Preliminary Review and Discussion

of the

Proposed Gas Pipeline Contract

and the

10 May, 2006

Fiscal Interest Finding

Alaska State Legislature

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The Administration's Government take statistics are misleading.

If you recall we had considerable discussion about how to treat "government participation" when I testified on March 6th. The government take statistics used by ConocoPhillips from the Woodmackenzie report were terribly unfair to Alaska. The Woodmackenzie reported take statistics ignored any government participation as a means of obtaining a share of profits. This made Alaskan terms look particularly tough by comparison, and this is simply wrong and unfair. And, it makes a huge difference to Alaskans. But remember too, I actually agreed with the one instance (Azerbaijan) where Dr. Pedro van Meurs explicitly excluded Azerbaijan's 20% government participation because the government "paid its way" or was "straight up" as he said (also called "heads-up"). I provide the words of Dr. van Meurs on the subject below:

Azerbaijan

Azerbaijan represents a very important new oil development for the petroleum industry. Just as Alaska, Azerbaijan has to export its crude through long distance and costly pipeline systems and therefore the net back price for its crudes is relatively low. It is therefore an important country to compare with. Azerbaijan concludes its terms through production sharing agreements.

Azerbaijan terms. Azerbaijan does not have royalties. There is a 25% corporate income tax. Furthermore there is a production sharing arrangements. The cost oil limit is 50% for capital expenditures. Operating costs are not subject to the limit. The profit oil is based on an IRR based sliding scale which related to a real after tax IRR. This sliding scale is based on the pipeline transport costs. Higher transport costs result in a lower scale. It is assumed here that the transport costs are in excess of $ 4 per barrel. For these costs, the following scale of profit oil to government is being used:

Up to a real IRR of 16.75% - 20% profit oil to government
Up to a real IRR of 24.75% - 50% profit oil to government
Over a real IRR of 24.75% - 75% profit oil to government

<u>The national oil company SOCAR participates for 20% in the venture, but this is almost on a "straight up" basis and therefore this is participation is not included in the government take.</u>

There was a bonus of $ 120 million on the project. However, that bonus is excluded for analysis as explained in the beginning of this Chapter. A sequence of social expenditures was included.

Azerbaijan provides near absolute fiscal stability on its fiscal terms.

From: van Meurs 14 Feb., 2006 report "Proposal for a Profit Based Production Tax for Alaska" (Emphasis added)

So how is Alaska different than Azerbaijan in this regard?

- **Alaska actually pays more than its 20% share of costs for its 20% interest.**
- **Alaska takes on greater risk than other interest holders.**
- **Alaska is effectively giving up its royalty and severance tax for a 20% interest.**

Government participation analysis controversy

One of the more controversial aspects of fiscal system analysis is the treatment of the government participation or the back-in option. Some analysts believe it is not appropriate to view this element of a system as a rent extraction mechanism. The argument goes like this:

> **"Government take as a result of equity participation by government is really a government equity return, directly paid for by government, rather than a form of government take. Hence, comparing government take statistics by excluding government equity participation is probably a more accurate representation of levels of take."**

From: The above quote came from a 2003 World Bank report coauthored by Dr. van Meurs.

Typical LNG Project Government Take Existing Projects			
Country	**Project**	**Government Take** (No Participation)	**Government Take** (With Participation)
Abu Dhabi	**Das Island**	**45%**	**75%**
Australia	**All projects**	**35%**	**35%**
Brunei	**Lumut**	**50%**	**75%**
Indonesia	**Arun**	**54%**	**58%**
Malaysia	**Bintulu I, II**	**64%**	**80%**
Qatar	**Qatar Gas**	**32%**	**76%**
Qatar	**Ras Lafan**	**34%**	**80%**
	Average	**49%**	**68%**
Proposed Projects			
Indonesia	**Irian Jaya**	**49%**	**55%**
Indonesia	**Natuna**	**25%**	**41%**
Malaysia	**Bitulu III**	**64%**	**80%**
Oman	**Shell**	**20%**	**56%**
PNG	**Hides**	**28%**	**40%**
Russia	**Sakhalin II**	**38%**	**38%**
Vietnam	**Offshore**	**48%**	**48%**
Yemen	**Hunt**	**42%**	**63%**
	Average	**39%**	**53%**
Summarized from: Table 10-x of "Suggestions for New Terms for the Alaska North Slope LNG Project", Van Meurs & Associates, 1997 (Averages added)			

Using the same format for Alaska (Note unlike the above statistics, these are "real" i.e. discounted 3%) **(See the following tables)**			
Alaska	**Gas Pipeline**	**36%**	**51-52%**

Applying the same methodology to the Gas Pipeline Contract

Government Take @ $3.50/M ("real" i.e. discounted 3%)			
Country	**Project**	**Government Take** (No Participation)	**Government Take** (With Participation)
US + AK	**Gas Pipieline**	**36%**	**51%** (1)
Alaska only	**Gas Pipeline**	**1%**	**20 to 23%** (2)

(1) See Table 32. From FIF page 162 at $3.50/MMBTU
(2) See Tables 28 and 30. From FIF page 160 at $3.50/MMBTU

Government Take @ $7.50/M ("real" i.e. discounted 3%)			
Country	**Project**	**Government Take** (No Participation)	**Government Take** (With Participation)
US + AK	**Gas Pipieline**	**36%**	**52.2%** (1)
Alaska only	**Gas Pipeline**	**1%**	**22.5 to 23%** (2)

(1) See Table 32. From FIF page 162 at $7.50/MMBTU
(2) See Tables 28 and 30. From FIF page 160 at $7.50/MMBTU

Hypothetical discussion between the producers and the buyer of a 10% interest.

Buyer: So what does the 10% interest get us?

Producer: A 10% interest in 35 TCF gas = 3.5 TCF interest in a "World-class" investment opportunity

Buyer: What are our work commitments?

Producer: Actually not much unless the pipeline goes forward but if/when it does a 10% share of capital costs will be around $2 Billion or $2.6 Billion depending on whether or not we go to Gordondale or Chicago.

Buyer: How much of our working interest share of gas (3.5 TCF) can we book?

Producer: 100% of your equity share!

Buyer: Holy Cow! What kind of terms are there?

Producer: Government take is only 36% with no royalty and numerous incentives!!!

Buyer: How did you arrange that?

Producer: Instead of the normal Alaska royalty and severance taxes the state is now a 20% partner.

Buyer: So basically they gave up their royalty and severance tax and are going to pay 20% of the costs now for an equity position instead?

Producer: Yes and that ain't all, we have the terms "locked-in" for a very long time, essentially forever.

Buyer: How?

Producer: A couple of reasons: (first) we will be in a strong position to re-negotiate further certainty as we approach the end of the certainty period and (second) by that time there will not be much oil or gas left.

Is Alaska's bargaining position really so lame?

As Profits Surge, Oil Giants Find Hurdles Abroad

The New York Times - **World Business** - **By Jad Mouawad** - 6 May, 2006

"Paolo Scaroni, the chief executive of Eni, called it '*the paradox of plenty*.' International oil companies, he said during a conference in London earlier this year, '*are awash with enormous cash flows, but their opportunities to reinvest that cash are severely limited*.'"

National oil companies: Majors have tough job

The Financial Times. Monday, May 29th, 2006

By Carola Hoyos

Things would not be so bad for Exxon and its sisters if Latin America's fifth biggest oil producer were the only country favouring national oil companies. But more than 90 per cent of the world's oil reserves are off limits to the likes of Shell, BP and Exxon, a fact that record profits are unable to mask. The signs are writ large on balance sheets from London to Texas. Despite paying out $2bn a month to shareholders, Exxon has $32bn in cash and nowhere to spend it, while Shell is struggling to find reserves, managing only a 67 percent proved reserves replacement rate in 2005.

Alaska is Bending Over Backwards

Fairbanks Daily News-Miner
May 21, 2006

> To sweeten the pot, the administration put together an offer that guarantees the companies their tax liabilities won't increase and has the state shoulder some of the financial risk of building the immense metal straw needed to carry Alaska's gas to market.
>
> "We had to find a way to improve the rate of return on the project without lowering revenue to the state," said Pedro van Meurs, Murkowski's chief adviser on oil and gas. "That's how we decided on state participation."

Alaska's backbreaking efforts:

- **Taking the gas in-kind**
- **Taking an equity position**
- **Providing a credit of 35% for the GTP and other capital items**
- **Gross Revenue Exclusion (GRE) for gas**
- **Fiscal certainty for oil (30 years)**
- **Fiscal certainty for gas (45 years)**
- **Lack of true progressivity**
- **Negotiations based on assumed "low-prices"**

Taking the gas in-kind

Taking the gas in-kind sounds harmless enough and has a ring of virtue and advantage. However, it comes at a price as mentioned in the FIF.

> "Foregoing this option value will result in the State receiving about two percent less for its royalty gas sales under the fiscal contract than could be achieved under the 2005 fiscal system."
> (FIF pg 114 last paragraph)

> "In doing so, the state would give up the rights (1) to argue under the lease or production tax regulations that field and marketing costs are not deductible from certain leases' royalty or tax share, (2) that the state has the right to switch from taking cash to taking gas for royalty, and (3) that the state can take the 'higher-of' various measures of value when taking royalty or severance tax in cash. Also, in taking delivery of the gas, the state assumes ownership, title, financial responsibility, and risk of loss for its tax gas and royalty gas."
> (FIF pg 11 first paragraph)

(emphasis added)

Taking an equity position

The virtues of an equity position in many countries is rarely disputed. Many countries have an option to participate and they value this option. However, the countries around the world with an option to take an equity position (over half do) would hardly recognize the situation in Alaska. In order to obtain the 20% equity position essentially the state of Alaska relinquished its royalty and severance taxes. And this was only part of the price paid.

> **(This basically means that the state will pay-its-way on capital and operating costs for royalties and severance taxes that it otherwise would have received without payment.)**

35% credit for the GTP

> "The state loses marketing costs of the gas, the upstream cost allowance, and the state share of property taxes outside municipal boundaries along the pipeline right-of-way and provides the 35 percent PPT on the GTP and lateral lines. "
>
> (FIF pg 155 second paragraph)

SGDA guidelines regarding progressivity and back-end loading are not met.

The kind of fiscal certainty suggested by the oil companies and the Administration is unprecedented. It is too much. However, whatever degree of certainty is provided it must be accompanied and balanced by appropriately designed progressivity. Fiscal certainty goes hand-in-hand with progressivity.

For many years most countries had sliding scales of one sort or another but most of them simply did not account for a price shock like we are experiencing now. Alaska should make every effort to succeed in this effort because we will certainly be judged on this in the future. I can hardly imagine how we could face future generations if we cannot design a fair **progressive** system. It is not rocket science – it involves field-proven, off-the-shelf mechanisms such as "R factors" and such.

With the desire (demands) of the oil companies for "**fiscal certainty**" especially the *kind* of certainty they want it is unthinkable to have a system that is regressive, neutral, or even modestly progressive. This is the year 2006 and we have many years of experience that we should honor and utilize—we can't turn our back on past lessons and make the same mistakes.

It is not enough to have a system that is supposedly "progressive". The system should be ***adequately* progressive**. For example with a WTI oil price of $60/BBL the Government take should be *at least* five percentage points greater than it is at $20/BBL. Nothing that has been proposed so far has come close to this degree of progressivity. With the Gas Pipeline Contract as it is proposed Government take only increases by 1.2% (from 52% to 53.2%) when gas price goes from $3.50 to $7.50/MMBTU.

Oil Price Forecasts

Goldman: High Oil Prices may continue at least five more years

At 12th annual Executive Oil Conference in Midland, TX

Oil and Gas Investor, May, 2006

"Oil prices will be around $60 to $65 per barrel for the next five to 10 years, because not enough investment has been made in oil production and refining infrastructure, said David Greely."

Citigroup Global Oil Team Raises Oil Price

12 June, 2006

	1Q 06	2Q 06	3Q 06	4Q 06	04	05	06E	07E	08E	09E	10E
WTI	63.3	70.0	65.0	65.0	41.5	56.6	66.0	60.0	55.0	50.0	45.0
WTI old	63.3	59.0	57.0	60.0	41.5	56.6	60.0	53.5	48.0	45.0	40.0
WTI Chg (%)	0%	19%	14%	8%	0%	0%	10%	12%	15%	11%	13%
Brent	62.3	70.0	64.0	63.5	38.3	54.4	65.0	58.0	52.5	47.5	42.5
Brent-Old	62.0	56.5	54.5	57.5	38.3	54.4	57.5	51.0	45.5	42.5	37.5
Brent Chg (%)	1%	24%	17%	10%	0%	0%	13%	14%	15%	12%	13%

https://www.citigroupgeo.com/pdf/SZB183742.pdf

"In our second oil price upgrade of 2006, we have marked-to-market for 2Q06, and effectively pushed up our oil price forecasting curve by an average of 10% out to 2010, where our mid-cycle is raised to US$45 WTI (US$40 previously) and $42.5/bbl Brent ($37.5 previously)."

Citigroup Global Oil Team Raises Oil Price – 12 June, 2006

High Price Scenarios Deserve Greater Consideration

It does not matter whether or not we agree with forecasts like those summarized above. Neither does it matter that the Administration expects oil and gas prices to soften. What matters is that we design a contract that can be satisfactory under a wide range of prices. We have not done that yet.

Furthermore, the negotiations and rhetoric seem to have clearly focused on gas prices in the range of $3.50 - $5.50. I do not have a huge problem with that but we should make sure we design this system for $20/MCF environment despite how remote we may feel that may be. We have not quite managed the kind of progressivity with oil yet so I am very concerned that we will fail to get adequate progressivity for gas too.

I agree with Professor Doug Reynolds when he said:

> "Most experts believe the future price of oil and gas is $50 per barrel for oil and $5 per thousand cubic feet for gas. Few expect it to go much higher, and in fact many experts and companies, including ExxonMobil (1) place an extremely low probability of oil and gas prices going much higher. If that is the case, why is there so much resistance to have a progressive tax above those prices?"
>
> (1) see www.exxonmobil.com/Corporate/Files/Corporate/OpEd_peakoil.pdf
>
> "What elements should the gas contract contain? It should have a progressive oil profits tax rate that levies roughly 80 percent in government taxes for oil at prices above $100 per barrel. Starting at roughly $50, it should rise from its base rate. For natural gas, an additional profits tax should start at about $10 per thousand cubic feet and increase until the price is $20, where the effective government take should again be 80 percent. A low state equity share of 20 percent for natural gas less than $10 is OK to compensate for the risks."
>
> "Some may say that if we tax the oil and gas industry too heavily, we will ruin it. That is true when labor and capital are mobile, but oil and gas reserves are not mobile and the competition for alternatives to oil and gas is weak. Alaska is in a position to maximize its oil and gas wealth, and it is obligated to do so. A progressive tax on both oil and gas does this."
>
> **From:** Fairbanks Daily News-Miner Doug Reynolds, May 25, 2006

Internal Rate of Return Comparisons in the FIF — Something is wrong.

Comparison of Projects from IFC Energy report (2006) discussed in the FIF page 147.		
	IRR @ $20/BBL	IRR @ $20/BBL
Kashagan	34.6%	47.3%
Dalia	27.8%	42.3%
Gorgon	25.6%	40.7%
Agbami	21.9%	37.5%
Ormen Lange	21.7%	30.3%
Greater Plutonio	21.1%	31.8%
Rasgas III	18.5%	36.0%
Qatargas II	18.1%	27.7%
Qatargas III	16.9%	31.5%
Shah Deniz	13.8%	21.7%
Papa Terra	12.8%	25.9%
Kearl Lake	11.3%	22.3%
Syncrude 5	9.6%	20.0%
Syncrude 4	6.9%	14.8%
Athabasca Expansion	6.8%	15.8%

- **Discounting back to 2005 or 2006?**
- **Ignoring past costs?**
- **Ignoring downstream costs for LNG projects?**
- **Wrong, wrong, wrong.**

Peer Group from PFC Energy 19 April, 2006 report

PFC Energy		My Comments
Project	**Capex ($ MM)**	**From: Various public documents**
Kashagan	**24,015**	**Kazakhstan.** Discovered in 2000. Over $6 Billion spent before end of 2005. PFC Energy Capex numbers are simply wrong.
Athagasca Expansion	**12,598**	**Alberta.**
Qatargas II	**7,173**	**Qatar.** $12.8 B project. Expected15.6 MMT/yr of LNG around 2 BCFG/day. Announced Start of project in early 2005
Kearl Lake (oil sands)	**7,150**	**Alberta.** Initially proposed in 1997. $5-8 B Capex. First oil in 2009. 100 MBOPD capacity initially, then 200 MBOPD with 2nd train
Rasgas III	**7,073**	**Qatar.** Rasgas II started 2003-5?
Ormen Lange	**6,695**	**Norway.** Discovered in 1997. Approval 2004. Startup 2007. Reported reserves = 11-13 TCF. Capacity of 1.74 BCFD. Production/Reserve ratio = 5.7%. $10.8 B Capex according to one source, other source quotes $4.7-5.4 B.
Shah Deniz	**5,651**	**Azerbaijan.** 1996 PSC. Commerciality date 1999. Start-up in 2006 at 800 MMCFD to 1.5 BCFD. Rated at 2 times as large as Ormen Lange
Syncrude Stage 5	**5,594**	**Alberta**. 2011-2015 4th train
Gorgon	**4,571**	**Australia.** $11 B or $8.4 B Capex. Approval "in-principal" in 2003. First gas 2010
Greater Plutonio	**4,318**	**Angola.** 6 fields. Startup in 2004 at 50 MBOPD capacity increasing in 2007 to 250 MBOPD.
Agbami	**4,258**	**Nigeria.** Discovered in 1999. $3.5-4 B Capex. 1st Appraisal in 2000. Startup expected in 2007 at 200 MBOPD.
Syncrude Stage 4	**3,978**	**Alberta.** Commence 2006-2010. 3rd train at Aurora mine
Dalia	**3,846**	**Angola.** Discovered in 1997. $3.4 B Capex. Onstream in 2006 at 240 MBOPD capacity. Crude gravity = 21°-23° API
Qatargas III	**3,742**	**Qatar.** Startup 2008-9
Papa Terra	**3,524**	**Brazil.** Discovered in 2003. Reserves = 700 – 1,000 MMBBLS. 14°-17° API startup expected in 2011

What about Iranian Buy-backs?

In Iran "A total of $15 Billion in direct foreign investments have been made in buyback projects.

Payvand's Iran News 7/9/04

With some of the typical Buy-back contracts in Iran in the late 1990s IRRs could be as high as 19% but everything had to go "just right". These projects could yield as high as 19% and they certainly could yield lower rates of return if the contractor (oil company) spent more than budgeted capital costs. Later contracts that followed the early buy-backs have lower IRRs around 15%. Plenty of buy-backs have been signed in Iran by companies like those in Alaska. Under the buy-backs oil companies have no access to any "upside" at all. In Alaska they want it all.

The Profitability Indicator Analysis in the FIF needs fixing.

When the PFC Energy analysis is cleaned up and "fixed" all of the profitability indicators will improve dramatically in favor of Alaska.

- **IRR @ $20/BBL**
- **IRR @ $35/BBL**
- **NPV @ $20/BBL**
- **NPV @ $35/BBL**
- **PIR (10% @ $35/BBL)**
- **NPV/BOE @ $20/BBL**
- **NPV/BOE @ $35/BBL**

Contract Duration

From:
FIF page 117 Table 19, Duration of Production Sharing Contracts

Duration in Years	Number of Contracts
20 – 24	2
25 – 29	10
30 – 34	15
35 – 39	7
40 – 44	7
45 – 49	5

Source: van Meurs, 2005b

The average here is 34 years.

Examples of Contract Duration Worldwide

Province/Block	Exploration Years		Production Years
Abu Dhabi	3 + 2 + 2		33
Ajman	2 + 2 + 2		35
Albania	2 + 3 + 1.5		24
Algeria	5 + 2		15 - 30
Algeria	5 + 2		20 - 25
Australia	6 + 5		42
Beliz	8		25
Benin	2 + 2 + 2		25 + 10
Bolivia			30 Max
Brunei	8		38 + 30
Brunei Offshore	17		40 + 30
Cambodia	3 + 2 + 1		22
Congo Br.	4 + 3 + 3		30
Congo Br.	10		30
Cote d'Ivoire	2 + 2 + 2		25
Czech Rep.	4 + 4		20
Dubai	3 + 2 + 3		35
Ecuador	4 + 2		22
Egypt	8		20
France	5 + 5 + 5		5 + 5 + 5
Gabon Deepwater	5 + 3		10 + 5 + 5
Gabon	3 + 2 + 2		25
Ghana	7		18 (25 Total)
Guyana	4 + 3 + 3		25 + 5
Honduras	4 + 2		20 + 5
Hungary	2 + 2 + 1		25
India	3 + 2 + 2		25 + 5
Indonesia	3		20
Liberia	3 + 3		25 + 10
Madagascar	8		15 + 5
Malaysia	3 + 2	2 + 2 Dev	15
Malaysia R/C	5		29 Total
Netherlands	10		40
Nigeria	3 + 3 + 4		20
Oman	2 + 2 + 2		20 + 10
Peru	7		30
Poland	3 + 3		20 + 5 + 5
Rep. of Guinea	5		21 (Maz 25)
Senegal	3 + 2 + 2		25 + 10
South Africa	4 + 3 + 3		as long as is profitable
Syria	3 + 2 + 1		20 + 10
Vietnam	3 + 1 + 1		20 (total not to exceed 25)
Zambia	8		25
Average/Typical	3 + 2.5 + 2 (7.5)		25

The average here for both the exploration and development phase is 32.5 years.

Beware — There is a Trap with the Certainty Provisions

The proposed 30-year lock on oil taxes creates a trap for AK. I have experienced this kind of situation before.

Imagine if Alaska provides the kind of certainty for oil and gas demanded by the oil companies (30 and 45 years respectively). Here is how it will go down. In 25 years the oil companies will approach the state of Alaska and say: "We cannot justify further investment at this time due to the uncertainty of what will happen to taxes in 5 years. We can't afford to make further investments now in either oil or gas without knowing what to expect in 5 years when the certainty period for oil ends."

This by-the-way is roughly the same logic being applied today. This is also exactly the kind of bargaining position Indonesia found itself in in the early 1990s when their first two production sharing contracts (Northwest Java and Southeast Sumatra) were approaching expiration and Indonesia would have had the right to take over. Companies were in a powerful position to exact concessions from the government of Indonesia because Indonesia did not want to see exploration and development activity wither during the final years of those contracts. This same issue strongly influenced treatment of ExxonMobil's Cepu discovery in Indonesia recently. The discovery came towards the end of the contract period.

So around 5-6 years before the end of the 30-year period for oil the companies are going to start threatening to wind down or shut down their investment activities unless Alaska is willing to provide further guarantees or extend the contract or something equivalent. The argument is simple: "Why should we risk further investment in the next 5 years with the chance that there may be big changes following the end of the "certainty period".

The bottom line is this: It is not realistic to assume that a 30-year certainty provision for oil taxes will be as simple as it sounds on first blush. Same is true for the certainty for gas.

Is the Gas Pipeline Contract a lawyer's dream?

- **Yes**
- **Oil Company Lawyers in particular are advantaged**
- **New dispute resolution provisions favor the Oil Companies**
- **Arbitration is not necessarily cheaper than litigation**
- **With arbitration is there a difference regarding disclosure?** We should discuss this.

Consultant offered different positions on 30-year oil tax freeze

Fairbanks Daily News–Miner **Highlights added by DJ (Now) vs (Then)**

Friday, May 26, 2006 - OIL FREEZE: One of the Murkowski administration's oil and gas consultants, Pedro van Meurs, spoke to legislators last week about how the governor's plan to lock in oil taxes for 30 years is necessary to wrap up a gas line deal.

The producers "consider it an absolute deal-breaker" if this provision is not in the gas line contract, van Meurs said.

The reason they want it, he said, is that once the immense investment to build a gas pipeline has been made, the project will be generating large profits. And seeing those profits, Alaska lawmakers will want a bigger percentage for the state, the companies believe.

If lawmakers can't raise gas revenues because they are frozen as part of the Stranded Gas Act agreement, the Legislature will raise oil taxes instead, the companies believe.

"And that is a plausible scenario, particularly if you look at the enormous net present values that will be generated over time as we go forward," van Meurs said.

"It is for this reason that the producers consider it an absolute deal-breaker unless there was fiscal certainty for oil, because they could see the writing on the wall," he said.

The consultant said a 30-year freeze on oil taxes would encourage exploration and it is a "reasonable period."

The argument by van Meurs on extending "fiscal certainty" to oil taxes is weakened and open to question, however, because he took a contradictory position a year ago in advice he gave to the state.

In a memo on July 19, 2005, he said the oil companies were proposing "fiscal stability on oil that cannot be part of the contract."

In that document, recently posted on the state Web site, van Meurs referred to a comment by an oil industry representative that "all international petroleum arrangements provide fiscal stability for oil and gas."

"It is my view that this is very much overstating the case of international fiscal stability," he wrote in the memo. "To begin with, the vast majority of the worldwide production of ExxonMobil, BP and ConocoPhillips is not subject (to) any fiscal stability.

"Producers want fiscal stability on oil, which is currently already in production and on which no fiscal stability was granted when the oil was developed. In other words, the producers want 'retroactive' fiscal stability on oil that is external to the contract," he said.

"I do not know of a single international case where fiscal stability was granted to petroleum that was external to the contract," he said.

He added that the fiscal stability offered the producers on natural gas was more favorable to the companies than many such arrangements around the world.

"Internationally, one finds that many production sharing and concession contracts exclude fiscal stability for certain taxes, usually corporate income tax. Such contracts, therefore, offer a level of fiscal stability that is of a 'lower quality' than Alaska has already offered,"

he said.

Murkowski administration officials acknowledge that the consultant has offered conflicting positions on the issue of locking in oil taxes.

They say that the state's position has evolved over the past year, as is natural in any negotiation. The oil companies wanted a freeze on oil taxes with the current tax system, but the administration refused to go along, said Jim Clark, the governor's chief of staff.

The governor responded with the proposed net profits tax that has consumed the Legislature's attention for most of this year.

Last Tuesday, responding to a question from a legislator, van Meurs did say that no other nation has offered fiscal stability on existing production in a contract. He said this is a "unique feature" to Alaska.

The unique 30-year oil freeze, which wouldn't be much more popular if it shrinks to a 20-year freeze, is one of the biggest obstacles to legislative approval of the gas line contract.

Dermot Cole can be reached at cole@newsminer.com or 459-7530

Cost of Capital

US Federal Funds Rate (Nov., 2004)	**2.0%**
1-year Libor Rate (Nov., 2004)	**2.8%**
US Federal Funds Rate (Nov., 2005)	**4.0%**
US Treasuries (2005 – 10-year)	**4.5%**
1-year Libor Rate (Nov., 2005)	**4.6%**
US Market After-tax Cost of Debt (2005)	**4.8%**
US Treasuries (2001 – 10-year)	**5.1%**
US Mortgage Rates (30 year fixed-4th Q 2005)	**5.2-5.9%**
Corporate Bond Yields (2005)	**7%**
Oil Industry Cost of Capital (2005)	**7-8%**
US Utility Rates of Return (WACC 2005)	**8-9%**
US Oil Exploration (1999)	**9%**
US Market Cost of Equity (2005)	**9%**
Junk Bond Yields (2000)	**10%**
US Stock Market ROR (1924-2004)	**10.4%**
Junk Bond *Fund* Yields (2001)	**10.6%**
Junk Bond Yields (2001)	**12%**
US Utility Return on Equity (ROE 2005)	**10-13%**
Iranian Buy-back (2003+)	**15%**
Iranian Buy-back (1998 – 2002)	**16-19%**

Remember: Cost of equity (which is a huge part of cost of capital factors-in some risk already with the wide use of "beta". The capital asset pricing model (CAPM) for determining cost of equity capital is a function of "beta" which includes an element of risk.

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DOUG REYNOLDS Thursday, May 25, 2006

The real constitutional problem is that the contract grants a roughly 20 percent royalty and severance equity share to the state for natural gas with no possibility for an additional production tax. What we must demand is an additional production profits tax for natural gas and a PPT base rate for oil that is progressive when natural gas and oil prices change. As long as these elements are missing, the contract can never "maximize benefits" to Alaska citizens; therefore, the contract is unconstitutional.

Most experts believe the future price of oil and gas is $50 per barrel for oil and $5 per thousand cubic feet for gas. Few expect it to go much higher, and in fact many experts and companies, including Exxon Mobil (see www.exxonmobil.com/Corporate/Files/Corporate/OpEd_peakoil.pdf). place an extremely low probability of oil and gas prices going much higher. If that is the case, why is there so much resistance to have a progressive tax above those prices? In my books, I explain exactly why oil and gas will be extremely valuable and high priced for many years to come. I think the state should prepare for that contingency, because without it we are giving away our oil and gas.

What elements should the gas contract contain? It should have a progressive oil profits tax rate that levies roughly 80 percent in government taxes for oil at prices above $100 per barrel. Starting at roughly $50, it should rise from its base rate. For natural gas, an additional profits tax should start at about $10 per thousand cubic feet and increase until the price is $20, where the effective government take should again be 80 percent. A low state equity share of 20 percent for natural gas less than $10 is OK to compensate for the risks.

Some may say that if we tax the oil and gas industry too heavily, we will ruin it. That is true when labor and capital are mobile, but oil and gas reserves are not mobile and the competition for alternatives to oil and gas is weak. Alaska is in a position to maximize its oil and gas wealth, and it is obligated to do so. A progressive tax on both oil and gas does this.

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