

**SB**

**2001**

**(FILE 13)**

**10/23/07**

**1. Gavel In & Call to Order : Note time – members present**

**I CALL THE SENATE RESOURCES COMMITTEE TO ORDER ON TUESDAY, OCTOBER 23, 2007. LET THE RECORD REFLECT THAT IT IS \_\_\_\_\_ A.M..**

**PRESENT ARE:**

**Vice-Chairman Senator Bert Stedman  
Senator Gary Stevens  
Senator Lyda Green  
Senator Lesil McGuire  
Senator Bill Wielechowski  
Senator Tom Wagoner  
& myself, Senator Charlie Huggins**

**2. SB 2001 OIL & GAS TAX AMENDMENTS**

**Chevron North America Exploration & Production,  
John P. Zager, General Manager, Alaska**

**Pioneer Natural Resources Alaska, Inc.,  
Ken Sheffield, President  
Pat Foley, Manager, Land & External Affairs**

**Anadarko Petroleum Corporation  
Mark Hanley, Manager, Public Affairs, Alaska**

**\*\*\*\*\*Lunch Break\*\*\*\*\***

**Recess**

**Alaska Oil & Gas Association,  
Marilyn Crockett, Executive Director**

**Alaska Support Industry Alliance,  
Lynn Thompson, President  
Paul Laird, General Manager**

**Resource Development Council  
John Shively, President**

**RECESS**

**\*\*\*\*\*Dinner Break\*\*\*\*\***

**I CALL THE SENATE RESOURCES COMMITTEE MEETING OF TUESDAY,  
OCTOBER 23, BACK TO ORDER**

**6:15 PM**

**Public Testimony**

**-Time Limit May Be Set -**

**3. Announce:** We'll be back tomorrow @ 10 AM, --THIS IS A TIME CHANGE--  
when we'll hear from the major producers: BP & ConocoPhillips.

And in the early evening tomorrow we'll have another opportunity for public  
testimony beginning @ 6:15 PM

**6. Meeting adjourned @ \_\_\_\_\_.**

# ALASKA STATE LEGISLATURE

Sen. Charlie Huggins, Chair  
Sen. Bert Stedman, Vice Chair  
Sen. Lyda Green  
Sen. Gary Stevens  
Sen. Lesil McGuire  
Sen. Bill Wielechowski  
Sen. Thomas Wagoner



State Capitol, Room 119  
Juneau AK 99801-1182  
907-465-3878  
Fax: 907-465-3265  
800-862-3878

## Senate Resources Committee

Butrovich Rm 205

Tuesday, October 23, 2007

9:00 a.m. - 5:00 p.m.

&

Public Testimony 6:15 - TBD

## AGENDA

### SB 2001 - Oil and Gas Production Tax

#### Morning

Chevron North America Exploration & Production,  
John P. Zager, General Manager, Alaska

Pioneer Natural Resources Alaska, Inc.,  
Ken Sheffield, President

Anadarko Petroleum Corporation  
Mark Hanley, Manager, Public Affairs, Alaska

#### Afternoon

Alaska Oil & Gas Association,  
Marilyn Crockett, Executive Director

Alaska Support Industry Alliance,  
Lynn Thompson, President  
Paul Laird, General Manager

Resource Development Council  
John Shively, President

*No Handout*

6:15 PM

Public Testimony

-Time Limit May Be Set -



**Testimony on SB2001/ HB2001**

**John P. Zager  
General Manager, Alaska**

**Juneau, Alaska  
October 23, 2007**



# Chevron's Alaska Presence

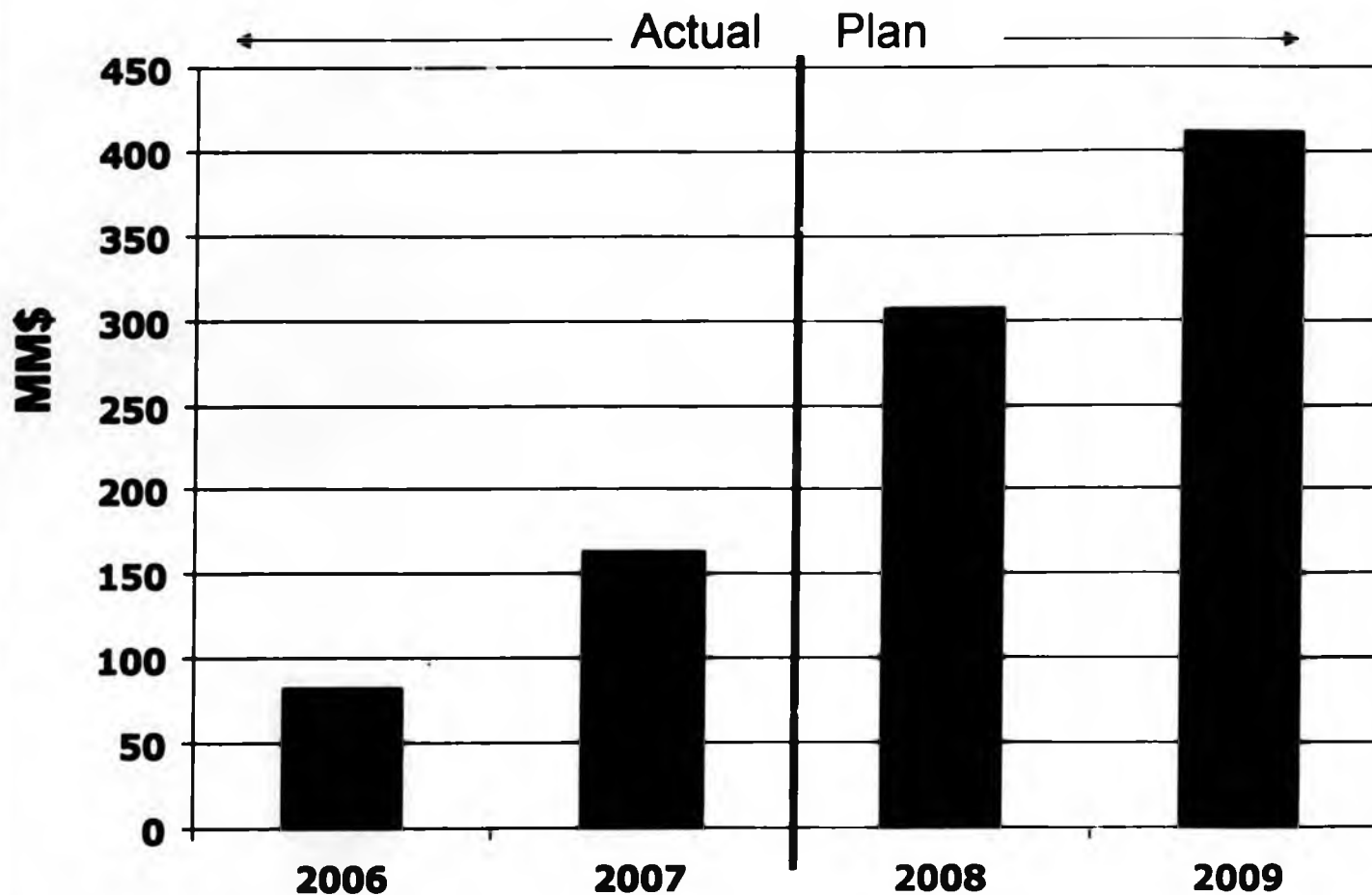
- 4<sup>th</sup> largest producer in state
- 3<sup>rd</sup> largest operator
- ~500 employees or full time contractors
  - >300 on the Kenai Peninsula
- Chevron is the only producer in the state with a relative balance of assets in the Cook Inlet and on the North Slope
  - Cook Inlet production – 23M BOPD
    - Old oil production, very high lifting cost
  - North Slope production – 15M BOPD
  - In early stages of increased capital program
    - Extend life of Cook Inlet O&G production
    - North Slope exploration on state lands
    - Investment decisions made under PPT

*15/16 wells to drill*

# Chevron is increasing investment under PPT



## Capital Investment





## **Introductory Comments**

- We do have a common enemy – decline
  
- Disappointing to be back so soon after passage of PPT
  - Lack of actual PPT results to revise tax policy
  - Review scheduled for 2011
  - Too soon for a change
  
- Need to strike a balance between tax rate and investment climate

# Factors that affect investment decisions



- Corporations have a responsibility to operate safely, seek returns, and increase shareholder value
- Corporate Cash Flow Management
  - Corporate uses of cash:
    - ▶ Operating Costs
    - ▶ Investment: upstream, downstream, technology, acquisitions
    - ▶ Pay down debt, build cash
    - ▶ Pay dividends to shareholders
    - ▶ Buy back stock

*not Gov Take - not most important*



## Upstream Investment Decisions

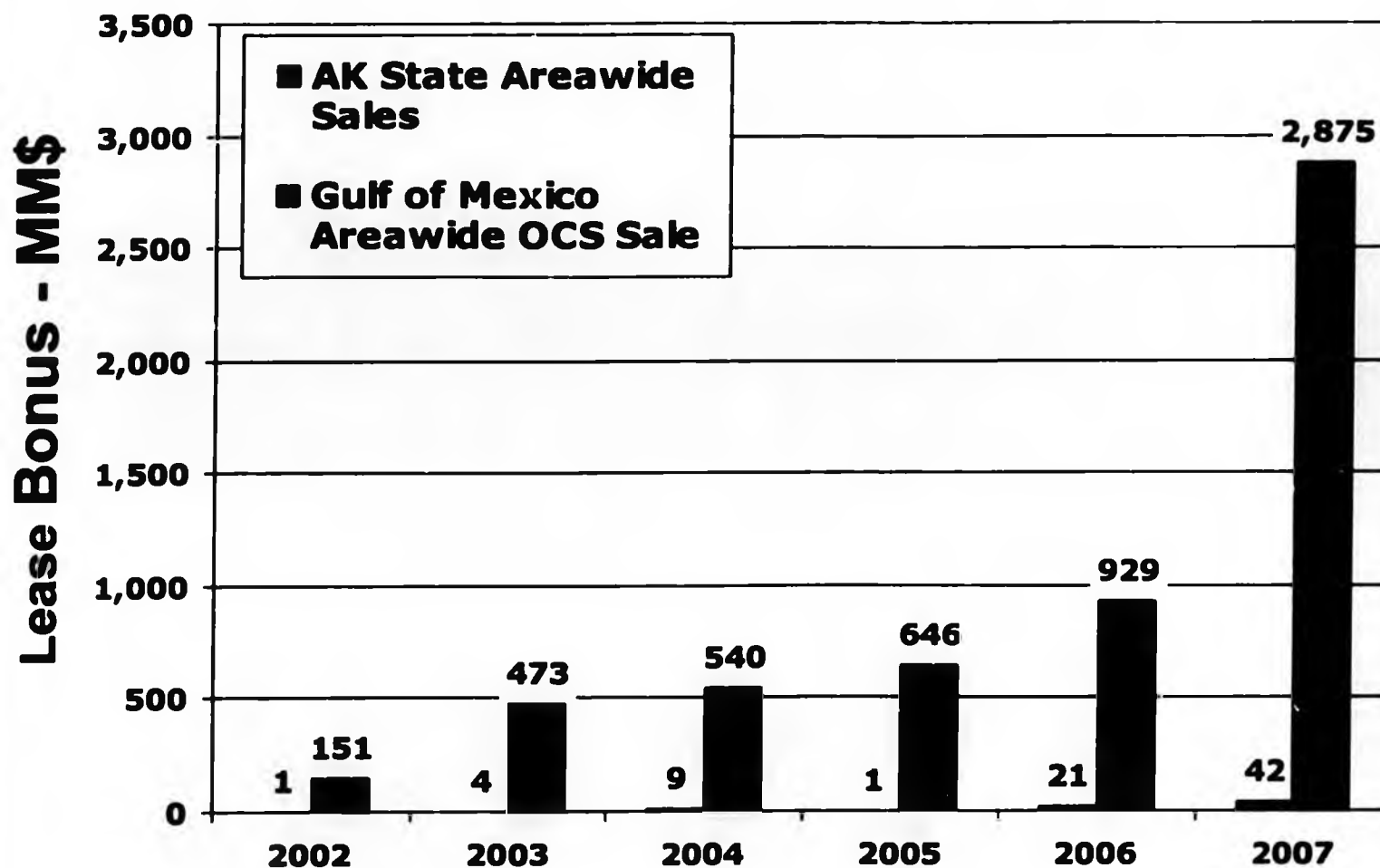
- Always more opportunities than can be funded or staffed
- Key Factors – How do Alaska state lands stack up?
  - Rocks – What is the reserve and production potential? – *Faint to Midway*
  - Cost – How much will it cost to find, develop, and produce? – *Fly in from Nova Scotia* – High End
  - Time – How long will it take to realize revenue?
  - Risk - What is the probability of success?
  - Fiscal regime – How much revenue does the investor get to keep? – *Don't care*
- Economic models are developed, opportunities ranked, and investment decisions are made on an After-Tax Net Present Value (NPV) basis
  - Does the investor get enough to justify the investment?
    - Great rocks can trump poor fiscal terms

**How does Alaska stack up? Let's look at a real data point!**

# How attractive is Alaska as an investment?



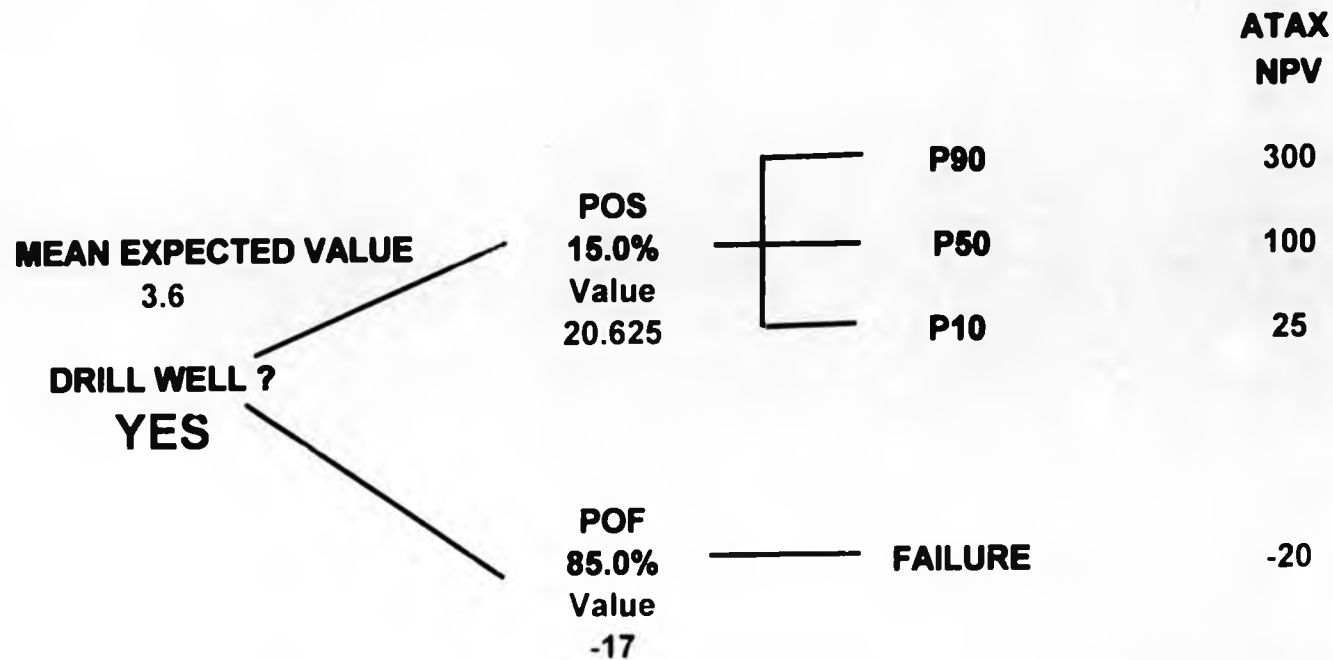
Let's look at results of recent lease sales as a scorecard: This is industry voting with their dollars



# Exploration – How taxing the upside can deter investment decision



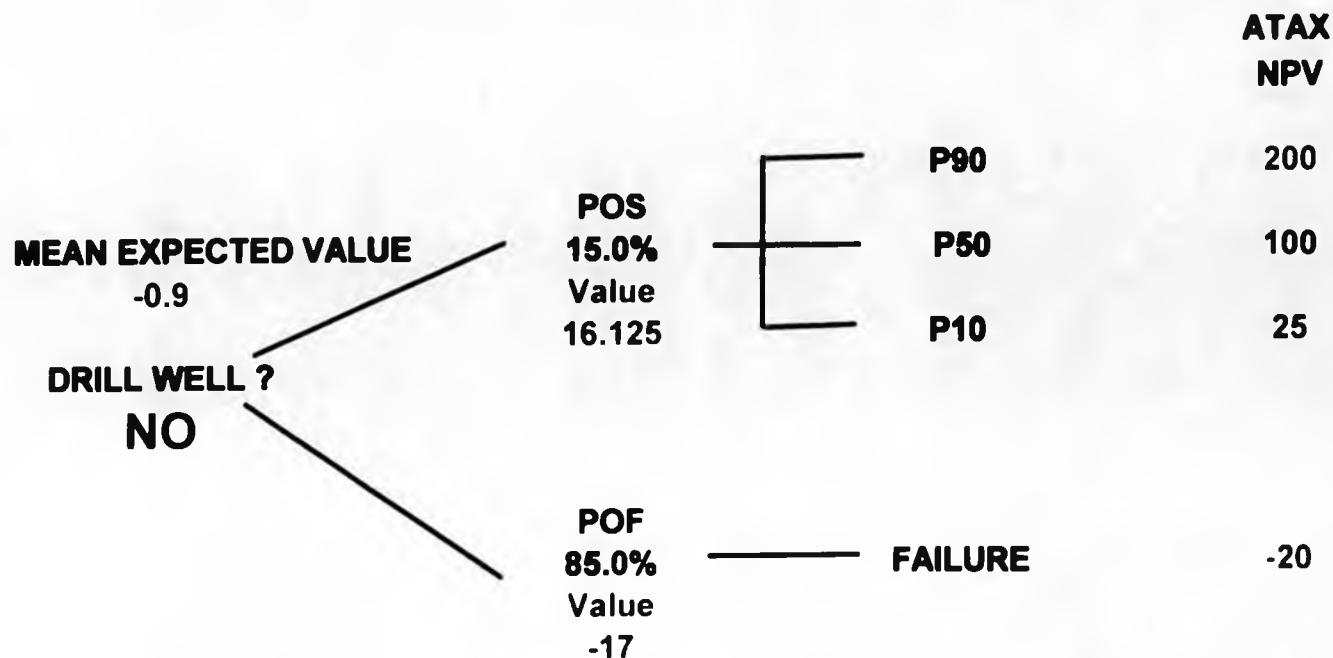
## ACES EXAMPLE *RISKED ECONOMIC ANALYSIS, 4 pt Economic Model*



# Exploration – How taxing the upside can deter investment decision



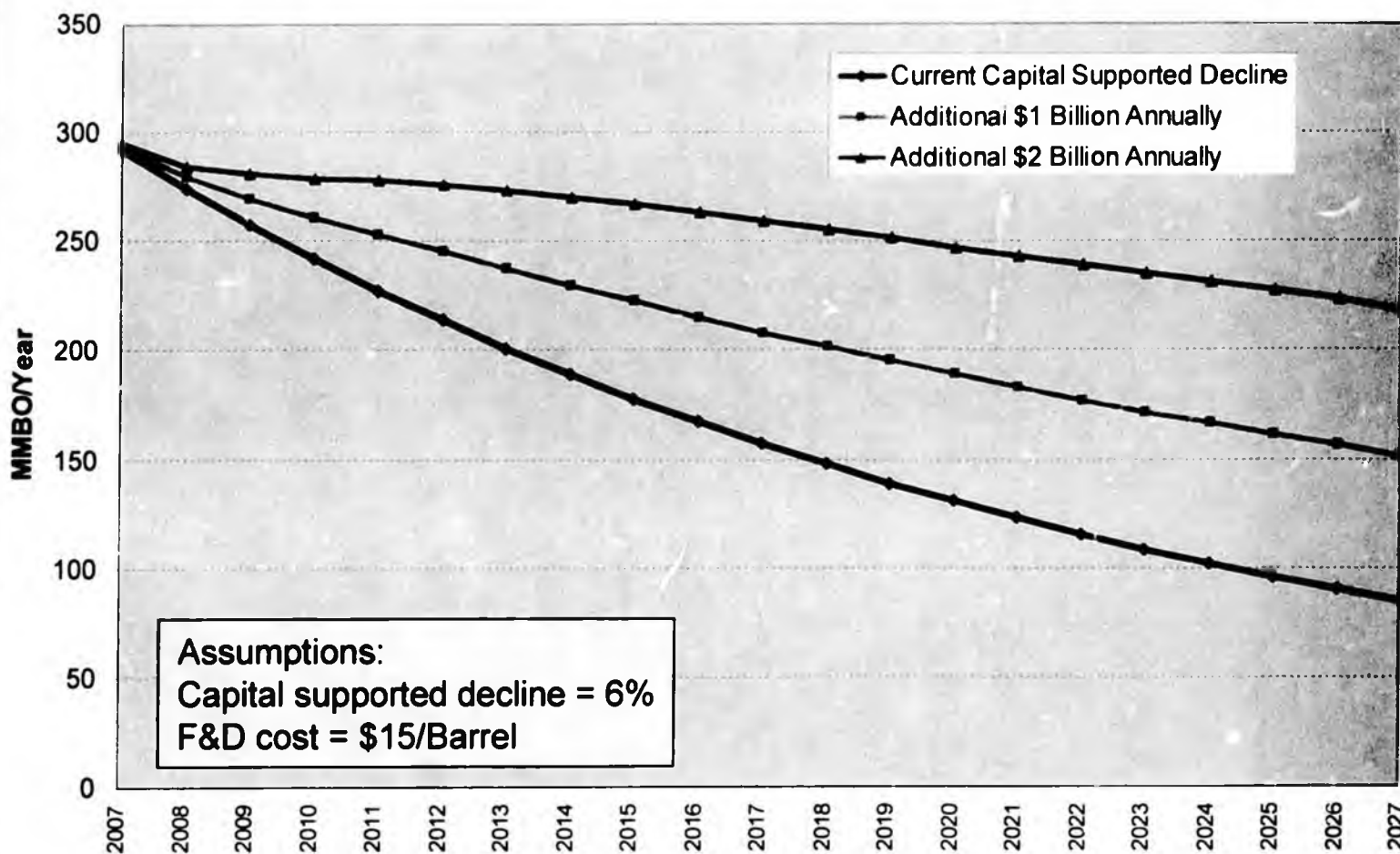
## ACES EXAMPLE RISKED ECONOMIC ANALYSIS, 4 pt Economic Model



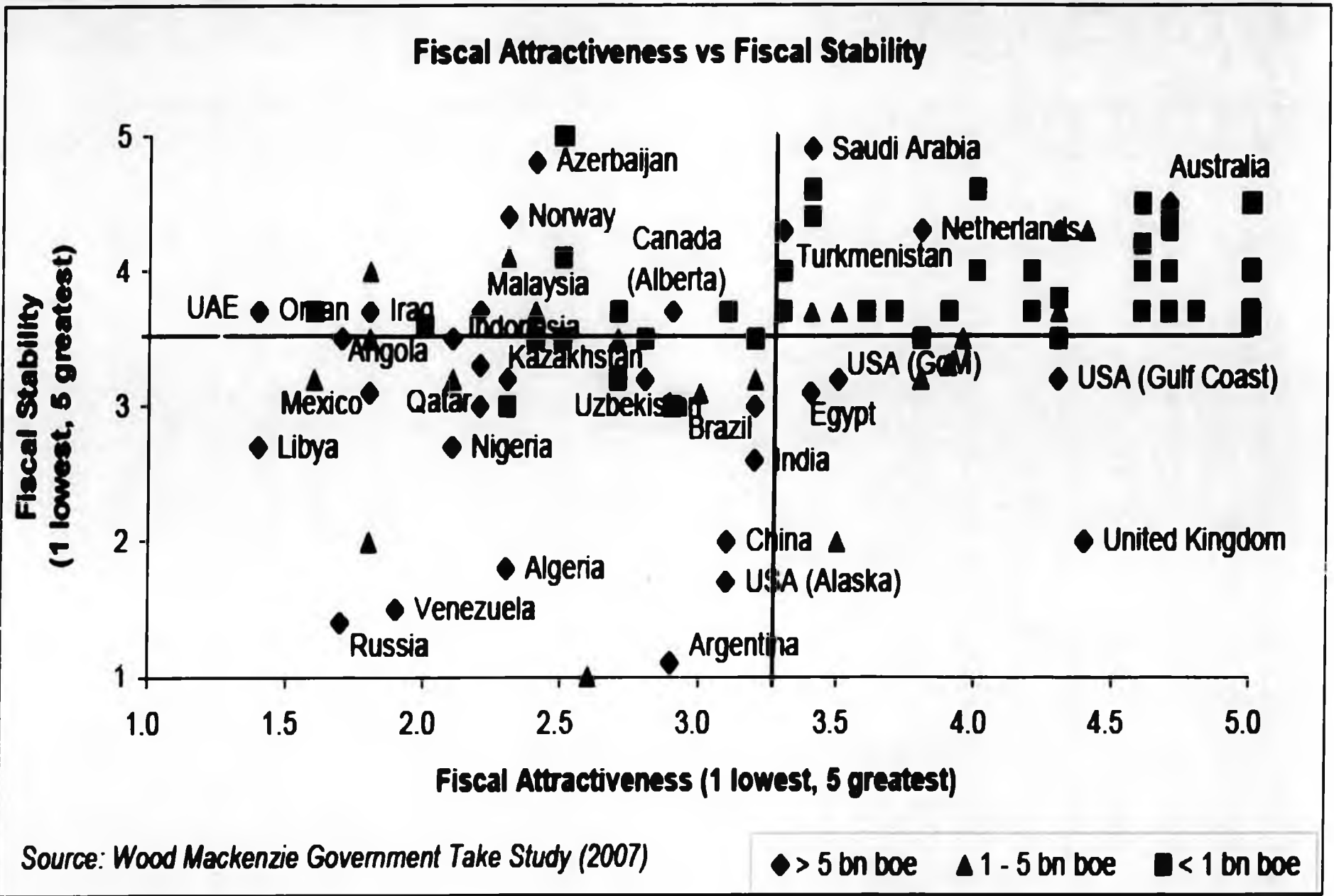
# Investment is Needed to Maintain Production at Reasonable Levels



## Alaska Production Forecast Estimate



# Chart 14 – Fiscal Attractiveness Rating versus Fiscal Stability Rating



# Summary Comments



- You have the power to increase short term state revenue through raising taxes
- Energy companies have the responsibility to invest where they see the best risk/reward ratio
- The common enemy is decline,
- Investment is the only way to stem decline
- How do you price Alaska's product ?
  - Lowest possible taxes and stability will encourage investment
- Chevron intends to invest and grow in Alaska, but ACES makes investing in Alaska more difficult





**PIONEER**  
ENERGY SERVICES

# Pioneer's View of

Senate Resources Committee  
House Oil and Gas Committee  
October 23, 2007

NYSE: PXD  
[www.pxd.com](http://www.pxd.com)



# Presentation Outline



- Pioneer Profile
- Competition for Investment Capital
- Pioneer Projects & SOA Impact
- SOA "Fair Share" of Oooguruk
- Benefits of Current PPT Law
- ACES Proposal
- Conclusions



# Pioneer Corporate Profile

- Large U.S. independent
- Operation Areas:
  - Alaska – *Syns*
  - Lower 48 – *Texas, KS*
  - South Africa – *Gas*
  - Tunisia – *oil*
- In 2006 Pioneer:
  - 1,600 employees
  - 36 mmboe production
  - \$1.6 billion in revenue



*90% fuel & reserves in N. America*

# Pioneer Capital Investment Decisions

- **Global Investment Opportunities compete for capital**
  - Pioneer and most independents prefer U.S. L48 projects:
    - lower risk, cost
    - shorter cycle time
    - flexibility
  - **Portfolio selection drivers:**
    - Production Growth *\* - Double Digit:*
    - Reserve Replacement
    - Finding & Development cost *\$15.00*
    - Economic & Financial metrics
  - **Project economics evaluated over a range**
    - probabilistic outcomes *75% - OK*
    - commodity price calls *- Super Others*

# Competition for Pioneer Capital

- **Rising commodity prices have improved margins in L48** *(Lower AK)*
  - Budget dollars flowing to low risk resource plays
    - Tight sands, coal bed methane, shale gas
  - Less emphasis on high risk exploration
- **Pioneer Alaska's Competition for Capital**
  - Low risk, short cycle projects in Texas and Rockies
  - Low risk, high margin gas project in South Africa
  - High margin, short cycle oil drilling in Tunisia
  - New ventures in Resource Plays

*AK competes with L48*

March 25<sup>th</sup>, Courting Independents

# Pioneer's Alaska Entry

## Strengths

- Prolific petroleum system
- High impact opportunities
- Located in North America
- ELF and EIC's

## Weaknesses

- High operations & transport cost
- Infrastructure challenged
- Long project cycle times
- Complex regulatory processes
- Limited season for access

## Opportunities

- Business opportunities opening for Independents
- Improving regulatory process
- North Slope gas resources

## Threats

- Higher taxes
- Regulatory delays or costs
- Project delays or cost overruns
- Return to lower oil prices

1. Reservoirs  
2. Complex Regulatory  
3. Cost much higher

4. Super later  
Tax Policy 5  
Still discussed

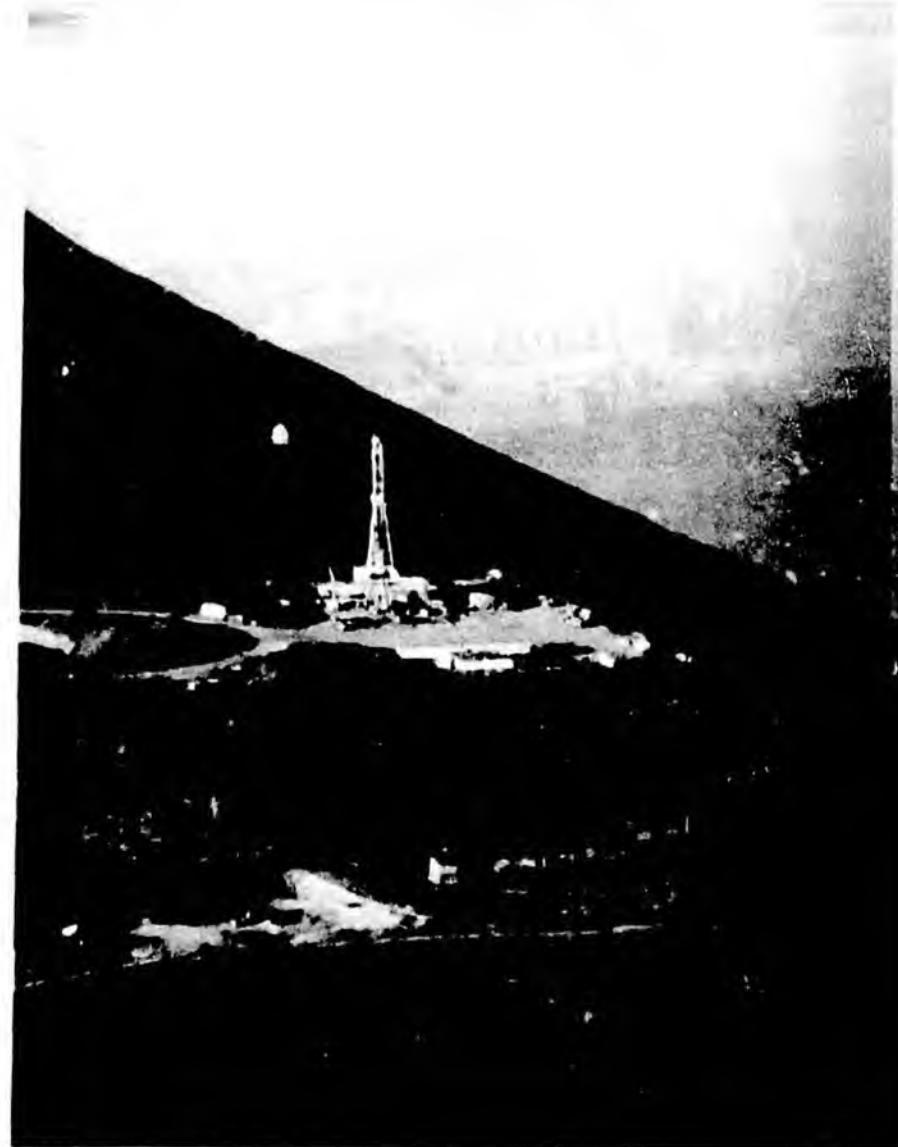
# Pioneer Alaska Profile



## Cosmopolitan

- Entered Alaska in late 2002
- Oooguruk Unit Operator
- 2005 ▪ Cosmopolitan Unit Operator
- ~1.5 million acre leasehold
- 11 NS exploration wells
- 35 local Alaska staff

*over last 5 yrs - not much to show*



# Oooguruk Project Summary



PIONEER

## Future Operating Statistics

<b>Field Life Cycle</b>	<b>Development</b>
<b>Project Type</b>	<b>Oil, EOR</b>
<b>Gross Acres</b>	<b>58,000</b>
<b>Working Interest</b>	<b>70% (Operator)</b>
<b>Partner</b>	<b>ENI (30%)</b>
<b>Gross Reserve Potential</b>	<b>70 - 90 MMBO</b>
<b>First Production</b>	<b>2008</b>
<b>Gross Peak Flow Rates</b>	<b>15 - 20 MBOPD</b>
<b>Productive Life</b>	<b>25+ Years</b>
<b>Development Wells</b>	<b>~40</b>



# Oooguruk Project Summary



PIONEER

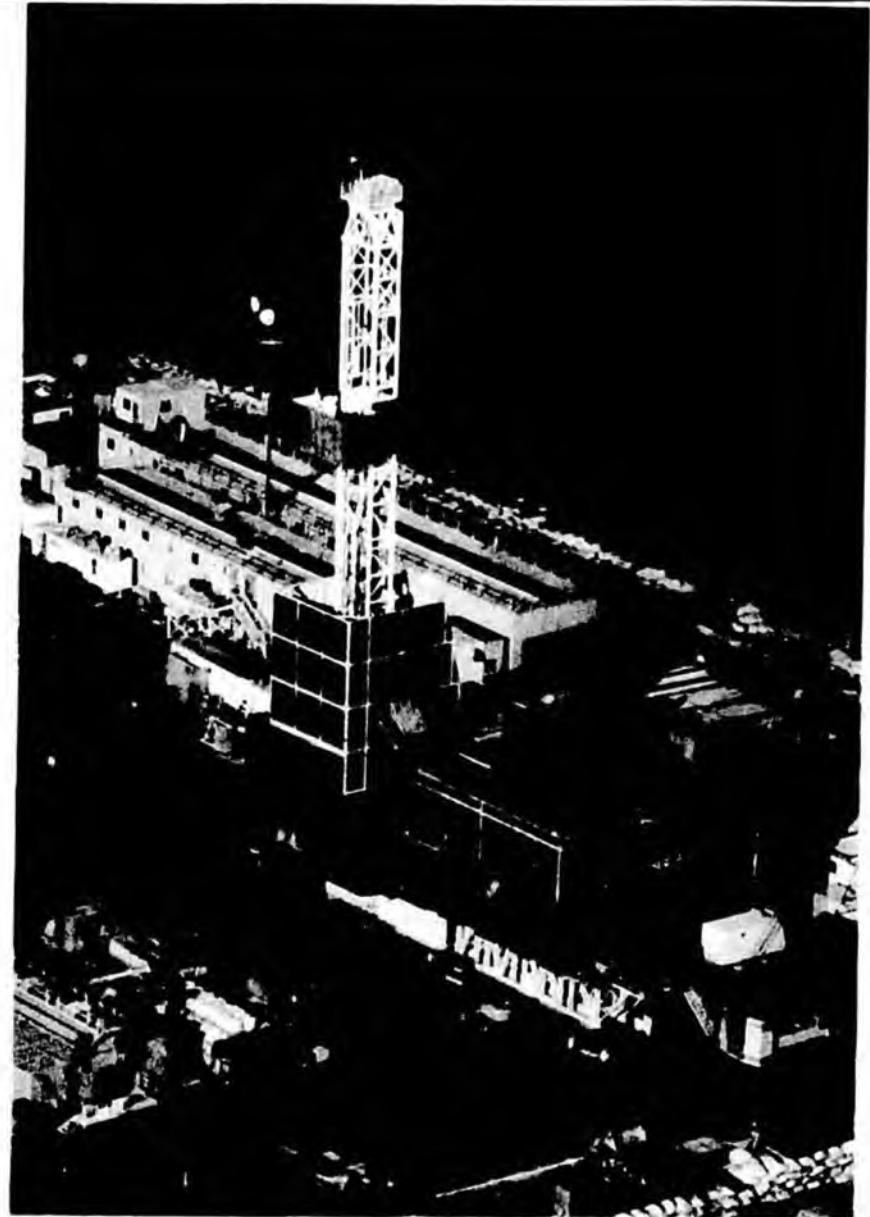
- **Project sanction Feb 2006**
- **Constructed island drill site**
- **Fab/set ~ 120 modules**
- **Installed subsea flowline**
- **3 year development drilling**
- **600+ contractors at peak**
- **Total capex \$550+ MM**
- **First oil in 2008**



# Oooguruk Project Benefits



- **First independent oil producer on the North Slope**
- **First third party facility access**
- **Other investors are watching for Pioneer success**
- **Royalty plus 30% net profits to SOA**
- **PPT revenues on Pioneer profits and KRU processing**
- **State income tax**
- **Property taxes to NSB**
- **Construction jobs and contractor profits**
- **Operating jobs and contractor profits**



# Oooguruk Capital Expenditure Beneficiaries

<b>Engineering</b>	<b>Fabrication</b>	<b>Transport</b>	<b>Installation</b>	<b>Drilling</b>
<b>ASRC/ Tri-Ocean</b>	<b>ASRC</b>	<b>Lynden</b>	<b>Nanuq</b>	<b>Nabors</b>
<b>Intec</b>	<b>ASRC/Omega</b>	<b>Carlisle</b>	<b>HC Price</b>	<b>Halliburton</b>
<b>Sandwell</b>	<b>Steel Fab</b>	<b>Tote</b>	<b>Veco</b>	<b>Baker Centrilift</b>
<b>Coastal Frontiers</b>	<b>Dowland-Bach</b>	<b>Penn Air</b>	<b>ASRC</b>	
<b>EEIS</b>		<b>Alaska Airlines</b>	<b>F&amp;W</b>	

# Pioneer's View of PPT

- **PPT rolled out with no Pioneer consultation**
  - Huge investments and Oooguruk sanction prior to PPT
- **Balanced system - Investment credits offset high tax rate**
- **Modest incentive for investment**
  - Encourages development of abundant lower tier resources
    - Challenged by size, quality, viscosity or location
  - Encourages more aggressive exploration spending
- **Sustainable and fair across a broad range of investments**
- **PPT should grow the pie and give the State a bigger slice**

# ACES Erodes Modest PPT Incentives

- **Changes are mostly negative for the investor**
  - Base Tax Rate Increase from 22.5% to 25%
  - Tax Rate Increase via more aggressive Progressivity Formula
  - Transitional Investment Expenditures Eliminated
    - Unfair to Pioneer - no recovery of \$100MM sunk investment
  - Spreads utilization of Earned Tax Credits over 2 years
  - Increased uncertainty for allowable deductions
- **Increased government take jeopardizes lower tier project funding**
  - Unfunded projects generate no state income
- **Oooguruk project returns reduced**
  - Oooguruk highest government take in the State (net profit)
- **Positive Elements**
  - Retains net tax framework for non-legacy fields
  - Allows credits to be monetized at face value (with time delay)

# ACES Impact on New Projects

## Project Net Present Value of Cash Flows (10% Discount Rate)

\$40 Test Price (\$-Millions)

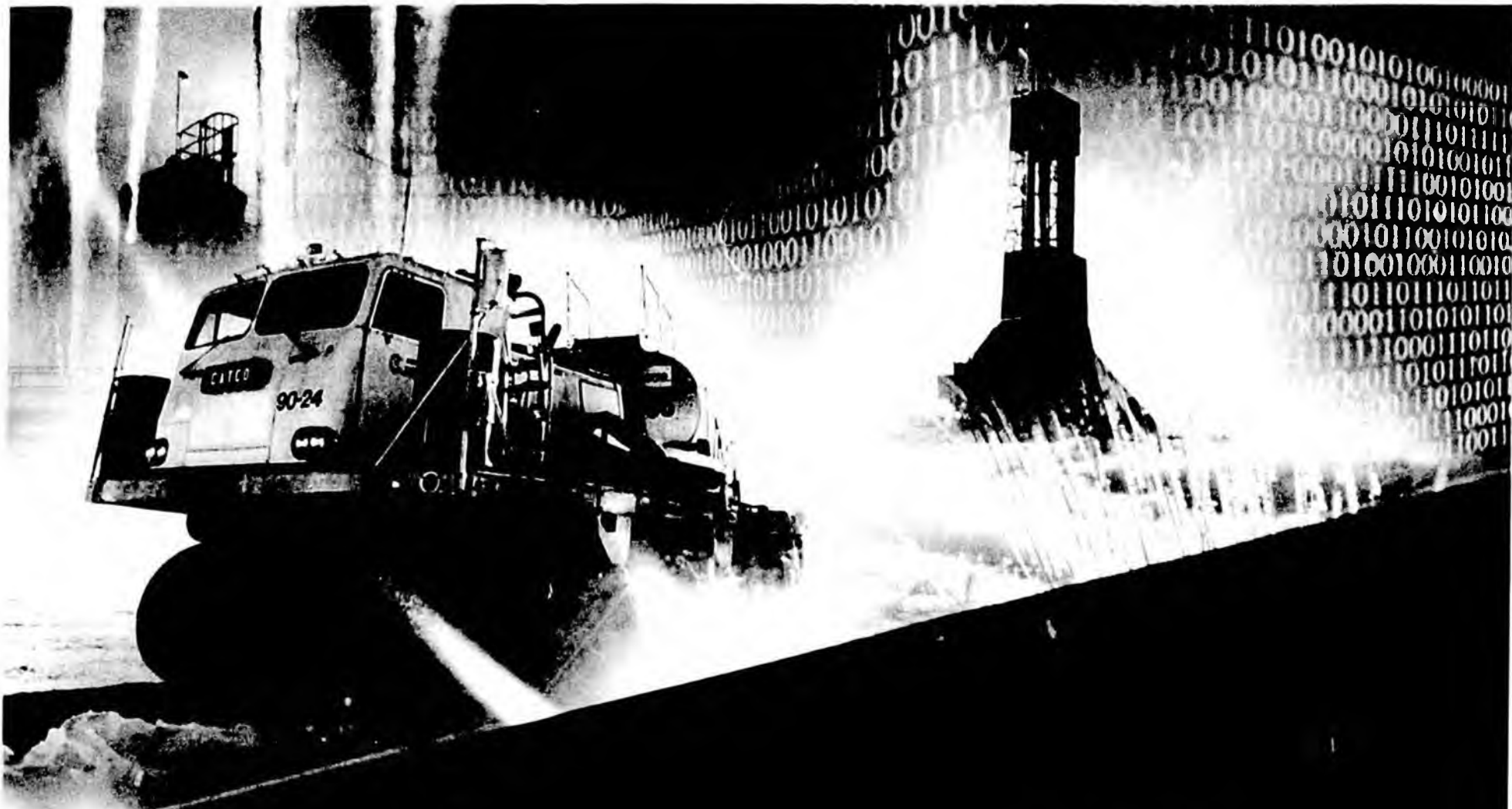
	Status Quo PPT	ACES Plan	16% Gross Tax No Capital Credits	19% Gross Tax With Capital Credits
Field/Project A	178	128	-35	27
Field/Project B	72	48	-22	9
Field/Project C	59	27	-53	-22
Field/Project D	-64	-90	-398	-282
<b>Production Tax Revenues FY2008 @ \$60 oil price</b>	<b>\$1.3B</b>	<b>\$2.0B</b>	<b>\$2.1B</b>	<b>\$2.0B</b>



Source: Alaska Department of Revenue

## Conclusions

- **Pioneer AK's primary competition for capital is L48**
- **Pioneer has been an aggressive investor to date**
- **Fiscal stability needed to attract future Pioneer capital**
- **PPT provides balance/stability to grow our AK business**
- **ACES plan erodes modest PPT incentives**
- **Raising taxes jeopardizes lower tier project funding**
  - **Royalty, state income/property tax and jobs at risk**



# ACES

**Anadarko** ATF  
Petroleum Corporation

Senate Resources  
October 23, 2007

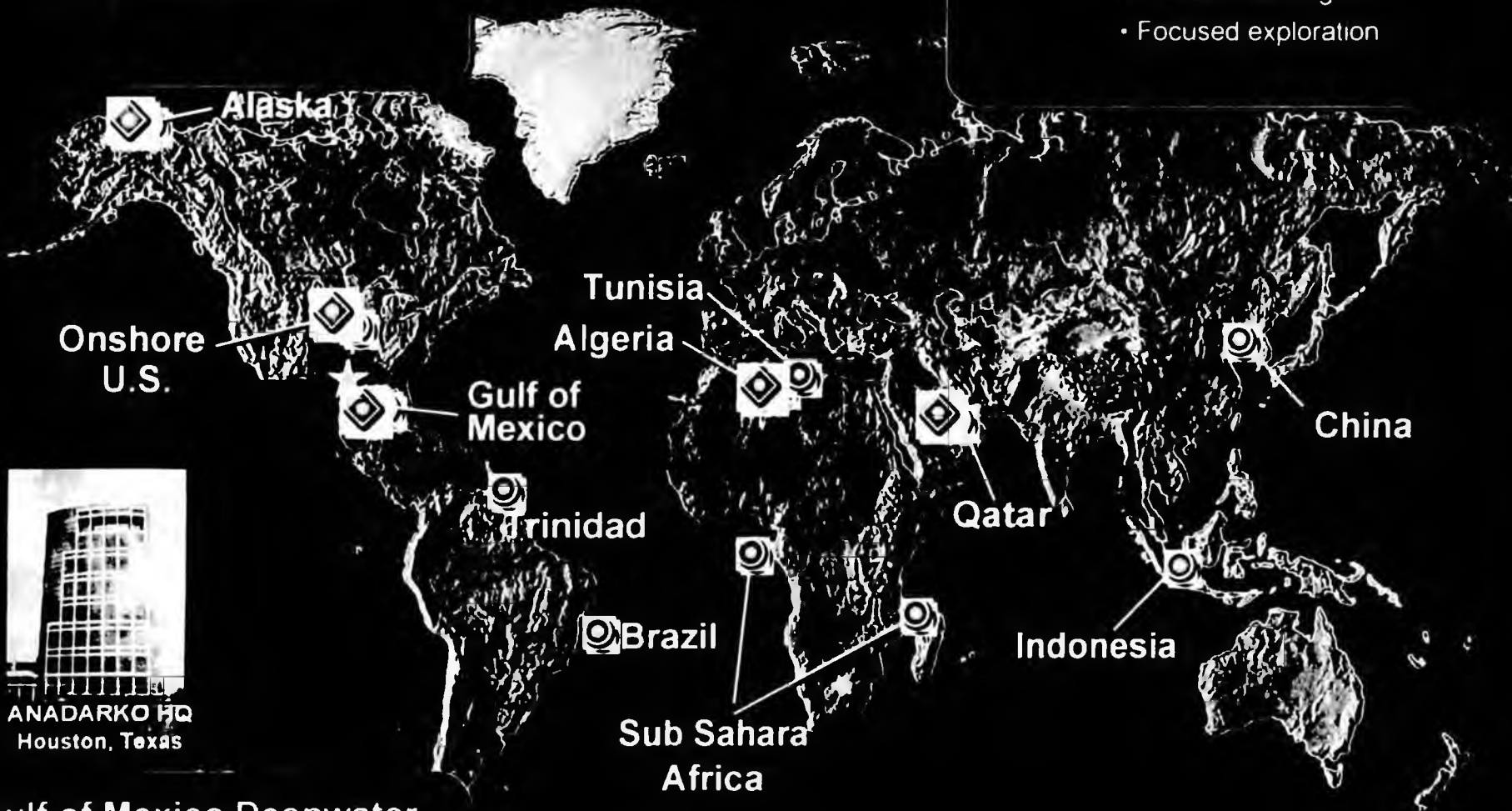
# APC Operational Overview

## Rockies

- Large acreage holdings

## International

- World class targets
- Focused exploration



ANADARKO HQ  
Houston, Texas

## Gulf of Mexico Deepwater

- Significant Acreage position

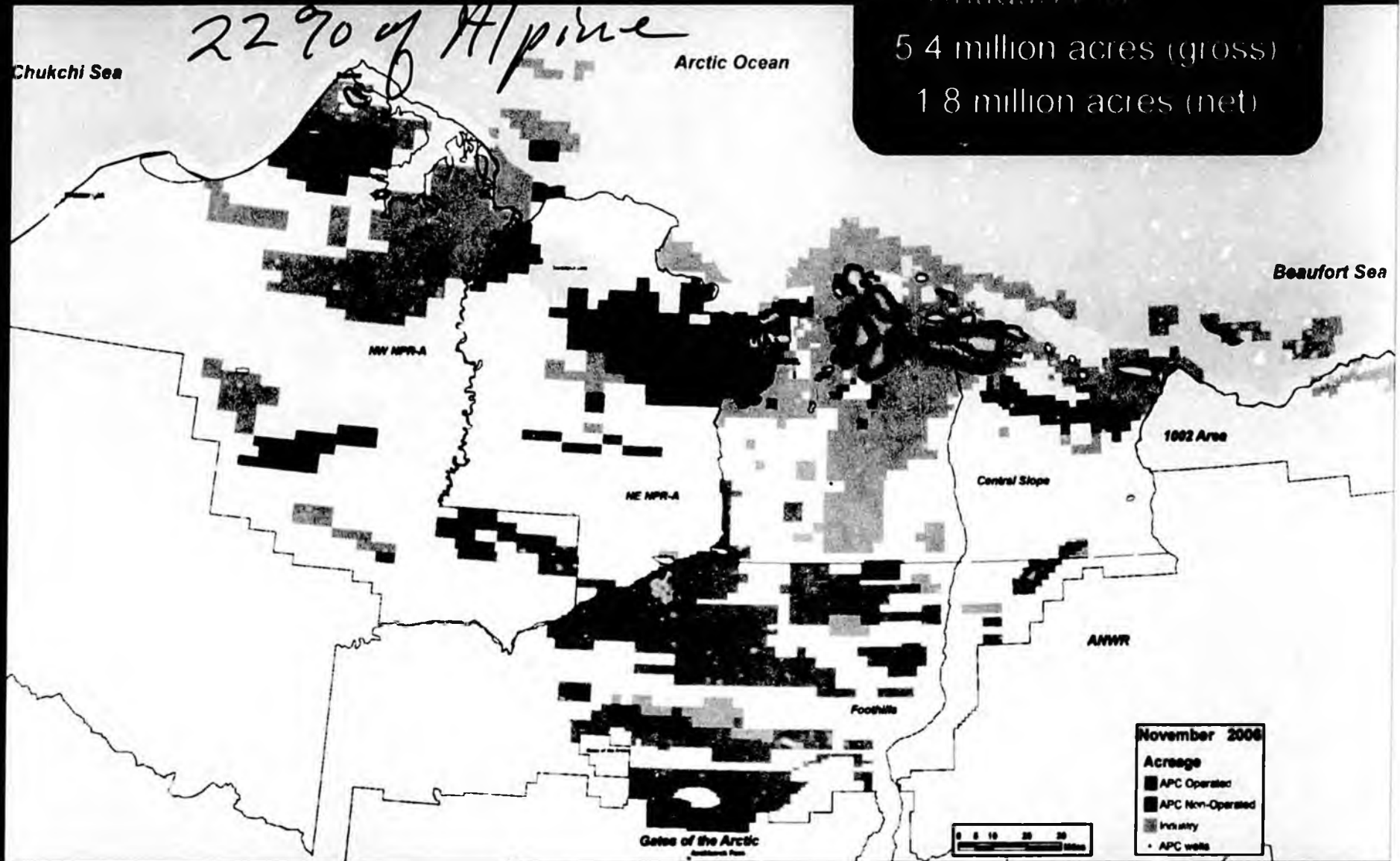
- ◉ Exploration Areas
- ◊ Producing Areas

# Anadarko's Investment in Alaska-Land

Anadarko's

5.4 million acres (gross)

1.8 million acres (net)



# **Alaska Opportunities**

- **World class petroleum basin**
- **Significant remaining resource potential**
- **Legacy type prospectivity (i.e. Anchor Fields)**
- **New entrants/partnering opportunities**
- **APC possesses tangible competitive advantages**

# Alaska Challenges

- **Maturing basin/materiality/smaller prospects**
- **High costs**
- **Lack of infrastructure and competition**
- **Extremely long lead-time exploration**
- **Seasonal drilling, & regulatory timing requirements**
- **Distance from market**
- **Lack of gas transportation**

## Our View of PPT & Recap of 2006 Testimony

- ▲ **Significant tax increase at existing fields**
  - *Can be offset by increased exploration & development investment*
- ▲ **Improvement in exploration economics versus elf system encourages new investment**
  - *Credits help reduce high costs & improve NPV*
  - *25 – 20 worse than old elf system*
- ▲ **On balance supportive of PPT system**

# Support Net Profits Approach

- ▶ **Appreciate Administration work to evaluate gross vs. net and conclusion to stick with net**
- ▶ **Net considers varying economics & costs**
  - *Tax paid on net income after costs*
  - *Accounts for costs and levels playing field*
  - *Still doesn't account for risk*
- ▶ **Gross collects on income regardless of profit**
  - *Gross tax with proper incentives harder to develop equitably and still complicated to administer*
- ▶ **Royalty acts like a gross tax**

# Our View of ACES- Negatives Outweigh Positives

## • Support some parts of ACES

- *Expand time to qualify for Exploration Incentive Credits (offset by new exclusions and requirements)*
- *Modify Net Loss carry forward to create level playing field*
- *Goal of increased transparency & state auditor capability*

## • Stability

- *Concern that PPT/ACES will be revisited again in next few years to deal with gas*
  - *Gas definitely needs to be addressed, but will reopen everything again*

## • The significant tax increases would decrease exploration & development economics and far outweigh any positives in the bill

- *Tax rate increase*
- *Tax escalator changes increase costs*
- *Transition Investment Expenditure Credits Elimination*
  - *Fairness and Investment Impact*

*Howardanko - Floor? (Regressive)*

# Administrative

Table below from Sept 4, 2007 Administration Presentation

<b>Project Net Present Value of Cash Flows (10% Discount Rate)</b>				
<b>\$40 Test Price (\$ Millions)</b>				
	<b>Status Quo PPT</b>	<b>ACES Plan</b>	<b>16% Gross Tax No Capital Credits</b>	<b>19% Gross Tax With Capital Credits</b>
<b>Field/Project A</b>	<b>178</b>	<b>128</b>	<b>-35</b>	<b>27</b>
<b>Field/Project B</b>	<b>72</b>	<b>48</b>	<b>-22</b>	<b>9</b>
<b>Field/Project C</b>	<b>59</b>	<b>27</b>	<b>-53</b>	<b>-22</b>
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<b>Production Tax Revenues FY2008 @ \$60 oil price</b>				
	<b>\$1.3B</b>	<b>\$2.0B</b>	<b>\$2.1B</b>	<b>\$2.0B</b>

- Project Economics decrease by 33% to 54%
- What geologic & commercial risks were assigned?
- Where are dry holes & failed projects accounted for?

## Summary

- ▲ **Significant tax increases outweigh any potential benefits**

**SENATE TESTIMONY  
on SB 2001  
October 23, 2007**

Thank you, Chairman Huggins. My name is Joe Mathis. My wife and I are the owner and operators of Montana Creek Campground located at mile 95.5 of Parks Highway. We own a 14 acre site with store and 66 sites. We have 7 employees all are Alaskans and employed from the local area providing jobs in an area of high unemployment. We also manage and operate for the state parks one of their campgrounds located nearby.

For me as a small business owner, I need to have certainty in my tax obligations for payroll, property, and sales taxes.

As a small business owner, we have struggled with the uncertainties of risk and disasters. Last year, we had floods that have done serious damage to our business but we were able to survive. We have faced high cost of fuel and seen huge declines in border crossing of RVs and travelers to Alaska coming up the Alcan Highway. These risks that we take in our small business are nothing compared to the risks that you are contemplating. Risk management should be part of your due diligence in this process. Can Alaska really afford to take the risk of discouraging future investment when 50 percent of our production ten years from now will come from 'new oil' generated by future investment?

If you are risking the long term health of our state's future without good foundation of information then you are making serious error in judgment. We need more factual information on how PPT is working. Making decisions based on emotion and rhetoric is poor decision making. The facts are:

- With the oil pipeline two-thirds empty and production continuing to decline, Alaska should be focused on doing whatever is necessary to increase oil production.
- Investments, which for Prudhoe Bay alone amount to about \$1 billion yearly, are aimed at keeping the decline rate at an average of about 6

percent yearly. If the investment rate is slowed the decline rates could increase to about 15 percent yearly before too long.

As others have said, we do not know what the right number is for the tax rate. However, we do know that increased taxation will not stimulate the industry or the economy. Increased taxation on the industry will not improve the business in our campground.

We need a change the dynamics of this process from one of negatives to one of positives. In past year we have had more than enough negatives that has consumed the public process as well as diverted our energies from those long term issues that will keep our economy from disaster in next 10 years.

I would prefer to be giving testimony on a long term fiscal plan or the POMV should be structured.

What has happen to long term planning? In this time of high oil prices we have a huge opportunity to encourage small independent oil companies to flock to our state. I am sure they now have a "wait and see attitude". If you start changing the rules again it will be a long, long wait.

As I stated before that my small business needs certainty in taxation so does the oil industry.

I have seen my business take two major floods. We were able to survive however I do not think that this state can take this third flood of taxes and survive. You need to give the PPT infrastructure put in place last year a chance to work.

## Alaska Oil and Gas Association

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121 W. Fireweed Lane, Suite 207  
Anchorage, Alaska 99503-2035  
Phone: (907) 272-1481 Fax: (907) 279-8114

TESTIMONY OF THE  
ALASKA OIL AND GAS ASSOCIATION  
TO THE SENATE RESOURCES COMMITTEE  
ON SENATE BILL 2001

October 23, 2007

Mr. Chairman and Members of the Committee. Thank you for the opportunity to testify before you today on Senate Bill 2001.

My name is Marilyn Crockett and I am the Executive Director of the Alaska Oil and Gas Association ("AOGA"). AOGA is the trade association for the oil and gas industry in Alaska. Our 17 members account for the majority of oil and gas exploration, development, production, transportation, refining and marketing activities in the state. In addition to Alaska's instate refiners, Agrium and Alyeska, our membership includes companies new to Alaska hoping for the opportunity to explore, companies which are exploring today but do not yet have production (but hope to in the future) and those companies which are producing today.

One of the important functions the Association performs is to provide a forum for member companies to consider regulatory and legislative proposals, and to reach agreement on an industry position on those proposals. To establish an AOGA position, a 5/6 vote of the members is required. What this means, of course, is that when AOGA voices that position, regulators and legislators can be assured that that position is the position of the overwhelming majority of Alaska's oil and gas industry.

But on tax issues, AOGA members have taken this approval process to the highest level. AOGA positions on tax-related issues require 100% consensus of the AOGA Members. Let me be clear: my testimony today reflects the full consensus of the members of the AOGA Tax Committee, with no dissent.

The focus of our testimony today will be on the practical impact of declining production levels on industry operations and the State of Alaska. And while we are not in a position at this early date in this Special Session to provide you with a complete analysis of the many components of SB 2001, we will describe for you but a few of the troubling aspects of this legislation. The AOGA Tax Committee is in the midst of a comprehensive review of the legislation and will be in a position at a future date to characterize those concerns.

Here we are in Juneau for the fourth time in the past two years to deliberate whether one of the State's taxes on oil and gas should be changed, and if so, what it should be changed to.

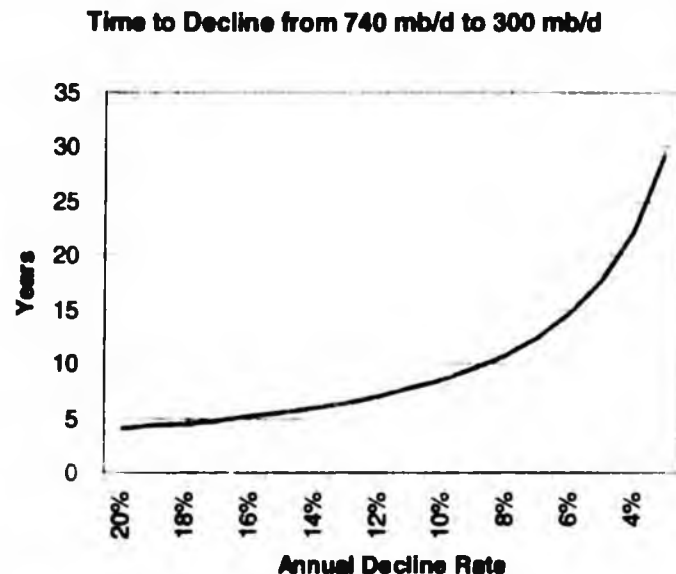
Last year the Legislature passed the Petroleum Production Tax, or PPT. Now, less than a year later, the Administration is telling you that the PPT is broken. They say it's too complicated to forecast, it isn't bringing in the revenue that was forecast last year, and they don't have enough capable auditors to enforce it.

In discussing the merits of SB 2001 versus PPT and the Administration's concerns, we must always keep in mind the real-world situation that Alaska faces. The greatest challenge that confronts this generation of Alaskans and the next is the ongoing decline of oil production, which has been, is today, and promises to remain the cornerstone of the finances of state government.

Production decline is eroding this cornerstone. It is a historical fact that even with the massive investments being made, North Slope production declined an average of 6.2% a year from FY 1997 to FY 2007, and Cook Inlet oil production declined at 8.0% a year.<sup>1</sup> Without those investments, decline would have been 15%.

With respect to the future of the North Slope, there is going to be a major challenge when ANS production gets down to about 300,000 barrels a day. According to Alyeska Pipeline Service Company, which operates the trans-Alaska oil pipeline (TAPS), the minimum mechanical capacity of the new electronic pumps that are being installed is about 300,000 barrels a day.

Here is a graph showing how long we have before ANS production reaches this 300,000 barrel-a-day mechanical threshold, depending on what the rate of decline is. If decline continues at the



*Handwritten:*  
Year 2022  
300,000  
BBL/D

historical rate of 6%, ANS will decline to 300,000 barrels a day in about 15 years, or FY 2022.

On the other hand, if decline can be held to 3% or less as DOR assumes, then we would have 30 years or so before we hit the mechanical threshold.

Let me stress that this graph is not a prediction. It merely plots the results of the mathematical calculations<sup>2</sup> of how long it would take to get to 300,000 barrels a day from the level of 740,000 barrels a day in FY 2007, depending on what decline rate you choose. What it does show is how important the rate of production decline is for Alaska's future. The difference between a 6% decline rate and 3% doesn't sound like much, but as you can see from the graph, that difference determines whether the 300,000 barrier is reached around FY 2022 or FY 2037. If you have a child in junior high school, this represents the difference between that child being able to grow up and have a career on the North Slope, and not having this opportunity.

Investment in new production is the only way to slow the decline enough to give the children of this state a future with the North Slope similar to what we have enjoyed. That's why new investment is such a crucial question facing the State, both in the context of the proposed tax proposal and in other areas that affect the business climate here.

There are three categories of investment that can slow the rate of decline on the North Slope, or at least keep it from getting any worse. These are, first, investment in exploration to discover new fields; second, investment in existing fields to prevent their decline from accelerating; and third, investment in innovation, technology, and new infrastructure to allow development of the vast but challenging resource of heavy and viscous oil that has already been discovered.

A great deal of the testimony to the Legislature, and a lot of the questions being asked, have focused on the fiscal terms of the "government take" for exploring in Alaska and the competitiveness of these terms relative to the terms in regimes elsewhere in the world. This kind of "who takes more" analysis is faulty for two fundamental reasons.

First, it assumes that the geologic prospects for making a commercial discovery in Alaska are comparable to those other regimes. This assumption is unsound. The North Slope has three major areas of significant oil and gas potential: the state lands in the central North Slope between the Colville and Canning rivers, the federal land in the National Petroleum Reserve - Alaska to the west of the state lands, and the coastal plain of ANWR to the east of the state lands. The exploration potential of the state lands is limited today primarily to the discovery of new satellite fields, as opposed to fields large enough to stand on their own economically. Exploration is still active in NPR-A and by no means over, but the courts have recently blocked federal leasing of the geologically promising lands around Teshekpuk Lake. And even if the Ninth Circuit decides to let that leasing go forward, the pro-leasing Bush Administration has less than 14 months left in office in which to hold the lease sale. Elsewhere in NPR-A, the relinquishment earlier this fall of some 300,000 acres of lands reflects disappointing results from leaseholder exploration efforts there. As for ANWR, despite Republican majorities in both houses of Congress and a pro-development president in the White House, the coastal plain is still closed.

And this brings me to the second reason why it is unwise to focus too much on investment in exploration as the solution to production decline. Exploration is a risky business, and there is no assurance that spending money to test a particular prospect will ever yield a dime of payback. Even when exploration succeeds in discovering a commercially viable field, it will take years from the time of its discovery until the time production from it begins. But the challenge of declining production confronts Alaska today — not eight, ten or a dozen years from now. By its nature, investing in exploration can make a significant contribution toward solving the challenge of declining production in the longer term, but not the shorter term when results are urgently needed.

Investment in heavy and viscous oil development is also a solution in the mid to long term. The first well ever drilled to test production from the Ugnu Formation was only drilled earlier this year in the Milne Point Unit, and it is still being tested and evaluated to gain a better understanding of the physical characteristics of the Ugnu oil. There are plans to use the results of these tests and evaluations to plan and develop a pilot project for producing Ugnu oil. Until then, West Sak will continue to be the only commercial heavy/viscous opportunity.

This gets us to investment in currently producing fields. Fortunately, there are investments that can be made, and are being made, in these fields to slow their decline. In the short term, this is in-fill drilling — that is, drilling new wells into the portions of a reservoir that are between the wells that have already been drilled. This accelerates the drainage of oil from the rock that currently lies in between existing wells. In-fill drilling last year contributed some 70,000 barrels a day to production from the Prudhoe Bay field. To put this into perspective, a 70,000 barrel per day field would be the 4<sup>th</sup> largest stand-alone field on the North Slope today.

There are also major investments being made, and yet to be made, in “renewal” of the surface facilities for existing fields. For instance, the gathering centers and flow stations for the Prudhoe Bay field have been in service for over 30 years now. For them the situation is not all that different from what yours would be if you bought a minivan van years ago when your children were young, and now that the kids are all grown up and it’s just you and your spouse who are driving it, it’s time to replace that minivan with a new vehicle that suits your needs better. If Prudhoe Bay and the other producing fields are to continue producing in the decades to come, their original production facilities will need to be overhauled or replaced. Also, as increasing amounts of heavy and viscous oil come into production, even relatively new facilities that were designed for comparatively light “conventional” oil will probably need to be modified, refitted or replaced in order to minimize operating problems in handling that heavy/viscous oil. Regardless of the stimulus or purpose for making them, renewal investments in production infrastructure present a very similar cash-flow pattern as there is for investments in the original infrastructure to develop a field. And consequently, an incentive that is effective for the initial development infrastructure is equally effective for renewal as well.

So, this is the harsh reality in which we — government, industry, the present generation of Alaskans, and the next one — find ourselves. For all of us, decline is the great challenge that

we must grapple with. It already threatens us now, and if unaddressed, will only get worse. Massive new investments for additional oil production are the only way to deal with this menace, and there are three areas of investment that can be made to deal with it: exploration, heavy and viscous oil development, and slowing decline of existing fields. The first two are of greatest benefit for the long term, and the other one is of great benefit for the near term. We need all three kinds of investment and don't have the luxury of ignoring one or two of them. I have explained our collective situation in such detail so we can each see for ourselves why declining production is the great issue of the day for Alaska.

Turning now to the relative merits of SB 2001 versus PPT, AOGA submits there are several self-evident principles of taxation that should be used to test those merits. First, a tax must be "fit for purpose" — that is, it must do the things it is intended to do, and it should do them well. Second, the administration and enforcement of a tax should be as efficient as possible, consistent with ensuring compliance by taxpayers. Third, for a taxpayer who wants to calculate and pay the correct amount of tax when it comes due, it must be possible to do so.

Regarding the first test — achieving what the tax is supposed to achieve — most new taxes have as their primary or only purpose the new revenues that they will bring in for the government. In the case of PPT, however, things were not so simple. In part its purpose certainly was revenue-related, because most legislators viewed the prior ELF-based production tax as outdated and unduly generous to producers in terms of the reduction in tax rate that the ELF caused. But, as Pedro van Meurs explained repeatedly in his testimony last year and again at the beginning of this special session, the PPT was also designed to provide incentives for investing in production and in that way answering the threat of declining production.

With respect to the revenue side, no one disputes that PPT has brought the State more tax revenue since April last year than ELF would have. According to DOR, the increase was more than \$800 million in the last nine months of 2006,<sup>3</sup> and at that rate it would have been over a billion dollars in additional production tax revenue for a full year. DOR also said at the time that the March 31<sup>st</sup> payments were about \$137 million less than the \$950 million that it had estimated, and in due course I'll come back to the questions of forecasting the PPT and higher-than-forecasted lease expenditures. For now, my point is that PPT has certainly outperformed the old ELF tax, which is just what it is supposed to do.

As a consequence of the fact that field costs are higher than DOR predicted last year, this Administration criticizes PPT for failing to generate all the tax revenues that the fiscal note for HB 3001 predicted. It has even been suggested that Alaskans were somehow promised that PPT would generate \$800 million more this year than is now being projected, and that it is therefore necessary to raise the tax rate in order to make good on that promise.

That whole line of reasoning is flawed. First of all, DOR is complaining that they can't forecast PPT accurately because it has so many variables that affect the results. However, if they can't forecast it accurately, then why should so much reliance be placed on its current forecast

that shows the prior forecast was off by \$800 million? If the first forecast was poor, what has changed to make this latest one so good?

As I explained just a while ago, the purpose of PPT was more than just the tax revenues it would generate. It was to create incentives for attracting the massive new investments that will be needed in order to meet the threat posed by declining production. The system of tax credits under PPT provides significant incentives for investing in capital assets to explore for, develop, and produce more oil and gas.

- Current capital expenditures generate a 20% tax credit in addition to being immediately deductible as lease expenditures. For the kinds of economic analysis that reflect the time-value of money, these front-end benefits have the greatest possible positive effects on the results of the analysis.
- The incentive to invest sooner rather than later is materially increased by the fact that the "transitional investment expenditure" or "TIE" credit for pre-PPT capital investments can only be taken to the extent those prior expenditures are matched two for one by new capital expenditures, and taxpayers have only until the end of 2013 to use up their "TIE" credits.<sup>4</sup>
- The 20% tax credit for a carried-forward annual loss particularly benefits explorers and those who are bringing new fields into production for the first time in Alaska and don't have production yet that they can deduct their costs against.
- The "section 024(c) credit" of up to \$12 million a year for producers with less than 100,000 barrels a day of production is an incentive for independents and other smaller players to come to Alaska for oil and gas.
- The \$6 million annual credit under AS 43.55.024(c) is an incentive for exploration and development in the areas of Alaska outside the North Slope and Cook Inlet basin.

Have these incentives under PPT worked? The preliminary results so far say yes. DOR's August 3<sup>rd</sup> report on PPT states that capital investments for FY 2008 are 80% greater than previously estimated, despite the fact that operating expenditures are up by 101% over the prior projections.<sup>5</sup> Of course, it will take time before companies can fully respond to these incentives, and it will take even more time to tell whether the new investments to increase oil production succeed in actually getting more production. But so far things appear to be moving in the right direction.

There is the question of whether the inability of explorers and almost-producers to sell their credit certificates near face value has been a material problem. As the Executive Director of AOGA, I can assure you there is no one among AOGA's membership who thinks any problem in selling the certificates has been serious enough to justify amending the PPT.

Now, moving on to SB 2001, how well does it stack up under the standard of being fit for purpose? Certainly, it would generate even more tax revenue than the PPT will, at least in the

short term. But it is premised on the totally mistaken notion that increasing what the government takes from the economic "pie" will encourage greater investment, or at least not decrease it from what it would be anyway. No one has ever taxed economic growth and development into existence. SB 2001 will not do so, either.

The second standard for evaluating SB 2001 versus PPT is that the administration and enforcement of the tax must be as efficient as possible, consistent with ensuring compliance by taxpayers. Here, the two chief objections to PPT have been, first, that it is all but impossible to forecast the revenues from it with the accuracy needed for state budget purposes, and second, that the audit challenges of PPT leave DOR's auditors hopelessly outgunned.<sup>6</sup> So the questions that need to be answered are, how much merit do these criticisms have, and how would SB 2001 address these concerns?

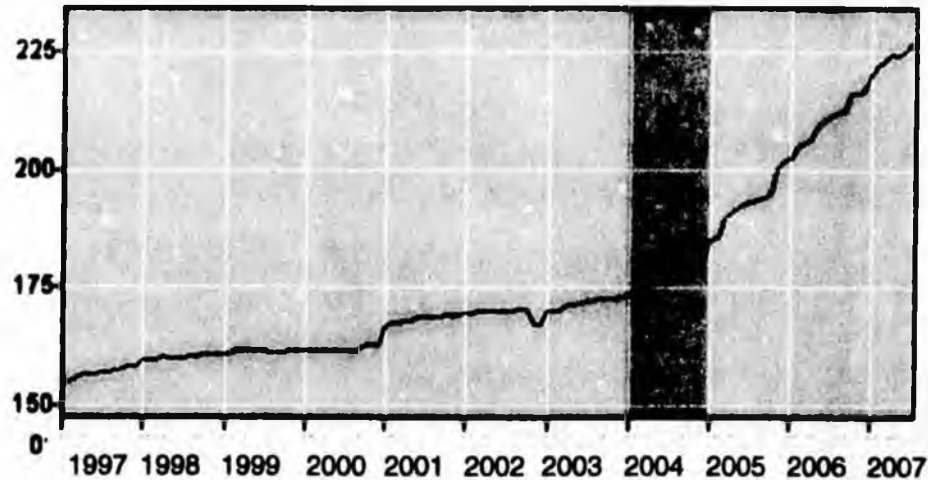
Regarding forecasts for PPT, DOR cites two major concerns about the forecasts. One is that, "[w]hile costs would be expected to increase, the dramatic difference between what was predicted [in the prior Administration's fiscal note for HB 3001] and what has actually been experienced brings into question whether the legislature made its decisions based upon appropriate information."<sup>7</sup> The other is that DOR needs cost information about current and planned spending from the operators, producers and explorers, and this allegedly has not been forthcoming from them.

Let us consider this "dramatic difference" between the projected expenditures behind the fiscal note last year, and what those expenditures have actually been. When the DOR staff in the prior Administration sought information about expenditures, they chose not to rely on the representations about 2006 costs that individual companies gave the Legislature in public testimony at that time.<sup>8</sup> Instead, they looked at what they believed to be more reliable information contained in the most recent partnership tax returns that had been filed with the IRS for fields on the North Slope.

Federal partnership returns are not due to be filed with the IRS until October of the following year, so even as late as August 2006 when the Legislature passed HB 3001, the most recent returns available were those for 2004. Here is a chart showing the Producer Price Index

### Oil and Gas Field Machinery and Equipment PPI

Source: U.S. Department of Labor



for oil and gas field machinery and equipment during the last decade. The highlighted bar in the graph marks 2004, and you can see right away why a fiscal note based on the most recently filed federal tax returns, for 2004, would be way off the mark in predicting what the field costs would be in 2006 and '07.

There was nothing sinister about what that Administration did. The companies said the 2006 costs were high, but the latest tax returns at that time indicated the costs were significantly less, with a fairly lengthy track record of gradual increases. DOR went with the reported information on the tax returns. I suspect the DOR staff in the present Administration would do the same in those circumstances. In any event, this is not a reason for casting PPT aside.

The other criticism that DOR makes of PPT is that producers and other taxpayers are not providing DOR with the information it needs in order to be able to forecast PPT revenues with sufficient accuracy. Obviously, AOGA is not privy to what these taxpayers are reporting to DOR as they make their monthly installment payments and their annual true-up payment on March 31<sup>st</sup>.

DOR's second chief objection to the administrability and enforceability of PPT is that the audit challenges of PPT leave its auditors hopelessly outgunned. It is not for us to comment about the proposal to put auditors in the "exempt" service.

But there is a dimension to PPT audits, however, that we can and should address. This has to do with what the source or starting point for determining how much a producer's deductible lease expenditures are. The PPT statutes currently allow DOR a choice between starting from the joint-interest billings and invoices that operators bill to the other participants in

an oil and gas field or venture,<sup>9</sup> or starting from a comprehensive set of accounting rules and principles that DOR writes up.<sup>10</sup> Which choice DOR chooses will determine nothing less than the very success or failure of PPT as a tax — and for SB 2001 as well, if it is enacted. It is like having a tax based on your federal taxable income, and choosing between your federal tax return (as audited by IRS) as the starting point, or starting with the Internal Revenue Code and leaving it up to you and DOR's auditors alike to find what the right answer is under the Code. It is like having a tax based on your financial book income, and choosing between your audited financial statements filed with the SEC as the starting point, or starting with Generally Accepted Accounting Principles and leaving it up to you and DOR's auditors alike to find what the right answer is under GAAP.

From the taxpayer's perspective, this means a near certainty of continual assessments year after year for additional tax, interest, and perhaps penalties, and depending on how litigious a company may feel, it may mean a long series of lawsuits and appeals as well.

From the State's perspective, these same troubles for the taxpayer will mean that the incentives for investment under PPT, or SB 2001, will be seriously eroded. The greater the uncertainty about how much tax a company owes, the greater the likelihood that the incentives will turn out be less than their face value. A taxpayer's only recourse in this situation will be to discount the face-value of those incentives significantly, perhaps completely, in running the economic analysis about making an investment or not. As a consequence, the effectiveness of those incentives will be less than it should be, and Alaska will fail to realize the full amount of new production that it needs to meet the challenge of decline.

The other choice that DOR could make is to start with what an operator bills to the other participants in an oil and gas operation. Note that I said "start" with those billings — not "end." Anything in those billings that is nondeductible under AS 43.55.165(e) would have to be backed out. The central concept of lease expenditures in AS 43.55.165(a) is that they must be "direct" and "ordinary and necessary" costs of exploration, development, or production. It would be most surprising if there are anything in those billings that goes outside this standard.

How can Alaska be sure of this? Because the participants in an oil and gas operation do not give the operator a license to waste their money. I have heard a great deal of concern expressed during these hearings about how the companies might somehow try to "game the system" in order to reduce the tax they will pay the State. While so many are so worried about efforts by the companies not to overpay the State, why would most of these same people think the companies are somehow more willing to overpay the operator than the State? Clearly they don't want to overpay either one. If anything, since the operator usually is a direct competitor, they probably don't want to overpay it even more than they don't want to overpay the State. In other words, if an operator is exploring a geologic prospect, the non-operating participants don't want to pay any costs that are not for the exploration of that prospect. Similarly, if the operator is operating a producing field, they don't want to pay any costs that aren't for the operation of that field. It is reasonable to rely, in the first instance, on the non-operators' self-interests to

police and limit what the operator can spend their money on, and they will do that policing by auditing the operator's invoices to them.

In the context of PPT, DOR should "audit the audits" to verify that the non-operators do indeed audit an operator's invoices on a regular basis, and that those audits are rigorous and at arm's length. But once these things have been confirmed by DOR in its verification of the non-operators' audits, there is little point for DOR to spend the time and effort to re-plow the field that the companies' audits have already plowed.

Daniel Johnston, a consultant hired during last year's debate on PPT, gave an informal presentation to members of the Legislature on Friday, Oct. 19, 2007. During that meeting, he praised the expertise of joint interest auditors and the ability for the state to utilize unit accounting. He went on to say that it would be "extremely insightful for the state to get unit accounting". Mr. Johnston observed that state auditors can be "vicious", but that joint interest auditors are "even more vicious".

Of course, for operations where there is only one participant or where there are no audits of the operator's invoices, this approach will be inapplicable. But there are still things DOR could do to build off the billing systems where there are such audits and extend them to these other fields. However, DOR has not yet adopted the "Phase II" regulations to implement and apply its existing statutory authority to authorize or require taxpayers to follow this approach.

A very dismaying thing about SB 2001 is that Section 64 would repeal DOR's explicit statutory authority under AS 43.55.165(c) and (d) to require or authorize the use of operators' joint-interest billings as the starting point for computing the amount of a producer's deductible lease expenditures for that unit or field, while Section 71(b) would make that repeal retroactive to April 1, 2006.

We believe that this repeal will mean DOR cannot authorize or require a producer to start with an operator's joint-interest billings, even when DOR wants to allow or require their use. Since these repeals are in the proposed legislation that has been introduced, we expect that DOR, in response to us, will testify that somehow they will still be able to require or authorize the use operator billings even if these present statutory provisions are repealed. However, if you enact a law specifically saying DOR may do something and later on you repeal that law, doesn't that repeal mean DOR can't do it anymore? We think so. But even if you are persuaded by DOR that we're wrong on this point, why should you repeal those statutes and take the chance that the courts won't agree? ~~You could probably repeal AS 43.55.165(d) and keep subsection (c) on the books without taking much risk, because the text of (d) is very repetitive of that in (c). But repealing them both is taking a hollow chance.~~

The reason I've spent so much time about the use of joint-interest billings as the starting point for determining a producer's lease expenditures is this: Consider the situation that a non-operating participant faces. All the information it has about what's being spent for the operation

is what it gets from its billings from the operator, plus whatever it may learn by auditing those invoices. But if such a non-operator cannot start from those invoices, how can it figure out what to report as the lease expenditures for that operation? All the books and records of the expenditures are with the operator, and if the non-operator hasn't yet audited the operator, it will have no idea what those books and records show. It is infeasible for a non-operator to be auditing the operator month by month, yet the non-operator will somehow have to be reporting and paying installments month by month throughout the year. Even by the March 31 true-up the following year, it is unlikely that any audit of the operator's books and records will have been begun by that date, much less completed. The penalty for mis-estimating the installment payments is principally in the difference between the rate of interest on overpaid installments and underpaid ones. But the March 31 true-up is very serious business. Interest at an APR not less than 11% compounded quarterly begins to accrue, and penalties of up to 30% for negligence and failure-to-pay<sup>11</sup> can be assessed, on the amount of any underpayment continuing after that true-up date. If a non-operator cannot rely on its billings from the operator as the starting point for these purposes, what is it supposed to use?<sup>12</sup>

If, as we fear, the repeals of AS 43.55.165(c) and (d) under the proposed bill will indeed take away DOR's discretion to allow or require the use of operators' joint-interest billings, then SB 2001 will completely fail the third standard by which a tax is measured — that it must be possible for a taxpayer to get the tax right when it is due, when the taxpayer wants to do so. This will be impossible for non-operators under the proposed legislation. Even PPT will fail if the "Phase II" regulations do not reasonably implement DOR's present authority under AS 43.55.165(c) and (d) regarding the use of operator billings.

Before I close, there are a few confusing things in the SB 2001 I would like to address.

The first of these is Section 1, declaring that subsection (b) in the new production-tax statute of limitations being enacted is intended to "confirm by clarification the long-standing interpretation of AS 43.05.260 by the Department of Revenue relating to limitation of assessments for the production tax on oil and gas and conservation surcharges on oil." Does anyone here know why this is in the bill? AS 43.05.260 is the existing statute of limitations for auditing all state taxes under AS 43, and what is it about this present limitations statute that is being "confirm[ed]" by the new AS 43.55.075(b)?

If you read this new section 075(b) — which begins on page 35 line 30 and runs through line 15 on page 36 of the bill — you see there are two parts to the subsection. One part is the first two sentences, which address the effects for tax purposes of judicial or administrative decisions that retroactively change parameters for calculating the tax. The other part is the last sentence, including paragraphs (1) and (2), and requires producers to report such decisions to DOR within 60 days and to file amended returns within 120 days.

The curious thing is that the existing statute of limitations (AS 43.05.260) — the interpretation of which is to be "confirmed" — has nothing in it pertaining to either of these

subjects. Here is the text of AS 43.05.260 and you can see this for yourselves. Subsection (a)

**Sec. 43.05.260. Limitation on assessment.** (a) Except as provided in (c) of this section and AS 43.20.200 (b), the amount of a tax imposed by this title must be assessed within three years after the return was filed, whether or not a return was filed on or after the date prescribed by law. If the tax is not assessed before the expiration of the three-year period, proceedings may not be instituted in court for the collection of the tax.

(b) For purposes of this section, a return filed before the last day prescribed by law or regulation is considered as filed on the last day.

(c) The following exceptions apply to the limitation period in (a) of this section:

(1) in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of the tax may be begun without assessment, at any time;

(2) in the case of a failure to file a return, the tax may be assessed, or a proceeding in court for the collection of the tax may be begun without assessment, at any time;

(3) if, before the expiration of the time prescribed in this section for the assessment of a tax imposed by this title, both the department and the taxpayer have consented in writing to the assessment after the expiration of the time, the tax may be assessed at any time before the expiration of the period agreed upon; however, the period agreed upon may be extended by a subsequent agreement in writing made before the expiration of the period previously agreed upon.

sets three years as the period for DOR to audit and assess any additional tax that may be due, and it bars suits to collect any additional tax if that tax is not assessed within the three-year period. Subsection (b) says that, if a taxpayer files its tax return early before it is due, the three-year period starts running from the due date instead of the actual filing date. Subsection (c) creates three exceptions to the rule under subsection (a), which appear as paragraphs (1) – (3) of subsection (c): namely, for false or fraudulent returns to evade tax, for a failure to file any return at all, and for extensions of the three-year period that are mutually agreed upon in writing by DOR and the taxpayer.

Which of these provisions has anything to do with tax effects of retroactive decisions? Which has anything to do with having to report such decisions to DOR and filing amended tax returns? It is not immediately clear to us what either of these topics in the new statute of limitations has to do with interpreting any of the provisions in existing statute of limitations I've just reviewed with you. So what's going on with Bill Section 1?

We believe Section 1 is a stealthy attempt to legislate an outcome to matters that are already being litigated in the due course of administrative and judicial proceedings. In 1999 DOR amended one of its production tax regulations, 15 AAC 55.200, so that it reads remarkably like AS 43.55.075(b) being enacted in this bill. Here you have the regulation and the proposed

15 AAC 55.200. Retroactive adjustments. If retroactive adjustments in costs of transportation, sales price, prevailing value, or consideration for quality differentials relating to the commingling of oils or of oil and NGLs result from decisions of regulatory agencies, courts, or any other preemptive authority, those adjustments have a corresponding effect, either an increase or decrease as applicable, on the gross value at point of production as determined under this chapter, and the producer shall, on or before the third monthly payment due date specified in AS 43.55.020(a) after any adjustment, file amended returns covering the entire period of an adjustment unless the producer has obtained a stay on that filing or payment, regardless of the pendency of appeals of those decisions. [emphasis added]

(b) A decision of a regulatory agency, court, or other body with authority to resolve disputes that results in a retroactive change to a lease expenditure, to an adjustment to a lease expenditure, to costs of transportation, to sales price, to prevailing value, or to consideration of quality differentials relating to the commingling of oils has a corresponding effect, either an increase or decrease, as applicable, on the production tax value of oil or gas or the amount or availability of a tax credit as determined under this chapter. For purposes of this section, a change to a lease expenditure includes a change in the categorization of a lease expenditure as a qualified capital expenditure or as not a qualified capital expenditure. The producer shall (1) within 60 days after the change, notify the department in writing; and (2) within 120 after the change, file amended returns covering all periods affected by the Change, unless the department agrees otherwise or a stay is in place that affects the filing or payment, regardless of the pendency of appeals of the decision. [emphasis added]

new AS 43.55.075(b) side by side, with identical or parallel language in them being underlined. As you can see, the regulation deals with “decisions of regulatory agencies, courts, or any other preemptive authority” while the proposed new statute addresses any “decision of a regulatory agency, court, or other body with authority to resolve disputes[.]” The regulation deals with “retroactive adjustments in costs of transportation, sales price, prevailing value, or consideration for quality differentials relating to the commingling of oils or of oil and NGLs” while the proposed statute addresses “a retroactive change” to the very same things,<sup>13</sup> plus any change to “a lease expenditure[.]” Both state that retroactive changes in the parameters for calculating the taxable value have “a corresponding effect, either an increase or decrease.[<sup>14</sup>] as applicable on” that taxable value.

Now, the “interpretation” that comes into play here has to do with the question of when interest begins accruing on a tax increase or decrease that results from one of these retroactive decisions — does it begin to accrue as of the date of that decision? Or does it begin to accrue all

the way back to the original payment due date? When DOR adopted the amendment to the regulation in 1999, the director of the Tax Division at that time told AOGA members that DOR was interpreting that amendment to mean interest would start to accrue as of the original payment due date for the tax, not as of the date of the retroactive decision.

We believe it is this "interpretation" of its own regulation, which is in the process of being appealed in due course, that the Administration intends to have "confirm[ed]" under Section 1 of SB 2001 as the proper interpretation of the pre-PPT statute of limitations. The question for you is, do you really want to confirm this?

Confirming it would set a destabilizing precedent, because it will mean that the laws can effectively be rewritten to deal with subjects that they did not originally deal with, and this can be done clandestinely by "confirming" some purported "interpretation" of it. For one thing, it would be an attempt by the Executive and Legislative branches to determine the outcome of matters that are already before or headed to the Judicial Branch in due course. Can the Legislature intervene in Judicial matters under the Separation of Powers Doctrine, and even if it can, should it attempt to do so here? Second, what does it say to potential investors in this state about our sense of justice, Due Process, and fair play?

Now, if the Administration appears before you or any other committee of this Legislature and disavows any and all intention to do such a thing, I would encourage you to ask them to clearly explain what they did intend to achieve with Section 1, so that it will be part of the legislative history of this bill. Then, if it becomes law, the legislative history will be there to establish that the "interpretation" which we fear is not the Legislature's intent, nor the Administration's.

A second confusing thing in SB 2001 relates to the new statute of limitations being proposed for production tax only. Why does the limitations period need be six years instead of three, when the three-year period can be extended and re-extended any number of times as appropriate? If the state auditors are anything like me and everyone I know, their work will expand to fill the time allowed — giving them six years to get their audits done will mean they'll take six years to audit even when they could otherwise be done more quickly. Unfortunately, the longer the audit runs, the greater the amount of interest there will be that accrues on any underpayment claimed in the audit. After three years, interest represents 38¢ for each dollar of additional tax claimed, assuming interest is not above its 11% APR floor rate. But after six years the accrued interest is 92¢ for each dollar of additional tax. By raising the stakes so substantially for each audit claim that is raised, the longer limitations period will make it easier to justify litigating claims.

The purpose of a statute of limitations is to bar claims when they start to become so old that the records, documents, and recollections of witnesses may well be lost or not readily available by the time those claims are finally raised. The present statute of limitations has worked for all the other taxes under Title 43, including the present worldwide corporate income

*Jeopardy Assessment*

tax for oil and gas taxpayers, the domestic or "water's edge" income tax for other corporations, even the former separate-accounting income tax. It is worth noting that separate-accounting involved not only determining net income from all of a taxpayer's interests in oil and gas fields and prospects, but also its income from interests in oil or gas pipelines as well.<sup>15</sup> While PPT and SB 2001 are not simple taxes, separate-accounting was probably even more challenging to administer and audit. If Alaska didn't need a longer statute of limitations for separate-accounting, we don't see why one is needed now.

In conclusion, SB 2001 fails two of the three standards for evaluating a tax, while PPT passes two of them and would pass the third one as well if DOR adopts the appropriate regulations. SB 2001 in the short term will generate more tax revenue for the State than PPT; however, it will achieve this at the cost of reducing the incentives for new investments, and worsening the overall tax climate for making them here. SB 2001 fails the test of being administrable as efficiently as possible, consistent with ensuring taxpayer compliance. This failure will primarily be due to repealing DOR's existing statutory discretion to allow, as appropriate, joint-interest partners do the auditing of the operator's billings to them. Instead DOR auditors could have to re-invent the wheel for themselves in each audit. SB 2001 also fails the test that a taxpayer who wants to pay the correct amount of tax when it comes due must be able to do so. This will be impossible for every company that owns an interest in a lease or property that it does not operate. This in turn will effectively destroy the value of the remaining tax incentives under this bill that potential investors will perceive. If they cannot tell what they owe, they surely cannot put a reliable figure to the value of the incentives under the tax.

All of this brings us back to the fundamental issue facing Alaska today...the decline of Alaska production. Today Alaska's production has fallen from its peak of 2.1 million barrels a day down to the 700,000 range. This means that the trans Alaska pipeline is 2/3 empty. I would remind you of my chart earlier that showed the purely mathematical results about how long we have before hitting the 300,000 barrel-a-day TAPS mechanical threshold, depending on what rate of decline you assume will turn out to come true.

And it's important to remember that today's 6% decline rate would be on the order of 15-16% were it not for the substantial investments which continue to be made by operators in existing fields. Further, Alaska is fortunate to have on the nearby horizon Pioneer's Oooguruk project, scheduled to go into production in 2008.

The importance of future investment is further emphasized when one looks at the Department of Revenue's forecast of future production levels. In three short years, DOR projects that production will come from projects requiring significant new investment. Draw that timeline out to 2017—ten years from now—and you discover that half of Alaska's production will come from new production—production which will only come from investments yet to be made.

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**The most important policy question is whether SB 2001 provides a framework for encouraging this additional new investment. AOGA's 17 member companies unanimously agree that PPT does accomplish that goal, and as such, should not be changed at this time.**

## ENDNOTES

<sup>1</sup> When production declines at  $X\%$  a year, this means the production rate after one year ( $P_1$ ) is  $(1 - X\%)$  of the initial production rate ( $P_0$ ), or  $P_1 = P_0 \times (1 - X\%)$ . After the second year the production rate ( $P_2$ ) is  $(1 - X\%)$  of the rate after one year of production, or  $P_2 = P_1 \times (1 - X\%) = [P_0 \times (1 - X\%)] \times (1 - X\%)$ , which can be simplified as  $P_2 = P_0 \times (1 - X\%)^2$ . After 10 years of decline, the rate  $P_{10}$  is  $P_0 \times (1 - X\%)^{10}$ . North Slope production was 1,404 million barrels a day in FY 1997 and 740 thousand barrels a day in FY 2007, while Cook Inlet produced 37 thousand barrels a day in '97 and 16 thousand barrels a day in '07. See DOR, *Revenue Sources Book Spring 2007*, pp. 97-98. So for North Slope production,

$$1,404,000 \times (1 - X\%)^{10} = 740,000.$$

Dividing both sides of this equation by 1,404,000 gives:

$$(1 - X\%)^{10} = 740,000/1,404,000 = 0.5271.$$

One can solve for  $(1 - X\%)$  by taking the 10th root of both sides of this latter equation:

$$\sqrt[10]{(1 - X\%)^{10}} = \sqrt[10]{0.5271}, \text{ or}$$
$$(1 - X\%) = 0.9380.$$

In other words, on average the production rate each year was 93.80% of the rate for the prior year, which means the rate of decline averaged 6.20% a year. The same calculation for Cook Inlet, using 37,000 and 16,000 barrels a day instead of 1,404,000 and 740,000 respectively, yields an average annual decline rate of 8.0 percent

<sup>2</sup> Here is the math: From the analysis in Endnote 1 above, we know that for a given decline rate  $R$ , the volume of production after  $N$  years of decline is  $P \times (1 - R)^N$ . So for each decline rate in the table, you use that as the value of  $R$  in the formula, and then you solve for  $X$  as the value of  $N$  that gives 300,000 barrels a day as the rate. The equation for this is:

$$740,000 \times (1 - R)^X = 300,000.$$

When you take the logarithm of both sides of this equation, you get the following equation:

$$\log[740,000 \times (1 - R)^X] = \log[300,000].$$

The reason for using logarithms is that they have the property that the logarithm of two numbers being multiplied together equals the sum of the logarithms for each of them, while the logarithm of a number raised to an exponent  $X$  equals  $X$  times the logarithm of that number. Using this gives the following restatement of the prior equation:

$$\log[740,000] + X \times \log[(1 - R)] = \log[300,000].$$

Subtracting  $\log[740,000]$  from both sides of the last equation yields the following:

$$X \times \log[(1 - R)] = \log[300,000] - \log[740,000]. \quad \text{[continued on next page]}$$

Now you can solve for  $X$  by dividing both sides of the last equation by  $\log[(1 - R)]$ , which yields:

$$X = \frac{\log[300,000] - \log[740,000]}{\log[(1 - R)]}$$

By plugging the decline rate of your choice into this last equation as the value of  $R$ , the value of  $X$  can be calculated by simple arithmetic. This straightforward calculation has been done for each of the decline rates shown in the graph.

<sup>3</sup> DOR Press Release, "New Production Tax Nets Increased Revenues For Alaska" (April 3, 2007).

<sup>4</sup> For producers who begin producing in Alaska on or after April 1, 2006, they have six years from the year of that first production in which to use up their "TIE" credits. The rule still applies during those six years that it takes \$2 of new capital investment in order to get a credit for \$1 of the "TIE" investment from the years before their production begins.

<sup>5</sup> See DOR, *Petroleum Profits [sic] Tax (PPT) Implementation Status Report* (August 3, 2007), p. 3.

<sup>6</sup> See DOR, *Petroleum Profits [sic] Tax (PPT) Implementation Status Report* (August 3, 2007): "The Department has been severely hampered in its ability to provide the administration and the legislature with accurate revenue forecasts ...." *Id.*, p. 4. "The complexity of auditing production tax has increased several fold under the PPT, and the PPT increased the number of determinations an auditor must make." *Id.*, p. 5.

<sup>7</sup> *Id.*, p. 5.

<sup>8</sup> See, e.g., Alaska State Legislature, House Finance Committee, *Minutes* (March 29, 2006), p. 15:

Representative Holm ... asked about the rate of return at \$60 per barrel. Mr. [Angus] Walker [Commercial Vice President of BP Exploration (Alaska) Inc.] said BP is excited about current prices. BP does not make a profit until oil is above \$22.50 a barrel.

At a \$22.50 West Coast price, BP's implicit upstream field expenditures were about \$11.95 a barrel, as opposed to the \$7.27 per barrel in the fiscal note for HB 3001.

\$22.50	ANS price on West Coast
1.76	Marine transportation to West Coast
4.38	TAPS
0.67	North Slope pipelines, quality bank, etc.
\$15.69	Average North Slope wellhead value
1.96	State royalty (1/8)
\$13.73	Taxable value
1.09	Production tax (15% base rate × ELF of 0.529)
0.69	Property tax (\$/bbl average)
\$11.95	Implicit expenditures/bbl.

SOURCE: DOR, *Revenue Sources Book Fall 2006*, p. 33 Fig. 4-6 (average ANS ELF); p. 39 Fig. 4-9 (marine, TAPS, and Slope pipelines/quality bank); p. 40 Fig 4-11 (ANS production); p. 42 Fig. 4-12 (property tax; \$60 million for tax on TAPS is deducted from total for North Slope Borough, Fairbanks, Valdez and Unorganized Borough). All data are for FY 2006.

<sup>9</sup> The authority for DOR to take this approach is in AS 43.55.165(c) and (d). Subsection (c) states in pertinent part: "if the department finds that the pertinent provisions of a unit operating agreement or similar operating agreement are substantially consistent with the department's ... standards under (a) of this section concerning whether costs are lease expenditures, the department may authorize or require a producer ... to treat as ... lease expenditures ... the costs, other than items listed in (e) of this section, that are incurred by the operator ... and ... billable to the producer by the operator in accordance with the terms of the [operating] agreement[.]" Subsection (d) has very similar language.

<sup>10</sup> The authority for DOR to take this approach is in AS 43.55.165(a), which states in pertinent part: "In determining whether costs are lease expenditures, the department shall consider, among other factors, (1) the typical industry practices and standards in the state that determine the costs, other than items listed in (c) of this section, that an operator is allowed to bill a working interest owner that is not the operator, under unit operating agreements or similar operating agreements ... and (2) the standards adopted by the Department of Natural Resources that determine the costs, other than items listed in (e) of this section, that a lessee is allowed to deduct from revenue in calculating net profits under [net profit share] lease[.]"

<sup>11</sup> The penalty for an underpayment due to negligence is 5% of the amount of the underpayment. AS 43.05.220(b). The failure-to-pay penalty for an underpayment is 5% of the underpayment for each month or partial month that the underpayment continues after payment was due, up to a maximum of 25 percent. AS 43.05.220(a). By regulation, DOR has adopted the policy that the imposition of a negligence penalty automatically triggers the imposition of a failure-to-pay penalty as well. 15 AAC 05.210(g).

<sup>12</sup> It follows that, if a non-operator can rely on the operator's joint-interest billings as the starting point for the non-operator's own lease expenditures for that operation, then the operator should similarly be able to use its proportionate share of the same total billable costs as the starting point for its lease expenditures for that operation. There is no reason to discriminate between them.

<sup>13</sup> The regulation addresses "quality differentials relating to the commingling of oils or of oil and NGLs" (emphasis added) while the proposed statute lacks the emphasized phrase. The PPT legislation last year changed the definitions of "oil" and "gas" so that "oil" includes "NGLs" and consequently emphasized language in the regulation is encompassed now by the phrase "commingling of oils" in the proposed statute.

<sup>14</sup> The regulation lacks the comma that appears here in the proposed statute.

<sup>15</sup> See former AS 43.21.020 (production income) and 43.21.030 (pipeline income).



# **THE ALLIANCE**

... for responsible development of Alaska's Oil, Gas & Mineral Resources

**SENATE TESTIMONY  
on SB 2001  
October 23, 2007**

Thank you, Chairman Huggins. My name is Paul Laird. I'm general manager and testifying on behalf of the Alaska Support Industry Alliance, a trade organization representing companies and individuals that provide goods and services to Alaska's oil, gas and mining industries.

Our members range from small local contractors and vendors to the largest Alaska Native and Alaska-based corporations to the Alaska subsidiaries of multinational service companies. Our members don't make the multibillion-dollar investments in oil and gas development that fuel Alaska's economy ... our 400 member companies and their 35,000-plus Alaska employees make those investments work.

In turn, those investments put our members and their employees to work.

As companies and workers whose livelihoods depend on oil and gas investment, we're deeply concerned about constant changes in fiscal policy that put some investments at risk.

As Alaskans whose economic future depends on the level of oil and gas production in our state, we're deeply concerned about the impact of an even steeper rate of production decline on our families' and our own ability to build long-term futures here.

Chairman Huggins, members of the Senate Resources Committee, I will be brief in my remarks to you today. We don't know if a 22.5% tax rate with the current escalator and credits strikes the right balance between ensuring the state its fair share of OIL revenues and encouraging long-term investment and production. We don't know if 25% is the right rate ... or 20 ... or 15.

None of us does ... not the Alliance, not the legislature, not the administration and not even the producers. Regulations for the Petroleum Production Tax system just 14 months ago haven't been finalized, and the first returns haven't been audited.

**ALASKA SUPPORT INDUSTRY ALLIANCE**

360 W. Benson Blvd., Suite 200 • Anchorage, Alaska 99503 • Phone: (907) 563-2226 • Fax: (907) 561-8870 • [www.alaskaalliance.com](http://www.alaskaalliance.com)

It's difficult for us to understand why we're back here so soon to fix a system that hasn't even had time to work, let alone for there to be compelling evidence that it's broken. That case simply hasn't been made; you've been presented with a plethora of projections and a paucity of proof.

We do know that the PPT has already generated an additional \$1 billion in state revenues.

We do know that the increase being proposed would be the third major severance tax increase on the industry in the past three years.

We do know that every dollar in additional taxes is a dollar that won't be invested in sustaining production, in creating business opportunities for Alaska companies like Alliance members, in generating good-paying private sector jobs for Alaskans.

We do know that throughput in Trans-Alaska Pipeline has already declined by two-thirds, and despite multibillion-dollar investments by the industry, it continues to decline by 6% a year.

We do know that without those investments, TAPS will reach its economic threshold in the next 15 or 20 years instead of the the next 50 or 60.

We do know that our 400 members and many of their 35,000 Alaska employees want to be here long after the legislature's and the administration's consultants on this issue are gone ... as long as there are still enough economic opportunities to keep them here. They'll be the ones to bear the consequences if higher taxes and higher costs really do result in less investment ... a novel economic concept, to be sure.

We do know that while the extent to which yet another tax increase will discourage investment is debatable, the fact that it will do absolutely nothing to encourage new oil production and construction of a gas project is not.

Isn't that what this discussion should be about, Mr. Chairman and members of this committee: how we can work together to promote investments ... how we can ensure our "fair share" of long-term jobs and business opportunities for Alaskans, rather than how much more money we can extract from the private sector without further risking our long-term future ... just so state government can have more money to spend in the short term?

What's the plan when this \$700-900 million a year tax increase isn't enough to sustain state spending?

In your wisdom, when you adopted the new PPT in 2006 after six months of extensive deliberations, aggressive debate and countless votes, you included provisions requiring a complete review of the system five years later - in 2011. You understood then that it would take several years to reasonably determine how and if it's working.

So far, there's been no compelling evidence to the contrary. It will still take several years to responsibly make that determination.

Do what you need to do in the short term to make the PPT work - hire more auditors, pay them more, take steps to ensure the timely flow of accurate data from the producers to the state, authorize the state to buy back credits.

But on behalf of the Alliance's 400 member organizations and their 35,000-plus Alaska employees, all Alaska businesses and workers and Alaska's economic future, we urge you to reject premature, fundamental changes to the PPT that will increase taxes, increase costs and jeopardize the economics of critical long-term investments and put production, Alaska jobs and business opportunities at risk.

Thank you.

CH - 35,000 of them, we live next to them.  
thanks for the verbatim we just  
can't extract money - taxes; bureaucracy -  
from private sector  
thank you -

23 October 2007

To Members of the Senate Resources Committee:-

My name is Maynard V. Tapp, I am an Alaskan resident since 1990. I founded my company Hawk Construction Consultants, Inc. now Hawk Consultants, LLC in 1985 as an Alaskan corporation.

I strongly believe any new approach to raise taxes should be viewed as a "RESOURCE DEVELOPMENT" effort. The state will raise more tax revenues if we raise production.

If you ask any of the tax experts that will testify before your committee, none will say that increasing the tax will increase exploration and production.

The most reliable source of long-term revenue is to increase production. As I understand the state gets 75% of the 12.5% royalty (9.375%). The "fair share" to the Alaskans is the remaining (3.125%) paid into the Permanent Fund. I believe you can build a long term future for my company's employees based on the increase in production.

Hawk employs over 60 Alaskans. Much of their work is related to the reconfiguration of the Trans Alaska Pipeline, and the refurbishment and maintenance of the existing pipelines and facilities in Greater Prudhoe Bay.

Our company, its employees and the State of Alaska will greatly benefit from new production. We hope to be involved in all phases of the continuing projects.

From my point of view an increase of 2.5% in tax rates increases the size of government by \$25.0Million. One Senator made the point to me that "there is no guarantee that if the rate was reduced by 1% that the producers would invest that 1% here in Alaska". While this may or may not be true, one thing is certain that \$25.0Million will not be invested by the companies if it is taken away by increasing the tax.

What is the State of Alaska doing to increase oil production which then translates into more tax revenue?

Also, if that \$25.0Million is invested in new production, that amount is the equivalent of 3 new production wells. Those new wells at a nominal rate of 2,500bbls per day could gain the state revenue an additional \$21.0Million per year. (This would include the current PPT of 22.5% of Net plus 9.375% Royalty at \$80/bbl).

My math may not be totally correct but the case remains that the benefits from investment made by the "producers" in the state of Alaska for oil and gas field development far exceeds the benefits to Alaskans from raising an individual tax rate.

If the previous administration made a mistake, I believe your committee could rectify that mistake by dropping the tax rate to "10%/20%". That would make us more competitive at 51% which is closer to the Gulf of Mexico's 45% tax rate. I want the state of Alaska to be at the TOP of the "producers" list when it comes to selecting investment opportunities.

Please, I humbly request you reframe this bill as a Resource Development Bill and not a tax generation bill.

When all is said and done, all the experts will go away. They don't live here, their businesses does not depend on the Alaskan Oil and Gas industry. We live here and the wealth and health of the state of Alaska rest's in your hands.

I want us to recognize that Alaska is "big oil" and we get our revenues with our partners, the producers. Our fare share is calculated in the jobs created by employing Alaskans in the development of our common resource.

One other thing, thanks to all you who were here last year when the PPT was agreed. Your months of hard work resulted in the 22.5/20 agreement. Please don't try to fix that which is not broken.

Thank-you,  
Maynard Tapp  
200 West 34<sup>th</sup> Ave. #809  
Anchorage, Alaska 99503

**SENATE TESTIMONY  
on SB 2001  
October 23, 2007**

Thank you, Chairman Huggins. My name is Tom Walsh. I am a managing partner and co-founder of Petrotechnical Resources of Alaska (PRA), an Alaskan oil and gas consulting company employing about seventy highly experienced and respected oil and gas professionals. Our clients include major oil companies, independent oil and gas companies, Alaskan native corporations, and state and federal agencies, and we provide a wide array of services to our clients.

I have come to speak to you tonight because I am worried about the future of PRA's seventy employees and their families, and about the future of the oil and gas business in Alaska. The Governor's proposed tax increase is a threat to the future of oil and gas development in Alaska. One of the services we offer is commercial analysis of potential oil and gas exploration and development opportunities. Across the board, our clients are finding that the tax structure is currently a key factor in marginalizing their prospect economics, and they expect the situation to worsen with the Governor's proposed legislation. These concerns are being voiced by the entire spectrum of E&P companies, and their concerns are well-founded.

These companies are doing their homework, looking at detailed project plans and economics for significant investment in oil and gas projects, and what they are finding is that their projects don't work under the ever-increasing burden of rapidly escalating development costs and tax increases. We have recently lost two significant clients who have left the State, discouraged by the business climate and disappointed by project results. This trend will continue, and will accelerate if we continue to be driven by greed and paranoia, rather than by rational management of our resources. Whether it is "tax and spend", or "tax and save", it is still taxation with no clear strategy or purpose, and it is driving our declining industry to an accelerated economic limit. I implore you to take the time to develop a long range fiscal plan for the state to determine what services state government should provide to Alaskans, and how much these services will cost, before changing the tax structure once again with no clear vision or purpose.

PRA produced a report several years ago regarding the impact of a major gas sale on the oil production from the North Slope, and the study clearly pointed out that the declining liquid hydrocarbon production would likely become sub-

**economic before a gas pipeline could be built. This is a disaster scenario for the State of Alaska, and for the oil and gas industry in Alaska. Obviously, if the revenue from oil production is curtailed prior to revenue from gas sales commences, we are all going to suffer greatly. This is where we are headed, and we should be trying to compete for more interest in our resources, rather than for a greater share of the shrinking pie.**

**Thank you for your time**

Angeline M. Braham  
11328 Echo St.  
Eagle River, AK 99577  
(907) 684 2939

OCT 23 2007

October 18, 2007

Senator Charlie Huggins  
State Capitol  
Juneau, AK 99801-1182

Dear Senator Huggins,

*Charlie*

The most significant fiscal issue for Alaska is the decline in oil production. Finding new oil is the most expedient way to replace declining production. It takes significant investment to accomplish this and it comes with high costs and high risk.

After many many hours of hard work, the current PPT was passed by a significant majority of hardworking, honest, dedicated officials who felt that the deal was fair. No one side achieved exactly what they wanted, but that is what negotiation and compromise is all about.

The PPT has generated approximately a billion dollars more this past year than ELF and it comes with a five year review built in. No legislation is perfect, and PPT is no exception to this.

The state needs time to assess all of the positives and negatives so that they can be addressed in one package rather than piecemeal special sessions. In the long run, this will save the state money, time and effort. All tax legislation needs tweaking, but let it play out for the five years to see where all the snags are. This yearly tax increase on the industry will just end up costing us creditability with future investment decisions.

Good legislation should not be based on a popularity contest. It should be based on sound rational judgment. Please don't let the Governor's popularity at the polls stop you from doing what is best for the state of Alaska in the long run.

My children and grandchildren's futures are in your hands. Big oil is not the enemy - they have brought families to the state that has made our communities grow. They are volunteers for a myriad of organizations, as well as employees of the oil companies.

Yes, the state should get a fair share, but we need to move forward NOW to insure that our futures can be secure. We need to get PPT resolved so that we can move on with the gas line. The state's share of that will be zero if action is not taken now!

Please don't let the public's emotional reaction related to the recent indictments force a premature change. Your constituents will stand behind you when you support the state's best interests. Please act for the state and not the popularity polls!

Regards,



Angeline M. Braham

District 17 - 210