

ALASKA LEGISLATURE COMMITTEE FILES 2007-2008 SRES 12717

SENATOR THERRIAULT: So, in ... the total life cost, cradle to grave, generally who decides what costs are contractible?

3:57:33 PM

MR. JOHNSTON: Oh, in most countries, especially the countries that use production sharing contracts, but this is not exclusive to them, it is the contract which will specify what costs are eligible for either cost recovery or as tax deductions or both. And the government has the right to audit and they're pretty rigorous about [it], which is an understatement in some countries. But, the auditors will inspect the books and audit. In addition to that, many, many of these systems in this world - and it's not exclusive to the production-sharing arrangements - have what we call procurement guidelines in the petroleum regulations and the petroleum laws. There are specific laws about how you can procure goods and services, and it's almost as rigorous in some countries as the procurement requirements that you work under when you bring in consultants like Pedro and I. You have to do it a certain way. Well, for the oil companies in these countries, they have to be very careful about how they procure goods and services, and then it's all auditable and the governments have a significant amount of control. Sometimes so much, that they are, they're really a nuisance, and it costs them, everybody in the long run, but significant control in those countries through those mechanisms.

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DR. VAN MEURS: Maybe I can add a few words there. The, of course, in the PPT law, as it is today, there is clear mention of the kind of costs that are deductible and not deductible. So, if you have a tax system that works, say on a consolidated basis, and that is not a contractual relationship, you could, in your law, and in your regulations, specify which costs are not deductible for PPT purposes. And, in fact, you gave the example of the corrosion issue and that the idea was to make that a cost that is not deductible. So, consequently, you don't necessarily have to have production sharing contracts, as Alaska proved in their PPT law. You can, in the law, describe - and ... more precisely in the regulations describe - what costs are not deductible. In production sharing contracts, the costs that are deductible and not deductible are typically contained in what's called the accounting procedure. It's just an annex to the contract, but that is a contractual agreement. So, you sit together with the government and say: I agree that these costs are not deductible.

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SENATOR THERRIAULT: So, so really you've got recouplement of costs, the total economic take from the project, long term sharing of the project, the profits. It really is a net structure, isn't it? A production sharing contract?

4:00:35 PM

MR. JOHNSTON: Oh, no. Almost all governments receive a certain amount, through net. Is that what you're talking about; net as opposed to gross, right?

SENATOR THERRIAULT: You've taken out the cost. The company has recouped the cost and then you're arguing about what's left.

MR. JOHNSTON: Well, some of these production sharing contracts have royalties, too. Are we speaking, is that...

4:00:40 PM

DR. VAN MEURS: Sorry, no, no, no. I would agree, very old data. The production sharing feature itself, consisting of what you call cost oil and profit oil, subject to maybe a cost limit being in place. But, if you have the cost oil and profit oil concept, yes. The profit oil is the split after you have taken out, after, after, all the cost oil has gone to the contractor, based on the recoverable cost, based on the definition of the accounting procedures. Then the remaining of the profit is split between, let's say the state and the investor. As, Daniel says, these days most, more comprehensive production sharing agreements would have other features in it, like royalties whereby, you know, certain amounts are actually set aside directly for the state in addition to the profit share that the state receives.

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SENATOR THERRIAULT: Mr. Chairman, I think one thing that would be ... helpful for the new members but helpful for all legislators to look at, too, is if we look back at the last year, the State of Alaska, we get revenue from the operation from royalty, we've got severance, we've got property tax, we've got corporate tax. And so, when we talk about where we've changed our system, and it's now terribly [destabilized], the royalty didn't change, property tax didn't change, corporate tax

didn't change. So, I think it would be helpful if we looked at the total, a year's worth, and look at the total state take from oil and gas operation. How much of it was royalty? That was stable. How much of it was property tax? Well, we ... argue about the value of the pipeline and pump stations and stuff like that. How much was corporate tax? So, you really get down to just if there is instability because of the change, it's just in one component of the state's total tax. And I think if we look at, you know, a total of \$4 billion, how much of that really are we talking about? You know, ... probably off the top of my head I'd say a billion dollars, maybe a billion-five, something like that.

4:02:45 PM

CHAIR SAMUELS: ... Just so, once again, mostly for the new members, the debate over ... - and I know that Representative Kerttula's on my list, but I get to go first, and that's the advantage of having the microphone in front of me - ... putting the deductions in the ... statute and what the first committee of referral did last year is: We wanted the regulators to put them in, or knowing how difficult to get something to the legislative process was that we wanted the regulators who are far more nimble. And, quite frankly, taking for Representative Ramras myself, we got attacked from all sides. The industry wanted it in the statutes, which kind of raises a red flag. A lot of the members wanted it in the statutes, which -- it was an odd thing. But that was the thinking. I couldn't tell you how it'd end up. I'm sure that Representative Kerttula, who's now fourth on the list to ask you questions, can ask this very specific question about having it the statute, versus having it in the regulations. But that was the internal debate that we had last year. ... And I was of a mind to let the regulators do it who are far more nimble and flexible, and let them do it, and I will look forward to, as the debate goes on, I think it's an excellent question Senator Therriault just brought, as the debate continues over the next month, and I'll be asking Ms. Davis the same thing: Can the regulators do these things, should some of them be in the statute or not, knowing how hard it would be two years from now to open this up again, to add something or take something away from these deductions, and two years after that to add something or take something away from those deductions, rather than having regulatory changes. Those are the -- and I'm trying to pitch both sides here, Representative Kerttula. So, that was the internal debate that we had there.

CHAIR SAMUELS: Do you have any follow-up questions? I've got Gara, Crawford, Ellis, and Kerttula...

4:04:29 PM

SENATOR THERRIAULT: Could we ask the LB&A staff to just get those figures for, say, ... the last fiscal year? What was the total take in royalty?

CHAIR SAMUELS: Certainly. Certainly. We won't get them right this very second, but we will have them distribute those.

SENATOR THERRIAULT: Right. Just to get them and distribute them. And then I've ... got a question for these two gentlemen - Pedro, perhaps more to you. When you developed your model for the PPT, it was in calendar year 2005, I believe.

DR. VAN MEURS: Yes.

SENATOR THERRIAULT: Primarily 2005. You would have used actual data that would have been reported most likely in 2004 - cost data from the companies. Probably the most recent data was -- there was probably about a ... year's worth of lag, I would think.

4:05:26 PM

DR. VAN MEURS: Yes, no. There was a difference between what the Department of Revenue used and what I used. The Department of Revenue for the forecast of whatever the reviews would be - one billion or two billion - they used stylized figures that largely came out of the 2004 data, largely from confidential tax returns, and so, they have pretty good (indisc. 4:05:29). My data were based - since I did it not on the total Alaska revenues, I actually did an analysis on a field by field basis - ... on extensive discussions we had with the oil industry or by the industry themselves at that time provided the cost data to us, which I checked with other areas in the world, and I thought that at that point in time these data looked reasonable, in terms of cost structure.

4:06:45 PM

SENATOR THERRIAULT: So, that all came together in 2005...

DR. VAN MEURS: Yes.

SENATOR THERRIAULT: ...and then the debate ended up going much longer than, I think, anybody anticipated. At some point...

DR. VAN MEURS: No, sorry, could I interrupt? No, the data that I used for 2005 data - the data that, the way I understood it, the Department of Revenue used in the -- Roger can comment on that - were derived from 2004 data. But I actually used the data that were based on actual cash flows that were discussed with the oil industry that I checked against other fields, similar fields around the world, and at that time I thought that were a reasonable cost.

SENATOR THERRIAULT: Okay, so ... then you developed your model, and that sort of, you know, a point in time was established as you developed your model in 2005. As we went through the debate in 2006, number one for the Department of Revenue, some new cost data from operations in the State of Alaska - confidential data - should have come in at some time in 2006. In addition, I don't know whether you went back and double-checked your -- or had new negotiations with the companies about, "Hey, what's happening to cost?" But the point I'm trying to get at, and this is a question that I have already passed to the administration for response: Was there a point in 2006 where we should have known that the costs were going up faster than the models originally anticipated, and ... was that incorporated into the model, which would have lowered the legislator's expectations of what profit was going to spin off this new tax?

4:07:42 PM

DR. VAN MEURS: My model was not ... the statewide review forecasting model; my model was an economic analysis model. And I have in my ... model a standard feature, whereby after I have set tentative costs for a set of different fields, ... it is very easy in an economic model to do plus or minus 10, plus or minus 20, plus or minus 30 percent cost and look at the effect. And, of course, that was the kind of analysis that I also did. That ... is standard analysis. And that was, as you recall, during some of the debates, some people said, "Why not go to 25/25, for instance?" ... Because of my model or because I had done cost sensitivity on the possible impacts of higher cost, it was my strong recommendation to the legislature to ... not go higher than the 20 percent, because that kind of a cost analysis showed that that could ... - and I in fact testified to that - ... expose the state revenues to risk. Now, that is a different kind of analysis than the total reviews analysis from the state which ... were based on ... trying to estimate the totality of

the revenue. I was more interested in actual (indisc.). Design a system for the next 15 years, you know the costs are going to be very different from what they are in 2005. I never really follow (indisc.) for 50 cents more or 50 cents less per barrel. What ... I'm trying to do is look at the fiscal system, look at the cost structure, do sensitivity analysis, and see how does this system perform under a wide range of circumstances? And, yes, of course, you know that if costs go up, then you will receive less, and if costs go down, you will receive more. Out of that analysis, as I said, came my caution, which I strongly defended to the legislature, as you may recall, that ... I strongly recommended not to go higher than 20 percent (indisc.). And despite the fact that there were some other proposals, this (indisc.). And that was the result of my analysis.

4:10:00 PM

SENATOR THERRIAULT: And I remember you testifying to that fact, but I guess what I'm trying to get at is: If part of the rub with the Alaska public and legislators is the expected revenues are not projected to materialize out of this new system, should we have known at some point that that ... was happening - that costs were going up higher than perhaps you had projected or ... modeled? Were they going up smoothly or had they actually jumped up to a new plateau and then we're going up from that new plateau? Should our expectations out of PPT have been lower than what was being graphed?

DR. VAN MEURS: No. As I mentioned also to the legislature, you know, I warned the legislature, as I showed you in the slides and that (indisc. 4:10:48) example, so I can -- I have almost every presentation I made during the gas line debate, I warned about the price increases.

4:10:55 PM

DR. VAN MEURS: So, you know, I think that, you know, [there's] ample evidence around the world, in 2005, ... and in fact beginning in 2004, 2005, 2006, that costs were going up, and I tried to convey that to the legislature as an additional risk factor in ... the pipeline. The -- as I mentioned, it was my own -- Having working simultaneously in different countries with different, kind of, cost structures, at the time, it was not my strong impression that the arctic, say, in Alaska had the same kind of local cost escalation as Alberta had. I mean, if you go to Alberta, you know, clear signs of overstress of the economy. Nothing like that happened in Alaska; nothing like that happened

in certain countries in the Middle East where I work. So, that gave me the impression that, yes, there could be some cost increases in the Arctic, but I didn't have hard data as to what that could be. Certainly, it is still my view today that these cost increases are not necessarily as high as occur somewhere else, and that is why I strongly urge the administration, and I'm happy that they take strong measures to do proper auditing, because I can easily see how, after a proper audit, you will come to the conclusion that actually not that much money -- it's less than anticipated. And I wouldn't be surprised if that would be the conclusion two or three years from now. But in my model there was no need to (indisc.), because I do cost sensitivity anyway.

SENATOR THERRIAULT: Thank you. Thank you, Mr. Chairman, I'll let somebody else take a turn, but put me back on the list.

4:12:55 PM

CHAIR SAMUELS: Okay. Representative Gara. I've got Gara, Crawford, Senator Ellis, and Representative Kerttula.

REPRESENTATIVE GARA: Thank you, Mr. Chair. Senator Jonny Ellis here, member of the Senate Majority. That's going to drive the clerks crazy. Representative Gara - not the member of the Senate Majority. Mr. Johnston, I want to grab as much information from you as possible before you leave. And one of the issues that you talked about was a different tax rate for the legacy fields. And looking at something like that, I want to make sure that we understand how to do it and how to talk about it if you want to do it. And Representative Doogan starting asking you this, and I'm not sure if I understand that answer yet. You've got Prudhoe Bay and Kuparuk, for example, and you'd said maybe a 30/35 percent tax rate on those fields, but the caveat is in the future there might be heavy oil there that we need to extract, there might be new pools of oil that the companies have to access that aren't part of their ongoing operations. How, with a higher tax rate on the legacy fields, do we also accommodate for the fact that some of the oil on ... those fields, some of the new oil on those fields that we're hoping for is going to be more expensive than -- how would we treat those sections separately within ... those units? And do other countries do anything like that?

MR. JOHNSTON: Yes, other countries do things like that. I refer to them as rehabilitation or redevelopment-type projects,

or sometimes they're called improved oil recovery or enhanced oil recovery contracts.

4:14:30 PM

MR. JOHNSTON: And they're characterized by a producing field that's in decline and in need of additional work, and things like that. The negotiations focus on the fiscal terms - that's a natural thing - but the terms that are negotiated are typically two dimensional. One dimension deals with what's called incremental production - anything that is the result of additional work, enhanced recovery techniques, additional technology, and things like that. The base production in your case would be, you know, maybe a 6 percent decline. That's another element that's negotiated. And there's a fee that's often paid to the companies for the base production or a different set of terms. I would be very comfortable, you know, looking at that sort of relationship, because it's been done so often. When we talk about the science of fiscal system analysis and fiscal system design, and all these average statistics, they usually focus on exploration. If you're able to segregate out the portion up there that really isn't exploration - and that's the base production - then there are example contracts all over the world that deal with situations like that.

4:15:50 PM

REPRESENTATIVE GARA: Thank you Mr. Johnston. Just on that subject, could you have a special credit or deduction system for enhanced production also, if you did it by statute - something like that?

4:16:06 PM

MR. JOHNSTON: Heck, no. You know, if you ... didn't have to have -- listen, I never was against the credits - not one bit - because if you're confined to a single system, you kind of have to do this juggling that we've been doing for a couple years now. If you can segregate the base production on the legacy fields, and then create fiscal terms for everything else, those fiscal terms for everything else could be an awful lot simpler. And there are standard formulas that have worked, not a lot of bells and whistles that make people confused - those wouldn't be out there. And so, in my mind that would be so much easier and exciting, you know.

REPRESENTATIVE GARA: A couple follow-ups?

CHAIR SAMUELS: Yes.

4:16:45 PM

REPRESENTATIVE GARA: The -- I forgot about the testimony that you handed out, and what I had from you from last year was this April 22 memo, I think, that's being distributed. And I'm just looking -- this is on the issue that you discussed of how quickly and how strongly you raise the tax rate at a certain benchmark oil price - you know, the progressivity factor we've been talking about. And ... I think I'm saying this accurately: I think PPT is somewhere around \$55 or \$60 a barrel, you raise it by .225 percent for every dollar the price goes up. I think ACES is something like .2 percent for every dollar the price goes up a little bit earlier. And I just want you to explain to us, on page 4 of your report from last year, you'd said something to what you're saying now, which is you don't think those, that that progressivity rate is high enough, I ... think. And you had recommended a .375 percent increase for every dollar, I think, on a legacy field, starting at \$40 dollars a barrel. Can you explain to us -- and that's a much higher number that we've been talking around, around here. Can you explain to us why that's not too much? And ... if you raise the progressivity factor to something like you recommend, is that fair to the oil company, does that allow them to achieve additional profits as the price goes up too?

4:18:29 PM

MR. JOHNSTON: First of all, thank you for showing that essay. Almost have no recollection of drafting it, but it's starting to come back to me, and it was one of the first issues that I bought up when I started to discuss progressivity. I was pretty adamant about the need for progressivity - I guess I've made that clear - but the natural question the is, well you know: Well, how progressive is a progressive system in this world? And there's fairly readily available statistics that I provided in my testimony either March or April or February - whenever, I kind of lost track - that showed some of those systems that are. And in this world, there's about 20 percent of the countries actually have a progressive system that responded to this price shock that we're experiencing now. And another 10 percent of the fiscal systems in this world are about average - excuse me, neutral - and nothing changes. It's the other 70-odd countries in this world, like you guys, that were regressive. The price goes up, but your take actually goes down. And that -- in this

world, in this day and age, that, for me, is not a state of the art system, it's, you know, if you can change it I recommended that you do. I looked at those countries around the world that actually had progressive systems, and ... I looked at the average progressivity, and my feeling was that - and I think I provided here, if I have to go off the top of my head it might not be as meaningful or helpful, but I'm going to have to - if you go from \$20 to \$60 a barrel - and that was an example I used many times, because we had experienced a \$20 a barrel era for nearly two decades during the '80s and '90s, and then we were up to \$60 a barrel, and the industry was starting to believe it around the time that I came here and first testified. If you look at the difference between \$20 a barrel and \$60 then, for the universe of systems in this world, the neutral countries didn't change - the government take didn't change, the regressive countries' take went down 2-3 percentage points, the progressive countries, their government take went up from 5 to 10 percent, as I recall. And I figured, that makes sense to me. So, if you went from \$40 a barrel to \$100 a barrel here, and the ... government take went up 10 or 15 percent, even, which is a lot higher rate than this modest little increase would yield, by the way, you ... are in a ... glorious place. And there's an acid test in my opinion as to, you know, at least one dimension of how high you could go.

4:21:03 PM

MR. JOHNSTON: Because there's a natural question then, too: Now, wait a minute, if you go from 20 to 60, and you have a 10 percent increase in government take, and then you go from 60 to a -- at some point it gets very, very high. But, you know, we saw some interesting licensing here in Alaska ... during a time when prices were just as high as they are now, and that's when Northstar was put out for bid. And that's one of those examples where the industry lets you know how much they can sustain. And wasn't that an 80 percent net profits interest bid? When the oil prices were high, Amerada Hess bid an 80 percent net profits interest. On top of that there was a 20 percent royalty. On top of that, actually ... it's followed by the government tax rate at the time, which I think at that time even was higher than 35 percent. Northstar government take, as I recall, was over 90 percent. It wasn't legislated; it wasn't agonized over all of you guys in here; it was a bid submitted by the oil companies - not you guys. And so, with prices like this, or prices like, you know, what they could be when you're designing progressive element, you can go very, very high, and the oil companies have shown that they can handle that.

MR. JOHNSTON: There's more examples than Libya out there these days. When the prices are this high, there's still a lot of money to be made. In Iran, the government take on those contracts probably is 98 percent. So, a lot of people just got absolutely weak in the knees and thought I was crazy, and yet - wait a minute - I can find lots of support for some very high taxes amongst the oil industry bids around this world. So, in many respects, I think I was pretty mild, ... which is consistent with my attempts to be fair, too. I'm not -- if my mandate was to help you get the absolute most out of the tax system here, and just beat the oil companies up, well I'd recommend that you have Pedro help you out there, because obviously Alberta...

4:23:09 PM

DR. VAN MEURS: I'm ready to start the Bolivian revolution in Alaska, also, yes, yes.

MR. JOHNSTON: And I'm glad I'm not the only person that's compared to [Cesar] Chavez; I'm glad it's Pedro, too. So, ... there was some logic behind what I recommended, and it's that kind of logic that you have to think about, too, if you ... design or redesign the ... progressive element of the system here.

REPRESENTATIVE GARA: Just one final question?

4:23:46 PM

DR. VAN MEURS: Can I maybe do -- Representative Gara, you asked what specific measures could you use to increase the government take on the ... legacy fields. And now, what I'd like to highlight is, broadly speaking, there are two methodologies. One is the mosaic thing, where you ... simply, you know, try to design a fiscal system around different size fields, as we tried to do with the ELF. And consequently, that is one methodology. If you opt for the PPT as a consolidated system, then you cannot really design anything for any particular field, because you have a consolidated system. So, ... a consolidated system means it is for total Alaska, so you're not considering individual fields. If you nevertheless want to increase the government take on legacy field, then I would typically look for that outside the PPT itself. You would simply say, "Okay, for legacy fields, in addition to the PPT that you always pay, you have, say, a supplemental petroleum tax

of 10 percent of gross over 50,000 barrels a day." I mean, just an arbitrary number. But ... I would not look for inside the PPT; that is a very inefficient way of trying to do that. I would look for that as a specialty feature outside the PPT. Now, what I dislike about the legislature's proposal that is being made is that they are actually trying to more or less create a mosaic out of a consolidated PPT by having this 10 percent floor and thereby requiring separate accounting again for each of the (indisc.) blocks. I just don't think that's worth it. If ... the goal is to achieve a higher government take out of legacy fields, [there] are much easier ways to do that without destroying the ... simplified accounting system that the PPT establishes.

4:25:58 PM

REPRESENTATIVE GARA: ... Finally, Mr. Johnston, after listening to you for the last year, I think I understand why you're proposing a different rate for the legacy fields, but, I mean, could you just explain why you think that makes sense, just so folks understand and so I maybe understand it better?

4:26:23 PM

MR. JOHNSTON: When we spent so much time talking about government take and how it compared up here, those government take statistics usually deal with exploration licenses around the world. And you have 700-800 thousand barrels a day of production here in Alaska that's not exploration; that's a different matter. And the time had come to make a change for those fields and that production, but if the change was going to have to be built around an exploration system, it was going to be very, very difficult. That was the hard part for me. There is lots of room in the legacy fields for bigger changes than what I was seeing that were well, well within the zone of what I would consider fair, and I'm not talking about subjective measures of fairness. There's lots of examples ... in this world of how high you can go. And I've ... kind of broken a rule that I have lived by fairly well by mentioning some of the really intense areas around this world where the government take is shocking - like 98 percent, 97 percent - and in such wonderful, stable places as Iran and Libya. If they can handle it there, than surely you can handle increasing governed take on those legacy fields by 10 ... percent, or so. And we never even came close to that here with the PPT - not in my opinion. I don't think we came anywhere close to ... creating a tax that would make the government take here increase by 10 percentage

points going from 40 to 80 or 40 to 100, even. I don't think even at \$100 we really increased it that much. And I'm thinking, "Holy cow, we have companies in this world that are willing to live with 90" - excuse me - "5 percent of the profit for exploration - high risk exploration." In my mind there was just so much room, and yet here we were talking about plus or minus one percent, and it's just been a mess for me. And ... it was an apples and oranges thing; you really had two different animals here. And ... I was burdened by the unfortunate experience of seeing it handled more efficiently in many other countries.

4:28:42 PM

DR. VAN MEURS: ... If I can make a small addition here, like very high government takes have been mentioned. Now, I think then, well you'll have to give me the distinction that I worked on the highest government take in the world in Kuwait - this 98.5 percent - and consequently, I definitely know how to negotiate and how to obtain very high government take. I would say 98.5 percent is somewhat high for Prudhoe Bay. So, consequently, I definitely think we should take in to consideration that this is now a field in very high status of enhanced oil recovery. It is definitely not a field in its prime years; it is a field in ... serious decline. And that still requires, you know, very high investment to maintain and extend the productive life. So, although I agree that there are many examples, and I worked on them myself in the world where we achieved very, very high government takes, in the case of Prudhoe Bay, although it's called a legacy field, I would definitely still take into account that this is a field in it's, you know, ... last legs, and it requires quite a bit of extra and higher costs to gradually start to manage these things. So, ... I would recommend some caution with respect to these matters. That is also the nice part of the PPT, whereby, of course, automatically the higher cost will ... be absorbed in the formula. But it was not necessary to criticize the existence of 98 percent government take.

4:30:39 PM

[UNKNOWN SPEAKER]: Yeah, I'm not shooting for 95 percent government take.

[overlapping voices]

[UNKNOWN SPEAKER]: How about 94 percent.

CHAIR SAMUELS: Representative Crawford.

REPRESENTATIVE CRAWFORD: Thank you, Mr. Chairman, for calling on me. And I really want to ... have my question answered, but you know, it's really hard for me to decide whether it's more important to have my question answered or a bathroom break.

CHAIR SAMUELS: ... I'll tell you what, I can put you -- whenever you get back I'll put you on the list.

REPRESENTATIVE CRAWFORD: Well, all right, I'm going to ask my question now.

CHAIR SAMUELS: I will put you ... next on the list.

REPRESENTATIVE CRAWFORD: Pardon?

CHAIR SAMUELS: I will put you next on the list. We can go to Senator Ellis if you want to... It's under negotiation; you'll be able to do whatever you want. I just want to make sure you have time and be able to listen to the question.

REPRESENTATIVE CRAWFORD: I just thought maybe there might be other people in the room that were in the same predicament.

[UNIDENTIFIED SPEAKER]: Me. (Indisc. - laughter) take just...

CHAIR SAMUELS: If you -- all right. Tell you what, we'll take 10 minutes.

The committee took an at-ease from 4:31 p.m. to 4:39 p.m.

4:39:53 PM

CHAIRMAN OLSON: Call the meeting back to order please. Representative Crawford.

4:40:04 PM

REPRESENTATIVE CRAWFORD: Thank you Mr. Chairman. Every year we talk about oil taxes, every year that I've been here, and I'm sure it was a big topic of discussion before I ever got here. We have two goals it seems to me. One is to get our fair share for our dwindling resource and the other is to not disadvantage new exploration and development. Those would seem to be almost, you know, mutually exclusive goals, but it seems that other

countries are getting higher takes, we've got a low tax environment here. Certainly we had a low tax environment under ELF. We still have a low tax environment relative to a lot of places in the world, but we don't have any investment. Historically here there's been a real disconnect, whether there was, you know, we had lots of, lots of profit in these fields and the, the companies were getting lots of, of profit from them but not reinvesting.

REPRESENTATIVE CRAWFORD: Are there other things - what are your suggestions - what other things that we could be doing to, to get companies competing for our oil again? You know, other than maybe giving away hundreds of millions of dollars in what a lot of us feel might be a fair share for Alaska. So, if you could both give your suggestions of other things that we can do short of just tax breaks to, to get that pipeline more full.

4:41:47 PM

MR. JOHNSTON: Ya, the, the issue of the mutual exclusivity was the thing that just is been driving me crazy and we've all recognized it and that's why the credits were designed to offset the, the increase in the tax. And we've seen these credits work and, and they can be relatively spectacular - it just depends on how big of a credit you're willing to give, and how you structure it because they're not all a credit system like yours, but they can have the same characteristics, it's just slightly different arithmetic. So they can be spectacular, no doubt about that, it just depends on how much the government wants to give up. And, and see that's the thing, that's the problem that I worry so much about here, because you're similar to a lot of other countries who want to increase exploration activity fairly substantially - there's no doubt in my mind that that's a key objective. And it was heartwarming for me and exciting for me that it was clear there was almost unanimous with every legislator I've talked to that you really did, as I say, this, and I've used this terminology before, but you guys wanted to put a smile on the face of explorers, because you're going have to if you're going get the kind of exploration activity you desire.

MR. JOHNSON: And, will the credits do it or not? It's a step in the right direction and it's the right mechanics because I know really of no other alternative with the one main imposing boundary condition that we had and that was the one-size-fits-all fiscal system. I don't think you're going to get as spectacular exploration activity, just, you know, not, not the

kind that we've seen in some situations where there's been a bigger changes. But I think there was a, a fair chance that you're going to get, you know, more. And the credit system, I thought, had worked, you know, well enough that people up here were familiar with it and it had been working and some wells had been drilled under the system. The - whether 20 percent credit is enough - I, I don't know yet. I think I'd, I'd have to wait and see, personally, right now. But, the guy that did the modeling on it is sitting' next to me so I'll turn the time over to Pedro.

4:44:00 PM

DR. VAN MEURS: Now, as I, as I mentioned earlier, I personally believe that you shouldn't really go beyond 20 and that is -- in fact, I, I already felt that the, the curve ball that exists today for these special exploration is simply gone too far. Because, yes, it is nice to attract investors, but no, you don't want to attract investors because you pay 80 percent of the, of the shot. That, that doesn't make any sense. Beyond the fiscal system, there are many situations where you can definitely create a new environment of interest in the jurisdiction.

DR. VAN MEURS: As I mentioned, I, I, or as you well know, I've worked in almost 70 countries, and in a number of countries my task was, literally, to re-brand the country - to, to, to, to create a new image for the country. And, I honestly believe Alaska needs a new image. It is very important for the governor and, and, and for this legislature to, to re-brand Alaska to investors. And, I think - although I disagree with the extreme position of Wood Mackenzie - there is no question that internationally among the developing, among the developed countries, Alaska is clearly perceived as the, the least stable.

DR. VAN MEURS: Alaska is also perceived as the most confrontational and, and, and consequently that is, you know, a, a very serious issue. I have seen over the last 10 years now, many events where, where, clearly, Alaska seems to be in a confrontational mode with the industry in a way that you wouldn't have in Britain, Norway, Alberta for that matter despite the current upheavals, or many other jurisdictions. So I think it is good to sit down and start to look at what are the potential investors in Alaska, what would they be interested in, beyond the fiscal system what are they looking for, to do the market research on that and subsequently re-brand Alaska in some kind of important way.

DR. VAN MEURS: And, in other countries I've done that a number of times by simply organizing promotional conferences. I mean, let's say, my toughest task in last month was to try to re-brand Iraq. Now, that, that, that's a tough task. So, to, I mean, to try to generate investment interest in Iraq is not what you call easy. So, can you do that? Yes. For instance, the oil minister of Iraq did an absolute spectacular job, say, on a promotional conference in Dubai convincing the oil industry, interacting with the oil industry, you know, illustrating, you know, the, the desire of the country for, for investment, the openness that they eventually like to have. And I think it was enormously well received. So consequently now, this is probably the most difficult re-branding operation that you, that you face in the world.

DR. VAN MEURS: So, can you re-brand Alaska? I think you can. And I think you should. Because I definitely believe you're getting less in (indisc.--coughing) than you deserve, than the geology deserves. And I think because of the somewhat negative image of, of Alaska - I don't want to exaggerate it - as I said, I'm, I absolutely disagree with the Wood Mackenzie Study, but definitely my feedback from the international oil and gas community whenever I'm on conferences or whenever I speak about Alaska there is a negative image. And, the negative image is based on, you know, sense of instability and the negative image is derived, derived from a sense of, of confrontational attitude between the industry and, and Alaska. And I think that is an area that Alaskans can work on. And I think you're going to see wonders if you do.

4:49:13 PM

MR. JOHNSTON: Oh, there is another point just real quickly. I agree with Pedro about the re-branding. And there is almost always room for that. You hear people say often that you have no control over what God gave you. And that is true, you, you had no control over the gift of God that we're talking about today. But you do have control over the industry's perception, or at least some control. And especially if you feel there is a misperception like Pedro does - and I agree with him - then you need to re-brand and market in a way that you can change that perception. And we see, you know this acreage in this world and opportunities are a commodity. And yet, you know, the Columbians use Madison Avenue marketing techniques to sell one of their important commodities - coffee. But they just can't bring themselves to quite do that for their acreage and stuff, although they do a little bit better than most.

MR. JOHNSTON: Here that could happen too, but then there is one other thing - access to the pipelines. Now I don't remember -- I do, do need to know, you know, how much of a tariff do the little guys have to pay on the oil pipeline, and then the same issue is going to come up with the gas. I thought it was a bit of irony, by the way, because I talked about basin mastering in my testimony in the past and I don't remember which particular testimony. But a basin master, and the concept of a basin master is a big important concept in the industry, and many of the big old companies are intimate with it because they've seen how spectacularly successful a company can be if they're the first one into a basin and they build that first infrastructure because they are in a tremendously powerful position. And, depending upon how powerful that position is, you could, for all practical purposes, choke off any future exploration if you're not careful. And so that issue of access to, to the pipelines - - it is interesting, I saw a letter requesting open equal access and, and the kind of tariff structure by one of the companies in this world who is a famous basin master. They, they're famous for going into countries and keeping everybody out. And I thought it was really interesting - that letter made it clear to me they didn't want that happening here because they weren't the first ones in. And so they want equal access to that line if and when it is built.

CHAIRMAN OLSON: Follow up? Representative Crawford.

4:51:47 PM

REPRESENTATIVE CRAWFORD: Thank you Mr. Chairman. That - it, it seems to me - that, you know, when you've got absolute land rushes going into places like Libya that are, that are unstable to degrees that we don't even understand, that we've had basically three players here for a long time and it -- we've had a very low tax environment, you know, under ELF. We've still got a low tax environment, maybe not quite as low, and we just don't see the...anything like the rushes that have, have happened in, in other areas, and it seems that we should be focusing not only on the, the economic tool that we have, but other tools like facilities access. And I, I think that suggestions along that line are, are, you know, what we need to have so that we can, we can get oil companies competing for our oil again.

CHAIRMAN OLSON: Senator Ellis.

4:52:44 PM

SENATOR ELLIS: Thank you Mr. Chairman. I want to go back to deductions when the - under PPT - when the PPT was being worked on last several iterations. I, I was worried about the lack of specificity in the deductions and the chairman made reference to the list and his judgment that, that specificity should be left to the bureaucrats and the promulgation of regulations. When some of us met with the governor's team - Pat Galvin and Marsha Davis and others - they talked about - we, we tried to get to the issue of why the 800 million dollars - we were 800 million dollars short - why that hadn't come in under the estimates. And, and there was the, there's the talk of the higher cost, the escalating cost, that were not all factored in or expected. And a significant portion of that may well be true. There may be other things and, of course, the folks at the Department of Revenue didn't, couldn't really answer our questions. And, you know, they -- I've been worried about a lack of auditors and it being 3, 4, 5 years before we know the answers to these questions. And so the work on the regulations is far from complete is my understanding.

SENATOR ELLIS: What do other sovereign owners of, of hydrocarbon resources do in terms of requiring specificity about deductions that are allowed, and so that there are no surprises, so that you really do know? I mean, audits are always going to be necessary and we, we are going to have to compete for talented auditors. More of them at, at whatever we have to do to get them. But, are there things that can be in the statute or that must be in regulation - and I'd like your opinion on that too - for us to actually be in this with our eyes open and being able to know what has been deducted? And not being surprised to the tune of \$800 million or whatever it might be in the future?

4:54:25 PM

DR. VAN MEURS: Ya, no, I, I can maybe comment on that. I do believe that the current PPT law broadly describes, reasonably, the, the, the, the categories of costs that should not be deductible. Obviously, what is missing, as I understand it - I, I haven't seen the details of it but what you described to me - it was always understood, let's say a year ago...or that, yes, there would be more detailed regulations. DNR is, is also referenced in, in the, in the act, actually has relatively detailed regulations with respect to profit-based royalties. And, and one of the concepts was to use that as a starting point

and then improve upon it. And, and I think, and, and I would still highly recommend it, and I'm sure that work is underway somewhere in the department.

DR. VAN MEURS: I cannot -- there are a number of things that you have to understand. It is not just the, the regulations. What you need is a number of system - number of concepts. You need, first, a precise definition of deductible costs and how these costs have to be classified. Secondly, you need a proper information collection system. Or, in other words, you need a proper interaction between, say, ideally an accounting system in the Department of Revenue and the accounting systems that are being used by the oil industry. These days, everything can be done electronically - there is no need for paper. So, consequently, really at the end of each month you should be able to get the stream of data.

DR. VAN MEURS: What is also often missing in governments - and I don't know whether Alaska, I haven't had the, the pleasure to, to meet, visit Department of Revenue before this meeting, otherwise I would have asked that - but what is also often missing in many governments is actually what you call a management information system. A management information system is a system that can what you call - rollup - from the accounting system whatever information you want and can spit out, so to speak, whatever data you want. That's a pretty crucial factors.

DR. VAN MEURS: So, what you need is not just regulations. You need proper regulations to describe precisely the classification of the costs that you want in terms of costs and, and of cost types, and in terms of credits against these costs and a number of other features. Then you need a proper accounting system that ties properly in with the accounting system and with the proper chart of accounts and the proper kind of electronics. And then you need a management information system that can rollup all information that you want in order to effectively understand what, what is going on. So, unless you have those three systems you are not doing a good job at supervising, say, a profit share. So it is three components that you need, not just one.

SENATOR ELLIS: Thank you.

4:58:05 PM

MR. JOHNSTON: Senator Ellis, you asked about how it is handled in other jurisdictions or sovereign, sovereign states and stuff. The spectrum of arrangements that exist in regard to this issue are, are diverse. And, and on the far end of the system are some fairly draconian measures ... by your standards...and as awful as people might say Alaska is, as far as stability and stuff is concerned, there are elements - and this is a good example - of where Alaska is pretty mild. There's quite a few countries where the work programs and budgets of the oil companies are overseen by a management committee that is chaired by either the national oil company chairman or somebody chosen by him or the oil minister, and the work programs and budgets and stuff go through an approvals process. And then once the budget has been approved - and there are ... rules and regulations for budget adjustments and stuff like that - these can be, you know, fairly realistic with line item limits for particular line items that can't go over budget by a certain amount and then rules for the budget itself that can't go over a certain amount. And so they have tremendous control. And in addition to that and see - by the way I'm not recommending that but you asked how weird it can get - that's way out there...

SENATOR ELLIS: ...Extreme.

MR. JOHNSTON: ...but it would be a luxury at times, wouldn't you think, because in addition to that sometimes there is this government participation element. So there are government representatives, typically the national oil company people, who sit in on the technical committee meetings and the management committee meetings. And so they're there at the grassroots level seeing and participating in the development of the budget and the decisions that are made and stuff. So, the chances of surprises the likes of which you have experiences here, in my opinion, on a system like that are much lower.

4:59:54 PM

SENATOR ELLIS: Mr. Chairman, I, just a related thing, ... we heard ... from Pedro a pessimistic view of a conventional gasline being constructed in the near to midterm for a bunch of factors and reasons that are beyond our control. And I just pose to each of you: Isn't that an argument in favor of the State of Alaska sort of, essentially, wising up, and moving reasonably closer to the world average, in ... total government take for our oil resource and banking that money for the hard times, until the economics change or we go to gas-to-liquids or whatever it might be. Why would we want to -- I have a problem,

personally, with discounting our oil resources in these intervening years ,and knowing that the gasline may be a long, a long haul.

DR. VAN MEURS: As you know, Alaska officially has already a mechanism to achieve that goal, which is the constitutional budget reserve fund. And consequently, and, you know, separately, of course, from the permanent fund. It's a whole different concept. So, the concept of a stabilization fund is there, I mean Alaska already approved that. So, so, the question now is: How effectively are you using this fund? I'm absolutely in agreement with you, I an only see oil production going down, even if the PPT, you know, is at it's most success in attracting investment. And even if you have nice conferences over all the worlds and everybody loves Alaska ..., after that I can still only oil production going down. I really cannot see, you know, something whereby Alaska regains 2 million barrels a day or something. So, the pipeline will never be full again. But, at least I hope it will be different, of course. As a geologist, I'm an optimist and you always hope for this unexpected discovery. But, it seems highly unlikely. This gas in a dark corner right now for Alaska, you absolutely have to start preparing for a different future or you have to start rescheduling and rethinking the whole concept of exporting gas. As I said, the only - this is just my gut feel, I haven't done any studies on that - but, I believe that the only way to monetize gas that I see today would be gas-to-liquids. That is the only practical economic way that I see at this point in time that could keep the line ... that could maintain a reasonable level of liquids production for ... a long period to come. So, I would recommend looking more intensively at that because as of today, with the economics that we have today, that seems to be the only economic option.

SENATOR ELLIS: Mr. Chairman. I'd like to say, in spite of my original comments this morning opening up, I want to maintain the legislative prerogative to pick and choose what I agree and disagree with Dr. van Meurs, and I appreciate the answer and guidance.

MR. JOHNSTON: Could I comment on that just a little bit more. I see where you coming from, and personally I've avoided the issue. But the answer is: Yes, there is the potential of - and I'm sure there's plenty of room there for buffering the potential pain that might be felt - and if no ... gasline were to be built, and it is that harsh, the actual natural next question then is: Is there enough room in the legacy fields ...

to get more and save enough to buffer that ... pain in the future. And I think, definitely yes. But my mandate was a little bit different and I hesitate to go there. But, holy cow, the answer is there's a lot of room there.

SENATOR ELLIS: Thank you.

5:04:08 PM

CHAIR SAMUELS: And one of the questions I'll be asking since Ms. Davis is still in the room here: ... obviously, ... the choice will be the more investment that you get ... it's going to keep declining and how much did it cost you versus how much did you stem the decline? And that's really the only question. And if you think for sure they're going to keep investing money, no matter what you do, no problem. If you think you can stem the decline a little or stem the decline by getting more investment by the tax, then that's where we're going to be from months sitting around here being very friendly about it. Representative Kerttula.

5:04:53 PM

CHAIR SAMUELS: I got to go first, but I'll let you have the last word on it.

REPRESENTATIVE KERTTULA: You did. I'm not trying to be confrontational though. You know, we asked many, many questions to try to delineate the deductions and we offered many amendments on the floor to limit corrosion - the other offset aside - to limit lobbying expenses, and you know, they were not definable. And that's been one of the hold ups in the current PPT. So, I've been wondering whether, along Senator Ellis' line of thinking, but maybe you could share with us some of the accounting agreements that you've seen that you think are appropriate and some appropriate standards. I know the current department is working extremely hard, but I will tell you that it is maybe my singular foremost concern: is that we not allow what we're going to get to be eaten up later on. So, ... I'd ask if, you know, you do have information that you feel that you could share with us, I think that would be helpful because we don't have good answers right now about what those deductions are going to be. But, my question was: Dr. van Meurs described what sounds like a true hybrid, a mixture of a grosser tax. And I just, I know that you offered to speak with us, but I don't know what kind of time you're going to have. So, maybe you could just give us a little more definition on that idea, here.

And maybe Mr. Johnston could give us, you know, his feelings about whether something like that, you know, could be a way out.

5:06:27 PM

DR. VAN MEURS: Yes, I will, with great pleasure. ... although I'm generally a strong, you know, proponent of progressive systems, I have also seen quite a bit of progressive systems in the world that have been wrongly designed, created significant gold plating, created ... negative impacts on the docket. And in fact, that's one of the battles I'm in Alberta right now, on the oil sand side. ... I'm a firm believer in that if design progressive systems, keep it as simple as you can. Don't ... make it so sophisticated that you have to go through 20 hoops to get your extra dollar. So, consequently the simplest systems are ... based on the gross revenues from the resource. In fact, that's why we all like royalties because of this. Now, I don't want to say it is simple; I know how difficult it is.

REPRESENTATIVE KERTTULA: But relative.

DR. VAN MEURS: But relatively speaking, it is simpler than a profit sharing system. So, that was when I understood I had the task to design some progressive system, you know, when the governor decided ... on the 20:20. And when we discussed, I said, "Okay, if you ... want to back down from the 20, then we need to have something extra. Let's look at a progressive system." And out of that came, then, the memo that I mentioned. In that memo, I said okay we need to strike balance between a system on gross that is progressive, so that means if the West Texas Intermediate price is ... 50, the feature would create zero, nothing. If the price goes up, the feature, based on the gross revenues, collect significantly more. So consequently, think about it as a literally traditional severance tax as we used to have. We used to have the severance tax of 12.5 percent, and 10 percent and so on. So, think about it as a traditional severance tax that ... slides with price. So, it is clearly a feature based on gross. Then in order to make sure that there was not really a double counting, relative to the PPT I said okay if we ... establish such a system that, let's say, - - and that is why also called it in my memo the base petroleum tax. It was kind of like hanging on to a sliver of the original petroleum tax. And say okay, let's make that price sensitive, it's a very simple windfall profit formula, as I put on the board; that if the prices say 90 and use WTI 50 as a base and .25 percent as a gross factor, then at \$90 you collect 10 percent. You collect it as if it is a 10 percent severance tax,

as if it is a 10 percent production tax. That then would be deductible. Of course, royalties would be deductible from this as a ... typical severance tax. Then what you would do is, make this, in turn, deductible from the PPT so that you strike a balance, you know, between the tax base of the PPT. Or, in other words rather than starting this 100 percent of the value for the PPT. Say, if this price sensitive severance tax would result in 10 percent, you would start this 90 percent of the basis, and then you apply the 25 percent, say, PPT rate. So, ... it strikes a very simple balance between a concept on gross and a concept on net. And, it automatically slides with price. If the price is less than 50, it disappears. If the price goes higher, it automatically increases. Now, this was an initial memo that I wrote and, ... I'm not ... very proud of it, it was just a concept that I ... suggested to introduce. Could you refine that a little bit? I think I would recommend refining it. As I said, bring in more recognition of the heavy oil that we talked so much about so that you don't start making heavy oil uneconomic again. Maybe the sliding scale of .25 or the \$50 are not the right numbers. These are things you can debate and you can do more economic analysis on. But, I think the concept merits a great deal of consideration. And, as I said, in Alberta I recommended an identical system there, it was called the bitumen tax or the oil sands severance tax. As I said, the royalty review panel of Alberta accepted that recommendation, and put it in their royalty review report. Now, ... that would be pretty revolutionary in Alberta to get that through and it is now on the premier's desk to see whether he wants to go with. So, I'm kind of eager to learn, over the next few days, whether he will pick it up or not. But, I recommended it in Alberta because I believe is a good system. I recommended it here because I believe it is a good system. And so consequently, this is a system that I would trust, that would absolutely guarantee that Alaska would get its extra fair share, if the price rose up. And consequently, that's what you look for in a progressive system, not a system that is so complex that you never know where you are. And that is why, I think, going from 40 to 30 is kind of a Band-Aid solution, which I wouldn't recommend. If want to have a stronger progressive system, then go for a real stronger progressive system.

REPRESENTATIVE KERTTULA: Thank you.

CHAIR SAMUELS: Thank you. Representative Seaton.

REPRESENTATIVE KERTTULA: Could Daniel maybe comment.

CHAIR SAMUELS: I'm sorry. I'm trying to get through my list.

5:13:34 PM

MR. JOHNSTON. I forgot the question.

DR. VAN MEURS: On this formula that I suggested.

5:13:49 PM

REPRESENTATIVE SEATON: I was concerned about something in your testimony, Dr. van Meurs, and that was on the waiting until 2011 before we do anything on stability. Isn't the fact that we're discussing these items and putting them on the table, I mean, you know, changing the rate, progressivity, all of these things and then saying we're going to address these. Doesn't that relate to what we've always been told, it takes three to four years to sanction a project so that the oil companies are all going to know that these are the items that we're considering changing, by the time that any project that they would go forward with sanctioning would be in line and be producing. So that the difference between addressing them now, they'll have the stability of knowing what those, how we're going to address that, instead of saying that, well, by the time your project gets sanctioned we're going to probably change these things, because we've identified them, but we're going to wait until 2011 and your not going to know whether tax is going to be 25 or 30 per cent or whether progressivity is going to be .25 or .375. It seems to me, and, I'm trying to get an idea here of the idea of stability for projects that, you know, are in the works to sanction, that aren't going to come on line, there is much more stability if we address these issues that we see as problematic now instead of waiting to pick these items up.

5:15:28 PM

DR. VAN MEURS: There are many layers to the concept of stability. Firstly, as I said, the big problem is the big objective of the PPT, the whole design of the objective of the PPT, was to try to attract new companies to Alaska and create a medium size level of companies that would take on the smaller fields and the smaller targets. And, the problem with kind of creating an international image, knowing already that the image is not that great to begin with, if you create an international image where, you know, again in the newspaper is they now change the tax again. Then you simply get scrap of the list of potential new investors that may wish to come to Alaska, because

they are going to say 'this is just too wild up there' and 'let's lay back and see what happens.' Obviously if somebody would precisely today, would like to start a multi-billion dollar investment it would add to the stability if he would know what you're planning to do, say, in 2011. However, weighing that against, you know, as I said, the international image because you want to attract the new companies coming in, I think unbalance, although I think you're absolutely right. If you could tell an oil company this is what we're going to do five years from now, that would be wonderful information to have for project planning. But you have to weigh that against, you know, the image that you're creating internationally, whereby you, from an image that is already somewhat negative, you simply add to kind of the overall feeling in the oil industry that Alaska is just too wild a place to invest in. And so, that's why I would greatly caution, kind of, changing the fiscal terms again say immediately now. Apart from that, I honestly think you need a few years of reflection on what was done so far. So we need a few years of reflection on, you know, what are the exact amount of monies that they're going to receive, what are the precise audited figures in the end, how much did we in the end receive, is it working. We need to set up the administration system that we just talked about: a good definition of cost; a good accounting system; a good management information system; a good information system, as is suggested in the bill; a good transparency system, as is suggested in the bill - so that people have time to absorb the new system, reflect on it, and then as I said, in 2011 you have probably enough information to design a system that is going to be more stable through the future. I still believe, as I said, that is the best solution that was considered a good solution more than a year ago. I think it is still a very good solution today.

5:19:16 PM

MR. JOHNSTON: You make a good point. I agree that there's that dimension, and it's an important one because there's not a lot of difference between 2008 and 2011. And now, Pedro said earlier today, and touched on that a lit bit, that you don't have enough information, but I think we have a ton more information now than we did a year ago when we were doing this. We have a lot more information. And then, I will just say it again, because I feel this strongly: If the cloud turns out to be as dark as it might could be, then I don't think any rational company is going to view this as two changes consecutively in the ordinary sense. And it, almost, in my opinion, almost neutralizes. And, you know, in Indonesia they had an incentive

package, it was a little funny. They did a little bit of tweaking in 1988, in August of 1988, and that was when they did the first trans-petroleum. And then in April of [1989], just a year later, they did a little bit more tweaking. And it was generally acknowledged in the industry, that OK, yeah, it took two tries but they got it. And people don't look at that in the same way that some people are looking at this. I think, and I'm repeating myself again, we can give the industry a little more credit, and I think that is going to mitigate quite a bit. And you don't have to make them all happy; got to make some thought, for sure.

5:20:59 PM

DR. VAN MEURS: I like to amend my own statement, in the sense that of course, if there is absolute proof that corruption led to approval the PPT system that we have today, as in a contract. If a contract turns out to be concluded under, you know, dishonorable circumstances such a contract should be null and void. That is, I mean I think that is what you are referring to - and I would. Now, the reason that I personally don't believe that cloud exists and that is where I'm coming from, is because my experience, intensive experience over the six months that this was discussed, or more than six months, was that precisely the people that are accused every time (indisc) assured me that they would vote against all the ideas that I had. So consequently, you know, basically, I feel very certain that one the PPT law must pass. It was the approval of those people that had nothing to do with any of this. And that is in, that is why I don't see a cloud. That is, you know, just differing opinion.

5:22:23 PM

REPRESENTATIVE SEATON: What I heard in your testimony was that maybe the oil companies have over deducted maybe four or five hundred million dollars.

DR. VAN MEURS: I just gave that as an example as what could happen; I have no proof of anything that happened.

REPRESENTATIVE SEATON: I understand that but the problem is that if we're faced with maybe two problems. One is the tax isn't performing the way we thought it was. The other one is that it's being over deducted, and will maybe with, four years from now, you've mentioned with maybe some law suits and everything, we might recover some of that money. But by leaving the tax the same way it is now, for another four years while we

go through this process, aren't we just rewarding the behavior of over deducting?

DR. VAN MEURS: No, no. Of course Dan Dickinson could comment on that much better, but one of the recommendations I absolutely made, in my presentation, is anything you can do to improve what you are referring to is inefficient control of the accounting system and auditing system. Or inefficient, kind of management of the system. I described the system that I think you need to have. You need the three factors that I already mentioned to [Senator] Ramras. I think that will take some time to set up. I also think you need to review what precisely are the penalties of under declaring revenues and over declaring costs, and see whether those need to be revised. And if that needs to be done, it would be my strong recommendation that you do that in this session. Once a good penalty system is in place, it may already be in place, you know I'm not an administrative expert. Once you have a good penalty system in place, if you can have a good accounting system, a good management system, and a clear definition of deductible costs, so that an administration can effectively implement it, and you take the measures that are proposed in this bill to make it easier to attract high quality auditors, I'm sure you're going to obtain your fair share on the basis of the existing law in the coming years. But that's a lot of work; you have a lot of work ahead of you.

5:24:59 PM

REPRESENTATIVE SEATON: Another question that I have, through the chair.

CHAIR SAMUELS: Yes.

REPRESENTATIVE SEATON: On your page 18, you're talking about the gas revenue exclusion, and I'm really troubled by that idea that is being proposed that there should be a gas revenue exclusion again proposed, because we're in a different situation, as I see it, with our gas on the North Slope, than somebody going out exploring for gas. I mean we've got gas being expensively pushed back into the ground and stored. There isn't any exploration costs. There isn't any those costs. Sure there's some conditioning plant, but that's, you know, midstream, downstream. And, why, under a profit scenario, would you suggest a billion dollars made on oil would get taxed at twenty two and one half per cent and a billion dollars made on gas, with much less costs of production, because the production in the wells and everything are already in, should be taxed at

seven per cent, or seven and one quarter per cent. I'm at a loss to find, to figure out how, with lower expenses of producing that gas and the gas at Pt. Thompson already defined and known, why we would be looking at saying that taxing profits would be at a much lower rate than taxing oil.

DR. VAN MEURS: Now this goes to the heart of, you know, debate that we had on the gas line a number of times, whereby some persons felt that in order to judge the economics of the line you only had to do your upstream cash flows - you only had to look at the cost of production and your price. I argued repetitively, was that in order to judge the economics of a gas project, if producers have to make commitments to use the transportation system downstream from say the wells, or the point of production, (indisc - coughing) have to make commitments for gas conditioning, have to make commitments for gas transportation, let alone liquefaction and so on. This heavily impacts on the overall economics of the project, and consequently, for exactly the same reason that Trinidad and Tobago have successfully allowed very strong LNG trade to the East Coast of the United States, and to Europe by the way, because they looked at the economics of the total project not the economics of just the upstream. They looked at the total economics of the project and judged it that way. You have to look at the gas in exactly the same way. You have to look, unless you find a buyer with extremely deep pockets, which is willing to buy all the gas at the well head.

5:28:24 PM

REPRESENTATIVE SEATON: I can understand that if we were taxing on the gross, but if we're taxing on the net profits, all those expenses are taken out. I'm trying to get to the idea of there is no cost of drilling the wells; there's cost incurred in ... recycling the gas now. How is it that billion dollars made on that gas that's already being taken out of the ground ... should be less than the cost for the oil.

DR. VAN MEURS: The reason is that for oil companies to make the kind of commitments to the kind of system that we are discussing, you have to have a reasonable minimum, a net present value per barrel of oil equivalent. And if that is not happening, then there is no incentive to make a commitment to such system. So consequently, of course this was the debate that we had a year ago with some intensity, but the, to say it softly, but as I said, I'm absolutely convinced of that. And I think therefore, you have to make it attractive for those who

would be the exclusive, those who have the exclusive right to produce the gas, to engage in such a project. And consequently, that's where the issue is. The issue is not in the actual cost incurred in producing the gas up north. I agree with you. The gas is being reinjected today and you may even save some costs by simply putting it in your gas conditioning plant from that perspective.

5:30:31 PM

REPRESENTATIVE SAMUELS: I don't want to go too far down the rabbit trail. If the governor's bill comes up with a licensee and the legislature blesses it you'll lock in the tax terms for ten years, right before the open season. So we're going to have the debate on gas in three years. We're not, no matter what we did with gas, we could do this idea, we could not do it - it's not locked in, you're going to have that debate in three years. So, if you've got a real short comment, Mr. Johnston, that's fine, but I've still got a list here in front of me.

5:30:52 PM

MR. JOHNSTON: By the way, Representative Seaton, that's a good question, but I think I can help put your mind to rest a little. It is very common around the world, that gas terms are, from an oil company point of view better than oil terms; and it's a present value thing often, in addition to what Dr. van Meurs just said. With a typical oil field, when you start producing, you might produce from ten to fifteen per cent of the oil in the first year. And then you have, then it will decline. If you only produce ten per cent of the oil in one year, you might produce for three or four years at that rate and then decline. With gas production in most parts of this world, and it's just going to be the same up there, the production rate, in terms of the percentage of the reserves produced in one year, is much lower. And so in terms of present value a thousand dollars of profit for the oil, if we don't factor in the time value of money, looks the same as a thousand dollars of profit for the gas, but you factor in time value of money, and there is a big difference then. That is almost always one of the bigger differences between oil and gas.

5:31:58 PM

SENATOR WIELECHOWSKI: Dr. van Meurs, I wasn't here last year. (indisc. - microphone not adjusted, paper rustling)

DR. VAN MEURS: He wasn't here, yeah, last year, and that's to his great credit; a new blood in the [legislature].

SENATOR WIELECHOWSKI: So when you were designing the PPT last year, you were designing it with the intent of encouraging investment.

DR. VAN MEURS: Absolutely.

SENATOR WIELECHOWSKI: And when you made your recommendations last year, for 25 per cent, for no fall back, for limiting exploration perhaps to 20 per cent, I, is it safe to assume that you made those recommendations, all the ones you have in here, with the understanding that that would still encourage investments.

DR. VAN MEURS: Absolutely.

SENATOR WIELECHOWSKI: How much more would Alaska have made had we adopted your recommendations?

DR. VAN MEURS: I would have to calculate that out. That is difficult to do. But, by heart, but it is easy to calculate that out. I mean you would have to use the review model in the DOR, which has a sophisticated model to calculate these things. So I think if you wanted to ask the DOR I'm sure they can give you those figures. I don't have their model, that you would need to have the total Alaska model to do this. (Disc - head turned from microphone) the department has all the background to, if you, that's exactly the work we did, kind of a year ago. Every time the legislature was asking how much is this generating and how much is that generating, and all the options were compared from that basis. If you ask that question to DOR, I'm sure you will get an answer as to how much more will be generated on that basis. Now, I can tell you at \$84 a barrel, a lot more will be generated.

SENATOR WIELECHOWSKI: One hundred million, two hundred million?

DR. VAN MEURS: I would have to leave that to the department, because it is somewhat of a complex total set of calculations. Don't forget all the companies are not the same, and the cost structures are not the same, so. But the DOR can give you a very good answer on that, I am sure.

5:34:29 PM

SENATOR THERRIAULT: I was wondering if either of you can just make a comment on reserve placement ratios. There was a very interesting article, report or something, about a year and a half ago that many of the larger companies are having difficulty in maintaining their reserve replacement ratios. And so, the very profitable companies at this price but if you're not replacing the goods on the shelf, you're just a very good business going out of business. Part of that is stemming from different areas of the world, you know, changing the terms and kicking companies out, or nationalizing, or. So, is, have things turned back, has the tide turned back, and the companies are doing better at replacing their reserves or it's gotten worse?

DR. VAN MEURS: No, they are more or less stable. The, as I mentioned, I think, in that same presentation of May the 10th in the building, you know one of the enormous advantages of a gas project, if you actually go through the entire procedure of launching a gas project, and concluding all the deals. The amount of bookable reserves that you would get on your books is astounding. So consequently, from a bookable reserve point of view, as I mentioned earlier, the gas project would be an extremely attractive project. That is also why, you know, we considered the PPT, not the exact PPT, but a severance tax kind of structure that would not be a royalty, because royalties are not bookable. So consequently, the whole thing was designed to maximize the benefit of a possible bookable reserve. I mean the gas line contract, the PPT of course, by its very nature the PPT doesn't diminish the bookable reserve. So, and that is an attraction of the PPT over a royalty. It has always been my belief, and I think the companies share that absolutely, there has never been a discrepancy of opinion on it, that if gas project ever would go ahead, it would be a wonderful addition, and wonderful improvement of the reserve production ratio. Now, on the other hand I don't want to necessarily overplay the importance of that reserve ratio. It is a very important ratio used by financial analysts in Wall Street and other stock markets in the world to judge the financial health of companies. But, you know, there are many other factors that result in the judgment of financial health. SO if you launch a completely uneconomic project you may get a lot more reserves, but your forecast of future cash flow may be so bad that the financial community would discount it. So, but, yes, shortly would a gas project be beneficial for the reserve production ratio? Absolutely.

5:37:45 PM

MR. JOHNSTON: Senator Therriault, if I could add to that. Now, I disagree a little bit with Pedro. It's not as -- I don't think it's as -- maybe I don't disagree, but I want to say it differently. And for the new legislators, I think it's important to point out how important this issue of booking barrels is. And I've said it many times, I'm almost certain it's in writing in the past where I've said it. It began around the early 1990's, over ten years ago, that companies started to get a little psychotic about booking barrels. Now booking barrels deals with the reserves that they must legally report in the 10K reports to their shareholders. It didn't used to be a big thing in the 1980's. But towards the end of the 1980's and the early 1990's, many oil companies started realizing, man it's -- and the analysts too and unfortunately much of this was driven by the analysts - they noticed to that booking barrels and maintaining this production, this reserve replacement ratio was getting more difficult. So they started focusing more closely on the reserves that the companies were booking. So this issue of booking barrels started to get very interesting during those years. And then companies truly have gotten psychotic about it. And the reason I belabor this point to a certain extent is this: A lot of times there's been mention made of, you know, if Alaska goofs this up the oil companies have lots of other places to take their money. Well if that was true, then why are they spending half a million dollars a day, just on a day rate, for a rig in ultra deep water? Because the easy stuff just ain't so plentiful anymore. And then in addition to that there's another dynamic, and that's not nationalization and stuff so much, it's the national oil companies of this world. They all have seen and perceived Petronas the national oil company of Malaysia to be quite successful in their dramatic efforts to go overseas. And the governments of this world, and I think it's fair to say, many of them, find dealing with the foreign oil companies, the Chinese, and, although the Chinese are wearing out their welcome in a few places it's looks like, but they find dealing with the national oil companies a whole lot more pleasant than dealing with the big oil companies. And even some of the independents. And so there is much less acreage available to American oil companies and western oil companies and traditional oil companies because the national oil companies, the Chinese National oil company, and the Malaysians in particular, but, and the Indians as well, they're out there beating the bush. It's hard to make a living out there in this world exploring for hydrocarbons, and it's not so easy to say OK if you're going to goof, we've got lots of other places to go. It's hard to keep those reserves up and if

a company is going to grow, you can't just maintain the production, the reserve replacement ratio, it's got to increase each year. And they're not doing such a great job of it. And every now and then you see some big jumps, but thank god for (indisc) because the reserves are so large a lot of companies got to add barrels and it distorted the statistics. My experience is, a lot of the barrels that are being replaced right now are paper barrels. They're not the ordinary kind of barrels that we are used to. And part of that is because there has been a lot of latitude for the oil companies to book, there's a certain amount they can't overbook, but there's a lot of times they'll, they have a cushion and stuff. And there's a recent study about the, a field in Norway that only booked about 28 per cent others that booked up to 70 per cent of what they were entitled to book. So yeah, they're going to add reserves in the coming years and that reserve replacement ratio is going to look good. It won't be from having found additional reserves during this period, for all of what they replace the reserves with. And they wouldn't be psychotic if it was easy to find; it's getting tougher.

5:41:41 PM

SENATOR THERRIAULT: Then a second question for Dr. van Meurs, primarily: I think when you did your modeling, you talked about take Alaska, make it a tidewater - I forget the terminology that you used - an you had a \$5 transportation cost in there. But the strange dynamic that we have here in the State of Alaska is the major players that have ... major control of the basin also control that transportation string. And now we've got a battle going in FERC that it currently appears we're winning; but ultimately who knows what the decision might be there where \$5 of that transportation cost actually goes into their pockets. How do we take that into account on looking at the net present value and rates of return for these companies, where generally that transportation expense is true expense; it's not a shifting of a dollar from one pocket to the other?

DR. VAN MEURS: No, that's exactly also the debate we had on the gas line. Like this is exactly the same issue that I brought out when I advocated the state participation for the exactly the reason that you just mentioned: That if the state is 20 percent partner in the pipeline - by the way, tax free from a certain point in time - the rate of return from the state paying itself through the pipeline tariff creates a very different dynamic for the government revenue then, say, if you're just delivering to a pipeline system. So, that is why, actually, ... this state

participation in the line, I felt, was beneficial to the state, because it changed exactly the dynamics that you mentioned in the ... gas line for the State of Alaska. It also, of course, by assuming the commitments for the line, resulted in the higher rate if you ... for the private parties. So, yes, integrated oil companies like to be integrated oil companies, because there are huge benefits being integrated oil companies. And ... consequently, not just in the ... transportation, also in the refining, also in other distribution areas. So, consequently, all the way back from Rockefeller, the oil industry discovered that there is great benefit in having an integrated oil company, precisely for the reason that you mentioned. And the way to do that is, yes, you can assess, just upstream you can assess upstream plus midstream. You can assess all the way down the line, and of course, particularly in LNG projects, that is how you have to do it, because it is often considered, and ..., you know, an integrated operation. So, yes, the dynamics are quite different, whether you are an owner or not.

5:44:56 PM

SENATOR THERRIAULT: But, as a legislator, when the company reps comes to my office and says. "Well, you may have now gone past that tipping point." I just need to know to always ask, "Well, have you included the transportation money that you're putting in your pocket. And I understand, that that's for those companies that own the line. We want to have a lot more companies come here and explore and they're taking a dollar out of their pocket and they're giving it to their competitor, above and beyond what we think the FERC will allow ultimately. But, it just seems like, I guess we've just got to always know well wait a minute, are you one of the ones that own the line because you'll also making money in operating the line.

DR. VAN MEURS: No. Sorry, if I can just to comment on this for a second. Now, of course, the Alaska State Legislature passed, for a while, and ... advocated and is still kind of advocating that that gaslines, and ideally oil lines, should be third party lines. Precisely to create a level playing field in the upstream, and there is some merit in that concept. And consequently, that was ... definitely one of the ... considerations. Now, on the other hand, I don't want to overplay it as an absolute must. But, ... yes, there are certain advantages and disadvantages in having a third party pipeline and that was well discussed ... in the past and I think that is well known, particularly from the point of creating a level playing field.

5:46:35 PM

MR. JOHNSTON: Senator Therriault, if you don't mind. I think you can blame the \$5 a barrel tariff in the tidewater approach on me. And ... there is an important point that you make or bring out. The reason that I recommended that we do that approach -- and it's kind of an analytical approach that I felt help put Alaska on a more level playing field and opened up the peer group. Because one of the big boundary conditions here, as it was explained to me when I first started looking at the oil tax and I was aware of it too, is the high transportation cost that you experience here that other countries and provinces do not. ... and so my recommendation was this: Well, let's pretend as though the \$5 transportation cost is a part of a government rent extraction mechanism and then see what the government take is. And it increased the government take about 3 or 4 percentage points by doing it that way, as I recall.

DR. VAN MEURS: Yeah, a little bit more, actually. Yeah.

DR. JOHNSTON: Okay. I knew at the time that there was some profit involved, I just didn't know how much. And so, I never ever changed it and never revisited it, but I always knew that it was a little bit wrong. The analytical technique could be improved if we had a better feel for what percentage of that \$5 is true profit and what is not. Because if the oil companies are getting a significant amount, it wouldn't be appropriate to add the whole \$5 in, in that tidewater approach. And ... with that modification, even plugging in the whole \$5, I felt that the take was still quite low for what I considered to be ... 80 percent of the action here, and that's that production up there.

DR. VAN MEURS: But ... actually the question was asked, actually, from the perspective of a third party company because the whole idea was to attract new investment. And we wanted to judge ... is this government take -- ... if the North Slope would be in tidewater and if you were an independent, you invest looking at Alaska, like does this government take compare with what would you face somewhere else in the world. And that was really the question. So, ... the tidewater approach was done from the perspective of attracting new investment to Alaska through third party, which, as you said, had to pay this tariff as if it was an extra royalty.

MR. JOHNSTON: That's the way I understood it.

DR. VAN MEURS: Yeah.

5:49:04 PM

CHAIR SAMUELS: How difficult is it then, if you look at the ownership in TAPS right now, I believe ... Conoco's a net payer because they own more oil than they own a percentage in the pipeline, BP is the majority owner, while Anadarko ... owns none of the pipeline and yet they all own different shares of the oil. So, to construct a system in there you would incorporate somehow that cost mechanism in there. But they don't own a proportionate share. Is that?

DR. VAN MEURS: Yes, for the PPT purposes we assumed, of course, that the value they would receive is the value at the production point, as the PPT law establishes. So, for companies like Anadarko ... and for all the other companies, the economics was determined ... the point of production methodology. It is well understood that companies that also own the line would have an extra benefit. But companies that don't are involved and the companies like Pioneer and other companies that you like to attract to Alaska, they face the kind of economics that ... we determined.

5:50:21 PM

CHAIR SAMUELS: Okay. We've got Representative Seaton and Representative Kelly.

REPRESENTATIVE SEATON: Thank you, Mr. Chairman. A couple of questions on progressivity. Can you compare for me the idea that you had proposed in your paper here about gross tax at \$50 WTI versus what we had proposed through House Resources, which was increasing the net tax, that they increase by the same amount but at \$50 WTI. In other words, the same benchmark of having ... that .25 start at WTI minus 50 ... but one applying to the net tax and one being a whole new, separate gross tax. Can you kind of compare the viability to those? ... by the time you get to 50 you, you've eaten up all the expenses, so basically you're talking gross anyway.

5:51:22 PM

DR. VAN MEURS: ... three broad groups of progressivity were explored by the legislature. The first one was this, which ... had the limited ... review. When I came back after I had worked on this, the legislature actually had incorporated the concept

of progressivity ... related to gross value of the production. And so consequently, the first efforts ... of the legislature was to do something halfway between what I suggested here and what was ultimately accepted, which was that: Yeah, let's have a windfall profit sharing formula, but let's apply it to the gross value of the production. So, we measure it relative to the gross value of the production at the Arctic. And consequently, you just deduct the \$5 transportation cost and that gives you the value that you work with. And that then, at the end of session, kind of fell by the wayside. ... under the last session what was introduced was, then, to say ... we can make the whole system more sensitive if we actually base it on the net value whereby we deduct all the costs. And let's then, rather than taking 60 as a base, ... let's now take 40 as base because the difference is \$20 in cost. And that is how we ended up with that 40. And then we said, okay, let's do progressivity based from the 40 upwards. ... as you go from my original proposal to the proposal with respect to ... the gross value of the PPT to the net value of the PPT the certainty that you collect goes down in the system because with the gross plus net system, no matter what the costs are, even if the costs are equal to ... \$100 barrel, you would still collect. So, with the gross plus net system you have eliminated the cost factor. By applying gross scales to the net production, ... -- if there is no net, then it doesn't matter; 27 percent or 30 percent of zero is still zero. So consequently, the moment you move from the gross plus net concept to a gross formula to adjust the progressivity of the net, you the risk that won't get anything. Now, if you go even one step lower, and you say we base it on the net net, then, of course, the chance that you may not get anything gets very high because now everything depends, not just on the price but also on the cost. So, the certainty of actually collecting on a progressive system with my March 5 memo is higher than say the intermediate step and the lower step.

REPRESENTATIVE SEATON: May I follow up?

CHAIR SAMUELS: Yes.

5:55:02 PM

REPRESENTATIVE SEATON: And I guess what I'm trying to do is relate this to the ACES proposal that has an annualized instead of a monthly tax and collecting once a year with no interest. Is that something that ... either one of you would support as far as taking the progressivity to an annualized instead of ... a monthly payment system.

DR. VAN MEURS: Now, from the point of view of Alaska, ... if you have a monthly system or a quarterly system, particular monthly system, the chance that you collect something is much higher. Let's take ... the formula that, for instance, I proposed. Let's say if ... you do it monthly. If you have 11 months of West Texas Intermediate price of 45 and one month of 60, you collect something, in that one month because in the other months you're zero. If you take the yearly average and you blend in the one month of 60 with the 11 months of 45, you still collect nothing. So, if the goal is to collect whenever there is a high price, in whatever month, then the monthly system collects more than the annual system.

MR. JOHNSTON: And I don't have anything to add to that.

5:56:48 PM

CHAIR SAMUELS: Okay. And I'd like to just walk through my recollection of the various committees and the arguments very briefly - and I don't need a comment - just for the new members. In the House Resources Committee, we added the entire concept of progressivity. And you wanted the tax rate to go up after the decision making had taken place and you took a best guess, as you could, as when investment decisions got made. And I think at the time we were talking ... I think it was like \$35 to \$40 a barrel; that was when decisions got made. We separated ourselves from that as best we could. I believe at the time we got to 50, we added the progressive feature, then. The arguments on both sides because we ... kept it closer to the gross ...; but it was more on a gross as a true windfall profits tax in the first committee. The argument when it got switched to net, which I would appreciate your comments on, was that as costs went up the decision making point no longer was between 35 and 40, ... it could shift up to let's say, 55 or 60 where your investment decisions are now looking at that. But now, you've raised your tax and affected the investment decision. And so with the net, it said along the line a little bit better. And that was the argument for going to the next on the progressivity. When the ... choice was, as we told the folks in industry that came forward is you can always come forward to the legislature and change it. Well, as we have seen that is far easier said than done to start changing technical things. We would've had a hearing just like this to change something that far. And so, you can see that the two sides ... of the argument and the compromise that got reached ended up being on the net, and I don't remember offhand where it started at. But you're

trying to get away from the decision-making point of investment so your progressivity does not affect the investment decision. So, ... you've given the argument for the gross and so, why are we wrong, when the legislature, as an entity, ... what's the downside, the argument on the net where this decision making for investment is no longer at, in my example, 35 to 40 but the decision making is now 45 to 50 and you've raised your tax rate and now you are affecting the investment decisions. Setting aside that you think the rate's too low ... but philosophically, ... how do you find some middle ground there?

5:59:32 PM

DR. VAN MEURS: Now, it is a matter of risk. ... as I mentioned the more you move to a gross plus net system, the more you put risk on the lap of the investor and you put certainty in the lap of the government. So, obviously, the more you go to the net system, the more risk is in the lap of the government of not potentially collecting and the less risk is in the lap of the company. So, it is a matter of how to allocate risk in the formula. And consequently, obviously, the more certain Alaska wants to be about its revenue, the higher risk in investment would become. And consequently, because now you have to start pondering as an investor, you know, can I live with this particular risk profile? There's absolutely no question that the formula that came out, from an investor's point of view, is the lowest risk formula from the point of view of progressivity, but as a consequence for the State of Alaska, the highest risk formula. And that is then a question of judgment: Do we feel confident enough to put that risk in lap of companies and go for a full scale gross-based system, or do we feel, in order to promote the investment in the resources, that we're better off with a net system. And that's then a judgment to make. And I think the legislature came down on the side of promoting the investment and putting the ... risk in the lap of the state rather than the investor.

6:01:23 PM

CHAIR SAMUELS: Thank you, anything you can add to that Mr. Johnston?

MR. JOHNSTON: Well, not much in the sum of what you've described is new to me and you'd probably have to go through it, this description again, which I think would be a waste of time. So the issue of gross versus net I missed some of that. I will say though, by the way, we compared Alaska with everybody under

the sun as far as government take. If you go one step further and try to add some dimension to the government take statistic, it's an issue of how much is based on gross, the means by which governments get a piece of the pie in this world. And what's being proposed here is pretty light, in that respect. I mean for countries that have the significant resources like you in a couple of fields like yours, there's times when they're guarantee share. ... the difference between net and gross is this issue of guarantee; and the more guarantee the government has the more risk on the oil companies, just like Pedro said. But I've seen the effective royalty rates where the government has guaranteed up to 60 percent, well we can name lots of situations where it's more, but as high as 60 percent, 50 percent, 40 percent, just the average for production sharing contracts in this world is 30. So, I can see why there was the agonizing over going with the gross versus net but you had a lot of room to maneuver so not only was the Alaska take relatively low in my opinion, but the front-end loadedness and the means by which you got a piece of the pie was fairly benign in my opinion, too, and that's why I was more bullish than most, I guess.

6:03:01 PM

CHAIR SAMUELS: Okay. And I want to follow up before I get to Representative Kelly, though, I've got as the last question right now. I want to follow up on a question that both Senator Therriault asked and Representative Crawford asked and it has frustrated me in the four years since I've been involved in learning, and still learning thanks to folks like you. ... we kind of beat our chests and say, "My God, look what they're doing in Libya." ... we need to raise our tax rate. But the reality is people, investors, a company that would invest in Venezuela after they've been nationalized. They got nationalized again. There are people that when invested, they go to Nigeria where you have this social unrest and the high taxes. So, you've got places like Nigeria, you've got places like Venezuela. People are investing in Russia with Putin, but people aren't investing here. So, I mean in some ways I spoke to a small group the other day and I said we can just raise the tax rate and ... "the heck with 25", give up. I give up and I go to 40, and I'm just going to get as much as I can and because they're not coming anyway. Or, we can try ... the PPT as attempting to entice some of the investment. I'd just like your comments generally speaking. We hear about all these comments about "we're such a stable government", but they don't come here. They go to places where getting executed is probably just

a ... cost of doing business. And it frustrates me as an Alaskan. It frustrates me to see where those dollars are going and I don't know I've said, we thought we reached middle ground last year and apparently ... we did not. So, anyway, I'd just ... like some comments, generally speaking. They ... spend the money in these places that are ... third world countries with dictatorships.

6:04:54 PM

DR. VAN MEURS: I think there is enormous hope for Alaska because ... by the time I went in debate in Alberta on the increases in the oil sand tax, they said they all going somewhere else. And I said now the only place I can think of is Alaska, so consequently.

CHAIR SAMUELS: [Laughing] I think they were paying Pedro under the table

MR. JOHNSTON: See I don't think those are mutually exclusive. I mean, you can raise the taxes and you can put a smile on the explorer's face, it's just very difficult to do with this type of system, full stop. It actually, in my opinion, could be easy to do if you segregate these more than even the new proposal. I mean, that's an attempt to start at least more down that path. And so yeah, you could do it. And there's the other trade-off then okay, putting a smile on the explorer's face means you're going to have to have some terms that are pretty exciting. And at the end of the day, those jobs that are created in Alaska because of your efforts to increase exploration if we're not careful will be some of the most expensive jobs in the world. You'll end up paying them you know a million dollars per man job per year ... it just was a hell of a lot to pay to get exploration, whether it's successful exploration or not.

CHAIR SAMUELS: Okay, thank you. Representative Kelly.

6:06:16 PM

REPRESENTATIVE KELLY: Thank you Mr. Chairman. Just a couple of comments. This ... is good prologue for everybody. For those of us that went through it, a lot of it is familiar. But there is a distinction between the two that I think is important, and ... it's not planned but I think we ... might need to do something about it. And that is, that Dr. Van Meurs you came in with a knowledge, at least a basic knowledge of the governor's proposed system, the bill that's before us tonight and you

(Johnston) didn't. And so, almost everything you've said is prologue for me. He went beyond that. And I think we need this guy too, and that's more of a discussion probably for LB&A. But getting your reaction to the governor's bill just as we got Dr. Van Meurs' would be of interest to me, maybe just one guy. Another thing that I think is important to point out, there was a question a little while ago -- and it's important with Dr. Van Meurs whom I've learned a ton from as well and respect a lot. But, getting confused between when Dr. Van Meurs creates a spreadsheet or advocates or proposes, there are three different areas that you've been involved in. And I understand the difficulty of that last year because you had a governor that you were working for and I respect that completely. But I thought I had stepped behind the looking glass a minute ago for a second when you answered a question that if we had gone with your proposals. somehow we'd have generated hundreds of millions, maybe more, in extra revenue. That is not strictly accurate because your role was ... also strongly advocacy for a 20:20 solution. A net solution not a gross solution. And some of these things ... are important to point out, not for contention, because ... that is not why I'm doing it. But, ... the three areas of creating a spreadsheet, making a proposal, and then advocating, you have had to do kind of a soft shoe among the three.

DR. VAN MEURS: What you're explaining to me is life of a consultant.

REPRESENTATIVE KELLY: Having done a just a little bit of that myself I understand that you did the three ... dances probably pretty well. But I think it's important for newcomers to understand that that question a few minutes ago about your proposal bringing in more money than what happened is not on the face of it the right way to state that. Because you were working for the governor, the governor was after 20:20, and if you got your way, that is your advocacy way, what you were being paid to do, the recovery would have been substantially less, I would argue.

DR. VAN MEURS: No, no I was just answering a question what would have happened if this was done and that can be calculated. I absolutely agree with you that as a consultant you have to be very careful not to become politician, point one.

REPRESENTATIVE KELLY: Sure, ... and I don't want to draw it out because I know you're on a time frame and you got to eat dinner and then we got to go to the Floor. But I just ... think it's

important to point out ... just reflecting the different roles that you have and reflecting the fact that today you guys came in here completely differently. And that is ... a concern to me because with Dr. van Meurs I have a sense that on my ... scorecard here of where you stand on some of the ACES stuff that we've got to opine on here and push buttons shortly. I kind of know. With you, if I had a half an hour I could get it out of you ... but I'm not going to ... try to do that because you'll shut me down.

CHAIR SAMUELS: I haven't shut anybody down all day.

REPRESENTATIVE KELLY: You've been very good. But what I would ... advocate for, Mr. Chairman, is that we get those answers. And I would expect that ... on the rate, I'd kind of check them both off as 25 guys now out in the middle of the field, stop me if I'm wrong. On the BP thing, we did the \$.30 cents a barrel. That may not have been the right number, but ... it was an attempt to send a signal, a strong signal at that time. I know where you are on that, I don't know where you are. When we look at the progressivity on the base cost of getting a barrel up ... into the pipe, the net is ... kind of the world system, I've heard both of you say that .... With the production sharing type contract arrangements it's a net based system at the end of the day. ... My question is, the governor has proposed a change to a hybrid and without prologue, and I see Beth about fell over backwards, I didn't mean to re-argue the gross and the net. I just need to know what your reaction is to the hybrid, and I didn't get yours as well. So, I feel ...

6:11:42 PM

DR. VAN MEURS: I can give you, because I had the pleasure of studying the bill. And as I said, ... one of my slides indicates that I'm negative about the hybrid, and why is that? As I said, the 10 percent floor for the legacy fields really is not a system based on gross, it is just a floor, a different kind of floor. So, you are really not collecting anything more unless the conditions of the floor actually occur. So, it also doesn't seem to generate more revenues if prices are high. My concern ... is to give Alaska a fair share if prices are high. I'm less concerned to creating an uneconomic situation if prices are low. ... in other words, I see very little value in that floor. And I wouldn't even call it a hybrid system; I think it is just a somewhat more sophisticated floor. That somewhat more sophisticated floor is put in place at the cost of an enormous complication in your accounting, and we have already difficulty

enough to setup a good system. So, now we are going to complicate it even more to separately account for the legacy fields and then so that we can always calculate the floor. ... I'm extremely negative about that whole concept. I think if you want a mixture of gross and net, make a mixture of gross and net, but don't make an imaginary mixture of gross and net make a real mixture of gross and net. That would be my suggestion.

6:13:31 PM

REPRESENTATIVE KELLY: Yeah. Mr. Chairman, one of the things that I fear here is that the ghost of Daniel Johnston, or the ghost of Pedro Van Meurs is going to hang around here after your bodies have flown, and we can't get answers. For the next month we're going to hear ... an estimate of what Johnston would have said, and we're going to hear an estimate of what Van Meurs would have said. And I'd like to know, as specifically as we can get it, what the punch-point comparisons are, whether you support them or not, and why. And most of yours are probably in this. One last thing, you know we've got a very popular governor who was elected who supported most of us on the waiting until 2011. Don't expect you to necessarily follow the politics that close. Most of us I think understood why, when the indictments came out, that she switched and said "Hey, we've got to take a look at that." That's because maybe half-a-million Alaskans were saying the same thing, is maybe this thing has got a problem. So, I was very much a person that wanted to wait till the 2011, which is where you are. I'm not there now, I don't think that we can. I think we've got a different situation. But one point, and then I will stop, is that ... your statement Dr. Van Meurs, that as you look back on the process before, and you're looking at somebody, as you know, I was in it from the ringing of the bell until the conference committees, miserable thing that it was. Anyway, so ... it's not lost on me. But what I want to say is that you've characterized it as okay, 20 was the other guys, let's just say if the alleged improprieties would have been in the 20 camp for some folks, okay just to give you a surrogate for that ... vote. You have stated that "Well, since it went to 22 and a half, I don't think that it had this cloud over it." Okay, as somebody that was in the trenches, I think that ... is a continuum, there are lots of iterations of where that damn thing could've landed that may not have been 20 or 22 and a half, just a point to make so that as ... the public listens to us as we go forward it could've been 23, I could talk for an hour on that; it could have been something else okay; it could have been a lot of things. But what we have ... is a trust issue. So, I just ...

wanted to say that your statement about the 22 and a half, and therefore the good guys won or something doesn't solve it for me.

6:16:05 PM

DR. VAN MEURS: No, maybe I'm somewhat too simplistic on that concept. But ... I do believe that in the end the good guys won and the people that ... honestly voted for what was right at that time they felt for Alaska, they ultimately won. It was a horrendously long process and of course I don't know all the twists and turns through that process because I was not here all that time. But, and even if you would be here all the twists and turns were too complex. But, I take comfort from the fact that those people that really ... felt positively about and wanted to do something good for Alaska, that they, in the end, got the legislation through. So, I ... only put that from the perspective of in the end ... a good law was created and no damage, as such, in that respect was done. ... I agree with you that's a personal judgment.

REPRESENTATIVE KELLY: Thank you. Thank you, Mr. Chairman.

CHAIR SAMUELS: Thank you. And Very short questions, I've got Senator Therriault and then Representative Doogan.

6:17:21 PM

SENATOR THERRIAULT: Thank you. Dr. van Meurs, I should've asked for a clarification earlier, now the news has been on, and they may have lead with the story saying that you've pronounced the gas pipeline uneconomic. And I'm just wondering, when you're an oil and gas advisor, but you're not a pipeline engineer, neither am I. Through the process that we've got going right now, we're going out to the open market to companies that build and operate gas pipelines and saying "Can you make this work? Come back to us with proposals." And I believe that the end of November we will have proposals, whether they ultimately ... lead to gas flowing any time real soon, I'm not sure. ... I'm just wondering what all you base your comment on? The price of steel is up, the price of workers is up, but I don't know that knowing those and agreeing with those would lead me to believe, to pronounce, the project uneconomic just across the board. What size pipe, 52, 48, 36, there's so many variables.

DR. VAN MEURS: No, no. I like to be precise, ... I pointed out the slide that related to the specific gasline project that ...

was on the discussion. I also mentioned if somebody offers ... \$5 per million Btu at the wellhead in the Arctic, I'm absolutely sure companies are happy to sell. And if that company is willing to build a pipeline, I'm sure the project will go forward. Now, I don't see those deep pockets, ... that is one issue. But, the slide that I was commenting on was the original gasline proposal. ... I don't know whether I mentioned it here in the audience, but I'm already contracted by the government of Canada, just to give you an example of the horrendous level of economic difficulty that these pipelines have now. Exxon Mobil actually is proposing a \$2 billion dollar subsidy .. from the government of Canada just to get the McKenzie line built. Now, translating that to Alaska would be an \$8 billion subsidy because the project would be four times as large, ... and it was always recognize that the Alaska project was less attractive than the McKenzie project. So, if you look at it from that perspective if you take that the cost since 2001, because we only assume regular inflation between 2001 and 2004. If you assume that between 2001 and 2007 the cost actually doubled - and I think there is immense evidence in Canada that that actually happened - then now you ... have an uneconomic project .... Now, I believe if you have similar LNG project, that even result in a lower net back, I ... see that very problematical. If there is a courageous national oil company, if Petro[unknown] would come to Alaska and say, we are willing to buy at Henry Hub less \$2 at the wellhead in the Arctic, and we take care of shipping all this gas to China. Yes, you have a wonderful project. Now, I don't see that happening, but who knows. If somebody comes out of the woodwork that makes an unexpected offer that happens to be attractive to the ... three major players in the gas field, then of course you have a possibility. But I'm not excluding that, I think that possibility would be very low.

6:21:24 PM

CHAIR SAMUELS: Thank you, before we get to Representative Doogan's last question, what time do you leave tomorrow Dr. Van Meurs?

DR. VAN MEURS: Early in the morning.

CHAIR SAMUELS: But you're here all day tomorrow? What I'd like to try to do, if the room is available, and particularly for the new members, is allow the new members to come in here and just have an infcrmal gathering and talk to Mr. Johnston tomorrow at 9 a.m. I mean particularly for the new members, I don't want

those of us that lived through this thing for eight months have kind of dominated the conversations today. For the new members, if you're here tomorrow at 9 a.m. for a couple hours allow you to come in here and after you've absorbed what you've heard today a little bit. And I'll try to get the word out to the members on the Floor tonight, and I'll talk to the Senate also.

UNIDENTIFIED SPEAKER: Is Oil and Gas meeting tomorrow morning? Do you know?

CHAIR SAMUELS: I believe that Oil and Gas is meeting tomorrow at 1:30 so at 9 a.m., maybe. we can just come back in here and informal, I'm not going to call it an LB&A meeting. But if you could make yourself available, particularly for the new people that probably have just got fed with a fire hose in the last little bit. So, with that the last question Representative Doogan.

6:22:23 PM

REPRESENTATIVE DOOGAN: Thank you Mr. Chairman. I hesitate to take another bite off the apple here, but I find myself somewhat bumfuzzled by Dr. van Meurs' statements about Alaska's reputation in the world as an oil province. And what I was curious about is this: the statement that you made Dr. van Meurs that Alaska is seen as confrontational and I was hoping that you would be able to explain that to me a little bit. ... is the problem that we're striking Exxon's fists too vigorously with our face. ... What do you see as the cause of that aspect of Alaska's reputation in the oil patch?

DR. VAN MEURS: I think it would clearly be wrong to portray let's say, Alaska in some kind of heroic battle with Exxon. Yes, the world knows that there has been a horrible oil spill. The world knows that ... Alaska has been very negative about how that matter was resolved and that so consequently, some hard feelings remain about that matter. And of course, that's something that many other people have ... a good understanding of. I think the confrontational attitude relates more to ... sometimes the details ... of the implementation in terms of money collection, in terms of attitude toward ... the oil industry. There seems to be ... somewhat of a ... frontier mentality in Alaska whereby standing up to the oil industry is a great credit for anybody that ... wants to advance in life, particularly in political life. And so consequently, some other governments approach that quite differently and ... I attribute a little bit to two factors. One, somewhat the frontier

mentality of Alaska, which ... creates people that feel fiercely about their independence. Also, I think there is some annoyance ... if I can describe it that way, among Alaskans to be dependent on these companies. And so, there is a negative dependency relationship say, I think between Alaskans generally that feel their future is determined by just three companies and they are therefore not masters of their own house. ... now, whether that is 100 percent correct is difficult to describe. But I think that is how ... I personally explain that relationship. If you go to Alberta, there is no feelings of that whatsoever. If you go to Britain in the North Sea there are no such feelings whatsoever or Norway for that matter, or Texas, or MMS .... So, there is a little bit of a ... confrontational environment in Alaska for a whole series of probably social economic reasons that are quite unique, but that at the same time have created a little bit of a culture that I think is not perceived very positively ... by the investor community. And therefore, that is why I use the word re-branding ... somewhat more concerted effort on the part of Alaskans to say yes, we know are a frontier society, yes we ... are pretty rambunctious here, but ... we really are prepared to open our arms to newer medium-sized companies that are willing to come to Alaska and please don't ... misunderstand our desires ... and how we see our future. I think that needs to be marketed better. And I think ... far more of a concerted effort needs to be done to smooth out relationship with the industry to overcome these ... somewhat confrontational kind of attitudes and I think that will help greatly in bringing investment to Alaska. I have seen absolute incredible changes in some nations when they started to re-brand their image. Qatar is probably the absolute stellar example, which used to be a backwater pretty nasty kind of reactions to the oil industry over-negotiating every ... little tidbit and ... fighting every little payment coming to government and ... really they didn't go anywhere. And then they re-branded themselves as the modern center of gas development in the Middle East and now they are the leaders. And ... it is more psychology than hard reality and I think something like that is necessary. Would that be a good description of Qatar?

MR. JOHNSTON: Well, I think it was partly the result of the coup, wasn't it.

DR. VAN MEURS: I'm not recommending coups in Alaska, no.

MR. JOHNSTON: Yeah, the dad left town for a couple days and the son took over and the son was a little more aggressive, shall we say.

REPRESENTATIVE DOOGAN: Thank you very much.

6:28:41 PM

CHAIR SAMUELS: Thank you both very much. I hope that it has been informative, particularly for those who didn't live and breathe for quite some time.

DR. VAN MEURS: Thank you so much, it was a great pleasure.

CHAIR SAMUELS: Thank you much and we're adjourned.

**ADJOURNMENT**

There being no further business before the committee, the Legislative Budget and Audit Committee meeting was adjourned at 6:28:49 PM.

# Proposed revisions to the PPT

October 18, 2007

Presentation to  
The Alaska Legislature

*Handwritten notes:*  
The meeting was at  
Tibata -  
PVT's  
OK

# Overall Recommendation

I would strongly recommend **not** to make any changes in the PPT law, other than the transparency provisions.

Changing taxes substantially every year creates an image of serious fiscal instability that could damage investor confidence in Alaska.

# Overall Recommendation

The current law already provides for a review mechanism by 2011.

The year 2011 is the appropriate time to make such revisions because at that time the first audits will have been completed and final and reliable information would be available.

Chosen there  
because there  
would be  
enough info  
to really  
know how the  
law worked