

ALASKA LEGISLATURE COMMITTEE FILES 2007-2008 RES

12704

an oil and gas field or venture,<sup>9</sup> or starting from a comprehensive set of accounting rules and principles that DOR writes up.<sup>10</sup> Which choice DOR chooses will determine nothing less than the very success or failure of PPT as a tax — and for SB 2001 as well, if it is enacted. It is like having a tax based on your federal taxable income, and choosing between your federal tax return (as audited by IRS) as the starting point, or starting with the Internal Revenue Code and leaving it up to you and DOR's auditors alike to find what the right answer is under the Code. It is like having a tax based on your financial book income, and choosing between your audited financial statements filed with the SEC as the starting point, or starting with Generally Accepted Accounting Principles and leaving it up to you and DOR's auditors alike to find what the right answer is under GAAP.

From the taxpayer's perspective, this means a near certainty of continual assessments year after year for additional tax, interest, and perhaps penalties, and depending on how litigious a company may feel, it may mean a long series of lawsuits and appeals as well.

From the State's perspective, these same troubles for the taxpayer will mean that the incentives for investment under PPT, or SB 2001, will be seriously eroded. The greater the uncertainty about how much tax a company owes, the greater the likelihood that the incentives will turn out be less than their face value. A taxpayer's only recourse in this situation will be to discount the face-value of those incentives significantly, perhaps completely, in running the economic analysis about making an investment or not. As a consequence, the effectiveness of those incentives will be less than it should be, and Alaska will fail to realize the full amount of new production that it needs to meet the challenge of decline.

The other choice that DOR could make is to start with what an operator bills to the other participants in an oil and gas operation. Note that I said "start" with those billings — not "end." Anything in those billings that is nondeductible under AS 43.55.165(e) would have to be backed out. The central concept of lease expenditures in AS 43.55.165(a) is that they must be "direct" and "ordinary and necessary" costs of exploration, development, or production. It would be most surprising if there are anything in those billings that goes outside this standard.

How can Alaska be sure of this? Because the participants in an oil and gas operation do not give the operator a license to waste their money. I have heard a great deal of concern expressed during these hearings about how the companies might somehow try to "game the system" in order to reduce the tax they will pay the State. While so many are so worried about efforts by the companies not to overpay the State, why would most of these same people think the companies are somehow more willing to overpay the operator than the State? Clearly they don't want to overpay either one. If anything, since the operator usually is a direct competitor, they probably don't want to overpay it even more than they don't want to overpay the State. In other words, if an operator is exploring a geologic prospect, the non-operating participants don't want to pay any costs that are not for the exploration of that prospect. Similarly, if the operator is operating a producing field, they don't want to pay any costs that aren't for the operation of that field. It is reasonable to rely, in the first instance, on the non-operators' self-interests to

police and limit what the operator can spend their money on, and they will do that policing by auditing the operator's invoices to them.

In the context of PPT, DOR should "audit the audits" to verify that the non-operators do indeed audit an operator's invoices on a regular basis, and that those audits are rigorous and at arm's length. But once these things have been confirmed by DOR in its verification of the non-operators' audits, there is little point for DOR to spend the time and effort to re-plow the field that the companies' audits have already plowed.

Daniel Johnston, a consultant hired during last year's debate on PPT, gave an informal presentation to members of the Legislature on Friday, Oct. 19, 2007. During that meeting, he praised the expertise of joint interest auditors and the ability for the state to utilize unit accounting. He went on to say that it would be "extremely insightful for the state to get unit accounting". Mr. Johnston observed that state auditors can be "vicious", but that joint interest auditors are "even more vicious".

Of course, for operations where there is only one participant or where there are no audits of the operator's invoices, this approach will be inapplicable. But there are still things DOR could do to build off the billing systems where there are such audits and extend them to these other fields. However, DOR has not yet adopted the "Phase II" regulations to implement and apply its existing statutory authority to authorize or require taxpayers to follow this approach.

A very dismaying thing about SB 2001 is that Section 64 would repeal DOR's explicit statutory authority under AS 43.55.165(c) and (d) to require or authorize the use of operators' joint-interest billings as the starting point for computing the amount of a producer's deductible lease expenditures for that unit or field, while Section 71(b) would make that repeal retroactive to April 1, 2006.

We believe that this repeal will mean DOR cannot authorize or require a producer to start with an operator's joint-interest billings, even when DOR wants to allow or require their use. Since these repeals are in the proposed legislation that has been introduced, we expect that DOR, in response to us, will testify that somehow they will still be able to require or authorize the use operator billings even if these present statutory provisions are repealed. However, if you enact a law specifically saying DOR may do something and later on you repeal that law, doesn't that repeal mean DOR can't do it anymore? We think so. But even if you are persuaded by DOR that we're wrong on this point, why should you repeal those statutes and take the chance that the courts won't agree? ~~You could probably repeal AS 43.55.165(d) and keep subsection (c) on the books without taking much risk, because the text of (d) is very repetitive of that in (c). But repealing them both is taking a hollow chance.~~

The reason I've spent so much time about the use of joint-interest billings as the starting point for determining a producer's lease expenditures is this: Consider the situation that a non-operating participant faces. All the information it has about what's being spent for the operation

is what it gets from its billings from the operator, plus whatever it may learn by auditing those invoices. But if such a non-operator cannot start from those invoices, how can it figure out what to report as the lease expenditures for that operation? All the books and records of the expenditures are with the operator, and if the non-operator hasn't yet audited the operator, it will have no idea what those books and records show. It is infeasible for a non-operator to be auditing the operator month by month, yet the non-operator will somehow have to be reporting and paying installments month by month throughout the year. Even by the March 31 true-up the following year, it is unlikely that any audit of the operator's books and records will have been begun by that date, much less completed. The penalty for mis-estimating the installment payments is principally in the difference between the rate of interest on overpaid installments and underpaid ones. But the March 31 true-up is very serious business. Interest at an APR not less than 11% compounded quarterly begins to accrue, and penalties of up to 30% for negligence and failure-to-pay<sup>11</sup> can be assessed, on the amount of any underpayment continuing after that true-up date. If a non-operator cannot rely on its billings from the operator as the starting point for these purposes, what is it supposed to use?<sup>12</sup>

If, as we fear, the repeals of AS 43.55.165(c) and (d) under the proposed bill will indeed take away DOR's discretion to allow or require the use of operators' joint-interest billings, then SB 2001 will completely fail the third standard by which a tax is measured — that it must be possible for a taxpayer to get the tax right when it is due, when the taxpayer wants to do so. This will be impossible for non-operators under the proposed legislation. Even PPT will fail if the "Phase II" regulations do not reasonably implement DOR's present authority under AS 43.55.165(c) and (d) regarding the use of operator billings.

Before I close, there are a few confusing things in the SB 2001 I would like to address.

The first of these is Section 1, declaring that subsection (b) in the new production-tax statute of limitations being enacted is intended to "confirm by clarification the long-standing interpretation of AS 43.05.260 by the Department of Revenue relating to limitation of assessments for the production tax on oil and gas and conservation surcharges on oil." Does anyone here know why this is in the bill? AS 43.05.260 is the existing statute of limitations for auditing all state taxes under AS 43, and what is it about this present limitations statute that is being "confirm[ed]" by the new AS 43.55.075(b)?

If you read this new section 075(b) — which begins on page 35 line 30 and runs through line 15 on page 36 of the bill — you see there are two parts to the subsection. One part is the first two sentences, which address the effects for tax purposes of judicial or administrative decisions that retroactively change parameters for calculating the tax. The other part is the last sentence, including paragraphs (1) and (2), and requires producers to report such decisions to DOR within 60 days and to file amended returns within 120 days.

The curious thing is that the existing statute of limitations (AS 43.05.260) — the interpretation of which is to be "confirmed" — has nothing in it pertaining to either of these

subjects. Here is the text of AS 43.05.260 and you can see this for yourselves. Subsection (a)

**Sec. 43.05.260. Limitation on assessment.** (a) Except as provided in (c) of this section and AS 43.20.200 (b), the amount of a tax imposed by this title must be assessed within three years after the return was filed, whether or not a return was filed on or after the date prescribed by law. If the tax is not assessed before the expiration of the three-year period, proceedings may not be instituted in court for the collection of the tax.

(b) For purposes of this section, a return filed before the last day prescribed by law or regulation is considered as filed on the last day.

(c) The following exceptions apply to the limitation period in (a) of this section:

(1) in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of the tax may be begun without assessment, at any time;

(2) in the case of a failure to file a return, the tax may be assessed, or a proceeding in court for the collection of the tax may be begun without assessment, at any time;

(3) if, before the expiration of the time prescribed in this section for the assessment of a tax imposed by this title, both the department and the taxpayer have consented in writing to the assessment after the expiration of the time, the tax may be assessed at any time before the expiration of the period agreed upon; however, the period agreed upon may be extended by a subsequent agreement in writing made before the expiration of the period previously agreed upon.

sets three years as the period for DOR to audit and assess any additional tax that may be due, and it bars suits to collect any additional tax if that tax is not assessed within the three-year period. Subsection (b) says that, if a taxpayer files its tax return early before it is due, the three-year period starts running from the due date instead of the actual filing date. Subsection (c) creates three exceptions to the rule under subsection (a), which appear as paragraphs (1) – (3) of subsection (c): namely, for false or fraudulent returns to evade tax, for a failure to file any return at all, and for extensions of the three-year period that are mutually agreed upon in writing by DOR and the taxpayer.

Which of these provisions has anything to do with tax effects of retroactive decisions? Which has anything to do with having to report such decisions to DOR and filing amended tax returns? It is not immediately clear to us what either of these topics in the new statute of limitations has to do with interpreting any of the provisions in existing statute of limitations I've just reviewed with you. So what's going on with Bill Section 1?

We believe Section 1 is a stealthy attempt to legislate an outcome to matters that are already being litigated in the due course of administrative and judicial proceedings. In 1999 DOR amended one of its production tax regulations, 15 AAC 55.200, so that it reads remarkably like AS 43.55.075(b) being enacted in this bill. Here you have the regulation and the proposed

15 AAC 55.200. Retroactive adjustments. If retroactive adjustments in costs of transportation, sales price, prevailing value, or consideration for quality differentials relating to the commingling of oils or of oil and NGLs result from decisions of regulatory agencies, courts, or any other preemptive authority, those adjustments have a corresponding effect, either an increase or decrease as applicable, on the gross value at point of production as determined under this chapter, and the producer shall, on or before the third monthly payment due date specified in AS 43.55.020(a) after any adjustment, file amended returns covering the entire period of an adjustment unless the producer has obtained a stay on that filing or payment, regardless of the pendency of appeals of those decisions. [emphasis added]

(b) A decision of a regulatory agency, court, or other body with authority to resolve disputes that results in a retroactive change to a lease expenditure, to an adjustment to a lease expenditure, to costs of transportation, to sales price, to prevailing value, or to consideration of quality differentials relating to the commingling of oils has a corresponding effect, either an increase or decrease, as applicable, on the production tax value of oil or gas or the amount or availability of a tax credit as determined under this chapter. For purposes of this section, a change to a lease expenditure includes a change in the categorization of a lease expenditure as a qualified capital expenditure or as not a qualified capital expenditure. The producer shall (1) within 60 days after the change, notify the department in writing; and (2) within 120 after the change, file amended returns covering all periods affected by the Change, unless the department agrees otherwise or a stay is in place that affects the filing or payment, regardless of the pendency of appeals of the decision. [emphasis added]

new AS 43.55.075(b) side by side, with identical or parallel language in them being underlined. As you can see, the regulation deals with “decisions of regulatory agencies, courts, or any other preemptive authority” while the proposed new statute addresses any “decision of a regulatory agency, court, or other body with authority to resolve disputes[.]” The regulation deals with “retroactive adjustments in costs of transportation, sales price, prevailing value, or consideration for quality differentials relating to the commingling of oils or of oil and NGLs” while the proposed statute addresses “a retroactive change” to the very same things,<sup>13</sup> plus any change to “a lease expenditure[.]” Both state that retroactive changes in the parameters for calculating the taxable value have “a corresponding effect, either an increase or decrease.[<sup>14</sup>] as applicable on” that taxable value.

Now, the “interpretation” that comes into play here has to do with the question of when interest begins accruing on a tax increase or decrease that results from one of these retroactive decisions — does it begin to accrue as of the date of that decision? Or does it begin to accrue all

the way back to the original payment due date? When DOR adopted the amendment to the regulation in 1999, the director of the Tax Division at that time told AOGA members that DOR was interpreting that amendment to mean interest would start to accrue as of the original payment due date for the tax, not as of the date of the retroactive decision.

We believe it is this "interpretation" of its own regulation, which is in the process of being appealed in due course, that the Administration intends to have "confirm[ed]" under Section 1 of SB 2001 as the proper interpretation of the pre-PPT statute of limitations. The question for you is, do you really want to confirm this?

Confirming it would set a destabilizing precedent, because it will mean that the laws can effectively be rewritten to deal with subjects that they did not originally deal with, and this can be done clandestinely by "confirming" some purported "interpretation" of it. For one thing, it would be an attempt by the Executive and Legislative branches to determine the outcome of matters that are already before or headed to the Judicial Branch in due course. Can the Legislature intervene in Judicial matters under the Separation of Powers Doctrine, and even if it can, should it attempt to do so here? Second, what does it say to potential investors in this state about our sense of justice, Due Process, and fair play?

Now, if the Administration appears before you or any other committee of this Legislature and disavows any and all intention to do such a thing, I would encourage you to ask them to clearly explain what they did intend to achieve with Section 1, so that it will be part of the legislative history of this bill. Then, if it becomes law, the legislative history will be there to establish that the "interpretation" which we fear is not the Legislature's intent, nor the Administration's.

A second confusing thing in SB 2001 relates to the new statute of limitations being proposed for production tax only. Why does the limitations period need be six years instead of three, when the three-year period can be extended and re-extended any number of times as appropriate? If the state auditors are anything like me and everyone I know, their work will expand to fill the time allowed — giving them six years to get their audits done will mean they'll take six years to audit even when they could otherwise be done more quickly. Unfortunately, the longer the audit runs, the greater the amount of interest there will be that accrues on any underpayment claimed in the audit. After three years, interest represents 38¢ for each dollar of additional tax claimed, assuming interest is not above its 11% APR floor rate. But after six years the accrued interest is 92¢ for each dollar of additional tax. By raising the stakes so substantially for each audit claim that is raised, the longer limitations period will make it easier to justify litigating claims.

The purpose of a statute of limitations is to bar claims when they start to become so old that the records, documents, and recollections of witnesses may well be lost or not readily available by the time those claims are finally raised. The present statute of limitations has worked for all the other taxes under Title 43, including the present worldwide corporate income

*Jeopardy Assessment*

tax for oil and gas taxpayers, the domestic or "water's edge" income tax for other corporations, even the former separate-accounting income tax. It is worth noting that separate-accounting involved not only determining net income from all of a taxpayer's interests in oil and gas fields and prospects, but also its income from interests in oil or gas pipelines as well.<sup>15</sup> While PPT and SB 2001 are not simple taxes, separate-accounting was probably even more challenging to administer and audit. If Alaska didn't need a longer statute of limitations for separate-accounting, we don't see why one is needed now.

In conclusion, SB 2001 fails two of the three standards for evaluating a tax, while PPT passes two of them and would pass the third one as well if DOR adopts the appropriate regulations. SB 2001 in the short term will generate more tax revenue for the State than PPT; however, it will achieve this at the cost of reducing the incentives for new investments, and worsening the overall tax climate for making them here. SB 2001 fails the test of being administrable as efficiently as possible, consistent with ensuring taxpayer compliance. This failure will primarily be due to repealing DOR's existing statutory discretion to allow, as appropriate, joint-interest partners do the auditing of the operator's billings to them. Instead DOR auditors could have to re-invent the wheel for themselves in each audit. SB 2001 also fails the test that a taxpayer who wants to pay the correct amount of tax when it comes due must be able to do so. This will be impossible for every company that owns an interest in a lease or property that it does not operate. This in turn will effectively destroy the value of the remaining tax incentives under this bill that potential investors will perceive. If they cannot tell what they owe, they surely cannot put a reliable figure to the value of the incentives under the tax.

All of this brings us back to the fundamental issue facing Alaska today...the decline of Alaska production. Today Alaska's production has fallen from its peak of 2.1 million barrels a day down to the 700,000 range. This means that the trans Alaska pipeline is 2/3 empty. I would remind you of my chart earlier that showed the purely mathematical results about how long we have before hitting the 300,000 barrel-a-day TAPS mechanical threshold, depending on what rate of decline you assume will turn out to come true.

And it's important to remember that today's 6% decline rate would be on the order of 15-16% were it not for the substantial investments which continue to be made by operators in existing fields. Further, Alaska is fortunate to have on the nearby horizon Pioneer's Oooguruk project, scheduled to go into production in 2008.

The importance of future investment is further emphasized when one looks at the Department of Revenue's forecast of future production levels. In three short years, DOR projects that production will come from projects requiring significant new investment. Draw that timeline out to 2017—ten years from now—and you discover that half of Alaska's production will come from new production—production which will only come from investments yet to be made.

**AOGA Testimony to Senate Resources Committee  
On SB 2001  
October 23, 2007  
Page 16**

**The most important policy question is whether SB 2001 provides a framework for encouraging this additional new investment. AOGA's 17 member companies unanimously agree that PPT does accomplish that goal, and as such, should not be changed at this time.**

## ENDNOTES

<sup>1</sup> When production declines at  $X\%$  a year, this means the production rate after one year ( $P_1$ ) is  $(1 - X\%)$  of the initial production rate ( $P_0$ ), or  $P_1 = P_0 \times (1 - X\%)$ . After the second year the production rate ( $P_2$ ) is  $(1 - X\%)$  of the rate after one year of production, or  $P_2 = P_1 \times (1 - X\%) = [P_0 \times (1 - X\%)] \times (1 - X\%)$ , which can be simplified as  $P_2 = P_0 \times (1 - X\%)^2$ . After 10 years of decline, the rate  $P_{10}$  is  $P_0 \times (1 - X\%)^{10}$ . North Slope production was 1,404 million barrels a day in FY 1997 and 740 thousand barrels a day in FY 2007, while Cook Inlet produced 37 thousand barrels a day in '97 and 16 thousand barrels a day in '07. See DOR, *Revenue Sources Book Spring 2007*, pp. 97-98. So for North Slope production,

$$1,404,000 \times (1 - X\%)^{10} = 740,000.$$

Dividing both sides of this equation by 1,404,000 gives:

$$(1 - X\%)^{10} = 740,000/1,404,000 = 0.5271.$$

One can solve for  $(1 - X\%)$  by taking the 10th root of both sides of this latter equation:

$$\sqrt[10]{(1 - X\%)^{10}} = \sqrt[10]{0.5271}, \text{ or}$$
$$(1 - X\%) = 0.9380.$$

In other words, on average the production rate each year was 93.80% of the rate for the prior year, which means the rate of decline averaged 6.20% a year. The same calculation for Cook Inlet, using 37,000 and 16,000 barrels a day instead of 1,404,000 and 740,000 respectively, yields an average annual decline rate of 8.0 percent

<sup>2</sup> Here is the math: From the analysis in Endnote 1 above, we know that for a given decline rate  $R$ , the volume of production after  $N$  years of decline is  $P \times (1 - R)^N$ . So for each decline rate in the table, you use that as the value of  $R$  in the formula, and then you solve for  $X$  as the value of  $N$  that gives 300,000 barrels a day as the rate. The equation for this is:

$$740,000 \times (1 - R)^X = 300,000.$$

When you take the logarithm of both sides of this equation, you get the following equation:

$$\log[740,000 \times (1 - R)^X] = \log[300,000].$$

The reason for using logarithms is that they have the property that the logarithm of two numbers being multiplied together equals the sum of the logarithms for each of them, while the logarithm of a number raised to an exponent  $X$  equals  $X$  times the logarithm of that number. Using this gives the following restatement of the prior equation:

$$\log[740,000] + X \times \log[(1 - R)] = \log[300,000].$$

Subtracting  $\log[740,000]$  from both sides of the last equation yields the following:

$$X \times \log[(1 - R)] = \log[300,000] - \log[740,000]. \quad \text{[continued on next page]}$$

Now you can solve for  $X$  by dividing both sides of the last equation by  $\log[(1 - R)]$ , which yields:

$$X = \frac{\log[300,000] - \log[740,000]}{\log[(1 - R)]}$$

By plugging the decline rate of your choice into this last equation as the value of  $R$ , the value of  $X$  can be calculated by simple arithmetic. This straightforward calculation has been done for each of the decline rates shown in the graph.

<sup>3</sup> DOR Press Release, "New Production Tax Nets Increased Revenues For Alaska" (April 3, 2007).

<sup>4</sup> For producers who begin producing in Alaska on or after April 1, 2006, they have six years from the year of that first production in which to use up their "TIE" credits. The rule still applies during those six years that it takes \$2 of new capital investment in order to get a credit for \$1 of the "TIE" investment from the years before their production begins.

<sup>5</sup> See DOR, *Petroleum Profits [sic] Tax (PPT) Implementation Status Report* (August 3, 2007), p. 3.

<sup>6</sup> See DOR, *Petroleum Profits [sic] Tax (PPT) Implementation Status Report* (August 3, 2007): "The Department has been severely hampered in its ability to provide the administration and the legislature with accurate revenue forecasts ...." *Id.*, p. 4. "The complexity of auditing production tax has increased several fold under the PPT, and the PPT increased the number of determinations an auditor must make." *Id.*, p. 5.

<sup>7</sup> *Id.*, p. 5.

<sup>8</sup> See, e.g., Alaska State Legislature, House Finance Committee, *Minutes* (March 29, 2006), p. 15:

Representative Holm ... asked about the rate of return at \$60 per barrel. Mr. [Angus] Walker [Commercial Vice President of BP Exploration (Alaska) Inc.] said BP is excited about current prices. BP does not make a profit until oil is above \$22.50 a barrel.

At a \$22.50 West Coast price, BP's implicit upstream field expenditures were about \$11.95 a barrel, as opposed to the \$7.27 per barrel in the fiscal note for HB 3001.

\$22.50	ANS price on West Coast
1.76	Marine transportation to West Coast
4.38	TAPS
0.67	North Slope pipelines, quality bank, etc.
\$15.69	Average North Slope wellhead value
1.96	State royalty (1/8)
\$13.73	Taxable value
1.09	Production tax (15% base rate × ELF of 0.529)
0.69	Property tax (\$/bbl average)
\$11.95	Implicit expenditures/bbl.

SOURCE: DOR, *Revenue Sources Book Fall 2006*, p. 33 Fig. 4-6 (average ANS ELF); p. 39 Fig. 4-9 (marine, TAPS, and Slope pipelines/quality bank); p. 40 Fig 4-11 (ANS production); p. 42 Fig. 4-12 (property tax; \$60 million for tax on TAPS is deducted from total for North Slope Borough, Fairbanks, Valdez and Unorganized Borough). All data are for FY 2006.

<sup>9</sup> The authority for DOR to take this approach is in AS 43.55.165(c) and (d). Subsection (c) states in pertinent part: "if the department finds that the pertinent provisions of a unit operating agreement or similar operating agreement are substantially consistent with the department's ... standards under (a) of this section concerning whether costs are lease expenditures, the department may authorize or require a producer ... to treat as ... lease expenditures ... the costs, other than items listed in (e) of this section, that are incurred by the operator ... and ... billable to the producer by the operator in accordance with the terms of the [operating] agreement[.]" Subsection (d) has very similar language.

<sup>10</sup> The authority for DOR to take this approach is in AS 43.55.165(a), which states in pertinent part: "In determining whether costs are lease expenditures, the department shall consider, among other factors, (1) the typical industry practices and standards in the state that determine the costs, other than items listed in (c) of this section, that an operator is allowed to bill a working interest owner that is not the operator, under unit operating agreements or similar operating agreements ... and (2) the standards adopted by the Department of Natural Resources that determine the costs, other than items listed in (e) of this section, that a lessee is allowed to deduct from revenue in calculating net profits under [net profit share] lease[.]"

<sup>11</sup> The penalty for an underpayment due to negligence is 5% of the amount of the underpayment. AS 43.05.220(b). The failure-to-pay penalty for an underpayment is 5% of the underpayment for each month or partial month that the underpayment continues after payment was due, up to a maximum of 25 percent. AS 43.05.220(a). By regulation, DOR has adopted the policy that the imposition of a negligence penalty automatically triggers the imposition of a failure-to-pay penalty as well. 15 AAC 05.210(g).

<sup>12</sup> It follows that, if a non-operator can rely on the operator's joint-interest billings as the starting point for the non-operator's own lease expenditures for that operation, then the operator should similarly be able to use its proportionate share of the same total billable costs as the starting point for its lease expenditures for that operation. There is no reason to discriminate between them.

<sup>13</sup> The regulation addresses "quality differentials relating to the commingling of oils or of oil and NGLs" (emphasis added) while the proposed statute lacks the emphasized phrase. The PPT legislation last year changed the definitions of "oil" and "gas" so that "oil" includes "NGLs" and consequently emphasized language in the regulation is encompassed now by the phrase "commingling of oils" in the proposed statute.

<sup>14</sup> The regulation lacks the comma that appears here in the proposed statute.

<sup>15</sup> See former AS 43.21.020 (production income) and 43.21.030 (pipeline income).



# THE ALLIANCE

... for responsible development of Alaska's Oil, Gas & Mineral Resources

## SENATE TESTIMONY on SB 2001 October 23, 2007

Thank you, Chairman Huggins. My name is Paul Laird. I'm general manager and testifying on behalf of the Alaska Support Industry Alliance, a trade organization representing companies and individuals that provide goods and services to Alaska's oil, gas and mining industries.

Our members range from small local contractors and vendors to the largest Alaska Native and Alaska-based corporations to the Alaska subsidiaries of multinational service companies. Our members don't make the multibillion-dollar investments in oil and gas development that fuel Alaska's economy ... our 400 member companies and their 35,000-plus Alaska employees make those investments work.

In turn, those investments put our members and their employees to work.

As companies and workers whose livelihoods depend on oil and gas investment, we're deeply concerned about constant changes in fiscal policy that put some investments at risk.

As Alaskans whose economic future depends on the level of oil and gas production in our state, we're deeply concerned about the impact of an even steeper rate of production decline on our families' and our own ability to build long-term futures here.

Chairman Huggins, members of the Senate Resources Committee, I will be brief in my remarks to you today. We don't know if a 22.5% tax rate with the current escalator and credits strikes the right balance between ensuring the state its fair share of OIL revenues and encouraging long-term investment and production. We don't know if 25% is the right rate ... or 20 ... or 15.

None of us does ... not the Alliance, not the legislature, not the administration and not even the producers. Regulations for the Petroleum Production Tax system just 14 months ago haven't been finalized, and the first returns haven't been audited.

### ALASKA SUPPORT INDUSTRY ALLIANCE

360 W. Benson Blvd., Suite 200 • Anchorage, Alaska 99503 • Phone: (907) 563-2226 • Fax: (907) 561-8870 • [www.alaskaalliance.com](http://www.alaskaalliance.com)

It's difficult for us to understand why we're back here so soon to fix a system that hasn't even had time to work, let alone for there to be compelling evidence that it's broken. That case simply hasn't been made; you've been presented with a plethora of projections and a paucity of proof.

We do know that the PPT has already generated an additional \$1 billion in state revenues.

We do know that the increase being proposed would be the third major severance tax increase on the industry in the past three years.

We do know that every dollar in additional taxes is a dollar that won't be invested in sustaining production, in creating business opportunities for Alaska companies like Alliance members, in generating good-paying private sector jobs for Alaskans.

We do know that throughput in Trans-Alaska Pipeline has already declined by two-thirds, and despite multibillion-dollar investments by the industry, it continues to decline by 6% a year.

We do know that without those investments, TAPS will reach its economic threshold in the next 15 or 20 years instead of the the next 50 or 60.

We do know that our 400 members and many of their 35,000 Alaska employees want to be here long after the legislature's and the administration's consultants on this issue are gone ... as long as there are still enough economic opportunities to keep them here. They'll be the ones to bear the consequences if higher taxes and higher costs really do result in less investment ... a novel economic concept, to be sure.

We do know that while the extent to which yet another tax increase will discourage investment is debatable, the fact that it will do absolutely nothing to encourage new oil production and construction of a gas project is not.

Isn't that what this discussion should be about, Mr. Chairman and members of this committee: how we can work together to promote investments ... how we can ensure our "fair share" of long-term jobs and business opportunities for Alaskans, rather than how much more money we can extract from the private sector without further risking our long-term future ... just so state government can have more money to spend in the short term?

What's the plan when this \$700-900 million a year tax increase isn't enough to sustain state spending?

In your wisdom, when you adopted the new PPT in 2006 after six months of extensive deliberations, aggressive debate and countless votes, you included provisions requiring a complete review of the system five years later - in 2011. You understood then that it would take several years to reasonably determine how and if it's working.

So far, there's been no compelling evidence to the contrary. It will still take several years to responsibly make that determination.

Do what you need to do in the short term to make the PPT work - hire more auditors, pay them more, take steps to ensure the timely flow of accurate data from the producers to the state, authorize the state to buy back credits.

But on behalf of the Alliance's 400 member organizations and their 35,000-plus Alaska employees, all Alaska businesses and workers and Alaska's economic future, we urge you to reject premature, fundamental changes to the PPT that will increase taxes, increase costs and jeopardize the economics of critical long-term investments and put production, Alaska jobs and business opportunities at risk.

Thank you.

CH - 35,000 of them, we live next to them.  
thanks for the verbatim we just  
can't extract money - taxes; bureaucracy -  
from private sector  
thank you -

23 October 2007

To Members of the Senate Resources Committee:-

My name is Maynard V. Tapp, I am an Alaskan resident since 1990. I founded my company Hawk Construction Consultants, Inc. now Hawk Consultants, LLC in 1985 as an Alaskan corporation.

I strongly believe any new approach to raise taxes should be viewed as a "RESOURCE DEVELOPMENT" effort. The state will raise more tax revenues if we raise production.

If you ask any of the tax experts that will testify before your committee, none will say that increasing the tax will increase exploration and production.

The most reliable source of long-term revenue is to increase production. As I understand the state gets 75% of the 12.5% royalty (9.375%). The "fair share" to the Alaskans is the remaining (3.125%) paid into the Permanent Fund. I believe you can build a long term future for my company's employees based on the increase in production.

Hawk employs over 60 Alaskans. Much of their work is related to the reconfiguration of the Trans Alaska Pipeline, and the refurbishment and maintenance of the existing pipelines and facilities in Greater Prudhoe Bay.

Our company, its employees and the State of Alaska will greatly benefit from new production. We hope to be involved in all phases of the continuing projects.

From my point of view an increase of 2.5% in tax rates increases the size of government by \$25.0Million. One Senator made the point to me that "there is no guarantee that if the rate was reduced by 1% that the producers would invest that 1% here in Alaska". While this may or may not be true, one thing is certain that \$25.0Million will not be invested by the companies if it is taken away by increasing the tax.

What is the State of Alaska doing to increase oil production which then translates into more tax revenue?

Also, if that \$25.0Million is invested in new production, that amount is the equivalent of 3 new production wells. Those new wells at a nominal rate of 2,500bbls per day could gain the state revenue an additional \$21.0Million per year. (This would include the current PPT of 22.5% of Net plus 9.375% Royalty at \$80/bbl).

My math may not be totally correct but the case remains that the benefits from investment made by the "producers" in the state of Alaska for oil and gas field development far exceeds the benefits to Alaskans from raising an individual tax rate.

If the previous administration made a mistake, I believe your committee could rectify that mistake by dropping the tax rate to "10%/20%". That would make us more competitive at 51% which is closer to the Gulf of Mexico's 45% tax rate. I want the state of Alaska to be at the TOP of the "producers" list when it comes to selecting investment opportunities.

Please, I humbly request you reframe this bill as a Resource Development Bill and not a tax generation bill.

When all is said and done, all the experts will go away. They don't live here, their businesses does not depend on the Alaskan Oil and Gas industry. We live here and the wealth and health of the state of Alaska rest's in your hands.

I want us to recognize that Alaska is "big oil" and we get our revenues with our partners, the producers. Our fare share is calculated in the jobs created by employing Alaskans in the development of our common resource.

One other thing, thanks to all you who were here last year when the PPT was agreed. Your months of hard work resulted in the 22.5/20 agreement. Please don't try to fix that which is not broken.

Thank-you,  
Maynard Tapp  
200 West 34<sup>th</sup> Ave. #809  
Anchorage, Alaska 99503

**SENATE TESTIMONY  
on SB 2001  
October 23, 2007**

Thank you, Chairman Huggins. My name is Tom Walsh. I am a managing partner and co-founder of Petrotechnical Resources of Alaska (PRA), an Alaskan oil and gas consulting company employing about seventy highly experienced and respected oil and gas professionals. Our clients include major oil companies, independent oil and gas companies, Alaskan native corporations, and state and federal agencies, and we provide a wide array of services to our clients.

I have come to speak to you tonight because I am worried about the future of PRA's seventy employees and their families, and about the future of the oil and gas business in Alaska. The Governor's proposed tax increase is a threat to the future of oil and gas development in Alaska. One of the services we offer is commercial analysis of potential oil and gas exploration and development opportunities. Across the board, our clients are finding that the tax structure is currently a key factor in marginalizing their prospect economics, and they expect the situation to worsen with the Governor's proposed legislation. These concerns are being voiced by the entire spectrum of E&P companies, and their concerns are well-founded.

These companies are doing their homework, looking at detailed project plans and economics for significant investment in oil and gas projects, and what they are finding is that their projects don't work under the ever-increasing burden of rapidly escalating development costs and tax increases. We have recently lost two significant clients who have left the State, discouraged by the business climate and disappointed by project results. This trend will continue, and will accelerate if we continue to be driven by greed and paranoia, rather than by rational management of our resources. Whether it is "tax and spend", or "tax and save", it is still taxation with no clear strategy or purpose, and it is driving our declining industry to an accelerated economic limit. I implore you to take the time to develop a long range fiscal plan for the state to determine what services state government should provide to Alaskans, and how much these services will cost, before changing the tax structure once again with no clear vision or purpose.

PRA produced a report several years ago regarding the impact of a major gas sale on the oil production from the North Slope, and the study clearly pointed out that the declining liquid hydrocarbon production would likely become sub-

**economic before a gas pipeline could be built. This is a disaster scenario for the State of Alaska, and for the oil and gas industry in Alaska. Obviously, if the revenue from oil production is curtailed prior to revenue from gas sales commences, we are all going to suffer greatly. This is where we are headed, and we should be trying to compete for more interest in our resources, rather than for a greater share of the shrinking pie.**

**Thank you for your time**

Angeline M. Braham  
11328 Echo St.  
Eagle River, AK 99577  
(907) 684 2939

OCT 23 2007

October 18, 2007

Senator Charlie Huggins  
State Capitol  
Juneau, AK 99801-1182

Dear Senator Huggins,

*Charlie*

The most significant fiscal issue for Alaska is the decline in oil production. Finding new oil is the most expedient way to replace declining production. It takes significant investment to accomplish this and it comes with high costs and high risk.

After many many hours of hard work, the current PPT was passed by a significant majority of hardworking, honest, dedicated officials who felt that the deal was fair. No one side achieved exactly what they wanted, but that is what negotiation and compromise is all about.

The PPT has generated approximately a billion dollars more this past year than ELF and it comes with a five year review built in. No legislation is perfect, and PPT is no exception to this.

The state needs time to assess all of the positives and negatives so that they can be addressed in one package rather than piecemeal special sessions. In the long run, this will save the state money, time and effort. All tax legislation needs tweaking, but let it play out for the five years to see where all the snags are. This yearly tax increase on the industry will just end up costing us creditability with future investment decisions.

Good legislation should not be based on a popularity contest. It should be based on sound rational judgment. Please don't let the Governor's popularity at the polls stop you from doing what is best for the state of Alaska in the long run.

My children and grandchildren's futures are in your hands. Big oil is not the enemy - they have brought families to the state that has made our communities grow. They are volunteers for a myriad of organizations, as well as employees of the oil companies.

Yes, the state should get a fair share, but we need to move forward NOW to insure that our futures can be secure. We need to get PPT resolved so that we can move on with the gas line. The state's share of that will be zero if action is not taken now!

Please don't let the public's emotional reaction related to the recent indictments force a premature change. Your constituents will stand behind you when you support the state's best interests. Please act for the state and not the popularity polls!

Regards,



Angeline M. Braham

District 17 - 210

**SB**

**2001**

**(FILE 14)**

**10/24/07**

# ALASKA STATE LEGISLATURE

Sen. Charlie Huggins, Chair  
Sen. Bert Stedman, Vice Chair  
Sen. Lyda Green  
Sen. Gary Stevens  
Sen. Lesil McGuire  
Sen. Bill Wielechowski  
Sen. Thomas Wagoner



State Capitol, Room 119  
Juneau AK 99801-1182  
907-465-3878  
Fax: 907-465-3265  
800-862-3878

## Senate Resources Committee

Butrovich Rm 205

Wednesday, October 24, 2007

10:00 a.m. – 5:00 p.m.

6:15 p.m.

## AGENDA

### SB 2001 - Oil and Gas Production Tax

Morning

#### BP Exploration

Claire Fitzpatrick - Commercial Senior Vice President

Mike Utsler - Senior Vice President – Prudhoe Bay

Afternoon

(continuation) BP Exploration testimony

#### ConocoPhillips

Kevin Mitchell - Vice President, Finance & Administration

Jim Taylor - Vice President, Commercial Assets

6:15 PM

Public Testimony

-Time Limit May Be Set -

**1. Gavel In & Call to Order : Note time – members present**

**I CALL THE SENATE RESOURCES COMMITTEE TO ORDER ON  
WEDNESDAY, OCTOBER 24, 2007. LET THE RECORD REFLECT THAT IT  
IS \_\_\_\_\_ A.M..**

**PRESENT ARE:**

**Vice-Chairman Senator Bert Stedman  
Senator Gary Stevens  
Senator Lyda Green  
Senator Lesil McGuire  
Senator Bill Wielechowski  
Senator Tom Wagoner  
& myself, Senator Charlie Huggins**

**2. SB 2001 OIL & GAS TAX AMENDMENTS**

**Morning**

**BP Exploration**

**Claire Fitzpatrick - Commercial Senior Vice President**

**Mike Utsler - Senior Vice President – Prudhoe Bay**

**\*\*\*\*\*Lunch Break\*\*\*\*\***

**Recess until \_\_\_\_\_ p.m.**

Afternoon

**I CALL THE SENATE RESOURCES COMMITTEE MEETING OF TUESDAY,  
OCTOBER 23, BACK TO ORDER**

(continuation) BP Exploration testimony  
ConocoPhillips

Kevin Mitchell - Vice President, Finance & Administration  
Jim Taylor - Vice President, Commercial Assets

**\*\*\*\*\*Dinner Break\*\*\*\*\***

**RECESS - afterwhich we'll return for public testimony @ 6:15 PM**

**6:15 PM**

**Public Testimony  
Time Limit May Be Set**

**I CALL THE SENATE RESOURCES COMMITTEE MEETING OF TUESDAY,  
OCTOBER 23, BACK TO ORDER**

**3. Announce:** We'll be back tomorrow @ 10 AM, --[THIS IS A TIME CHANGE]-- when we'll hear from the Alaska State Chamber of Commerce; Brooks Range Petroleum and ExxonMobil with the added possibility of some call backs to look at some of the questions which have been raised here over the last week.

**6. Meeting adjourned @ \_\_\_\_\_.**

bp



BP Presentation on SB 2001  
Senate Resource Committee

Claire Fitzpatrick and Mike Utsler - Sr VP *Production*  
October 24, 2007

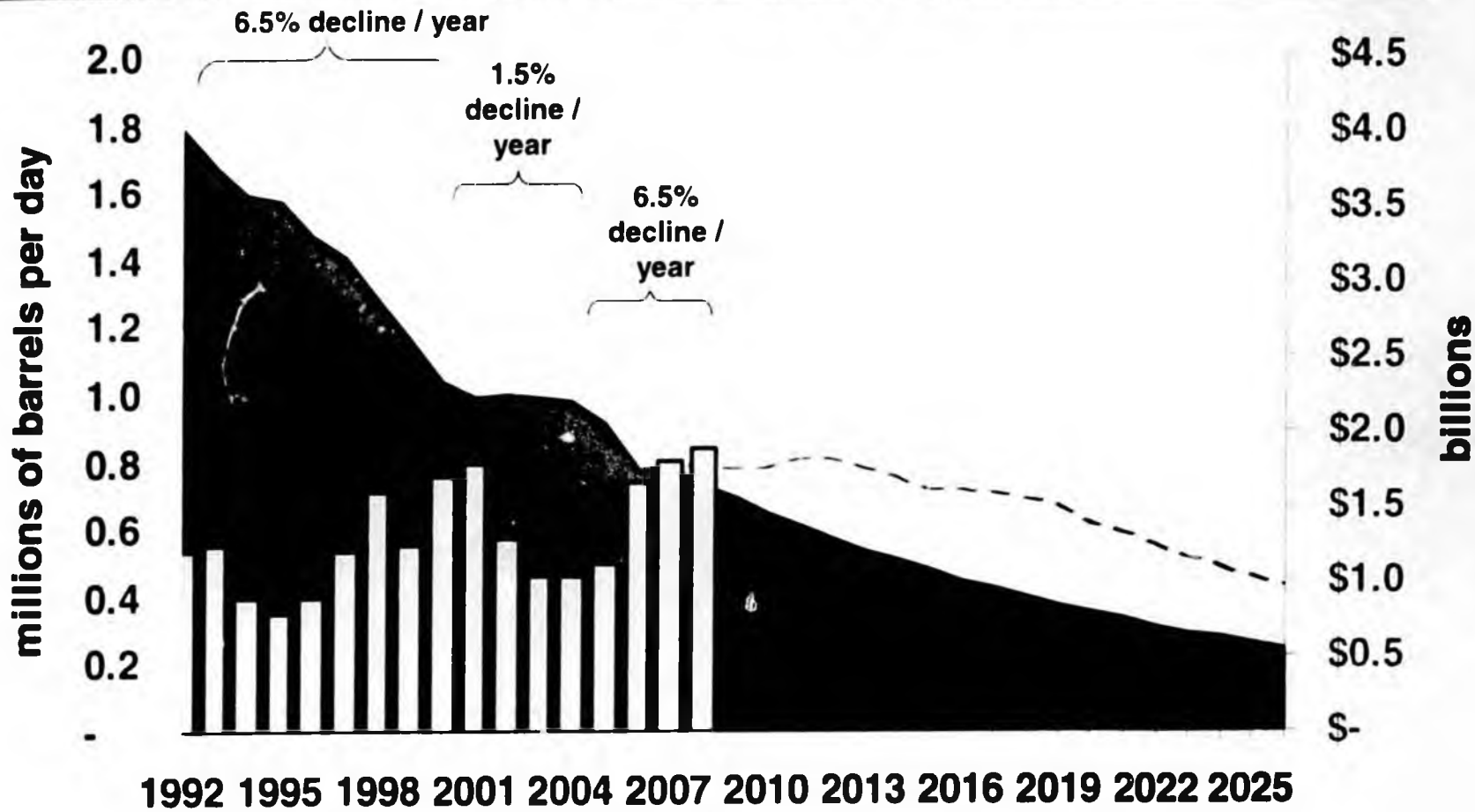
*Commercial  
Sr. VP*

# Key Messages



- **Production**, not tax rate, is the major factor in determining state revenue for the future years
- Delivering the State's production forecast will require tens of billions of **investment**
- **Investment decisions** are made on the **combination** of strategy, resource prospects, technology, economics including **fiscal policy**, and risk.
- The proposed bill significantly **deteriorates economics on 70%** of investment options in the next 20 years
- Higher prices and developing technology could give the Alaska fields a new lease on life, but huge **investments are needed**

# The State's production and revenue forecast counts on higher than historical investment



□ Spring 2007 DOR Forecast

■ Actual Production

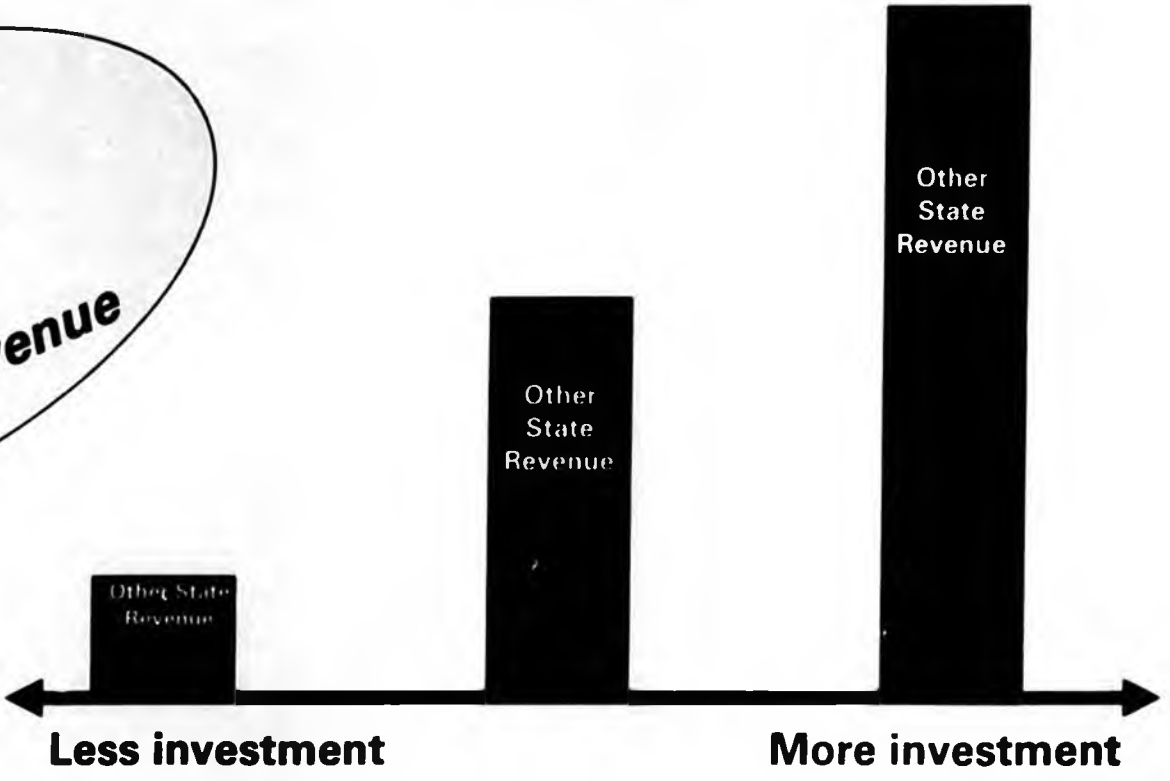
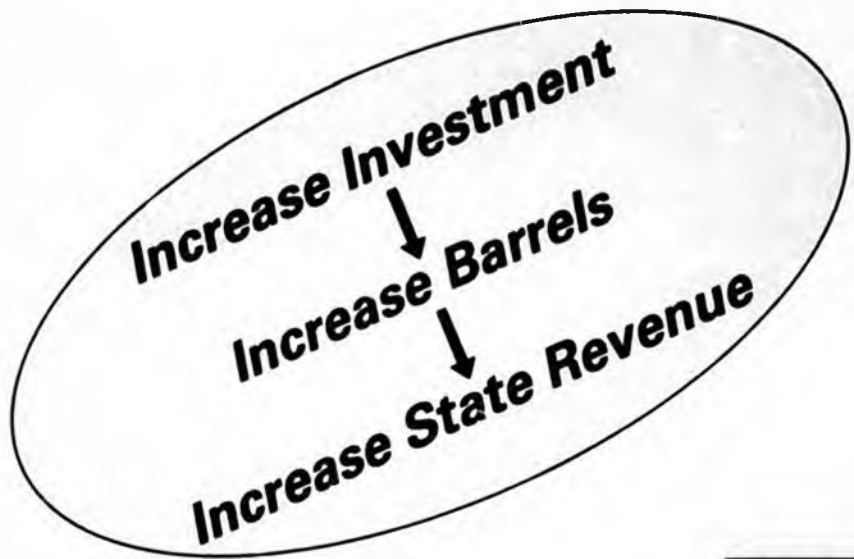
■ 6% Production Decline starting 2008

□ Capital Spend Estimate, \$billion

# Production Drives Revenue



Decline Rate	15%	<b>6%</b>	3%
Produced Barrels	1.3 bn	3.9 bn	7.5 bn
Industry Investment	\$5 bn	\$25 bn	\$70 bn
		<b>Status quo</b>	



**ALASKA NORTH SLOPE  
80 YEARS OF ONGOING DEVELOPMENT**

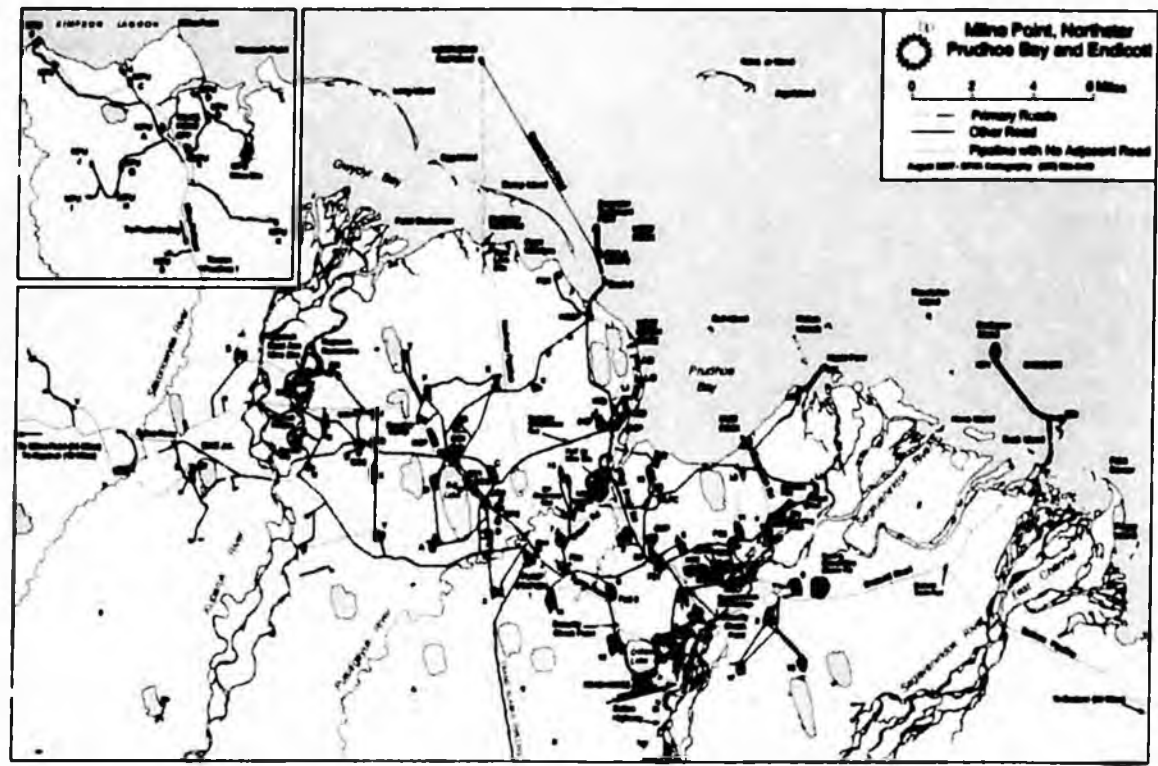


dq

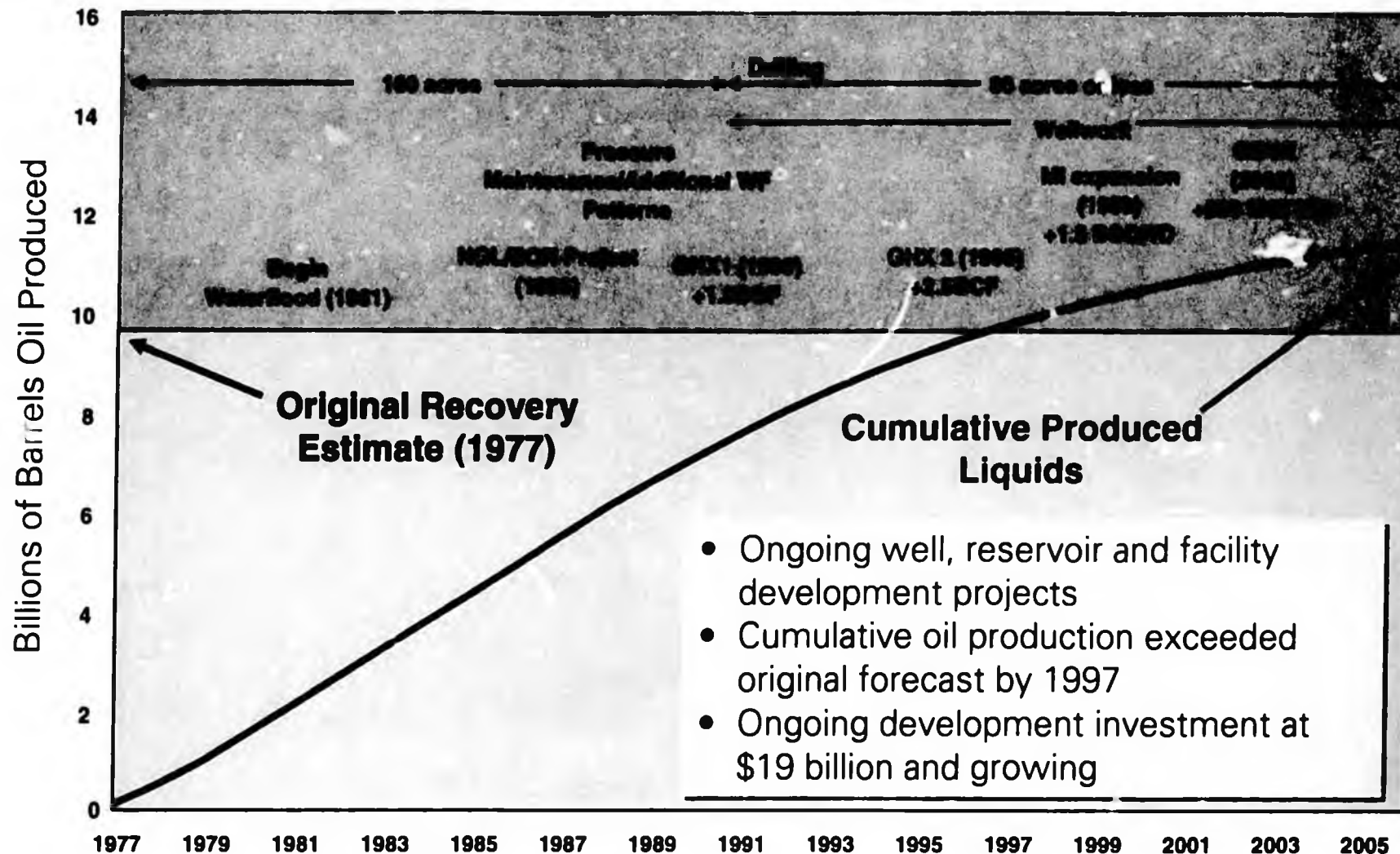
# Prudhoe Bay



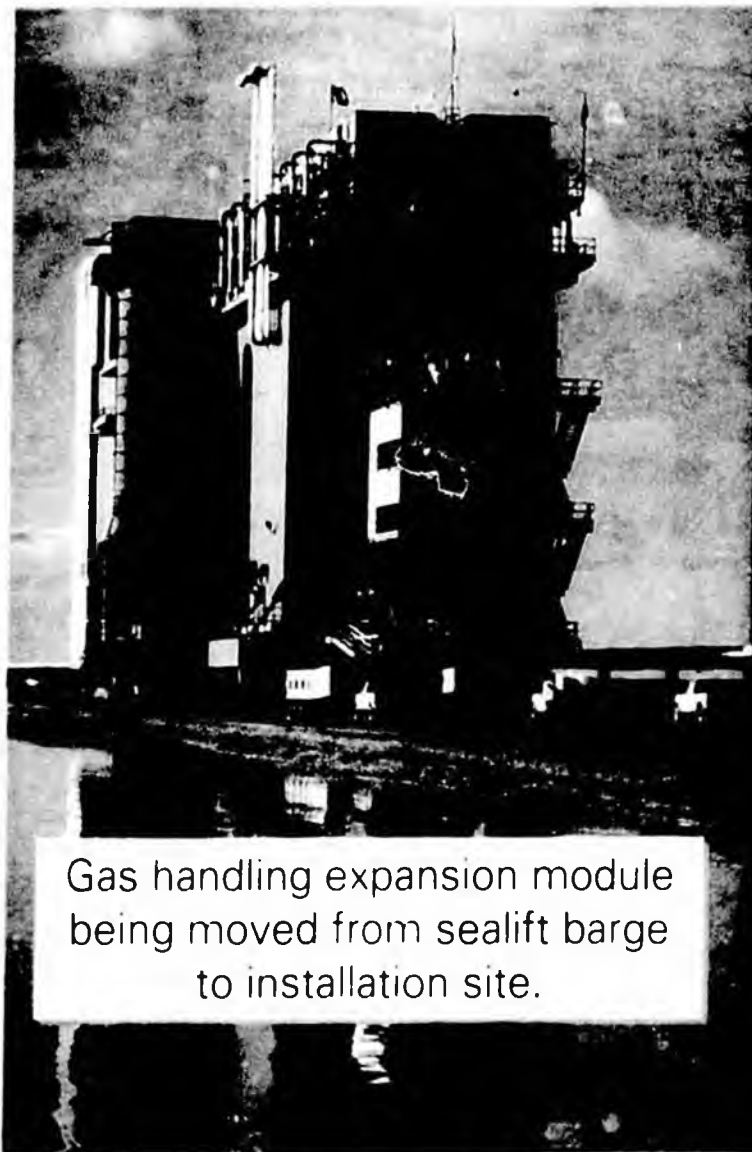
- Largest Oil Field in North America
- Extensive and successful development
  - 60 square miles
  - 11 major facility locations
  - 42 Drill sites
  - 1200 active wells
- Future challenges
  - Managing declining oil rate, and increasing water and gas rates
  - Ongoing developments, light and heavy oil, to offset steep natural decline
- Technology development and deployment is key
  - Arctic specific
  - Advanced reservoir processes
  - World class drilling and workover
  - Facility upgrades



# Prudhoe Bay Development History



# Prudhoe Gas Facilities



Gas handling expansion module being moved from sealift barge to installation site.



Central Compression Plant (top) and Central Gas Facility (bottom) represent the largest gas plant complex in the world

# Drilled in Prudhoe Bay

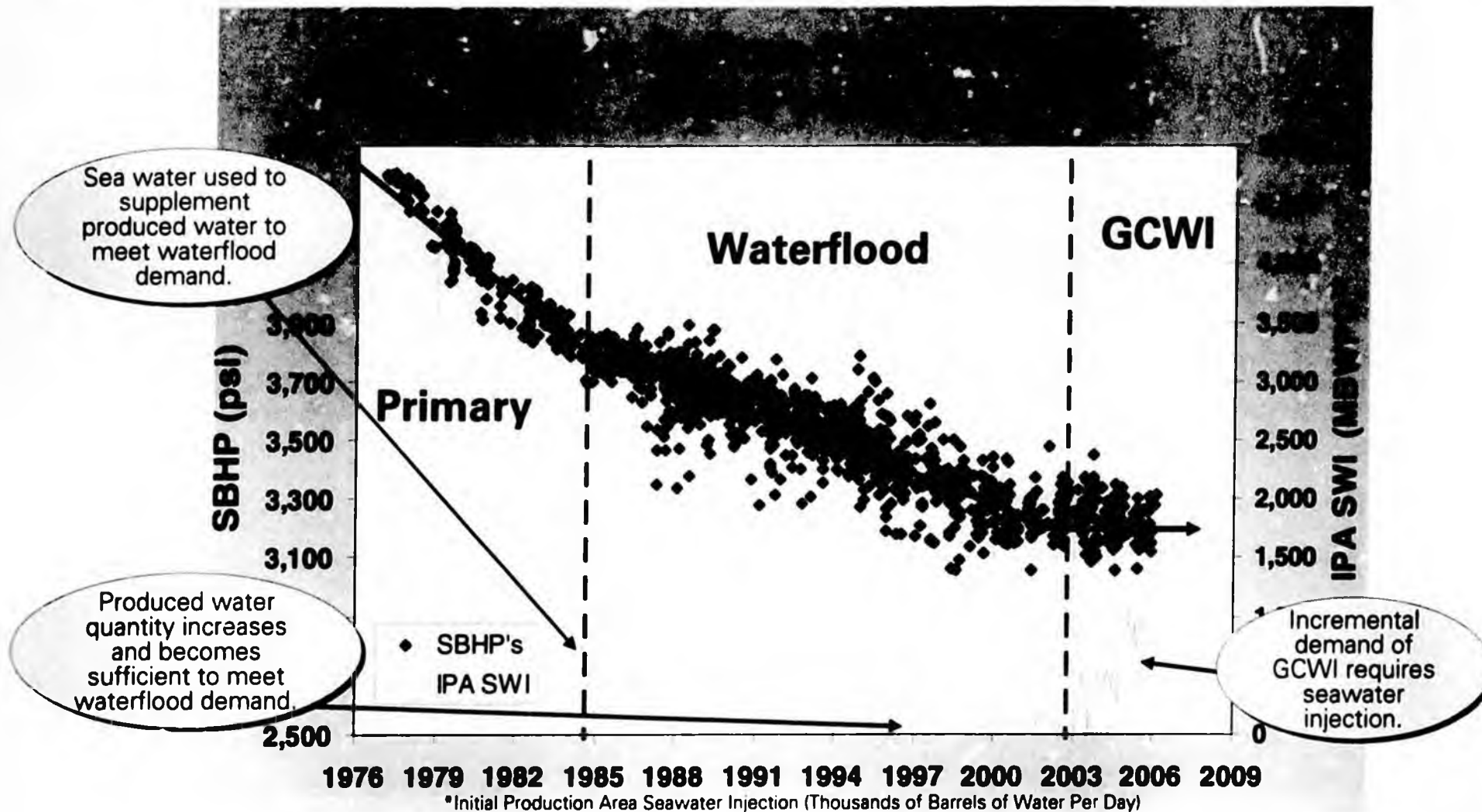


**Originally expected to drill only 500 wells**

# Water Injection Projects



Water injection into the oil reservoir (i.e., waterflood) to maintain field pressure followed by new Gas Cap Water Injection (GCWI) technology



# Projects: Bright Water™



## Objective

- Increase Oil recovery through improved sweep efficiency
- Reduce produced water

## Concept:

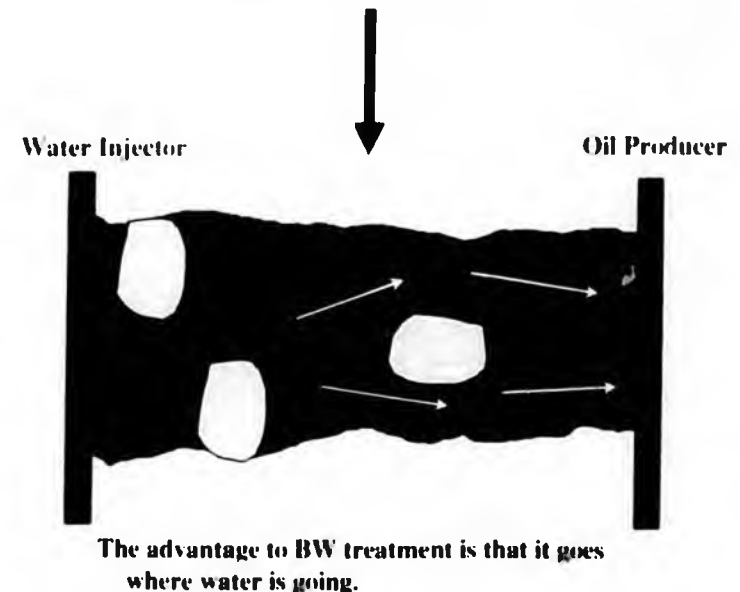
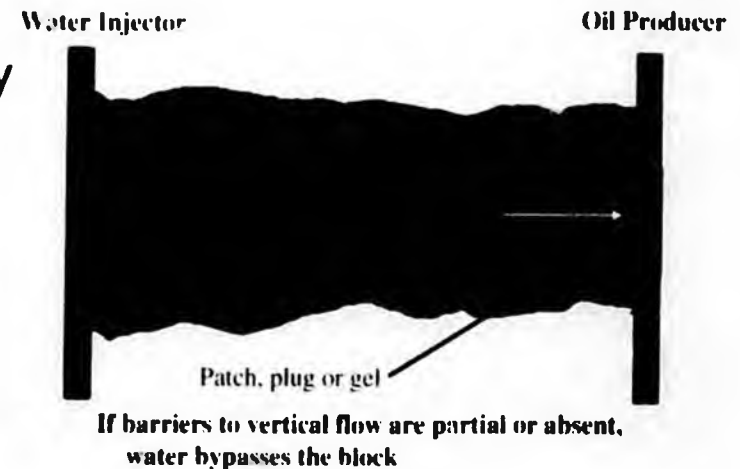
Polymer expands after deep penetration into reservoir, effectively blocking the swept zones and forcing the water into unswept oil zones. Timing for expansion and change in sweep is 9 months. Lab testing shows 2%-20% additional recovery.

## 2006 Highlights:

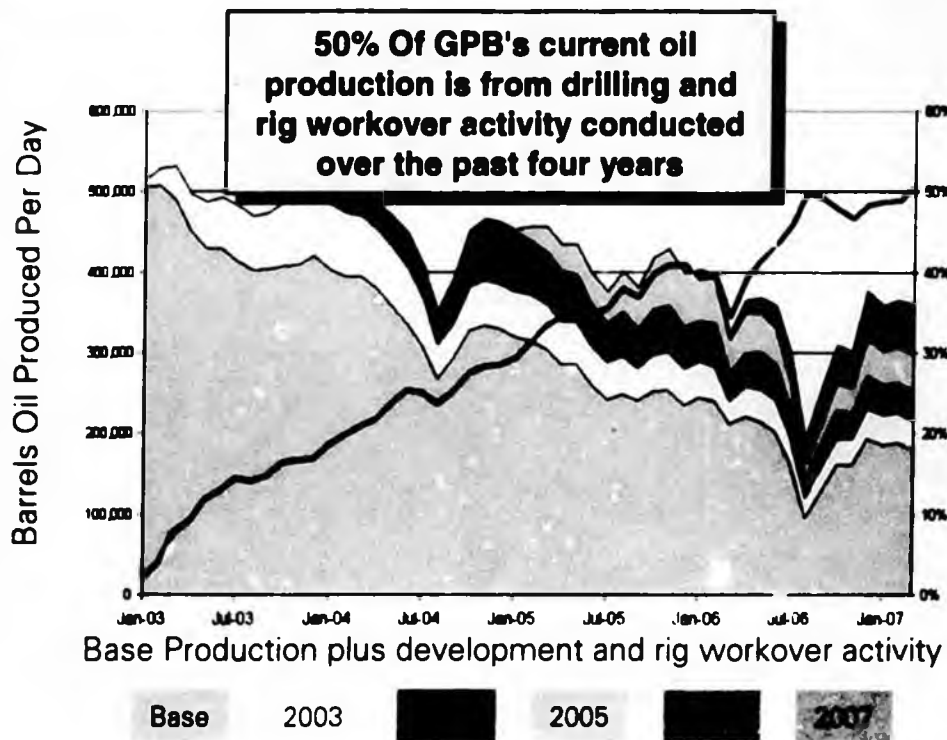
- NWFB Trial: limited response due to design and operational difficulties
- FS2 Trial: measurable response in 7 offsets

## 2007 Plan:

- Continued monitoring of FS2 and NWFB trials
- Pursuing additional treatments

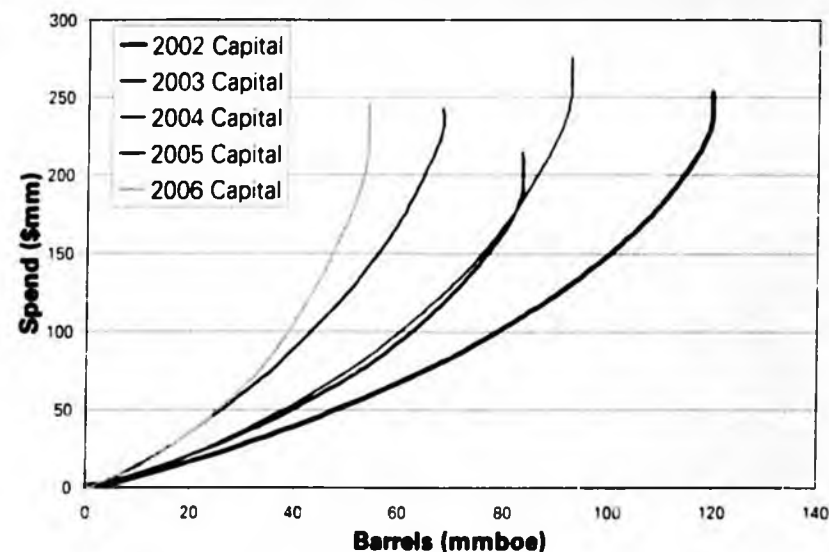


# New Wells and Wellwork Deliver Barrels

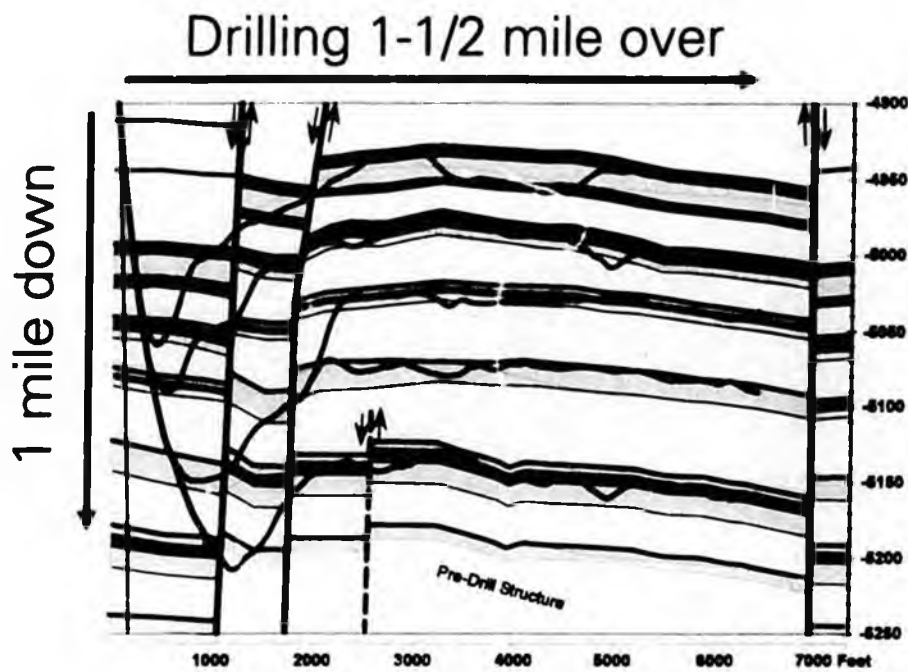


**Each year, the challenge to delivering more barrels becomes greater**

**GPB Well Investments 2002-2006**



# Seismic Imaging and Directional Drilling Enable Development

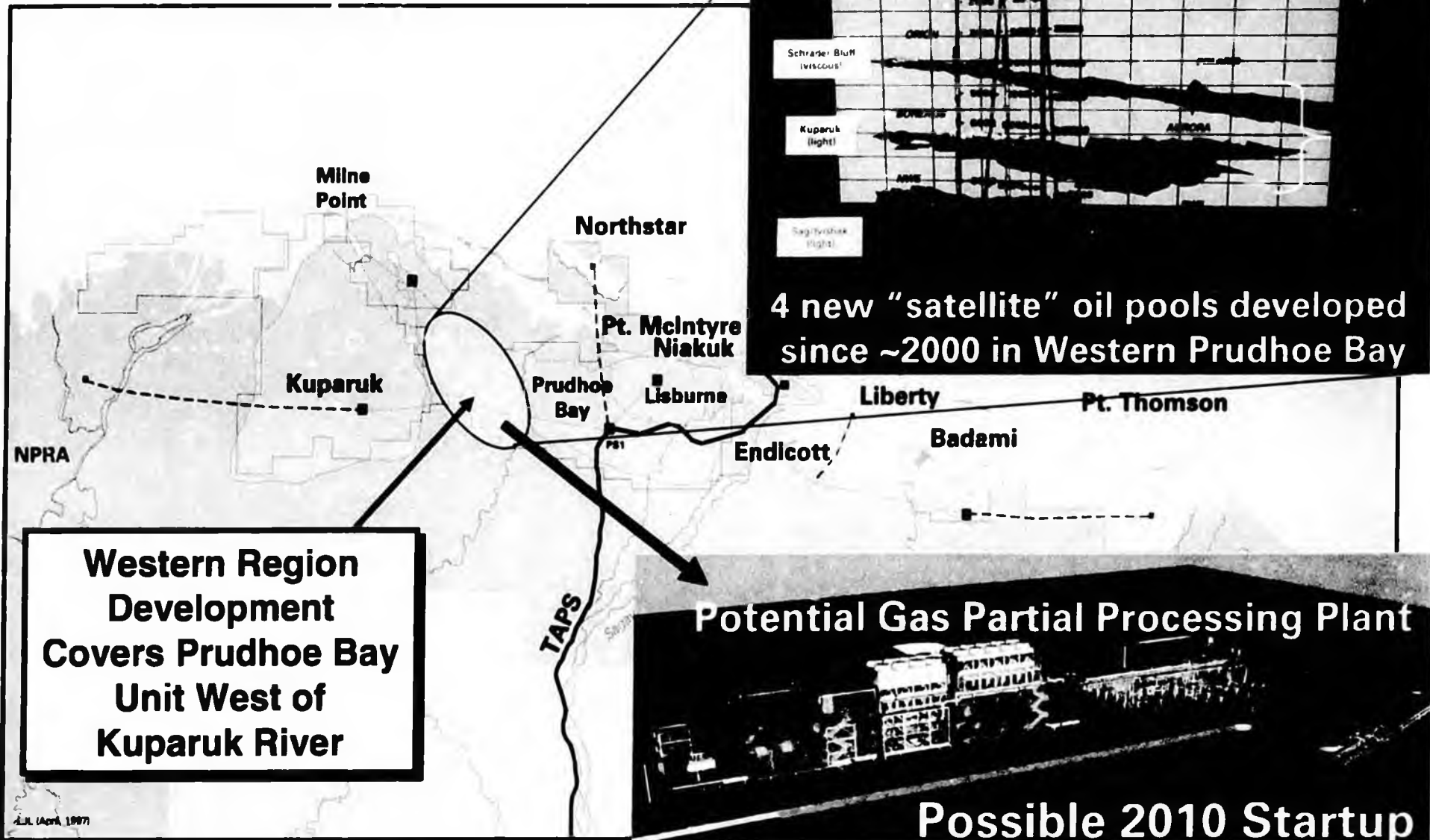


**Now 15 are producing and over 20 more are planned, but not all are approved**



**Technologies required to drill and operate these multi-lateral well did not exist eight years ago**

# Western Region Prudhoe Bay



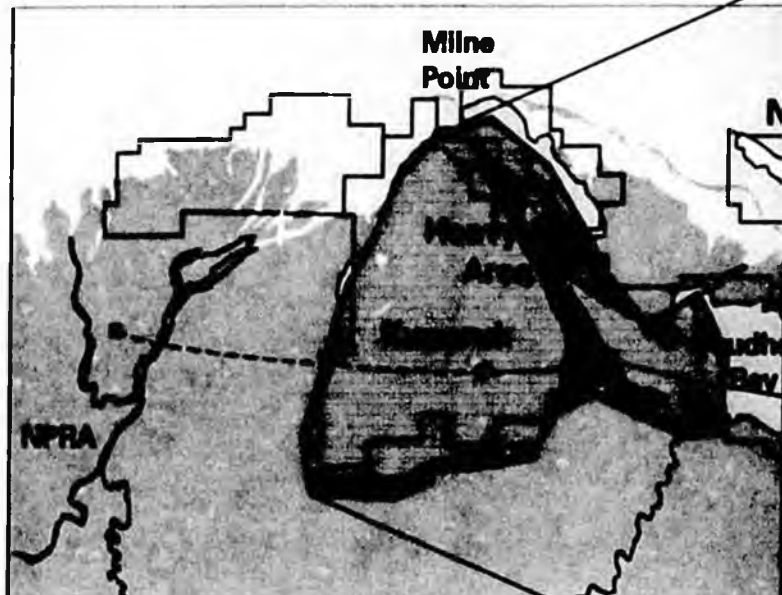
**Western Region  
Development  
Covers Prudhoe Bay  
Unit West of  
Kuparuk River**

**4 new "satellite" oil pools developed  
since ~2000 in Western Prudhoe Bay**

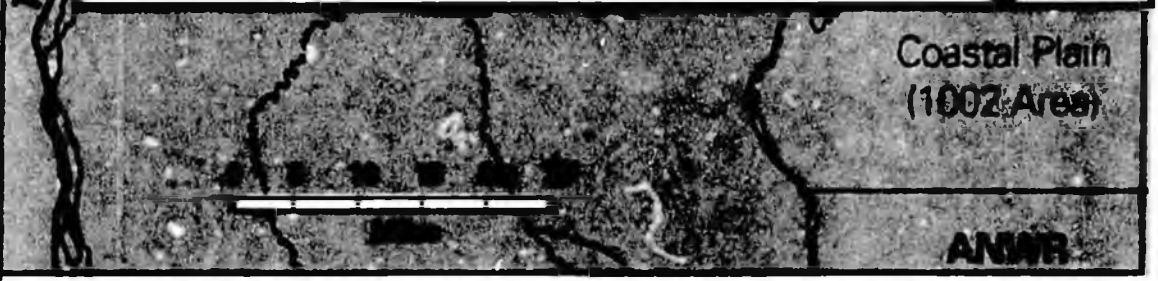
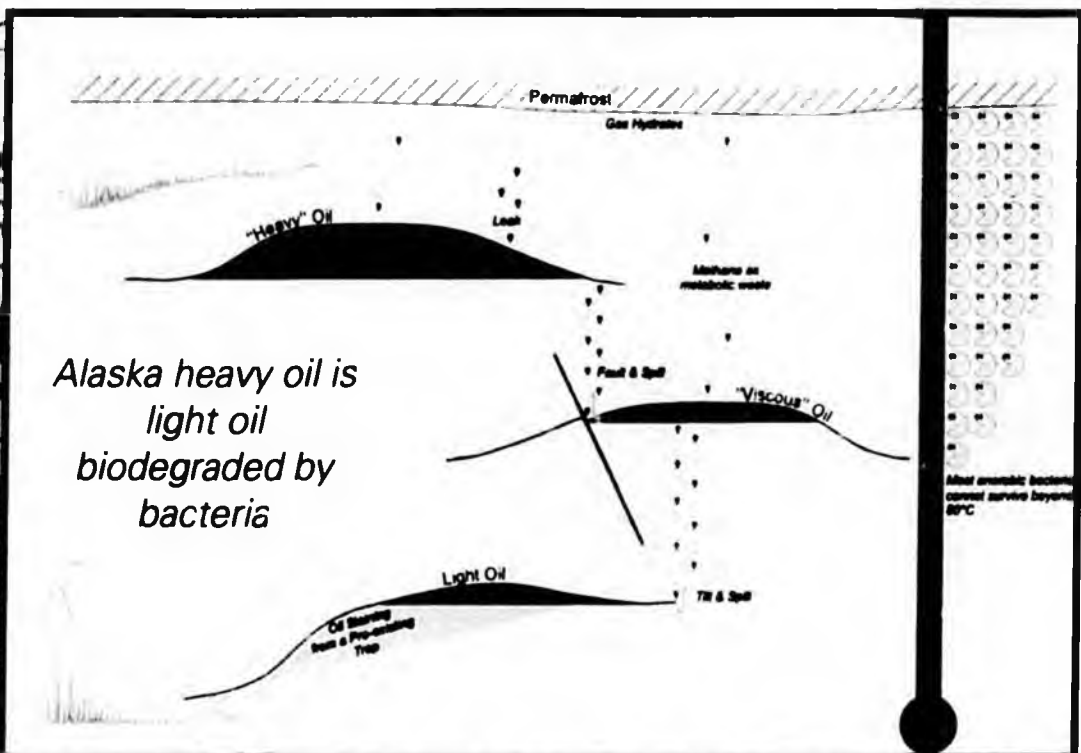
**Potential Gas Partial Processing Plant**

**Possible 2010 Startup**

# North Slope Heavy Oil



- Alaska Heavy Oil: 25 – 30 billion barrels oil in place
- Creating new technologies to overcome challenges
- Pilot trials began decades ago
- Only 100 million barrels (0.4%) recovered to date
- Heavy Oil Fields are within the existing oil fields



# Heavy Oil Challenges

*Heavy oil will always be disadvantaged relative to light oil on the basis of development cost and commodity price*



## PROPERTIES

- Chemical
  - Hydrogen depleted relative to light oil
- Physical
  - High viscosity

=

=

## BUSINESS IMPACT

- Retool refineries
- Take a lower price on market
- High well density
- Add heat to reservoir & transit lines
- Add diluent to major pipelines
- Upgrading (partial refining)
- Environmental Mitigation (e.g. CO<sub>2</sub> sequestration)
- Water treatment
- Sand Disposal
- Wellwork

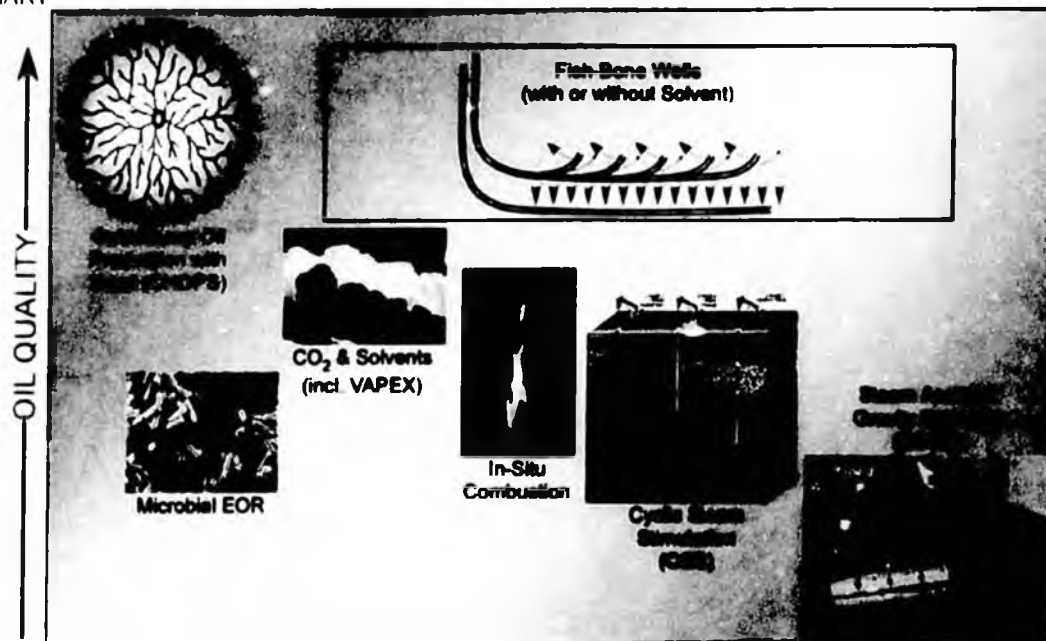
Revenue

Costs



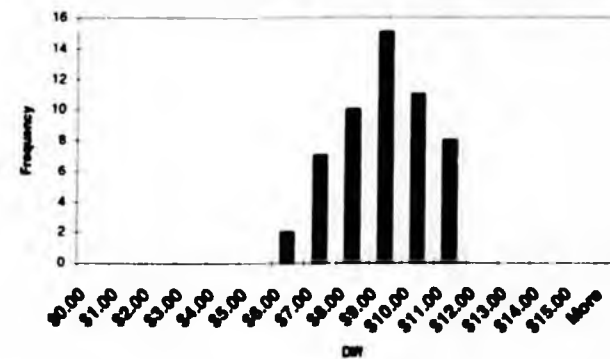
COLD - PRIMARY

RESERVOIR QUALITY



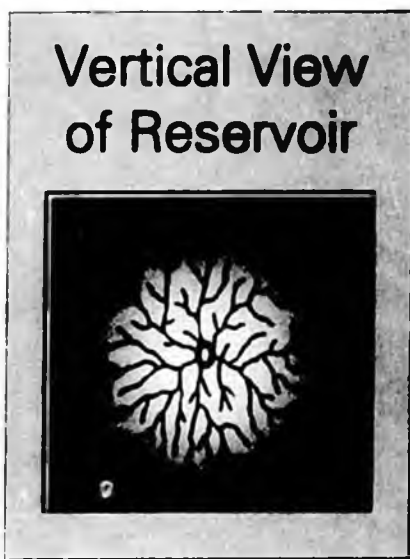
THERMAL EOR

2007 Differential: ANS-Kern River

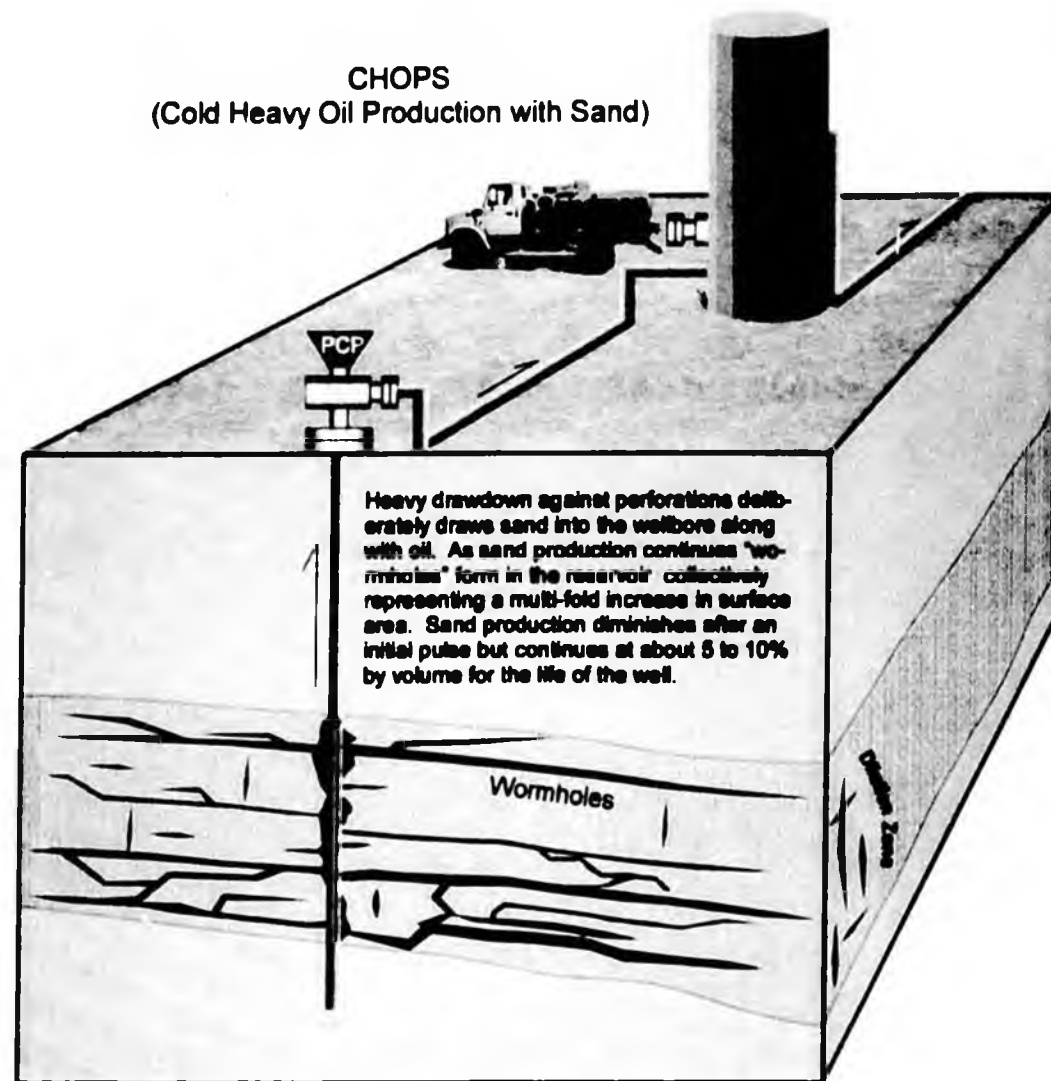


# CHOPS

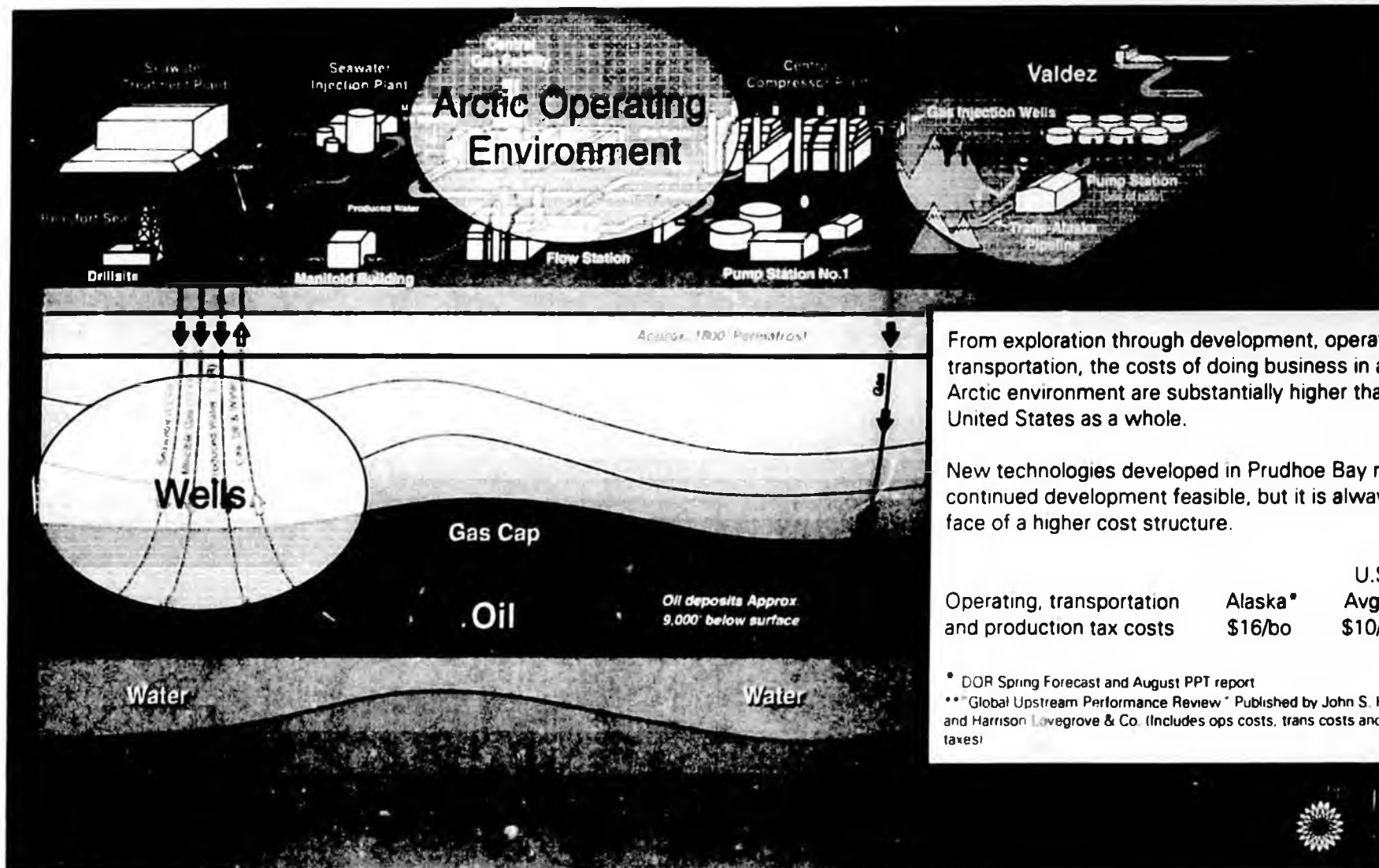
*Cold Heavy Oil Production with Sand*



CHOPS  
(Cold Heavy Oil Production with Sand)



# Alaska vs. Average U.S. Cost Structure



From exploration through development, operating and transportation, the costs of doing business in a remote Arctic environment are substantially higher than the United States as a whole.

New technologies developed in Prudhoe Bay make continued development feasible, but it is always in the face of a higher cost structure.

	Alaska*	U.S. Avg**
Operating, transportation and production tax costs	\$16/bo	\$10/bo

\* DOR Spring Forecast and August PPT report

\*\* Global Upstream Performance Review - Published by John S. Herold, Inc. and Harrison Lovegrove & Co. (Includes ops costs, trans costs and production taxes)



# Prudhoe Bay Development Summary

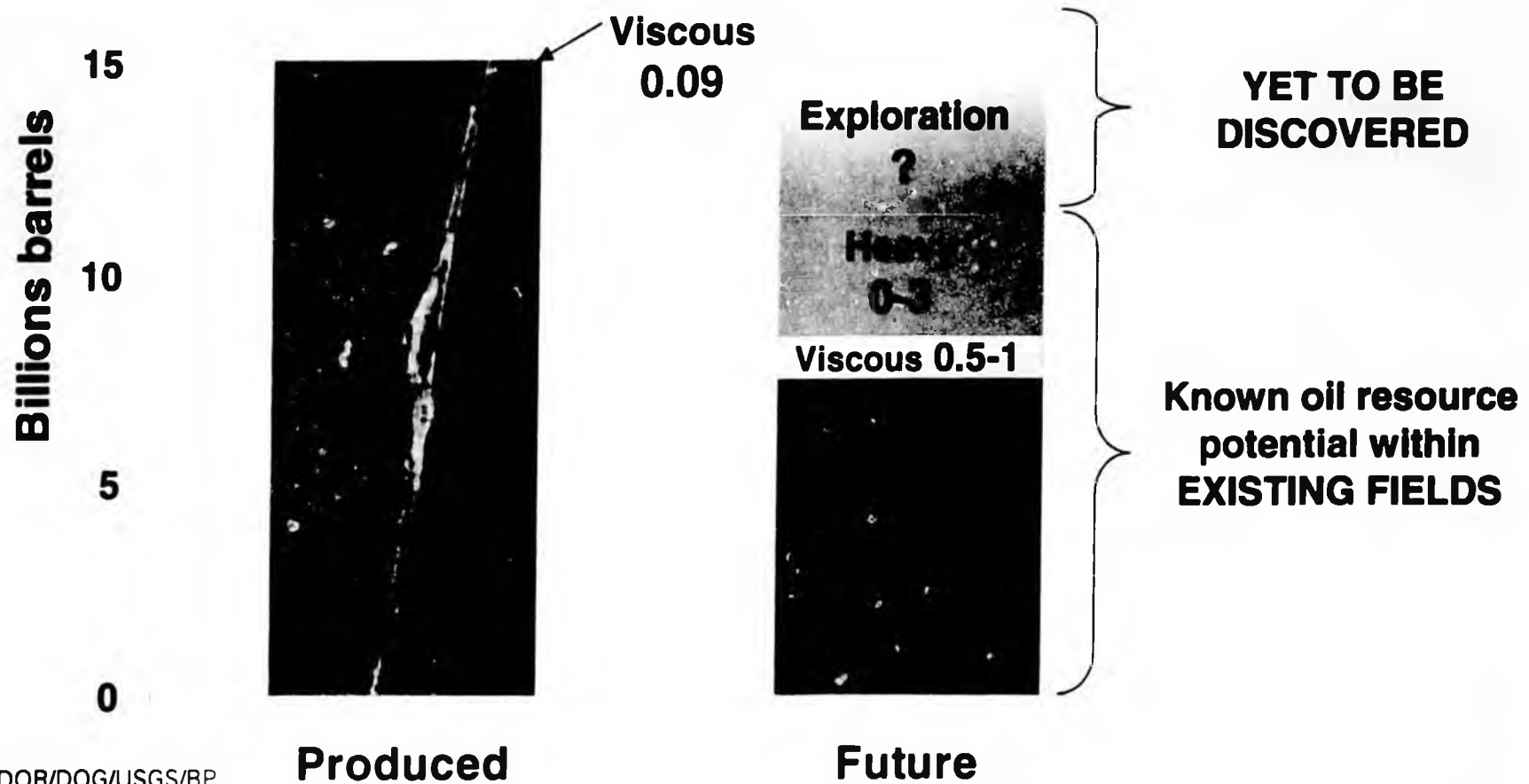


- Technology is Critical to Optimize Recovery:
  - Developing and applying new technology at scale
  - Arctic Technology
  - Major Facility Projects
  - Advanced Reservoir Processes Technology
  - Drilling/Workover Technology
- Development has been extensive and very successful
- Oil production is mature with over 11 billion barrels recovered
  - 1200 active wells
  - Declining oil rate and increasing water and gas rates
- Ongoing Projects Are Needed to Offset Steep Natural Decline
- Prudhoe Bay has a large part of Alaska's Future Opportunities

# The future of North Slope oil still tied to existing fields



Sustained investment in light oil development is critical to developing heavy oil and new fields

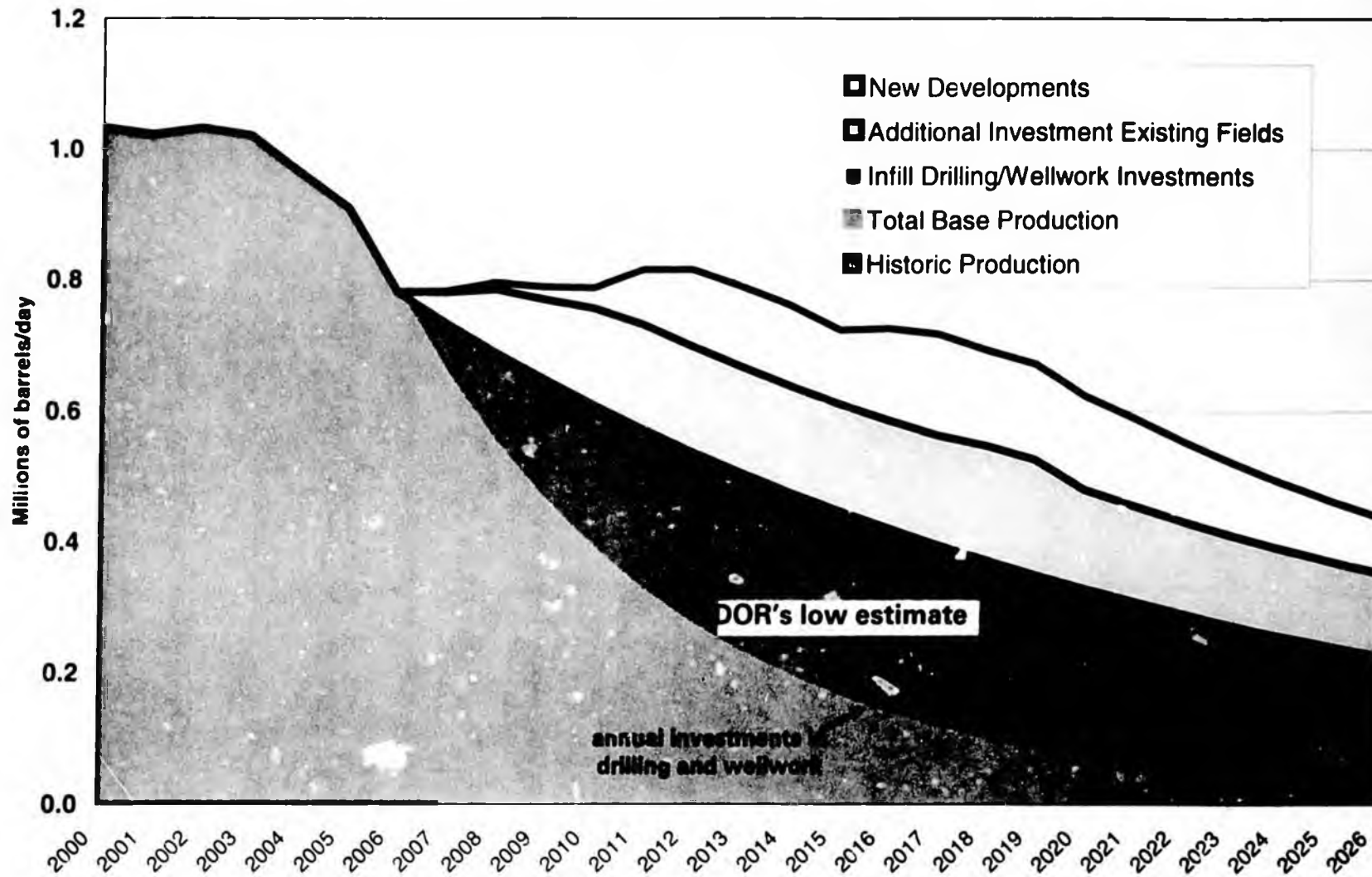


Source: DOR/DOG/USGS/BP

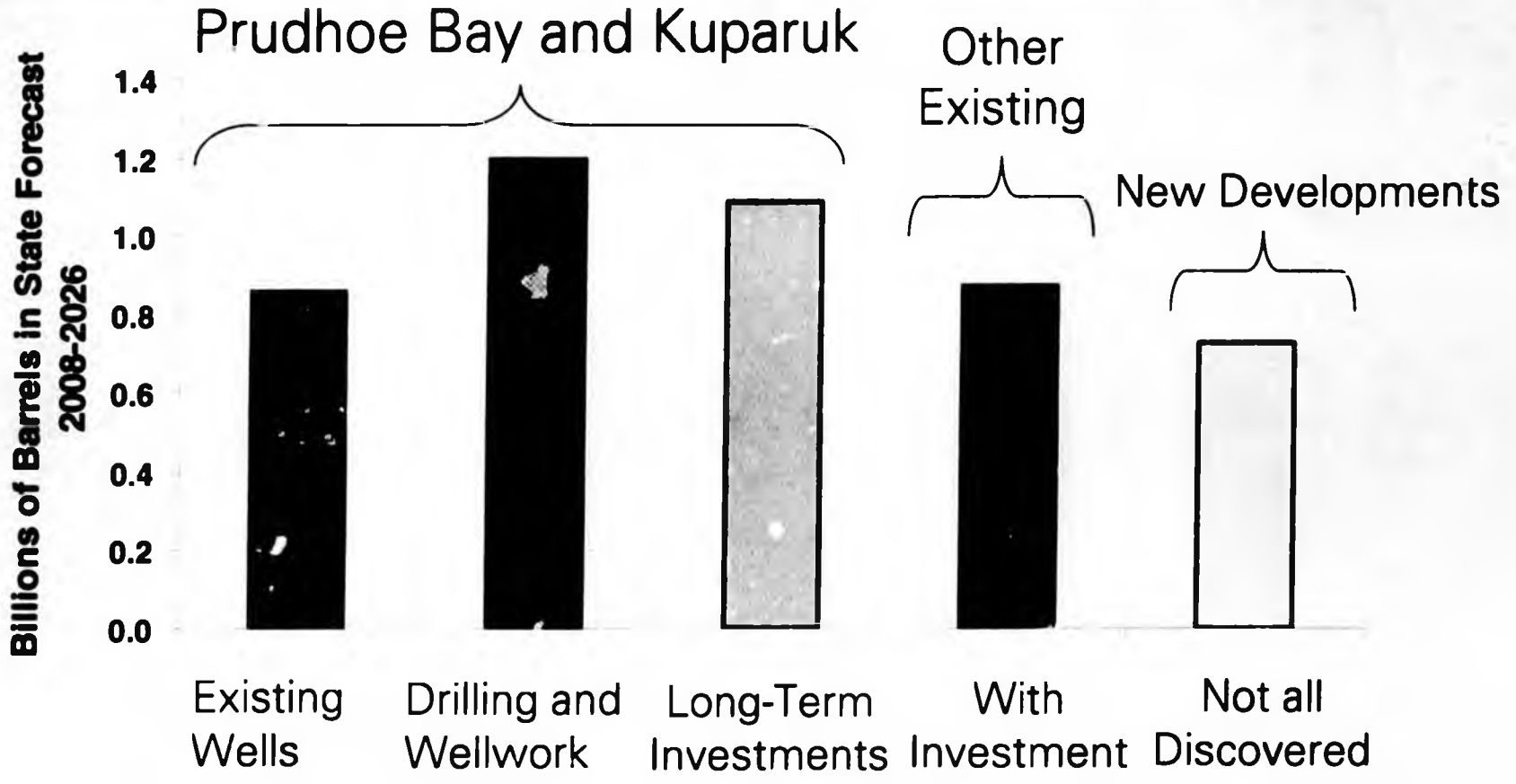
Future of oil production is critically dependent on existing large fields, additional investments



DOR Production History and Forecast



Alaska needs a world scale level of ALL types of investment to sustain the future of oil production



State Revenue, \$billion\*

13

18

16

11

9

\*assuming PPT terms and state revenue of \$15/bbl at \$60/bbl ANS

# Sector inflation triggered by high oil prices is real and substantial – example measures



“The Upstream Capital Costs Index, developed by Cambridge Energy Research Associates (CERA), shows that costs for oil and gas production equipment, facilities, construction, materials and personnel have increased 53% since 2005.” (Source: PPT Implementation Status Report, August 2007)

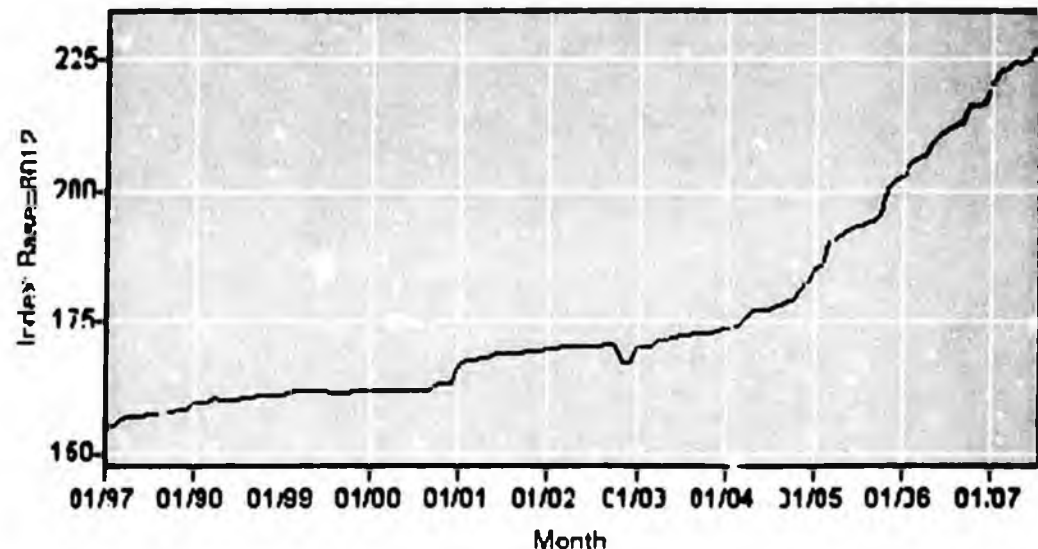
## 2004-2006 U.S. Average Cost Increases per barrel

- 153% on Finding and Development costs (Capital)
- 58% Lifting costs (Expense)

(Source: “Global Upstream Performance Review” published by: John S. Herold /Harrison Lovegrove)

## Oil and Gas Field Machinery and Equipment PPI

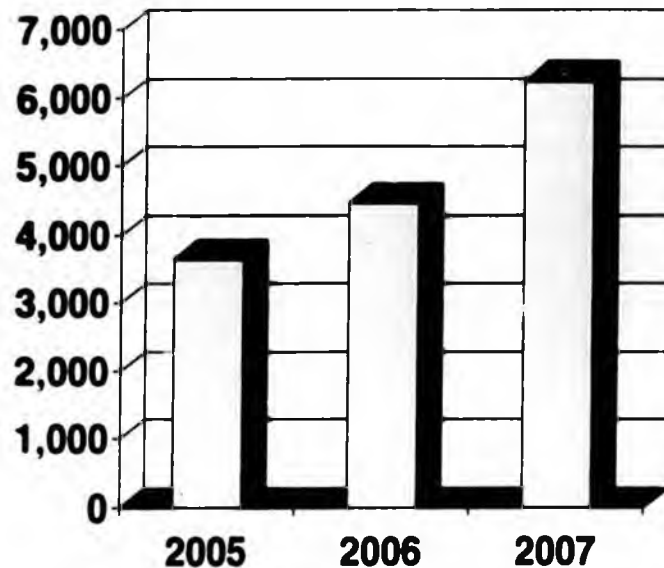
Source: U.S. Department of Labor



# Investment activity is also causing a large part of the increase



□ North Slope Contractor Jobs



- Since late 2004, BPXA staff has grown from 1300 to approaching 2000 employees
- Active drilling rig count on contract for BP has gone from 9 in 2004 to 10 in 2007
- BP commissioned a new camp this summer and rented 4 more, increasing our camp capacity by 30%
- Seismic acquisition activity brought in additional 100+ contractors to the Slope for the winter season
- Pickup truck rentals in support of NS operations has gone up approximately 60%
- Preventative maintenance and inspection programs on the 30-year old infrastructure are at an all-time high

# Economic impact of proposed bill on new investments



- About 70% of future investment decisions are within Prudhoe Bay and Kuparuk
- Minimum tax imposed on these fields causes a progressive deterioration of economics at medium to low prices
- A significant number of investment opportunities in Prudhoe Bay and Kuparuk will cross into marginal or non-economic territory, raising costs and lowering netbacks for the rest of the North slope production.