Senate Resources Committee

Alaska Fiscal System Discussion Slides

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PFC Energy
Alaska’s Future Petroleum Revenues: Sensitivities to Oil Price, Production Decline, and Fiscal Terms
The major factor determining Alaska’s future petroleum revenue is not oil & gas fiscal terms, or even, in the short run, production levels, but rather something entirely outside Alaska’s control: the crude oil price.

Restricting a sensitivity analysis only to the range of oil prices observed in the last 5 years, and holding future production constant (based on DOR forecasts) the potential variation in possible future petroleum revenue is substantial:

- In a $140/bbl environment, revenue in 2022 under ACES would approach $10bn
- In a $60/bbl environment, revenue in 2022 under ACES would be as low as $1.8bn

In reality, the potential for variation is even greater than this, since production also responds to price:

- In a sustained high price environment, more projects would be economic, and long-run production would improve
- In a sustained low price environment, fewer projects would be economic and sustaining capital would be lower, resulting in a more rapid decline in long run production.
The Base Forecast anticipates an average annual production decline between 2017 and 2022 of ~6% (including the contribution from new producing areas brought on-stream), yielding production of ~344 mb/d in 2022.

- Increasing the average decline rate by half to 9% in every year from the base case would see production declining to ~280 mb/d in 2032.

- Reducing the average decline rate by half to 3% in every year from the base case would see production of ~419 mb/d in 2032.

- In the low decline scenario, more robust production combined with the impact of inflation mean that nominal revenues would continue to grow beyond 2017, reaching ~$7.8 bn at a nominal crude price of $100/bbl.

- In the high decline scenario, 2022 nominal revenues would fall well below the $4 bn level anticipated in the Base Forecast case, reaching less than ~$4 bn even with nominal crude prices at $100/bbl.
• Even significant changes to fiscal terms, by contrast, have a far smaller impact on future revenues than either oil price or future production declines
  – Under the Base Forecast decline case, at $100/bbl crude oil, SB 21/HB72 results in a parallel shift of the revenue curve, reducing the state’s petroleum revenue by a little over $1 bn each year

• If an improvement in fiscal terms can stimulate sufficient new investment to stem declines, it has the long run potential to increase revenue, despite the near-term cost of the change
  – To maintain revenues to the state at a steady level in real terms, a reduction in government take such as that under SB 21 would need to spur sufficient investment to reduce the North Slope base decline from 6% as currently forecast to 1%
Context: Investment Competition & Global Oil Price Environment
Fixed-Royalty Jurisdictions in US Lower 48 Are A Key Competitor to Alaska for Investment Dollars

It is now an exception not to be targeting unconventionals in North America as a major growth platform.
American Energy Reset
United States Production – Back at Post-War Period

American Energy Reset: Oil

mb/d

- Oil Production
- Energy Reset
- Oil Production (forecast)
- Energy Reset (actual)

Alaska Hydrocarbons Fiscal System Analysis | © PFC Energy 2013 | February 2013
Anatomy of the Physical Market for Crude Oil

Final Product Consumption

• Fuel needed for economic activity
• Main ingredient in hot dogs

Refining Demand for Crude

• Inputs needed to provide fuel demanded by consumers

Non-OPEC Crude

• As price takers, will produce at capacity given positive project economics

OPEC Crude

• Plays a balancing role, adjusting output as needed in line with overall objectives

Four broad segments to balance the market
Non-OPEC Liquids Will Show Substantial Growth
In the past production not affected by price swings
Shale oil now forecast to reach ~4 mmb/d of production by end of the decade (largest recent Saudi swing was 2.2 mmb/d – post recession through Libya response)

Shale oil production joins ranks of potential short-term global oil balancers. Traditionally made up of:

- OPEC (Primarily Saudi Arabia)
- IEA/SPR stocks
- Demand destruction (potential is diminishing with rise of non-OECD demand growth given subsidies)

OPEC has yet to begin grasping both the scale and potential impact that shale oil will have on its traditional role.

- Is only now beginning to address Iraqi production
Initial Output Implications for Major OPEC Producers

Iran and Iraq complicate market management

A diplomatic solution that brings Iran back into the oil markets makes OPEC management worse via increased volumes.
Character of US Growth Changing
Potential for sudden stop to growth or even declines on price softness

- Each year more production must be brought on just to maintain the prior year’s levels.
Assumptions for Breakeven are:

- Drilling Cost: $8MM
- Acreage Costs by Class:
  - Class 1: $20,000/acre
  - Class 2: $13,333/acre
  - Class 3: $8,889/acre
  - Class 4: $5,926/acre
  - Class 5: $3,951/acre
- Risked: 95%
- Basis: $(10.00)/bbl
- Severance taxes:
  - Gas: 7.5%
  - Oil: 4.6%
- Fed taxes: 35%
- Operating Costs:
  - Fixed: $1,000/well/month
  - Variable: $7.00/boe
- Gen/Admin costs: $1.50/boe
- Royalty Rates:
  - Q 1: 18.8%
  - Q 2: 14.1%
  - Q 3: 10.6%
  - Q 4: 7.9%
  - Q 5: 5.9%
Eagleford Quintile Breakeven PV 10

Assumptions for Breakeven are:

- **Drilling Cost:** $7.5 MM
- **Acreage Costs by Class:**
  - Class 1: $20,000/acre
  - Class 2: $15,000/acre
  - Class 3: $10,000/acre
  - Class 4: $5,000/acre
  - Class 5: $2,000/acre
- **Risked:** 95%
- **Basis:** $(4.00)/bbl
- **Severance taxes:**
  - Gas: 7.5%
  - Oil: 4.6%
- **Fed taxes:** 35%
- **Operating Costs:**
  - Fixed: $1,000/well/month
  - Variable: $3.00/boe
- **Gen/Admin costs:** $1.50/boe
- **Royalty Rates:**
  - Q 1: 25%
  - Q 2: 20%
  - Q 3: 18%
  - Q 4: 14%
  - Q 5: 12.5%
Assumptions for Breakeven are:

Drilling Cost: $7.5 MM

Acreage Costs by Class:
- Class 1 $6,000/acre
- Class 2 $3,000/acre
- Class 3 $1,000/acre
- Class 4 $500/acre
- Class 5 $100/acre

Risked : 95%

Basis : $(4.00)/bbl

Severance taxes:
- Gas: 7.3%
- Oil: 7.3%

Fed taxes: 35%

Operating Costs:
- Fixed: $1,000/well/month
- Variable: $3.00/boe

Gen/Admin costs: $1.50 / boe

Royalty Rates:
- Q 1: 1/6
- Q 2: 1/6
- Q 3: 1/6
- Q 4: 1/8
- Q 5: 1/8
### Risks to Price Forecast

<table>
<thead>
<tr>
<th><strong>Upside Price Risk</strong></th>
<th><strong>Downside Price Risk</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strong global economic growth</strong></td>
<td>• Increases demand strongly, tightening supply/demand balance</td>
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</table>
| **Instability removes barrels from market** | • Repeat of Libya-type event  
• Confrontation with Iran |
| **American Energy Reset** | • US production boom is now delivering most of the worlds incremental demand growth, leaving little room for additional growth from other countries |
| **Economic slowdown** | • Eurozone, US or China slowdown causing demand slowdown. Loosens supply/demand balance |
| **OPEC mismanagement** | • OPEC will need to cut barrels in the future but may have difficulty organizing this among its members |
| **US WTI disconnect expands geographic scope** | • Discounts to WTI and other inland markers may begin to affect US west coast markets as Bakken and Eagle Ford crudes increase into those areas. |
What is the Potential Floor for ANS West Coast Crude?

- Since 2008, the average for the 100 lowest priced days ranged form $38-44/b for the three key markers.

- **In the short-term, the potential floor price for ANS is in the mid-$30/b range.**
  - Would require substantial global oversupply, likely through a combination of OPEC mismanagement and booming US production
  - This low price is not sustainable for long as it will begin to cut US production within 60-90 days.

- **In the medium- to long-term, the floor price is near the cost of the marginal barrel:**
  - If US constrained, potential for $55-60/b
  - If global (and assuming US production does not again surprise to the upside), the price floor is higher at $70-75/b
Alaska’s Fiscal System: Problems and Approaches
ACES: 5 key problems

• High levels of Government Take reduce competitiveness for capital, especially at high prices
• High marginal tax rates reduce incentives for spending control
• Complexity makes meaningful economic analysis and comparison difficult
• Significant state exposure in low price environments, and for high-cost developments
• Impact of large-scale gas sales on tax rates
Regime Competitiveness: Average Government Take at $80/bbl

Average Government Take of Global Fiscal Regimes at $80/bbl
Regime Competitiveness: Average Government Take at $100/bbl

Average Government Take of Global Fiscal Regimes at $100/bbl

- Syria
- Uzbekistan
- Pakistan
- Bolivia
- Oman
- Trinidad
- Azerbaijan
- Turkmenistan
- Angola
- ACEs (New Development)
- Algeria
- Vietnam
- Norway
- Indonesia
- Kazakhstan
- Malaysia
- Venezuela
- Russia
- ACEs (Existing Producer)
- Congo, Rep. of the
- Thailand
- US - LA (Haynesville)
- China
- US - TX (Eagleford)
- India
- Cote d'Ivorie
- Netherlands
- Yemen
- Egypt
- US - ND (Bakken)
- US - LA (conventional)
- UK
- Libya
- Australia
- UAE
- Nigeria
- Canada - Alberta Conv.
- Philippines
- US - TX (conventional)
- Argentina
- US - TX (Barnett)
- Equatorial Guinea
- Colombia
- Canada - Alberta OS
- Brazil
- Gabon
- Denmark
- US - GOM
- Canada - Nova Scotia
- New Zealand
- Peru
- Ireland

Alaska Hydrocarbons Fiscal System Analysis | © PFC Energy 2013 | February 2013
Difference Between New Investment vs Base Production is Critical

ConocoPhillips: 2011 Revenue and Income / bbl

- Production Taxes / BOE
- Income Tax / BOE
- Operating Costs / BOE
- DD&A / BOE
- Exploration Expenses / BOE
- Other Costs / BOE
- Net Income / BOE
ACES: 5 key problems

- High levels of Government Take reduce competitiveness for capital, especially at high prices
- **High marginal tax rates reduce incentives for spending control**
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ACES: Average and Marginal Production Tax Rates

![Graph showing ACES Average and Marginal Rates](image-url)
Impact of Spending Under High Marginal Rates

Calculation of ACES Tax: Additional Capital Spending

<table>
<thead>
<tr>
<th>Annual Taxable Production (Bbls)</th>
<th>50,000,000</th>
<th>50,000,000</th>
<th>50,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Expenditure ($)</td>
<td>$1,500,000,000</td>
<td>$1,500,000,000</td>
<td>$1,500,000,000</td>
</tr>
<tr>
<td>Additional Expenditure ($)</td>
<td>$250,000,000</td>
<td>$250,000,000</td>
<td>$250,000,000</td>
</tr>
<tr>
<td>Total Lease Expenditure ($)</td>
<td>$1,750,000,000</td>
<td>$1,750,000,000</td>
<td>$1,750,000,000</td>
</tr>
<tr>
<td>WC ANS Price ($/Bbl)</td>
<td>$80.00</td>
<td>$100.00</td>
<td>$120.00</td>
</tr>
<tr>
<td>Tax Value Prior To Additional Expenditure ($/Bbl)</td>
<td>$40.00</td>
<td>$60.00</td>
<td>$80.00</td>
</tr>
<tr>
<td>Additional Capital Spending Per-Barrel of Existing Production ($/Bbl)</td>
<td>5.00</td>
<td>5.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Tax Value After Additional Expenditure ($/Bbl)</td>
<td>$35.00</td>
<td>$55.00</td>
<td>$75.00</td>
</tr>
</tbody>
</table>

Taxes Before Additional Expenditure

<table>
<thead>
<tr>
<th>Tax Rate (%)</th>
<th>29.0%</th>
<th>37.0%</th>
<th>45.0%</th>
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</thead>
<tbody>
<tr>
<td>Production Tax Before Credits ($)</td>
<td>$580,000,000</td>
<td>$1,110,000,000</td>
<td>$1,800,000,000</td>
</tr>
<tr>
<td>Capital Credits (20% x Capital Expenditures) ($)</td>
<td>$300,000,000</td>
<td>$300,000,000</td>
<td>$300,000,000</td>
</tr>
<tr>
<td>Production Tax After Credits ($)</td>
<td>$280,000,000</td>
<td>$810,000,000</td>
<td>$1,500,000,000</td>
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</tbody>
</table>

Taxes After Additional Expenditure

<table>
<thead>
<tr>
<th>Tax Rate (%)</th>
<th>27.0%</th>
<th>35.0%</th>
<th>43.0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production Tax Before Credits ($)</td>
<td>$472,500,000</td>
<td>$962,500,000</td>
<td>$1,612,500,000</td>
</tr>
<tr>
<td>Capital Credits (20% x Capital Expenditures) ($)</td>
<td>$350,000,000</td>
<td>$350,000,000</td>
<td>$350,000,000</td>
</tr>
<tr>
<td>Production Tax After Credits ($)</td>
<td>$122,500,000</td>
<td>$612,500,000</td>
<td>$1,262,500,000</td>
</tr>
</tbody>
</table>

Reduction in Taxes From Additional Expenditure

<table>
<thead>
<tr>
<th>Before Credits</th>
<th>$107,500,000</th>
<th>$147,500,000</th>
<th>$187,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional Credits</td>
<td>$50,000,000</td>
<td>$50,000,000</td>
<td>$50,000,000</td>
</tr>
<tr>
<td>Total Reduction in Taxes After Credits</td>
<td>$157,500,000</td>
<td>$197,500,000</td>
<td>$237,500,000</td>
</tr>
</tbody>
</table>

| Reduction in Tax as % of Expenditure | 63% | 79% | 95% |
| Due to Change in Taxes (Buy Down Effect) | 43% | 59% | 75% |
| Due to Additional Credits | 20% | 20% | 20% |

Econ One Research

Source: Econ One Presentation, February 13 2013
ACES: 5 key problems

- High levels of Government Take reduce competitiveness for capital, especially at high prices
- High marginal tax rates reduce incentives for spending control
- **Complexity makes meaningful economic analysis and comparison difficult**
- Significant state exposure in low price environments, and for high-cost developments
- Impact of large-scale gas sales on tax rates
ACES: Standalone vs Incremental

Government Take
New 50mmb Development, $16/bbl Capex

IRR
New 50mmb Development, $16/bbl Capex

NPV12
New 50mmb Development, $16/bbl Capex

NPV12/boe
New 50mmb Development, $16/bbl Capex
**Return on Capital Employed**:
- ROCE = \[
\frac{\text{(Net profit before interest and taxes)}}{\text{(Gross Capital employed)}}\] x 100
- Where:
  - Gross capital employed = Fixed assets + Investments + Current assets **OR**
  - Gross capital employed = Share Capital + General & Capital Reserves + Long term loans
- (+) Correlation with production, commodity prices
- (-) Correlation with upstream spending
- Indicates how well management has used the investment made by owners and creditors into the business.
- The higher the return on capital employed, the more efficient the firm is in using its funds. Over time, ROCE reveals whether the profitability of the company is improving or eroding

*Global Players Average Upstream ROCE: 20.4%  
Tier I Independents Average Upstream ROCE: 11.4%*
ACES: 5 key problems

- High levels of Government Take reduce competitiveness for capital, especially at high prices
- High marginal tax rates reduce incentives for spending control
- Complexity makes meaningful economic analysis and comparison difficult
- **Significant state exposure in low price environments, and for high-cost developments**
- Impact of large-scale gas sales on tax rates
High state exposure for high-cost developments

The Economics of High Cost Heavy Oil Development

* Analysis of incumbent production includes “buy-down” impact for reduced taxes on existing production.
ACES: 5 key problems

- High levels of Government Take reduce competitiveness for capital, especially at high prices
- High marginal tax rates reduce incentives for spending control
- Complexity makes meaningful economic analysis and comparison difficult
- Significant state exposure in low price environments, and for high-cost developments
- **Impact of large-scale gas sales on tax rates**
Under ACES, production tax value is assessed on a combined BTU-equivalent basis for both oil and gas production:

- So long as no major gas export project is under development, this has no impact.
- In the event of the development of a major gas export project, however, when gas prices are significantly lower than oil prices, this could lead to significant reductions in Government Take.
ACES: 5 key problems – available solutions

- High levels of Government Take reduce competitiveness for capital, especially at high prices
  - Reduce, bracket or eliminate progressivity
  - Reduce base rate
- High marginal tax rates reduce incentives for spending control
  - Reduce, bracket or eliminate progressivity
  - Reduce, restrict or eliminate credits
- Complexity makes meaningful economic analysis and comparison difficult
  - Simplify overall system design, especially interaction of progressivity with credits
  - Improve economics for new development
- Significant state exposure in low price environments, and for high-cost developments
  - Reduce or eliminate some or all credits
  - Eliminate ability to claim credits from state treasury
  - Carry credits forward to production
- Impact of large-scale gas sales on tax rates
  - Eliminate progressivity, levy progressivity on gross basis, or use progressive Gross Revenue Exclusion
ACES: 5 key problems – **SB21/HB72 Solutions**

- High levels of Government Take reduce competitiveness for capital, especially at high prices
  - *Reduce, bracket or eliminate progressivity*
  - *Reduce base rate*

- High marginal tax rates reduce incentives for spending control
  - *Reduce, bracket or eliminate progressivity*
  - *Reduce, restrict or eliminate credits*

- Complexity makes meaningful economic analysis and comparison difficult
  - *Simplify overall system design, especially interaction of progressivity with credits*
  - *Improve economics for new development*

- Significant state exposure in low price environments, and for high-cost developments
  - *Reduce or eliminate some or all credits*
  - *Eliminate ability to claim credits from state treasury*
  - *Carry credits forward to production*

- Impact of large-scale gas sales on tax rates
  - *Eliminate progressivity*, levy progressivity on gross basis, or use progressive Gross Revenue Exclusion
Regime Competitiveness: Average Government Take at $80/bbl

Average Government Take of Global Fiscal Regimes at $80/bbl

- Alaska
- OECD
Regime Competitiveness: Average Government Take at $100/bbl

Average Government Take of Global Fiscal Regimes at $100/bbl

- Countries listed include Pakistan, Bolivia, Oman, Trinicaid, Azerbaijan, Turkmenistan, Angola, ACES (New Development), Algeria, Venezuela, Russia, ACES (Existing Producer), Egypt, US - LA (Haynesville), China, US - TX (Eagleford), India, Cote d'Ivoire, Netherlands, Yemen, S821/HB72 (Existing Producer), Libya, Australia, UAE, Nigeria, Canada - Alberta Conv., Philippines, US - TX (conventional), Argentina, US - TX (Barnhardt), Equatoria Guinea, Colombia, Canada - Alberta OS, Brazil, Gabon, Denmark, US - GOM, Canada - Nova Scotia, New Zealand, Peru, Ireland.

The chart compares the average government take to OECD and Alaska averages.
Regime Competitiveness: Average Government Take at $120/bbl

Average Government Take of Global Fiscal Regimes at $120/bbl
As noted in PFC Energy testimony on 1/31/13, at low oil prices, Relative Government Take under SB 21 is higher than under ACES, due to the impact of low or no progressivity, combined with the elimination of the 20% capital credit under SB 21.

- The oil price level at which this occurs is highly sensitive to annual levels of capital spending, since CAPEX both reduces the oil price level at which progressivity kicks in under ACES, and determines the size of the available capital credit under ACES.

- Looking at a single year of production also slightly raises this neutrality point, since over many years, inflation reduces the real price level at which progressivity starts under ACES.

- For mature, producing assets with a low ongoing CAPEX requirement ($10/bbl), SB21 represents a reduction in government take at prices above ~$75/bbl, however for capital intensive new developments in existing units, that neutrality point can be as high as ~$110/bbl.

- It is thus important to understand that one impact of the removal of the 20% capital credit under SB 21 is that for companies with high development costs relative to overall production, it can represent a tax increase at current prices.

For base production with low CAPEX requirements ($10/bbl*), SB21 represents a tax cut at all price levels above ~$75/bbl, and a tax increase at prices below that level.

At a CAPEX level of $15/bbl*, the neutrality point rises to ~$90/bbl.

For assets in development (and in existing units) with CAPEX as high as $25/bbl*, the neutrality point can be as high as ~$110/bbl.

* All CAPEX figures are in gross bbl terms ($15 per gross bbl is roughly equivalent to DOR 2014 average North Slope forecast of $19.6 per bbl net of royalty, when adjusted for gross/net and for capital expenditures by non-taxable entities.)
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