inflation has created this situation. He agreed that oil companies focus on costs and concluded that Alaska is disadvantaged by high costs.

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MR. HEINRICH focused on government and industry marginal share under ACES as prices increase. The marginal share is the change in distribution of cash for every dollar increase in price. He explained that the state's share also includes the effect of royalties, property taxes, and state income tax. The graph illustrates the effect of progressivity with the producer receiving less and less as the price of oil increases. He noted that oil companies do evaluate projects across a range of prices. The difference in marginal take at different prices impacts investment decisions.

CO-CHAIR MICCICHE referred to a press release about the high barrel of oil equivalency (boe) ConocoPhillips earns in Alaska. He wondered if the company earns more per barrel of oil equivalency in Alaska than in the Lower 48.

MR. HEINRICH replied that the numbers do confuse sometimes. ConocoPhillips has 90 percent of their business in Alaska from oil production. Only 10 percent of boe is from gas in Alaska, largely from Cook Inlet. He said that in the Lower 48, over 70 percent of their business is from gas and gas liquids production. When you compare recent depressed gas prices in the Lower 48, and the lower price received per barrel for natural gas liquids, to oil price revenue in Alaska, it is a hard comparison to make. On a boe basis, when blending gas and oil together, ConocoPhillips does have a higher net income per

barrel in Alaska. When comparing oil to oil, the net income per barrel is much higher in the Lower 48.

MR. JEPSEN emphasized that ConocoPhillips is not investing in natural gas in the Lower 48 anymore.

CO-CHAIR MICCICHE requested a breakdown of oil and gas boe.

MR. HEINRICH offered to provide that information.

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SENATOR GARDNER said progressivity was designed so that as the tax rate increased, the tax payer could make a capital investment in which the state participated, thus lowering their tax rate. She asked if that provision has had any impact on ConocoPhillips' investment decisions.

MR. JEPSEN replied that the extremely high tax rate under ACES impacts overall investment decisions in the Basin. He added that ACES impacts cash flow long term. ConocoPhillips looks at more metrics than just NPV or IRR. It also looks at undiscounted cash flow. Alaska's investment system is impaired because once a project is on line "your cash flow takes a pretty significant hair cut from there on out." Consequently, ConocoPhillips is investing in Alaska at a moderate rate and developing resources, but is not investing its discretionary cash flow.

SENATOR GARDNER restated her question. She asked if the ability to reduce the tax rate under ACES has resulted in an investment that has been beneficial to ConocoPhillips.

MR. JEPSEN explained that ConocoPhillips takes tax credits and progressivity into account, but also progressivity. They also look at projects for the long term regarding cash flow. Tax credits are only a part of the equation because they reduce the amount of tax, but do not impact the amount of capital that is required.

SENATOR GARDNER asked what ConocoPhillips' hurdle rate for oil investments is.

MR. JEPSEN said that is confidential information.

[5:07:50 PM](#)

CO-CHAIR DUNLEAVY asked about a gas-to-liquids approach to monetizing gas.

MR. JEPSEN replied that ConocoPhillips is not now pursuing gas-to-liquids options in Alaska. The current focus is on the evaluation of a large diameter, large scale LNG plant using ANS gas.

MR. HEINRICH turned to a slide about annual earnings per barrel by the state and by ConocoPhillips. It shows the annual average crude oil price from 2007 to 2011. ConocoPhillips Alaska's net income remained flat during that time due to progressivity, whereas the state had a 90 percent increase.

5:09:43 PM

MR. HEINRICH showed a graph that represents the producer share under SB 21 and under ACES. The producer share calculation depends on cost structure and capital credits. The graph shows results for FY 2014 as though SB 21 were in effect. The crossover point is about \$93 per barrel. To the left of \$93 represents a tax increase to the producers.

The shape of the curve is similar to other fiscal structures found in the Lower 48, but does not tilt the equation to encourage investment due to high costs in Alaska. He suggested ways to make Alaska investments more favorable.

5:13:09 PM

SENATOR GARDNER asked if the statement "does not encourage investment relative to ACES in a downward trending oil price environment" is part of the risk calculation, or if ConocoPhillips sees the world as having a downward trending oil price environment.

MR. HEINRICH replied that it is a complement to the statement "makes Alaska more competitive at \$100+ prices" and is not a perspective on an outlook.

CO-CHAIR MICCICHE commented that Alaskans are going to expect that the committee needs to fully understand the effects of the data presented. He assumed that the various entities would work together on the data and models.

SENATOR FAIRCLOUGH said the legislative consultant is also trying to reconcile models.

5:15:00 PM

CO-CHAIR DUNLEAVY noted there were graphs that needed to be reconciled.

MR. JEPSEN appreciated that effort.

MR. HEINRICH listed observations related to ACES and SB 21. He commented that under ACES, progressivity takes the upside and discourages investment. The tax credit investment incentives are positive, but they do not offset the negative effects of progressivity.

He said that there are positive elements to SB 21, but noted that there were also areas for improvement. It is a positive step toward improving Alaska's business climate and it solves the high marginal tax problem. It makes Alaska more competitive at higher oil prices.

He stressed that the bill does not contain sufficient investment incentives for legacy fields to offset Alaska's high cost environment. It does not encourage investment relative to ACES in a downward trending oil price environment.

[5:17:10 PM](#)

CO-CHAIR DUNLEAVY asked, if the right fiscal environment was created, would ConocoPhillips invest in Alaska.

MR. JEPSEN said they would - under the right investment climate, which was dependent on tax changes.

[5:18:31 PM](#)

CO-CHAIR DUNLEAVY returned the gavel to Co-chair Micciche.

CO-CHAIR MICCICHE requested that committee members submit amendments related to throughput increases. He Alaska to stay engaged and involved. He cautioned Alaskans to not assume where members are on the issues. He opined he would like to see some changes made before he could support SB 21.

[5:20:35 PM](#)

There being no further business to come before the committee, Co-Chair Micciche adjourned the Senate Special Committee on TAPS Throughput at 5:20 p.m.