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ARCO Alaska, Inc.

House Resources Committee

Agenda

Low Cost & Long Term

Common Goals

International Competitiveness

What it Takes

Immediate Actions

Next Steps

Common Goals

Low Cost & Long Term

The State and ARCO Share Important Common Goals

Jobs for Alaskans

Incremental Revenues

- **No Changes in Producing Reservoirs in Existing Fields**
- **Opportunity to Increase Permanent Fund Contributions, While Maintaining Current Contribution Levels**

Achieved By Sustained Economic Development

- **Exploration**
- **Marginal Developments**
- **Extension of Field Lives**

To Achieve Sustained Economic Development the Environment Must be Competitive

Worldwide Fiscal Regimes are Getting More Competitive

Low Cost & Long Term

EXAMPLES:

Australia introduced Resource Rent Tax in 1985 for offshore projects.

Venezuela:

- Income tax rate for extra heavy crude developments lowered from 67% to 34%
- Removal of onerous tax provisions for multinational firms

Alberta/Canada: Fiscal reformations lead to oil&gas industry turnaround after 1986 crash.

Norway abolished royalties on new fields in 1986. Removal of Sliding Scale state participation for new leases in 1992.

UK abolished royalties on new fields in 1984 and PRT for new fields in 1993, leading to a revival of UK oil industry.

Low Cost & Long Term

Fiscal Regime Comparison as of 1994 (New Fields)

	Alaska	U.K.	Australia (Offshore)
Profit taxes			
Corp. Income Tax	39%	33%	33%*
Revenue Taxes			
Royalty	13%	0% after 1984	0% after 1985
Production Tax	0-15%	-	-
Other			
Ad Valorem Tax	2%	-	-

* In addition a Resource Rent Tax kicks in once oil co's earned a return on investment. For marginal developments, this would add 0 to 5%pts at today's prices, and about 10%pts at $20 WTI.

Summary of Worldwide Fiscal Regimes (Petroconsultants, 1994)

Low Cost & Long Term

Number of Fiscal Systems by Category

Production Sharing Contract			Tax/Royalty System			Total
Standard PSC	w/ Royalty Variable	w/ Royalty Fixed	Profit-Based Tax Only	Royalty Variable	Royalty Fixed	
19	7	9	8	10	17	70

Countries > 200 MBOPD

Standard PSC	w/ Royalty Variable	w/ Royalty Fixed	Profit-Based Tax Only	Royalty Variable	Royalty Fixed	Total
9	1	5	3	1	3	22
Indonesia Oman Qatar Egypt Ecuador India Libya Angola Syria	China	Yemen Malaysia Algeria Columbia Gabon	U.K. Norway Australia	Canada	U.S. Argentina Nigeria	

What it Takes

Low Cost & Long Term

Work With the State to Develop That Competitive Environment

- **Support State's Effort to Achieve Soft Landing**
- **Develop Competitive Tax / Royalty Structure**
- **Transition to More Flexible Regulatory Environment**
- **Industry Must Focus on Keeping Cost Structure Low**

Immediate Actions for the Short Term

Low Cost & Long Term

Review / Clarify Legislative Intent for Application of Existing Incentives

- Exploration Incentive Credits
- Lease Sale Schedule
- Discovery Royalty Credit

Review / Support Flexibility in DNR to Provide Royalty Relief

- Lease Sale Terms
- Smaller Discoveries
- Prolonging Economic Life

Support Calls for Federal Tax Incentives for Oil and Gas Development

Low Cost
& Long Term

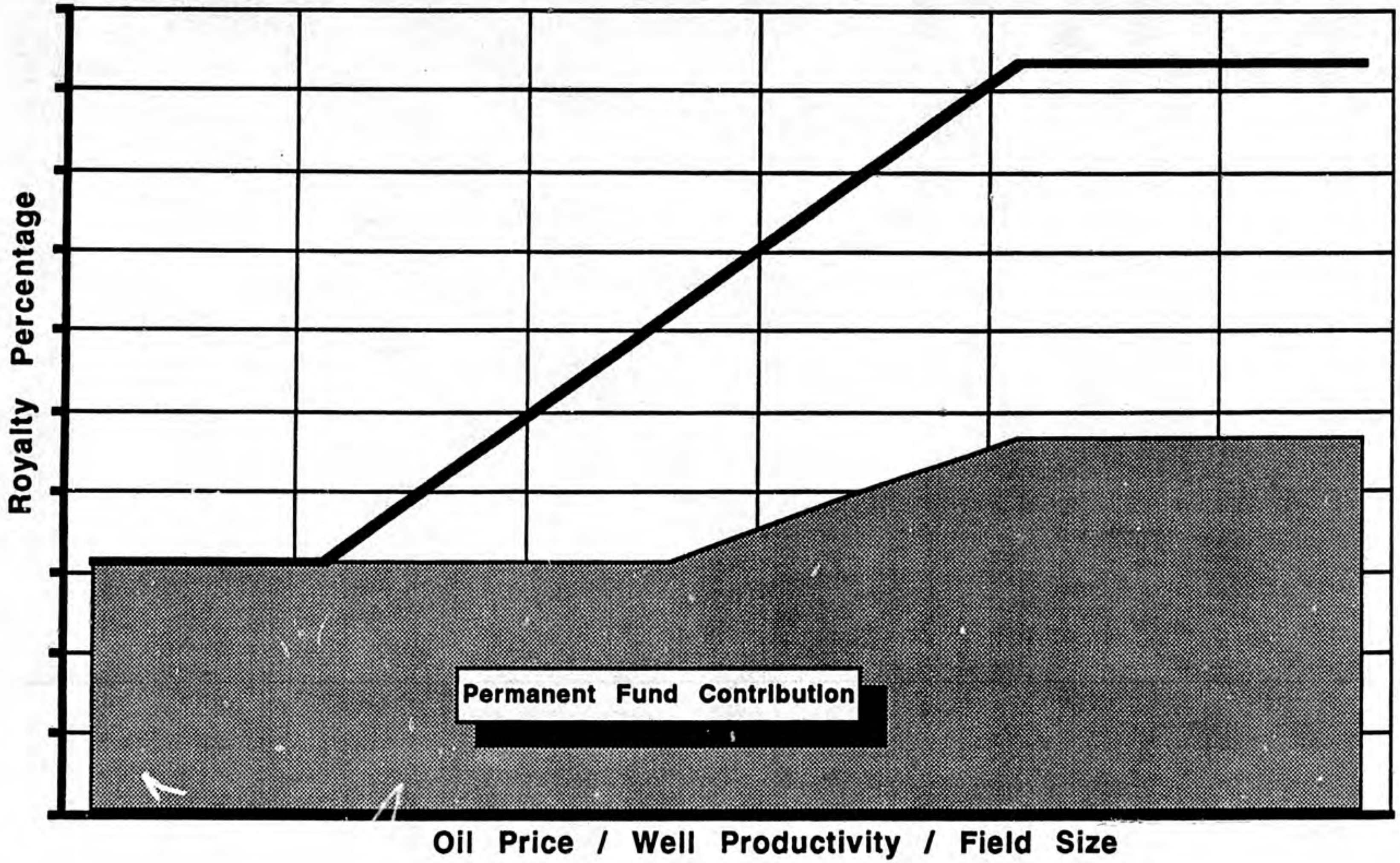
Next Steps for the Long Term

Implement the Process Described Below to Examine Alaska's Long Term International Competitive Position and Recommend Alternative Proposals for Legislative Consideration

- **Legislative / Administrative / Industry Cooperation**
- **Focus First on Gathering Information on Competitive Fiscal Regimes**
- **Develop a Broad Range of Options**
- **Narrow Finally to Specific Proposals for Legislative Action**

Conceptual "Fixed-Variable" Royalty

Low Cost & Long Term



Potential "Project Partnering"

Low Cost & Long Term

Whatever the New Tax/Royalty Regime Decided for Alaska
— There May Still be Projects on the Non Competitive Margin

For Those Projects Where the State's New Changes Aren't Enough
— ARCO Will Propose a "Project Partnering" Approach

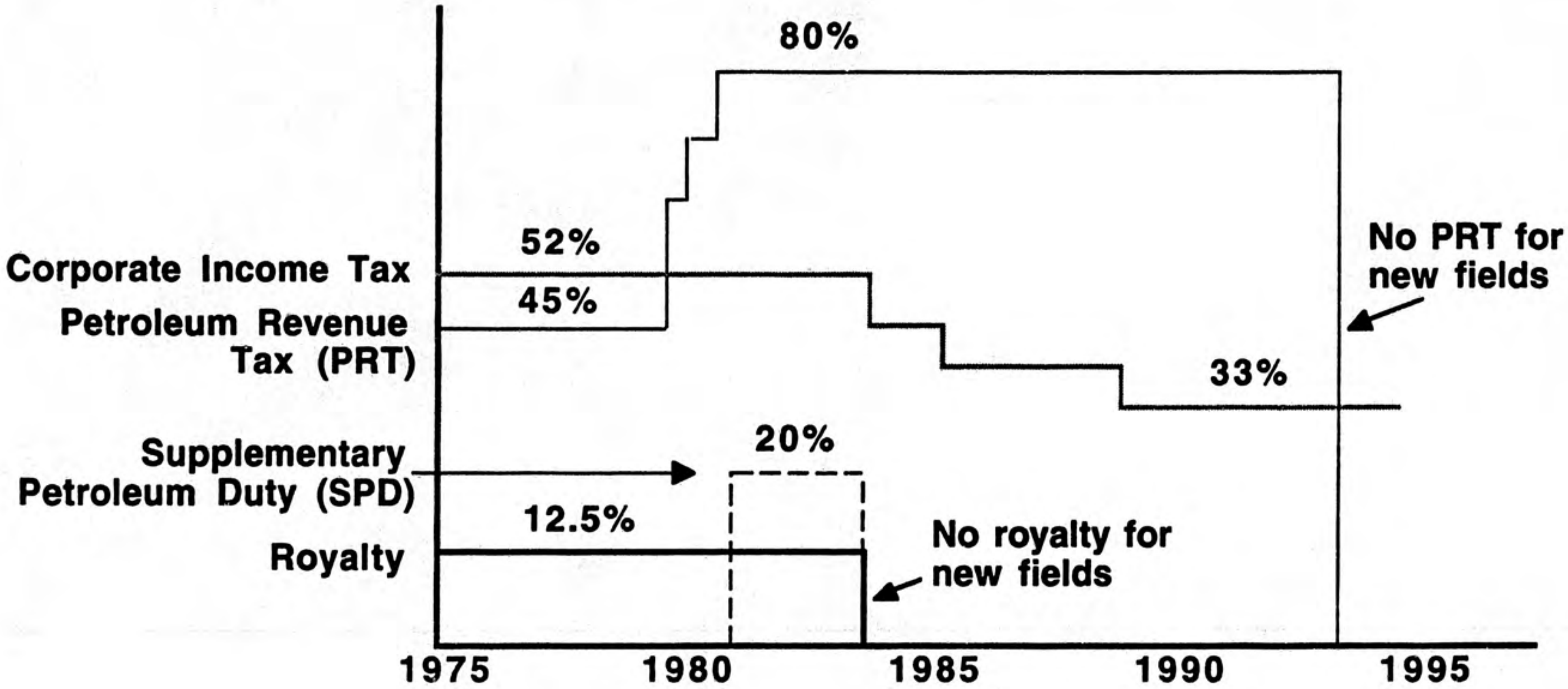
ARCO Would Come Forward With Information Shared Openly
— The State Would Decide

Potential Categories of Projects For This "Project Partnering" Process

- **New Marginal Exploration** (eg, Lease Sale 79)
- **Marginal Development, New Field** (eg, West Colville)
- **Marginal Development, Existing Field** (eg, West Sak)
- **Fields Near Abandonment** (eg, Cook Inlet or Kenai)

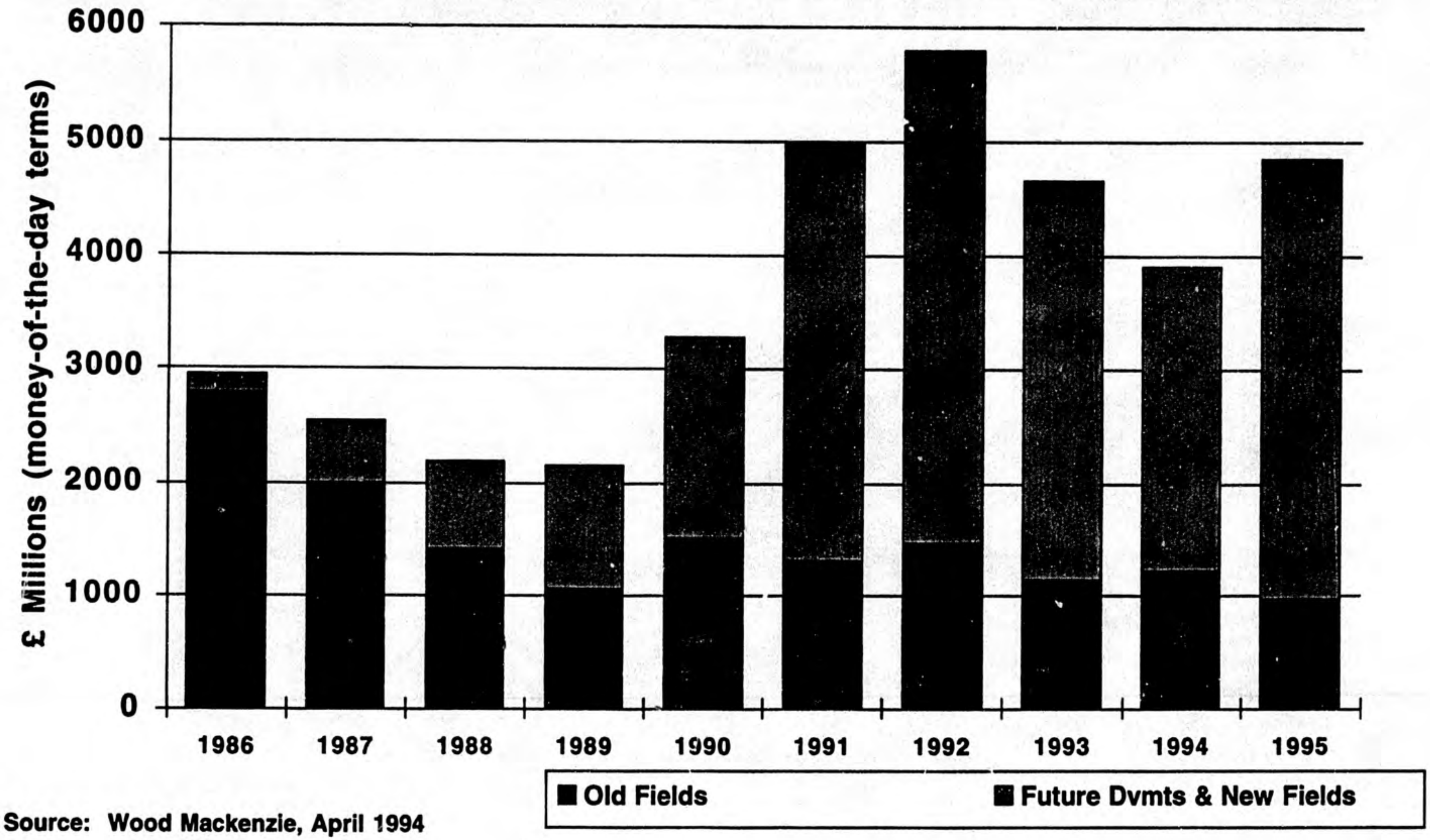
U.K. Taxation History Overview (New Fields)

Low Cost & Long Term



Capital Expenditures U.K. North Sea

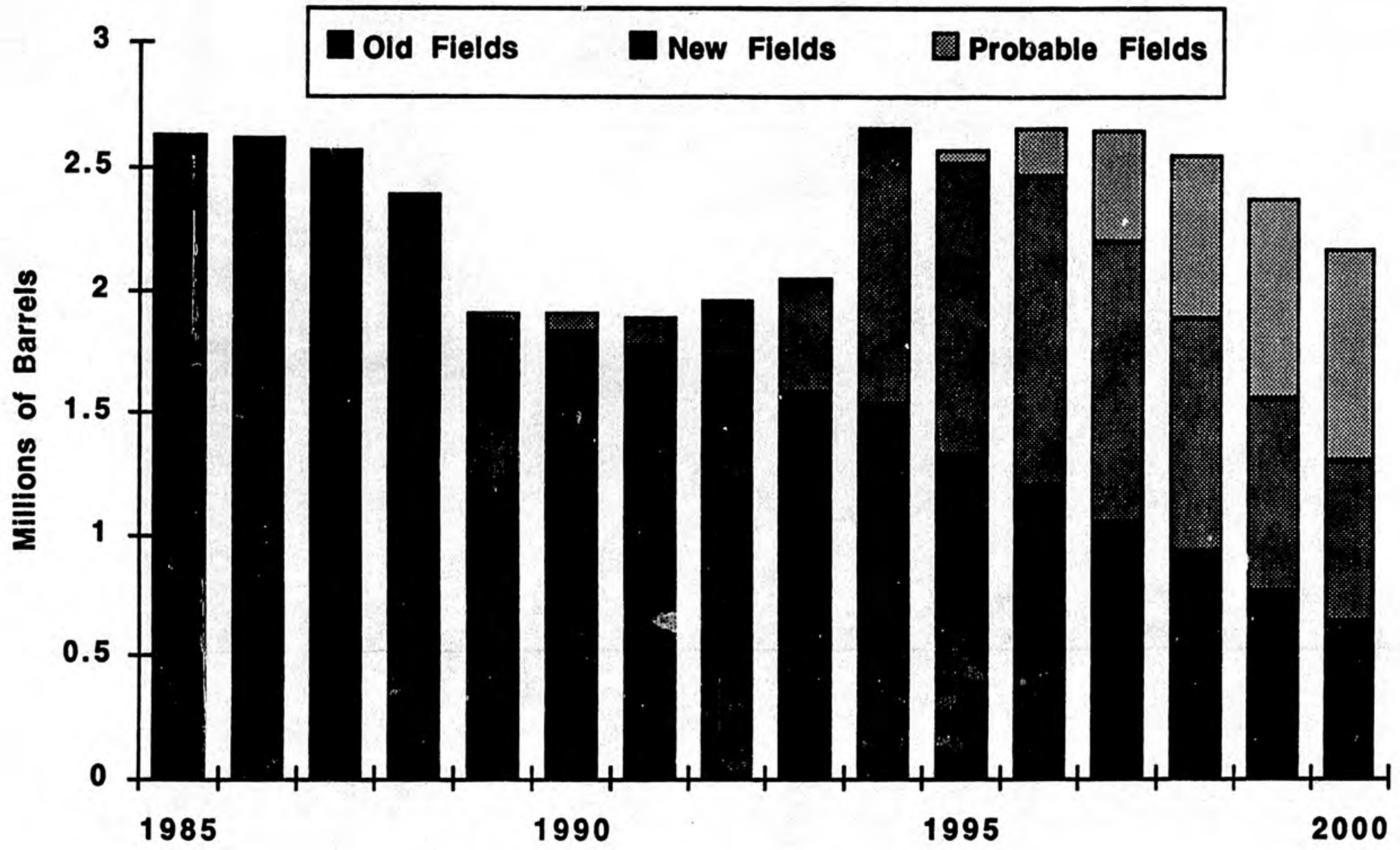
Low Cost & Long Term



Source: Wood Mackenzie, April 1994

UK North Sea Production Profile

Low Cost & Long Term



Testimony
of
J. Ken Thompson
President, ARCO Alaska, Inc.
to
the
House Resources Committee
February 15, 1995

Slide 1: Agenda

• Hello. For the record, I'm Ken Thompson, President of ARCO Alaska, Inc.

• Pleasure to be here. Thanks for opportunity to testify.

• Here today to talk about common goals shared by ARCO Alaska and the state.... and what its going to take to achieve our goals.

• I'll be sharing information about what other oil provinces are doing to boost production and create jobs for local residents. And I'll talk about some steps we can take .... today and in the future..... to ensure that oil and gas investment opportunities in Alaska remain competitive. When I'm done, I hope you'll be persuaded that the state can make a difference..... that the state can change the economic equation for marginal oil accumulations on the North Slope.

Slide 2: Common goals

• State and ARCO share common goals.

• The first is to mitigate the production decline now occurring in existing fields through the discovery and development of new oil accumulations and the development of marginal horizons in existing fields.

• Second..... we need the incremental revenue that will be derived from new production.

• Let me underscore the words "New Production." ARCO is not seeking changes in the tax or royalty treatment of existing production. Instead, we're asking that the state be willing and able to consider changes in the regulatory, tax and royalty treatment of marginal projects which can't go forward without such consideration. In short..... we must work together to turn zeroes into positive numbers.... which show up on our balance sheet and in your treasury. Or as was said on a recent Juneau news report..... half a loaf is better than none.

• If we can turn zeroes into positive numbers..... then you'll have the opportunity to increase Permanent Fund contributions over what they would otherwise be.... ..... while maintaining current contribution rates.

• Finally.... we want to create jobs and economic opportunity for Alaskans. Those who work in our industry and those who don't.

• The only way to reach these common goals is through sustained oil and gas development. That means:

- Continued exploration of Alaska
- Development of marginal oil accumulations
- And by extending the economic lives of existing fields.

• To have sustained oil and gas development we must be competitive.

• Companies like ARCO must reduce costs through improved operating practices and development of new, more cost effective technologies.

• And the state must be willing and able to consider changes in the tax, royalty and regulatory treatment of proposed oil and gas projects when change is necessary to turn a zero.... into new production..... new revenues..... and new jobs.

- We both have parts to play.

- There's a lot at stake.

- 85 percent of current state revenue dependent on oil production. According to state projections.... North Slope oil production will decrease more than 30 percent over next five years.

Slide 3: World fiscal regimes more competitive

- Other countries are turning zeroes into jobs, production..... and incremental revenue.

- Norway abolished royalties on new fields in 1986 and removed sliding scale state participation in new leases in 1992.

- Australia introduced a Resource Rent Tax in 1985 for offshore projects.

- Venezuela cut the income tax rate for heavy crude development from 67 to 34 percent. Removed onerous tax provisions for multi-national firms and improved bidding structure for operating contracts for marginal fields.

- In Alberta, Canada fiscal reformations led to oil & gas industry turnaround after the 1986 crash.

- Why all this change? Simple. Oil Prices are down and have been down for some time. Investment capital is in short supply and there is an abundance of oil and gas investment opportunities available.

- Mr. Chairman... members of the committee I'm an here today as one of Alaska's oldest and best customers. We've been doing business here more than 40 years. It's been a tremendous relationship. I like shopping in your store. I like the merchandise you carry. I want to keep shopping here. But a giant discount warehouse has moved in across the street. The merchandise is excellent.... and the terms are better. To survive.... to prosper.... Alaska and the companies that do business here must meet that competition.

Slide 4 -- UK fiscal history

• This graph shows how the United Kingdom has moved, incrementally.... and systematically to ensure the continued competitiveness of the North Sea.

• In 1984 they eliminated royalties on new fields.

• In 1993 they eliminated the Petroleum Revenue Tax, which is similar to Alaska's severance tax on new fields.

• Today....depends on 33 percent corporate income tax to collect incremental revenue on new production.

Slide 5 -- Fiscal regime comparison as of 1994

• This slide compares fiscal regimes in UK, offshore Australia and Alaska.

• All have corporate income taxes. In Alaska .... combined state and federal take is about 39 percent. (35% federal plus 9.4% state equals 39% total because of deductibility of state taxes on federal returns.)

• Of the three.... only Alaska has royalty, severance and ad valorem on new fields.

• Now, you've had a look at the competition. Now.... what can we do to ensure that oil and gas investment in Alaska remains competitive with opportunities elsewhere in the world?

Slide 6 - Summary of world wide fiscal regime comparisons

• During 1994, Petroconsultants surveyed the oil and gas fiscal regimes in 70 countries.

• Survey shows that 18 of the 22 nations with production greater than 200 M bopd rely on production or profit sharing arrangements to derive revenue from oil and gas production.

• Alaska, and the United States are not among the 18. Alaska and the United States are among only three countries which still employ a fixed rate royalty.

Slide 7 - What it takes

• Industry, state must work together to create competitive environment.

• Industry must focus on keeping cost structure low.

• State -- faced with declining production and revenues -- faces many of the same challenges. We support efforts to gradually balance spending with revenues, closing fiscal gap and achieving soft landing.

• Encouraged by what we're hearing from Administration, Legislature about budget discipline. Closing fiscal gap will increase investor confidence in Alaska.... and give us confidence that any incentives you provide today..... will be honored tomorrow.

• State must develop a more competitive tax and royalty structure for new fields. Alaska must meet the competition.

• Finally, the state must be willing and able to consider alternative business arrangements when necessary for marginal projects. Current regulations may not provide necessary flexibility.

Slide 8 -- Immediate actions

• I know that many of you are eager to take immediate action to improve Alaska's competitiveness. I'm encouraged by your enthusiasm and willingness to consider positive change. However, we must move carefully, coordinate among the legislature, the administration and industry and ensure that the steps we take are the right steps and will be effective.

• That's why I'm recommending today that your first step be a comprehensive review of the incentives the Legislature has already approved.

• Are they being used effectively? Are they being used in the way you intended? Are they obtaining the results you expected?

• **Exploration Incentive Credits:** State has exploration incentive credit program. DNR still grappling with how to administer. Rules, guidelines unclear as to what qualifies, what doesn't. In fact, regulations don't exist yet.

• In the last year, we've approached DNR three times. We've been turned down three times. We're concerned about the final form these regulations will take and believe that in order to be effective, the incentive must apply to a broad range wells.

• For example.... any well that meets the IRS / SEC definition for an exploratory well. Simple, straightforward application of exploration incentive credits could increase the number of exploratory wells drilled in Alaska every year, attract outside capital to Alaska and increase the likelihood of additional commercial oil discoveries.

• **Lease Sale / Land Access:** Existing program not working well. State having difficult time maintaining sale schedule. Even when sales occur, lawsuits likely. Increased certainty created by HB 308 appreciated. The administration and legislature worked well together to enact that law.

• **Discovery Royalty Credit:** Currently covers only the lease on which the discovery well is drilled. Good for ten years from date of discovery. Time required to permit, develop Alaska discoveries reduces value / incentive of this credit. This credit would provide more of an incentive if, for example, the credit were applied for five years from date initial production and / or were applied to leases covering the entire discovery. This would make investment in the new fields more attractive because the credit would lower our up front development costs.

SUPPORT FLEXIBILITY DNR ROYALTY RELIEF

• **Prolonging Economic Life:** Statutes allow DNR to reduce royalty in specific circumstances on fields nearing the end of their productive, economic lives. However, this relief is difficult to attain. Companies sometimes required to jump through impossible hoops. For example, one Cook Inlet operator was asked to provide detailed cost records back to field discovery. The company couldn't provide those records because it didn't have them. It had purchased the field from another operator. And yet, that was the reason the royalty reduction was declined.

• **Lease Sale Terms:** Existing lease sale program not working. Number of bidders participating in sales is half what it was six years ago. Your old customers aren't coming in the door anymore. They are going where the deals are better, the returns are higher.

• Lease sale bonus bids not major source of revenue for state, especially when compared to severance, royalties. Revenue results from production. State should be doing all it can to encourage evaluation and exploration of its lands.

• Existing law gives DNR authority to vary lease terms, relying less on bonus bids and offering more attractive royalty terms.... net profit share royalties, for example, in place of fixed percentage.

• In fact, we have proposed a net-profit share royalty for State Lease Sale 79 scheduled later this year. We think this approach will increase interest and participation in the lease sale.

• **Smaller Discoveries:** Exploration may yield discoveries which are too small or too marginal during periods of low oil prices to carry the royalty rate under which they were originally leased. DNR has flexibility to reduce royalties in certain circumstances. However, that authority may not extend to new discoveries.

• There should be a means through which the state can help bring these fields on production by reducing the royalty burden. We need a mechanism which allows us to ask for royalty relief ..... and the state to grant it if the state deems action necessary and beneficial.

• **Federal Tax Incentives:** As you saw earlier.... in the UK, Australia, Alaska comparison..... Alaska is the only jurisdiction in which industry is taxed by multiple jurisdictions. There have been some discussions of federal incentives for the oil and gas industry. We would urge you to express your support for those proposals.

• State support of efforts to open ANWR and lift the Export Ban are also necessary.

COMPETITIVENESS

• Finally, we urge you to support and participate in a broad-based process to develop recommendations aimed at enhancing Alaska's international competitiveness.

Slide 9: Next steps

• Making the changes necessary to keep Alaska competitive will not be simple or easy. The initiatives the state undertakes must be chosen carefully, through an open, public, bi-partisan process which involves the legislature, the administration and the industry.

• We must ensure that the steps we take are the right steps. We must understand the competition. We must know and understand what other oil provinces are doing to attract oil industry investment.

• Only then can the administration and the legislature begin to develop options.

• This process will take time. I know that many are eager to act today. But this is far too important a process to hurry along. We must build public consensus if this effort is to succeed.

• I know concern has been expressed that variable or sliding scale royalty rates would adversely impact contributions to the Permanent Fund.

• Again..... I'd ask you to remember that the changes we're asking you to consider are changes designed to turn oil accumulations which are zeroes today --- into jobs, production and additional revenues. Contributions to the Permanent Fund will be higher than they would otherwise be.

• You..... as legislators .... will decide how to allocate incremental revenues from incremental production.

Slide 10: Conceptual "fixed / variable" royalty

• This slide shows one of the options available to you. The vertical axis is the royalty percentage. Here the royalty percentage increases as a function of oil price, well productivity or field size..... increasing from a low of 6.25 percent .... ramping up to percentages which would exceed the traditional 12.5 percent.

That's the variable portion of the royalty.

• The shaded area shows the contribution to the Permanent Fund. For this illustration..... we've set the minimum contribution at 6.25 percent, which is the prescribed contribution for production from leases issued since 1979.

As you can see..... the permanent fund contributions could be protected.... and even enhanced if the royalty rate exceeded 12.5 percent because of high oil prices or the discovery of a very large field.

Slide 11: Project partnering

• No matter what the oil price is..... no matter what the state's ultimate tax and royalty regime..... there may be projects on the margin.

• ARCO will look for ways to make these projects happen..... by lowering their cost....developing new technology..... reducing their scope. Those efforts may not always be successful.

• If we can't make a project work on our own ... we may ask you to help us find innovative ways to make the project happen.

• We envision a process in which we explain the project.... in which we explain the economics.... in which we lay our cards on the table. Then it's up to the state to evaluate the data and determine whether the proposal offered is in the state's best interest.

• West Sak might fall into this category.

• We are re-evaluating West Sak at this time. Our goal is to find a way to begin West Sak production at current and expected oil prices. This is a difficult challenge. It will take new technology and continued reduction in our operating costs. We don't know if we can get there from here.

• If we can't, we may be coming to you with a proposal. We'd like to think the state is willing and able to consider and implement new ideas for making West Sak happen.

• The state can make a difference. State can change the economic equation for marginal oil accumulations in Alaska. I'd like to close this presentation by showing you what can happen..... what did happen in the UK.

• Other areas which might benefit from project partnering are the Lease Sale 79 area, the Western Colville and for fields near abandonment..... which would not impact ARCO, but might help some Cook Inlet operators.

Slide 12: Capital expenditures UK

- This slide shows capital investment in the UK after the UK began turning zeroes into positive numbers by reducing the tax and royalty burden on new fields...

- The slide shows that $45 billion has flowed to the UK North Sea for development of new fields. 23 new fields have come on production since 1985. Twelve new fields are scheduled to come on line this year. That's 35 new fields......

Slide 13: UK North Sea production

- Production from new fields totals more than 1 million barrels a day and accounts for 40 percent of UK North Sea production. UK North Sea production is at record levels.

- The UK changed the economic equation for new, marginal North Sea fields.

- If we work together.....the legislature, the administration and the industry..... we can do it here.

Testimony of

James A. Palmer
Director, External Affairs

BP Exploration (Alaska) Inc.

to the

House Resources
&
House Oil & Gas committees

Juneau, Alaska
February 15, 1995

Good morning. My name is James A. Palmer, and I am director of external affairs for BP Exploration (Alaska) Inc.

Given our common challenges and shared opportunities as an industry and as a state, it's particularly fitting that we're gathered here together today to explore how we can work together to attract new industry investment to Alaska. BP is pleased to be part of this new dialogue, which we hope will lead to a new era of cooperation between state government and the state's largest investors and taxpayers.

Our industry has gone through an extended period of unprecedented change -- often painful -- to arrive at our current crossroads. We've experienced downsizing, rightsizing, restructuring, realignment, outsourcing, alliancing, shared services, streamlining, technological breakthroughs and countless other innovations and upheavals in the way we do business in order to remain competitive in the global market.

As a result, we've been able to reduce costs in a climate of declining production, we've been able to hold overall production decline on the North Slope to less than 5% per year. We have been able to hold decline to these levels only by continuing to invest in new and existing fields on the North Slope. This year we plan to invest more than a half a billion dollars of capital in Alaska, successfully competing within BP for those funds.

These investments generate jobs for Alaskans and revenues for Alaskan businesses. They help to sustain the flow of revenues that fund state government spending and fuel future investments in the Alaskan oil industry. They extend the lives of our North Slope operations, and they hold one of the keys to Alaska's economic future.

Despite our best efforts within the industry, however, we remain under siege from a variety of forces undermining our efforts to attract additional investments to Alaska. In real terms, the price of oil has been on a downward trend for the past 15 years. This, combined with declining production in Alaska, has slowed the flow of revenues that fund future investments.

At the same time, a world of new investment opportunities -- literally as well as figuratively -- has been opening up to the oil industry due to falling political barriers, new technologies and friendlier relationships with many host governments in oil provinces around the world. In this global environment, companies are limiting the scope of their activities and becoming increasingly selective in choosing which projects to pursue. Investments are directed to areas offering the highest returns with the lowest risks.

Alaska is disadvantaged in this fiercely competitive environment for increasingly scarce investment capital due to our remoteness, our high transportation costs, our restricted markets, a state budget deficit that casts a cloud of uncertainty over all of our investments and a history of antagonism between industry and the state. Furthermore, the opportunities that do exist on the North Slope consist of marginal new oil fields or marginal projects within existing fields.

The first step toward capturing the significant potential for new investments, revenues and jobs in Alaska in this emerging era of marginal development on the North Slope is redefining "us and them" to mean Alaska's *unity* as we compete globally for increasingly scarce investment capital rather than our *divisiveness* as we fight among ourselves. It's imperative that we work together to take tangible steps *today* toward a strong and stable industry, toward a strong and stable Alaskan economy *tomorrow*.

We're encouraged that the legislature is taking initiatives such as your hearing today to provide forums for the dialogue that will enable us to work together to develop win-win solutions to our common challenges. We're also encouraged that the governor has made unity between government and business a theme of his new administration and has reinforced his words with his actions since he took office.

The progress the State of Alaska and BP have made in the past year working cooperatively to lift the federal ban on North Slope oil exports is testimony to what we can accomplish together. Ending the ban will truly be a win-win outcome that will both enhance the flow of revenues to producers and the state and enhance the competitiveness of Alaskan investments.

Resolution of significant past tax disputes during 1994 have improved the investment climate in Alaska. We can now focus our efforts on the future without looking over our shoulders at liabilities of the past.

Recently enacted tax regulations have helped to clarify how to value oil for tax purposes for companies that refine their own oil. However, the same vagueness that led to past disputes continues for companies like BP that sell or trade the oil they produce on the North Slope. Vagueness equals uncertainty, uncertainty equals risk, and risk equals competitive disadvantage in our efforts to attract capital to Alaska.

Tax clarity for all producers would reduce our risk and would be a significant win for us and a significant win for the state. By helping to minimize our risk, you can strengthen our position to compete for investments that will benefit us all.

The fiercely competitive global environment in which we operate makes it an uphill struggle, and the marginal nature of projects we have to pursue on the North Slope makes the hill even steeper. We in BP and in the oil industry are doing all we can to compete for these investments.

Consider the Badami discovery about 30 miles east of the producing Endicott field on the North Slope. This field is typical of the projects in the 100- to 150-million-barrel range we expect will be developed over the short and medium terms. The first hurdle we must clear is confirming the size and quality of the reservoir. We're currently drilling two appraisal wells and hope to have the results assessed by this fall. We believe Badami must hold at least 100 million barrels of recoverable oil in order to have a *chance* to make it commercially viable.

If we clear that hurdle, we're still a long way from having a project. When we first began to evaluate Badami about a year ago, we identified four primary obstacles: it was too costly, there was too much time between discovery and production, there were time-consuming regulatory roadblocks, and there was no hedge against the risk of low prices. All four still remain, and we've been doing everything within our power to overcome them.

The cost hurdle is enormous. Our initial projection of the development cost, based on doing things the "old" way, was $800 million. We must reduce the pricetag by more than half in order to enable Badami to compete effectively for development funding.

In our effort to reduce costs without compromising safety or the environment, we've considered a myriad of innovative development techniques -- a buried, chilled pipeline, facility sharing and remote operations, to name a few. We've also assembled a team of key contractors who are working with us to find solutions to the cost challenge.

Traditionally, we'd be waiting for the results of this winter's wells before taking this step. However, traditions that have evolved over the past two decades of North Slope oil field development won't overcome the challenges posed by the marginal development opportunities of the future.

Timing is crucial, and it's imperative that we shorten the period between discovery and production. That's why we've assembled contractors now rather than later and asked them to work together as a team. It's also why we initiated discussions with state, federal and borough regulators months ago instead of later, when we filed for permits.

This approach unquestionably adds to our up-front risk. We understand there are no guarantees, but it's a risk we believe we *must* assume in order to have a *chance* to make this project viable. We also believe it will help to incorporate the best ideas into the planning process, and we hope it will help to resolve official and public concerns about the project and help to expedite the permitting process.

There's one other risk that we must manage, and that's the risk of low prices. That's why we're interested in a sliding-scale royalty for Badami that would be sensitive to oil prices. This would help to minimize our risk exposure to low prices, and it would enhance our prospects for making development commercially viable.

The sliding-scale royalty concept would enable us to share the risks of low prices and the rewards of higher prices with you, our co-beneficiary, if you will, in having Badami developed.

Badami is neither competitive nor commercially viable today. Our shared goal with the State of Alaska must be to *make* it competitive and commercially viable so we can share the benefits of the production, the revenues and the Alaska jobs the project would generate.

If we're to work together to successfully attract investments to Alaska, we must all be flexible in approaching the challenges and opportunities posed by each new project. We believe this suggests a broader discussion in the legislative arena of the use of royalties as a development incentive tool.

We believe it is appropriate for the legislature to consider giving the commissioner of Natural Resources the authority to adjust royalty terms on new developments on a case-by-case basis if changes are needed in order to make a project viable.

Some of the criteria that might be considered in reviewing royalty terms are:

- Does the project need a major cost breakthrough in order to be competitive?
- Even if it overcomes the initial cost hurdle, will it still be vulnerable to low oil prices?
- Could it bring jobs and new technology to Alaska?
- Could it make other exploration, appraisal or development projects more attractive?

We're not suggesting that flexible royalty terms are necessary -- or even appropriate -- for every project. But to the extent that they can be used to enhance the competitiveness of projects whose funding otherwise might go elsewhere, it's important that the state have the tool available and ready for use.

Whether to grant flexible royalty terms -- and what kind -- will be a judgment call on the state's part. It will be incumbent on companies like BP that are seeking them, therefore, to be completely open and forthcoming with the information state regulators need in order to make that determination. Only then can we deal with each other in an honest and collaborative manner and work together toward our common objective of securing new investments.

This is not the time for demands. It's not the time for threats or hollow promises, and it's not the time for brinksmanship or posturing. It is the time, if we're truly committed to working together to capture Alaska's share of industry investments, for constructive, open, productive dialogue such as we're having today that leads to win-win solutions for the industry, for state government and for all Alaskans.

I pledge BP's complete, unconditional cooperation and support in this endeavor. Thank you.

INSIDE OIL & GAS

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Dept. of Revenue

New Revenue Commissioner Wil Condon says his job is to make "this place work." Major policy will be left to Gov. Knowles, he says. Condon also believes that many of the big areas for disagreements with oil and gas taxpayers will soon be behind us. He believes the new tax regulations will help. *Page 2*

Cook Inlet

Unocal says "external" regulatory factors like potential new effluent discharge restrictions and escort tug requirements could shorten the economic viability of many Cook Inlet platforms. *Page 7*

Air Quality

Officials in DEC's air quality division are concerned that permit fees under the new Title V program may not be sufficient to meet costs, and are looking at ways to streamline administration. *Page 6*

Water Quality

Alaskan municipalities and resource industries, including oil and gas, are gearing up for another round on those new water quality standards. Meanwhile, DEC is adding new "anti-degradation" language to meet EPA requirements, including a new water body classification — "outstanding national resource waters." *Page 7*

Lawmakers look at ideas for new development incentives

State legislators in Juneau are looking at how new fiscal incentives might strengthen Alaska's ability to attract new oil and gas investment, a problem highlighted in a recent study on competitiveness by consultants Gaffney, Cline & Assoc., for the State Dept. of Commerce and Economic Development. The Senate Resources Committee, chaired by Sen. Loren Leman, held hearings Feb. 1 to hear industry's views. House Resources Committee, chaired by Rep. Joe Green, will take up the subject Feb. 15. Here are excerpts from the Senate Resources hearing:

ARCO:
No tax changes on existing production; new tax and royalty approaches should be considered on marginal fields

ARCO Alaska President Ken Thompson said his company would not ask for tax or royalty changes on existing production on the North Slope, "because we know the state depends on these revenues ... We are asking, however, that there be no new tax increases on existing production," considering there have already been 13 increases since just prior to Prudhoe Bay start-up, he said.

But ARCO does believe that, "for new investments in marginal or noneconomic reservoirs in existing fields, and for small to moderate-sized new field discoveries, new tax and royalty changes should be considered to make investments competitive."

"But before new ideas can be discussed, it is so important to realize that first, our industry and the government must learn to better trust each other and to have more open communication...we need a true 'partnership' relation."

BP:
Tax clarity reduces risk at no cost to the state; suggests sliding scale royalty pegged to oil prices for Badami

BP Exploration (Alaska) Inc.'s Director of External Affairs Jim Palmer noted that Alaska's industry has gone through "an extended period of unprecedented change,

Continued on Page 3

INSIDE: Department of Revenue

Condon: 'My job is to make this place work'

New state revenue commissioner Wil Condon says administering state taxes more efficiently and effectively is the best contribution the Department of Revenue can make toward Gov. Tony Knowles' goal of an improved business climate in Alaska. "My job is to make this place work," he says. If the governor or legislators want to examine policy options, for example, in response to the state's pending fiscal gap, "we want to make sure they have the tools to do it with," he says. "I'm not in the vision business." Broad policy initiatives will be left to his boss, Gov. Knowles, and to legislators.

There are, however, issues one level down from the broad policy arena the department will be working on. New oil tax regulations that went into effect at the start of the year will resolve many problems in tax administration, but there are some remaining issues the department, and the petroleum industry, are committed to resolving, Condon says.

A priority will be for the Division of Oil and Gas Audit to complete its work on long-standing oil and gas tax disputes. A goal of Condon's is to enable the state and industry to identify disagreements early and to resolve them quickly.

From now on, auditing and resolving issues in oil and gas taxes should move more smoothly and quickly, Condon explains.

The new commissioner says there are two reasons: First, new tax regulations will help resolve complex problems created by crude oil being sold in distant, and different, markets, he says. The state and industry agree that Alaska's oil tax situation is unique: Alaska is a big producer, but unlike long-standing traditional producing areas like Texas, relatively little crude oil is actually sold in the state. Because most of Alaska's oil is sold elsewhere, and in different markets (west coast, gulf coast), there will always be some disagreements over the relative values of oil transactions and transportation costs. The department has been wrestling with this for 15 years, Condon says, but the new tax regulations will help considerably.

Secondly, many past-year tax disputes arose out of disagreements between the industry and state as to how crude oil was to be valued during years when federal price controls set the price at which domestic oil, including Alaska, could be sold. "That was a perfect recipe for a 15-year, $5 billion tax dispute," Condon says. Once the "books" are closed for those years, the department's auditors will be working in tax years when market prices more clearly set the value of oil, which should reduce potential for disagreements.

Condon has been in private law practice in Anchorage and was deeply involved in the state's effort to litigate oil and gas royalty issues, including the subsequent settlement of the so-called "Amerada Hess" case, as well as in more recent tax disputes. He was State Attorney General from 1980 to 1982, Deputy Attorney General from 1975 to 1980, and was an Assistant Attorney General from 1971 to 1975. He received his undergraduate and law degrees from Stanford University.

Alyeska moving on audit items; 85%-90% completion in 1995

Alyeska Pipeline Service Co. completed 70 percent of the 4,900 work items identified under the federal audit by the end of 1994, and plans to have all the electrical items and 85 to 90 percent of all other work completed by the end of 1995, according to Doug Webb, Alyeska's public affairs vice president. Speaking at the Resource Development Council in January, Webb said Alyeska had mobilized about 1,000 people to work on the program during 1994.

Webb also said Alyeska has committed about $100 million to $125 million to 1995 capital projects.

The Alaska Oil and Gas Association is a private, non-profit industry trade association. Its members are companies engaged in oil and gas exploration, production, refining and marketing activities in Alaska. AOGA serves as a forum for its members to coordinate common public and government affairs efforts.

The AOGA newsletter, Inside Oil and Gas, is an informational publication published twice monthly, intended to update and advise its members and interested individuals on issues of interest. The views and opinions expressed in the newsletter do not necessarily reflect the views or opinions of individual AOGA member companies. Unless specifically stated as such, no opinions, views or positions in the newsletter are AOGA opinions, views or positions. Alaska Oil and Gas Association, 121 West Fireweed, Suite 207, Anchorage, Alaska 99503. Phone: (907) 272-1481. Judy Brady, Editor.

Incentives: Tax clarity, fiscal gap also important

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often painful ... in order to remain competitive in the global market."

"As a result, we've been able to reduce costs in a climate of declining production, we've been able to hold overall production decline on the North Slope to less than 5 percent a year... by continuing to invest in new and existing fields on the North Slope," Palmer said. At the same time, a world of new investment opportunities has caused companies to limit the scope of their activities and become increasingly selective in choosing which project to pursue, Palmer said. Alaska has already made gains in reducing risk by resolving past tax disputes, and enacting new tax regulations. "Tax clarity for all producers would reduce our risk at no expense to the state," he said.

But additional measures may be needed to compete for capital for marginal projects. For example, BP has suggested, for discussion purposes, a sliding-scale royalty pegged to oil prices for the Badami discovery east of Prudhoe Bay.

Exxon:
First tackle fiscal problem; second, improve administration of tax regulations

Exxon U.S.A.'s Alaska Production Manager Jim Branch told the committee his company felt state fiscal reform, tax and regulatory stability and clarity, and improved cooperation between the state and industry "are the most important initiatives that will have the greatest positive impact on investor perception and confidence in our state."

"First, the most important message the state can send any potential investor is that the budgetary problems that have plagued the state in the past are being corrected," Branch said. "Second, the state should improve the administration of its tax regulations to provide clarity, predictability and reasonable balance in the interests of both the state and the taxpayer."

These objectives addressed, Exxon does believe "well-designed exploration and production incentives have a role in enhancing the specific project, but any incentive should increase overall state revenues, not just subsidize one field at the expense of another. The incentive should have general applicability to all members of industry on a consistent basis."

"The state and all of industry wins when a well-designed incentive 'makes the pie bigger' without penalizing someone else in the process," Branch said.

UNOCAL:
Reduce or eliminate royalty on marginal producing property to extend platform life; regulatory issues critical to Inlet production

Unocal's Alaska Land Manager Kevin Tabler, now the major Cook Inlet offshore operator, said "we are at a critical juncture in the continued development of the existing producing fields in Cook Inlet." Tabler said. "We need to create a more favorable climate to eliminate uncertainty." Tabler said the state could help ease major economic uncertainties for Inlet operators, caused mostly by regulatory issues like facility abandonment requirements and discharge limitations.

"Reducing or eliminating the state's royalty on ... marginal properties could make the projects economically viable and significantly increase the economic life of the platforms, thereby maintaining employment and the associated community benefits," Tabler told the committee.

As for fiscal incentives, Tabler suggested there were many options, including reduced royalty being tied to future development in the same field or area and royalty could be reduced on new field exploration until payout. "The recovery of capital costs by the investing party before the non-investing party participates is a standard in the industry and a solid concept in joint-venture partnerships," he said.

Tabler also urged the state to broaden application of exploration incentive credits, which are already on the books. "Amendments to make them more accessible or usable would encourage investment," he said.

Marathon:
Cook Inlet producers to work on consensus approach to incentives; state should consider an independent appeal process for tax disputes

Marathon Oil's Alaska Region Manager Ralph Dartez said his company is working with other Inlet producers to identify a "consensus approach" on incentives that might work in the Inlet and Kenai Peninsula. Dartez complimented the Dept. of

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Alaska Oil & Gas Taxes

CURRENT TAXES:

Income Taxes: .... **9.4% Corporate Income Tax**
Property Tax: .... **20 mils/2% of assessed value**

Severance/Production:

GAS

10%of Market Value or $0.064 per MCF, whichever is greater.

OIL

12.25% of Market Value for first five years, 15% after first five years or $.80 per barrel, whichever is higher.

OIL

Oil & Gas Severance Taxes subject to Economic Limit Factor (ELF). *See next page.*

Conservation Tax:

GAS

4 tenths of a percent per 50,000 cubic feet of natural gas.

OIL

4 tenths of one percent per barrel with conservation surcharge of $0.03 and $0.02 per barrel of crude oil to fund Oil and Hazardous Substance Release Prevention and Response Fund ($0.02 per barrel surcharge suspended when Response Account balance equals $50 million.)

Alaska Oil & Gas Incentives

Economic Incentives: PRODUCTION/ DEVELOPMENT

Economic Limit Factor - AS 43.55.013

The respective severance tax rates for oil and gas are reduced by a fields' ELF. During the life of a field, production diminishes faster than operating costs. At the economic limit, total costs including operation costs, royalties and production taxes exceed gross revenue and the field becomes uneconomic. Production tax rates for each individual field are modified by the economic limit factor (ELF) which is a value between zero and one. The ELF is a factor which is multiplied by the nominal production tax rate to derive an effective production tax rate for each field. The ELF varies based upon a field's size, as measured in total throughput, and by the field's average per well productivity.

Co-Mingling - 15 AAC 55.027

...of the new production tax regulations (effective Jan. 1995) allow producing fields to share facilities while maintaining each fields' "distinct field" status for ELF purposes. Three "sets" of fields are currently sharing facilities. Section 027 of the new regulations provide for appealing Department of Revenue's decision if an application is denied. The Commissioner of Revenue makes the ultimate decision.

Non-Taxed Produced Gas - 15 AAC 55.151 (e)

...of the new production tax regulations allow free use of gas for enhanced recovery purposes.

Royalty Reduction - AS 38.05.180 (j)

After two years of lease production, royalty may be reduced to prolong economic life of a field. Lessee must show revenue is insufficient to yield a reasonable rate of return. DNR commissioner has authority to approve royalty reduction.

EOR Credit - Code Sec. 43

Federal Enhanced Recovery income tax credit deduction may be claimed on state income tax. May be taken as a line item deduction on state income tax return. Department of Revenue does not have compiled information on number of companies or amount of credits claimed or allowed.

Industrial Incentive Credit - AS 43.20.042

Credit of 10% of cost for gas processing projects applied against income tax. May be taken as a line item deduction on state income tax return. DOR does not have information on the number of companies or amount of credits claimed or allowed. Through the audit process claims can be contested or denied. Appeals are handled through the existing appeals process i.e., informal conference and formal hearing process. The Commissioner of Revenue ultimately signs the findings of the formal hearing.

Discovery Royalty Credit - AS 38.05.180 *Repealed by Chapter 65 SLA 1969*

Provides that a lessee who makes first discovery of oil or gas in commercial quantities in a geologic structure pay a royalty of five percent for 10 years following the date of discovery and 12.5 percent royalty thereafter. Some leases issued up to the point of repeal could still qualify.

Economic Incentives: EXPLORATION

Exploration Credits: AS 38.05.180 (i)

Provides for a credit of up to 50% of certain exploration costs that can be applied against royalty, rentals and severance taxes due the state. This provision is accomplished by state leases. Covers two years following the lease sale and applies to well footage drilled and geophysical costs. Geophysical data must be made public. EIC has been offered in 10 sales. Credits have been granted on 20 EIC wells. 11 AAC 83.820 defines the process for appeal to the DNR Commissioner, who makes the final decision.

NEW EXPLORATION INCENTIVES

Exploration Incentive Credits - AS 41.09.100

Provides for a credit of $5 million per project (total of all credits $30 million) for geophysical work, exploration or strat test wells. Credit may be applied against taxes or bonus payments. Credit may not exceed 50% of eligible costs on state-owned land and 25% on land not owned by the state. Credit must be used within 5 years and may be assigned. Data confidential for 24 months. Status - Regulations pending.

Exploration Licensing AS 38.05.132

Provides for licensing of up to 500,000 acres conditioned upon an obligation to perform a specific work commitment. (Maximum acres which can be held under license 2 million acres.) Gives licensee option to convert to lease upon completion of work commitment. Status - Regulations pending.

DEC's air program: Can its costs be cut?

Department of Environmental Conservation's air quality group is wrestling with the problem of how to get the Title V program costs within projected revenues to be received by the new $78 per hour processing fee and $5/ton annual "emissions" fee (federal law requires fees to cover total costs of the program). With the regulations, and the new program now in the approval process, targeting an effective November implementation (assuming EPA approval), DEC now has a better handle of what the program will cost. If the program is managed similar to the existing air program, costs would increase from the original estimate of $3 million per year to an estimated cost of $5 million. DEC officials say part of the reason the costs are higher is because some "overhead" items were not included in the original estimate, such as public information and complaint-response activities.

Changes possible in hourly fee or annual per-ton emissions fee, agency says

DEC adds that if $5 million were to be covered by higher fees, substantial increases in either the hourly charge or the per-ton charge, or some combination of both, would be needed. The first task, officials say, is to take a hard look at how the air quality group runs things to see if efficiencies can be gained. For example, some personnel in field offices are in so-called "rainbow" positions with jobs split among several functions (air and water quality, solid waste, oil pollution, etc.). It might make more sense (and the accounting would be easier) to have people purely dedicated to working air permits, officials say.

Marathon, Texaco suggest state should be more open to existing incentives

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Revenue's progress in defining taxable value, but said "we believe development of an independent appeals process for tax disputes could ultimately provide a means for reducing uncertainty for the taxpayer." As for royalty reductions, Dartez said Title 38 already delegates some authority to the Dept. of Natural Resources, "to consider royalty reductions for fields where weak economics threaten the future life of the field. We would like the state to review the statute and how it has been administered historically." Future requests should be considered, "more openly and aggressively," he said. Marathon views future exploration opportunities as small to moderate in size. "Economics ... are likely to be dependent on availability of existing infrastructure. Therefore, it is critical that new discoveries be made soon, before existing infrastructure surpasses its economic life," Dartez said. Land access is still the number one concern. "We appreciate the efforts of the legislature last year in passing Senate Bill 308, which provides more certainty to the lease sale process," he said.

Texaco:
Allow industry to use current incentive programs

Texaco USA's Alaska Land Manager Pete Nelson said the interest in incentives was, "very timely in terms of the current low ebb of exploration and production of marginal fields, declining Prudhoe Bay production and the beginning of an opportunity with the new administration to make things better." Nelson, herself a 19-year veteran with the State Dept. of Natural Resources, complimented the legislature with having done a pretty good job in passing incentive measures, and the executive branch in writing regulations to implement the legislation. "However, recent administrations have lacked the desire and motivation, and therefore the appropriate policy, to encourage or even allow industry to fully use these incentive provisions."Nelson cited two examples of problems from Texaco's experience, one a marginal Cook Inlet producing property where the company applied for royalty reduction, and second, an Exploration Incentive Credit applied on a North Slope exploration well.

Small companies look at ways to make Alaska more competitive

Small companies working in Alaska also commented at the hearing. Dan Donkel, president of Danco Exploration, Inc., suggested a holiday on royalties on new wells drilled until investment "payout" is achieved; more effective ways of resolving disputes between companies and the state; and a "one-stop" permitting process for oil and gas companies. Bill Stewart, president of Stewart Petroleum, suggested the five percent "discovery" royalty, repealed by the state in 1970, be reinstituted; that ways be found to make more acreage available for exploration, permitting be simplified, and that oil spill bonding requirements, which work a particular hardship on independents, be eased.

Discharge limits, rules on tugs threaten Inlet

Mature oil and gas fields in Cook Inlet are uniquely vulnerable to "external" influences, such as changes in effluent standards, requirements for tanker escorts, and state facility abandonment requirements, Unocal Alaska Land Manager Kevin Tabler told the Senate Resources Committee Feb. 1. "Any one of these external influences significantly impacts the economic viability of our operations and accelerates field abandonment." Four of the 10 inlet producing platforms operated by Unocal produce less than 2,000 barrels of oil daily. Unocal committed over $80 million in new capital investments in the last two years on its platforms, "with the potential to spend an additional $31 million in 1995," Tabler said. "But it may be difficult to commit additional capital to develop these properties due to their short remaining platform lives and marginal profitability."

Presently, platforms in the Inlet are allowed to discharge "produced water" (water brought up from underground reservoirs with oil and gas) as well as drilling cuttings and "mud" (used in drilling fluid, mostly natural compounds). If federal agencies apply "zero discharge" requirements to Cook Inlet, retrofit costs on Unocal's platforms will exceed $50 million, resulting in the premature closure of the Trading Bay and McArthur River fields. "This would result in lost revenues of over $500 million, most of which goes to the local community, and approximately 800 lost jobs. The state would lose nearly $100 million in royalties and taxes," Tabler said.

The U.S. Coast Guard is currently considering a requirement that tankers be escorted by tugs in U.S. waters. If Cook Inlet is not allowed an exemption, this would add $5 million per year per tug to operating costs, Tabler said. "If we are forced to divert our funds toward escort vessels, most likely the owners will not be Alaskan and that money will flow out of the state."

Cities, resource groups gear up again to push new water quality standards

Dept. of Environmental Conservation has set April 19 as the deadline for the new round of public comments on its revised water quality standards, adopted as regulations Dec. 5, 1994 but appealed by the Sierra Club Legal Defense Fund on Jan. 12, 1995. Municipalities and resource industries (including oil and gas) are gearing up once again to present arguments in favor of the new regulations. Public hearings are set for March 17 in Fairbanks, March 20 in Anchorage, March 22 in Juneau, with a statewide teleconference from teleconference centers in Legislative Information Offices set for March 28. A package of public information materials on the standards will be available in DEC offices Feb. 13.

In addition to the five sections addressed in the SCLDF petition, DEC is proposing a new "anti-degradation" section to be added to bring existing anti-degradation language in state regulations (where it has existed, in various forms, since 1970) into technical conformity with EPA requirements. The actual wording changes are relatively minor, but the section's absence from the package approved by former Lt. Gov. Coghill on Dec. 5 prompted objections from EPA, and could have been an issue raised in litigation, DEC staff sources say. The agency had actually included it in the previous package but deleted it at the last minute at the request of state attorneys, who felt certain changes might not have been properly noticed to the public.

New section added provides for "outstanding national resource waters" classification

What anti-degradation essentially means is that existing quality of water bodies will be maintained unless a "lowering" of water quality (i.e. by allowing discharge of a pollutant) is demonstrated to be necessary to accommodate important economic and social development. However, a new section being added, also needed to comply with EPA requirements, requires protection of existing water quality in "outstanding national resource waters." The new language is verbatim from EPA regulations, but what the section doesn't do is provide how outstanding national resource waters are determined. The section proposed last year provided for the legislature to lay out a system for nomination of outstanding waters for subsequent approval by the legislature, much as state parks or refuges are established. A process to nominate those waters will be set up later, DEC said. Meanwhile, "phase two" of the triennial water quality revisions is on hold until the current review is finished, DEC said. Phase two includes setting a "fish consumption" level to be used in the formula calculating human health risk levels (and therefore, allowable pollutant discharge levels) and specific human health risk criteria for several listed pollutants.

Upcoming events

Feb. 17, 1995: Deadline for submission of recommendations for changes to air quality control regulations. Comments should be submitted to John Stone, DEC, 410 Willoughby Ave. Suite 105, Juneau, Alaska 99801. Phone: (907) 465-5100.

March 29-31, 1995: The Fifteenth Annual Governor's Safety & Health Conference, sponsored by the Alaska Safety Advisory Council, will be held at the Sheraton Anchorage Hotel, Anchorage. Contact: Rebecca Custard, Labor Standards and Safety Division. Phone: (907) 269-4916.

April 19, 1995: Deadline for public comments on Alaska water quality regulations. Fairbanks hearing March 17; Anchorage March 20; Juneau March 22; statewide teleconference March 28. Contact: DEC Water Quality Management Section. Phone: (907) 465-5300.

Senate reconsiders vote on Long Range Financial Planning Commission

As this goes to press, the State Senate is preparing a final vote on HCR-1, a resolution creating a Long Range Financial Planning Commission to make recommendations on solving the impending state fiscal gap. The measure failed in the Senate Feb. 10 when HCR-1 failed to get 11 votes needed for passage. Senators will vote on "reconsideration" Feb. 14.

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