Proposed revisions to the PPT

October 18, 2007

Presentation to

The Alaska Legislature

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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.

Current System

Table 5.26. WEST SAK

Undiscounted Government Take (Income only)

WTI	WTI	Gas Price	Heavy oil price							
US $	Can $	Can $	Can $	COST-7	COST-6	COST-5	COST-4	COST-3	COST-2	COST-1
20	22.73	$1.89	$14.35							60.38%
30	34.09	$2.84	$24.32			60.22%	59.56%	59.31%	59.27%	59.19%
40	45.45	$3.79	$34.28	59.68%	59.60%	59.54%	59.49%	59.45%	59.21%	59.09%
50	56.82	$4.73	$44.25	59.81%	59.81%	59.83%	59.72%	59.62%	59.66%	59.77%
60	68.18	$5.68	$54.22	60.66%	60.66%	60.64%	60.69%	60.83%	60.98%	61.09%
70	79.55	$6.63	$64.18	61.83%	61.87%	62.02%	62.18%	62.34%	62.45%	62.53%
80	90.91	$7.58	$74.15	63.24%	63.39%	63.53%	63.68%	63.80%	63.88%	64.02%
90	102.27	$8.52	$84.11	64.74%	64.88%	65.02%	65.15%	65.24%	65.36%	65.53%
100	113.64	$9.47	$94.08	66.21%	66.35%	66.50%	66.59%	66.70%	66.86%	67.04%

Current System

Table 5.27. WEST SAK

5% Discounted Government Take (Income only)

WTI	WTI	Gas Price	Heavy oil price							
US $	**Can $**	**Can $**	**Can $**	**COST-7**	**COST-6**	**COST-5**	**COST-4**	**COST-3**	**COST-2**	**COST-1**
20	**22.73**	**$1.89**	**$14.35**							64.33%
30	**34.09**	**$2.84**	**$24.32**			69.77%	63.56%	61.41%	60.49%	59.82%
40	**45.45**	**$3.79**	**$34.28**	64.13%	62.57%	61.60%	60.94%	60.45%	59.75%	59.31%
50	**56.82**	**$4.73**	**$44.25**	61.80%	61.32%	60.95%	60.44%	60.00%	59.82%	59.76%
60	**68.18**	**$5.68**	**$54.22**	61.83%	61.48%	61.15%	60.96%	60.95%	60.96%	60.91%
70	**79.55**	**$6.63**	**$64.18**	62.50%	62.28%	62.29%	62.31%	62.35%	62.32%	62.25%
80	**90.91**	**$7.58**	**$74.15**	63.65%	63.66%	63.68%	63.71%	63.70%	63.63%	63.66%
90	**102.27**	**$8.52**	**$84.11**	65.01%	65.02%	65.05%	65.06%	65.02%	65.03%	65.12%
100	**113.64**	**$9.47**	**$94.08**	66.35%	66.38%	66.43%	66.39%	66.39%	66.47%	66.58%

Current System

The current system is designed to be sensitive to costs and thereby make the investment in heavy oil developments attractive.

The current system was is also designed to be price progressive.

Current System

The PPT credits encourage investments by new investors in new oil and gas exploration and development and to encourage re-investment by existing companies. The PPT is therefore a consolidated system.

The main goal is to reduce the decline of oil production.

Transparency

The transparency provisions related to cost projections, publication of data, short term audits and an exempt class for auditors seem good provisions.

They should be strongly supported.

These changes can be implemented now.

PPT amendments

In case the Alaska Legislature decides that it wants to change the PPT anyway, I would advise basing such amendments on my earlier recommendations contained in the reports of:

-- February 14, 2006

-- March 5, 2006 and

-- May 1, 2006

PPT Amendments

In my February 14, 2006 report I recommended a 25% PPT rate.

Since, this recommendation was made government takes have increased in the US GOM and Ireland and several developing countries. Alberta will also increase government take as a result of the royalty review.

I therefore reconfirm this recommendation

PPT Amendments

In my February 14, 2006 report I did **not** recommend the so-called clawback provision. Internally, I advised strongly against this provision. It does not make sense to reward a company for past investments.

Therefore deleting the Transitional Investment Expenditures credits is a good step.

PPT Amendments

In my March 5, 2006 report (which was written after the 20/20 concept had been decided by the Governor) I recommended:

- A price progressive Basic Production Tax based on the gross value of production **in addition to** the PPT.
- The price progressive Basic Production Tax would be deductible from the PPT.

PPT Amendments

The price progressive Basic Production Tax was based on the following formula:

BPT rate = (WTI - 50) x 0.25%

At the current price of $ 84 per barrel WTI this would be equal to 8.5% on the gross value of oil at the production point.

PPT Amendments

I believe that price progressive features based on the gross value of the production are more effective than features based on net.

I recently recommended a similar severance tax to the Alberta royalty review panel and this recommendation was accepted. The Alberta Government is now considering these recommendations.

PPT Amendments

The current progressive feature in the PPT law based on the net value is an ineffective mechanism. It is highly unpredictable and subject to cost verification difficulties. Bringing the price down from $40 to $ 30 is a relatively weak measure. I do not recommend this.

PPT Amendments

I therefore reconfirm my recommendation for a price progressive feature based on gross in addition to the 25% PPT Rate.

However, such a feature would need to have a modifier in the formula in order to soften the impact on heavy oils.

PPT Amendments

The May 1, 2006 report recommended the Gross Revenue Exclusion (“GRE”) for pipeline gas (not for condensates and liquids) of 64% of the gross value of the prior to the application of the PPT for gas other than from Cook Inlet.

Gas that needs to be transported over long distances has very different economics than oil.

PPT Amendments

Most jurisdictions that need to export gas over large distances have a government take that is lower for gas than for oil. If Alaska wants to compete with a gas project internationally, it has to start with a reasonable fiscal system for gas.

I therefore reconfirm my GRE recommendations.

Failure to forecast cost increases

Much discussion took place about the so-called failure to forecast cost increases. In this respect I like to emphasize that I provided the Legislature ample and precise warning about cost increases. The following three slides are repeat slides of my presentations in 2006.

May 10, 2006 slide: Alaska Gas Project

Cost overrun risks

The economic evaluations are based on a $ 21 billion project as originally presented.

However, cost have already escalated significantly, in particular steel prices and regional escalation in Alberta.

May 10 slide: Alaska Gas Project

Huge risks

The combination of gas price risk and cost overrun risk creates a possibility that the project may not be built over the next decade even with a stranded gas contract.

June 15 slide: Risk Assessment: Summary

In summary the view of EconOne is:

50% cost overrun – very low probability
FIF low gas price – very low probability
Project uneconomic – very low probability

My view is:

50% cost overrun – very likely
FIF low gas price - fair probability
Project uneconomic – fair probability

Failure to forecast cost increases

Despite the fact that I predicted strong cost increases generally and internationally, there was no evidence in early 2006 of strong local inflationary pressures on the North Slope (as compared to Alberta, for instance).

Failure to forecast cost increases

Therefore, I believe that it is imperative to carry out sound audits prior to reaching any conclusions on whether costs were significantly under estimated or not.

It might very well be that companies over-declared their costs for their first PPT declarations and that after proper audits the revenues to Alaska will be revised upward.

Failure to forecast cost increases

I am concerned about the fact that the earlier PPT law weakened the level of interest for late payments in 43.55.020(g). The current bill maintains this.

So this is an added incentive to over declare costs.

10% floor on large fields

The PPT is designed as a consolidated tax. Only in this way, does the tax promote the re-investment in Alaska.

The 10% floor on large fields turn the PPT into a tax that is essentially ring-fenced for the large fields. This is an administrative nightmare as is evidenced by the amendment of 43.55.165 (h) and it also removes the benefits of promoting re-investment in Alaska by the large corporations.

This makes no sense. I would strongly recommend not to apply this provision.

tax credits over two years

This is a silly an unnecessary provision.

The policy is to encourage new oil and gas developments on the North Slope. There is no change in overall government revenues over time, if credits are allowed over two years rather than one. However, it is a much stronger incentive to give the credits in the year the investments are incurred.

I would strongly recommend not to apply this provision.

“corrosion” issue

This is great politics, but difficult administration. Essentially, the PPT tax collectors would be placed in a constant battle to determine these costs.

The corrosion issue was already fixed in the PPT law by making the first $ 0.30 per BOE capital costs non-deductible. This was in lieu of the corrosion costs. This is easy to administer. If this overall figure seems too low, than this figure can be changed. Also an amount for non-deductible operating costs can be added.

Extra incentives for exploration

Beyond the 20% capital investment credit, there is in my view no need for further incentives in exploration.

“Joint Administration”

The Bill provides for more exchange of information between DNR and DOR.   This is good.

However, the bill seems to implement some type of joint administration by DNR and DOR of the PPT.   This is unnecessary and very confusing and will lead to bottlenecks.