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TESTIMONY FOR SRES
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Comments On ACES Petroleum Tax Proposal, October, 2007
By Ken Thompson, Managing Director, AVCG/Brooks Range Petroleum

Personal Background

For the record, my name is Ken Thompson. I reside at 12031 Lilac Drive, Anchorage, Alaska. I am the Managing Director for Alaska Venture Capital Group, or AVCG LLC, an independent oil exploration company formed with a sole focus on the North Slope of Alaska. AVCG is a privately held member LLC comprised of private equity investors made up of 15 independent oil and gas companies and individuals from Kansas and me as an owner/member partner from Alaska. AVCG has a technical and operational services' subsidiary company called Brooks Range Petroleum, with offices and staff in Anchorage. In Alaska and on the North Slope, we operate under the name Brooks Range Petroleum.

AVCG has lease holdings and explores currently only in Alaska...and nowhere else. AVCG/Brooks Range Petroleum likes to think of our company as "Alaska's *Independent* Oil and Gas Company."

AVCG LLC has been very active in the past seven North Slope areawide lease sales and active in acquiring acreage held by other companies where we see potential. We and our partners currently hold over 300,000 acres of exploration leases in five exploration prospect areas on the Slope. Our exploration strategy is to explore in the central part of the North Slope for fields in the 10-100+ million barrels range, fields that may be too small for the giant producers but satisfy as niche fields that can be "company makers" for a small independent. We believe there are hundreds of millions if not billions of barrels of oil left on the central North Slope in smaller fields of this size for small independents like ours that want to take this type of exploration risk.

Last year, AVCG LLC announced joint venture agreements with two Canadian independents, TG World Energy and Bow Valley Energy, and with a private exploration company from Houston, Ramshorn Exploration. Together, as working interest co-owners we are exploring the central part of the North Slope.

In the winter of 2006, AVCG participated with an ownership interest in the Cronus exploration well about 10 miles southwest of the Kuparuk Field, operated by Pioneer Natural Resources. Unfortunately, that well was a dry hole.

This past winter for the first time, our operations subsidiary, Brooks Range Petroleum operated the drilling of two exploration wells for our working interest partners in the Gwydyr Bay area of the North Slope, just northwest of Prudhoe Bay. One well, the Sak River #1, was a dry hole, but we were excited to announce earlier this year that our Northshore #1 well northwest of the Prudhoe Bay Field did strike oil. We plan to complete and test this well this winter. In addition, we ran a 130-square mile 3D seismic survey over our acreage and surrounding area in the Gwydyr Bay area on the North Slope. In total this past drilling season, our JV Group invested over $44 million on land, seismic and drilling activities.

This winter our Joint Venture Group will be among the most active of explorers as we plan to shoot over 200 square miles of new seismic data on the extreme western and eastern sides of the Central North Slope and to drill up to four exploration wells. We plan to test the Northshore #1 well and also drill one or two other exploration wells nearby to see if we can discover a sufficient volume of oil to warrant a commercial development at Gywdyr Bay. We will drill our Tofkat #1 well south of the Alpine Field and also drill a fourth exploration well on a prospect to be named. In total, our group will spend over $40 million in seismic and exploratory drilling in winter 2008. If our Northshore oil completion test is as suspected and one of the wells strikes oil close by, we may proceed with Northshore development with more substantial capital investment in the second half of 2008.

My comments today represent the perspectives of a small, independent exploration company that is actively exploring on the North Slope with a good level of activity, generally on prospects that because of smaller size no longer interests the major companies. At the end of next drilling season, AVCG since 1999 and our partners since last year will have jointly invested over $100 million in Alaska even though none in our group have generated any revenues yet from Alaska oil, so we sincerely appreciate being listened to. We think in the long run we can bring substantial, incremental value to the State of Alaska. Please wish us good luck.

Many of you also know me as the past President of ARCO Alaska, Inc. from 1994-1998. I also served as Executive Vice-President for ARCO and head of global oil and gas exploration for ARCO. I do have exploration and production experience in 10 U.S. states and in over 20 countries throughout the world, so I'll also share my perspective in how I see the ACES bill in the context of competitiveness in the United States and in the world.

<u>General Comments On ACES Legislation</u>

At this point, I would like to address various key points in the ACES legislation.

First, our company prefers that the PPT be allowed to run its course in the next few years, and that ACES not be approved with its current provisions. I agree with Dr. Pedro van Meurs that in the light of declining oil production in the state of Alaska and prospectivity trending to smaller field sizes, the State should not once again increase its taxes after having done so last year. I will tell you that when recruiting companies to join in our Alaska ventures in 2005 and 2006, many were concerned about the threat of tax increases in Alaska. PPT proved tax increases were not a threat but a reality. Adding yet another tax increase via the ACES bill this year shows instability in Alaska's tax policy which results in uncertainty and risk when making investment decisions.

I heard that consultant Daniel Johnston differed strongly from Dr. van Meurs and urged the oil industry to understand the "cloud of corruption" over the existing Petroleum Profits Tax, or PPT, and that this alone provides a good reason to change PPT. I challenge Daniel Johnston that the bushel should not be thrown out because of a few bad apples.

In fact, last year during the PPT debates, I recall those who are guilty of paying bribes and some who are accused of taking bribes actually supported a 20% base tax rate, not the 22.5% base rate that was finally adopted. In fact, I'd like to think that the almost all in the Legislature and in Industry were honest, that they could be trusted in their deliberations last year, and that the final answer of PPT was a good answer and an honorable answer.

It is also very important to keep in mind that the progressivity tax was added at high oil prices to drive the real tax rate to even higher levels than 22.5%, with a range exceeding 30% now possible at certain prices. And let's not forget to tack on the royalty, the corporate tax, the ad valorem property tax, and environmental and permitting fees. It appeared to me that the checks and balances in the system worked in the Legislature last year, and I applaud the honesty of the legislators who in the end made a positive difference.

But I sit here feeling as if the honest and trustworthy investors in this industry are being punished alongside the guilty. I personally think this will have negative consequences for Alaska in the long haul in relationships and even in sustainable increased value.

But I am politically astute enough to know that the ACES train is moving fast down the track, so I can stand out of the way or jump on board and try to make the ACES bill better before we reach derailment in the long-term relationships between this industry I love and this State I love.

So, I have some suggestions of things not to change and things to change in the ACES proposal.

<u>Five Things *Not* To Change In ACES</u>

1) **Keep the exploration and development investment tax credits.** For a small explorer startup company like AVCG LLC, the exploration economics with the exploration tax credits ranging from 20-40% as provided by PPT and with ACES are more favorable with an improvement in the investor's rate of return as compared with Alaska's old severance tax system. Near-term cash flow because of the investment tax credits is higher which improves the return

on investment. Plus refund of cash to companies like AVCG and our working interest partners via the credits mean that we can apply that cash to our capital budget the next year to run adequate seismic and do additional drilling that increases the chance of more oil production and reserves for us and for the State.

Likewise, the credits for losses for a startup company like ours while we establish production and also the development investment credit can take substantial risk out of development of smaller fields that our company is focusing on. May of these smaller fields can add up over time and provide significant incremental revenue to the State.

2) **Keep the "standard tax deduction/exemption" for smaller companies.** The "Small Producer Tax Credit" that exempts up to the first $12,000,000 in production taxes for smaller companies can allow us to return a larger share of our annual cash flow for exploration and investment while we build the company to a critical mass of reserves and production necessary to expand staffing and have a routine level of major capital spending each year.

3) **Keep the new ACES tax credit allowance for qualified delineation wells.** A new proposal in the ACES bill that was not in the PPT law is the possible tax credit allowance for the investment in up to two delineation wells following a discovery. This would be very helpful to small explorers as well as for large companies on the North Slope where often one well is not enough to determine if field size is large enough to warrant development.

   A real case in point is that should we have a discovery this coming winter at our Tofkat exploration well on the western side of the Slope, we will have to drill one or two delineation wells to confirm if field size is sufficient to develop the resource at this remote location. Often, due to the nature of these complex stratigraphic traps where sands unpredictably come and go, the delineation wells can be almost as risky as the initial exploration well. Having a credit where the State, in a real sense, is sharing in the risk will – I think – expedite delineation of new fields and advance development for revenues.

4) **Keep the revised progressivity tax rate at 0.2% per dollar increase in oil price.** The PPT tax law had an incremental tax rate of 0.25% per each dollar increase in oil price above a trigger price while the new ACES reduces this incremental tax rate to 0.2% per dollar increase in oil price at a trigger price. While we can debate all day long the competitiveness of Alaska's tax rate with other countries' fiscal systems, giving some reduction in this surcharge keeps the government take at more reasonable levels. However, as I'll outline below, I would change the ACES trigger price back to $40 per barrel net and not the proposed $30 per barrel net if Alaska wants to better balance revenues with industry capital investment at low prices as I'll more fully discuss.

5) **Do establish the Oil and Gas Tax Credit Fund** for the purposes of purchasing certain tax credits from explorers and producers. This ACES provision would establish a procedure and standard for appropriation into this fund and management of this fund. Having a clear and transparent way for small explorers to receive their credits at full value is extremely important for AVCG to then be able to plow those credits back into seismic and exploration on the North Slope.

Four Things To Change In ACES

1) **Change the recovery of tax credits from two years as proposed in ACES back to the recovery of credits in one year currently provided for in the PPT law.** In the PPT law, a company could file for the various credits, and if approved, would receive those full capital credits not to exceed credits of $25 million per company. In the new ACES law, while the cap has been removed which is very positive, the credits are refunded over two years instead of over one year, e.g., 50% of qualified credits can be applied for in the first year once a well is completed or abandoned and 50% in the following year.

   For a small company like ours, this will definitely affect our capital spending in a given winter as we plow all the credit refunds back into seismic or exploration drilling. As a very real example, AVCG and our working interest owners are projecting to spend $41 million in seismic and exploration drilling this coming winter and likely around the same in 2009. We calculate that we could receive $16 million cash in qualified credits in mid-year 2008. So essentially, our working interest owners are planning to provide cash out of pocket of $25 million for the 2009 drilling season; this is a fixed number based on cash availability in these small companies to spend toward the Alaska portfolio. If the State refunds only one-half of this credit in the first year, or only $8 million instead of $16 million, AVCG and our partners will still provide $25 million out of our pockets as now planned and budgeted...meaning our overall spending in 2009 will be $33 million, not $41 million, i.e. $25 million from our available funds and only $8MM from the State. This would mean one less well that will be drilled by our group in 2009. And one less chance for another discovery that eventually could provide revenues to us all. With small companies, this is just the way our cash flow situation works. And for some of our AVCG investors like me, when I say "out of pocket," I mean "out of pocket."

   So, we hope the full credit can be applied for and refunded in a given year. We hope this happens for all of industry. As an innovative compromise, however, the Legislature may consider a "Small Company Refund" provision that allows for companies that meet the no production or low production measures in the "Small Company Tax Credit" provision of the PPT law - that remains in ACES - to receive tax credit refunds that are fully refunded in the first year for qualified costs. Once a company grows in production beyond this "small company" measure with more substantial cash flow, perhaps refunds of 50% each year would apply as outlined in ACES.

2) **Change the base tax rate in ACES from 25% back to the PPT tax rate of 22.5%, and re-review again in 2011 after some time has passed as allowed for in current law.** As I mentioned in my introduction, I felt the 22.5% base tax rate was reasonable. And the real tax rate is much higher with the tax progressivity factor. But what is fair, and how exactly is "fair" determined?

   I saw a copy of a presentation entitled "Guiding Principles For A New Production Tax System" by the Department of Revenue urging the changes in ACES, arguing that the average government take in various international countries averaged 67% for all types of fiscal regimes internationally, averaged 74% for production sharing agreements, but only 55% for tax and royalty regimes internationally. Somehow, the Department of Revenue representatives concluded an average of 68% as provided for in ACES would be close to the average of 67% for all types of regimes internationally.

   First, the average recommended to Alaska is the average of all regimes, i.e. the averaging of government take from tax and royalty regimes with the government take from production sharing agreement (PSA) regimes. In some countries that I worked in that had production sharing regimes, the risk profile for capital development was often much different that in regimes that use a tax and royalty regime such as Alaska. In PSA countries, it was not unusual for a producer on capital projects to have a very low initial tax burden until the capital investment was fully recovered plus a negotiated rate-of-return was achieved. Then and only then was the government take increased substantially...thus giving the average take for such countries as 74%. But the risk profile was often much better than Alaska, i.e. there was up front recovery of capital and a preferred investor rate-of-return. That is not the risk profile of Alaska when a company first has production...the ACES high tax rate and the added progressivity tax will start immediately along with royalties, corporate taxes, property tax and other charges rather than allowing for recovery of capital and a contractual rate-of-return.

   As another distinction, most of the individual people and company investors specifically in AVCG, LLC, do not consider international regimes as areas to consider as competition for our investment dollars with Alaska. Rather, the main competition for most AVCG Owners' cash is in other states in the U.S. I found it astounding and concerning that the average of 67% for all international regimes did not consider weight-averaging in the major American producing states. As examples, the current government takes in the Gulf of Mexico offshore – one of the main competing areas for Alaska investment dollars – averages 45%. This is under consideration by the U.S. government for increase, but it is highly doubtful with the boom going on in deep water exploration and development that the U.S. government would increase the government take from 45% to 68%.

In other producing states that compete for investment by our AVCG investors, the state and federal combined government takes in 2006 were as follows and averaged 45-57%:

U.S. Gulf of Mexico	45%
Colorado	51%
Wyoming	52%
Kansas	53%
Texas	53%
New Mexico	53%
Oklahoma	53%
California	53%
Louisiana	57%

To my knowledge, these states do not have the added progressivity surcharge tax which further separates Alaska in government take from these competing states. I would argue that Alaska should have a government take of 55% if we were to maintain long-term competitiveness with these other states for investment dollars. Having said that, some of these states do not have the prospectivity of Alaska, so Alaska could command some premium in take, but certainly not as high as being proposed in ACES.

If Alaska set a government take at 60% to the government and 40% to the investor, the ACES legislation should be amended to allow for a base tax rate of 22.5% not 25%, should be amended to allow for a trigger price of $40 per barrel and not $30 per barrel, and the incremental progressivity tax rate increase should be 0.2% per dollar.

3) **Change the trigger price to $40 per barrel net and not $30 per barrel.** If the government take is to be the fair and equitable 60% and not the unfair 68%, the trigger price should stay the same as in the PPT law, i.e. $40 per barrel net. If Alaska is to share in high prices with the progressivity surcharge tax, then Alaska should share in the pain of low prices. To amend the trigger price lower when and if prices collapse will be a false economy measure for the State of Alaska. When prices fall and a company's cash flow is sharply reduced, capital spending will fall. A "double whammy" to be taxed more with a progressivity tax at lower prices further reduces the amount of capital for re-investment.

4) **Consider some type of "Transitional Investment Expenditure (TIE)" tax credit.** This provision allowed for in PPT was repealed in ACES. While this provision does not greatly benefit our company, AVCG, because we did not have large seismic or exploration drilling costs between March 31, 2001, and April 1, 2006, it is important to other major investors in Alaska.

   As an example, the largest explorer and developer in Alaska, ConocoPhillips, now with the ARCO heritage assets was hardest hit in tax exposure with the change from the old severance tax law to the PPT and now to ACES. I simply think allowing a good steward who is the largest explorer in Alaska some transition allowance to ease the pain of greatly increased taxes is the right thing to do and can only build better, more trusting relationships.

   Again, this provision does not greatly benefit our company, however.

Concluding Remarks

This concludes my remarks. I tried to share the perspective of an independent exploration company that only invests in Alaska. My ultimate wish would be for the State to leave PPT alone and re-review it under the law as planned in 2011 or perhaps even in 2010. But if the ACES train has left the station and cannot be stopped, I urge you to at least consider the five things our company would not change in this bill and the four things we would change.

The above comments are offered with a hope that there can be an eventual win-win solution to this complex subject of the State realizing more revenues at higher prices while attracting exploration and development investors who can also realize upside at higher prices for the substantial risk they have taken in the remote and harsh environment of the North Slope. In the end, I hope both sides get a fair and equitable share at all price levels.

And my comments are offered with the highest sincerity that the State and Industry can someday restore a mutual trust at all levels.

I sincerely thank you for the opportunity to present my comments, and I would be happy to take any questions.

Respectfully submitted,

Ken Thompson