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Alaska Legislative Budget and Audit Committee
Twenty-Fourth Legislature 2005-2006 Second Session
Juneau, Alaska

22 April, 2006

Re: Alaska Oil Tax Legislation

Dear Legislators,

Further to our numerous meetings, discussions, my prior testimony, and in response to recent queries I submit these additional thoughts.

The Appropriate Tax Rate

Considerable discussion has centered on the tax rates that would be appropriate for the different situations, basins and provinces that exist in Alaska.

As you may recall some of the exploration companies in Alaska said the 20/20% PPT, as proposed by the Administration, could be acceptable. However, they were concerned about the status of the existing credit arrangement and whether or not that would continue. However, many of the smaller companies also confirmed that a 25/20% PPT arrangement would work too if oil prices remained above $40-45/BBL. Below a $35/BBL price threshold Arctic exploration under any circumstances gets tight.

If we consider that an explorer in the Alaskan Arctic could live with a 25/20% PPT (as originally structured) at $40-45/BBL then clearly non-exploration efforts would be substantially better off. While much discussion from BP, ExxonMobil and ConocoPhillips centered on the risks associated with further development at Prudhoe Bay (PHB) and Kuraruk (KRU), these risks are simply not in the same category. Not even close.

The greatest beneficiaries of a single system that attempts to accommodate the needs of all parties will be the existing producers at PHB and KRU. The benefits AND the pain should be distributed equally amongst a wider group.

Why only 25% vs 20%?

It surprised me how quickly debate centered and focused on such a narrow band of tax rates i.e. **20% vs 25%.** The difference between these two is just a government take of about 2%. I believe to a certain extent that it is a strange coincidence that we so quickly ended up in this narrow debate. It is certainly strange but unfortunate for Alaskans because the difference is minute and the oil companies must be ecstatic.

Different Tax Rates for Different Situations

I have been asked my opinion about the appropriate level of taxation (or credits) for each distinct region/situation. This of course is consistent with my views that a "one-size-fits-all" system is problematic at best.

In my opinion a more appropriate landscape would look like this:
(Please forgive the gross over-simplification)

Prudhoe Bay/Kuparuk	**30/20% PPT**	increasing above $40/BBL
North Slope Exploration	**20/20% PPT**	increasing above $45/BBL
Cook Inlet	**10/20% PPT**	or less, with options of royalty relief

Heavy or Challenged Oil

At current prices (by which I mean around $50/BBL) many heavy oil projects are in good condition from an economic/financial point of view. However, if the fiscal system is to be designed to try and put these and other *challenged* projects on a "level-playing-field" (at any price) with **non**-heavy/viscous oil fields, then the proposed additional 15% credit is probably close to helping many of these projects compete (they are all different).

My working number for what constitutes "heavy oil" is 25° API and lower. A few good working numbers for the difference between a 25° API crude and a typical light 35° crude are:

(1) Price discount for 25° crude (relative to 35° crude) at least 10%.
[Roughly a 1% price adjustment (in this range) per degree API (at least) — My experience]
(2) 25° crude is typically about 10 times more viscous than 35° crude
(3) Heavier crudes typically have higher operating costs
(4) Heavier crudes typically have lower recovery factors (all other things being equal)

However, as we know there are other attributes that cause problems unrelated to API gravity.

Progressivity

This issue is extremely important. It is one of the first things I investigated when I evaluated (1) the Producer's and the Administration's Gas Pipeline Proposals last August and September, (2) the Governor's PPT 20/20% plan this winter and (3) the Committee Substitute proposals from the Legislature.

There are two key issues here:

> **(1) Should the system be progressive or not?**
> **(2) If it is going to be progressive – how progressive should it be?**

The system simply must be progressive. This has been a strong trend around the world and for good reason too. **It is an issue of fairness, flexibility, economic efficiency and dignity.** We have been discussing "terms" and hearing much rhetoric based on assumed future prices in the range of $30-35/BBL (according to the oil companies) yet world prices today are in excess of $70/BBL. It is possible that oil prices could get back down to $30/BBL again but anything over $50/BBL is fabulous for the oil companies. They have been particularly reluctant to share any upside i.e. reluctant to agree with a progressive system YET they insist on a degree of certainty that is nearly unprecedented. These things go hand-in-hand. <u>With the kind of certainty they demand Alaska would be crazy to not have a reasonably progressive system</u>.

How progressive should the system be?

I discussed this issue in my testimony on March 6th and provided a few examples from various sources. Around 25% of the worlds systems were progressive at the turn of the Century. Many governments are re-designing their systems in one fashion or another to either build-in greater flexibility (progressivity) or simply change their terms as the British have done (twice in the last 4 years). A typically progressive system (at a minimum) would increase Government Take by 5 percentage points with oil prices going from $20/BBL to $40/BBL. I figure the average change in Government Take for these systems would be under 10 percentage points in that price range. If Alaska was going to only have a minimum-level of progressivity by these criteria and the progressive feature started at $40/BBL then at $70-80/BBL Government Take should increase by <u>at least</u> 5 percentage points. This represents a change in the PPT rate of around 12 percentage points (assuming a change in Government Take of 2 percentage points for every 5% change in PPT rate).

Therefore, from $40/BBL to say $80/BBL the PPT rate should increase by around 12-15 points. **Example:**

PPT 25/20% at $40/BBL ⇒ **PPT 40/20% at $80/BBL**

In this example going from $40/BBL to $80/BBL, Government Take would increase by only around 5 percentage points or so. Please be aware that a PPT 40/20% at $80/BBL is extremely more profitable for the companies than PPT 25/20% at $40/BBL. Don't think of it as "painful". This example is only modestly progressive.

This slope amounts to around 0.375% per $/BBL. It compares as follows:

Example (above)	.375% starting @ $40 WTI
House CS (Version L)	.3% starting @ $50 WTI
Senate CS (Version C)	.2% starting @ $40 ANSwh
Senate Finance CS draft	.1% starting @ $45 "net value"

The Senate Finance CS recommendation has virtually gutted the progressivity.

Gas Pipeline Linkage?

Complaints from various sectors regarding the threat to the gas pipeline are legitimate. In addition to some of the threats, I recall some rhetoric regarding the Administration's 20/20% PPT being structured in such a way that it would "help *enhance* the chances for a gas pipeline" or something to that effect. We know that there are some links between the gas contract and the oil taxes. However, I see no need for the oil terms to be structured in such a way that they "help" the gas pipeline economics. Furthermore, that threat is unfair without adequate information to justify the threats. My response to these threats is:

(1) What is the Producer's Internal Rate of Return for the Gas Pipeline Project:

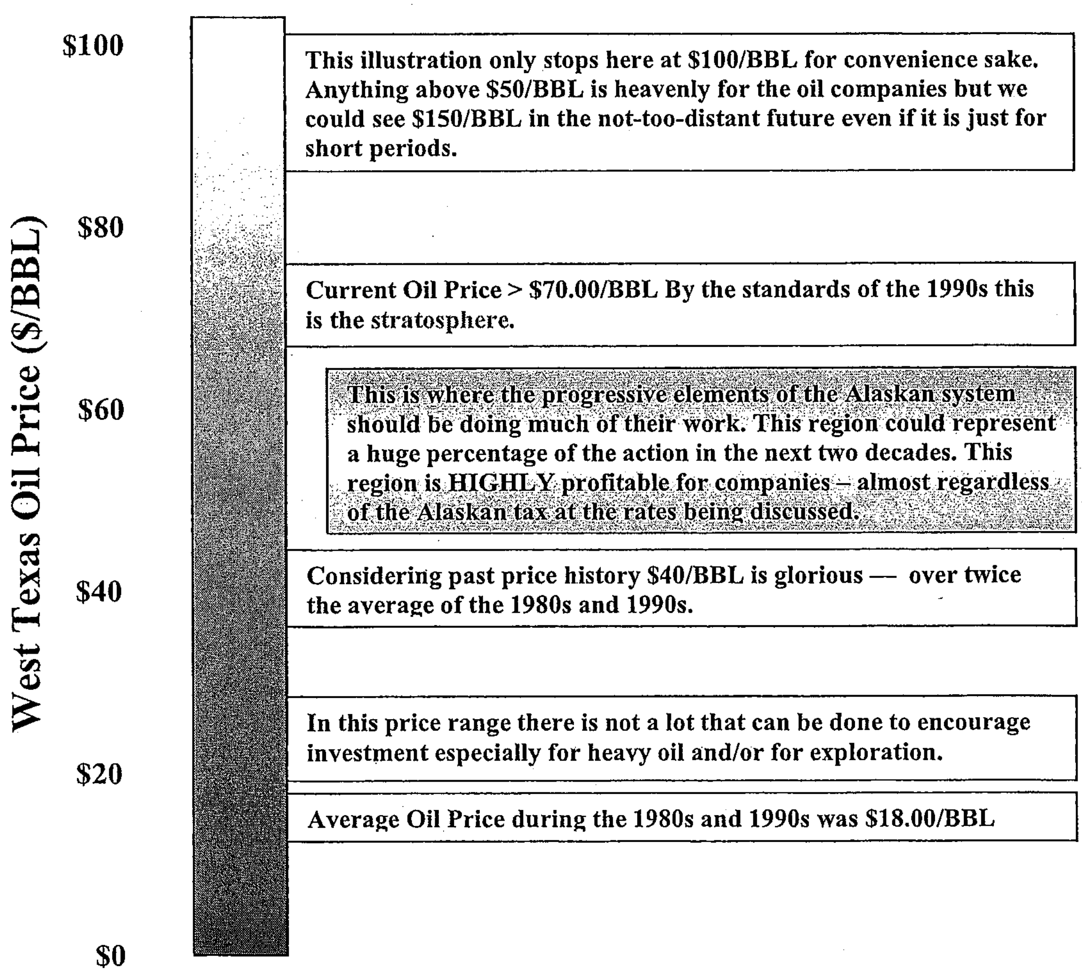
A. Under the Administration's 20/20% PPT system as proposed?
B. Under the Senate CS
C. Under the House CS
D. Under the Senate Finance Committee CS

Even this information is not sufficient to justify ratification of an oil tax system with the gas terms unknown. <u>I could not in good conscience make a decision about the oil taxes without knowing the gas pipeline terms that have been agreed between the producers and the Administration.</u> How can we claim to have exercised due diligence?

This did not become quite the issue it is now but for the numerous threats about the gas pipeline project from both the producers AND the Administration during these discussions about oil taxes.

Furthermore, the linkage (especially regarding "certainty") that has also obviously been agreed to must be understood. I feel more strongly about this now because of the way the gas pipeline project has been used by the producers to threaten Alaskans with petroleum economic doom, loss of jobs, and a ruined reputation.

Considering the history of oil prices and the drama involved with today's high prices it is impossible for me to contemplate a neutral or even a *mildly* progressive system. If we are going to do it let's do it right.



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(sent by e-mail)