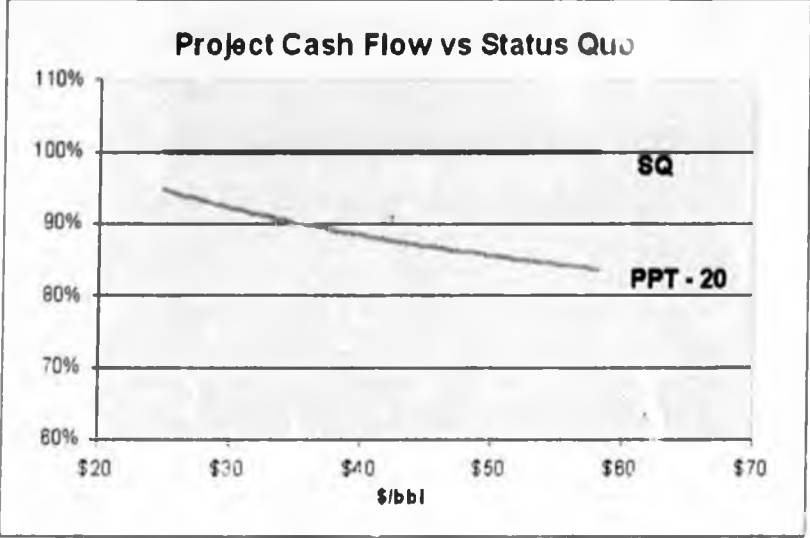


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1589 HOUSE RESOURCES

PPT Impacts  
Project Cash Flow



- **Rate of Return improves, but it's only one measure**
- **Project Cash is lower at all prices**

So what about future investments? We agree with Pedro Van Meurs, PPT will tend to increase the rate of return on many new projects, but we look at many metrics when making decisions about investing (Net Present Value (NPV), Net Income, and cash flow per barrel are but a few examples).

This graphic shows how PPT (20/20) impacts a new investment.

Rate of return is increased due to the positive impact of the capital credits on the upfront investment, but

Total return to the investor (after tax cash flow) is decreased due to the increased state take. This project takes the same effort / capacity to execute regardless of the tax regime. Increasing State take reduces total returns to investors making investments less attractive.

It is thus our sincere belief that the best result for Alaska is to implement a Petroleum Production Tax with a tax rate less than the 20% proposed by the Administration.

I would like to leave with you the key messages from this testimony.

## PPT: Key Messages



- **Decline is a problem**  
Alaska has been in decline because profitability has been insufficient to attract capital, not due to a lack of resources
- **Large increases in investment are required**  
To stem ongoing decline and attract the required investment (\$50 - \$100bn), PPT must work for the major investors
- **Capital is mobile**  
International investment flows to basins where it can earn a profit
- **Profit-based taxes are superior to revenue-based taxes**  
The PPT structure has merit and could serve Alaska well for the long term
- **Higher taxes means less investment**  
The 20% rate is very high and will not maximize investment and production
- **Oil needs Gas . . . and Gas needs Oil**  
For Gas to work, the Oil business must be healthy

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On behalf of BP I would like to thank you for this opportunity to testify and wish you well with your deliberations.

We will of course be available to provide further testimony as appropriate.

bp



# Alaska fiscal regime in global context

**Raymond Hall, BP**

**February 2006**



## Fiscal regime principles

## Regime comparisons (*detailed*)

- *UK*
- *Norway*
- *Gulf of Mexico (deep water)*
- Alberta heavy oil
- US oil states

## Key points for regime comparisons

1. Basin maturity, resource quality and policy objectives
2. Higher tax burden generally equates to less investment
3. Lowering tax rate generally equates to more investment



## **Equitable: to investors and government**

- **Government should have adequate control over their resources**
- **Investor's profit potential should be consistent with the risk it bears and its resource commitment**

## **Simple : to understand and administer**

## **Stable: to protect economics of committed investments**

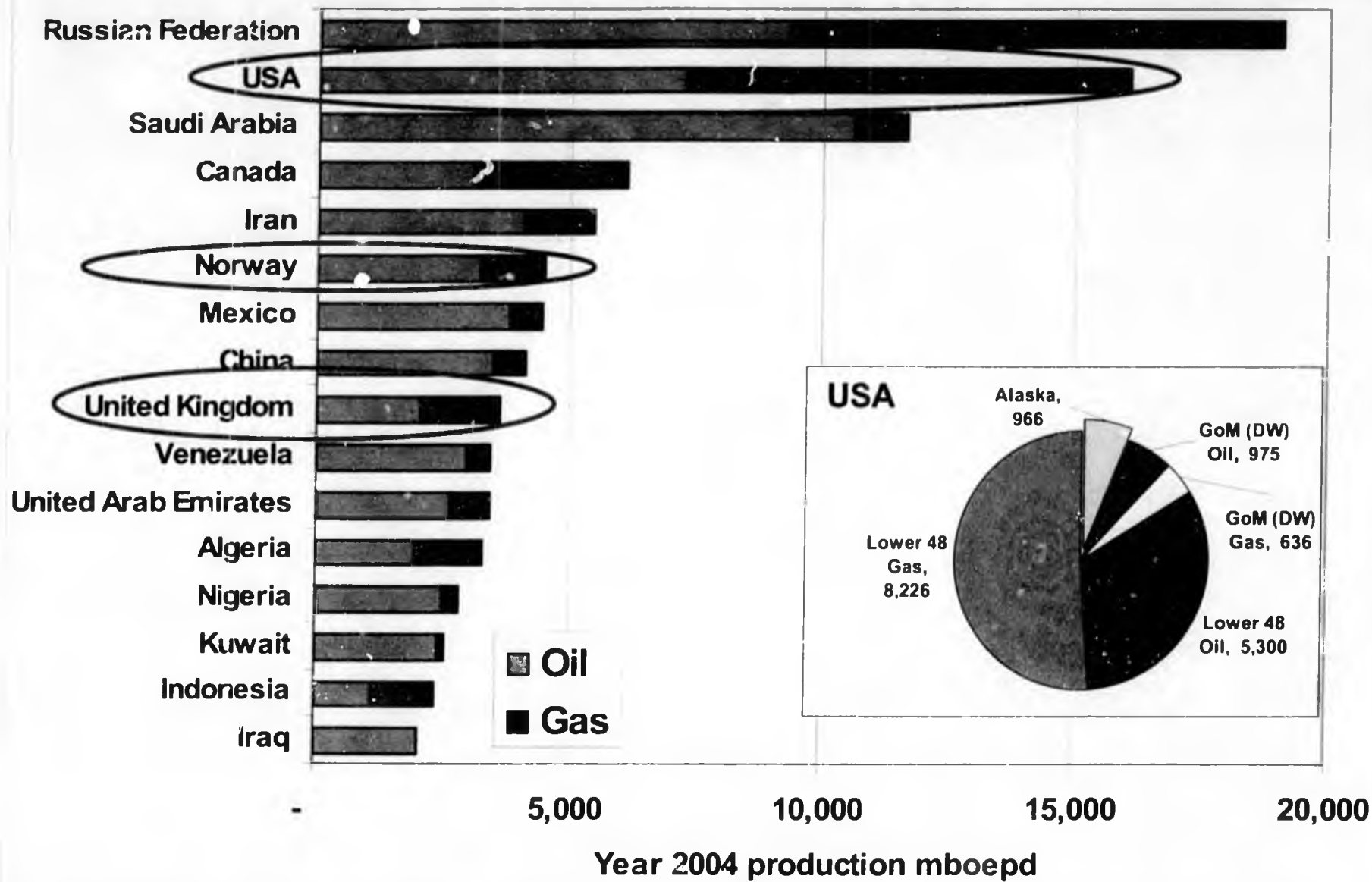
## **Profit related: tax levied on profits not revenues**

## **Competitive**

- **Reflects maturity, geology & cost structure**

## **Efficient**

# Leading Global Producing Countries 2004

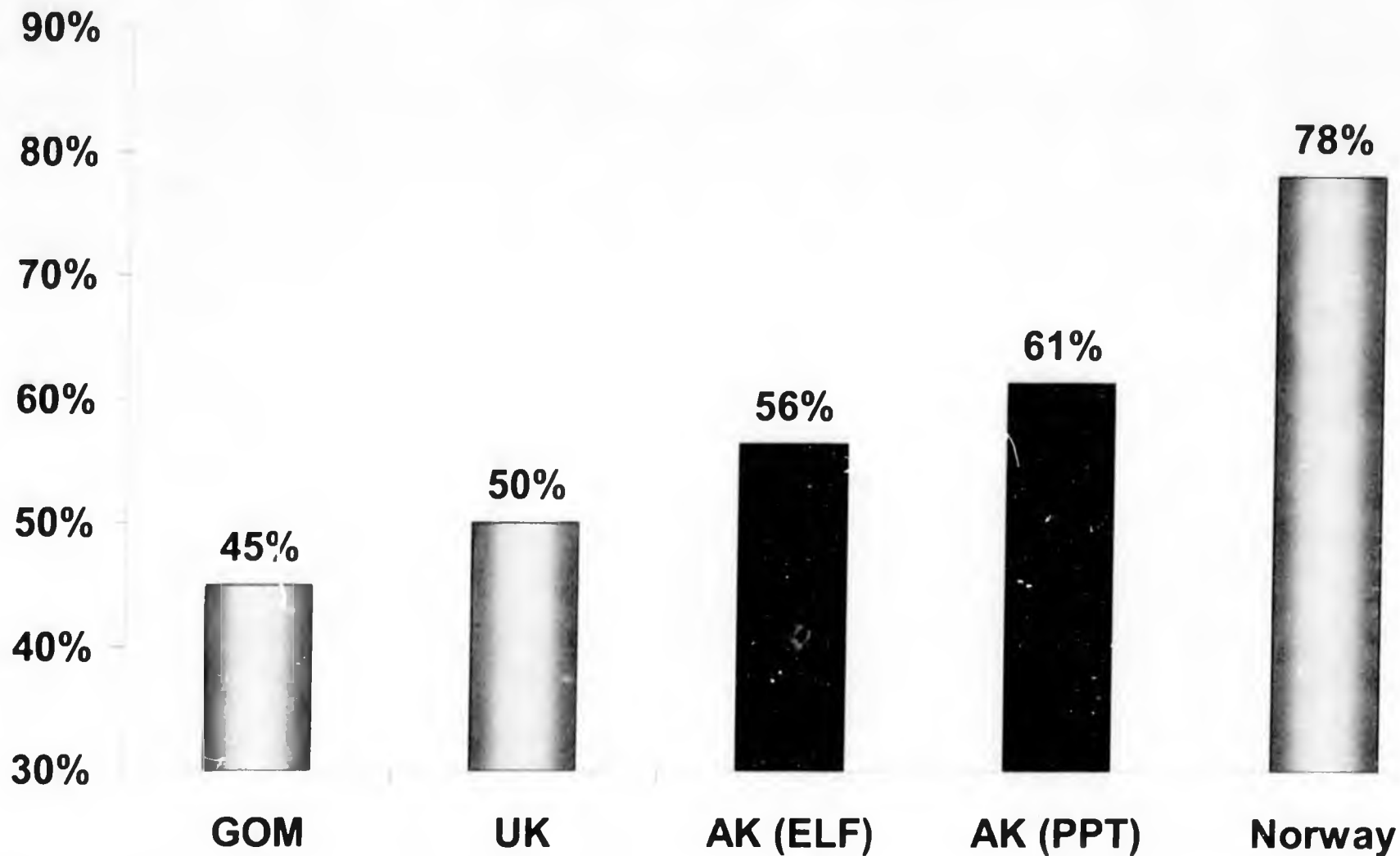


Source : BP Statistical review 2004



Marginal  
Tax Rate

## Tax Rate Comparison



BP data

Note: UK rate 40% prior to 1/1/2006

# Trend to profit based taxes



## UK

- Royalty: Rate of 12.5% (now abolished)
  - ✓ Abolished for **new** developments from 1983
  - ✓ Abolished for **all** developments from 2003

## Norway

- Royalty : Rate in range 8% to 16% (now abolished)
  - ✓ Abolished for **new** developments in 1986
  - ✓ Abolished on **all** gas production in 1992
  - ✓ Phased out for **all** oil fields by 2006

## Gulf of Mexico (GOM)

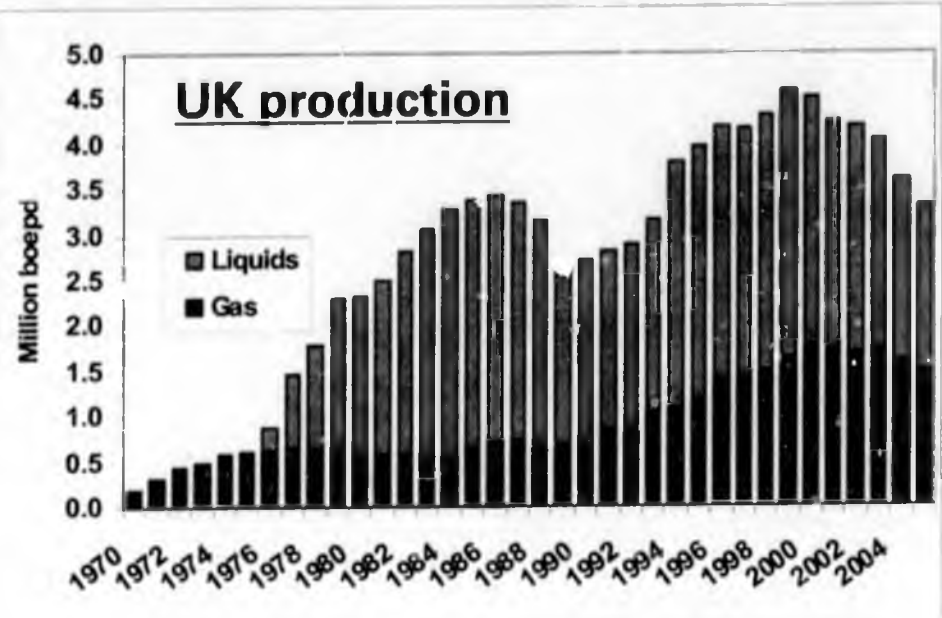
- Royalty : Rate of 12.5% to 16.7%
  - ✓ Rate varies with water depth and cumulative production
  - ✓ Above 400 metres water depth rate is 12.5% maximum
  - ✓ Up to first 88 million bbs of production is Royalty exempt

# UK a mature basin facing many challenges

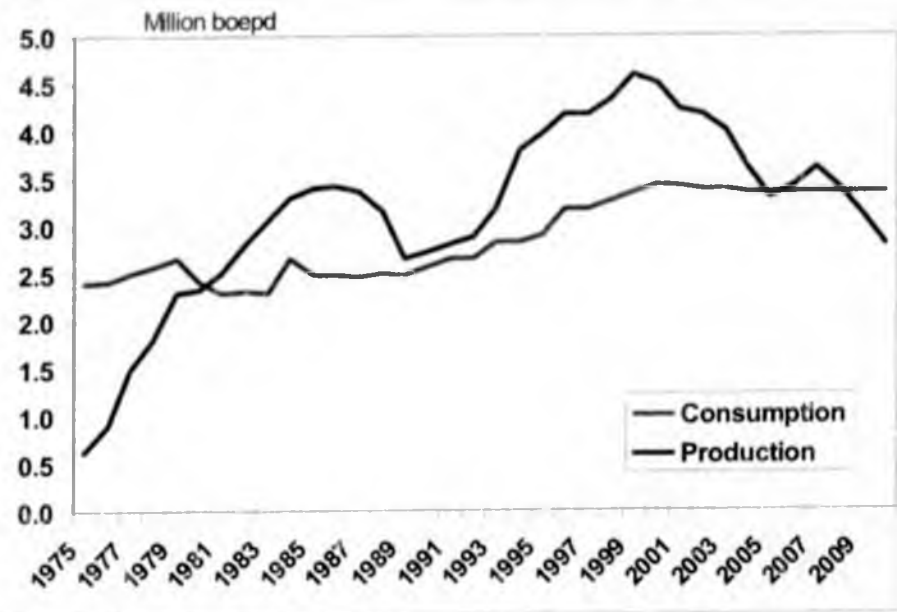
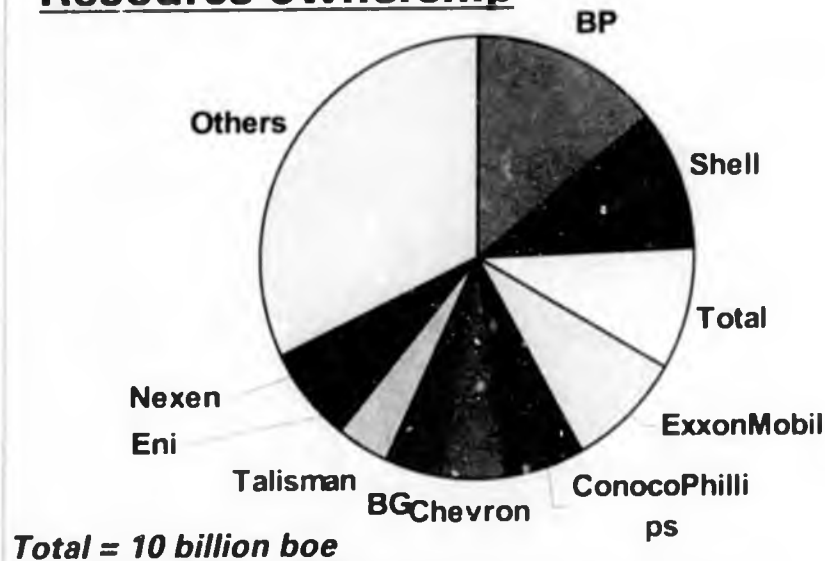


## Policy objectives

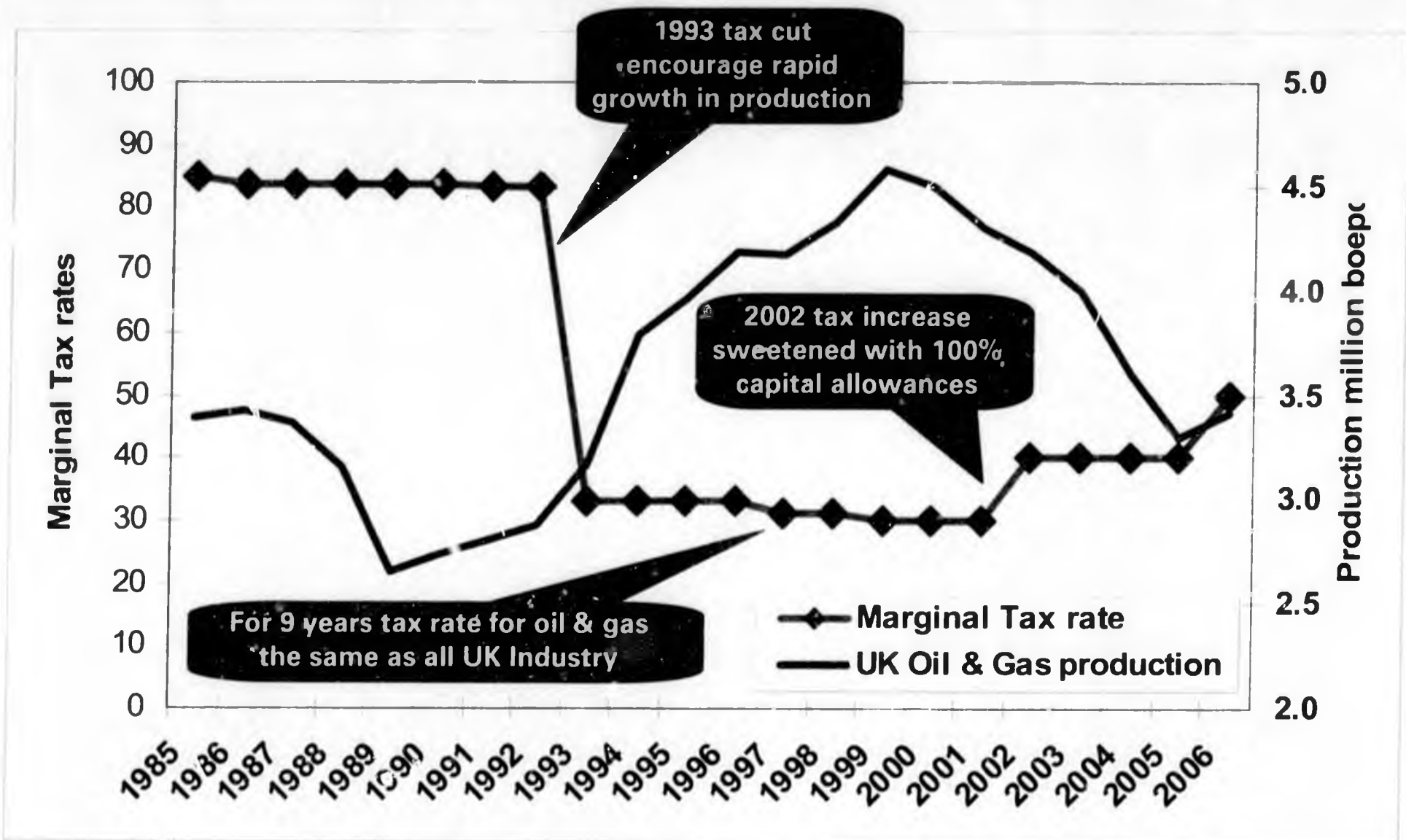
- Prolong self sufficiency
- Sustain competitive fiscal regime to
  - ✓ Maximize recovery
  - ✓ Encourage exploration
  - ✓ Encourage diversity (142 licensees)
  - ✓ Prolong infrastructure longevity
- Current challenges
  - ✓ Rapid production decline
  - ✓ Small opportunities
  - ✓ Recent Tax increase eroded confidence



## Resource ownership



# But lowering tax rates will encourage investment

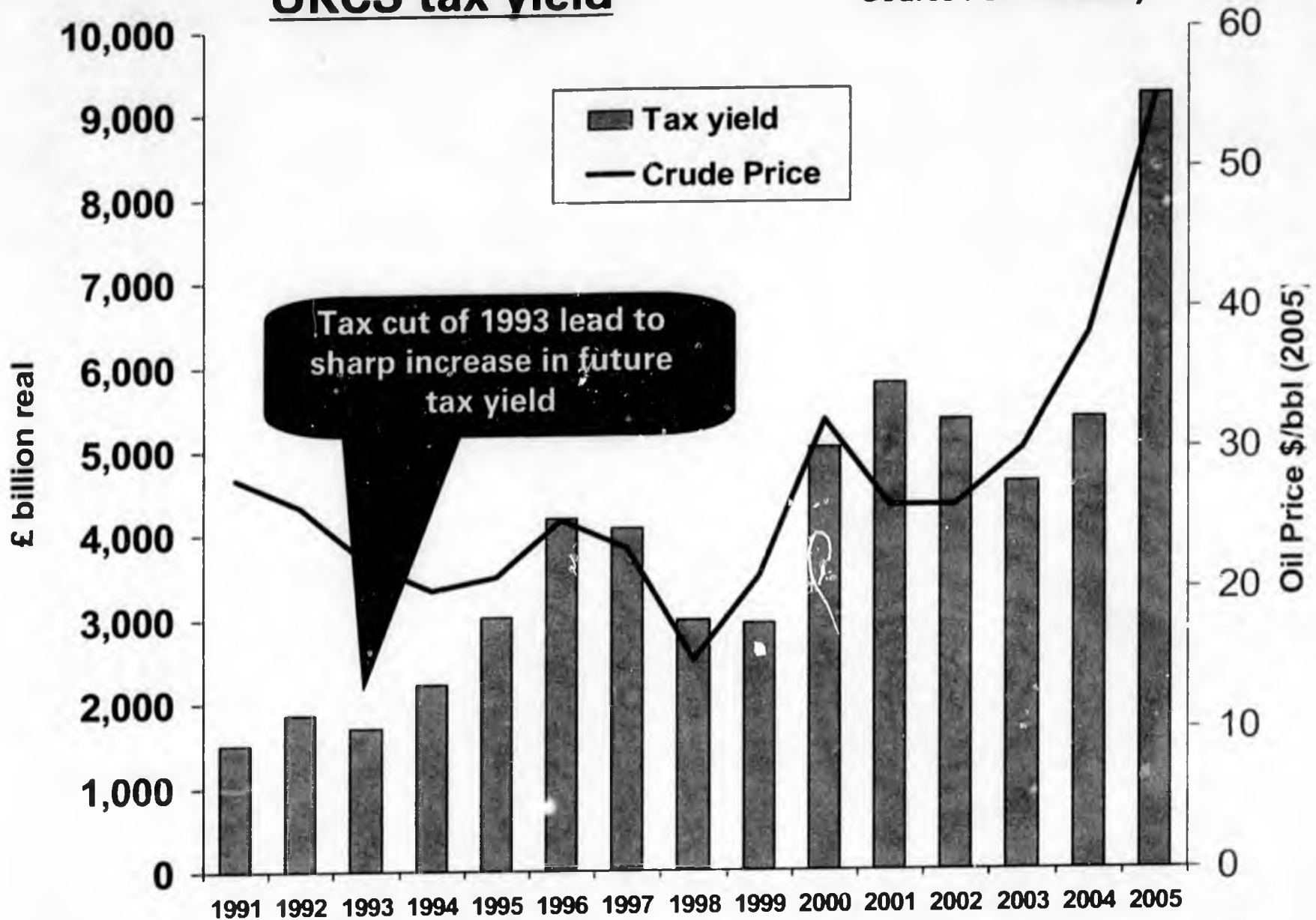


and increases tax yield



## UKCS tax yield

Source : UK Treasury



# Norway less mature with much potential



## Less mature than UK

- Produced 1/3 of resources
- UK produced over half

## Strong state control

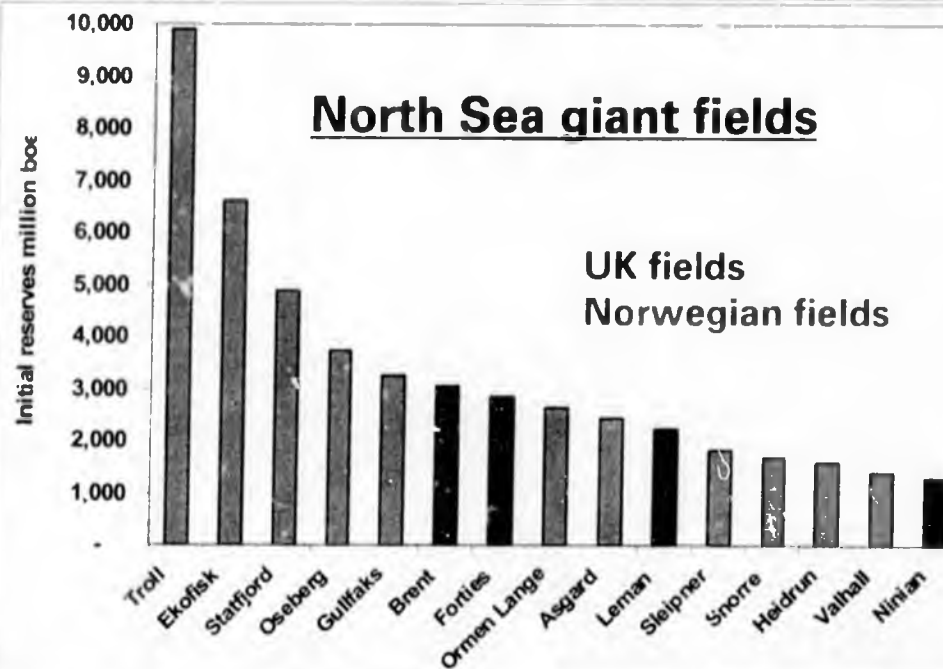
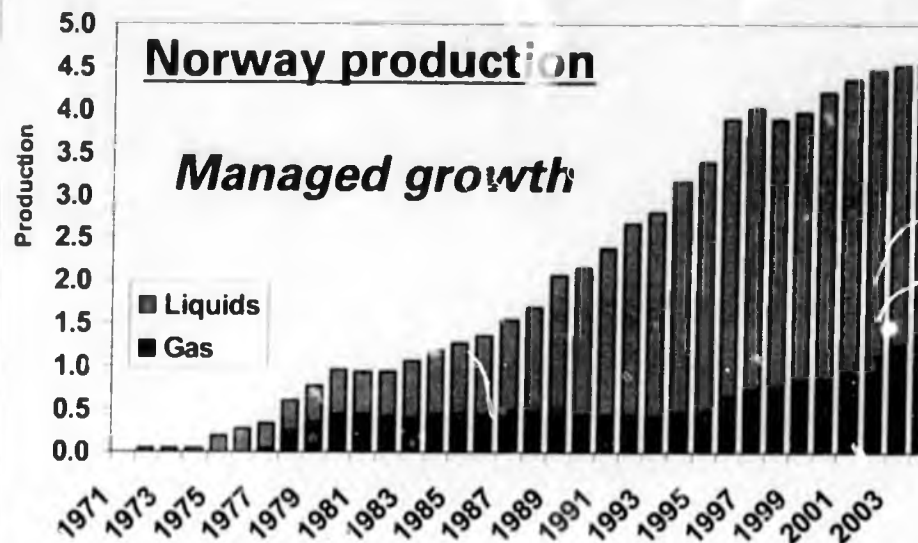
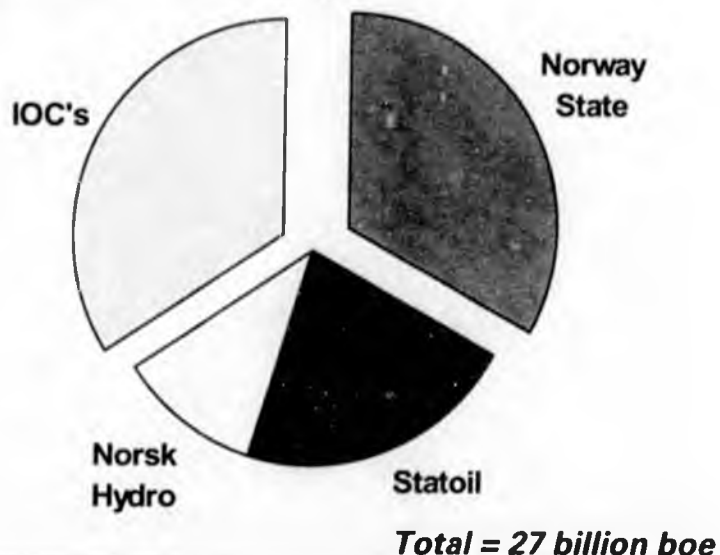
- State owns 1/3 directly
- Large equity in 2 largest players

## Blessed with many giant fields

- 5 largest fields in North sea
- 11 of the 14 largest

## Close to European markets

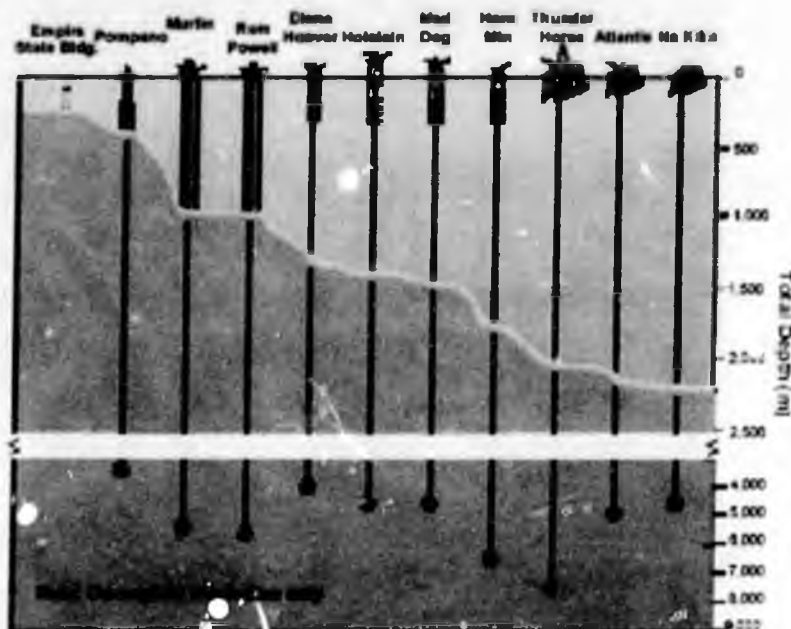
## Resource ownership



# Gulf of Mexico (DW)...lessons for all



BP Deepwater Developments in Gulf of Mexico



## Most active global exploration basin 1993-2004

- Highest E & A spend
- 2<sup>nd</sup> highest discovered volumes

## Rapid growth in production

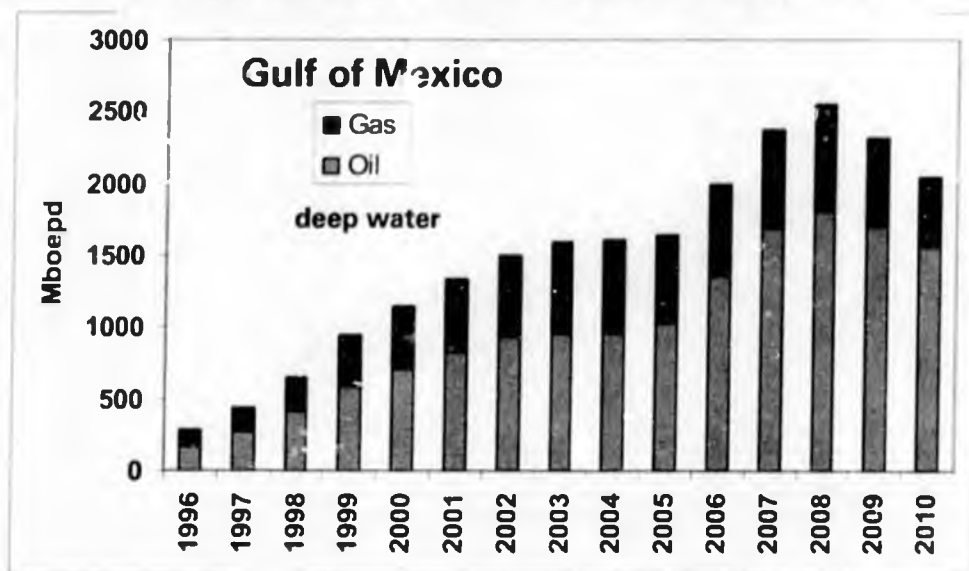
- Despite challenging deep water environment

## Enabling factors

- Extension of existing Industry
- High volumetric potential
- Competitive and stable fiscal regime
- Close to markets
- Deployment of new technologies

## Represents growing share of US production

- 10% in 2004
- Helps US Energy security





## Investment boom underway

- Capex increasing up to \$10 billion p.a
- Alaska flat circa \$1 billion p.a

## Enabling fiscal regime

- Key reform in 1995
  - ✓ 1% Royalty until project payout
  - ✓ 25% after payout
  - ✓ Federal and State tax of 39%

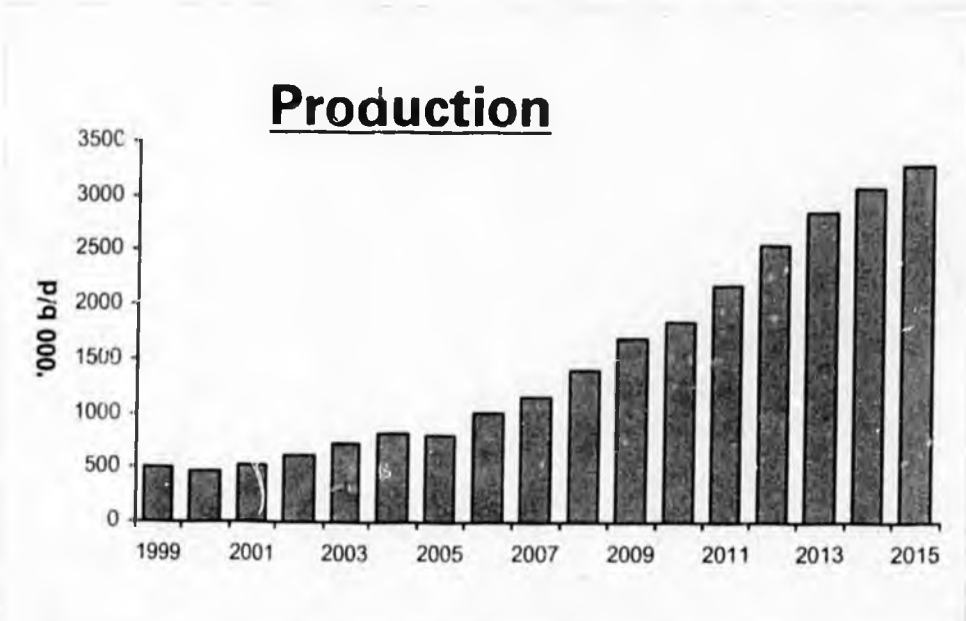
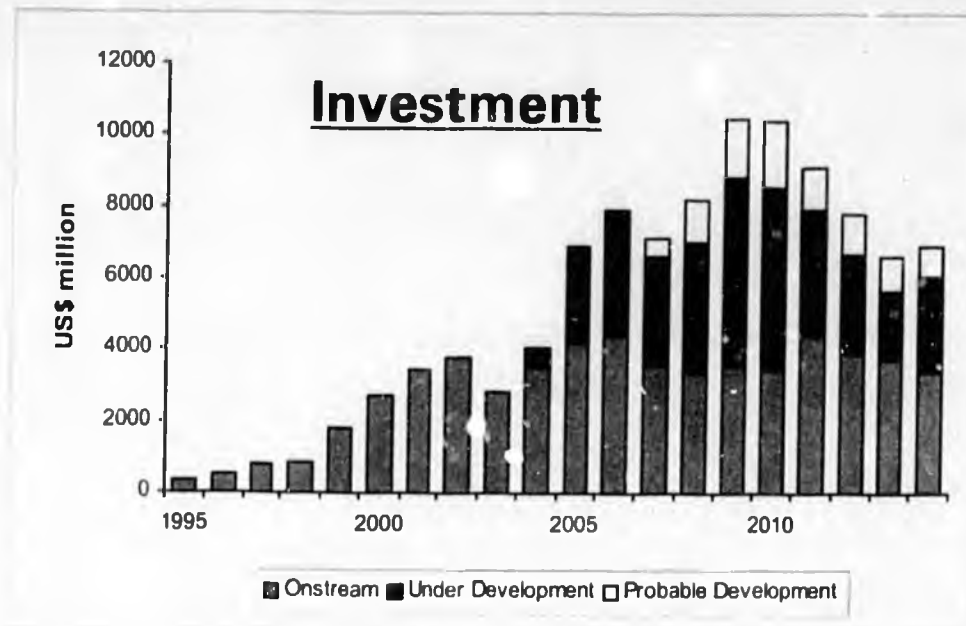
## Marginal tax rates

- 39% pre payout
- 54% post payout

Above rates will decline by 4% through 2007

- via phased reduction in Federal tax rates

Source: Wood MacKenzie

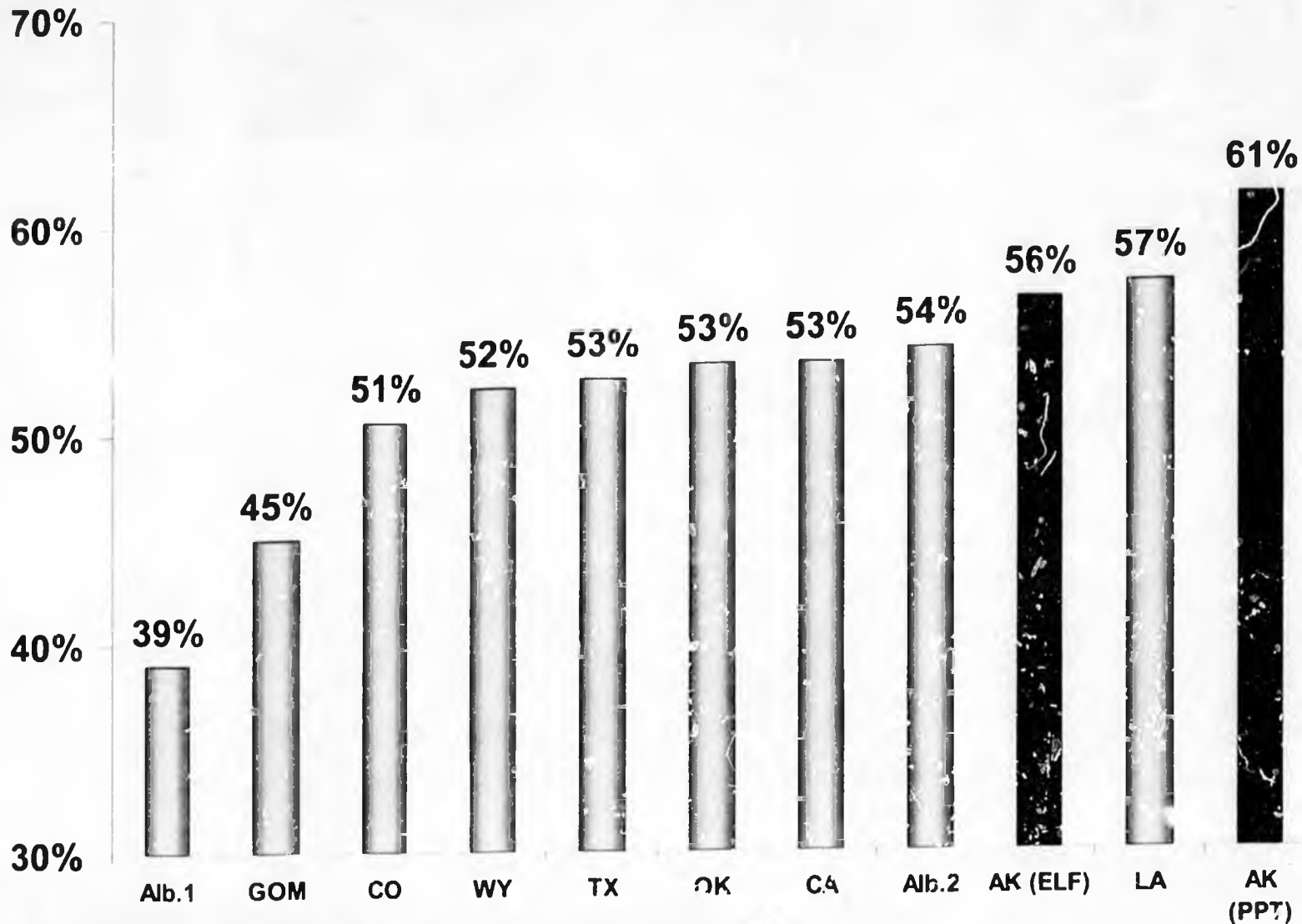


# Selected Fiscal Regimes in North America



Marginal  
Tax Rate

## North America: Tax Rate Comparison



\*Alb: ALBERTA HEAVY OIL – pre and post-payout



### Regime comparison context is vitally important

- Basin maturity, resource quality, risk-reward relationship, cost environment, market considerations and policy objectives

### Clear cause & effect relationship between fiscal policy & basin activity

- Higher tax burden equates to less investment
- Lower tax burden equates to more investment

**UK experience, Gulf of Mexico, Alberta Heavy oil**

2/24/2006

The Petroleum Production Tax (PPT) legislation currently under consideration by the State Legislature is part an agreement between the sponsor group (BP, ExxonMobil & ConocoPhillips) which covers fiscal terms for both oil and gas. The agreement represents a finely balanced package that will support the producers strategy to develop the massive oil and gas resources on the North Slope. It is a big milestone in delivering that strategy to the future of oil and gas in Alaska. Any further tax increase will jeopardize that future.

**Points to consider -**

- The Governor and producers have worked well over a year to reach this finely balanced agreement. Please don't mess this up.
- Alaska has abundant natural resources, but they are challenged by cost and geography
- The producers are working hard to apply innovative technologies to bring Alaska's oil and gas resources to energy consumers.
- These investments mean jobs for Alaskans and revenue for the state.
- But those investments won't happen if Alaska has a weak investment climate
- Alaska's fiscal policies should encourage investment and focus on growing the pie rather than taking an increased share of a shrinking pie.
- The rules of the game need to be clear and lasting. Big investments won't happen if taxes are too high, or if the rules can be changed once investments are made.
- We are on the brink of something very big: a fiscal contract that creates a healthy oil and gas business for generations to come.
- This delicately balanced legislation can help deliver that future, and I support this legislation as drafted because it enables a gas project to move ahead.
- New developments like the Ooguruk needed royalty relief to move forward, but also require infrastructure of the majors. The existing business must be healthy to provide this sort of development opportunity.
- Alaska's oil business must be healthy for gas to work.

Respectfully Yours,



James Gilbert  
9201 Main Tree Dr.  
Anchorage, AK. 99507

And

35290 King Salmon Ave.  
Funny River, AK.

## Role of the Alaska Oil and Gas Conservation Commission in Establishing an Allowable Gas Offtake Rate for North Slope Gas Sales

The State of Alaska and other interested parties are engaged in determining how best to bring North Slope gas to market. The AOGCC has a very important role in this process – to protect the public's interest by preventing waste and encouraging maximum recovery of both oil and gas. To fulfill this role, the AOGCC will decide what gas production rates should be allowed from Prudhoe Bay and other North Slope oil fields. Considering only the laws of science, these decisions are very simple; to prevent waste and maximize hydrocarbon recovery, produce all of the oil in a reservoir first and then "blow down" its gas cap only when there is no commercially recoverable oil left. However, as is typical of just about anything Alaskan, many other factors will – and should – play an important part in reaching the best decisions for maximizing total hydrocarbon recovery and deriving maximum economic benefit for the citizens of Alaska.

Before considering other factors, it is essential first to understand the science. Extracting gas from an oil field like Prudhoe Bay triggers a series of events. First, the pressure in the gas cap decreases and becomes lower than the pressure in the oil-bearing part of the reservoir. As driven by the laws of physics, the reservoir then works to get back to equilibrium, i.e., the same pressure throughout. To do this, some oil, which is at a higher pressure, moves up into the lower pressure gas cap and the pressure in the oil-bearing part of the reservoir drops. This process continues as the pressure throughout the reservoir equalizes at a lower pressure than before. And as more gas is withdrawn, the process repeats, causing more oil to move into the gas cap and also causing the reservoir pressure to decrease further.

Both the movement of oil into the gas cap and the decrease in reservoir pressure jeopardize oil reserves.

Let's look at movement of oil into the gas cap first. Think about what happens when you drain the oil from your car or when you pour cooking oil into a measuring cup. When you empty the container, some of the oil sticks to it and will not come off. That is what happens to oil when it moves into the gas cap, a part of the reservoir that has never contained oil but has always only held gas. However, because that container is porous rock rather

than glass or plastic, the amount of oil that sticks is much greater. The previously "dry" reservoir rock becomes coated with oil. Although some of this oil can be produced, a substantial portion (in some fields over 20 to 30 percent) sticks to the rock and will never come out. In short, producing gas without replacing the gas cap fluids will cause some oil to stick to the reservoir rock and result in a decrease of ultimate recovery of oil.

Now let's look at decreasing reservoir pressure. Think about an aerosol container. It starts out with high pressure inside; if you puncture it, it will explode. As you use it, more and more of the fluids -- both the active product and the carrier gas -- are released and the pressure decreases until, eventually, you push the button and nothing happens. When you shake it, you might be able to hear that there is still hair spray or some other product inside, but you can no longer get it out. At this point the pressure has decreased so that you could even puncture the container and nothing would happen. Similarly, in an oil reservoir, the reservoir pressure provides the energy that allows the oil to flow through the reservoir and up the well bore. As fluids are produced, the pressure decreases and the reservoir loses this energy. Eventually, as more and more gas is produced and the pressure continues to drop, there is insufficient energy to drive the oil from the reservoir. Typically operators of oil reservoirs maintain reservoir pressure and energy by re-injecting produced gas and injecting water to replace produced oil. They continue this process until they have recovered all the oil. Then, when no commercially recoverable oil is at risk, they "blow down" the gas cap. They do this because producing gas from an oil reservoir and not replacing it will result in a decrease of reservoir energy and, therefore, a decrease in oil recovery.

Another bad thing happens when the reservoir pressure decreases; some oil changes from liquid to gas. The remaining oil becomes thicker. Think about soup cooking; as water evaporates, the remaining liquid becomes thicker. In an oil field this thickening makes it harder for the oil to flow and, thus, decreases oil recovery. We all know that it is much easier to suck water up a straw than it is molasses.

In summary, looking simply at the reservoir engineering science, producing gas from an oil reservoir while there is still commercial oil remaining to be produced WILL cause a portion of the oil resources to be lost and, thus, it is always best to keep the gas in an oil reservoir until no more commercially recoverable oil remains. Only then should the gas cap be "blown down."

The explanation above assumes that all of the gas can be recovered after all of the oil has been produced, and for most Lower 48 scenarios this is a reasonable assumption. However, for the North Slope there will be a trade-off between leaving black oil in the ground and leaving gas stranded, and this trade-off will be influenced by several factors.

For example, the remaining useful life and increasing operating cost of the aging North Slope infrastructure will impact this balance between losing oil and stranding gas. Much of the North Slope infrastructure that was put in place thirty years ago for oil production will still be necessary for gas production. As this infrastructure ages, two things happen: 1) the cost to operate the equipment increases, and 2) components break and must be repaired or replaced. The later in time the gas is produced the higher the costs will be to operate, repair and replace equipment and, thus, the sooner the gas will become uneconomical to produce and the more gas will be left stranded.

The minimum rate at which TAPS can operate will also impact the balance between losing oil and stranding gas. Although the gas will have its own line which will operate independently of TAPS, continued operation of the TAPS line will impact the economic life of the gas production because, as long as TAPS is operating, many of the operating, repair and replacement costs will be shared by both the oil and gas production, thus extending the time before either becomes uneconomical.

These and other factors will complicate the gas off take rate and timing decisions for North Slope fields. The AOGCC must balance black oil recovery optimization with gas recovery optimization to insure maximum total hydrocarbon recovery, and this will be no trivial task.

**Tim Benintendi**

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**From:** Kevin Brown [kevin.brown@gci.net]  
**Sent:** Saturday, February 25, 2006 2:58 PM  
**To:** Sen. Ben Stevens; Sen. Gary Stevens; Sen. Johnny Ellis; Sen. Con Bunde; Sen. John Cowdery; Sen. Beltie Davis; Sen. Fred Dyson; Sen. Kim Elton; Sen. Hollis French; Sen. Lyda Green; Sen. Gretchen Guess; Sen. Lyman Hoffman; Sen. Charlie Huggins; Sen. Albert Kookash; Sen. Donny Olson; Sen. Ralph Seekins; Sen. Bert Stedman; Sen. Gene Therriault; Sen. Gary Wilken; Rep. Tom Anderson; Rep. Ethan Berkowitz; Rep. Mike Chenault; Rep. Sharon Cissna; Rep. John Coghill; Rep. Harry Crawford; Rep. Eric Croft; Rep. Nancy Dahlstrom; Rep. Jim Elkins; Rep. Richard Foster; Rep. Les Gara; Rep. Berta Gardner; Rep. Carl Gatto; Rep. Max Gruenberg; Rep. David Guttenberg; Rep. John Harris; Rep. Mike Hawker; Rep. Jim Holm; Rep. Reggie Joule; Rep. Mary Kapsner; Rep. Mike Kelly; Rep. Beth Kerttula; Rep. Vic Kohring; Rep. Pete Kott; Rep. Gabrielle LeDoux; Rep. Bob Lynn; Rep. Lesil McGuire; Rep. Kevin Meyer; Rep. Carl Moses; Rep. Mark Neuman; Rep. Kurt Olson; Rep. Jay Ramras; Rep. Norman Rokeberg; Rep. Woodie Salmon; Rep. Paul Seaton; Rep. Bill Stoltze; Rep. Bill Thomas; Rep. Bruce Weyhrauch; Rep. Peggy Wilson; Sen. Tom Wagoner; Rep. Ralph Samuels  
**Subject:** Fw: HB488 & SB 305 PPT  
**Attachments:** K.Brown Comments HB488 & SB 305.doc

Dear Alaska Legislator,

My comments represent my personal views. They are a bit long, but I hope you can review them before you vote on or ammend the very important PPT bill.

Sincerely,

Kevin Brown

Anchorage, Alaska

To the honorable chairmen:  
**Thomas Wagoner**  
**Ralph Samuels**

Comments from Alaskan, Kevin Brown

**Re: HB 488 & SB 305 before the Legislature**

Thank you for the opportunity to share my views regarding the bills under consideration.

### **Background**

I'm transplanted, but have spent the majority of my life in Alaska, 29 years. My wife and I have six children ranging from 10 to 23 years old. My son graduates as a mechanical engineer this spring and hopes to return home to find work supporting the design and construction of the gas line. As a proud dad, I am very excited for him and those of his generation that will help deliver this building block of Alaska's fiscal future.

It is in this frame of mind I write to you. You and your colleagues in state leadership are trusted to secure this project for Alaska and our country. I am pleased that the State has reached agreement with the major producers. Soon, we can begin the engineering and planning that will take us to the point where we all celebrate the first sections of pipe being laid in Alaskan and Canadian soil. I implore you to do your part in assuring that politics does not impede this process.

### **Gas line**

As to the pipeline project, please let reason prevail. There is only one proposal that has been evaluated in detail and explained. Also, that project's sponsors have the technical and financial capacity to deliver a thirty billion dollar project. Yes \$30 billion! TAPS was estimated at less than \$1 billion and exceeded \$9 billion.

I'd ask that you not tolerate the distractions caused by ill conceived alternatives or misguided sentiment around all Alaska anything. The shortest distance to the market is a "straight line." I suggest it is time "all Alaskans get it" and "our leaders help us get on with it."

### **The deal**

As I understand it, the Legislature has two steps before it votes for the gas contract itself. The first step is to create an oil production tax framework that can be added to the gas contract. In my view, this is an incredibly important step and I sympathize with producers. Please pass something they can support.

### ***Prudence(what is being asked for is reasonable)***

*It is unreasonable to expect these companies to invest \$30 billion without due diligence. Alaskan lessons can be attributed to numerous rule revisions, challenges and actions of DOR, DNR and RCA. Also, consider TAPS owners who have paid and fought to defend their tariff settlement ever sense oil began flowing. I would certainly ask for tax-rule clarity before I invested \$30 billion. From the State's perspective I can think of more than 30 billion reasons to grant it.*

*Why are oil terms important? The oil business and gas business are the same business. God placed the oil and gas together; the same wells penetrate the same formations; gas and oil will flow to the same facilities; the same people, systems and processes will prepare the products for shipment; and, the companies running it all will report combined financial results to their shareholders. Gas will only work if built upon the foundation of a profitable oil business.*

*Bad timing (they could not have picked a worse time to ask for fiscal certainty- \$60<sup>+</sup>/bbl) We have been blessed and cursed with 18 months of extremely high oil prices. We've been blessed with additional revenues from royalty, severance tax and state income tax. And, we have been cursed with a lack of fiscal discipline, increased spending and a lust for our industry's profits. Is it right to participate in the upside? Yes; but Alaska must be careful not to bite the hand that feeds us, or worse yet, make Alaska less attractive for investment than it already is. Yes, they are making a lot of money. But, no one is asking how much Coke made selling sugar water last year. No one seems to remember Alaska at \$10/bbl. And, I don't hear anyone talking about how these companies need good times to pay for the bad times. In the bad times (moderate to low prices), Alaska's amalgamation of taxes (royalty, severance, state income, property, environmental, federal income) cause the combined government share of revenues to exceed 100%. The PPT proposal does not eliminate this effect.*

*So, from producer's perspective, could you think of a worse time to negotiate a fiscal contract? And, recognizing this, isn't it all the more important that the legislature demonstrate constraint and wisdom while designing the new PPT? I'm confident that you can and I trust you will.*

So here we are:

**HB 488 & SB 305**

This important decision affects the future of oil and gas, Alaska's future. The Legislature's decisions will be of immense benefit or detriment to Alaska. This is where I begin to worry a bit.

In general, I worry that a short-sighted grab for increased revenue may put the gas project at risk and also begin to put the Alaska industry into an unhealthy downward spiral.

The PPT method is a definite improvement over the old severance tax system. My issue is that the proposed 20% rate is too high and some of the other bells and whistles seem purely political; as, it is difficult to see how they add production or revenue to the State. The most obvious is the "give-away" in the form of a \$73 million exemption. No company needs this if the rate is lowered and the credits raised. Revenue exemptions will not generate additional investment, but they will produce unwanted consequences. Low tax and attractive investment credits will attract investment. And, Alaska needs a lot more than historical levels to stop decline.

High investment credits can be made "safe" for the state with creation of simple deductibility limits (carry forwards) based on price. For example, have investment credits put in carried forward status unless oil is above \$35 per bbl. Such limits will provide for a minimum tax during moderate and low price cycles. Further, if these key terms are

adjusted (tax rate□ - credit rate□), you may improve the balance enough to make an effective date of January 1 and a shorter transition term agreeable.

Alaska's resource quality and costs will determine our attractiveness for investment. Alaska has a cost disadvantage as Dr van Meurs illustrates; however, van Meurs doesn't realize that this disadvantage widens every year. Also, as ANS crude quality changes with increased viscous production, one may expect that market differentials would grow – another burden on the cost side. These "givens" must be considered collectively with the total government take to understand Alaska's competitiveness. Even at \$60 per barrel this represents another 10% to 15% of disadvantage, or taken another way, add 10% to 15% before you compare Alaska tax burden to other regimes that are close to the market and have a product comparable to WTI.

Two last general points related to what Dr. van Meurs' testimony and analysis miss.

1. Given Alaska resource quality, our main competition is for development dollars with mature areas of North America and the United Kingdom and with booming and highly competitive areas like deep water Gulf of Mexico.
2. Alaska currently only has one market to sell its crude, the US West Coast. If the market changes, transportation costs increase and so does our competitive gap.

**Analysis Paralysis**, I've been watching gavel to gavel and I am concerned about the mind numbing presentations by DOR and state consultants. I actually feel for you as a simple concept has become incredibly confusing. The other problem with much of the work is that it does not focus on the real application of the tax (current producing ANS assets) and the taxes probable adverse impacts. These producing assets are life blood of this state.

#### **Dr. van Meurs analysis**

- his model assumptions do not reflect Alaska business
- understates tax and over emphasizes "first investment", "small players" and "incremental IRR"
- takes your eye's off the real ball – the \$billions of increases you have been shown = \$billions of decreases to investors and increased burdens on mature, declining and already high cost businesses
- tax will cause decline rate to increase – less production

#### **DOR's analysis**

- understates tax and exaggerates the \$/bbl crossover point because they include gas development costs as a deduction in the oil PPT – the explanation I have heard is evasive and misses the point
- overestimates production in all cases (this is historically consistent with DOR track record)

**Here is the simple equation neither DOR nor van Meurs has shared with you (and likely other consultants hired by the Legislature to support tax increases):**

- More tax equals less investment
- Less investment equals less production
- Less production equals higher costs
- Higher cost equals a less competitive Alaska
- Less competitive equals even-less investment

- o Even-less investment equals even-less production
- o Even-less production equals **death spiral**

**PPT proposal**, Please consider

- o Report by Dr. van Meurs has over 130 of pages of analysis supporting a structure where the tax rate is between 13% and 20%, includes a warning that 30% is too high and has two sections with a conclusion that a 25% tax rate is appropriate(?). The report is incongruent. (Does "best" mean "highest" in Dutch?)
- o The emphasis on small players is noble, but no real reason to give a \$73 million revenue exemption to anyone. Revenue exemptions won't add one barrel of production and will cost the state money. This provision will lead to poor behaviors and unintended consequences. If you need a revenue exemption, the rate is too high.
- o Too many misleading graphs in van Meurs report. Where is the analysis of business being taxed: Prudhoe, Kuparuk, Milne, Alpine, Northstar & Satellites? Taxes have consequences and retrospective tax increases on sunken investment cause companies to readjust their view of regime risk.
- o If Alaska wants to grow the business, consider a lower rate and higher credit. I've watched the discussion go from "ELF doesn't work" where the effective production tax rate is currently ~6%, to "how about 20, 25, 30, 35%??" This type of dialog is irresponsible. Please do your part in regaining balance. In other parts of the world, they have abolished royalties to help tail end production. We are talking about significantly raising taxes????
- o Alaska needs major companies to increase their investment above historical levels. Increased oil prices have been helping. Will increased taxes?
- o Alaska needs to attract other major companies (eg. Shell ...). Will provisions tailored to small players do this? The majors provide the niche for small players like Kerr McGee and Pioneer.
- o If the base business is healthy, new players, large and small alike, will add value, but no free rides are necessary (e.g. \$73 m exemption). A balanced system with a competitive rate and attractive credits will do.
- o It seems reasonable for the companies to expect their return on recent investment ("claw back").

**In summary**

- o The proposed rate of 20% is too high
- o Consultants are confusing your decision with distorted analysis
- o 25% rate announced just prior to agreement seems odd. *Weren't we all waiting to hear the outcome of a negotiation? How is it there was an announcement just prior to the final negotiation?*
- o A reading of van Meurs report leaves you questioning the validity of his rate recommendation. *Are there previous drafts? Did DOR edit their consultant's report?*
- o Must consider potential impact to base business and potential risk of downward spiral.
- o Tax rate should be adjusted downward and credits upward.
- o \$73 million revenue exemption is a political-giveaway, adds no value to the state and should be dropped
- o All modifications by Legislature should improve terms for existing business and represent terms which producers will support, paste into their gas line contract, and produce forward momentum on securing Alaska's oil and gas future

**Finally, a little back seat driving (my day on the state Legislature)**

1. Make improvements to PPT that the producers will support. These terms should increase state revenue when prices are up, create much more incentive for investment, provide some protection when prices are down, and secure the gas contract.
  - a. Rate based upon oil price \$/bbl

i. Below 30 per barrel	PPT – 0%	Credit – 25% carry forward
ii. Between 30 and 60 \$35/bbl)	PPT – 15%	Credit – 25% (usable >
iii. Between 60 and 90 \$35/bbl)	PPT – 20%	Credit – 25% (usable >
iv. Greater than 90 \$35/bbl)	PPT – 30%	Credit – 25% (usable >
v. challenged viscous oil \$35/bbl)	PPT- same	Credit – 30% (usable >
  - b. Eliminate \$73 million revenue exemption – PPT is good for small and large alike
  - c. Limit "claw-back" to three years (usable above \$40/bbl)
  - d. Use credit and deduction carry forwards (without interest) to provide for minimum tax during moderately low oil price, but let companies recover during higher price cycles (this will continue to encourage more investment when prices are down).
  - e. Legislature develop fiscal discipline to save excesses so we do not grow the fixed cost of running Alaska and make the whole system unstable with bulging state budgets.

I hope you will consider these views as my family's future rides on our getting this right.

Sincerely,

Kevin Brown  
Anchorage, Alaska  
February 25, 2006

Deborah Vogt  
P.O. Box 675  
Haines, AK 99827  
(907) 766-3849

Testimony – Joint House/Senate Resource Committees  
House Bill 488 / Senate Bill 305  
February 25, 2006

Good Morning. Thank you for the opportunity to testify on this important bill

My name is Deborah Vogt and I live in Haines.

I served for five years as the Deputy Commissioner for the Dept of Revenue. I retired from that position in 1999; before that, I was an assistant attorney general for many years, and much of my practice was with oil and gas tax matters. I was the lead attorney for the state in the litigation challenging the separate accounting income tax; I mention that because in many ways this legislation is much closer to an income tax than a traditional severance tax.

It is great that the administration has recognized the defects in our current oil and gas tax structure, with the problems with the ELF being the most fundamental of those defects at this point in time. I am gratified to see the Governor bring a bill before this body, and I urge you to give it your most serious consideration. Having listened in on the hearings the last several days, I believe you are doing that. In my view, this is the most important topic over which you have real control that will probably come before in your careers. In many ways, the long term economic future of the state rests in your hands.

Specifically, then, with reference to House Bill 488: In short, I think it is a good fundamental approach, but with a seriously flawed execution. Certainly, an oil tax system in which the producers can recover their sunk costs before they pay taxes is a modern, and – as Dr. Van Meurs has testified – a common approach throughout the world.

However, **this** bill does not protect the interests of Alaskans. It gives far too much away, and unnecessarily so. I sit on the local municipal assembly here in Haines, and I am acutely aware of how much the state's reduction in municipal revenue sharing, coupled with the high cost of heating oil for schools and municipal buildings, has challenged local governments' ability to make ends meet, or in some cases, even stay open for business.

Any of you who operate a business can imagine the incredible benefit of not only being able to expense, in the first year, any capital expenditure that you make, but also getting a dollar-for-dollar credit for a portion of that expenditure. If I ran a dry cleaning business, and bought a new delivery truck for \$50,000, I could not only deduct the ENTIRE \$50,000 from my income that year (or carry forward a loss) but I would also receive a credit against my tax liability of \$10,000. If I didn't have enough tax liability to offset the credit, I could SELL the credit. These provisions of the production tax bill make it very competitive in the international arena.

If the bill stopped right there, I think we'd have a generous, competitive piece of legislation, so long as the tax rate were appropriate. But the bill goes on to grant what I believe are totally unnecessary give-aways to the taxpayers.

Examples include: the \$73,000,000 tax-free allowance that every taxpayer gets, whether it needs it or not, and whether it invests that money in Alaska or not. I really cannot see the advantage of handing \$73 million tax free dollars to a company, like Exxon, that has declared profits of \$39 billion dollars unless it is developing something new in Alaska. These dollars don't have to be spent in Alaska; they can be spent to develop oil fields anywhere on earth. This is an overbroad and unnecessary provision; Roger Marks testified yesterday that the provision will cost the state about \$40 million annually. Surely all the creative minds there in Juneau could design a provision that tailored an allowance like that to new development. There are a thousand ways to do it.

Second, the so-called "claw-back" provisions are just a give-away. These expenditures were not made with the thought that they would be recovered in this manner. This whole bill is about incentives; it is impossible to "incent" (a new word I learned this week) activities that took place half a decade ago. This provision, Marks testified, will cost the state \$170 million for the next six years, if this bill is passed. If you don't want those dollars, let me tell you that the municipalities will take them!!! This provision should be deleted.

A much less expensive give-away, but still one that is unnecessary and should be recognized, is the repeal of the conservation surcharge of \$.05 / bbl. (now divided into 2 cents and 3 cents) Thankfully, we have not had another major oil spill since the Exxon Valdez; but this is a giveaway we don't need to make. I don't, by the way, see a fiscal note from the DEC on this provision.

The change from the Governor's original proposal of a January 1, 2006 effective date to a July 1 date, which took place after the Governor's meeting with the industry, is a give-away of a half a billion dollars (at the 20% tax rate now in the bill). I've litigated effective date (or more precisely, applicability date) provisions, and Assistant Attorney General Mintz was certainly right yesterday when he testified that the courts generally uphold these provisions. This tax greatly resembles an income tax, and in my experience, an income tax law almost always applies throughout a calendar year. It is very very common for such a provision to relate back to the beginning of the tax year. As I recall, the separate accounting income tax was enacted back to January 1 of 1978; its repeal

applied to an entire tax year. These sort of provisions have been litigated; I don't know of a case where a court has thrown out an applicability section in a tax case which goes back less than a full year. The January 1, 2006 date should be restored..

Much of this is no doubt dwarfed by the rate that is included in the legislation. Again, this rate changed from 25% to 20% after the Governor sat down behind closed doors with the industry. The Governor's own fiscal note projects that, at the 20% rate, this tax is better than the status quo for ONLY TWO YEARS, using the DOR's current long term price projections. Granted, most of us think, and we certainly all hope, that the long term price of oil will be above \$25.50; but that is what they are projecting, and unless they revise that number, it makes sense to use it.

Certainly, a tax structure that plunges to worse than what we have now at a \$25 / bbl price of oil is absurd. Clearly, at \$25.00 oil, the companies are making plenty of money; the DOR's numbers show that if the price were \$25 during FY 07, they'd clear \$1.7 billion under the current tax structure, and the state would take in about the same amount. But under the bill you have before you, the state would lose the entire severance tax component of that amount, or about \$400 million dollars. That's overly generous; we hope we don't see that price of oil any time soon, but if we did, your constituents would have good reason to be upset with you.

What's the right rate?? Certainly, the 25% originally proposed by the governor would be better. Dr. Van Meurs' study is based on this rate, and shows that Alaska would be very competitive internationally at this rate. I hope you take this question very very seriously and make the best deal for Alaskans. Have a special session if you need to, nothing could be more important. Hire your own international expert to advise you; hire two. Take your time.

An important part of that analysis should be the comparative share of the economic rents of production that are realized by the state and industry. Roger Mark's "Figure 12" shows those comparative amounts for \$58/bbl oil at the 20% tax rate. The corporate share is 44%, and the state's share is 32%. Historically, policy makers since the 70's have thought that the industry and the state should enjoy an equal share. You should certainly request that DOR provide similar charts at various rates, and I'd recommend you adopt the rate that shows state and industry shares about equal. I would not be surprised if that rate were more like 30% than 20%. Find a system that doesn't tube to zero when the industry is still making significant money; find a system that gives the state an equal share of its natural resource wealth.

Thanks for the opportunity to testify; I wish you well in this endeavor.

Written Testimony of Adam M. Pener, Chief Operating Officer  
Conflict Securities Advisory Group, Inc.  
Submitted to the Alaska House State Affairs Committee  
February 27, 2006

**Introduction**

Thank you Mr. Chairman and Members of the Committee for this opportunity to submit written testimony regarding Alaska House Concurrent Resolution 27. By way of background, I am Chief Operating Officer of Conflict Securities Advisory Group, Inc. (CSAG), a Washington, DC-based independent research provider that specializes in identifying and assessing U.S. and foreign publicly traded companies that have business activities in or with Iran, North Korea, Sudan, Syria and Libya.

To my knowledge, CSAG's *Global Security Risk Monitor* (Monitor) online database of public companies with such business ties is the only one of its kind. Our clients include the U.S. Securities and Exchange Commission (SEC), the Department of Defense and the Department of State and leading public pension systems such as the \$85 billion New York City Employees Retirement Systems, the Missouri State Employees Retirement System and the Office of Arizona State Treasurer David Petersen. Numerous asset management firms, mutual fund providers and universities also utilize CSAG's products and services.

As a private, for-profit and impartial research firm, CSAG neither supports nor opposes HCR 27. Likewise, our firm, as a matter of corporate policy, does not take a position on how our data should be used by clients. Rather, CSAG seeks to provide impartial information that allows investors and their asset managers to conduct expanded due diligence in the area of global security risk.<sup>1</sup>

Over the past year, investors and state legislatures have increasingly sought to restrict investment in companies with ties to Sudan and/or other terrorist-sponsoring states. In a number of such cases, CSAG's research has been employed by asset management firms to comply with these new restrictions on a cost-effective basis.

I have submitted to the Committee a detailed Product Overview that describes our qualifications, provides additional background on our firm and global security risk and describes our research methodology and verification processes. More information on CSAG as well as a "Free Trial" of our database can be found at [www.conflictsecurities.com](http://www.conflictsecurities.com).

**Testimony Content**

CSAG believes that its extensive experience in helping pension systems and asset management firms comply with legislative requirements, investment mandates and corporate governance initiatives will assist the Committee in its deliberations with respect to HCR 27. At the request of the Committee, I am pleased to offer testimony that will:

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<sup>1</sup> CSAG was established following a determination by the SEC in May 2001 that corporate ties to U.S.-sanctioned countries, including U.S. State Department-designated terrorist-sponsoring states, can be material to investors. This new risk category was termed "global security risk," or the risk to a company's share value and corporate reputation stemming from its business activities in or with terrorist-sponsoring states. The majority of CSAG's clients use the data to identify portfolio companies that may be exposed to global security risk and to help assess such risks.

1. Address the issue of whether data is available that would allow the Alaska Permanent Fund (APF) and Alaska State Pension Investment Board (ASPIB) to comply with HCR 27;
2. Provide a cost estimate for implementation; and
3. Address, to the best of our ability, the issue of "divestment costs" (i.e., prospective portfolio losses associated with divesting from companies with ties to Iran or North Korea).

Before continuing, I should note that CSAG's experiences in this field have netted results that differ from those anticipated in Ms. Achee's testimony. I hope that Ms. Achee, the Committee and the Alaska Permanent Fund will accept my apology in advance if any of these differences were a result of my inability to articulate properly the capabilities of our firm and CSAG's pricing models during my call with her of Wednesday, February 21.

### List of Companies

In the event that APF and ASPIB are required to screen out companies with business activities in Iran or North Korea, the question has been raised as to how the Funds could identify the relevant companies.

I respectfully disagree with APF's suggestion that the Federal Government, via the SEC -- rather than private research firms -- should be looked to as a source to identify and publish a list of companies that have business ties to terrorist-sponsoring states. The SEC and the Treasury Department -- in public statements and letters to public pension systems -- have made clear that the government cannot, and will not, provide a list of companies that do business in terrorist-sponsoring states. There are several reasons why the government has been firm on this matter.

### *Legality of Operations*

The USG can (and does) provide investors with a "do not buy" list of companies that have engaged in **illegal** activity. The vast majority of companies with ties to Iran, North Korea and other terrorist-sponsoring states, however, maintain such operations legally. The U.S. government, including the SEC, cannot and does not provide lists of companies that are not in violation of any law.

This is likely why U.S. Treasury Spokesman Taylor Griffen, in response to pension system requests for a government-identified list of these companies, stated in an Associated Press article dated July 8, 2003: "[Divesting from companies with ties to terrorist-sponsoring states is] not a question of regulation, but of policy, and we would leave that for the states to decide." (See Attachment 1.)

### *Global Security Risk*

While pension systems can legally invest in these companies, such investments can still introduce risk to the investor. In that connection, it is the job of the federal government to ensure that companies disclose all activities that could put the investor at risk (usually via public filings).

It is not the responsibility of the federal government, however, to provide a list of companies that may be risky investments. SEC Deputy Director Shelley Parratt said as much in a letter to Nick

Maiale, Chairman of the Pennsylvania State Employee's Retirement System (PSERS) dated July 28, 2004 (see Attachment 2):

"It would be inappropriate for [the SEC] to publish a list of companies whose securities might be deemed to involve terrorism-related investment risk without publishing corresponding lists for every other possible type of investment risk."

This unwillingness of the government to identify companies exposed to risk might help explain why the SEC looks, in large part, to CSAG to make these identifications through a subscription to our aforementioned *Monitor* product.

### *Values Based Investing*

As Mr. Griffen and Ms. Parratt make clear, it is not possible for the government to provide a list of companies that have legal ties to terrorist-sponsoring states. It is likewise restricted from providing a list of companies that may be exposed to global security risk.

Interestingly, HCR 27 speaks to neither the legality of these investments nor the risk factors they involve. Rather, the Alaska Resolution reflects the fact that some investors that business activities in terrorist sponsoring states run counter to their personal values or beliefs, or that of their constituencies. This is commonly referred to as "values-based investing." For example, some investors choose to avoid investing in companies that promote tobacco, gambling, firearms or alcohol – *not because it is illegal or risky to invest in such companies*, but because the investor is seeking to align their personal values with their financial goals.

This "values-based investing" question lies at the heart of HCR 27. Apparently, some state legislators believe that Alaskans simply do not want to invest in companies with business ties to Iran or North Korea.

This position is, again, perfectly within the rights of the investor or, in this case, the state of Alaska. For example, some states and public pension systems restrict investments in companies that produce tobacco products. Others will not invest in companies that fail to meet certain labor rights standards. **However, it is important to note that in no case, will the USG tell an investor whether or not to establish such "values-based" investment restrictions or provide a list of such companies.**

As Ms. Parratt goes on to say in the aforementioned letter,

"It would also be inappropriate for [the SEC] to engage in any activity that might be construed as providing investment advice."

**[We probably need a summary b-4 transitioning here..] To summarize, HCR 27 seeks to assess whether Alaskans want to invest in companies that operate in Iran or North Korea.**

Finally, the APF has correctly pointed out that companies such as CSAG do not promote the use of their data as a "divestment list." As noted above, our firm believes that advocacy of any type runs counter to our corporate mandate to provide impartial, independent data to our clients. Moreover, our list is designed to be a comprehensive research tool that includes information on a variety of

corporate ties to Iran and North Korea. Whether such ties meet Alaska's threshold for disinvestment should be up to the state and its Funds to determine.

To be clear, CSAG has not designed its research or products for any predetermined use by its clients. Accordingly, subscribers are welcome to use our products in any way they deem indicated – including to develop screens or implement a divestment policy.

**The bottom line is that CSAG has extensive experience in helping clients comply with divestment policies and similar investment restrictions. We are confident that our firm could likewise work with the State of Alaska, its public pension systems and its asset managers to help meet their needs.**

### Cost of Data

Naturally, there would be modest costs involved should APF and ASPIB decide to identify or screen out companies that do business in Iran and North Korea.

- Our standard subscription is \$15,000 per year to access the full *Monitor* database and research. This option is widely used by clients that wish to use our product to enhance their due diligence process and have comprehensive information on the business activities of publicly traded companies in Iran, North Korea, Sudan, Syria and Libya.
- If the Committee (or APF and ASPIB) wanted to determine how many APF and ASPIB holdings would be affected by the HCR 27 restrictions, CSAG could provide a "Certification Report," including sample company profiles, for \$3,500.

In the event that APF and ASPIB establish investment restrictions on companies with business ties to Iran and/or North Korea, implementation could be approached in several ways. For example, the Funds could allow their asset managers to comply independently with state law by purchasing their choice of research products – which is the process being employed by Illinois.

Based on our understanding of the concerns raised by APF and ASPIB regarding how a Iran and North Korea screen would be implemented, CSAG believes the more "top-down" approach described below might guarantee a higher level of uniformity in the data used by asset managers.

In this "top-down" approach, CSAG could work with APF and ASPIB to configure a custom screen for Iran- and North Korea-linked companies to comply with Alaska. The custom screen would involve the formulation and maintenance of a "do not buy" list based on CSAG's research. This single, statewide list would then be available to asset managers for the consistent application of state law. For example:

- The Funds would review CSAG's data and establish a "do not buy" list of companies that meets Alaska's specifications. (Please note that such a list could exclude companies that, for example, only have humanitarian ties to these countries.)
- Determine an agreed price point for CSAG to provide the Alaska custom screen to all APF and ASPIB asset managers, including regular updates of the list.

- Managers that are already subscribers to CSAG's *Monitor* product would be able to employ the Alaska screen at no cost.
- The Alaska Funds would have access to the custom screen at no cost to assist the process of overseeing their managers.

While I cannot provide a firm price point for such a custom screen at this time, I am confident CSAG would be able to execute this proposed process for substantially less than the APF-estimated price tag of between \$267,000 and \$585,000 annually.

Specifically, I would estimate that CSAG's custom screen proposal for Alaska would be priced between \$1,500 and \$3,000 annually, per manager. The exact price point would depend on the number of asset management firms that would require ongoing access to the custom screen. Naturally, the cost-per-manager to access the screen decreases as the number of managers using the service increases.

Accordingly, I would anticipate the entire set of deliverables described in this implementation scenario to cost *Alaska asset managers* cumulatively some \$75,000 - \$100,000 per year. Interestingly, in the event that Alaska's asset managers were required to implement a screen, the cost estimates I have provided would likely represent less than one quarter of one percent of the APF's FY06 budget for asset managers (i.e., based on APF's estimates, asset managers will collectively receive \$46.6 million from Alaska in 2006, while having to budget only \$100,000 to comply with HCR 27).

Finally, the APF stated in its testimony that the costs associated with this type of screen will be passed back from the asset manager to the pension funds. Again, this has not been our experience. For example, in the case of Sudan divestment legislation in Oregon and Illinois, it was stipulated that the costs of setting up screens were to be borne by the asset manager. In working with Illinois asset managers, I have received no indication that these firms planned to, in effect, charge their pension system clients for minor expenses incurred in establishing a Sudan screen.

### **The Performance Costs of Divestment**

On Sunday, February 19, the *New York Times* ran an article on the Illinois divestment legislation (see Attachment 3). Despite the fact that the legislation affects some 10 public pension systems with more than \$120 billion in assets under management – as well as over 150 asset managers ranging in size from small, local firms to some of the biggest names in the business – the *Times* article made no mention of any financial losses incurred by Illinois pension systems as a result of this policy.

Practical experience also casts doubt with respect to anticipated losses stemming from divestment of a relatively small number of companies. Specifically, CSAG's data is licensed by The Roosevelt Investment Group (Roosevelt), a New York-based asset management firm. Roosevelt uses CSAG's database to exclude from of its Bull Moose Growth Fund all companies identified by CSAG as having business ties to any terrorist-sponsoring states. Not only has Roosevelt been able to avoid losses since employing its screen, but it has outperformed the S&P 500 by a substantial margin.

Oregon likewise does not expect to lose money in employing a Sudan screen for its public funds. According to a recent *Socialfunds.com* article (see Attachment 4),

“Oregon law goes a step further than Illinois law, requiring institutional investors' asset managers to prevent negative financial impacts on the portfolio when divesting. ‘What I'm hearing from [asset management firms], though, is that this is not very difficult --they've been able to reposition their portfolios without a lot of adverse impact,’ Ms. Ivy [of Institutional Shareholder Services] concluded.”

None of this is to suggest the APF's assessment is misguided. There may be performance losses associated with implementing a screen. However, it is important to note that the SEC has determined that companies that do certain types of business in terrorist-sponsoring states could face new material risks. This is likely why Missouri Treasurer Sarah Steelman recently made clear that her state should seek to protect the *investments* of Missourians when assessing corporate ties to terrorist-sponsoring countries: “We can and must develop and adopt a real policy that protects our citizens and our investments.”

The fact of the matter is that Alaska could take significant losses by holding companies that are exposed to global security risk, just as easily as the state could experience performance losses from restricting such holdings.

### **Conclusion**

In closing, I would note that Alaska is not alone in considering this issue. In addition to three states that have already enacted legislation that establishes investment restrictions on companies with business activities in Sudan, published reports indicate that as many as five states are expected to introduce divestment legislation this spring targeting companies that do business in any terrorist-sponsoring state.

Should Alaska choose to restrict APF and ASPIB from investing in companies with ties to Iran and North Korea, it is my view and experience that CSAG could help the Funds develop and implement such a screen on a cost-effective and relatively non-disruptive basis.

I would be pleased to discuss this matter further with the Committee and/or Alaska's Funds. Also, I would recommend that the Committee look to the following experts and public officials for additional information on those matters raised in my testimony:

1. **New York City Comptroller William Thompson:** Comptroller Thompson can be reached via Pat Doherty, 212-669-2651 or [pdohert@comptroller.nyc.gov](mailto:pdohert@comptroller.nyc.gov)
2. **Missouri Treasurer Sarah Steelman:** Treasurer Steelman can be reached through Mark Mathers (see below).
3. **Nell Minow**, Expert on Corporate Governance and President of The Corporate Library, [nminow@thecorporatelibrary.com](mailto:nminow@thecorporatelibrary.com).
4. **Mark Mathers**, Director of Investments for the State of Missouri and Board Member for the Missouri Investment Trust, 573-751-8530 [Mark.Mathers@treasurer.mo.gov](mailto:Mark.Mathers@treasurer.mo.gov).
5. **Steven Schoenfeld\*\***, Chief Investment Strategist for Quantitative Investments for Northern Trust, .

6. **Tony Malaj**, Chief of Staff for Arizona Treasurer David Petersen, 602-604-7809 or [tonym@treasury.state.az.us](mailto:tonym@treasury.state.az.us).

**\*\* As noted in the attached *New York Times* article, Mr. Schoenfeld is responsible for implementing six "Sudan-Free" indices for Northern Trust that already have over \$8 billion in assets under management – mainly from Illinois pension systems that are required to divest from companies operating in Sudan. CSAG has spoken with Mr. Schoenfeld and received no indication that Northern Trust's "Sudan-Free" indices are experiencing sub-standard performance.**

**Mr. Schoenfeld is one of the country's leading thinkers on indexed funds and should be able to shed additional light on whether divestment and/or the development of "Iran- and North Korea-Free" indices would have the negative financial impact predicted by the APF in its testimony.**

**Tim BenIntendi**

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**From:** JRWINTHER@aol.com  
**Sent:** Monday, February 27, 2006 8:36 AM  
**To:** Rep. Ralph Samuels  
**Subject:** SB305 Testimony  
**Attachments:** SB305--JRWTESTIMONY--2-25-2006.doc

Rep. Samuels,

Enclosed is my testimony I did via telephone at the Saturday hearing.

It is important to for the small independent oil companies that the \$73M deduction and the tax credits stay in the bill.

John Winther

2/27/2006

MR. CHAIRMAN, MEMEBERS OF THE COMMITTEE

THANK YOU FOR THE OPPORTUNITY TO TESTIFY ON SB 305.

FOR THE RECORD, MY NAME IS JOHN WINTHER AND I RESIDE IN PETERSBURG.

MY PRIMARY BUSINESS IS FISHING, BUT I AM ASLO AN OWNER OF TWO INDEPENDENT OIL COMPANIES THAT OWN ACREAGE ON THE NORTH SLOPE WITH HOPES OF BECOMING A PRODUCER.

IN 1997, DALE LINDSEY, MYSELF AND SEVERAL OTHERS FOUNDED WINSTAR PETROLEUM IN 1997. WE SUCCESSFULLY BID ON LEASES TOTALING ABOUT 20,000 ACRES OVER THE NEXT SEVERAL YEARS.

IN 2002 DALE LINDSEY, JIM WEEKS AND I STARTED ANOTHER COMPANY CALLED UNLTRASTAR EXPLORATION. WE CURRENTLY HOLD 4700 ACRES NORTH SLOPE .

DALE AND I WERE INSTRUMENTAL IN GETTING THE PROVISIONS IN THE CHARTER FOR DEVELOPMENT THAT IS IN THE MERGER AGREEMENT BETWEEN BP AND ARCO. I CAN SAY WITH OUT THESE PROVISIONS IN THE CHARTER FOR DEVELOPMENT, THERE WOULDN'T BE ANY OPPORTUNITY FOR AN INDEPENDENT ON THE NORTH SLOPE TODAY. THE KEY PROVISIONS WERE ACCESS TO THEIR FACILITIES ON REASONABLE TERMS, THE MAJORS HAD TO PURCHASE UP 5000 BBL/DAY OF PRODUCTION, THEY WERE REQUIRED TO SELL SEISMIC TO AN INDEPENDENT, AND THERE WAS A BINDING ARBITRATION CLAUSE IN THE EVENT TERMS AND CONDITIONS CANNOT BE AGREED.

DALE AND I ALSO WENT TO WASHINGTON DC ON OUR OWN TO COMMENT ON THE MERGER AND PARTLY BECAUSE OF OUR EFFORTS, THE ARCO ASSETS IN ALASKA HAD TO BE SOLD OFF. THIS LED TO PHILLIPS COMING TO ALASKA. WE FELT THERE HAS TO BE THREE MAJORS ON THE SLOPE TO ENSURE COMPETITION.

WE ARE UNIQUE IN THAT I BELIEVE WE ARE THE ONLY ALASKAN OWNED INDEPENDENT OIL COMPANY TO EVER DRILL A WELL ON THE NORTH SLOPE. WE DID THIS IN 2003 ON A LEASE WE OWNED NORTH OF OLIK TOK POINT. WE CONTRACTED WITH CONOCCO TO DRILL AND IF WE WERE SUCCESSFUL, TO DRILL ANOTHER WELL AND OPERATE THE WELLS. I WISH I COULD SAY WE STRUCK OIL, BUT ALL WE FOUND WAS WATER.

WHILE WE WERE DISAPPOINTED, WE WEREN'T DISCOURAGED AND BEGAN NEGOCIATING WITH BP TO DRILL A WELL FOR US AT PT MCINTIRE. WE

EXPECT TO COMPLETE THESE NEGOTIATIONS IN TIME TO DRILL A WELL LATER THIS YEAR.

I AM HERE TO SUPPORT SB305. WHILE THERE ARE MANY PARTS TO THIS BILL, I SUPPORT WHAT TO ME IS THE MAJOR PARTS OF THE BILL THAT IS THE 20% TAX LISTED IN SECTION 5 ON PAGE 2 OF THE BILL, THE \$73 M DEDUCTION AND THE TAX CREDIT PROVISIONS THAT ARE ALSO IN THE BILL.

I SEE THAT THERE IS SOME SUPPORT IN THIS LEGISLATURE FOR RAISING THE 20% TAX ON OIL AND GAS PRODUCTION. I URGE YOU TO LEAVE THIS AS NEGOTIATED BY GOVERNOR MURKOWSKI.

RAISING THIS TAX IS GOING TO DISCOURAGE EXPLORATION AND DEVELOPMENT BY THE MAJORS.

BEFORE BECOMING INVOLVED IN THE OIL INDUSTRY, I DIDN'T REALLY UNDERSTAND MUCH ABOUT BIG OIL, OTHER THAT THEY MADE HUGE MONEY AND PUMPED LOT OF OIL, AT LEAST THAT IS WHAT I THOUGHT.

AFTER DEALING WITH THEM, I HAVE A BETTER UNDERSTANDING ON HOW THEY WORK AND WHY THEY DO THINGS THE WAY THEY DO.

I THINK THE MOST IMPORTANT THING TO REMEMBER IS THEY HAVE MORE OPPORTUNITIES TO DRILL FOR OIL AROUND THE WORLD THEN THEY HAVE THE MONEY FOR SO THEY HAVE TO PICK AND CHOOSE THEIR PROJECTS. IT IS A WELL KNOWN FACT THAT ALASKA IS THE MOST COSTLY PLACE TO DO BUSINESS, BUT IT IS ALSO THE MOST POLITICALLY STABLE OIL SUPPLY FOR THE UNITED STATES IN THE WORLD. WHILE WE MAY THINK ALASKA IS A PLACE THEY MUST DO BUSINESS, I DOUBT THEY THINK THAT WAY. THIS 20% IS WHAT THEY HAVE AGREED TO AND I THINK IT SHOULD NOT BE RAISED.

WE WHO WERE IN ALASKA KNOW WHAT KIND OF ECONOMY WE HAD BEFORE OIL AND IT WASN'T WHAT YOU CALL ROBUST. I THINK THE STATE BUDGET IN 1967 OR 68 WAS \$98M.

OUR PRODUCTION IS DECLINING EVERY YEAR SO WHY DISCOURAGE DEVELOPMENT BY INCREASING THIS 20% TAX?

THE \$73M DEDUCTION IS SOMETHING THAT HEAVILY FAVORS THE INDEPENDENTS AND REALLY DOESN'T DO MUCH FOR THE MAJORS BECAUSE OF THEIR HIGH PROFITS SO, I URGE YOU TO KEEP THIS IN THE BILL ALONG WITH THE TAX CREDITS.

IN CLOSING, SOME OF MY REMARKS MAY SOUND LIKE I'M SPEAKING FOR THE MAJORS, BUT I'M NOT. HAVING NEGOTIATED WITH THEM TO DRILL A WELL FOR US, I LEARNED A LOT ABOUT THEM AND I RESPECT THE WAY THEY DO BUSINESS. AT 20% ALASKA, IS GOING TO DO VERY WELL AND TRYING TO GET MORE MAY WORK BUT YOU MAY HAVE DISGRUNTLED MAJORS WHICH IN THE LONG RUN ISN'T GOOD. AGAIN I URGE YOU TO SUPPORT AND APPROVE THE KEY PROVISIONS OF THIS BILL.

**Tim Benintendi**

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**From:** Jim Sykes [jsykes@ak.net]  
**Sent:** Monday, February 27, 2006 12:47 PM  
**To:** Sen. Tom Wagoner; Rep. Jay Ramras; Rep. Ralph Samuels  
**Subject:** Info for Oil tax hearings  
**Attachments:** WorldOilCompare.pdf

Dear Resource Committee Chairs,

This is a resend. I wasn't sure if you received the chart I had sent in advance of my testimony on Saturday. My intent was to allow every member of the respective committees to have a copy. I'm not sure my original email was received, so I'm just sending it again so that it can be shared with all members.

It begs the question whether Alaska is getting a fair return on its nonrenewable resources. This and other indicators point to a "no" answer. So, as the oil tax structure is considered for revision, we need to figure out what is fair, how we're going to get it and how we will monitor and maintain a fair and transparent process. Since I did not prepare comments for the testimony I gave, I will forward some specific questions and concerns that deserve further consideration.

Thank you. If you have any further questions, please call anytime.

Jim Sykes 745-6962

----- Original Message -----

**From:** Jim Sykes  
**To:** Senator\_Thomas\_Wagoner@legis.state.ak.us ; Representative\_Jay\_Ramras@legis.state.ak.us ; Representative\_Ralph\_Samuels@legis.state.ak.us  
**Sent:** Saturday, February 25, 2006 9:15 AM  
**Subject:** Info for Oil tax hearings

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It basically shows that Alaska is near the bottom of the world's oil producing regions in getting a share of economic rent for oil. It is very relevant to the discussions at hand. If you have any questions please call.

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Jim Sykes 745-6962

# How Alaska's oil tax policies compare to other countries around the world.

## International Petroleum Exploration and Development Contracts

### Government Participation

= Government taking an ownership position in a development venture.

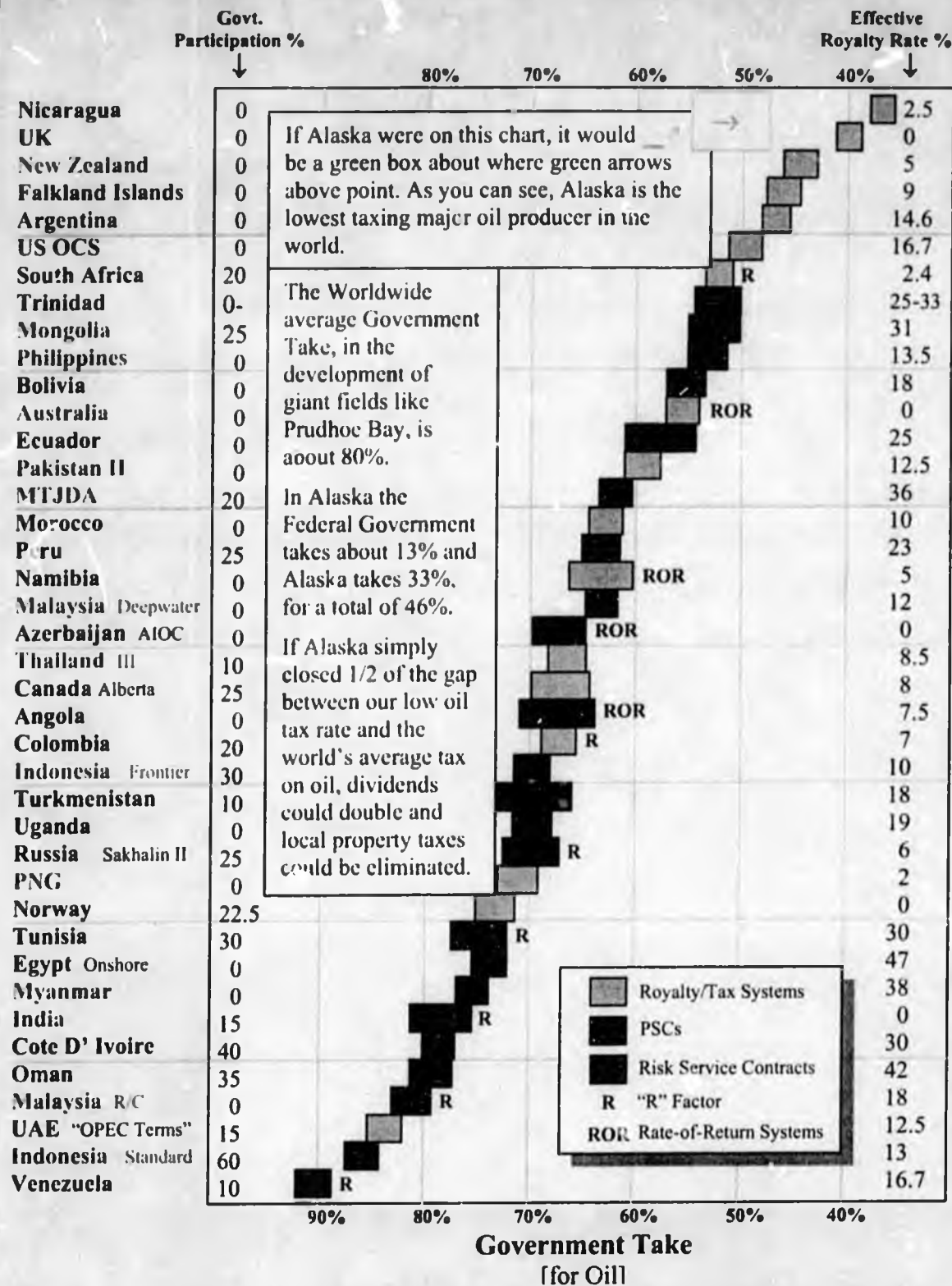
### Effective Royalty rate

= All combined guaranteed returns subject only to fluctuation in the price of oil. Not sharing in risks of loss.

### Government Take

= Total percent of revenue taken from production, regardless of whether it was a tax, a royalty, a risk sharing production contract, risk service contract or some other method of taking revenue.

**PSCs** = Production Sharing Contracts.



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Figure 5. Chart reprinted with permission; with Definitions and Alaska statistics added by Ray Metcalfe.

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The oil companies want you to believe that Alaskan oil is more expensive to produce. **That is misleading for two reasons. (1.)** When we are talking about sharing the wealth, we are talking about how we share the money left over after all production expenses are paid. What's our fair share? How does Alaska compare to the rest of the world? **(Reason #2.)** Due to the size of the field, Prudhoe Bay enjoys a among the lowest pre-barrel production costs in the world. The low cost of producing giant oil fields is why "Government Take" for giant fields averages 80% around the world; everywhere but Alaska. In Alaska, it's about 46%. (See the chart for details) To Alaska, that's about three billion dollars per year in services, dividends and Permanent Fund savings that we don't get.

Out of the hundreds of wells in production throughout Alaska, Alaska has only one well in production which was leased on terms bearing any resemblance to world market values.

Leased in 1982 and in production on the North Slope for nearly 20 years now, it is:  
State of Alaska Department of Natural Resources Lease # 312828

DUCK ISLAND UNIT-PORION OF TRACT 15, FILE: ADL 312828.

ITS LEASE TERMS ARE: ROYALTY SHARE % TO ALASKA = 20%  
PLUS NET PROFIT SHARE % TO ALASKA = 79.593500%

The balance of the net profit share from Duck Island is retained by British Petroleum, who spends millions every year to convince you and your legislators that they couldn't possibly operate a well in Alaska under such circumstances.

If Duck Island weren't profitable, it wouldn't be in production.

Contrary to popular opinion, Alaska's percent of retention of profits from the production of its oil is among the lowest in the world. Alaska's Legislators and Governor have given tax break after tax break to the oil companies who fund their campaigns. Consequently we now have wells in production producing as little as 9% in total returns (government take) to the State of Alaska. Returns so low they wouldn't even fit on the chart showing how Alaska compares to other countries.

If Alaska simply closed 1/2 of the gap between our low oil tax rate and the world's average tax on oil, dividends could double and local property taxes could be eliminated.

Giant oil companies with refineries and retail facilities are constantly searching the world for giant oilfields. They do so to insure uninterrupted long-term supplies.

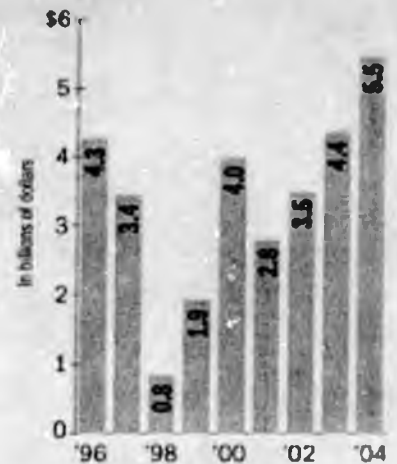
Selling refined products is by far the most profitable part of being in the oil business and consequently, oil companies are far more concerned about uninterrupted long-term supplies than they are with Alaska's rate of taxation. If this were not so, BP would not now be investing its exploration dollars in Venezuela, the country with the highest oil taxes in the world. Please note Venezuela on the chart comparing Alaska to other countries

Giant oil companies won't stay a day longer if we give them our last barrel of oil for free. Alaska's best chance for a bright future is to wrestle control of our resources back from the oil giants while there is still enough oil left to make a difference.

Ray Metcalfe  
RayinAK@aol.com

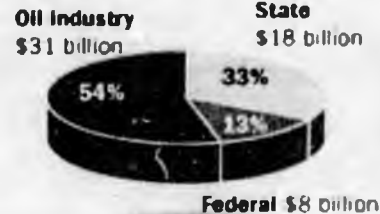
## North Slope oil company profits

1996-2004



## The state, federal treasuries got billions too

1996-2004



NOTE: All figures are rounded.  
Source: Price, William & Sons Regional Citizens' Advisors, Counsel and Consultant  
Richard Fineberg

RON ENGSTROM / Anchorage Daily News



The Associated Press  
**A gas station in Stockbridge, Ga., posted prices for gasoline from \$5.87 to \$6.07 per gallon Wednesday.**

Anchorage Daily News, Sept. 1, 2005

**Emily Stancliff**

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**From:** Kirby Koy [kirbykoy@gmail.com]  
**Sent:** Monday, February 27, 2006 9:32 AM  
**Subject:** Oil & Gas Employee - Opportunity to Testify  
**Attachments:** MRK - CV.doc

Dear Representative,

I am currently on a leave of absence from BP where I have worked for over ten years in Alaska and abroad on various business development projects - all from the position of strategy development, partner negotiations, economic valuation, long term planning and capital allocation. I am well versed in how major oil companies make economic decisions and how they choose to make capital investments. Specifically, I worked for two years developing BP's economics and basic strategy for a pipeline development to market natural gas from the north slope.

This week the oil companies will be testifying regarding the oil tax proposed by the Governor. I would like to offer to testify and provide the opportunity for the committee to hear from someone who has worked for and understands the oil company perspective, but isn't tied to toting the company line. Specific points I would make are:

- The premise of the Governor's oil tax plan is reasonable: more progressive, based on profits, investment incentive. However,
- Investment decisions are usually made assuming oil prices of between \$20-\$30/bbl. In this range is where Alaska needs to be competitive relative to other regions and where the greatest tax breaks should be focused. The tax proposal gives the largest tax break relative to the current system at oil prices between \$16-\$20/bbl. The mechanisms should be adjusted to raise this to be between \$20-\$30/bbl.
- High oil price (above \$30/bbl) is incentive enough to invest. Investment incentives above this price should be eliminated or phased out.
- The tax as proposed gives too much of a tax break, relative to the current tax structure, at low oil prices and shares in too little of the upside on the high side. Because companies look at oil prices between \$20-\$30/bbl when making investments, it is possible to flatten out the tax break in the low oil price world and increase the tax take in the high oil price world without impacting investment.
- Given long term oil prices average between \$15-\$20/bbl. more times than not the oil price will be in the range where Alaska is earning fewer dollars relative to the current system instead of in the high oil price range where Alaska earns relatively more tax dollars. The structure as proposed is therefore more risky for the State.
- Oil taxes and investment in a gas pipeline are not related other than by the oil companies to minimize their oil taxes. The decision to invest in a gas pipeline is an incremental investment decision not impacted by oil production and each company will make the decision to invest in a gas pipeline based on the economics of gas solely and without regard to the oil business.

Best Regards,  
Mike Koy  
1-907-250-7169

# Michael Ronald Koy

**Address:** 5901 Greece Circle  
Anchorage, Alaska 99516

**Home:** 907-250-7169  
**Email:** kirbykoy@gmail.com

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## SUMMARY OF QUALIFICATIONS

**Business Development Manager** with more than ten years experience preparing business strategies and plans; conducting and leading economic and investment valuations; managing third party relationships; working in operational and corporate head-office environments and leading multi-disciplinary/multi-cultural teams. Industry experience includes oil & gas exploration and manufacturing: both domestic and international.

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## WORK EXPERIENCE

**BP Exploration (Alaska), Inc., Anchorage, Alaska** **2004-2005**

**Business Development Manager** **GPB Performance Unit**

- Lead long term planning process for Performance Unit (PU)
- Lead/support 3<sup>rd</sup> party negotiations with partners/state
- Restructuring PU capital governance framework to align with Alaska Business Unit (BU) and Segment frameworks
- Lead development of economic valuations related to new business development opportunities
- Develop and lead methods for efficiently managing over \$900million in annual capital and expense expenditures

**BP International, plc., London, England** **2001-2004**

**Planning Manager** **TNK-BP Business Unit**

- Lead long term planning process for Strategic Performance Unit (SPU)
- Monitor TNK-BP's performance and long term expectations, provide challenge where appropriate and report clearly and meaningfully to Business Unit Leader, Group Vice-Presidents (GVP) and Managing Directors with an objective perspective developed via rigorous analysis/interpretation of management information
- Communicate Business Unit performance to Group Planning and other stakeholders within BP
- Maintain required networks/relationships with extended team members (BP Finance, M&A, Tax, Legal, HSE), Planning & Performance Management (PPM) and Investor Relations
- Interface with TNK-BP Managing Directors to:
  - Develop appropriate context and understanding of business environment within TNK-BP and Russia
  - Understand and challenge, when necessary, performance
  - Participate in framing of work products in order to gain a better understanding of the business and increase performance
- Support SPU leader and BP's TNK-BP Board members as required

**Project Manager** **Mergers & Acquisitions**

Integral part of three person team responsible for managing investment bank relationships, coordinating work product development for numerous work groups, negotiating and supporting Group GVP through internal BP approval process, related to \$16bn merger creating the TNK-BP joint venture.

**Project Leader** **BP Finance**

Responsible for positioning concepts with BP Sr. management and within the Financial Skills framework, developing training materials, acting as BP expert through leading analysis and training the BP Group how to recognize and value optionality inherent within real assets. Projects involved with included: Kovykta gas pipeline, Alaska gas pipeline, miscible injection vs NGL sales, LNG shipping, Indonesian gas and Gulf of Mexico value chain.

**BP Exploration (Alaska), Inc., Anchorage, Alaska**

**1998-2001**

**Sr. Commercial Analyst**

**Alaska Gas Business Unit**

Developed an integrated economic model to evaluate the many related facets of a scheme to commercialize 35+ tcf of gas from the North Slope of Alaska which was used to align technical and commercial work focus. Worked with BP Finance and BP Pipelines to develop innovative ways to finance and structure pipeline investment.

**Commercial Manager**

**Alaska Gas Business Unit**

Managed commercial team responsible with commercializing 35+ tcf of gas from the North Slope of Alaska.

**Commercial Analyst**

**Management Team**

Recruited to a small team to complete economic evaluations and asset reviews, consistent with regional and globally stated objectives, in support of BP negotiations with Exxon and Arco/Phillips to align Prudhoe Bay Unit equity interests. Commercial lead during negotiations which ultimately aligned Prudhoe Bay Unit equity interests and the deepening of BP's in Pt. Thompson.

**Commercial Analyst**

**Prudhoe Bay Asset**

Worked with the Operations Team to identify marginal operating costs and potential facility consolidations. Negotiated yearly overhead allocations with partners resulting in a perpetual \$500,000 per year savings to BP.

**BP Developments Australia Limited, Inc., Melbourne, Australia**

**1996-1998**

**Commercial Analyst**

**Papua New Guinea Team**

Developed unique methods for creating an integrated gas project attractive to project sponsors, prospective buyers, host-governments and project area landowners. Defined project structure, financing and fiscal package that produced the highest sustainable value to the project sponsors while meeting the objectives of all parties involved.

**Commercial Analyst**

**North West Shelf ("NWS") Team**

Supported Sr. Commercial Analyst during pre-investment valuation of NWS liquefied natural gas (LNG) project expansion (US\$1.25 billion investment). In addition, I filled the lead commercial role during the 1996 and 1997 exploration access valuations and was an integral member of team developing BP's regional and NWS development strategies.

**BP Exploration (Alaska), Inc., Houston, Texas**

**1996-1996**

**Commercial Analyst**

**Prudhoe Alignment Team**

Integral part of a four member team representing BP during Federal Energy Regulatory Commission (FERC) and Alaska Public Utilities Commission (APUC) arbitration and depositions. I worked with external consultants and BP specialists to develop BP's settlement proposal that was ultimately adopted and approved by the FERC.

**BP Exploration (Alaska), Inc., Anchorage, Alaska**

**1995-1995**

**Commercial Analyst Intern**

**Planning & Commercial Team**

Worked with consultants to develop portions of a pan-BP Alaska economic model. Completed in two weeks what was expected to take three months. Balance of time was utilized developing test cases for the model, writing parts of the users manual and assisting the Planning Team organize regional inputs for the yearly planning cycle.

---

**EDUCATION**

**Colorado School of Mines - Golden, Colorado**  
Master's of Science degree in Mineral Economics  
Graduated: December 1995 GPA: (4.0/4.0)

**Purdue University - West Lafayette, Indiana**  
Bachelors of Science degree in Mechanical Engineering  
Graduated: May 1992 GPA: (3.2/4.0)

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**INTERESTS**

mountaineering, rock/ice climbing, jogging, weight lifting, hiking, reading and writing

**Emily Stancliff**

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**From:** Jim Sykes [jsykes@ak.net]  
**Sent:** Monday, February 27, 2006 12:47 PM  
**To:** Sen. Tom Wagoner; Rep. Jay Ramras; Rep. Ralph Samuels  
**Subject:** Info for Oil tax hearings  
**Attachments:** WorldOilCompare.pdf

Dear Resource Committee Chairs,

This is a resend. I wasn't sure if you received the chart I had sent in advance of my testimony on Saturday. My intent was to allow every member of the respective committees to have a copy. I'm not sure my original email was received, so I'm just sending it again so that it can be shared with all members.

It begs the question whether Alaska is getting a fair return on it's nonrenewable resources. This and other indicators point to a "no" answer. So, as the oil tax structure is considered for revision, we need to figure out what is fair, how we're going to get it and how we will monitor and maintain a fair and transparent process. Since I did not prepare comments for the testimony I gave, I will forward some specific questions and concerns that deserve further consideration.

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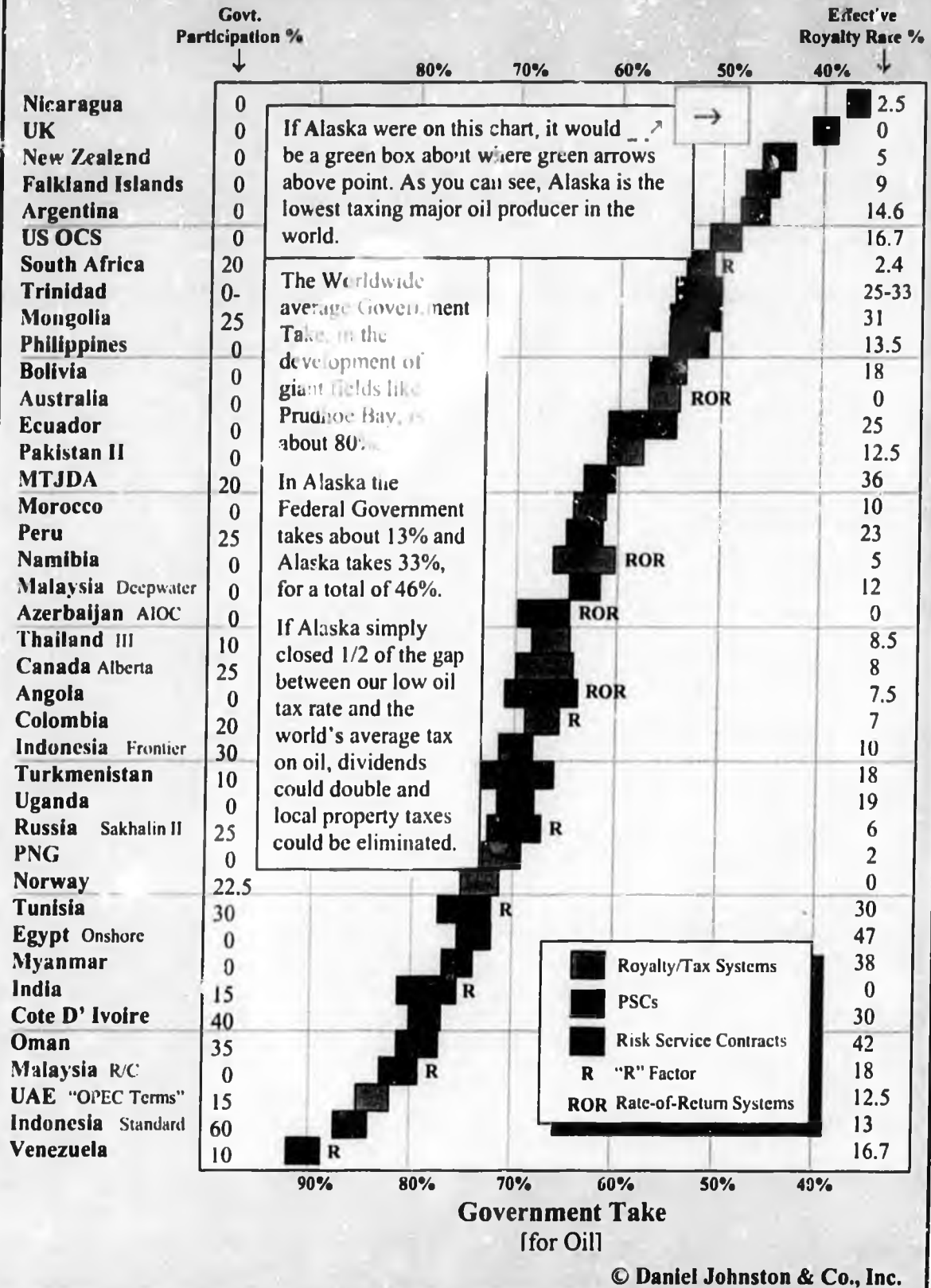


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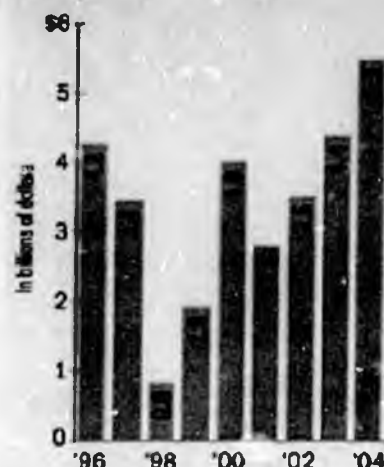
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Ray Metcalfe  
 RayinAK@aol.com

### North Slope oil company profits 1996-2004



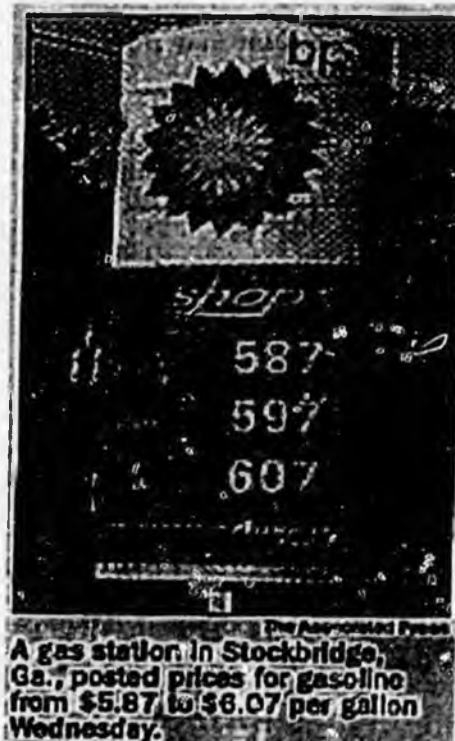
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1996-2004



NOTE: All figures are rounded  
 Source: Prince William Sound Regional Citizens' Advisory Council and consultant Richard Fineberg

RON ENGSTROM / Anchorage Daily News



Anchorage Daily News, Sept. 1, 2005

**Bonnie Robson**  
**Oil & Gas Attorney and Consultant**  
**408 West 11<sup>th</sup> Avenue**  
**Anchorage, Alaska 99501**

February 27, 2006

This memorandum begins with a general discussion of the workings of HB 488 and SB 305, the House and Senate versions of the Governor's bill repealing and replacing Alaska's tax on oil and gas production. It then identifies and discusses three issues raised by legislators in hearings on the bill. For each of the three issues raised by legislators, this memorandum suggests potential amendments to the Governor's bill to address concerns voiced by legislators.

**General Discussion of the Workings of the PPT**

The Governor's proposed legislation is referred to as the "petroleum production tax" or "PPT." The PPT taxes net profits at the point of production. Net profits are calculated by starting with gross profits at the point of production, then subtracting capital and operating expenses incurred upstream of the point of production. The first \$73 million in net profits per producer per year is exempt from taxation, with net profits in excess of \$73 million per producer per year treated as taxable income.

After subtraction of the first \$73 million in net profits, the remaining net profits, or taxable income, is multiplied by the 20% tax rate to arrive at a producer's initial tax liability. This initial tax liability may be further reduced by the application of tax credits, which may be applied dollar-for-dollar against the initial liability. Tax credits are available for 20% of losses as calculated annually at the point of production and 20% of capital expenses incurred upstream of the point of production.<sup>1</sup> Also, the value of tax credits purchased from those without sufficient net profits to fully utilize their own losses and credits may be applied to reduce a producer's initial tax liability. And while a producer's own tax losses and capital expense tax credits can be used to reduce its tax liability as low as \$0, tax losses and capital expense tax credits purchased from others cannot reduce a producer's tax payments to the State below 80% of the amount the producer calculated before application of losses and credits purchased from third parties.

An example of the workings of the PPT for an individual producer is set forth in the following table:

---

<sup>1</sup> For certain exploration capital expenditures incurred anywhere in the State during the first year of the PPT or south of 68 degrees, 15 minutes North latitude during the first four years of the PPT, an explorer or producer may take tax credits of up to 40% in lieu of the PPT's 20% tax credit for same exploration capital expenditures. As a result, the value provided by the State for these expenditures may rise to a total of 60% of the expenditures.

### Example of Workings of PPT for Individual Producer

Gross value at point of production	\$1,000,000,000
- Capital expenses	\$ 350,000,000
- Operating expenses	\$ 50,000,000
= Net profits (net value at point of production)	\$ 600,000,000
- \$73,000,000 annual profits exemption	\$ 73,000,000
= Taxable income	\$ 527,000,000
X 20% tax rate	\$ 105,400,000
Initial tax liability, before credits	\$ 105,400,000
- Producer's own capital expense tax credits ( $\$350,000,000 \times 20\% = \$70,000,000$ )	\$ 70,000,000
= Tax liability after application of producer's own credits	\$ 35,400,000
Maximum usage of purchased tax credits ( $\$35,400,000 \times 20\% = \$7,080,000$ )	\$ 7,080,000
Amount producer pays State, if max. credits purchased	\$ 28,320,000

**1. Tax deductions, losses, and credits are of greater value to established major producers than to those the State seeks to attract: explorers, small producers, and new entrants.**

The PPT is intended to bring explorers and new producers to the State of Alaska. Yet explorers and new producers will want to know that they can compete with existing, major producers on equal footing. This has not always been the case in the past. For example, explorers, potential new entrants, and those leaving the State after determining that they cannot compete have complained that the tariffs for transportation of oil through the Trans Alaska Pipeline System (TAPS) have exceeded just and reasonable rates, to the disadvantage of those without an ownership interest in TAPS. The problem with excessive TAPS tariffs, they argue, is compounded by the fact that the overages they must pay are paid to their competitors, since those that own TAPS are also the largest explorers and producers in this State.

Explorers, small producers, and potential new entrants may argue that the PPT's mechanisms for monetizing losses and tax credits exacerbates an uneven playing field in much the same way as do TAPS tariffs. Their argument may be expressed as follows: Those testifying before the legislature on behalf of the Administration have stated that major, existing producers will be able to immediately take full advantage of tax credits generated from their own activities—they can use 100 cents of every dollar, without limit. These same witnesses have acknowledged that transferable tax credits available through existing programs typically sell for \$0.90 on the dollar, and one should expect no more with the PPT. Further, they have revealed that the price offered by major, existing producers to explorers, small producers, and new entrants for the latter's transferable tax credits could be substantially less than \$0.90 on the dollar in the event of low oil prices, which are apt to trigger the Section 12(e) percentage limit on use of transferable or purchased tax credits.

The Administration seems to agree, then, that tax credits available to explorers, small producers, and new entrants will be worth no more than \$0.90 on the dollar, and possibly substantially less, even though those credits cost the State the full dollar, and major existing producers can take full advantage of 100 cents on the dollar. This inequity in value of tax credits is compounded by the fact that \$0.10 or more of every dollar in tax credits made available because of expenditures by the explorers, small producers, and new entrants will, in fact, be paid over to their competitors—the major, existing producers who buy their tax credits at a discount.

Administration witnesses have justified the PPT's approach to delivering value on two grounds. First, they state—correctly—that if the State was left to fund direct payments for the credit amounts through annual appropriations, in an era of low oil prices the legislature might fail or refuse to do so. Second, they state—also correctly—that the percentage limit on use of transferable tax credits protects the State's treasury. However, there may be an alternative or supplemental approach that accounts for the Administration's concerns in a fashion less likely to increase the disparity between major, existing producers and the explorers, small producers, and new entrants.

Undoubtedly, the Administration, all explorers, and all producers would rather not count on affirmative funding actions by future legislatures to assure that parties are rewarded for incurring expenses related to Alaska's upstream exploration, development, and production. However, HB 488 and SB 305 could be amended to recognize that future legislatures may choose to take affirmative funding actions, and only if they do not will the system of automatic transferable tax credits come into play. As a consequence, at least in robust years the State would be more apt to fund directly what it is going to pay for one way or another, and thus fully reward explorers, small producers, and new entrants for their own expenditures, rather than aggravating uncompetitive conditions.

Additionally, the bill could be amended so that in lean years the explorers, small producers, and new entrants are not "limited-out" while the major, existing producers take full value for their expenditures. While a limit is desirable to protect the public treasury, the limit could be more equitably formulated. For example, a threshold for minimum payments or maximum credits could be established, then credits could be prioritized so that they are not all taken in a year when the State cannot afford it, but some portion of everybody's credits roll forward into more lucrative years. For example, the PPT as currently drafted puts a 20% value on all capital and operating expenses incurred upstream of the point of production, which is taken either as a deduction from gross profits or as a loss; it puts an additional 20% value on the very same capital expenses, which value is taken as a capital expense tax credit. Rather than allowing a major, existing producer to take 100% of both forms of value during a lean year while an explorer, small producer, and new entrant takes little or none, instead deductions and losses could be taken first by all players, and some portion or all of every player's capital expense tax credits could be rolled forward into future tax years if the pre-determined overall limit on credits came into play.

Also, if tax credits that must be bought and sold to be monetized are to play a continuing role in PPT, the legislature may want to consider establishing a minimum price that must be paid to buy these tax credits—say \$0.95 cents on the dollar. Even at \$0.95 cents on the dollar, the \$0.05 amount ought to be sufficient “free money” to entice a major, existing producer to still buy transferable tax credits, yet the floor price will protect explorers, small producers, and new entrants from larger and potentially anti-competitive erosions in the value of their credits.

If the bill's language on tax credits is not amended, disparate treatment of existing, major productions and explorers, small producers, and new entrants may become the rule, as can be seen from the example of the workings of the PPT set forth on page 2. There the producer with \$1 billion in net income can fully utilize its own deductions and credits by taking deductions of \$400,000,000, which carry a cash value of \$80,000,000, and credits of \$70,000,000, for a combined tax savings in the year at issue of \$150,000,000, while explorers, small producers, and new entrants that must rely on the very same producer to monetize their tax credits can only sell that producer credits with a total value of 1/20<sup>th</sup> that amount—just over \$7,000,000. As a result, their credits may sell into a constrained market at substantially less than \$0.90 on the dollar or be rolled forward into future years, with their time value significantly eroded.

**2. The \$73,000,000 tax free allowance was devised to protect those that do not currently pay taxes; its phase-out would prevent an abrupt imposition of taxes on those formerly untaxed, yet discourage multiplication of amounts escaping taxation.**

The PPT allows each producer to take its first \$73,000,000 in net profits each year tax-free. The Administration has explained this tax-free allowance by stating that a producer generating revenues from a 5,000 barrel/day field should not have to pay taxes when oil is selling for \$53/bbl on the West Coast and its net profits at the point of production total \$40/bbl. One could question this rationale, and further ask about the implications of a \$73,000,000 per producer per year tax-free allowance on the public psyche when and if Alaskans are asked to start paying state income taxes on their own, substantially smaller net incomes.

Perhaps a better rationale for the \$73,000,000 per producer per year tax-free allowance is that it is intended to allow those that currently pay little or no state production taxes to continue paying little or no state production taxes, and thus avoid the abrupt imposition of taxes. However, as currently formulated, the tax-free allowance benefits major, existing producers as well, even though they proposed its elimination. Furthermore, with time, the tax-free allowance encourages the proliferation of new entities for the sole purpose of multiplying income escaping taxation.

When considering whether the \$73,000,000 tax-free allowance is necessary to blunt the imposition of taxes on smaller players, it is important to note that, unlike the current system, at all oil and gas prices the PPT already taxes only the profitable, and further includes substantial credits for capital expenditures, which credits effectively permit a percentage of net profits to escape taxation. Thus, the impacts on a small player have already been softened even without the \$73,000,000 tax-free allowance, in a way they would not have happened with other possible changes to the State's production tax regime, such as a simple repeal of the economic limit factor (ELF). Still, if legislators choose to leave the tax-free allowance in place in light of expenditures made by industry with the expectation of lower taxes, the tax-free allowance could be phased out. Phasing out could be accomplished by reducing the allowance each year for a period of

years or simply sun-setting the full allowance a number of years hence. In either case, the largest value of the allowance would be received in the early years of the new tax regime, and thus substantially improve a producer's net present value calculations (whereas allowances to be received in years after a possible sunset date would be of lesser value—and a lesser loss—to producers).

If the tax-free allowance is to be phased out, a phase out over five years may discourage the proliferation of entities created or entering Alaska for no reason other than multiplication of income escaping taxation, whereas a phase out over a longer period (such as ten years) may mean that multiplication is still worthwhile and can be accomplished without clearly triggering the Department of Revenue's ability to aggregate taxpayers under Section 21(j) of the bill.

**3. The PPT may obligate the State to pay up to 40% of abandonment costs, even for fields with little in net profits left to garner.**

Through the PPT the State conveys value—either as a deduction, loss, or transferable tax credit—equal to 20% of all operating costs and 40% of all capital costs incurred upstream of the point of production. In exchange, the State receives 20% of all taxable net income earned upstream of the point of production from and after July 1, 2006. The State's 20% share of net profits and obligation to “pay” 20-40% of costs applies to all oil and gas fields throughout the state—whether on state, federal, or private lands, and without regard to the stage of field life. Thus, for fields past their prime, and even for fields where production has ceased but abandonment has not been completed, as well as for wells, facilities, and fields abandon during the five year “look-back” period for transition expenses, the State through the PPT is undertaking to “pay” (through deductions and credits) up to 40% of abandonment costs, though those costs currently fall exclusively upon oil and gas companies that undoubtedly accounted for their obligation to cover such costs in years past when deciding whether to invest in particular fields. As a consequence, the PPT's treatment of abandonment expenses may result in a huge and disproportionate liability for the State where it currently has none.

There a number of ways in which the legislature could change the treatment of abandonment expenses by amending HB 488 and SB 305. First, abandonment expenses could be disallowed when calculating deductions, losses, and tax credits. Alternatively, abandonment expenses could be prorated, based on the number of barrels of oil (or barrel-equivalents in the case of gas) produced before the effective date of the PPT and the number produced thereafter. Additionally, since the Internal Revenue Code or the PPT's definition of “qualified capital expenses” may allow producers (and former producers) to claim that some or all abandonment expenses are capital expenses subject to a 40% benefit, the PPT could be amended to limit producer benefits at State expense to 20%—that is, require all abandonment costs to be treated as operating costs for purposes of the PPT.

## **Conclusion**

This memorandum does not attempt to identify or address all issues surrounding HB 488 and SB 305, the petroleum production tax legislation introduced by the Governor. Rather, it selects three concerns raised by legislators, discusses them, and provides suggestions on how these concerns could be met through amendments to the proposed legislation. If legislators are interested in further pursuing the possibility of one or more of the amendments mentioned, I recommend that Administration personnel be included in the drafting process to assure that there is no unintended damage to the overall regime of taxation. Also, I would be happy to assist in drafting or reviewing any such changes to the language of the bills.

Preliminary Analysis of Alaska Oil Production Tax  
February 27, 2006

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**Introduction.**

Legislation has been introduced that would revamp Alaska's oil production tax from a severance based tax based on the amount of oil produced, to a net profits based tax. The discussion is a preliminary analysis of the proposed legislation from a tax law perspective.

Most states impose a severance tax on minerals extracted, based on a fixed value per unit of minerals removed from the earth, or a percentage of the gross value. The principal advantage of a traditional severance tax is its simplicity and ease of administration. The oil company determines how much oil it produces, and pays the tax based on the per unit or percentage tax rate. The oil production tax proposed in the bill would calculate the net profit inherent in oil that is produced. The net profit is determined as the gross value of the oil produced during the month, less the production costs. Accordingly, the proposed bill would add a level of complexity not present in the existing tax. There are two principal disadvantages of this added complexity: (1) It allows oil companies more opportunities to plan their production activities in a way to minimize the net profits; and (2) It will require increased resources to the Department of Revenue to administer and enforce the tax.

**Nature of the Proposed Tax.**

The oil tax, as noted, is not a traditional severance tax, because it is not based on the value of the oil produced (although this is the starting point). Although Texas allows a deduction for natural gas marketing costs in calculating its gas severance tax, this deduction is designed to tax all gas on an equal footing even if it must be transported a further distance from the wellhead and is not considered a net profits tax. With this exception, we are unaware of any severance tax that is determined by deducting any cost (and the Texas deduction is not a production cost).

The proposed oil production tax is not really an income tax because the oil is taxed when it is pumped out of the ground, not necessarily when sold. However, it shares many characteristics of an income tax because the tax is determined on the gross value oil produced, less the production costs. Although the oil is a fungible commodity, easily sold on world markets, it nevertheless does not result in the recognition of gross income for federal income tax purposes until it is sold on the market, so it is not technically an income tax.

The tax also bears some resemblance to a tax on tangible personal property (i.e., the value of the oil produced), but a tangible personal property tax is imposed on the fair market value of an asset, with no deduction for costs.

This tax has a strong resemblance to a value added tax. Value added tax ("VAT") is the norm in the European Union. It imposes a tax by the value added at each stage of the production of a product. Since the proposed oil production tax is determined as the difference between the value of the oil produced and the value of the oil in the ground, the net difference is in effect the value added as a result of the production efforts of the oil companies, and therefore has the primary earmarks of a value added tax.

### **Apportionment of Tax.**

The oil production tax bill does not apportion the tax on the proportion of the activities in Alaska to all production activities. Although a pure severance tax is not required to be apportioned, there is the potential that a value added tax might be challenged on constitutional grounds if it is not apportioned. As noted below, any such potential challenge can be preempted by Congress.

In order for a state tax that is imposed on a foreign corporation to be valid under the commerce clause of the U.S. Constitution, it must not discriminate against interstate commerce and must be fairly apportioned. It is possible that a corporation subject to the oil production tax might challenge the tax based on the argument that it is not fairly apportioned to the company's activities inside and outside Alaska. Although a pure severance tax based on the gross value of oil extracted should not have to be apportioned, because the tax base is determined on the number of barrels extracted, the determination of the net profits under the proposed tax takes into consideration activities that might occur outside of the state. Therefore, this might open the door to a challenge that the oil production tax violates the commerce clause requirement that the tax be fairly apportioned.

Michigan has had a value added tax - known as the Single Business Tax ("SBT") - since 1976. The SBT is apportioned based on a standard apportionment formula used by many states to calculate income tax liability based on the proportion of (sales, assets and payroll in the state over total sales, assets and payroll). An auto parts manufacturer based in Ohio challenged the SBT as violating the commerce clause, arguing that the tax was not fairly apportioned (Trinova Corporation v. Michigan 498 U.S. 358 (1991)). The Supreme Court upheld the SBT, holding that it was fairly apportioned. This case, however, raises the issue that a value added tax must be apportioned.

The Supreme Court has also ruled that a typical severance tax must satisfy the fair apportionment test in order to satisfy the requirements of the commerce clause. Commonwealth Edison Company v. Montana 453 U.S. 609 (1981). The court upheld the Montana coal severance tax, as being fairly apportioned, because the tax was a percentage of the value of the coal taken and therefore, was in proper proportion to the company's activities in the state.

Because the proposed oil production tax adds to the traditional severance tax calculation the determination of a company's cost to produce the oil, this could cause a disgruntled oil company, or possibly just a disgruntled citizen to challenge the tax based on the argument that the tax is not fairly apportioned. Since there is no other similar oil production tax that calculates net profits, it is difficult to predict how such a challenge would be greeted by the courts. This could create a level of uncertainty that could hinder the state's efforts to use the tax as a mechanism to help build the much needed gas pipeline.

One sure fix to this potential "fair apportionment" problem would be for the United States Congress to pass legislation authorizing a state to impose an oil production tax based on net profits like the proposed oil production tax. Since Congress has the power to regulate interstate commerce (as discussed more thoroughly below in the discussion on the tax credit), such federal legislation would cut short any potential challenge based on a commerce clause argument. Because of the important national energy security policy that would be advanced by the construction of a natural gas pipeline to bring domestic energy to American markets, Congress might be inclined to adopt such legislation.

#### **Tax Credit-Constitutional Concern.**

The 20% tax credit set out in Section 43.55.024 is a typical state tax incentive to encourage economic development.

Unfortunately, the legality of these tax incentives has been successfully challenged in Ohio, and the United States Supreme Court may soon decide the viability of these programs. The forthcoming Supreme Court decision, might invalidate the economic development tax incentives offered by states around the U.S. Such an adverse decision might invalidate the proposed Alaska tax credit.

The Ohio Case. The Supreme Court will review an appeals court case that declared illegal Ohio's corporate income tax credit for the purchase of new equipment - designed as an incentive for companies to expand investment in the state. The Ohio tax credit is very similar to the proposed Alaska tax credit.

The Ohio case, Cuno v DaimlerChrysler, involved incentives taken advantage of by DaimlerChrysler to build a plant in Toledo, Ohio. DaimlerChrysler was entitled to the Ohio investment tax credit for the purchase of equipment for the plant. In addition, as allowed by Ohio law, the City of Toledo granted a property tax abatement for the equipment purchased for the plant. The total incentives package was valued at \$ 280 million. These substantial tax benefits were obviously a critical aspect of DaimlerChrysler's decision to build the plant in Toledo.

Individual taxpayers from Ohio and Michigan brought a legal action challenging the legality of these tax incentives in Cuno. The trial court dismissed the action, and the plaintiffs appealed to the Sixth Circuit Court of Appeals.

On Appeal, the Sixth Circuit ruled that the tax credit component of the Ohio tax incentive program for equipment purchases was illegal, as a violation of the commerce clause of the United States constitution. DaimlerChrysler appealed the case to the United States Supreme Court, which agreed to review this case.

The Commerce Clause. The Sixth Circuit found that the tax credit component of the Ohio program is illegal because it violates the commerce clause of the constitution. The commerce clause reserves to Congress all power to regulate interstate commerce. This is the provision of the constitution that creates the authority of the federal government to regulate all aspects of commerce. The commerce clause also prohibits states from putting up barriers to interstate commerce. One state can not create trade barriers to regulate the importation of goods from another state, either by regulation or tariffs. For example, a state can not impose a tax at a lower rate for products manufactured within its borders than for products made elsewhere. The plaintiffs in Cuno argued that the commerce clause prohibition against burdening business activity in another state by imposing a higher tax rate also prohibits Ohio from favoring investment within its borders. The Sixth Circuit agreed with this argument, concluding that the commerce clause prohibits a state from adopting tax incentives that favor investment in its state.

If the Supreme Court agrees with the Sixth Circuit Court that the Ohio tax credit violates the commerce clause, then the proposed Alaska tax credit would likely be invalid.

Possible Supreme Court Outcomes. The Supreme Court will hear oral arguments in Cuno on March 1, 2006. There are several possible outcomes when the Supreme Court decides this case.

The Court might very well decline to make any decision for now based on procedural grounds. The Court has asked the parties to file briefs based on the issue of "standing." Only someone who is directly effected by an act has the standing to file litigation in the courts. The plaintiffs in Cuno are individual taxpayers from Ohio and Michigan. The question that the Supreme Court wants them to address is whether an individual taxpayer has the standing to challenge the Ohio tax incentives. It is quite possible that the Supreme Court might rule that the harm suffered by these individual taxpayers as a result of these tax incentives is so indirect and tenuous that they do not have standing to bring this action. In such an event the entire case would be thrown out, and the Sixth Circuit decision would have no force or effect, at least for the time being. If this happens, then the plaintiffs in Cuno have indicated that they will take their case to the state courts, and litigate in that forum. If and when this happens, the entire process would start over, and presumably the case might again make it back to the Supreme Court. This process would likely take several years, leaving the final result up in the air.

The Supreme Court might decide to return this case back to the trial court for a determination of facts as to whether the Ohio tax incentives actually caused DaimlerChrysler to open the plant in Ohio, rather than in some other state. Because the trial court dismissed the case in its early stages, this evidence was not fully developed. By

sending this case back for a trial, the record would be more fully developed. It is possible that DaimlerChrysler was not swayed by the available tax benefits in making its decision to invest in Ohio. If so, this would likely end up back in the Supreme Court, a process that would also take several years.

The Supreme Court might decide to overrule the Sixth Circuit, and say that these tax incentives do not violate the commerce clause. This should return everything back to the status quo, and the proposed Alaska tax credit would likely be safe from the argument that it violates the commerce clause.

Finally, the Supreme Court might decide to affirm the Sixth Circuit, which would put an end to all similar tax incentive programs, including the proposed Alaska tax credit.

Intervention by Congress. Because the constitution gives to Congress the sole power to regulate interstate commerce, Congress has the authority to deal with the issue of state economic development tax subsidies. Accordingly, Congress has the power to fix the Sixth Circuit ruling. Even if the Supreme Court decides to uphold the Sixth Circuit, Congress has the power to statutorily overrule the Supreme Court. In fact, legislation has been introduced in both the House ( H.R. 2471) and the Senate (S 1066) that would do just that - allow states to offer this type of tax subsidy. Accordingly, if these federal bills are adopted by Congress, and signed by the President, this would immunize the proposed Alaska tax credit from a potential commerce clause challenge. As such, the state should champion these bills in Congress if it intends to move forward with the tax credit for investment in Alaska.

#### Tax Credit- Transferability.

The bill would create Section 43.55.024(d) which would allow a taxpayer who has earned a tax credit to sell any unused tax credits, with the consent of the Department of Revenue. The problem with the sale of state tax credits is that they are frequently result in a sale at a deep discount (this is a major issue with state film production tax credits allowed by many states). This is not a desirable result because the state is paying 100 cents on the dollar for every dollar of tax credit, but the company that made the investment in the state is only getting a fraction of this amount. The difference - the "tax credit transfer profit" - goes to the companies that purchase the credit at a discount and the middlemen tax credit brokers who put the buyer and seller together.

Although the big oil companies will clearly be able to use all of the tax credits they earn, the exploration and development companies are less likely to be able to use up all of the credits that they earn. If the exploration companies sell their unused tax credits at a discount to the oil companies, then the oil companies (and any middlemen brokers) would recognize a significant benefit.

There are two potential fixes to this problem. The first would be to allow the tax credit as a credit against any other Alaska tax. This way, if an exploration company did not have

any oil production tax liability to use up the tax credit, it could at least use the tax credit to offset other Alaska tax obligations.

The second alternative would be for the state to "buy back" any unused credits at a modest discount. For example, say that a company could redeem unused tax credits at a 10% discount, so that if a company had \$1 million in unused credits, it could sell these unused credits to the Department of Revenue for \$900 thousand. In this way, it would be the state of Alaska that would gain the benefit of a 10% discount, not the oil companies who would purchase the credits at a discount. This would allow a market to develop for these tax credits at a reasonable discount. A company would not sell its tax credits to an oil company for 85 cents on the dollar if it can sell the unused credits back to the state of Alaska for 90 cents on the dollar.

#### **Limitation on Carry Forward Tax Credit.**

Section 43.55.04(c) allows a carry forward of the unused credit to a later month. This appears to allow a carry forward of any unused credit in a later month without any time limitation. The legislature might want to consider placing an outside time limitation.

Most corporate tax benefits that can be carried forward if they are unable to be used in the year earned have a limit to the number of years to which they can be carried forward. There are sound administrative reasons to place a limit on the number of years that carry forwards should be allowed. For example, tax examinations are much more difficult if the auditor has to look back to events generating the credit that occurred several years earlier. It also creates state budgeting complexities.

#### **Outlay for Capital Expenditures - - Stock of Companies.**

The direct expense deduction for outlays for capital expenses is quite broad, and it is not clear if it is intended that this deduction be allowed for the acquisition of the stock of another company that is involved with exploration development or production of oil or gas in Alaska. If this is the intention, then this should be expanded to prevent a direct cost expense if the Company merely purchases a related company from a common parent corporation.

For example, if the development subsidiary purchased the stock of a development subsidiary from the common parent corporation, the purchase price should not be allowed as a direct cost.

If it is not the intent of the legislature to allow a direct cost deduction for the purchase of the stock of a company, then this should be expressly stated.

#### **Outlays for Capital Expenses - Related Party Transaction.**

If an asset is purchased from a related company, and the company pays an amount that is greater than its fair market value, then the direct cost should be limited to the fair market value.

**Subtraction from Direct Costs - Ownership Interests.**

Section 43.55.160(e)(1) requires a company to subtract from direct costs the amount received from another company for the use of production facilities in which the taxpayer has an ownership interest. This should be broadened to include net payments received for the use of production facilities in which the taxpayer has a management agreement where the management fee is determined by the income received.

**Subtraction from Direct Costs - Credits and Reimbursements.**

Section 43.55.160(e)(2) requires a company to subtract from direct costs the amount of credits and reimbursements received from state and local governments for the company's upstream costs. This provision does not expressly state that this applies to tax credits, including the proposed oil and gas production tax credit. It is also not clear if this would apply to property tax exemptions. If it is the intent of the Legislature that tax credits and property tax exemptions should be subtracted from direct costs, then this should be expressly set out.

**Subtraction from Direct Costs - Recapture of Outlays for Capital Assets.**

Section 43.55.160(c) would allow a company to deduct its direct costs incurred in the exploration, development and production of oil and gas in calculating its net profit for purposes of the oil production tax. The term "direct cost" includes outlays for capital assets. There is a recapture provision in Section 43.55.160(e)(3)(A), which requires a company to subtract from direct costs the amount it receives from the sale or transfer of an asset that it previously deducted as a "direct cost". This rule is designed to prevent a company from churning assets merely to generate "direct cost deductions". For example, if a company purchases a piece of equipment for \$1 million in June which would generate a direct cost deduction, and then sells it in July for \$1 million, the amount received from the sale would be deducted in calculating its direct costs for July. In order to avoid manipulation of the intent and policy behind this rule, the concept should be expanded as follows:

(a) **Related Party Transactions.** If a company sells an asset to a related company for less than fair market value, then the amount it must subtract from its direct costs should be the fair market value of the asset.

(b) **Removal of Asset From Alaska.** If an asset that was purchased is subsequently removed from Alaska to be used by the Company elsewhere, this should be treated as a sale by the Company at its fair market value, so that it would be deducted from the Company's direct costs in the month that it was removed from Alaska. Otherwise a

company might attempt to enhance its deductions merely by purchasing assets for use in Alaska, and later moving it to another state or country for use there.

(c) Wash Sales. It is possible that a Company might attempt to increase its direct costs by selling an asset that it purchased prior to July 1, 2006, and purchasing an identical asset in order to generate a direct cost deduction. Since the asset that was sold was purchased prior to July 1, 2006, the amount received from the sale would not be deducted from direct costs, but the purchase of the identical replacement asset would be included in direct costs, thereby reducing tax liability without actually incurring any real direct cost. In order to prevent this type of manipulation, the recapture provision should be expanded to require the direct costs to be reduced by the amount received from the sale of an asset purchased prior to July 1, 2006 where a similar replacement asset is purchased.

**Exemption for Small Producers.**

Section 43.55.160(i) and (j) provides an exemption for smaller producers. In order to qualify for this exemption, a smaller producer must demonstrate that it is not owned by a single producer entity. This would prevent a large oil company from setting up numerous subsidiaries so that the oil produced by the subsidiaries would be exempt under the small producer exemption.

Large oil companies might try to circumvent this by banding together to form jointly owned enterprises. For example, if four oil companies each own 25% of several production companies, the bill should be clarified to make clear that such smaller production companies would not be eligible for this exemption, even though the ownership can not be attributed to a single large oil company.

Testimony Regarding HB 488 and SB 305, a  
Petroleum Production Tax Bill

Brian Wenzel, Marianne Kah, Darren Jones  
ConocoPhillips

Before the  
House Resources Committee &  
Senate Resources Committee  
February 27, 2006

Mr. Chairman, members of the committee:

Good afternoon. My name is Brian Wenzel, and I am the Vice President, Finance and Administration, for ConocoPhillips Alaska. With me today are Marianne Kah, Chief Economist for ConocoPhillips globally, and Darren Jones, Vice President, Commercial Assets Alaska. Thank you for allowing ConocoPhillips the opportunity to present testimony on HB 488 / SB 305, a bill designed by the Administration to replace the current production tax system.

ConocoPhillips is proud of its 45 year long history (through ARCO and Phillips Petroleum) here in Alaska. We have been actively exploring and developing oil and gas since the early 50's and have been a producer for 49 years. ConocoPhillips is the State's leading oil producer, its leading explorer, and its leading champion for the gas pipeline. ConocoPhillips is also the leading investor in Alaska. We are committed to Alaska and this year alone we are reinvesting over \$700 million on Alaska capital projects, most in our core legacy fields but also in bringing on new developments.

something that ConocoPhillips supports with great reluctance. We should acknowledge that the State is currently enjoying a budget surplus and if one were to consider moving to a profits tax that collected the same amount that is collected today under current law, the PPT rate would be approximately 13% vs the 20% in the proposed bill.

Nevertheless, the legislature has fielded many questions over the last week some of which suggest that a tax rate of 20% is too low and that 25% would be more appropriate. Anytime the government raises taxes it is taking away money from the private sector that could be used for reinvestment and continued job growth. While it is obvious that higher rates would negatively affect the oil and gas industry, we also believe that those higher rates would not be in the long-term best interest of the State.

New field sizes in Alaska are small and arctic operating and development costs are high. We therefore spend a lot of time and resources assessing the upside potential and the downside risk. When we invest, we fully understand that there is a chance that we may not get a return on the investment, but also acknowledge that results could exceed expectations; hopefully we are right more than we are wrong. As we bear the greatest risk, it is fair that we should be appropriately rewarded. We acknowledge that the presence of tax credits reduces the downside risk for investors, but conversely higher tax rates significantly reduce the upside potential.

To attract investors, the State needs to set an appropriate risk/reward balance. If the credits are too high, the state will take too much downside risk, if the tax rate is too high, investors see insufficient upside potential and

look for better opportunities elsewhere. As we have mentioned before, with the high field costs and limited exploration prospectivity, investors in Alaska need upside potential. Moving upwards from 20% will seriously disrupt this risk/reward balance.

Getting the right balance between the tax rate and the credits for reinvestment is critical to future resource development in Alaska. The balance provided in this bill, while incorporating a significant tax increase, reflects, as we've said, a balance we are willing to reluctantly accept. Changes, even small ones will impact this balance and will cause investors to re-evaluate potential investments. Twenty percent can be implemented; but, the question you have to wrestle with is, with a rate that high, are you really going to get the level of long-term investment you desire.

**Transition Plan:** Under the bill, a fraction of a producer's expenditures on exploration, appraisal, and development capital incurred over the past five years may be deducted for purposes of calculating the producer's monthly profit tax obligation. ConocoPhillips supports this plan as it provides an equitable transition to the new tax system and is an essential piece of the overall balance reflected in the bill.

The Fiord field was discovered in 1992 (prior to the discovery of the Alpine Field). It was not possible to develop this small field by itself and it is only with the expansion of the Alpine facilities in 2004 that it is now possible to develop this satellite.

The project kicked off in 2003 and when faced with ELF aggregation, was in

jeopardy of not moving forward. In 2005, the Department of Revenue provided ConocoPhillips with a letter ruling stating that Fiord would be treated as stand-alone satellite and not be aggregated with Alpine for severance tax purposes. As a small satellite, Fiord would have a low ELF and hence pay little severance tax. Once this decision was received from the DOR, ConocoPhillips and its partners sanctioned the project.

Fiord will be an 18 well, roadless satellite with first production in late third or fourth quarter this year. Drilling will continue in 2007 and 2008 and production will peak at around 17,000 bpd. Total capital costs are expected to be around \$300MM. While oil and gas prices have significantly increased over the past few years, we are also seeing dramatically increased labor and material costs. On this project alone, we expect the costs to be \$30MM more than originally sanctioned.

The majority of the costs associated with developing Fiord will have been expended prior to the bill becoming effective. Without the Transitional Investment Expenditure plan, only costs associated with the 2007 and 2008 winter drilling programs would be eligible for PPT deductions and credits. As previously discussed, the project was sanctioned (based on the letter ruling from the DOR) assuming that the field would pay full state corporate income tax, royalty and property tax, but little or no severance tax. However, under the new bill, the development would now be subject to the 20% PPT rate. Without the transition plan, the increase in fiscal terms will result in a reduction of over \$100MM in gross value and a 6% reduction in IRR at a \$40 ANS West Coast Price.

ConocoPhillips is currently working on two other satellites in addition to Fiord. These are Nanuq, due to start up in late 2006, and West Sak IJ, which came on line in late 2005. All of these projects will have similar value loss impacts without the transition plan. In addition there are several other projects undertaken over the last few years which are now almost fully developed and will have value eroded as a result of the PPT.

In order to ensure that these past investments are equitably treated, a transition plan is essential.

I would now like to ask Marianne Kah to spend a few moments discussing how this proposed tax change might impact Alaska's competitiveness from the perspective of a global investor.

Good afternoon. I am Marianne Kah, the Chief Economist for ConocoPhillips in Houston. Thank you for providing me the opportunity to discuss how this proposed tax change might impact Alaska's competitiveness from the perspective of a global investor.

First, let me say that I appreciate the difficulty of your position. Many factors have to be considered by a government in choosing an appropriate tax rate for an industry as complex as the oil and gas industry. Cost structure, prospectivity, potential field size, reservoir quality, regulatory constraints, and the desired level of investment are perhaps but a few of the factors that have to be considered. Moreover, how these factors interrelate is not always obvious or easy to predict. Nevertheless, I will discuss several of

these factors and try to give you information that I hope will be helpful and relevant to your deliberations.

With that said, let me turn to some things that may be important to your decision and that I can illustrate with some slides.

**Global Total Cost per Barrel:** This slide shows for Alaska and other locations average capital and operating costs on a per dollar per BOE basis over the last decade. You can see that Alaska has higher capital and operating costs than other regions. Cost needs to be taken into account when setting the tax take. The countries with the lowest costs can afford to have higher tax rates while remaining competitive. Similarly, higher cost countries need to offset these conditions with lower tax takes.

In addition, with higher taxes there is actually less of an incentive for companies to control costs so you can say that higher taxes lead to higher costs.

**Alaska - High Cost, High Tax:** My next slide, shows the total costs as a function of government take for about 50 countries/states in the world. This data was taken from the Wood Mackenzie 2004 "Global Oil and Gas Risks and Reward Study". As can be seen, there are inverse relationships between Government take and Total Costs. Alaska under the ELF is shown as the Green Box and the peer companies referenced by the State's consultant in his PPT report are annotated and shown as red data points. As can be seen, Alaska under ELF is on the same trend line as many of the countries used by the consultant for his competitive analysis in his PPT report and is in the

“High Cost-Low Tax” quadrant. Based on his analysis, Government Take under PPT will go up about 6%. Alaska’s position on the charts under PPT is shown high-lighted with a circle in the upper right-hand quadrant. Using the new Government take figures estimated by the State’s consultant, Alaska has now shifted from the original trend line and moved into the high cost-high tax quadrant.

It is interesting to note that peer areas (according to the consultant’s competitive analysis) such as the Gulf of Mexico and UK North Sea (even adjusted for the recent tax increase) are still significantly more favorable investment regimes. The high cost in the Arctic and the types of fields that are likely to be found suggest that the proposed fiscal regime could detract, rather than encourage, significant additional investment.

**Global Average Commercial Discovery Size:** My next slide shows the average commercial discovery size in Alaska versus various countries around the world. Areas with high prospectivity can generally assess higher tax rates, while maintaining investment. The Alaska North Slope, however, has limited prospectivity as compared to many parts of the world that we are exploring. Tax rates need to reflect that.

The State’s consultant assessed the competitiveness of Alaska’s tax rates by comparing tax rates of different regimes around the world. He assessed the impact on investor net present value using similar sized fields in all locations. That is not the way investors look at it. When we compare investments in Russia versus Alaska, for example, we compare the prospects of finding a very large field with very high tax rates in Russia versus finding

a much smaller field with lower tax rates in Alaska. The greater prospectivity in Russia may compensate for the higher tax rates. Thus, it is not meaningful to compare the competitiveness of Alaskan tax terms with Russia's terms or those in Azerbaijan and Angola at the same field sizes.

**Norwegian Crude Production:** The State's consultant has stated that Norway is comparable to Alaska in its wealth of natural resources and should be an analogue for Alaska. I don't believe that it is a good analogue because Norway has a lower cost structure and better prospectivity than Alaska. However, Norway has significantly higher taxes than Alaska. I don't believe that the Norwegian tax model is a helpful comparison for Alaska because as shown in this slide, Norwegian crude production has declined by 17% since 2001 despite the high oil prices we have seen in recent years. Thus, I would assert that Norway is not getting sufficient investment since its tax regime isn't in line with its cost and prospectivity position.

**Petroleum Industry Re-Investment Rates:** Investors most need stable fiscal terms with tax rates that are commensurate with the cost structure and size of the opportunity. Alaska's tax regime has offered that in the past and that is why we have found Alaska to be an attractive place to invest.

With the recent tax increases we have seen in a few locations around the world, I have become concerned that global tax takes are reaching a point where private companies are finding it challenging to invest. I believe that is one of the main reasons why petroleum industry re-investment rates, including those of independents, have not completely followed the rise up in

crude prices.

Of course, there are several other reasons why we haven't seen a greater spending response thus far -- the expectation that prices will cycle down to more "normal" levels and a lag time in developing new projects to invest in. But I firmly believe that tax rates around the world are also playing a key role. I also believe that re-investment rates could be lagging due to fear that governments will change tax rates after investments are made. Longer term, I am concerned that private oil companies will not be able to invest in conventional oil under terms being offered and will be forced to invest in alternative energy supplies with more favorable tax terms.

**Cost of Capital:** Another concern from a major oil company's point of view is the bias in the proposed tax regime change in favor of new versus legacy investors. There is a common misperception that small and medium-sized petroleum companies have lower return requirements than the majors. I would like to point out that the independent petroleum companies as a group, for example, have a higher cost of capital than the supermajors, and they should therefore have higher return requirements. Companies of all sizes who have not maintained adequate returns for their shareholders are no longer with us today.

I would also imagine that independents will also be comparing Alaska's tax rates to those in the Gulf of Mexico, United Kingdom and Canadian oil sands, where they have been frequent investors. The State's consultant concludes that tax rates in these locations are more competitive than the existing and proposed tax rates in Alaska.

If countries have high tax rates, it is possible that only government-controlled oil companies with different objectives, like energy security, will be willing to invest.

There is another concern created by the bias in favor of new versus legacy investors. This bias creates the potential of having a large number of small players active in the environmentally sensitive North Slope. The costs associated with the environmental protections that companies like ConocoPhillips insist on and are demanded by federal, state, and local governments are significant. This level of environmental sensitivity may be new to many of these smaller players.

**Majors Offer Important Benefits:** ConocoPhillips has been a long-term investor in Alaska and we want to make the case for why our company, along with other majors, should continue to have a significant role in the state.

We have the size and financial strength to carry out projects of any size. We have the skills to manage large and complex projects and we have substantial experience in developing projects and operating in Arctic conditions. ConocoPhillips, in particular, has substantial experience in heavy oil production and has leading coking technology to process heavier crudes. We are also the second largest refiner in the United States so we have the ability to upgrade our numerous refineries to process additional heavy crude oil. We also have strong commercial acumen and access to markets, which allows us to design projects to maximize the value of the

resource. For example, ConocoPhillips is the second largest gas marketer in the United States. And we have strong risk management skills. Finally, we have a long-term investment horizon. That means that we invest year in and year out and won't leave when market conditions get rough.

**Majors Have Great Spending Capability:** The last point I wanted to make about why major oil companies should be viewed as desirable investors is our great investment capability. This chart shows the three-year average total upstream spending in billions of dollars of the majors versus various independent petroleum companies. We can and would like to bring a lot of investment dollars into this state provided the terms are competitive. The tax proposal as introduced is the upper bound of what we believe is reasonable given the totality of the deal.

Thank you for your attention.

Thank you Marianne

**Bill Language:**

Prior to some concluding remarks, I would like to note that we have identified some suggested changes in language to improve or clarify the intent of the bill. Among other things, these changes concern how eligible deductions and credits are identified and how the value at the point of production should be calculated. We are developing proposed language to reflect these changes and hope to offer this language to you shortly.

Finally, we would like to summarize several key messages.

One, the proposed tax results in a more than doubling of the effective tax rate over the current system. In isolation, we would not view this change as reasonable, fair or appropriate, particularly given the state's current budget surplus. However, as a foundation for oil and gas fiscal stability that facilitates future investment in Alaska, the balance proposed in this bill is something ConocoPhillips will reluctantly support.

Two, the North Slope has a huge heavy oil resource that is already significantly disadvantaged from a technology, quality and cost perspective; incentivizing this resource will be key to increasing production levels in Alaska.

Three, a transition plan from the current production tax system to the next is essential to ensure equitable treatment of our legacy investments. Many of these investments were associated with the development of marginal assets that were justified on the basis of ELF. Qualifying these legacy investments for deduction against PPT is an essential part of the balance reflected in the bill.

Four, the tax rate proposed in the bill pushes Alaska into a high cost/high tax bracket as compared to many regimes around the world. This will affect the risk/reward balance that companies will evaluate before deciding to invest here. Before you accept the rate reflected in the Governor's bill, you must be comfortable with the potential risks to future investment that such a high rate imposes.

I would like to reiterate that Alaska and ConocoPhillips are aligned as partners on many important goals:

- increasing investment in Alaska;
- increasing Alaska's oil and gas production,
- increasing Alaska's competitive position, and
- developing long-term relationships with proven partners for long-term, mutual benefit.

In closing, many factors have to be considered by a government in choosing an appropriate tax rate for an industry as complex as the oil and gas industry. Cost structure (including distance to market), prospectivity, potential field size, reservoir quality, regulatory constraints, and the desired level of investment are perhaps but a few of the factors that have to be considered. Today, Alaska is challenged in each of these areas and the fiscal regime needs to recognize this.

Thank you for considering our views.