

SCOMM

134:9

ALASKA STATE LEGISLATURE



REPRESENTATIVE LES GARA

February 12, 2004

SPONSOR STATEMENT: HB 441 **A Rational Approach To Fixing Alaska's Oil Tax Laws.**

Under Alaska's Constitution, oil belongs to all citizens in common. It is incumbent upon government to make sure Alaskans receive a fair share for this public resource, and that a fair share is provided to those companies who have contracted with us to develop and sell it. HB 441 fixes two flaws with Alaska's current oil taxation system. One flaw comes from the way Alaska's Economic Limit Factor (ELF) is written. Under the ELF, the production or "severance" tax rate on oil companies has fallen for over a decade, and will continue to fall. That is because under the ELF most new fields are effectively exempted from Alaska's 15% severance tax.

A second flaw is that oil companies have arguably reaped an unfair share of the state's oil wealth at average and high oil prices. The windfall at high prices has not been shared evenly. At successively higher prices the imbalance between corporate profits and State oil revenue grows greater. The Department of Revenue estimates that at \$30/barrel, oil companies receive \$1.2 billion more in profits than the state receives in total oil revenue.

This portion of the tax structure has not been reviewed in 15 years. People from across the political spectrum, from Governors Jay Hammond and Wally Hickel, to Former Deputy Commissioner of Revenue Deborah Vogt, to Ray Metcalfe, Clem Tillion and Rick Halford have called for a review of the current tax structure. HB 441 does that. It raises roughly \$110 million at average oil prices, and \$400 million at prices of \$30/barrel.

Proposal Summary

1. HB 441 Establishes a Minimum 5% Severance Tax. Eleven of the last 14 fields that have come on line since 1989 pay none, or almost none of the state's 15% severance tax. This proposal establishes a minimum severance tax at 5%.

Under current law, and without such a change, the average severance tax has fallen from 13.5% in 1993, to 7.5% today, and it will fall below 5% by 2013. If we do nothing, the fiscal gap will continue to grow as severance tax revenue continues to fall.

2. Adjusts Severance Tax Amount Upwards above \$20/barrel & Downwards Below \$16/barrel. This provision will allow the state's share at average and high prices to rise and fall as oil prices rise and fall. Under this proposal, the state would recover about \$500 million more than it does today at \$32/barrel.

The Formula: Above \$20/barrel, the proposal would multiply the severance tax by this formula: *The Price Per Barrel / 20*. Thus, nothing would change at \$20/barrel because the severance tax would be multiplied by 20/20, or by 1. But at \$30/barrel, the severance tax would be multiplied by 30/20, or 1.5. Thus, at \$30, a field with a 10% severance tax would pay an adjusted 15% severance tax (1.5 X 10%). This still allows oil company income to increase significantly at higher prices. This price factor will never increase the severance tax to more than 25%, thereby also protecting the interest of oil companies in high profits at high prices.

Below \$16/barrel, the severance tax is **reduced** by multiplying it by this formula: *The Price/16*. Thus, for example, at \$12/barrel, the severance tax would be multiplied by 12/16, and thereby waiving twenty-five percent of the production tax.

3. Deferral Of Severance Taxes Below \$10/barrel. Below \$10/barrel, half the severance tax would be waived and the other may be deferred. Severance tax payments may be deferred at this price until prices exceed \$16/barrel.

4. Inflation Adjustments. These price factors will be adjusted for inflation. Thus, for example, as inflation occurs, the formula will use a higher price before the high price factor kicks in to multiple the severance tax. Since oil company costs increase over time, the high price multiplier arguably shouldn't kick in until high prices. See detailed proposal, attached.

5. Heavy Oil Not Affected. The Fair Share proposal exempts "heavy oil" from any of the enhanced taxes to encourage development of that resource. Heavy oil requires entails a more expensive and intensive extraction process.

Analysis Of Impacts and Current Shortfalls

Alaska raises oil revenue under 4 different provisions. In order of magnitude, we raise revenue from oil under our royalty laws, our severance tax, our corporate profits tax, and our property tax. In 2003 the revenue raised under the first 3 provisions was greatly increased because of the high price of oil, which averaged about \$28/barrel. The State received:

- \$830 million in royalties;
 - \$599 million in severance taxes;
 - \$150 million in corporate taxes; and,
 - \$50 million in property taxes.
- Total: \$1.64 billion.

Figures provided by Department of Revenue.

The proposal grants the state a more equitable share of oil revenue:

- an additional \$110 million at a \$22/barrel average price;
- an additional \$400 million at \$30/barrel; and,
- an additional \$500 million at \$32/barrel.

According to the Department of Revenue, at \$30/barrel the oil industry receives 60%, or \$1.2 billion more in corporate profits than the state takes in revenue. The imbalance is greater if corporate profits are just considered the amount they earn minus their current costs.¹

At the projected average price of \$22/barrel, the industry takes roughly 13%, or \$210 million more than the state. At high January, 2004 prices of \$34/barrel an equal share between the state and industry would bring in more than \$600 in revenue. The higher the price, the more the imbalance grows. This is shown in the following table:

<u>Price</u>	<u>Company %</u>	<u>Company Profits</u>	<u>State %</u>	<u>State Revenue</u>
\$30/brl	61%	\$3.242 billion	39%	\$2.081 billion
\$22/brl	54%	\$1.735 billion	46%	\$1.523 billion

The Current ELF

Because of the way the ELF works, state oil revenue is projected to steadily fall over the next decade, assuming an average price of \$22/barrel, and even assuming stable levels of production. The most recent DOR forecast is for a slight decline in production over the next decade, which will contribute to an even greater decline in severance tax revenue. Of the most recent 14 fields that have come on line since 1989, 11 of them pay a severance tax of 0% or less than 1%.

The ELF was enacted in part because Prudhoe Bay was declining in production by the late 1980's. Proponents argued economies of scale justified a lower tax rate for older, declining fields, and for smaller fields as well. The ELF, which ranges from 0 to 1.0 determines how much of the state's 15% severance tax a field operator must pay.

To determine the severance tax for a particular field, one multiplies the severance tax rate (15%) by the ELF. Thus, a field with an ELF of "0" pays a severance tax of $0 \times 15\%$, or 0%. A field with a .5 ELF pays a severance tax of $.5 \times 15\%$, or 7.5%. A field with a 1.0 Elf pays a severance tax of $1.0 \times 15\%$, or 15%.

A field's ELF is based upon its size and productivity. As production at Prudhoe Bay declines, its ELF has fallen to roughly .9, so that it pays a roughly 13.5% severance tax. No field has a 1.0 ELF anymore.

The addition of smaller fields with ELF's that give them near or complete exemptions from the state's severance tax, combined with less production at high ELF fields like Prudhoe Bay, are the major reasons state oil revenue is projected to continue to decline in future years.

In 2003 higher oil prices (\$28.15/barrel) resulted in \$599 million in severance tax revenue. Assuming the Department of revenue's projection of \$22/barrel prices starting in 2006,

¹ The "profits" definition the Department of Revenue has used deducts a certain amount of revenue to cover past sunk facility costs, and future capital costs.

the falling average ELF will cause severance tax revenue to fall by over 80%. The DOR estimates severance tax income to fall as follows:

<u>Year</u>	<u>Estimated Price</u>	<u>Avg. ELF</u>	<u>Avg. Severance Tax %</u>	<u>Est. Severance Tax</u>
2003	\$28.15 (actual)	.50 (actual)	7.5%	\$599 million (actual)
2006	\$22	.47	7.05%	\$341 million
2009	\$22	.40	6.0%	\$287 million
2013	\$22	.27	4.05%	\$180 million

It is estimated that production will fall by roughly 7% from now through 2013. Today North Slope production is roughly 1 million barrels/day. By 2013 it is projected to fall to roughly 930,000,000/day. That is a lesser, though important component of the fall in revenue.

The Metcalfe, Fineberg & "Shelf the ELF" Proposals

There are many who feel Alaska's small fields are profitable enough to pay some severance tax. Many small fields have economized by "sharing" processing facilities at larger fields. In addition, many have called for changes in the law that would allow the state to share more equally at high oil prices.

It should be noted that this would not raise as much revenue as more aggressive proposals some have made, and that are worthy of consideration and analysis. Those include:

- 1) "shelf the ELF" proposals like that by Rep. Masek in 2003, which would have imposed a flat 15% severance tax on all fields, and eliminated the ELF;
- 2) lease bid and taxation changes proposed by former Rep. Ray Metcalfe which he believes would fully close the fiscal gap; and,
- 3) a windfall profits tax proposed by oil industry analyst Richard Fineberg.

The Alaska Fair Share bill does not likely raise as much additional revenue as the above proposals, and seeks to provide companies with adequate incentive to continue with significant exploration efforts into the future.

Conclusion

At a time of budget shortfalls, it is important to make sure the state does not grant large tax exemptions to those who don't need them. The Alaska Fair Share bill seeks a balance between fairness to the state and those companies that are willing to explore and produce in Alaska. This bill makes the law progressive by modestly increasing taxes at high prices, and granting incentives at low prices.

Please feel free to call if you have any questions, or need any more information.

Sincerely,



Les Gara

ALASKA STATE LEGISLATURE



REPRESENTATIVE LES GARA

February 12, 2004

Sectional Analysis, HB 441: Alaska Fair Share Bill

Sections 1-3: 5% Minimum Production Tax in Most Cases: This provision seeks to remove a current exemption that lets most new oil fields pay less than 1% in production taxes. While not all fields can pay the state's full 15% production tax, the state should at least set a minimum tax at 5% (to be reduced at low prices, see below).

Taken together, these sections establish a minimum production tax rate. Currently the production tax is 15%, reduced by the ELF. In most recent cases, the ELF has reduced the production tax rate to 1% or less. Sections 1 – 3 set a field's production tax rate at the current rate, as determined by the ELF, but prevents the ELF-adjusted production tax from falling below 5%, except in certain circumstances when prices fall below \$16/barrel, or rise above \$20/barrel.

Section 4: Modest Increases to Production Tax above \$20/barrel, and below \$16/barrel; Deferral and Waiver of Taxes when price falls below \$10/barrel.

This provision aims to make the current tax code more progressive, so that at low prices oil companies are protected from high taxes, and at high prices, the state may share fairly in high oil company profits.

Enhanced Tax Factor Above \$20/Barrel. Above \$20/barrel, the severance tax rate is multiplied by the average monthly price of oil (West Coast Price) divided by 20. Thus, at \$20/barrel, the severance tax is multiplied by 20/20, or "1", and is left unchanged. At \$30/barrel, the severance tax is multiplied by 30/20, or "1.5." In that case, a field with a 5% base production tax will pay 5% time 1.5, or 7.5%.

Reduced Tax Factor Below \$16/Barrel. Below \$16/barrel, the production tax rate is reduced by the price divided by 16. Thus, at \$12/barrel, the rate on a field with a 5% base production tax would be 12/16 times 5%, or 3.75%.

Reduced Taxes Below \$10/Barrel. Below \$10/barrel, ½ of a field's production tax will be waived, and ½ will be deferred until a month when prices average above \$16/barrel.

Heavy Oil Exempted. Heavy Oil is more expensive to produce than normal crude oil. Many believe the future of oil production will rely heavily upon the production of heavy oil. The bill exempts heavy oil from the new enhanced tax provisions. It may be determined during hearings that a minimum tax should also be set for Heavy oil, but that would have to be shown by testimony.

Reconsider Our Oil Tax Structure? Says who?

- **Former Governors Hickel and Hammond have called on Legislature to take a look at whether tax breaks under ELF are still justified.**
- **Former Senators Halford and Torgerson, and voices from across the spectrum believe current tax breaks under ELF are no longer justified.**
- **Former DOR Commissioner Condon and Pedro Van Meurs have stated Alaska's tax system should be more progressive.**
- **Why?**

The ELF & Alaska's Oil Taxes

- **The Production Tax is Alaska's Main source of Oil Revenue outside of our Royalty Share:**

For FY 2004 Alaska received

- **Royalty - \$830 million**
- **Production Taxes - \$599 million**
- **Property Tax - \$50 million**
- **Corporate Oil Tax - \$150 million**

The ELF & The Production Tax

- **The 15% Production, or Severance Tax varies because of the ELF, or economic limit factor.**
- **At its simplest, the ELF is a number between 0 and 1. Multiplying the Base 15% production by a field's ELF determines a field's actual Production Tax Rate (Tax = ELF X 15).**

The ELF Rate

- **The ELF ranges between 0 and 1 depending upon a combination of factors. Generally speaking, they are:**
- **The size of a field**
- **The field's production**
- **The per well production at a field.**
- **Essentially, the larger the oil field, the larger the ELF.**

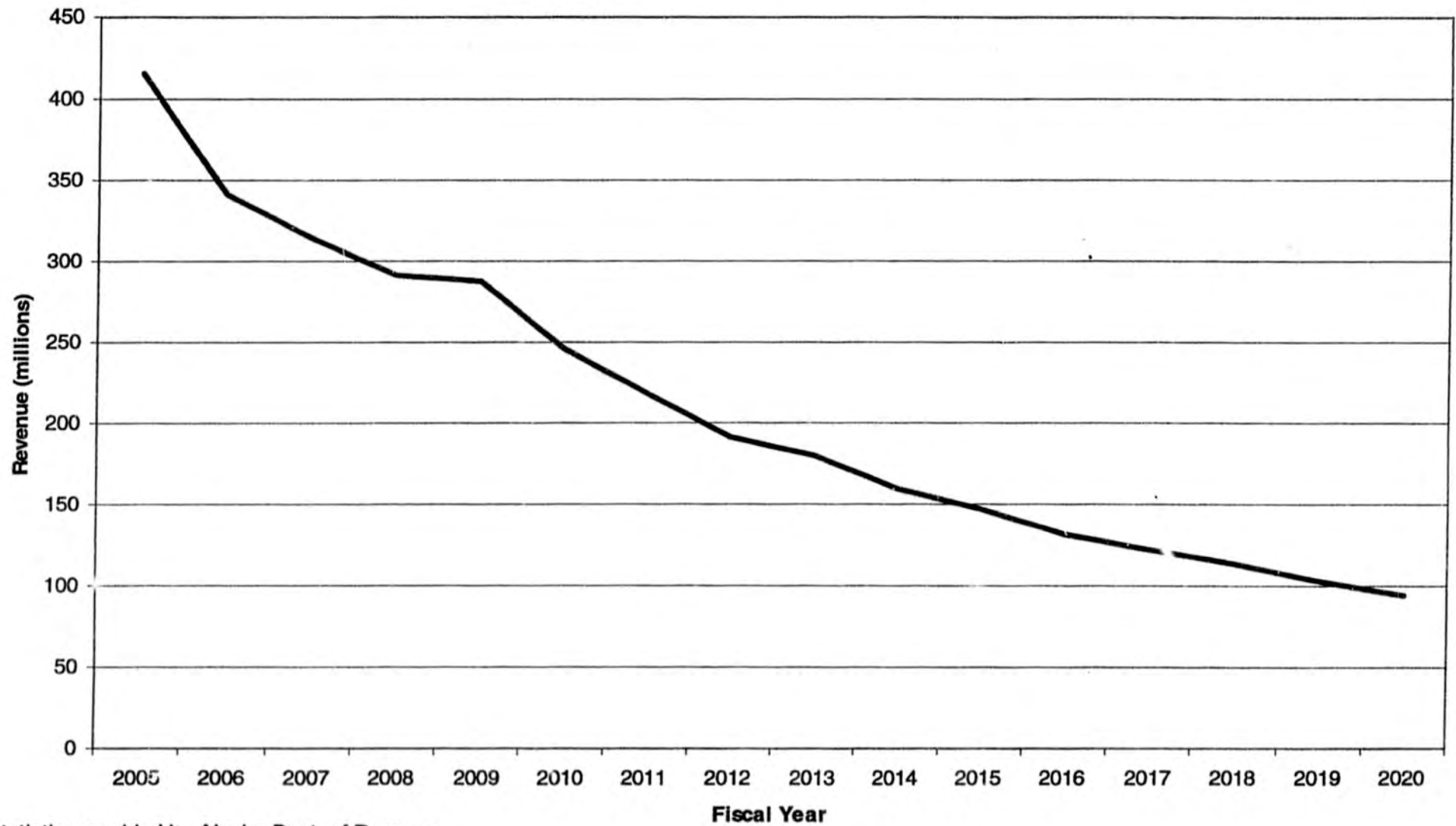
The Shrinking ELF

- **Production has declined at fields with high ELF rates (Prudhoe), and increases at fields with low ELF rates.**
- **In 1993 the average North Slope Production Tax Was 13.5%**
- **Today it has fallen to 7.5%.**
- **By 2013 it will fall below 4%.**

ELF's Impact On Revenue

- **DOR forecasts that the Production Tax revenue will fall from \$599 million last year:**
- **To \$341 Million in FY 2006 (\$22/bbl est)**
- **To \$180 Million in FY 2013 (\$22/bbl est)**
- **This assumes a roughly 7% decline in oil production in that period.**

Forecasted Decline in Severance Tax Revenue: Current Law



Statistics provided by Alaska Dept. of Revenue

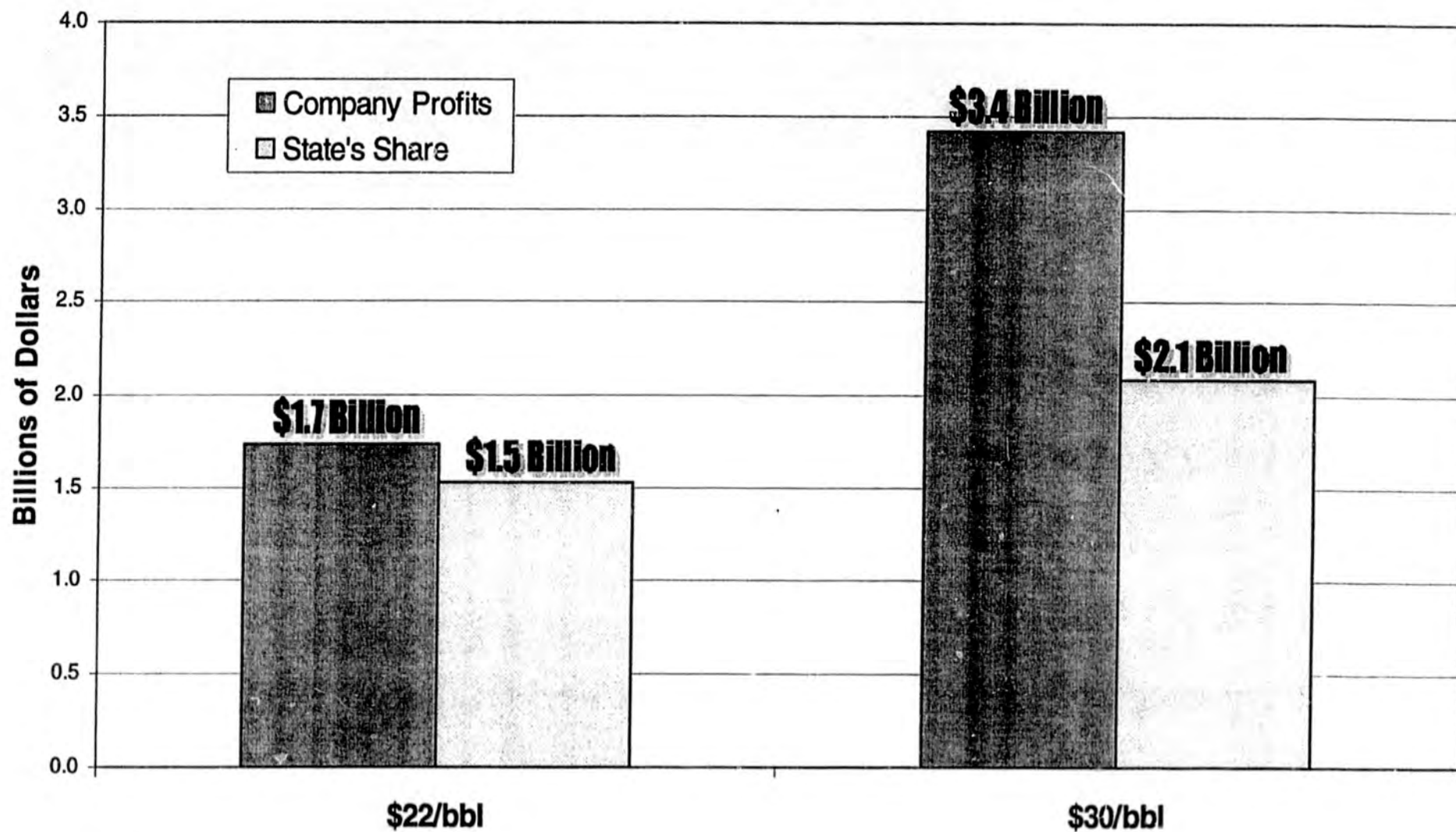
Obtaining “Maximum Benefit” For Public Oil Resource

- **The Constitution provides the State shall develop its oil and other resources for the “maximum benefit of its people.” Art. 8 Sec. 2.**
- **Are we obtaining the maximum benefit for our oil resources?**
- **Remember oil is a finite, non-renewable resource.**

Company vs. State Share

- **At \$35/barrel Company Profits Exceed total state oil revenue by \$1.72 billion/yr.**
- **At \$40/barrel they would exceed total state oil revenue by \$2.3 billion.**
- **At \$22/barrel, they exceed state revenue by \$220 million.**
- **At \$12/barrel state revenue exceeds company profits by \$930 million.**

Comparison Between Oil Company Profits and State Revenue: Current Law



Statistics provided by Alaska Dept. of Revenue

The ELF: Intent & Effect

- **The ELF was designed to promote the development of smaller fields, and prolong the life of declining fields.**
- **Has it provided producers with more of a benefit than needed?**

Are We Exempting Small Fields?

- **Endicott Pays a 0% Production Tax.
It is the 29th largest Field in the U.S.**
- **4 fields paying 0% Production Tax are
among the 100 largest fields in the U.S.
(Endicott, Milne Point, Aurora, West
Sak).**

The ELF Since 1989

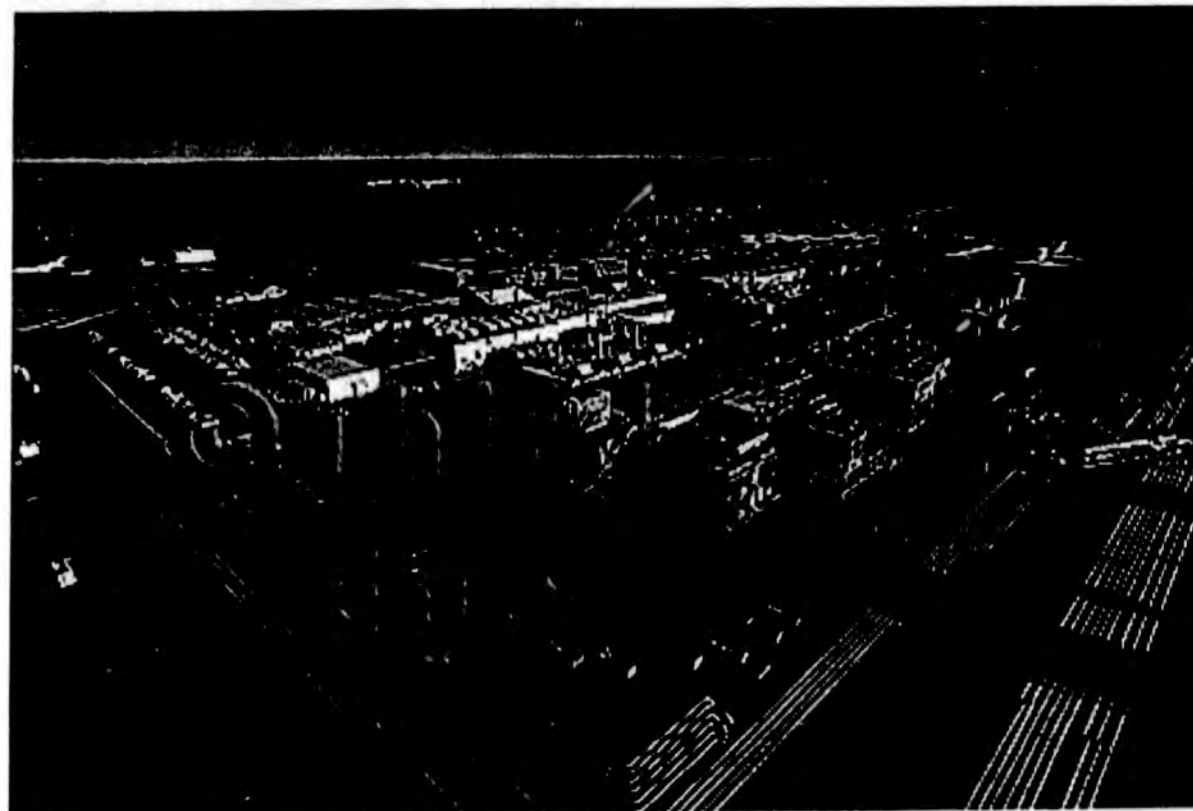
- **Of the 15 fields developed since 1989:**
- **10 fields pay a 0% Production Tax**
- **13 pay less than 3% in Production Taxes**
- **10 fields that produce over 1 million bbl/yr pay a 0% production tax (pre and post-1989 fields).**

The ELF is Inflexible

- **The Production Tax stays the same no matter how high the price of oil is, or how profitable a field is.**
- **A field that pays 0% in production taxes pays that rate at \$10, \$20, and even \$40/bbl oil.**

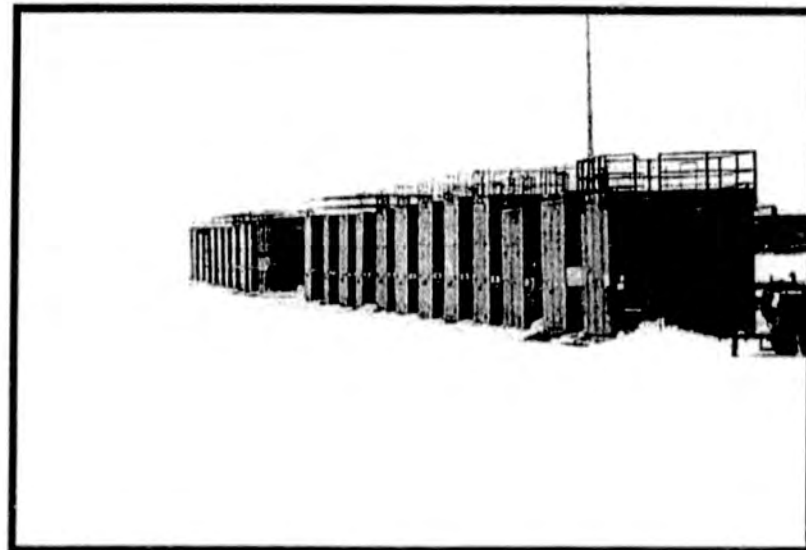
Company Cost Savings Since ELF Designed

- **Tarn is produced via Kuparuk's facilities.**



Cost Savings at Tarn

- **Tarn required only two drill sites and three ten mile pipelines. It produces 12 million bbl/yr., and pays a 1% production tax.**



More Economies

- **The Tabasco field did not require even a drill site. It was drilled in seven wells off an existing pad at Kuparuk.**
- **This field will produce 1,000,000 bbl this year and pay a 0% Production Tax.**

What Fields Are Exempted By ELF?

Field	Producing Since	Facilities	Annual Oil bbl	2004 ELF Rate
MIDNIGHT SUN	1998	Prudhoe Bay Unit	1,719,308	0.0000
POLARIS	1999	Prudhoe Bay Unit	917,642	0.0000
ORION	2002	Prudhoe Bay Unit	368,058	0.0000
AURORA	2000	Prudhoe Bay Unit	3,782,231	0.0000
WEST SAK	1997	Kuparuk River Unit	2,856,897	0.0000
TABASCO	1998	Kuparuk River Unit	1,541,615	0.0000
TARN	1998	Kuparuk River Unit	12,342,736	0.0849
MELTWATER	2001	Kuparuk River Unit	2,124,967	0.0000
MILNE POINT	1985-87 and 1989	Milne Point Unit	11,703,713	0.0000
SCHRADER BLUFF	1991	Milne Point Unit	7,001,109	0.0000
ENDICOTT	1987	Endicottt	9,195,798	0.0006
EDER	1998	Endicottt	242,135	0.0000
LISBURNE	1987	Lisburne Prod. Center	3,335,277	0.0000
NIAKUK	1994	Lisburne Prod. Center	4,599,262	0.0000
		Total Annual Oil bbl	61,730,748	

How the bill works

- **Two principal reforms:**
- **The first simply establishes a minimum 5% production tax. All fields must pay the minimum 5%.**
- **This provision alone would raise \$75 million at \$22 per bbl.**
- **This differs from “Shelf The ELF” efforts, which impose a flat 15% tax on all fields.**

How the bill works

- **The second major reform bases the production tax on the price of a barrel of oil.**
- **As the price rises, so does the tax. As the price of oil falls, so does the tax.**
- **The bill sets \$16 to \$20 oil as the norm.**
- **BP declares increasing shareholder dividends above \$20/barrel. Says profits at prices above that level are “in excess of the financial needs” of the company.**

How the bill works

- **Above \$20, the production tax would be multiplied by the price per barrel divided by 20.**
- **Below \$16, the production tax would be multiplied by the price per barrel divided by 16.**

How the bill works: High Prices

- **Example: At \$30 oil, the new formula would divide 30 by 20 yielding 1.5.**
- **Thus, a field that currently has a 10% production tax would pay an adjusted 15% production tax ($10\% \times 1.5 = 15\%$).**

Lower Tax at Lower Prices

- **At lower oil prices the production tax would be reduced. If oil goes to \$12 per barrel, the formula would divide 12 by 16 to yield .75. Thus the production tax on an oil field would be reduced by 1/4**
- **A field that currently has a 10% production tax would pay 7.5%.**

Incentive Rebate At Very Low Prices

- **If oil prices fall below \$10 per barrel, the bill would waive half the production tax and would defer the other half until prices rise above \$16 per barrel.**

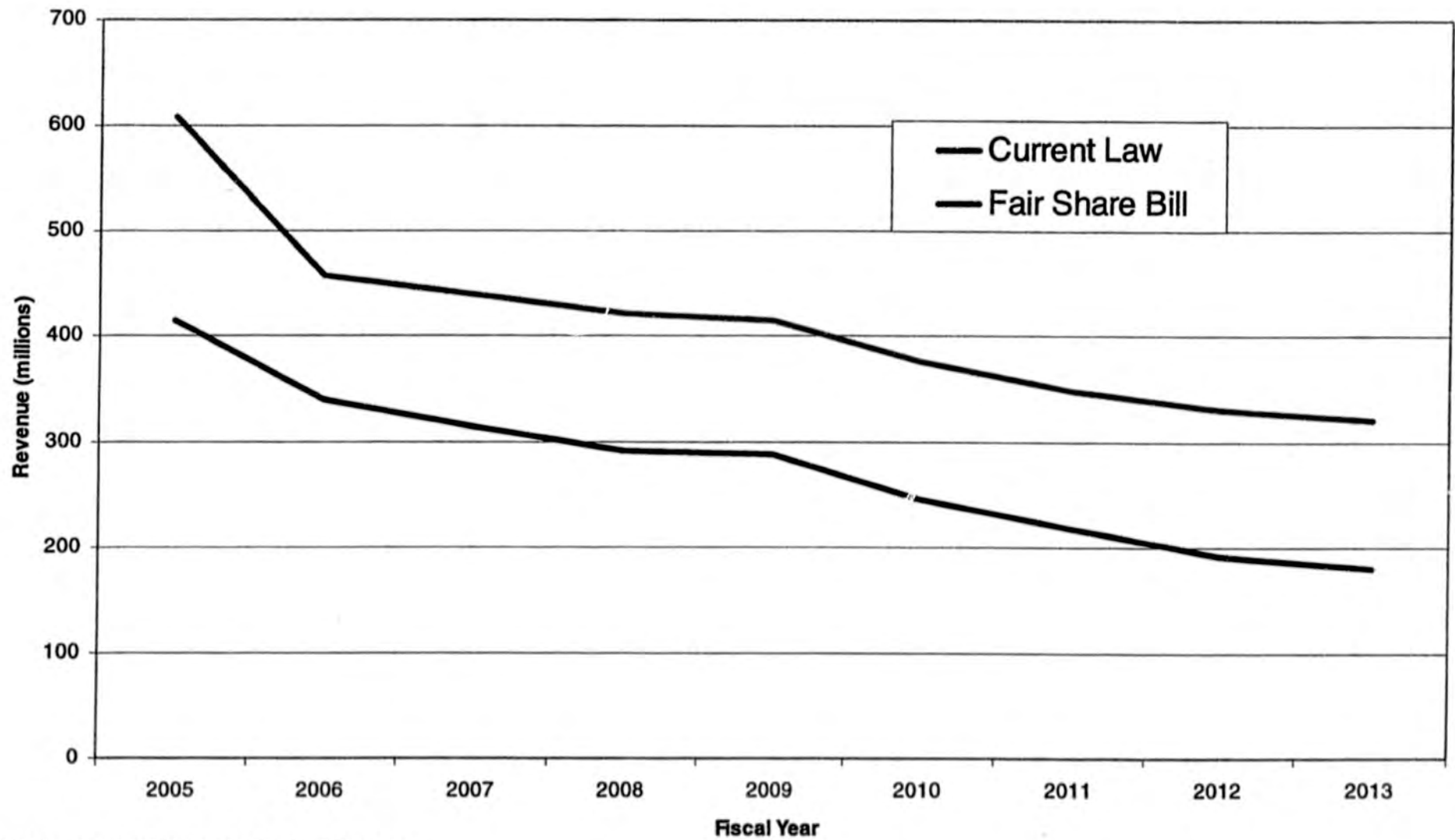
Encouraging Production of Heavy Oil

- **Finally, the bill exempts 'heavy oil' from any of its measures. Heavy oil, like that contained in the West Sak reservoir, requires more expensive drilling and production measures.**

Production Tax Revenue

- **Under this bill, the State would gain:**
- **an additional \$110 million at \$22/bbl.**
- **an additional \$400 million at \$30/bbl.**
- **an additional \$500 million at \$32/bbl.**

Projected Severance Tax Revenue Under Current Law and Fair Share Bill at Forecasted Prices



Statistics provided by Alaska Dept. of Revenue

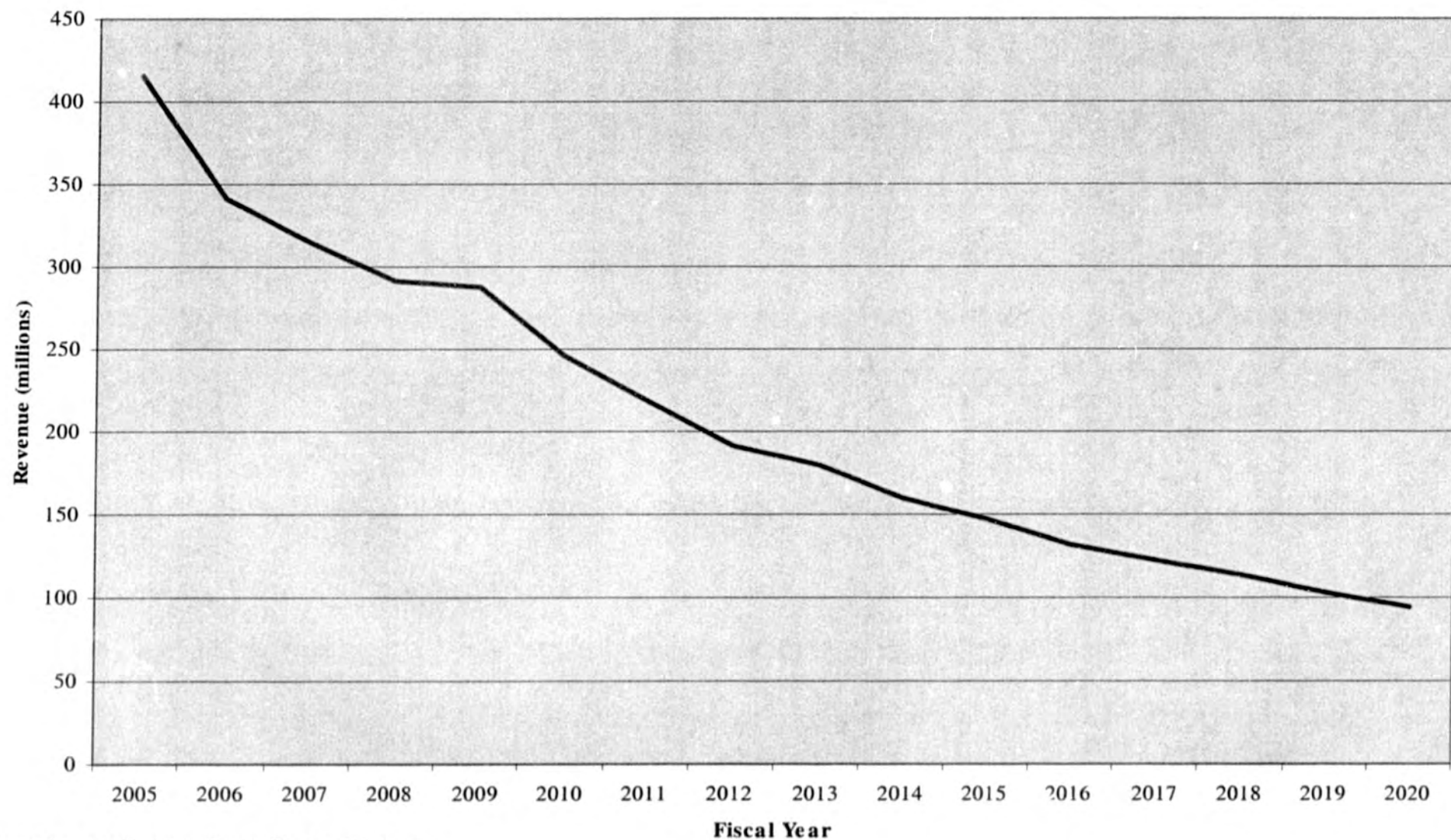
Incentives For Oil Industry

- **Reduction in Tax at low prices encourages investment.**
- **Guarantee of tax waiver and deferral encourage investment.**
- **Royalty Relief for “marginal fields” (HB 28) encourages investment.**
- **Fair to share burden as prices fall, windfall as prices rise.**

Conclusion

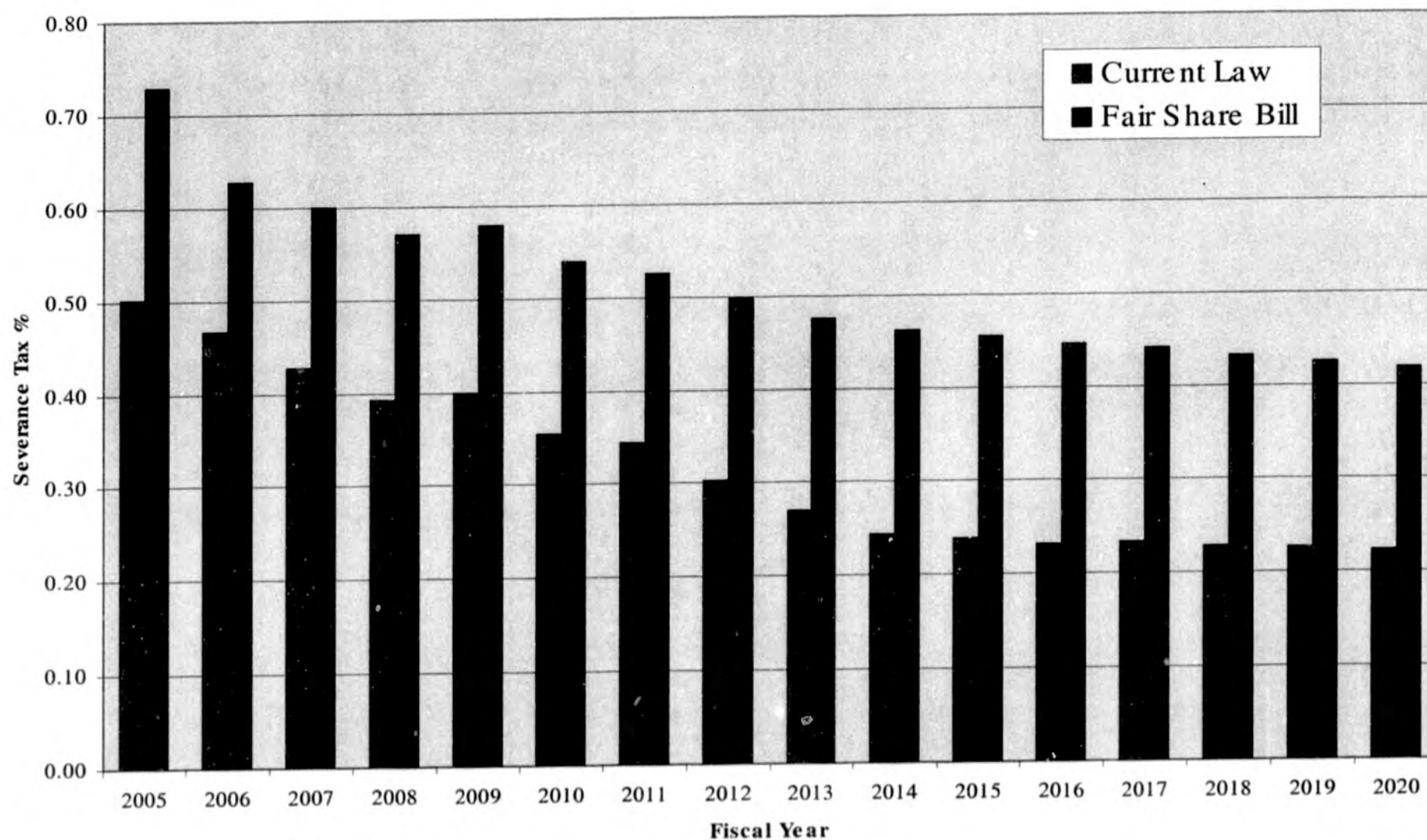
- **It is not unstable to amend a tax regime after 15 years (DOR).**
- **It is better to take a modest approach that adjusts with the price and profitability of oil than a wholesale “shelf the ELF” approach.**
- **A 0% production tax on profitable fields no longer makes sense.**

Forecasted Decline in Severance Tax Revenue: Current Law



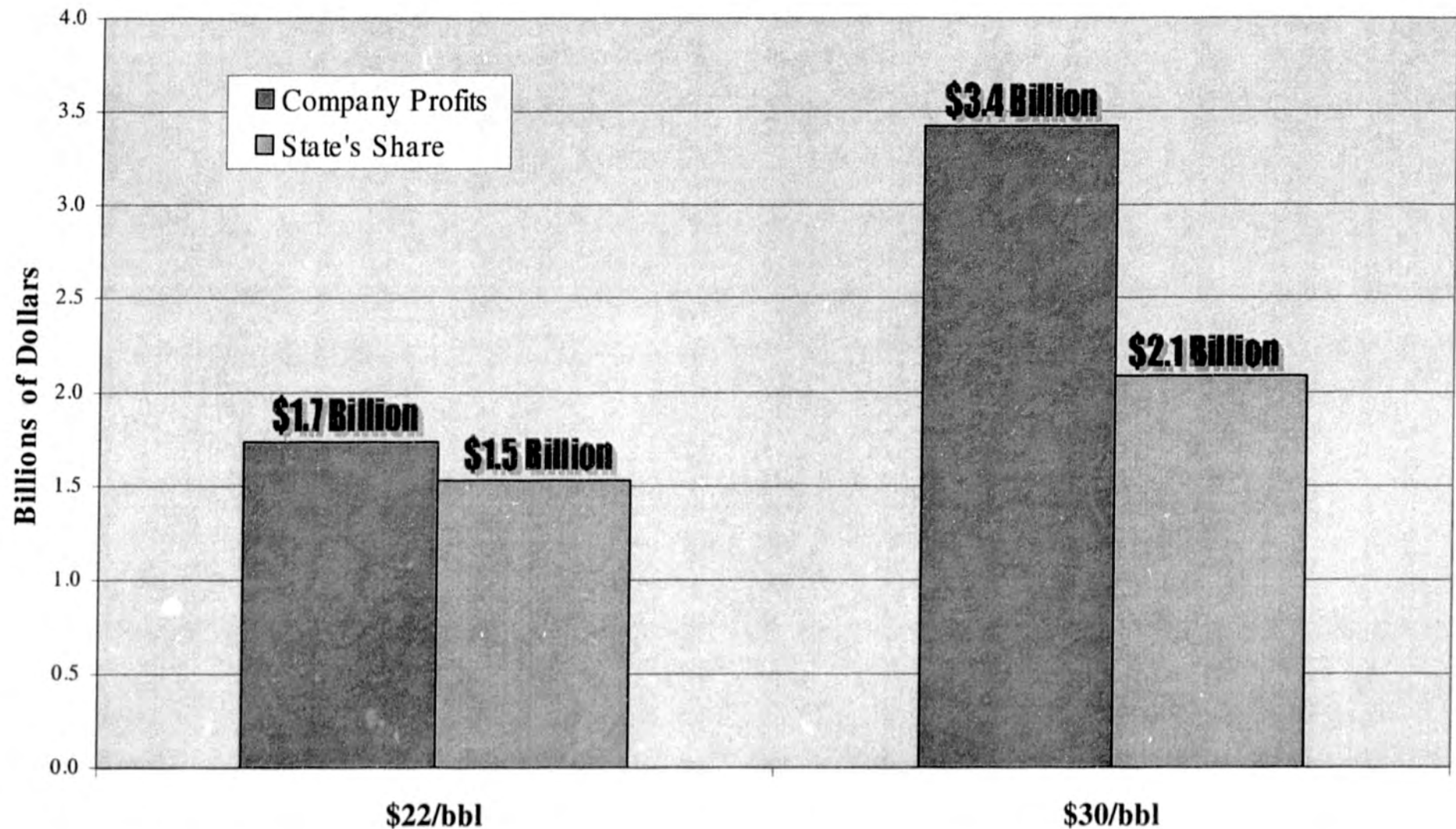
Statistics provided by Alaska Dept. of Revenue

Average Severance Tax Rate at Forecasted Oil Prices: Current Law and Fair Share Bill



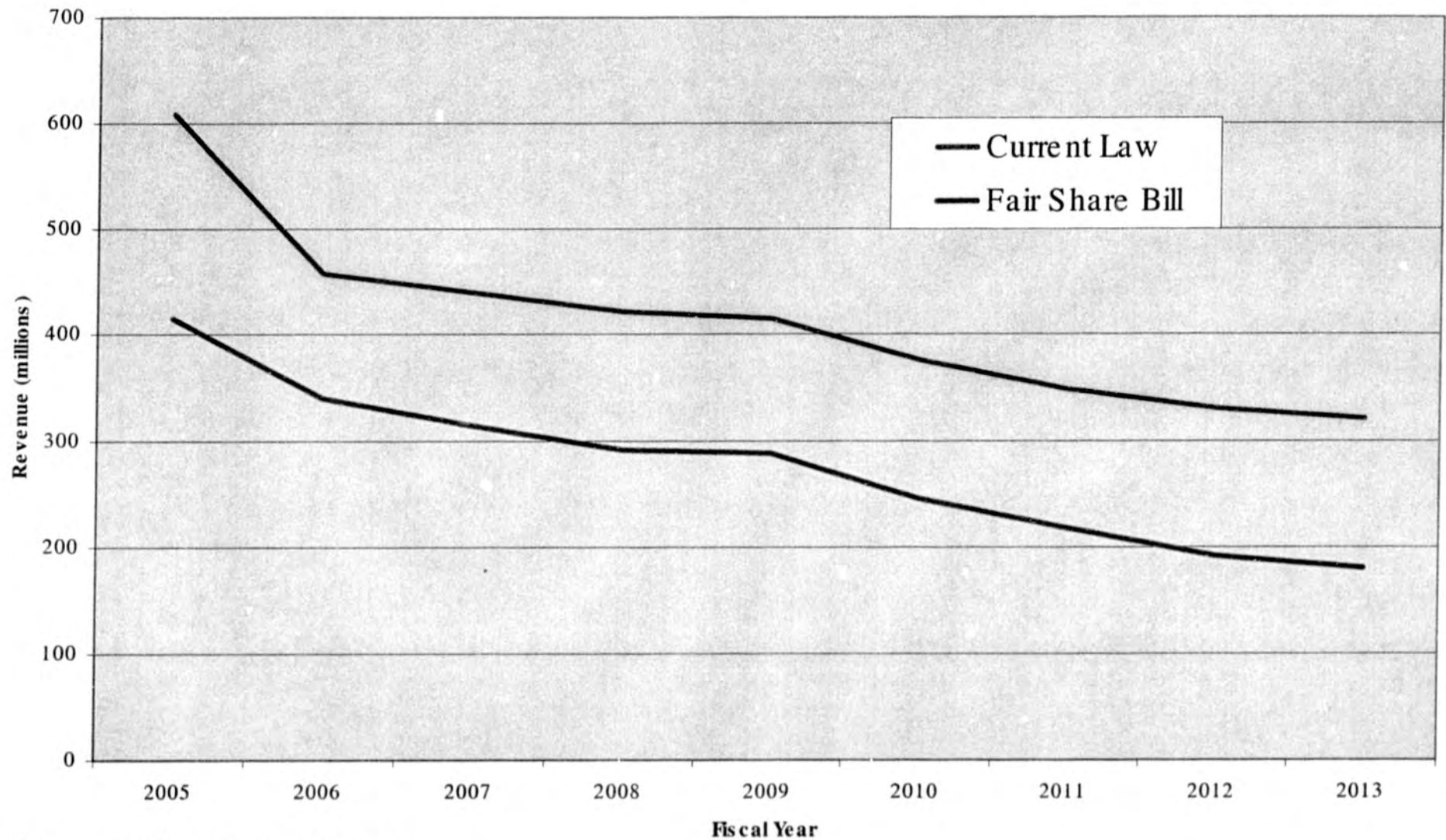
Statistics provided by Alaska Dept. of Revenue

Comparison Between Oil Company Profits and State Revenue: Current Law



Statistics provided by Alaska Dept. of Revenue

Projected Severance Tax Revenue Under Current Law and Fair Share Bill at Forecasted Prices



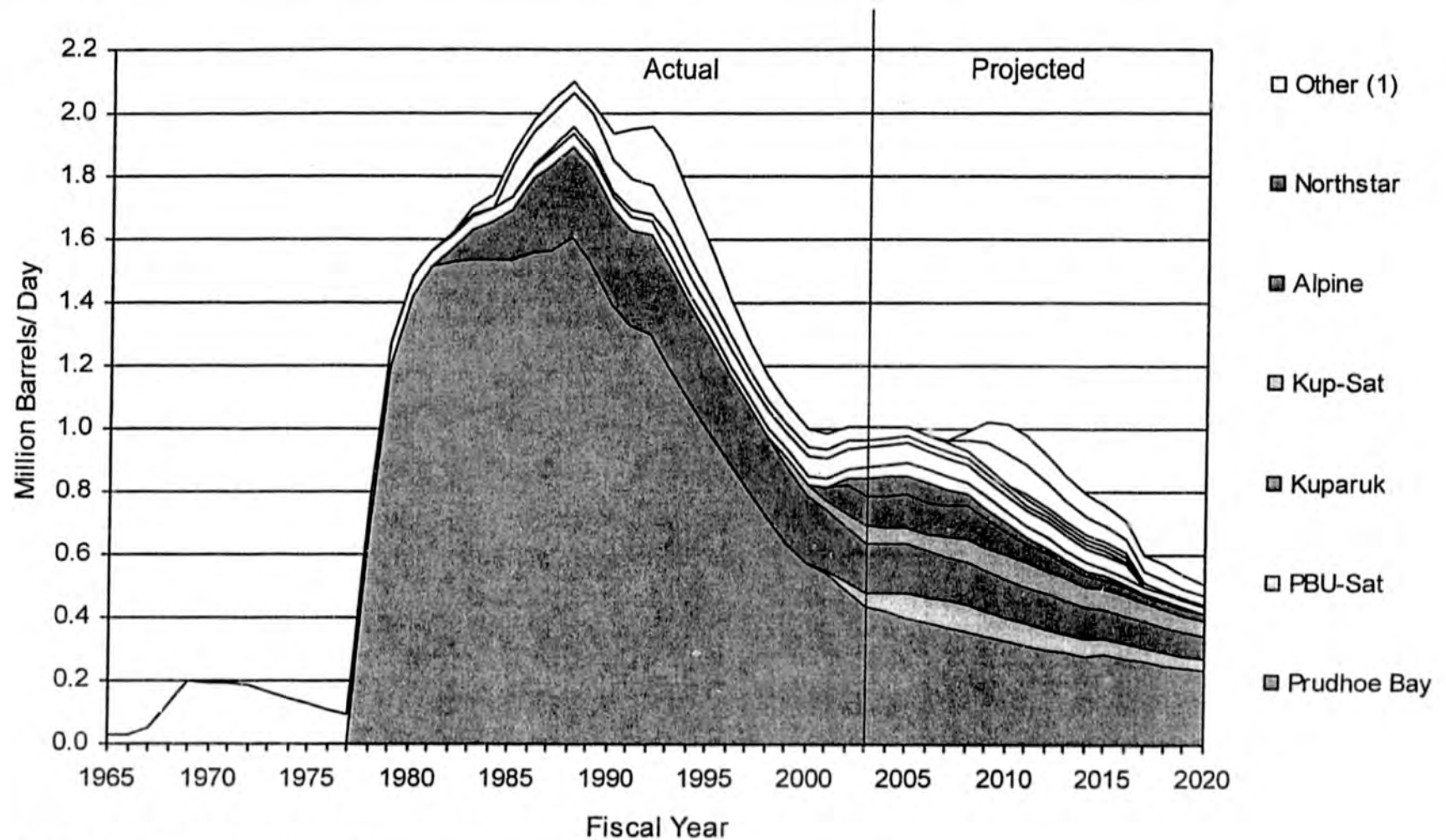
Statistics provided by Alaska Dept. of Revenue

House of Representatives Ways & Means Committee HB 441

Dan Dickinson
Department of Revenue, Tax Division
April 16, 2004



Alaska Oil Production, 1965-2020

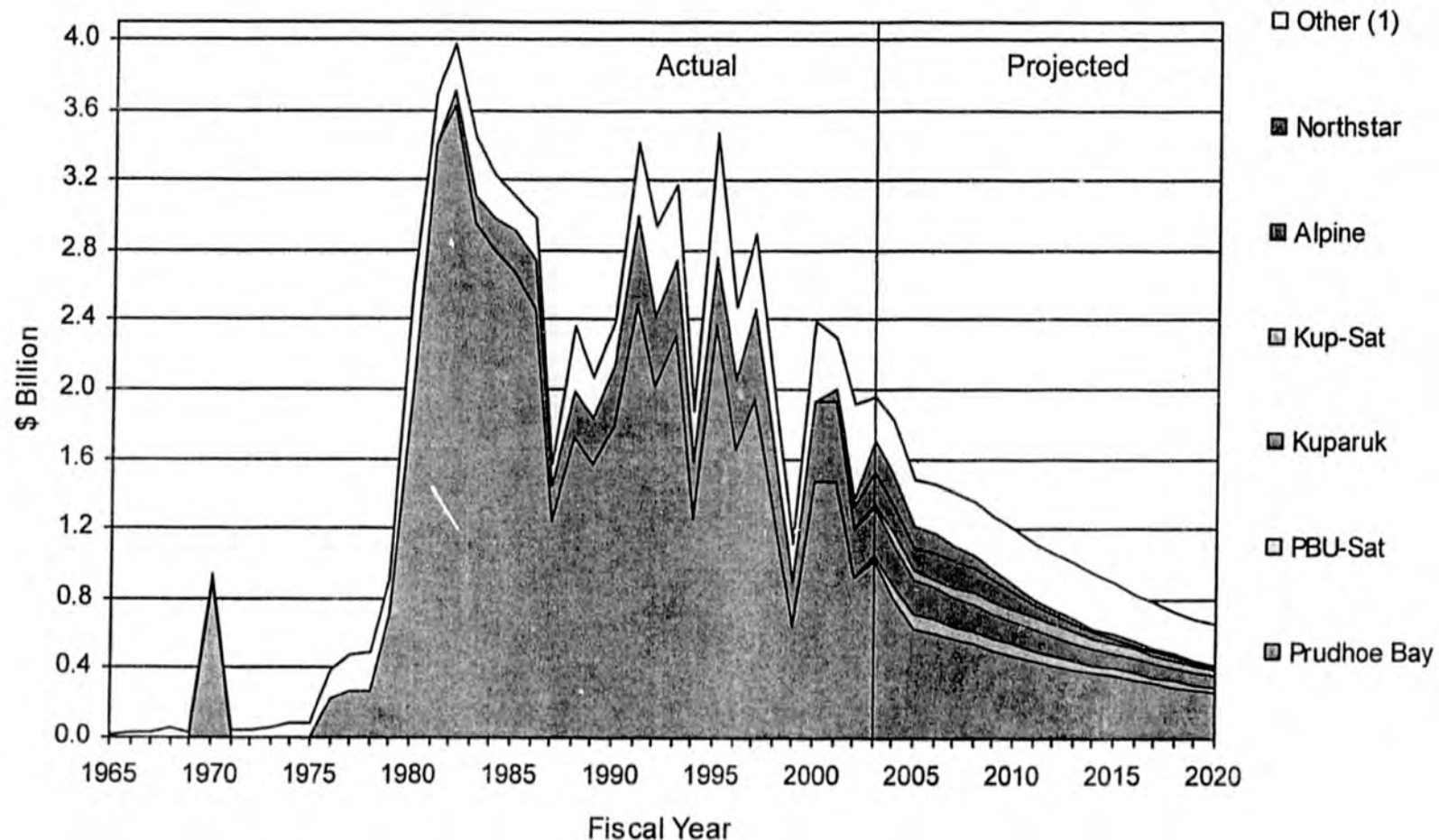


Source: Fall 2003 Revenue Sources Book

(1) Cook Inlet, Duck Island, Milne Point, Greater Point McIntyre, Liberty, Known On & Offshore, Fiord and NPRA.



Alaska Oil Revenue, 1965-2020



Source: Fall 2003 Revenue Sources Book

(1) Cook Inlet, Duck Island, Milne Point, Greater Point McIntyre, Liberty, Known On & Offshore, Fiord and NPRA.

(2) Actual and projected state petroleum revenue (General Fund, Permanent Fund, deposits to the CBRF, Public School Fund and NPRA) from all fields including lease bonuses and TAPS taxes.



FY 2003 ELF: Alaska North Slope Fields

Unit	Field	Daily Production (bbl/day)	Oil Wells	ELF	Production per Well (bbl/day)
CPU	Alpine	98,036	28	0.858354	3,501.3
BU	Badami	1,205	6	0	200.8
DI	Eider	1,011	1	0	1,010.9
DI	Endicott	26,199	49	0.000306	534.7
KRU	Kuparuk	157,990	460	0.226633	343.5
KRU	Meltwater	8,395	7	0	1,199.3
KRU	Tabasco	3,579	7	0	511.3
KRU	Tarn	33,799	25	0.088762	1,351.9
KRU	West Sak	6,673	25	0	266.9
MPU	Milne-Kuparuk	31,448	87	0.000150	361.5
MPU	Milne-Schrader Bluff	16,977	45	0.000000	377.3
NU	Northstar	58,022	8	0.866114	7,252.7
PBU	Aurora	7,676	8	0	959.5
PBU	Borealis	27,110	17	0.110790	1,594.7
PBU	Lisburne	9,801	31	0	316.2
PBU	Midnight Sun	7,351	2	0.001505	3,675.4
PBU	Niakuk	14,561	15	0.000590	970.7
PBU	Orion	383	1	0	383.3
PBU	Prudhoe Bay	394,632	800	0.869868	493.3
PBU	Polaris	2,653	6	0	442.2
PBU	Point McIntyre	42,380	39	0.160101	1,086.7

Source: Alaska Department of Revenue, Tax Division

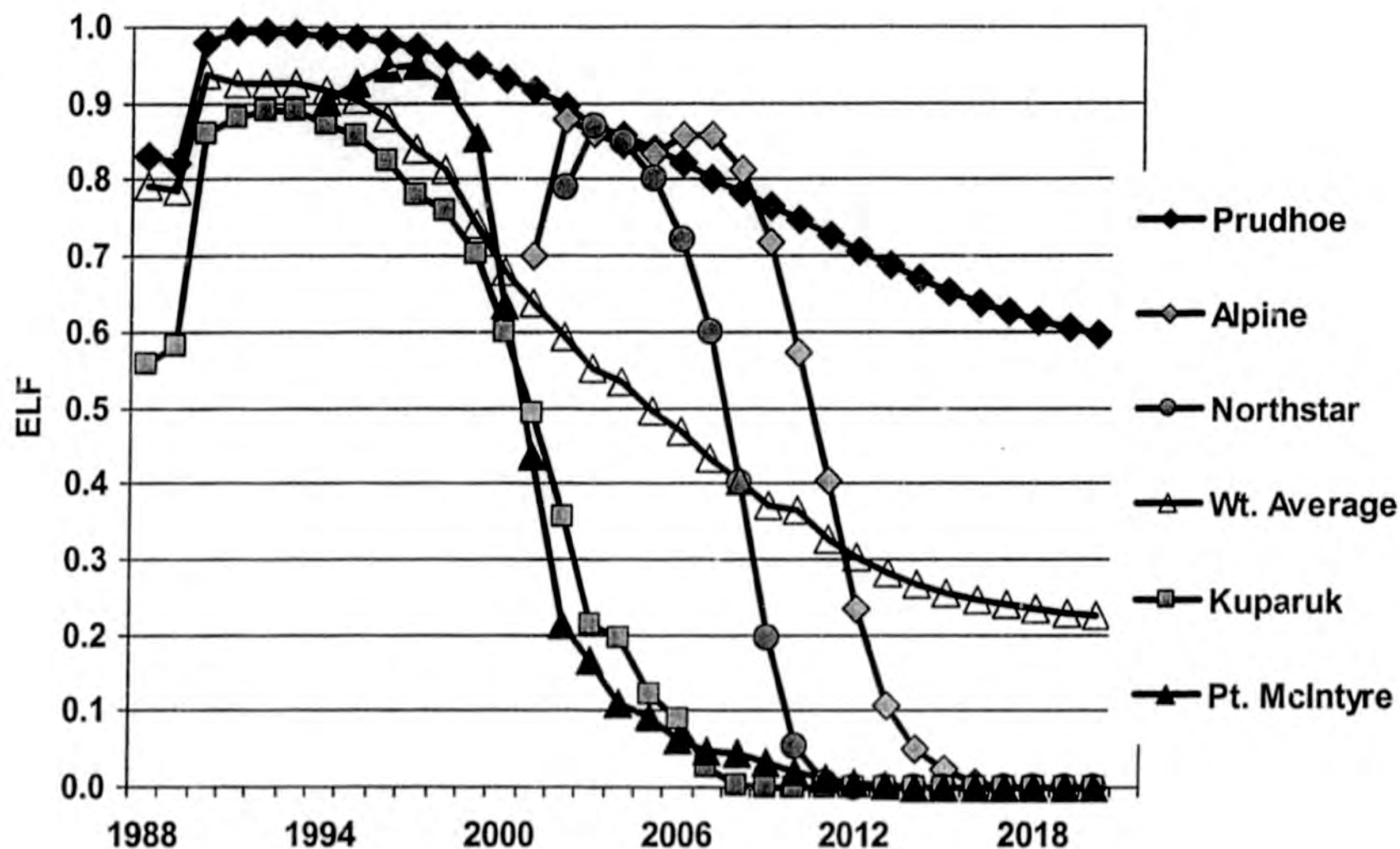
FY 2003 ELF: Cook Inlet Fields

	(bbl/day)			(bbl/day)	(bbl/day)
	Daily Production	Oil Wells	ELF	Production/ Well	Taxable Daily Production
Beaver Creek	207	2	0	103.5	-
Granite Point	3,821	34	0	112.4	-
McArthur River	13,564	57	0	238.0	-
Middle Ground Shoals	4,592	56	0	82.0	-
Swanson River	1,209	50	0	24.2	-
Trading Bay Field	2,018	20	0	100.9	-
West McArthur	2,572	4	0	643.0	-
Redoubt Shoal	4,000	5	0	800.0	-

Source: Alaska Department of Revenue, Tax Division



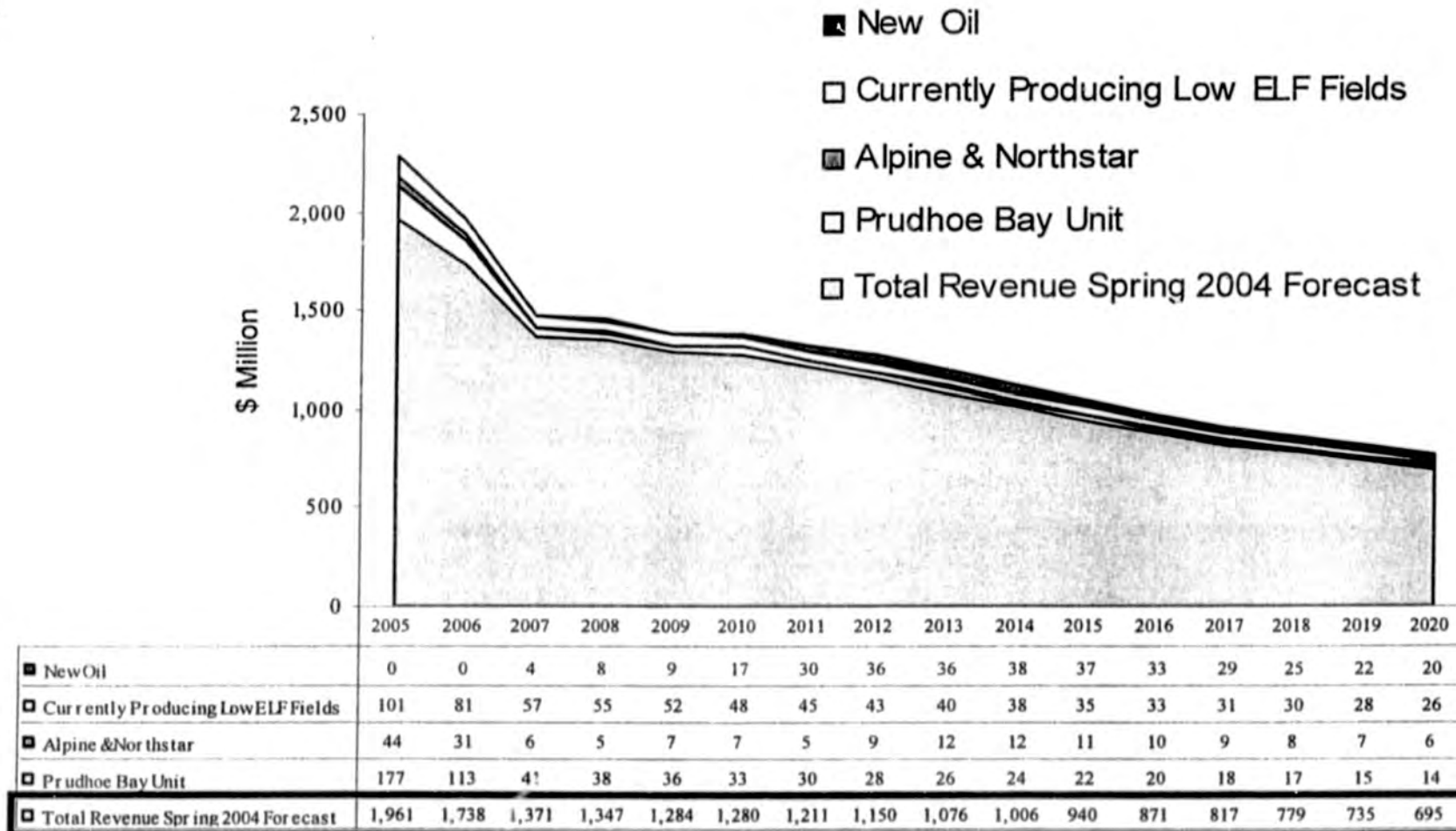
Oil ELF of Select Oil Fields, FY 1988 – FY 2020



Source: Spring 2004 Revenue Sources Book

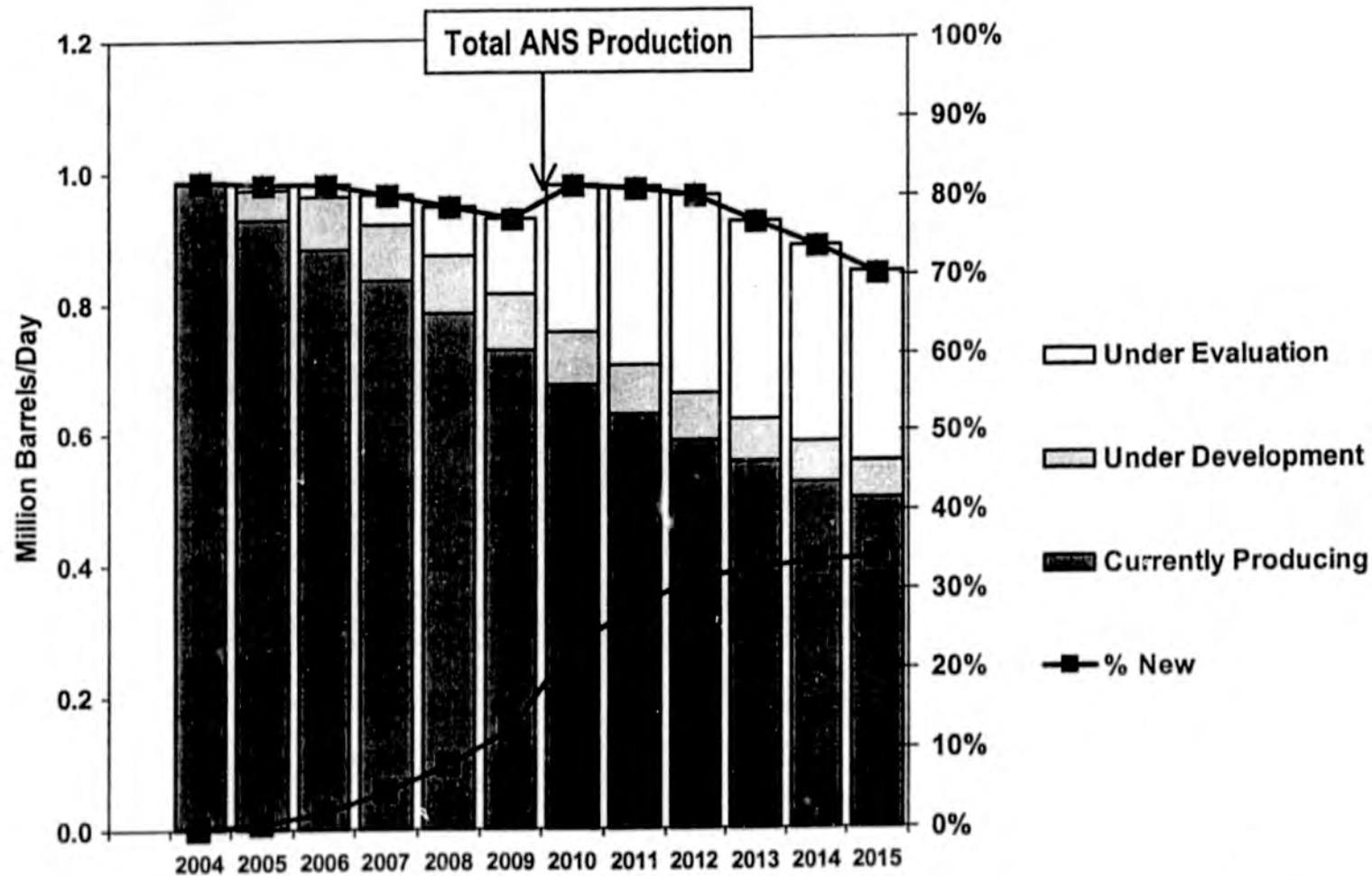


Spring 2004 Projection of Oil Revenue and Incremental Revenue From HB 441



Source: Spring 2004 Forecast of General Fund, Permanent Fund and Public School Fund

New Oil as a Percentage of Projected Oil

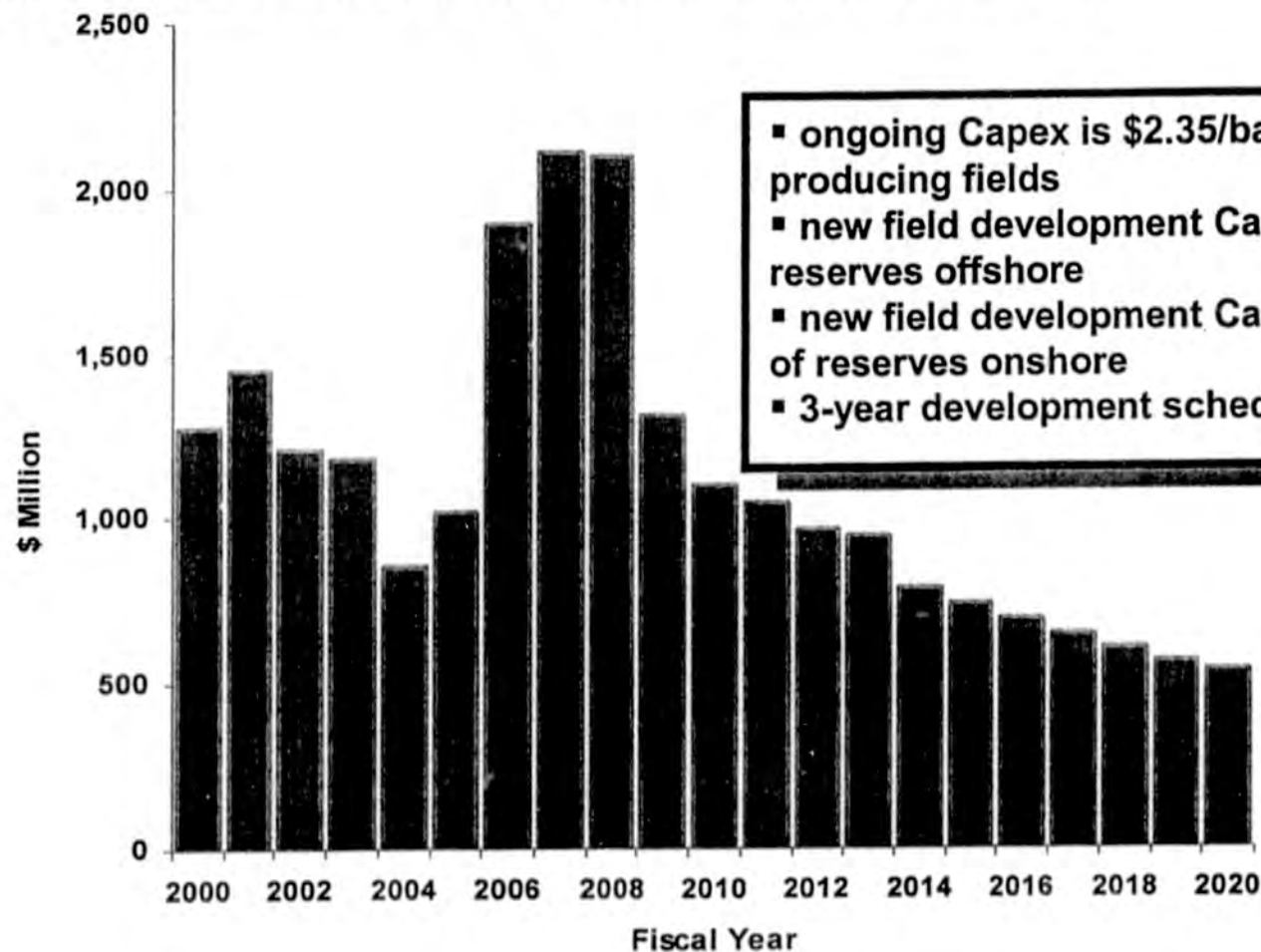


Source: Spring 2004 Revenue Sources Book



Oil Development Capital Spending for ANS

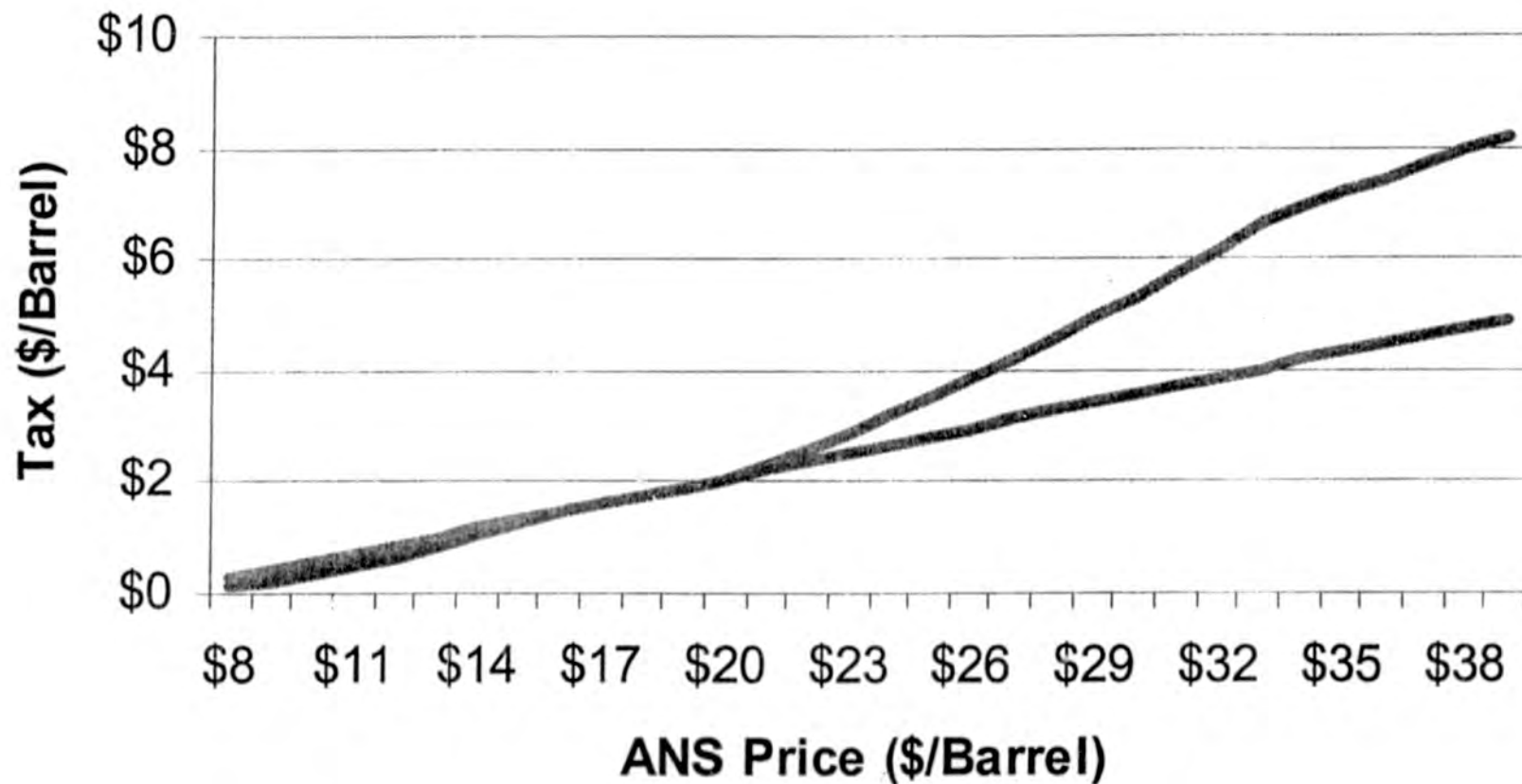
Estimated 2000-2004 and Projected Necessary to Meet
Current Oil Production Forecast 2005-2020



Source: Alaska Department of Revenue, Company Financial Statements



Effect of Price Factor in HB 441 Prior to Application of Volumetric ELF



— 15 % x Wellhead - - - 15 % x Wellhead x Price Adj. Factor

Assumptions: Wellhead = ANS price - \$6.25/barrel



THE
FOLLOWING
DOCUMENT(S)
ARE
POOR
ORIGINAL
COPIES

BP to buy back shares with free cash flow when oil price exceeds \$20 a barrel

Release date: 29 March 2004

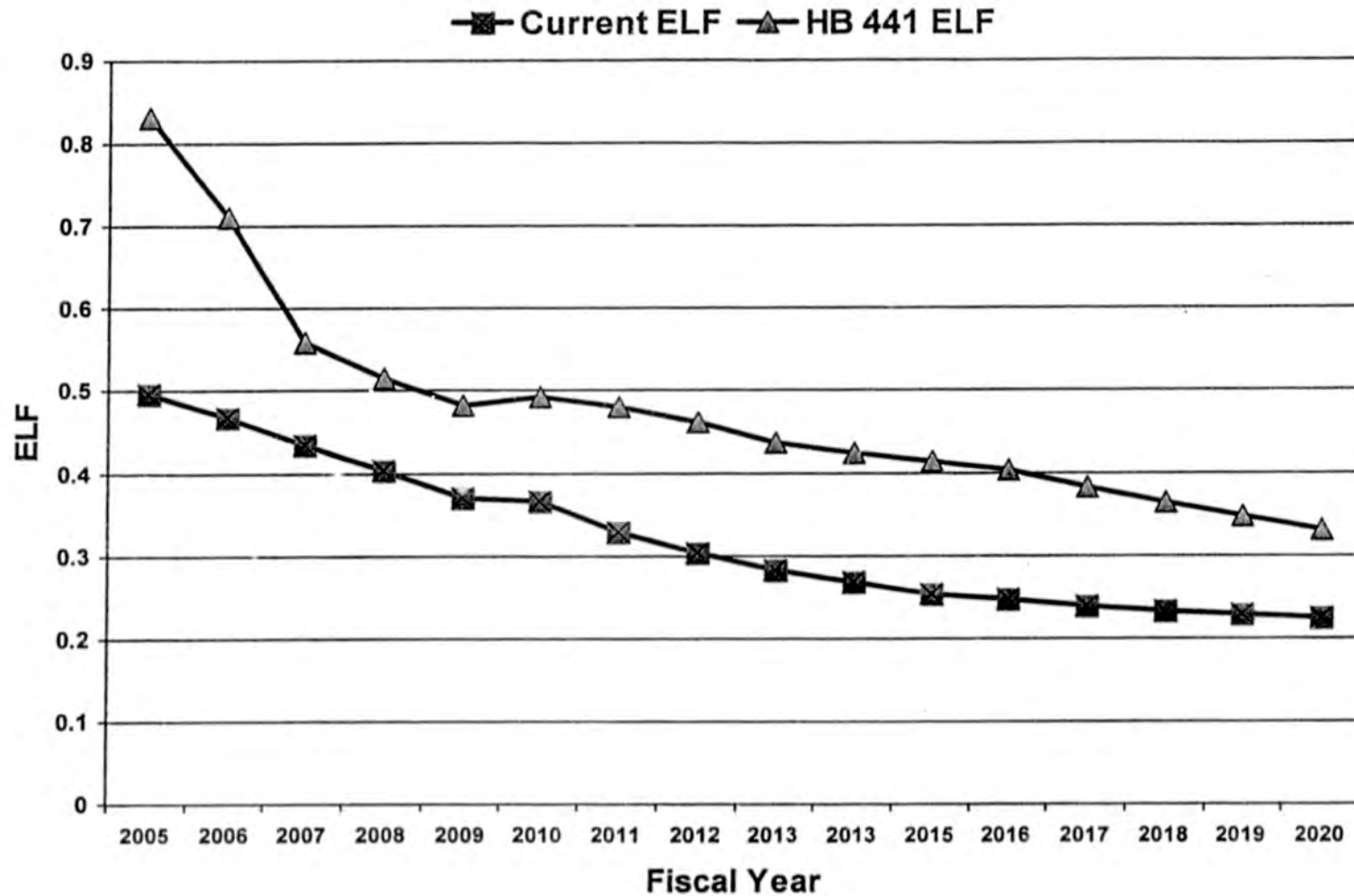
BP said today that, barring unexpected developments – or acquisitions it does not currently foresee – it expects to be able to deliver significant extra cash to its shareholders over the next three years and at the same time strongly grow production and long-term returns.

Chief executive Lord Browne said that a \$20 oil price would allow the company to meet its capital requirements and pay a progressive dividend, and that all the free cash generated when the oil price is above that level would be returned to shareholders through buybacks.

Source: www.BP.com



Current ELF and Proposed HB 441 ELF



Source: Alaska Department of Revenue, Spring 2004 forecast assumptions



STATE OF ALASKA

DEPARTMENT OF REVENUE

Tax Division

FRANK MURKOWSKI, GOVERNOR

☐ State Office Building
PO Box 110420
Juneau, AK 99811-0420
907.465.2320

☒ 550 W Seventh, Suite 500
Anchorage, AK 99501-3566
907.269.6620

www.tax.state.ak.us

January 27, 2004

Dear Representative Gara:

As requested in your e-mail of January 20, 2004, here are the revenue estimates corresponding to a minimum ELF of .333, price factors with \$16 and \$20 ANS boundary prices, and a maximum severance tax of 25%. We have also exempted heavy oil from your proposed tax changes.

These estimates reflect our model's severance tax revenue output using our Fall 2003 production forecast coupled with your proposed tax modifications. Our analysis does not include any possible negative impact on production from your tax proposals. The proposed tax may or may not have an impact on these investments, and therefore on future production. The analysis below and in the attached worksheet does not reflect this department's view on the merits of the proposed tax, or on whether this tax will have an impact on future production. We have only mechanically modified the way in which severance tax revenues are calculated to reflect your proposals.

Open up the excel file (without refreshing links of course) entitled "tables for Les Gara re ELF proposal". The worksheet "les jan 20 request" contains the tables with the revenue projections based on the most recent changes, while the worksheet "original request" contains revenue projections for our original request.

At our Fall 2003 forecasted prices, having a minimum ELF of .333 (exempting heavy oil) brings in about \$75 million more in tax revenue. This \$75 million increases to over \$100 million by the early part of the next decade. To track this, compare the columns entitled "Minimum ELF, Revenue" with the "Status Quo ELF; revenue" in the table below.

Forecasted prices

FY	Status quo ELF; revenue	Status quo ELF; weighted average	Minimum ELF; revenue	Minimum ELF; weighted average	Price adjusted ELF; revenue	Price adjusted ELF; weighted average	Forecast ANS price per barrel
2005	415	0.50	493	0.59	608	0.73	\$24.65
2006	341	0.47	416	0.57	458	0.63	\$22.00
2007	314	0.43	400	0.55	440	0.60	\$22.00
2008	292	0.39	383	0.52	421	0.57	\$22.00
2009	287	0.40	378	0.53	416	0.58	\$22.00
2010	246	0.35	342	0.49	376	0.54	\$22.00
2011	218	0.34	317	0.48	348	0.53	\$22.00
2012	191	0.30	301	0.45	330	0.50	\$22.00
2013	180	0.27	293	0.43	321	0.48	\$22.00
2014	160	0.24	270	0.42	297	0.46	\$22.00
2015	147	0.24	249	0.41	273	0.45	\$22.00
2016	132	0.23	224	0.41	246	0.45	\$22.00
2017	123	0.23	205	0.40	225	0.44	\$22.00
2018	113	0.23	188	0.39	206	0.43	\$22.00
2019	103	0.23	170	0.39	187	0.43	\$22.00
2020	94	0.22	155	0.38	170	0.42	\$22.00

Adding the price factor along with the minimum ELF increases tax revenue a further \$40 million at \$22 ANS. To see this, compare the columns "Price adjusted ELF, revenue" with "Minimum ELF; revenue".

At higher oil prices the ELF modifications will have more of a revenue impact. Referring to the table below, the minimum ELF will bring in \$100 million in FY 2005 at \$30 ANS, increasing to \$164 million by 2013. The price factor will add a further \$314 million in FY 2005, with the factor having less of an impact over time.

High prices

FY	Status quo ELF; revenue	Status quo ELF; weighted average	Minimum ELF; revenue	Minimum ELF; weighted average	Price adjusted ELF; revenue	Price adjusted ELF; weighted average	ANS price
2005	529	0.50	628	0.59	942	0.89	\$30.00
2006	503	0.47	614	0.57	921	0.85	\$30.00
2007	465	0.43	592	0.55	885	0.82	\$30.00
2008	432	0.39	568	0.52	851	0.78	\$30.00
2009	426	0.40	562	0.53	839	0.79	\$30.00
2010	367	0.35	506	0.49	757	0.73	\$30.00
2011	332	0.34	468	0.48	697	0.71	\$30.00
2012	291	0.30	443	0.45	663	0.68	\$30.00
2013	271	0.27	435	0.43	646	0.64	\$30.00
2014	239	0.24	403	0.42	602	0.63	\$30.00
2015	221	0.24	373	0.41	554	0.62	\$30.00
2016	199	0.23	337	0.41	503	0.61	\$30.00

2017	185	0.23	310	0.40	460	0.60	\$30.00
2018	172	0.23	285	0.39	424	0.59	\$30.00
2019	157	0.23	260	0.39	388	0.58	\$30.00
2020	144	0.22	238	0.38	356	0.57	\$30.00

At lower oil prices, the minimum ELF will bring in an additional \$35 to \$55 million. As against the status quo, while this minimum ELF increase will be mostly offset by the price factor initially, the price factor will become less of an offset as time goes on.

Low prices

FY	Status quo ELF; revenue	Status quo ELF; weighted average	Minimum ELF; revenue	Minimum ELF; weighted average	Price adjusted ELF; revenue	Price adjusted ELF; weighted average	ANS price
2005	189	0.50	224	0.59	196	0.52	\$14.00
2006	179	0.47	218	0.57	191	0.50	\$14.00
2007	164	0.43	208	0.55	182	0.48	\$14.00
2008	152	0.39	199	0.52	174	0.45	\$14.00
2009	148	0.40	195	0.53	171	0.46	\$14.00
2010	129	0.35	177	0.49	155	0.43	\$14.00
2011	120	0.34	166	0.48	145	0.42	\$14.00
2012	106	0.30	158	0.45	138	0.40	\$14.00
2013	96	0.27	151	0.43	132	0.38	\$14.00
2014	82	0.24	137	0.42	120	0.37	\$14.00
2015	74	0.24	125	0.41	110	0.36	\$14.00
2016	65	0.23	111	0.41	97	0.36	\$14.00
2017	60	0.23	100	0.40	88	0.35	\$14.00
2018	55	0.23	90	0.39	79	0.35	\$14.00
2019	49	0.39	81	0.39	71	0.34	\$14.00
2020	44	0.38	72	0.38	63	0.33	\$14.00

You asked us to evaluate the relative share of oil revenue going to the state, the federal government, and the companies at various prices under the current and proposed ELF. The table below provides a breakdown, derived using the excel spreadsheet Chuck Logsdon sent you in response to your request on January 20, of the relative share going to each under the current, status quo, tax law and with your proposed modifications.

**Sharing of revenue (millions \$) from ANS under different
scenarios for FY 2005**

Status quo \$22/bbl				With Les Modifications \$22/bbl		
	<u>State</u>	<u>Companies</u>	<u>Federal</u>	<u>State</u>	<u>Companies</u>	<u>Federal</u>
Revenue	1,523	1,735	915	1,632	1,664	876
%	36.49%	41.58%	21.92%	39.12%	39.87%	21.00%
\$30/bbl				\$30/bbl		
	<u>State</u>	<u>Companies</u>	<u>Federal</u>	<u>State</u>	<u>Companies</u>	<u>Federal</u>
Revenue	2,081	3,243	1,727	2,494	2,974	1,582
%	29.51%	45.99%	24.49%	35.37%	42.19%	22.44%
\$14/bbl				\$14/bbl		
	<u>State</u>	<u>Companies</u>	<u>Federal</u>	<u>State</u>	<u>Companies</u>	<u>Federal</u>
Revenue	974	221	100	981	217	97
%	75.22%	17.08%	7.70%	75.77%	16.73%	7.51%

If you have any questions about the spreadsheets I'm sending, please call.

Greg Bidwell
Petroleum Economist
Tax Division
(907) 269-1023

FY2005 Price Sensitivity

SHARES OF ALASKA'S OIL REVENUE PIE (PRODUCTION AND VALUE ADDED BY TAPS)												
FOR DIFFERENT OIL PRICES USING DEPT OF REVENUE FALL 2003 ASSUMPTIONS												
FOR FY 2005												
Sales Price (\$/Bbl)	\$40.00	\$35.00	\$32.00	\$30.00	\$26.00	\$22.00	\$20.00	\$16.00	\$15.00	\$12.00	\$10.00	
Transportation Cost to Market (\$/Bbl)	\$5.27	\$5.27	\$5.27	\$5.27	\$5.27	\$5.27	\$5.27	\$5.27	\$5.27	\$5.27	\$5.27	
Wellhead Price (\$/Bbl)	\$34.73	\$29.73	\$26.73	\$24.73	\$20.73	\$16.73	\$14.73	\$10.73	\$9.73	\$6.73	\$4.73	
ANS Production (oil and NGL) (Million Bbl/Yr)	359.7	359.7	359.7	359.7	359.7	359.7	359.7	359.7	359.7	359.7	359.7	
Production Value (Million \$)	12492.4	10693.9	9614.8	8895.4	7456.6	6017.8	5298.4	3859.6	3499.9	2420.8	1701.4	
Production Costs (\$/Bbl)	6.44	6.44	6.44	6.44	6.44	6.44	6.44	6.44	6.44	6.44	6.44	
Production Costs (Million \$)	2316.5	2316.5	2316.5	2316.5	2316.5	2316.5	2316.5	2316.5	2316.5	2316.5	2316.5	
State Revenue + Muni Oil Property (Millions \$)	2804.3	2444.9	2229.3	2085.6	1798.1	1510.6	1366.8	1079.4	1007.5	791.9	648.1	
Severance Tax	778.3	666.2	599.0	554.2	464.5	374.9	330.1	240.5	218.0	150.8	106.0	
wtd avg severance tax rate	14.24%	14.24%	14.24%	14.24%	14.24%	14.24%	14.24%	14.24%	14.24%	14.24%	14.24%	
wtd avg Economic Limit Factor (ELF)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	
per bbl severance tax	\$2.16	\$1.85	\$1.67	\$1.54	\$1.29	\$1.04	\$0.92	\$0.67	\$0.61	\$0.42	\$0.29	
Gross Royalty	1535.2	1310.4	1175.5	1085.6	905.7	725.9	635.9	456.1	411.1	276.2	186.3	
wtd avg royalty rate	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%	
wtd avg field costs	0.59	0.59	0.59	0.59	0.59	0.59	0.59	0.59	0.59	0.59	0.59	
per bbl royalty	\$4.27	\$3.64	\$3.27	\$3.02	\$2.52	\$2.02	\$1.77	\$1.27	\$1.14	\$0.77	\$0.52	
Adjustment for Cook Inlet Production Revenue	28.5	26.0	24.5	23.5	21.5	19.5	18.5	16.5	16.0	14.5	13.5	
Property Tax State Share												
Property Tax Muni Share												
Total property tax (production plus TAPS)	234.3	234.3	234.3	234.3	234.3	234.3	234.3	234.3	234.3	234.3	234.3	
property tax per bbl	\$0.65	\$0.65	\$0.65	\$0.65	\$0.65	\$0.65	\$0.65	\$0.65	\$0.65	\$0.65	\$0.65	
Total State Income Tax	\$285.00	\$260.00	\$245.00	\$235.00	\$215.00	\$195.00	\$185.00	\$165.00	\$160.00	\$145.00	\$135.00	
Income Tax Production	251.2	226.2	211.2	201.2	181.2	161.2	151.2	131.2	126.2	111.2	101.2	
State Income Tax TAPS	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	
TAPS tax allowance (Millions \$)	169.20	169.20	169.20	169.20	169.20	169.20	169.20	169.20	169.20	169.20	169.20	
TAPS after tax margin	242.37	242.37	242.37	242.37	242.37	242.37	242.37	242.37	242.37	242.37	242.37	
TAPS deferred return	45.14	45.14	45.14	45.14	45.14	45.14	45.14	45.14	45.14	45.14	45.14	
Federal Revenue (Millions \$)	2727.3	2223.6	1921.4	1719.9	1316.9	914.0	712.5	309.5	208.8	-93.4	-294.9	
Percentage Total	25.7%	25.2%	24.8%	24.4%	23.5%	22.0%	20.7%	15.5%	12.7%	-16.7%	186.2%	
Company Net Revenue (Millions \$)	5101.1	4165.6	3604.4	3230.2	2401.8	1733.5	1359.3	611.0	423.9	-137.4	-511.6	
Percentage Total	48.0%	47.2%	46.5%	45.9%	44.3%	41.7%	39.5%	30.6%	25.8%	-24.5%	323.0%	
State Revenue + Muni Share Oil Property (Millions \$)	2804.3	2444.9	2229.3	2085.6	1798.1	1510.6	1366.8	1079.4	1007.5	791.9	648.1	
Percentage Total	26.4%	27.7%	28.7%	29.6%	32.1%	36.3%	39.7%	54.0%	61.4%	141.1%	-409.2%	
Total Revenue Shared State, Federal, Company	10632.6	8834.1	7755.0	7035.6	5596.8	4158.0	3438.6	1999.8	1640.1	561.0	-158.4	
(If Revenue Shared is negative then state revenue gains are less than the total revenue losses by state and companies)												

Subject: Resolution in support of HB 441 / SB 321 Directed To The House Ways & Means Committee

Date: Thu, 15 Apr 2004 23:32:36 -0800

From: jcb@alaska.net

To: Mike Hawker <Representative_Mike_Hawker@legis.state.ak.us>,
Bruce Weyhrauch <Representative_Bruce_Weyhrauch@legis.state.ak.us>,
Vic Kohring <Representative_Vic_Kohring@legis.state.ak.us>,
Dan Ogg <Representative_Dan_Ogg@legis.state.ak.us>,
Norman Rokeberg <Representative_Norman_Rokeberg@legis.state.ak.us>,
Ralph Samuels <Representative_Ralph_Samuels@legis.state.ak.us>,
Peggy Wilson <Representative_Peggy_Wilson@legis.state.ak.us>,
Max Gruenberg <Representative_Max_Gruenberg@legis.state.ak.us>,
Carl Moses <Representative_Carl_Moses@legis.state.ak.us>

ALASKA VOTERS ORGANIZATION RESOLUTION 2004-04

A resolution to the 23rd Alaska State Legislature in SUPPORT of House Bill 441 and companion Senate Bill 321, short title: "Modification of Oil Severance Tax"; which would restore fair severance taxes on our state owned oil resources.

WHEREAS, the Alaska State Legislature is responsible for making the highest and best use of our natural resources; and

WHEREAS, in 1989 the Alaska State Legislature modified an incentive for oil companies to develop marginal fields called the "economic limit factor" or ELF; and

WHEREAS, the ELF was designed to encourage small field development; it now allows 12 of the 20 fields currently producing on the North Slope to pay NO severance taxes at all; and

WHEREAS, many of the fields receiving benefit from the ELF currently remain very profitable including the second highest producing oil field in North America at Kuparuk, which now only pays a 3% severance tax, and giant Prudhoe Bay which only pays a 12.9% severance tax; and

WHEREAS, Department of Revenue projections estimated the average severance tax collected in 1993 was 13.5%, but that average will fall to 4% in 2013 using the current ELF calculations; and

WHEREAS, proposed changes to the ELF could generate an additional \$500 million for the state at \$32/barrel; and

WHEREAS, at \$32/barrel, corporate profits from Alaska North Slope oil exceed state

revenues by \$1.2 Billion, and that gap increases to about \$1.5 Billion at \$35/barrel; and

WHEREAS, the Alaska State Legislature has failed to reduce spending to sustainable levels, and is actively seeking new revenue sources; and

WHEREAS, proposed changes to the ELF could fill the current budget gap without broad based taxes or permanent fund raids; and

WHEREAS, all components of the fiscal picture should be debated openly with budget cuts, new revenue sources, and changes to the ELF all being part of that discussion; and

NOW, THEREFORE, be it resolved that the Alaska Voters Organization Board of Directors, support **House Bill 441** and companion **Senate Bill 321**, as written this date, to receive a fair severance tax for our oil resources; and be it

FURTHER RESOLVED, that the 23rd Alaska State Legislature adopt **House Bill 441** and companion **Senate Bill 321** as a possible solution to their budget crisis; and be it

FURTHER RESOLVED, that no discussion about changes to the Permanent Fund be considered prior to an open public debate on modification to the ELF; and be it

FURTHER RESOLVED, that no long range fiscal plan or meaningless spending cap be adopted unless it recognizes future revenue projections from all known sources as the upper budget limit and trims current operational cost to match that reality, thus assuring state budgets are adopted which are sustainable without borrowing from Alaska's future.

Adopted by the Alaska Voters Organization Board of Directors, this 14th day of April, 2004

Signed:

Mike McBride,
Board President

Attest:

Laurie Churchill,
Board Secretary

**April is Spring Highlight Month!**

Receive a special gift with a Highlight Service!

adn.com

Anchorage Daily News

Opinion

Print Page

Close Window

*(Published: March 24, 2004)***Re-examine oil taxes**

State should consider changes to share the windfalls, share the risk

Even if Alaska lawmakers weren't struggling to balance the state's ledgers, this would be a good time to reconsider taxes on oil production. Almost all oil produced in Alaska comes from leases owned by the state on behalf of all Alaskans. Alaskans are entitled to ask if we are getting a full and fair share of the income those publicly owned resources produce. Today's long run of \$30-plus per barrel oil has pointed out how backwards the state's oil tax structure is.

The basic problem is this: Alaska's oil production tax takes a big bite of the meager margins when prices are low and takes a small share of the windfall when prices are high. That's backwards. The state should share the downside risk, taking relatively less when prices are low, and also share the upside gains, taking relatively more when prices stay high. The state's current production tax is regressive: It takes a bigger share of lower profits and a smaller share of bigger profits.

A more progressive tax rate should make Alaska a less risky place for oil industry investment -- and the Legislature now should take a hard look at whether that's true.

The state does make one effort to soften the bite of the production tax, also known as the severance tax. Oil fields in Alaska face a nominal severance tax rate of 15 percent. Older fields with declining production, smaller fields and fields where the wells don't produce great gushers of oil get a significant break through the Economic Limit Factor, or ELF. In fact, thanks to the ELF, most of the new fields brought on line in the past few years pay little or no severance tax.

Only Prudhoe Bay pays anything close to the 15 percent rate. Kuparuk, the second largest oil field in the nation, pays a 2 percent severance tax. With the ELF, the average severance tax on all fields is 7.6 percent, barely half the nominal rate.

Eliminating the ELF outright would be a mistake. It makes sense to scale the tax rate to the size of a field and the productivity of each well. Developing a new field in the Arctic is costly, especially if it requires a lot of wells, each pumping a modest amount of oil. As fields age, production goes down and operating costs go up. The ELF helps counter those economic realities.

But a zero tax rate is too generous. Even the smaller fields should contribute something. There ought to be a floor to the ELF, perhaps 5 percent, as Rep. Les Gara and some other Democrats have suggested.

The ELF has a second flaw: It is a one-way ratchet. It provides a significant break for a field that is expected to be less profitable. It makes no adjustment, though, when unexpectedly high prices produce unexpectedly high profits. The ELF deals only with the cost side of the equation; it leaves out the revenue side.

A field's profitability varies greatly with the price of oil. Even if the ELF were revised, the state should explore ways to take less when prices drop below a certain range and share in the windfall when prices jump higher.

Adjusting rates to variable economic conditions is not a radical concept. Millions of Americans have adjustable-rate mortgages, for example. Borrowers share the good fortune when interest rates are low and share the burden with lenders when interest rates rise.

A similar shared-risk principle appeared in discussions about tax breaks for the Alaska gas line to the Lower 48.

Producers wanted protection against the downside risk facing the multibillion-dollar project. They wanted a tax credit that would be triggered by unusually low natural gas prices. In return, the federal treasury would get money back if gas prices jumped above a certain level.

In revisiting Alaska's oil taxes, the point is not to grab easy money as state budgets get tighter and tighter. The point is not to continue the free ride Alaskans have enjoyed for two decades, thanks to oil money. The point is not whether Alaskans can find one last way to avoid a state sales or income tax.

The point of revisiting oil taxes is to find out whether those taxes make economic sense. The point is to find out whether Alaskans are getting the appropriate return on our oil. With today's astronomical oil prices, there's some reason to believe the answer is no to both questions. That's why restructuring oil taxes merits thorough and vigorous discussion in this year's Legislature. A more progressive oil tax structure might make sense for both the industry and Alaska.

BOTTOM LINE: Fiscal squeeze or not, lawmakers should revisit Alaska's oil production taxes.

Just puttering along

RUBY -- You meet the nicest people on the Iditarod Trail. Take the two couples from Kasilof camping out and marveling at the beauty of it all.

They were retirees, riding four separate snowmachines and towing sleds piled with camping gear and supplies. I never caught their names. They'd been planning the trip for months, had detailed lists of contacts and village logistics.

They had a story about spending the night in a drafty cabin in Rainy Pass, struggling to keep enough of a fire in the stove to ward off subzero winds. They had a better story about getting up the next day and pushing through the pass and down into Dalzell Gorge, the glories of the Alaska Range towering all around.

They were the tortoises to everybody else's hares. When somebody came up from behind, they'd pull over and get out of the way. "You're going faster than we are," they'd say. They'd offer to share a sandwich or a cup of coffee, a few stories from the day's adventures and always a big smile. Then they'd keep on plugging while others rested. Down the trail you'd pass them again, still smiling and making room for others to pass. "You're going faster than we are," they'd say again.

Maybe so, but it was always tempting to slow down and keep up with them. I sure hope they made it to Nome.

-- Steve Lindbeck

Print Page

Close Window

Copyright © 2004 [The Anchorage Daily News \(www.adn.com\)](http://www.adn.com)

[Contact us](#) | [Reports and publications](#) | [BP wc](#)Search [About BP](#) [Environment and society](#) [Products and services](#) [Investors](#) [Press](#) [Careers](#)[BP Home](#) [Press](#)[Browse by theme](#)

BP to buy back shares with free cash flow when oil price \$20 a barrel

Release date: 29 March 2004

BP said today that, barring unexpected developments – or acquisitions it does not currently foresee – it expects to be able to deliver significant extra cash to its shareholders over the next three years and at the same time strongly grow production and long-term returns.

Chief executive Lord Browne said that a \$20 oil price would allow the company to meet its capital requirements and pay a progressive dividend, and that all the free cash generated when the oil price is above that level would be returned to shareholders through buybacks.

Confirming that BP had already bought back some 155 million shares for \$1.25 billion in the first quarter of 2004 and has today made special arrangements to continue repurchases during a 'close' period, Browne said: "There appears, at present, to be overwhelmingly more chance of the oil price being above \$20 a barrel for the next few years, than not."

Previewing a strategy presentation to investors and analysts in London, Browne said that as well as increasing dividends in line with improvements in underlying results, BP intends "to distribute 100 per cent of all excess free cash flow to our shareholders, as part of our determination to provide them with additional returns through disciplined cash flow management."

BP has increased its dividends by 6.8 per cent a year in dollar terms since 1999. It bought back some 775 million of its shares at a cost of \$6 billion between 2000 and end-2003, shrinking its equity base by 2.5 per cent.

Laying out the Group's strategy to end-2006, Browne said BP was in transition from a period of acquisition and consolidation to a phase of strong organic growth. It intends over the next three years to focus on performance, particularly cash returns, while investing at a rate appropriate for long-term growth.

He said capital spending is expected to moderate from the "relatively high levels" of 2002 and 2003 to some \$13.5 billion this year, \$12–\$12.5 billion in 2005 and 2006 and \$12–\$13 billion beyond 2007, with the company maintaining its five-year rolling average finding and development cost for oil and gas at between \$4 and \$5 a barrel.

BP's production is expected to grow by five per cent a year between 2003 and 2008, or some seven per cent if the contribution of TNK-BP, its Russian joint venture, is included. TNK-BP's output alone is set to climb by 12 per cent this year and BP estimates it will rise a further five per cent annually to 2007.

BP's oil and gas reserves currently stand at 18.3 billion barrels of oil and gas equivalent, including its share of TNK-BP. This compares with a pre-merger figure of 8.6 billion barrels at end-1997 and includes replacing the Group's annual production at an average rate of 153 per cent over the last five years.

In addition, the company has estimated unproved resources of 24 billion barrels, excluding Russia which could contribute a further 13 billion net barrels.

Browne said BP's positive view of Russia remains unchanged. "The company's investment is attractive and self-financing in the short term but with significant longer term strategic importance in a region where yet-to-find estimates for the industry exceed 300 billion barrels."

At an oil price of \$20 a barrel BP anticipates TNK-BP can pay dividends equal to 40 per cent of its net income at the same time as funding its forward investment programme. "Our estimate is that replacement operating profit, in a \$20-a-barrel environment, divided by our average capital employed in TNK-BP, will be around 25 per cent on a steady-state basis."

Browne said all the ongoing developments in the company's five other new profit centres around the world are on track to meet their first-production dates. The Atlas methanol project in Trinidad, the Kizomba A field in Angola, Holstein in the Gulf of Mexico, and the fourth LNG train in Australia's North West Shelf, are due on stream this year, as is In Salah gas in Algeria.

Next year will see start-up of the Mad Dog and Thunderhorse fields in the deepwater Gulf of Mexico, the Azeri field in Azerbaijan, the fourth LNG train in Trinidad and the In Amenas project in Algeria.

As these and subsequent new upstream projects begin producing, BP expects to see underlying pre-tax cash returns rise by two per cent between 2003 and 2006, and an increase in operating capital employed of some 15 per cent during the same period.

Browne said BP had invested significantly in its customer-facing businesses – refining and marketing, petrochemicals and gas, power and renewables – essentially pumping back all the operating cash flow they had generated in recent years. The average pre-tax cash return from these businesses combined was some 20 per cent in 2001 to 2003.

"During their building, these segments produced no surplus cash flow to the Group and BP's intention now is to target them to produce underlying free cash flow in proportion to their capital employed – at least when compared with the potential of the upstream business at around \$20 oil price," Browne said.

In petrochemicals, with cash returns of only 10 per cent, BP will invest more in 'advantaged' products – paraxylene, PTA and acetyls – which account for some \$5 billion of operating capital employed. These have higher market shares, more proprietary technology, greater exposure to high-growth Asian markets and better returns.

BP said capital spending in the olefins and derivatives business will be held to very low levels and "all options examined for further improvement in this area".

Browne said that, while the oil price remains impossible to predict, the 20-year average for Brent has been some \$20 a barrel in nominal terms. "BP's view is that it is quite reasonable to use \$20 as a base case for balancing cash flows over the next couple of years.

"Over time, as production rises and capital spending declines, we expect the oil price at which cash flows balance to fall below \$20 a barrel."

The company manages its gearing in the range of 25-30 per cent, allowing itself headroom to 35 per cent if the oil price falls to \$16 a barrel.

Browne concluded: "As we look at how the company has developed, we believe BP already holds the assets, market positions and capability to enable us to go forward, expanding our capital base while maintaining underlying cash returns at broadly the same average level as in 2001 to 2003, thereby growing the cash flow generated.

"We expect to do this without affecting the financial risk profile of the Group so that we have sufficient financial capability to cover a contingency if oil prices

dropped to \$16 a barrel, maintain a balance between sources and uses of funds if oil prices are at \$20 a barrel, and to generate cash flows in excess of the financial needs for long-term growth if oil prices are above this level.

"So, we have three targets:

- First, to underpin growth by a focus on performance, particularly on cash returns, investing at a rate appropriate for long-term growth
- Second, to maintain a progressive dividend policy
- And third, to distribute to shareholders 100 per cent of all free cash flow in excess of operating investment and dividend needs, generally when the price of oil is above \$20 a barrel.

"Back in 1998 when we announced the merger with Amoco, we were only partly conscious of the chain of events we were setting in train. It is hard to predict the consequence of any particular step.

"We feel we are now at a similar point of change. The logic of restructuring is not just about making companies bigger. It is about using size and scale to do what was previously unachievable.

"We believe we're beginning to open that door, and beginning to be able to deliver a level of return – consistently, and sustainably year by year – which will improve on anything we've seen so far."