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ELF TAX DECISION GENERATES CONCERN THROUGHOUT PRIVATE SECTOR, SHAKES INVESTOR CONFIDENCE IN ALASKA

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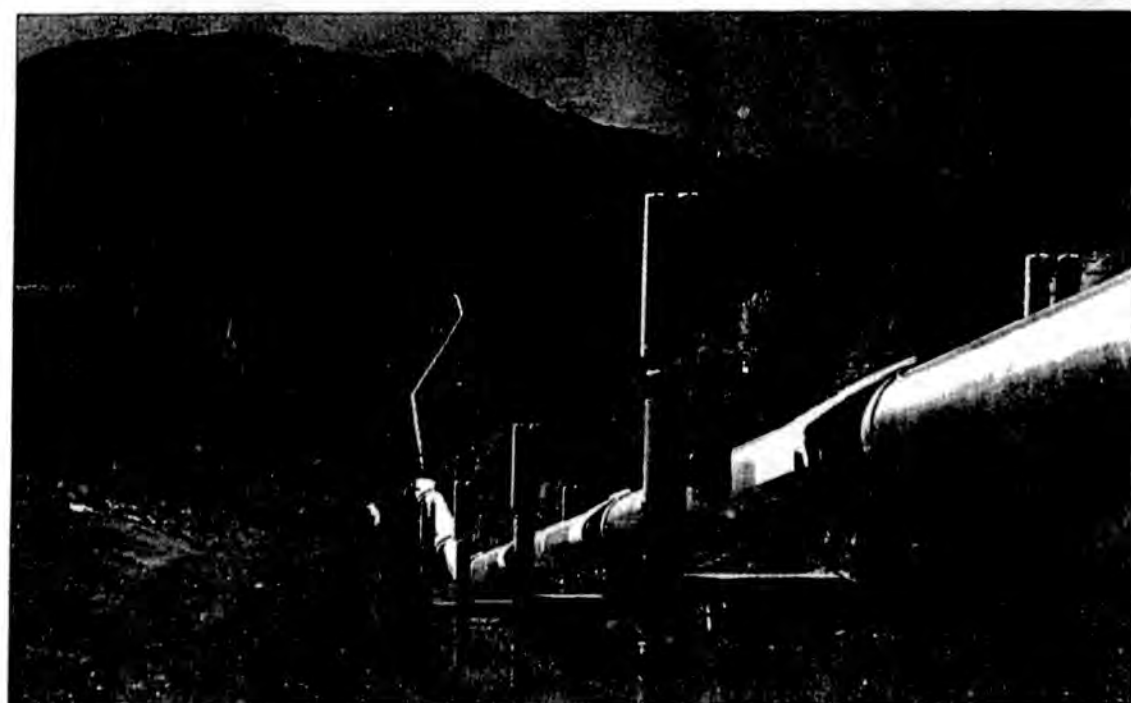
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The January decision by Governor Frank Murkowski to significantly increase production taxes on six North Slope satellite oil fields has sent shock waves through the oil industry and generated tremendous concern among business leaders throughout Alaska.

Industry is now reassessing short-term and long-range investment plans for Alaska. It has warned fallout from the governor's action is likely to have immediate consequences on North Slope investments, ultimately costing Alaska jobs, revenues and economic activity.

"The governor's action sets a troubling precedent for establishing tax policy in Alaska," said RDC Executive Director Tadd Owens. "Confidence in Alaska as a place to do business has been shaken – not only for the oil and gas industry, but for all prospective large-scale investors."

Owens said that since the governor's announcement, he has fielded numerous calls from business leaders outside the oil industry expressing disappointment and deep concern over the sudden change in tax policy. They also expressed frustration since this action was outside the context of a



Every barrel of oil produced in Alaska provides revenue to the state through royalties, corporate income taxes and property taxes. No barrel is produced tax free. The Economic Limit Factor (ELF) applies specifically to the severance tax, which is only one piece of the total tax structure.

comprehensive fiscal plan.

"The governor's tax hike on the industry already paying the vast majority of the state's operating budget runs counter to RDC's position on a responsible fiscal plan," Owens said.

Murkowski's administrative ruling increases oil and gas production taxes on small satellite fields in the Prudhoe Bay unit. The administration's new interpretation of the Economic Limit Factor (ELF) links Prudhoe Bay and its six satellites under a single tax-

ation formula, resulting in a \$150 million annual tax increase on North Slope producers. This increase is on top of royalties, property tax and state and federal income taxes the satellite fields currently pay.

The six fields now grouped with the larger Prudhoe Bay field for taxation purposes are Aurora, Borealis, Polaris, Orion, Midnight Sun and Pt. McIntyre. The industry is considering appealing

the governor's decision and would like the state to look at the small satellites on a case-by-case basis when applying

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INVESTORS: ELF DECISION RAISES RISKS, UNCERTAINTY IN ALASKA

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the ELF.

Prudhoe Bay owners have already been forced to defer an appraisal well that could lead to additional drilling and development work at Prudhoe, and they have shelved a major investment in the Orion satellite field.

Speaking at the Alliance's Meet Alaska Conference in Anchorage, ConocoPhillips Alaska president Jim Bowles pointed out that significant investment by industry in North Slope fields is required to achieve the Department of Revenue (DOR) forecast of total Slope daily production of 945,000 barrels by 2008. The DOR forecast states that satellite fields are estimated to contribute more than 200,000 barrels of oil per day in 2008.

However, Bowles said satellite production will require continued investment, and higher taxes could jeopardize that future investment, resulting in lower production. With these investments, North Slope satellite oil fields were also expected to generate an additional \$3 billion in taxes and other revenues to the state over the next ten years, according to DOR.

Bowles said his company would work with the governor to resolve the recently enacted changes to ELF. He

displayed a visual illustrating the impact of current and projected satellite field development on North Slope production.

"One project in particular, the Orion field development at Prudhoe Bay, has been shelved indefinitely because of the impact of the tax increase," Bowles said. "After careful evaluation of the tax increase, the project economics are no longer able to compete with other investment opportunities. The project represents a loss to Alaska of more than \$500 million of capital investment for drilling and facilities work. This project would have also generated an additional 20,000 barrels of daily production of incremental oil."

Satellite fields provide the greatest opportunity to increase oil production in and around Prudhoe Bay. The vast majority of known reserves on the North Slope are

within the existing fields, but all have their development challenges.

The Orion and Polaris fields are considered viscous oil or "heavy oil" reserves handicapped by high-costs and unique production barriers. The oil is thick and sticky, and it comes out of the ground mixed with sand. In BP's portfolio alone, there are 1 billion barrels of heavy oil that are today uneconomic to produce.

In his January announcement, the governor noted viscous fields would not be included or affected by the administrative change. However, with the state now combining Orion and Polaris with the Prudhoe Bay field for taxation purposes, industry believes the state has essentially eliminated ELF production tax relief for viscous oil in those fields.

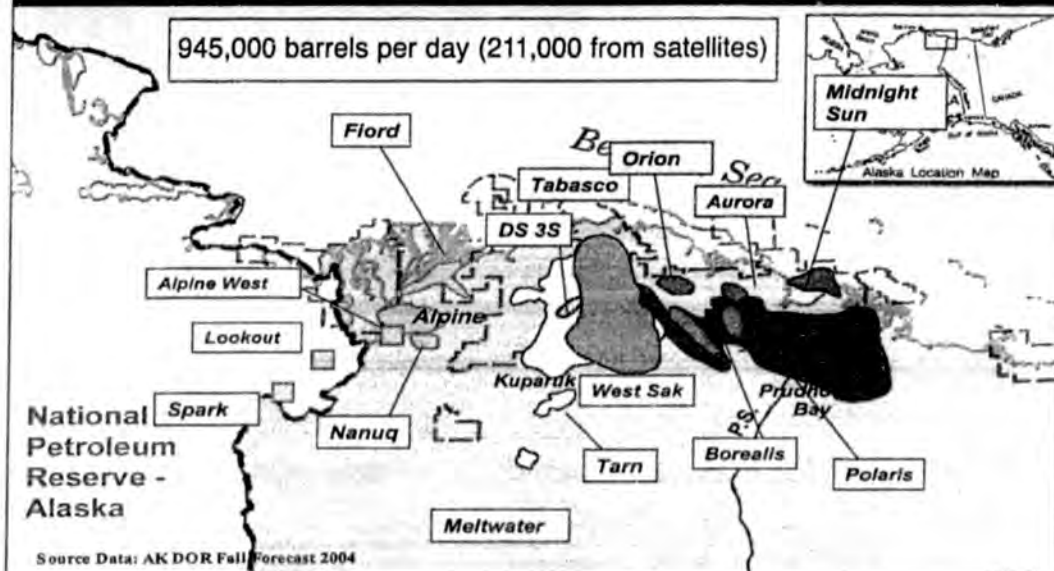
The Murkowski administration spoke earlier this win-

ter of potential adjustments to ELF, but industry insists the administrative change itself was not part of those or any other discussions. Furthermore, there was no opportunity to examine the decision's broad implications, nor any discussion surrounding the important role ELF plays in helping to offset rising costs, thin margins and growing technical challenges facing new investments.

Steve Marshall, Alaska president for BP, warned the governor's action has had a negative effect on investor confidence and has created a high level of uncertainty in Alaska investment opportunities.

"Increasing taxes by more than \$150 million a year at Prudhoe Bay makes all of our Alaskan investments less competitive, and it undermines the confidence of investors," Marshall told the Alliance's Meet Alaska

Satellite Development 2008.



Satellite fields provide the greatest opportunity to increase oil production in and around Prudhoe Bay. The state projects North Slope oil fields will be producing 945,000 barrels of oil daily in 2008. Of that total, 211,000 barrels are expected from satellite fields, some of which have yet to be developed and are dependent on the investment of new capital. Raising taxes on the oil industry makes Alaska less competitive in attracting capital.

audience. "As an industry, we've invested hundreds of millions of dollars since the 1980s to bring ourselves to the brink of unlocking the prize of large-scale viscous oil development. Changing ELF now lends credence to the adage that no good deed goes unpunished."

Marshall explained the current ELF was the basis on which industry invested hundreds of millions of dollars in small field development. Now it believes the state is changing the rules in the middle of the game, once investments have already been committed.

Marshall said BP and its partners are willingly taking on the challenge of drilling more complex, expensive wells and looking to overcome the huge operational challenges viscous wells pose. He said the companies face downtime and costs associated with unanticipated situations, but they're the type of risks industry is able to accept, provided it knows the fiscal and regulatory rules from the start.

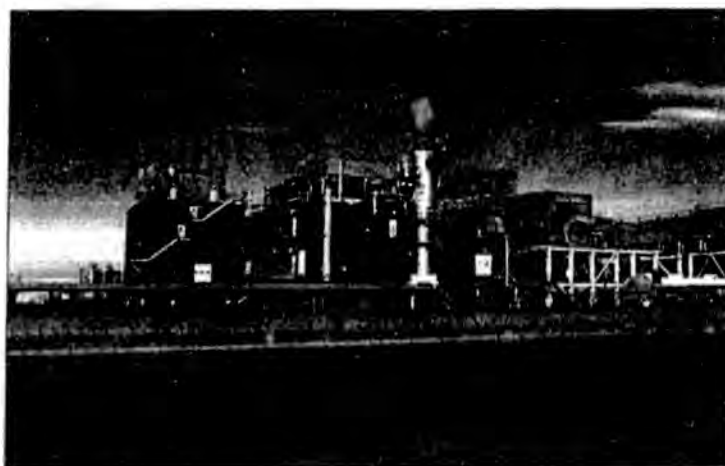
The BP Alaska president offered this analogy with regard to claims by some people that industry can "afford" higher taxes because oil prices are high: "Can you afford to pay a few thousand dollars more to buy a new car from one dealer than you would to buy the same car from another dealer on the next block? Maybe so, maybe not...but the question is: why would you?"

In terms of investment opportunities, Marshall emphasized, "there's a whole world of 'dealerships' competing with Alaska for capital, and if Alaskan projects don't offer competitive returns, the money will go elsewhere."

In a recent interview, Judy Brady, Executive Director of

the Alaska Oil and Gas Association, said the state should not raise taxes just because oil prices are high. "Higher prices are benefiting investment opportunities outside Alaska, just as they benefit the ones here," she said. "Raising taxes will not make Alaskan investments more competitive."

Countering a perception that Alaska is not getting its fair share of revenues from the oil industry when oil prices rise, Brady pointed out Alaska will likely collect over \$3 billion in revenues from North Slope production in FY2005, the first time the state has surpassed that threshold since the 1980s



The oil industry has invested over \$40 billion in North Slope infrastructure since the 1970s and may need to spend \$60 billion over the next ten years to sustain current production.

when daily production was higher.

Brady noted at \$35 per barrel, the state, federal and local governments take approximately 55% of the net revenues derived from each barrel of oil. At \$18, the average price of North Slope crude between 1986-2002, the total government take is 70 percent. While percentage wise, the government take is smaller at higher prices, it yields significantly more revenue. At \$35, the government's 55% share equates to \$4.5 billion; at \$18, its 70%

share equates to \$1.7 billion.

In 2004, the oil industry accounted for 87 percent of Alaska's unrestricted general fund revenues. Over the next decade, DOR projects oil revenues will provide at least 75% of unrestricted general purpose revenues in state coffers.

However, Brady stressed two elements are critical for that healthy revenue stream to materialize – price and production volume. While the state has no control over the price of oil, it can – through a stable and predictable tax regime – encourage new industry investment to offset a 15% forecasted annual decline in production

and predictable tax regime is key to supporting a business climate that can attract billions of dollars in new investments, Brady said.

Industry executives insist the governor's decision underscores the critical need for their companies to have a clear and durable fiscal contract for the proposed gas pipeline – a \$20 billion project requires fiscal certainty. The gas line is anticipated to have a 35-year life, but since the 1970s, the state has increased taxes on the oil and gas industry more than a dozen times, not including increases through changes in administrative interpretations.

Industry believes the governor's decision on ELF brings into serious question whether the state can offer the certainty and stability such a huge investment requires.

"A stable tax environment is absolutely necessary given the scale of investments being considered for Alaska," said Harry McDonald, President of Carile Transportation Systems. "Tax increases, especially those undertaken in a unilateral fashion, create uncertainty for future investors and elevate risk, making it much more difficult for Alaska to attract world-scale investments for world-class projects."

Contractors throughout the oil patch are concerned the tax increase and potential future revisions to the ELF tax structure will put future development and associated jobs at risk.

"Satellite developments in Alaska's maturing oil fields provide the greatest opportunity to increase oil production, as well as jobs in the oil patch," said Larry Houle, General Manager, Alaska

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Governor Defends ELF Decision, Says It Was Fair To Aggregate Six Satellite Fields With Prudhoe For Production Tax Purposes

(Continued from page 5)

Support Industry Alliance. "This action has created more uncertainty than \$9 oil did on industry and its contractors," he added. "Uncertainty leads to delayed investment decisions, and deferred investments mean lost jobs."

Murkowski said he is convinced it was fair to aggregate the six satellite fields with Prudhoe Bay for production tax purposes.

"My decision reflects the producers'

decision to consolidate the individual satellite fields into the Prudhoe Bay unit," Murkowski said. The governor insisted Alaska remains a competitive investment target and the recent decision does not change that.

He said his administration continues to support the intended purpose of ELF, and it is the policy of the state to make certain taxes are never a reason to shut down a field.

The governor sent a letter to RDC

board members last month defending his recent action. The letter is posted on RDC's web site at www.akrdc.org.

Meanwhile, Houle is hopeful there may be some wiggle-room in the state decision with regard to the heavy oil satellites. "Alaska contractors and their employees are concerned about their jobs and hope that reason will prevail and investment will not be reduced so as to ensure a bright future for Alaskans," Houle said.

FISHERY MANAGEMENT COUNCIL TAKES EFH ACTION, REPORT ON IMPACTS TO NON-FISHING ENTITIES REQUIRED

As part of the final essential fish habitat (EFH) Environmental Impact Statement (EIS), consultations will continue to be a requirement of all projects that may have an adverse effect on EFH. However, the National Marine Fisheries Service (NMFS) must now provide an annual report of how its recommended conservation measures waver from those listed in the EIS.

The report must also highlight the impact these conservation measures have on non-fishing activities and their related permits. This report will be presented to the North Pacific Fisheries Management Council on an annual basis.

EFH has been broadly defined by the Magnuson-Stevens Act to include "those waters and substrate necessary to fish for spawning, breeding, feeding, or growth to maturity." The EIS has identified most of Alaska's state waters as being necessary for Council managed anadromous fish (salmon).

The State of Alaska, in an open letter to the Council, expressed its concern regarding the inland reach of EFH and the required consultations. In a plea for states' rights, its letter questioned the need for additional oversight when current state processes adequately protect managed salmon habitat. The state complained the added time and cost to resource agencies, as well as permit applicants, may result in the loss of resource development opportunities without a corresponding benefit to salmon habitat.

Jason Brune, RDC Projects Coordinator, attended the

Seattle hearing, testifying in favor of limiting NMFS' oversight of non-fishing activities.

"The current North Pacific fishery management plans designate EFH in Alaska coastal and inland areas to an excessive and unworkably broad extent," said Brune. "For managed salmon species, the designation extends to virtually all stream and inland water areas salmon may occupy at some point during its life cycle, including wetland areas," Brune noted. "They fail to distinguish habitat truly necessary to managed fisheries from generic habitat, and therefore, render the term 'essential fish habitat' meaningless."

With the final EIS completed, RDC will focus its efforts on modifications to the statutory definition of EFH, as defined in the Magnuson-Stevens Act.

Senator Ted Stevens, Chairman of the Senate Commerce Committee, will be leading efforts to re-authorize the act this year. RDC is encouraging Senator Stevens to limit EFH in Alaska to the Exclusive Economic Zone (EEZ), 3-200 miles offshore.

In approving the final EIS, the Council also took significant action at the meeting to ban bottom trawling on more than 370,000 square miles in federal waters off Alaska. The majority of the new closures were established to protect coral habitats

in the Aleutian Islands. The Council also established numerous site-specific Habitat Areas of Particular Concern (HAPC) which include seamounts and fragile coral gardens, and put in place measures to protect these important habitats as well.



The Pogo Mine, 250 miles from the coast, was required to undergo EFH consultations. NMFS will now be required to provide an annual report of how its recommended conservation measures impact non-fishing activities.

**ELF: PUBLIC PROCESS ABSENT FROM STATE DECISION**

In the past I have used this column to discuss some of the abuses of public process that have bothered me. In this column I want to discuss what happens when there isn't any public process, which was the case recently when the state administration changed the calculation for the Economic Limit Factor (ELF) on the Prudhoe Bay field and surrounding oil developments.

I should begin by saying I am not opposed to revisiting ELF. However, I have always thought the issue should be considered as part of the development of a long-term fiscal plan, and not as a unilateral action affecting the industry already paying most of the state's bills.

I also believe any consideration given to potential ELF revisions should have resulted from a public process, most likely taking place in the legislature. Much to my surprise, the recent decision resulting in a \$150 million to \$200 million annual change in the interpretation of ELF met neither of these two seemingly reasonable criteria.

The results were predictable. The oil industry and many others in the business community were stunned. Those who have been clamoring for higher taxes on the oil industry were cheering. I wonder what their reaction would have been if the state had lowered taxes on the oil industry without any public process. Actually, I don't wonder at all – they would have been screaming for a public review of the decision.

But it is not just the process that concerns me. I also have some major questions about the decision itself.

In essence the state has decided the Prudhoe Bay field and some of the surrounding satellite fields are "economically interdependent" because they share the same processing facilities. The result of this decision is production taxes are increased both on the satellites and on the Prudhoe Bay field because the reserves from all the oil production are aggregated.

My concerns fall into several categories.

First, the state will now collect \$150 million or more annually from the oil industry to help address our fiscal dilemma without having any plan for addressing the rest of the problem. It seems to send the wrong message to the industry that has been the mainstay of support for Alaska's government for the past 30 years, and gives them no comfort we won't be asking more from them next year.

Next, this change in tax policy makes Alaska's fiscal regime even more regressive than it already is because the change made by the Department of Revenue (DOR) will apply to production at any oil price. Most people who advocate for a change in ELF want the change to take into account the current high oil prices. But most of these people are willing to give something up during times of low oil prices. The decision by DOR means we have substantially increased the risk to investors in current and future oil developments around Prudhoe Bay if and when low prices return. This increased

risk will be taken into account when investments in Alaska are measured against those in other parts of the world.

My next concern relates to what seems to be a reversal of the long-standing state philosophy of attempting to minimize construction

of processing facilities on the North Slope. There are both environmental and economic reasons for this philosophy. The environmental reasons are obvious. The economic reasons relate to the very high cost of constructing and operating facilities on the Slope. Using central facilities for processing clearly makes economic sense, but DOR's decision seems to send the message the state would prefer producers to build individual facilities for each new development.

Because the change in tax policy increases the tax rate not only on smaller satellite fields, but also on Prudhoe Bay itself, a particularly difficult situation is confronting the independents we have been attempting to attract to the Slope. The independents are a potential asset to the state because they are probably more interested in and better able to develop the smaller accumulations of oil, which may be the future trend of North Slope development.

However, the decision by DOR increases the cost and risk of these developments. In addition, the owners of existing facilities may be much less willing to allow the use of those facilities by independents, because adding new accumulations of oil to their existing production may up the owners' taxes, too.

DOR's precedent-setting decision leaves open a very important question: will this policy change apply to other areas with centralized facilities such as Alpine and Kuparuk? The administration says "No," but how can anyone be certain the answer won't be "Yes" in some future year or under a different administration?

I am also concerned about how this decision will affect the negotiations on the gas line. It's difficult for me to see how it can improve the odds of a speedy resolution of the difficult economic issues that need to be resolved in order for Alaska's stranded gas to be developed.

Some have suggested the administration was "firing a shot across the bow" to get the attention of the oil companies. If so, I fear the shot may have actually hit the ship, and it may be years before we can fully assess the damage to the unintended target and to the "ship of state."

"Some have suggested the administration was 'firing a shot across the bow' to get the attention of the oil companies. If so, I fear the shot may have actually hit the ship, and it may be years before we can fully assess the damage to the unintended target and to the 'ship of state.'"

Arguing Alaska's ELF issue

AOGA contends ELF doing job it was designed to do; state says Prudhoe satellites didn't require new infrastructure

Kristen Nelson

Petroleum News Editor-in-Chief

The debate over the governor's decision to aggregate Prudhoe Bay satellites for production tax purposes was heard in the Alaska House Special Committee on Oil and Gas in early February, with the Alaska Oil and Gas Association taking the floor Feb. 1, followed by the departments of Revenue and Natural Resources Feb. 3.

AOGA reviewed the history of the economic limit factor or ELF for the committee, while state officials provided the administration's perspective.

AOGA: Both price and volume 'critical'

Judy Brady, executive director of AOGA, introduced Tom Williams as the "conceptual father of ELF." Williams, Alaska tax counsel for BP Exploration (Alaska) and chairman of the AOGA tax committee, went to work for the state in 1973, was commissioner of Revenue from 1979 to 1982, and has been with BP since 1987.

Both the price and volume of oil are "critical for state revenue," Williams told the committee. To hold volume at just under a million barrels a day, the state needs new production — which requires new investment — from four sources: heavy oil, in-field development, satellites and wildcat exploration.

"The question is, does Alaska's fiscal system encourage or discourage new investments in each of these areas?" Williams asked.

There are four components to oil and gas taxes. Royalties, the state's cut from every barrel of oil or cubic foot of gas that comes from a state oil and gas lease, are "the mainstay of Alaska's revenue system," said Williams. Royalties are almost half of the general fund unrestricted revenues and "by far the largest source of oil and gas revenues."

Like production or severance tax, royalties are sensitive to oil and gas price fluctuations. Property tax is not sensitive to prices, and income tax is only moderately sensitive because it is based on a proportion of all of a company's operations, and the range of those operations makes the income tax less sensitive to oil and gas prices, Williams said.

AOGA: ELF aimed at sustaining production

In the 1970s the Alaska Department of Revenue wanted to make sure that the state's production tax, which comes off the top, before any operating costs are figured, did not result in production being shut in.

The ELF, Williams said, first "saw the public light of day" in a 1977 Department of Revenue report as a recommendation to prevent total production costs from overtaking the value of oil or gas as production costs rise later in the life of a field. When ELF was passed by the Legislature, Williams said, the formula proposed by the administration was changed so that the ELF was based on a presumption that 300 barrels a day was needed

for a well to break even at Prudhoe Bay.

In 1989, Williams said, field size was added to ELF, with 150,000 barrels per day added to the formula. The effect of the addition, he said, was that if a field produced more than 150,000 bpd, the 1989 change moved the ELF up towards one (an ELF of one means the field would pay the full production tax rate); if a field produced less than 100,000 bpd, the formula change moved the ELF down towards zero, which moved the production tax toward zero.

AOGA: 1989 ELF change aimed at smaller fields

In 1981 the Legislature reduced the state's corporate income tax on oil and gas and in an attempt to compensate for that tax loss, increased the production tax to 15 percent from 12.25 percent, and suspended the ELF at Prudhoe Bay until 1987. When the Prudhoe Bay suspension ended, the state's revenue was cut by \$135 million for the next fiscal year.

The Legislature, Williams noted, said the 1989 change would increase revenue, give an incentive for small fields and give an incentive for development of West Sak heavy oil.

The 1989 ELF changes reduced production tax rates for all fields except Prudhoe Bay and Kuparuk. The Legislature was told by the administration that Prudhoe Bay and Kuparuk could afford higher taxes; reduced investments as a result of the higher taxes were expected to have a small impact on total production.

The Legislature was also told that marginal fields included all the Cook Inlet fields and Milne Point, Lisburne, Endicott, Niakuk, West Sak, Point Thomson "and probably any other field that will be discovered in Alaska."

Endicott, which then produced some 100,000 bpd, was the largest field to have its taxes reduced under the 1989 ELF change, and the Legislature was

told that under the new ELF, for "marginal fields the severance tax ... will either be sharply reduced or eliminated entirely." The Legislature was also told that smaller fields would pay less tax — even with the same well productivity as larger fields.

AOGA: Williams: marginal equals small

Williams told the committee that in the 1989 discussions, "marginal was not used in a dictionary definition of marginal: small was marginal. Probably any other field that would be discovered in Alaska would be marginal, unless it was a super giant. ... This is a different concept of marginal than the standard concept, the dictionary definition.

"And it's important to understand that, because that's what the Legislature was told, not by the industry, so much, but by the administration," Williams said.

The Legislature was told, he said, that a small field could pay no severance tax.

And the Legislature was told there would be revenue gains, that over the next 20 years the state would be ahead by some \$2.7 billion "and in fact it was."

Williams was asked how Alaska's system compared to other countries, and if other oil provinces had anything similar to ELF, and he said he wasn't an expert on how other countries worked, but he thought the real question for Alaska is: "Are you getting the oil that you should be getting? Are you getting the investments that will keep oil production up?" You don't want to ignore what the rest of the world is doing, he told legislators, "but the real question is, are you seeing the investments here that need to be made? Do you expect to see them continue in the future" to keep production at a million barrels a day.

AOGA: Volume is the issue

Brady said oil will continue to be the mainstay of Alaska's economy and the big issues around oil are price and volume.

"We can't do very much about price," she said.

Volume, however, is a different thing.

In 1989 the Alaska departments of Revenue and Natural Resources said that in 15 years production would be down below 500,000 barrels per day, Brady said. That prediction was made at a time when 2.1 million bpd were moving through the pipeline.

And that prediction was based on Prudhoe Bay and Kuparuk.

"The reason that we didn't go all the way down was because of all the investments that were made in Prudhoe Bay and Kuparuk. And all the technological breakthroughs and all the things that the companies did to make sure that didn't happen."

Without those investments, Brady said, production would be about 300,000 bpd today.

The ELF changes in 1989, she said, were made "to help satellites and heavy oil, but those fields did not start coming on until almost 10 years later." And they have been developed "on the basis of the promise that there would be no tax on those fields. It took about 10 years for them to be developed and starting to produce ... and now we're starting to talk about taxing them again, after the investments have been made."

In 1989, Brady said, the state decided to "hit the big fields hard, but everything else is going to be home free because we need that production" that will come from small fields.

Volume is the issue, she said: "If we don't get this production, no matter what the prices are going to be, we're going to be in a world of hurts."

AOGA: Aggregation by ruling

State law has allowed for aggregation of fields since before Prudhoe Bay came online, Williams said. Because of complicated patterns of leases and ownership in Cook Inlet, where you have economic interdependence you can lump the various pieces together to recognize the whole operation.

Pre-1989, he said, it didn't make much difference if you lumped fields together or not. But the 1989 ELF changes, Williams noted, rewarded smallness, and after that lumping fields together made a big tax difference, "and that's in fact what this recent decision was about, whether the satellite fields, the six satellite fields, that are sharing facilities with the main field at Prudhoe Bay, should be lumped together with that main field."

Williams said the Department of Revenue has adopted regulations allowing it to give rulings in advance on whether satellites will be aggregated.

Companies that are proposing satellites can get rulings from the department on how a satellite will be treated, if it will have a separate ELF from the fields whose facilities it will share.

"And so those rulings have been granted. That's how the administrative response has been to deal with the issue."

The state is counting on new investments and new production from heavy oil, in-field development, satellites and wildcat exploration to keep production at just under a million barrels a day through 2015, Williams said.

"The question is, does Alaska's fiscal system encourage or discourage new investments in each of these areas?"

Brady said the Alaska Oil and Gas Association agrees "right now that the state tax system is working the best a tax system can work. It's not the perfect tax system, but it's pretty darn close. You're getting investments in heavy oil, in satellites, in-field and in wildcats, so we are getting investments that we need right now with this tax system."

The state, she said, gets "a consistently high overall return, especially on the medium prices — and even at high prices you're getting a very substantial return."

Industry hopes, she said, "that the fiscal system will stay the way that it is and as you look at it to see whether it should stay as it is, that you keep in mind that we continue to need these four kinds of investments."

Revenue: Investment in forecast

Dan Dickinson, director of the Alaska Department of Revenue's Tax Division, told the committee Feb. 3 that Revenue made its aggregation decision based on "what we thought was the appropriate way to tax those fields."

And, he noted, Jim Bowles, president of ConocoPhillips Alaska, "sent a letter to the governor that identified the fact that he'd asked us for rulings on Alpine — the satellites at Alpine — that ConocoPhillips hopes to bring on over the next several years."

The company based its economics on separate ELF treatment, Dickinson said, and told the state that if the Alpine satellites don't get separate ELF treatment, those economics will have to be revisited.

And how likely is it ELF treatment will mean less investment in Alaska? Dickinson asked.

There are several factors, he said, one of which is that "most of these

companies are capital constrained; they're going to take capital and they're going to invest it where they think they get the best return over time. And the best return isn't necessarily again a single dimension, but they look at the upsides, the downsides, they ... have a portfolio." Sometimes, he told the committee, "I don't understand" investment decisions the companies make and sometimes people in a company's Alaska office don't understand why headquarters made a decision the way they did.

Revenue: ELF results not what expected

Dickinson said he didn't think the people who redesigned ELF in 1989 "got what they expected."

"A lot of the focus (in 1989) was on standalone facilities, production facilities ... folks went out and made investments and created their own production facilities," he said.

"And that's I think what people were focused on because they talked about the cost of the production facilities and you have all those costs associated with that production."

But, he said, what has happened over time is that new production has been brought on that uses existing facilities and "that's not what was contemplated, that kind of development."

Revenue: Many fields have rulings

Committee Chair Vic Kohring, R-Wasilla, asked Dickinson if other fields with satellites could be hurt by aggregation.

Dickinson said Revenue's regulations provide a process for getting "an advance letter ruling, just like they would from the IRS, that says we will not aggregate this field... essentially giving them some certainty" about

production taxes.

Those letters have been issued, he said, and cover a good deal of production at the Milne Point and Kuparuk River fields. The division was careful, he said, not to overturn any of those existing rulings.

There are issues of taxpayer confidentiality, Dickinson said, and situations differ, but "we'll have to figure out some way of getting that language out to everyone else as we make policy for adjudication..."

The purpose behind the division's regulation, he said, "is to allow folks to understand what their taxes are going to be and I think another thing that it might be important for us to do is to be more precise when we grant these letters: to say, here's the situation, here's the tax situation."

Revenue: Infrastructure differences

Committee Vice Chair Ralph Samuels, R-Anchorage, asked Dickinson about recent decisions at Kuparuk, and Dickinson said there are a series of decisions including West Sak, Tabasco, Tarn and Meltwater. Why, Samuels asked, did decisions go in favor of a separate ELF at Kuparuk, and against it at Prudhoe?

Dickinson said Tarn and Meltwater are examples of the difference: Tarn is some 10 miles from Kuparuk facilities, he said, and was developed from new drill sites. Meltwater is an additional six or seven miles out from Tarn, again on a new drill site.

"If you go to the west end of Prudhoe Bay," where a lot of the Prudhoe satellites are, you find a drill site and "each well is going down to a different — at least before the aggregation decision — what might be a different field."

If you focus on "what's on the surface, on the economics of putting together these systems, I think you'll see that that's a very different situation,"

Dickinson said.

Another difference between Kuparuk and Prudhoe, he said, is that "in Kuparuk there is a slight difference of ownership ... between the satellites and the mother field" so satellite owners sending production to the main field have to deal with the different ownerships.

At Prudhoe, until 2000, "the satellites were owned in very different percentages than the mother field and that, I think, impeded a lot of the development." The equity re-determination at Prudhoe resulted in everybody owning the same percentage of everything — the field and satellites, the roads, the production facility. "So that somebody didn't say well, gee, if you put your production in this production facility on that road and you use that electrical line, I want to get reimbursed each time."

Dickinson said the regulations clearly contemplate that decisions on satellites "would be issued beforehand, in other words, if it's going to be a factor in the decision to invest, then you have the opportunity to get it before and to insist on getting the letter before you make your investment."

Oil and Gas: Economies of scale

Bill Van Dyke, Department of Natural Resources Division of Oil and Gas petroleum manager, told the committee that at Prudhoe, the main field "supported the initial development" and the smaller pools are "like icing on the cake."

There are multiple shared facilities at Prudhoe Bay, Van Dyke said, and for the satellite pools "they didn't go out and build all new facilities to produce pools. No, they're using the existing facilities. And that's good. Because that means obviously development costs are a lot lower, because you're just using what's already there."

The satellites at Prudhoe have been known, because the companies drilled

through them early on, Van Dyke said, but because of disparate ownership development was difficult until the common equity agreement was reached in 2000.

There are a few facilities at Prudhoe that the common equity agreement does not cover, but those are in the minority. But for the most part, he said, "everybody owns the same interest in everything, and it really changed the way business is done in Prudhoe Bay. I don't think it's any coincidence that starting in the year 2000 after this common equity agreement that you could see the satellite production blossom at Prudhoe Bay." The satellites are producing close to 50,000 bpd, he said. "It's like finding a huge new oil field on the North Slope."

Oil & Gas: Other opportunities

There are other investment opportunities on the North Slope, Van Dyke said, but companies will have to be able to make a profit in order to develop them. Companies look at factors such as the flow rate from wells, location in relation to infrastructure and access to that infrastructure, he said.

There are also some big fields that have been discovered but haven't been developed because they're offshore the Arctic National Wildlife Refuge "out in relatively deep water," Van Dyke said, on the federal outer continental shelf.

Because they are remote, "they're going to be very expensive to develop and so today they just sit there."

The offshore wells, like Kuvlum and Hammerhead, even if the federal government decided to charge zero royalty and zero severance tax "those fields are probably uneconomic to develop today. So there's not a whole lot government can do other than pay someone to produce them," he said.

An onshore example of an uneconomic accumulation is the viscous Ugnu

formation at Kuparuk, Prudhoe Bay and Milne Point. The accumulation is known because companies drill through it, but it sits there because it's not economic to develop today.

There is a continuum of projects on the North Slope, he said, "they'll always be projects that are very much uneconomic; they'll be some in the middle that are maybe right on the edge; and they'll be some that are highly economic. And that's true today. That was true 20 years ago. And it will be true probably 20 years out into the future."

Van Dyke said companies make decisions to develop on a case by case basis, looking at factors such as cash flow expected from a development, how much risk is involved and what the company's forecast is for oil prices. A project that's acceptable to one company might not be to another, he said. "They all forecast price differently. And they all evaluate the risks differently, both the geologic risk and the commercial risk and ... the chances of changes in government take down the road."

Alaska's Current Oil and Gas Fiscal System

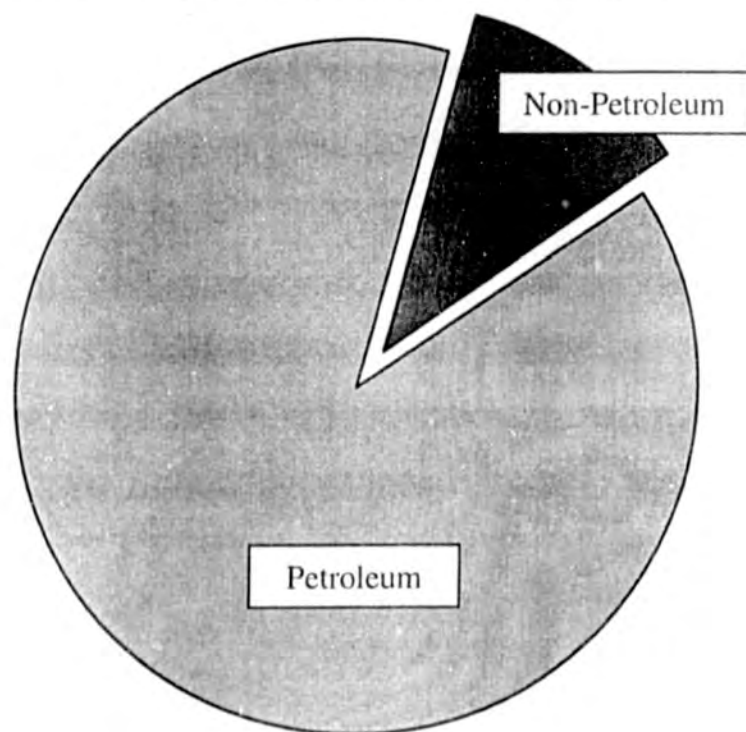
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Oil & Gas: Vital to Alaska

FY05 Unrestricted Revenue



“Oil revenue will provide at least 75% of forecasted Unrestricted General Purpose Revenue through FY 2014. Two elements are critical to the oil revenue forecast: price and volume.”

Fall 2004 Revenue Sources Book

Present System's Four Elements

	<u>FY2004 Actuals (\$millions)</u>	
	<u>To General Fund</u>	<u>To "Other"</u>
Royalty	1,043.6	485.2
Production Tax	651.9	-
Property Tax	47.3	218.7
Oil & Gas Corp. Income Tax	<u>298.8</u>	<u>-</u> a
TOTAL	2,041.6	703.9
ALL OIL & GAS PAYMENTS	 2,745.5	

(Royalty "Other" is the Permanent Fund; property tax "Other" is municipalities taxing the same property.)

Point No. 1

Even if ELF makes the production tax zero for a field, the field –

- pays full royalty to the State**
- pays full property taxes on its facilities**
- contributes fully to the owners' income taxes**
- increases the netback value by lowering tariffs**
- creates Alaska jobs**

Production Tax

- A tax on the act of producing oil, gas
- **Tax = ELF × Base Rate × Gross Resource Value**
 - Gross Resource Value = Netback × Taxable Volume
 - Base Rate: gas 10%; oil 12¼% 1st 5 yr, then 15%
 - ELF: a field-specific number from zero to one

Oil ELF is based on field size and well productivity; larger fields have larger ELF's and higher tax rates, as do fields with more productive wells; smaller fields and ones with low well productivity have smaller ELF's and lower tax rates. Gas ELF is based on well productivity only

Netback Methodology



West Coast Spot Price	\$25.00
Marine Transportation	(1.61)
TAPS	<u>(3.05)</u>
Netback at Pump Stn. 1	\$20.34

Why Have an ELF?

To allow a high-rate production tax early in a typical field's life, while avoiding the adverse consequences as the field is depleted

The Adverse Consequences of a High Rate

“As operating costs rise during the life of the field, the profit margin shrinks. At some point the total production costs overtake the value of the oil or gas produced, and production can then be continued only by operating at a loss. As one of the costs of doing business, the production tax contributes to the total costs and tends to hasten the time when this break-even point (called the economic limit) is reached.”

DOR, Alaska's Oil and Gas Tax Structure: A Study with Recommendations for Improvement (Feb. 1977), p. V-21 (emphasis added)

The Adverse Consequences of a High Rate



Stage 1



Stage 2



Stage 3



Stage 4

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Producers' Responses to the "Squeeze"

- **"Do nothing" stage**
- **"Drive for efficiency" stage**
- **"Harvest" stage**
- **"Running in the red" stage**

“[T]he Department of Revenue recommends an Economic Limit Factor (ELF), based on the ratio of the rate at the true economic limit to the current production, as a mechanism for scaling down the tax rate as the production declines toward the economic limit.”

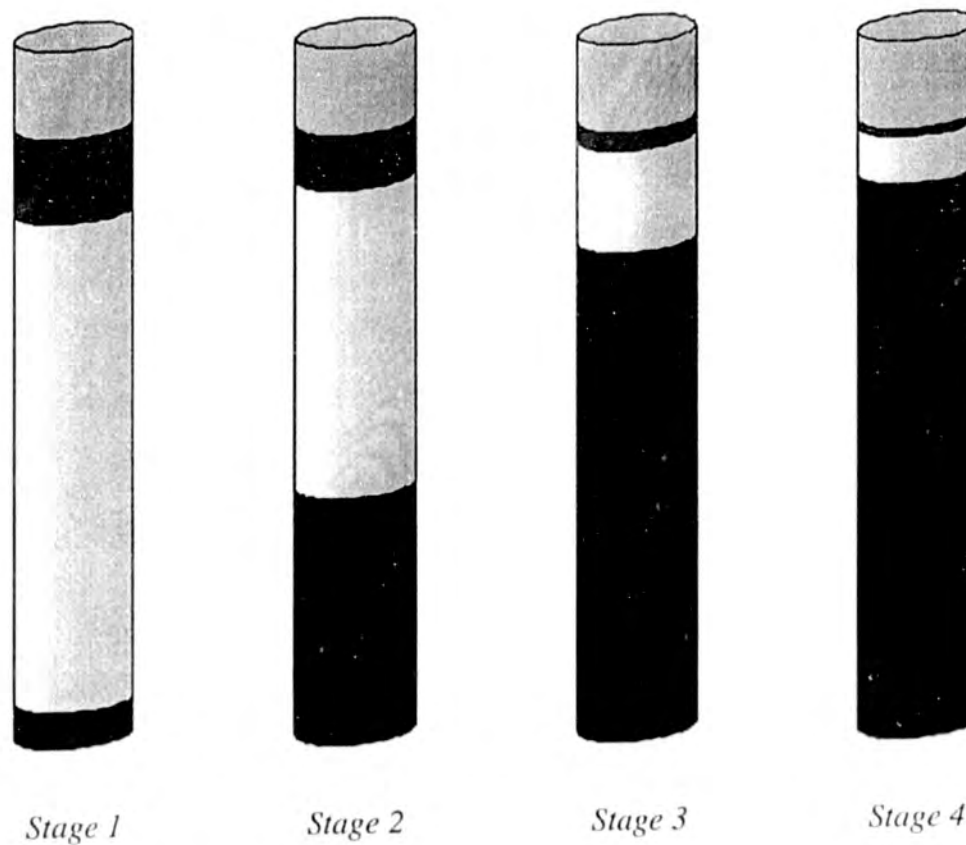
DOR, Alaska's Oil and Gas Tax Structure: A Study with Recommendations for Improvement (Feb. 1977), p. VI-17

$$\left(1 - \frac{PEL}{TP}\right)$$

PEL = Production at Economic Limit

TP = Total Production in tax period

How ELF Avoided the Adverse Consequences



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Point No. 2

ELF was enacted in 1977 over industry's strenuous objections

- **Why object? ELF allowed effective tax rate for Prudhoe Bay to be increased to ~11.7% from ~7.8%**

How the Oil ELF was Changed in 1989

1977 formula was driven by “well productivity”

1989 added “field size” (total daily production) to the formula

- **Larger fields have larger ELF's, higher tax rates**
- **Smaller fields have smaller ELF's, lower tax rates**
- **“Field size” is the dominant factor in the formula**

Reasons Given in 1989 for the ELF Change

- 1. To get more revenue**

Reasons Given in 1989 for the ELF Change

2. To give an incentive for small fields

“Marginal fields are fields with either relatively low per well productivity or relatively low daily production.”

DOR, Response to Questions from House Resources Committee – HB 118
(February 21, 1989), p. 1 (emphasis added)

Reasons Given in 1989 for the ELF Change

3. To give an incentive for West Sak viscous oil

“[T]he new ELF will increase drilling production and employment at the truly marginal fields ... and, let’s hope someday, West Sak In those fields the severance tax, under HB 118, will either be sharply reduced or eliminated entirely. That’s a pro-development impact on those fields.”

Tape HRC 89-121, side 1 (February 10, 1989), testimony of Gregg Erickson, Senior Economist, Division of Policy, Office of the Governor (transcript), p. 10

Reasons Given in 1989 for the ELF Change

4. Prudhoe Bay & Kuparuk could afford it

What legislators were told the change would do

1. Reduce rates for all fields except Prudhoe Bay & Kuparuk

“[For] marginal fields, ...the severance tax, under HB 118, will either be sharply reduced or eliminated entirely.”

Tape HRC 89-121, side 1 (February 10, 1989), testimony of Gregg Erickson, Senior Economist, Division of Policy, Office of the Governor (transcript), p. 10 (emphasis added)

“In Alaska the marginal fields are the six Cook Inlet fields ... [and] Milne Point, Lisburne, Endicott, Niakuk, West Sak, Point Thomson, Seal Island, and probably any other field that will be discovered in Alaska.”

DOR, Response to Questions from House Resources Committee – HB 118 (February 21, 1989), p. 1 (emphasis added)

What legislators were told the change would do

2. Tax rates for some fields could go to zero under the new ELF that weren't zero under the old ELF

“[For] marginal fields, ...the severance tax, under HB 118, will either be sharply reduced or eliminated entirely.”

Tape HRC 89-121, side 1 (February 10, 1989), testimony of Gregg Erickson, Senior Economist, Division of Policy, Office of the Governor (transcript), p. 10 (emphasis added)

What legislators were told the change would do

3. Smaller fields pay less tax even with the same well productivity as larger fields

What legislators were told the change would do

4. State revenue gains from changing the ELF

- **Projected cumulative effect through FY2010**

Prudhoe Bay	\$2.500 billion
Kuparuk	0.391 billion
All others	(0.200 billion)
Net	\$2.691 billion

Point No. 3

The 1989 ELF change has worked exactly the way legislators were told it would work

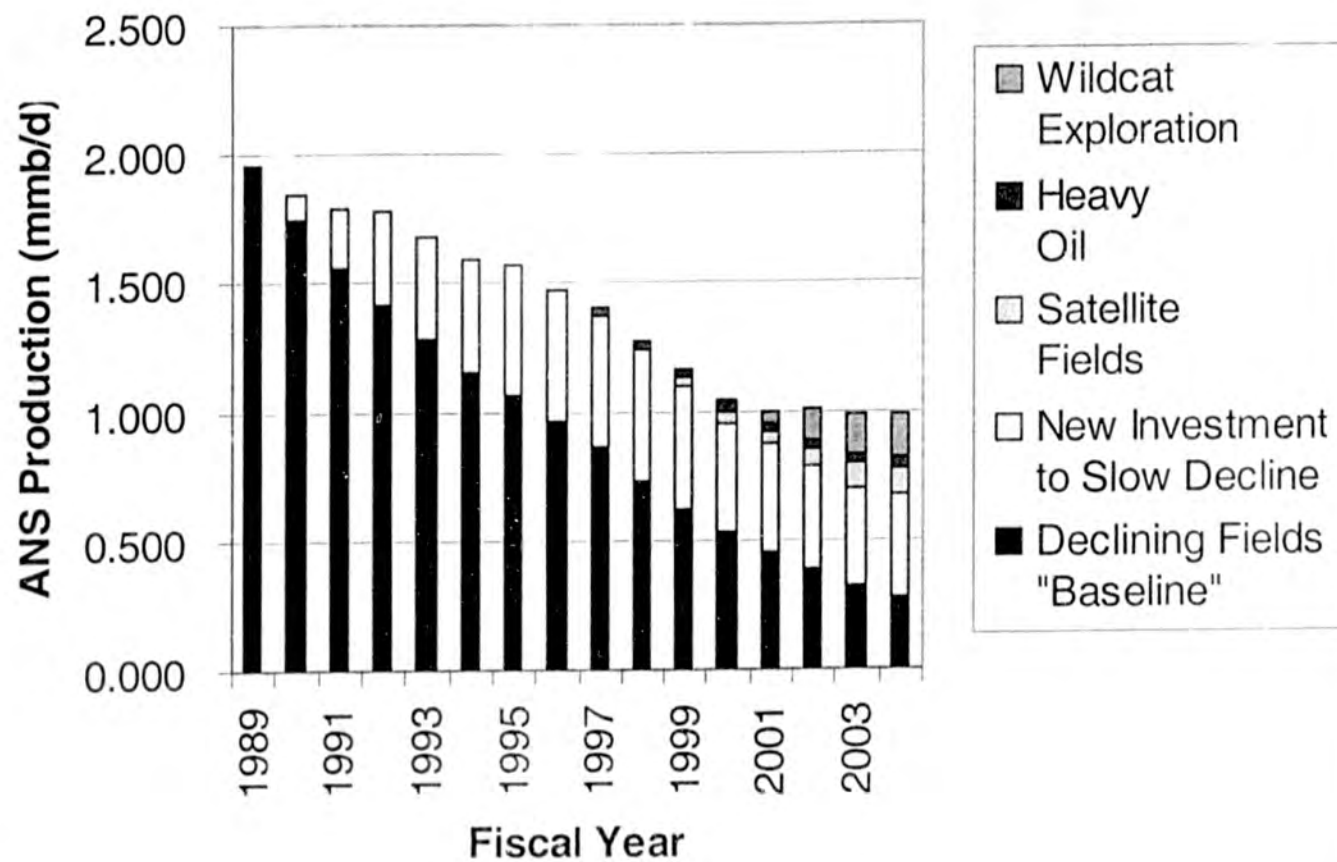
- **Prudhoe & Kuparuk still have higher production tax**
- **Some fields don't pay production tax**
- **Small fields pay less even with same well productivity**
- **State already is over \$2.7 billion ahead (net)**

Point No. 4

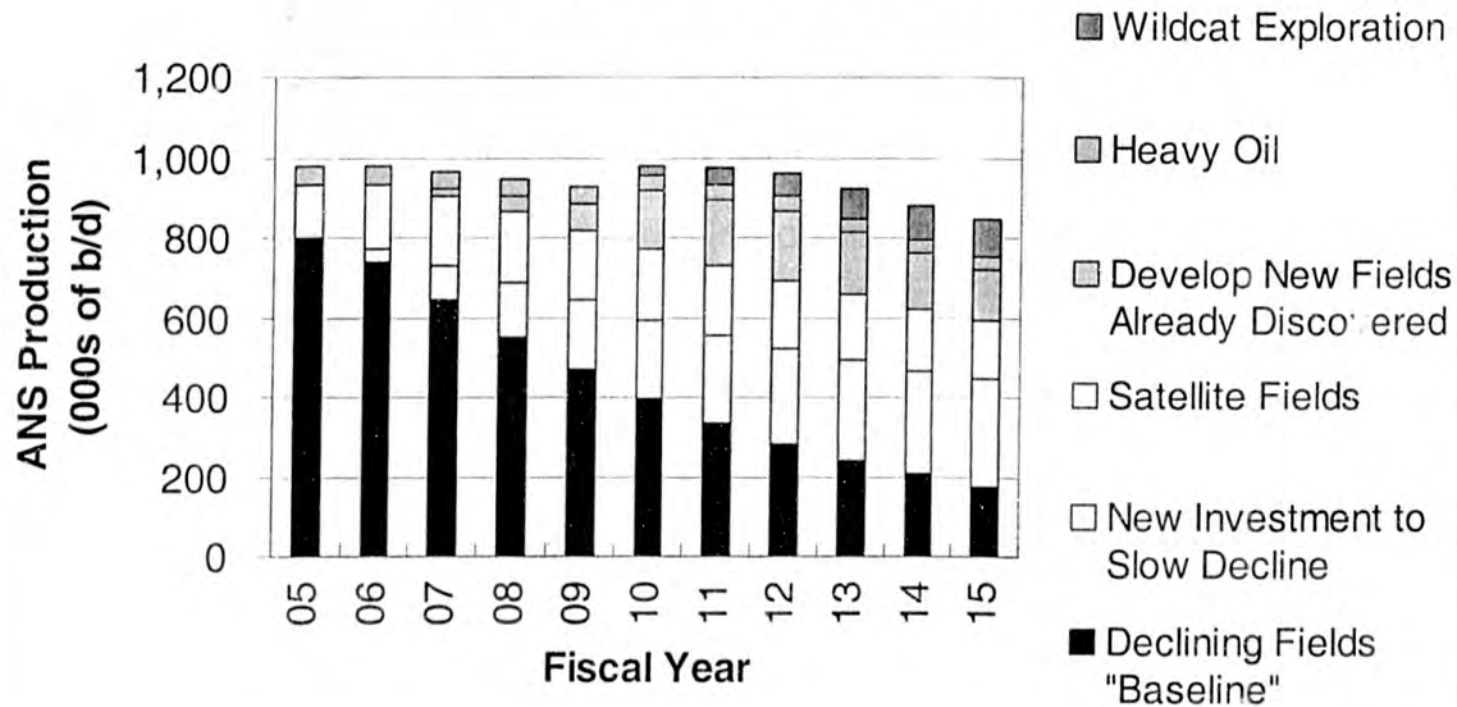
1989 ELF change was enacted over industry's strenuous objections

- **Why? Major tax increase for Prudhoe Bay & Kuparuk**

Historical Effects on ANS Production from Different Kinds of Investment



Contributions of Different Kinds of Investments in Additional Oil Production



SOURCE: DOR *Spring 2004 Revenue Source Book*, p. A5, "Historical and Projected Crude Oil Production".

Wildcat = "NPRA" production

Heavy Oil = "Milne Point" production (a simplifying assumption in the absence of published projections by DOR for West Sak production in other units)

New Fields Already Discovered = "Fiord" + "Point Thomson" + "Liberty" + "Nanuk" + "Known Onshore" + "Known Offshore" production

Satellites = "PBU-Satellite" + "KRU-Satellite" production

Declining Fields "Baseline" = "Prudhoe Bay" + "Kuparuk" + "Endicott" + "GPMA" production declining at 15%/yr starting in mid-2006, plus "Alpine" and "Northstar" production without adjustment from DOR's forecast

New Investment to Slow Decline = difference between Prudhoe/Kuparuk/Endicott/GPMA "baseline" above and DOR's forecasted production from them

Point No. 5

More investment is CRUCIAL

Different kinds of oil investment have different economic profiles

A given tax change promises to impact different classes of oil investment differently

Any change must be carefully examined for “unintended consequences”

What the Governor's ELF Decision Did

Lumped 6 smaller fields within the Prudhoe Bay Unit with the main Prudhoe Bay Field (aggregation)

Because of the “field size” component of the ELF formula, aggregating the fields increased the ELF and tax rate for all of them

Two of the 6 fields aggregated with the main Prudhoe Bay field are West Sak viscous oil

Recent Legislative Proposals – HB63/SB50

AOGA Opposes Passage of HB63/SB50

- Industry views these proposals as a structural tax increase at all price levels except extremely low ones
- Imposes a 27.5% structural tax increase at DOR's expected \$25.50 price
- Raises the maximum tax rate by 67% (from 15% to 25%)
- 5% minimum imposes a heavy burden on satellite development
- Fails to protect significant amounts of viscous oil (West Sak)
- Proposed without analysis of the consequences for investments
- Makes Alaska less competitive