State of Alaska

Department of Revenue

Commissioner's Office

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Honorable Senator Therriault
3340 Badger Rd Ste 290
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Dear Senator Therriault:

Representative Samuels forwarded me your August 30th letter requesting the department to address some of your questions. As you stated in your letter, the revenue generated under PPT was significantly less than projected. While several factors contributed to this disparity, it was in large part due to the outdated nature of the cost data available during the 24th Legislature PPT debate.

Much of the work to ascertain oil production costs on the North Slope was completed in the summer and fall of 2005. The department reviewed joint interest partnership returns, annual financial reports, and confidential information provided by the taxpayers, the majority of which detailed cost levels in the most recent year at the time – 2004. Final cost estimates were prepared in January 2006, and were incorporated into the department's economic models. These models were used to evaluate and forecast production tax revenues for the many different Legislative committee versions of the PPT.

The rapid escalation of costs experienced since 2004 are attributable in large part to the increased global competition for energy, material and skilled labor. Several reports and articles have detailed the substantial cost overruns experienced on oil and gas projects around the world - some of which have exceeded 100%. For example, development of the Gassi Touil gas field in Algeria has been delayed due to costs rising from $2.9 billion in 2004 to $6.8 billion in 2007; likewise, development of the Kashagan oil field in Kazakhstan has seen substantial increases in costs, with estimates rising from $57 billion to $136 billion, and first oil production has been pushed back from 2008 to 2010. The government of Kazakhstan is seeking compensation from the consortium of oil companies under the contract for the delays. While we believe this phenomenon has also affected the North Slope, other factors have played a role as well.

Multi-year contracts negotiated by North Slope producers in late 2005 and 2006 were at substantially higher prices than earlier agreements. The prior lower priced contracts were negotiated at a time when producers believed that oil prices would fall, and that belief suppressed the pricing of contractors who knew that work would only materialize if the oil and gas projects could be shown to be profitable at approximately $20 barrel oil. Once the oil industry determined that higher oil prices were in fact supportable in the future, they increased their price assumptions for new projects, and the suppression of oil service sectors' costs was reduced. We anticipate costs to rise slightly more before leveling off after the coming fiscal year, as additional North Slope multi-year contracts expire and are re-negotiated in 2007 and 2008.

Deductions associated with the North Slope corrosion response and cleanup also contributed to the inaccurate cost forecasts. However, we do not know the extent of this contribution because producers do not provide detailed information to the DOR or DNR, and no audits have yet taken place. We have seen published estimates that BP plans to spend $500 million over several years on "integrity management," and these reports suggest that the costs related to pipeline corrosion would fall into this category. It is quite possible that this spending could be causing a "spike" in the cost of doing business in Alaska as compared to the cost of producing oil and gas elsewhere.

Since PPT does not require industry to supply detailed information relating to past or future cost expectations, it is difficult for the department to determine what level of cost increase is due to unit prices on current investments, and what is due to increased investment activity. This is one of the primary reasons ACES seeks to collect cost information commensurate with other net taxing jurisdictions. This would require producers to share with the state the same real time and forward-looking cost information that they currently share with other joint-interest partners.

We are unable to satisfy your request for additional cost analysis by Econ One as they are currently under contract with the legislature. While this conflict prevents the administration from conducting such a study, information on an aggregated North Slope basis is available to the Legislature and to consultants to the Legislature. If the Legislature would like Econ One to review our analysis, we are happy to cooperate within the confidentiality guidelines imposed by state law.

I have included with this memo two analyses conducted by the Department of Revenue comparing the capital and operating expense estimates used during the PPT debates. They detail unaudited capital and operating expense information as submitted by taxpayers with annual and monthly production tax returns. I hope this information is helpful to you. Should you require any additional clarification please do not hesitate to contact me.

Sincerely,

Marcia Davis

Marcia Davis, *Deputy Commissioner*
Department of Revenue