

**Comments On SB 305 and HB 488 Oil and Gas Production Tax**  
**By Ken Thompson, Managing Director of AVCG/Brooks Range Petroleum**

Personal Background

For the record, my name is Ken Thompson. I reside at 12031 Lilac Drive, Anchorage, Alaska. I am the Managing Director of Alaska Venture Capital Group, or AVCG LLC, an independent oil exploration company with a focus on the North Slope of Alaska. AVCG is a consortium of 15 independent oil and gas companies and individuals from Kansas and me as an owner/investor from Alaska. AVCG has a technical and operational services' subsidiary company called Brooks Range Petroleum, with offices in Anchorage.

AVCG LLC has been very active in the past six North Slope areawide lease sales and we have acquired over 160,000 acres of exploration leases in five exploration prospect areas, including new acreage we acquired earlier this morning in the NS lease sale. Our exploration strategy is to explore in the central part of the North Slope for fields in the 25-100+ million barrels range, fields that may be too small for the giant producers but fields that can be produced profitably by smaller companies like ours. We believe there are hundreds of millions if not billions of barrels of oil left on the North Slope in smaller fields of this size.

Our company is excited to report that the first exploration well AVCG will participate in with an ownership interest should have started drilling last night...the Cronus exploration well about 10 miles southwest of the Kuparuk Field, operated by Pioneer Natural Resources. We plan two exploration wells next winter and two the winter after that. With success, we will continue exploring and producing.

My comments today represent the perspectives of a small, independent exploration company. Having said this, many of you also know me as the past President of ARCO Alaska, Inc. I also served as Executive Vice-President for ARCO and head of global oil and gas exploration for ARCO. I do have exploration and production experience in over 20 countries throughout the world, so I'll also share my perspective in how I see the new production profits tax bill in the context of competitiveness in the world.

Introduction

- In my first week as President of ARCO Alaska in June, 1994, our ARCO staff reviewed state policies with me to educate me about the oil and gas industry in Alaska. One of the items they reviewed with me was the production tax and the complicated policy of ELF. Our government affairs personnel told me that ELF was in jeopardy...that the production property tax was going to be changed. That did produce uncertainty in our project economics forecast. Every year since then, production taxes and the ELF have been topics...and uncertainty remains. Sixteen years have passed since that meeting, and every year, I hear discussion about production taxes, ELF, and the imminent

threat of change. I welcome change and I say, "It's time to put the new system into effect and let's get on with it."

- Our company, AVCG, supports the proposed production tax changes provided the most important terms remain as written.
- Alaska has long been challenged to be competitive with fiscal regimes in other countries that offer competing projects; as an Alaskan, I'm excited to see the State ensure that our State's new oil tax regime is more like that in other countries...a progressive, profit sharing type structure versus a regressive, straight tax on gross revenues.
- The State will "share the gain" at high oil prices, but will likewise "share the pain" at lower oil prices...this helps small investors like AVCG/Brooks Range Petroleum limit our downside risk in the event of price collapse. And we think it is fair to share our upside profits with the State at a 20% tax rate; the State owns the land and the oil...we realize that we only lease it and we do have implied covenants to be fair with the State.
- At this point, I would like to answer three questions from my perspective: 1) Is this new production tax good or bad for industry; 2) what three things should not be changed; and 3) what three things should be changed?

#### Is This New Production Tax Proposal Good Or Bad For Industry?

- Both...for a small explorer startup company like AVCG LLC with about 160,000 acres under lease for oil exploration on the North Slope, the exploration economics with the proposal are favorable with an improvement in the rate of return. Near-term cash flow because of the investment tax credits is higher which improves the return on investment. But cash flow is lower a few years after new production startup as the State shares a higher share of the profits than what it currently does. We think the State taking 20% of the upside profits is fair, and we recommend the tax rate stay at 20%...the old 80/20 rule has proven to be a good one over time. Keep in mind the State will also still receive a 12.5-16.67% royalty share of all oil and gas revenues on State leases, oil and gas property taxes, corporate income taxes, and other revenues, in addition to the production profits tax.
- A key part of the bill is the investment tax credit, and AVCG plans to use that...our only area of exploration investment is Alaska and we do plan to return a large share of our future production cash flow back into exploration and development only in this state so we can grow to a sizeable company...the tax credit creates a clear incentive for us to do that rather than take the money outside.
- For a large major producer who is planning to make large capital investments on the oil side or in the gas pipeline, the bill could possibly be favorable for them as well when all is said and done.
- For any producer – large or small - who is not planning to make large capital investments but plans to send cash flow outside without a high re-investment plan in Alaska, this bill is likely not good for that type of company in Alaska.

#### What three things should not be changed?

- I "panicked" when I saw the profit tax reported at 25%...this takes too large a chunk of positive cash flow away from small companies - or really companies of any size - and our company sees this as cash flow that could be re-invested into new exploration prospects and new oil leases. I started warming up to the bill only when the tax rate was changed to 20%...then the AVCG economics started showing sufficient improvement in capital investment rates of return for us to attract new capital from partners or investors. When the tax rate changed from 25% to 20%, I crossed over from opposition to support of this proposal.
- It is essential to keep the 20% investment tax credit. This will help us in attracting new capital from AVCG partners or equity investors for new exploration and development. With a tax credit of 20% and re-deployment of the tax savings back into our exploration in the State, we can essentially drill an extra exploration well for each five exploration wells we currently have budgeted.
- It is essential to keep the \$73,000,000/year operating cash flow "standard tax deduction" before production taxes are paid, at least for smaller producers. At a \$40/bbl oil price, this equates as a production tax exemption for the first 5,000 net barrels per day to encourage new producers. As our company is risking a lot of money currently with no revenues whatsoever and with our first revenues to possibly occur only 3-4 years from now, I cannot emphasize how important having such an exemption is while we get our feet on the ground to eventual financial strength. Having said this, I do suggest, however, that this "pill might be easier swallowed" if the exemption were simply changed to read "there is an exemption for the first 5,000 net barrels of oil per day;" this certainly sounds better to the general public and is much easier to understand than saying, "there is an exemption for the first \$73,000,000 of profits." This also implies that for larger companies, with say 300,000 barrels of oil production currently on the North Slope, they only get an exemption for the first 5,000 barrels per day...they still have to pay production profits tax on the other 295,000 barrels per day.

What three things should be changed in the bill?

- The bill allows for the investment tax credits to be sold to others in industry if a new explorer – like AVCG - does not yet have oil production revenues to use the credits. While this sounds good, in practical application these credits can only be sold to a few buyers...basically the major three oil producers who will literally set the market for these credits and the value they will receive when sold. With limited buyers, our company estimates the credits might be sold at only 70-75% on the dollar. This disadvantages new explorers...the majors get 100% of their credits while the new explorer must sell at 70-75% of value only to then see the major producers take 100% of the acquired tax credit against their production tax bill. It is suggested that the State consider establishing a pool of dollars from the production profits taxes taken in to buy the tax credits from small explorers. This makes sense...the State would not be giving up anything because the major producers would otherwise use the credits to reduce their tax bill and reduce revenue to the State....but using this approach,

the small explorer could turn around and re-invest the State-refunded credit into new leases, seismic or exploration drilling. In fact, the State might want to stipulate that if the State refunded the tax credits to a company, that company must use it for exploration or development. Our company would support such a concept. Explorers who don't want to do this option and re-invest in the State but just want the cash value of the credit could sell to the majors at 70-75% if they prefer that option.

- The section in the bill on "determination of net value of oil and gas" listed direct costs that could be deducted from gross oil revenues to calculate a profit, or "net value of oil and gas" to then be taxed at the 20% tax rate. For a new explorer in Alaska, the startup costs in the State can be very substantial, particularly for smaller players. This can include high costs for bonding, participation in the oil spill consortium Alaska Clean Seas, indemnification insurance, etc. These types of costs should be clearly mentioned in the bill as deductible.
- Again, we hope the \$73,000,000 "standard tax deduction" remains. But I certainly have seen that this item is a "hot button" to certain legislators. But I urge you that while you may be angry with certain large producers, please do not lose sight of how important this could be to a startup company like ours trying to establish a foothold in Alaska and someday contribute substantial oil revenues to the State. As an alternative, however, to the \$73,000,000 profits exemption, we offer that the State might choose to use an approach that the State has already approved in the 1999 "Charter for Development of the Alaskan North Slope" between the State of Alaska, BP and ARCO. In that charter, there was a section entitled "Purchases From Qualified Producers" that guaranteed that BP and ARCO (now ConocoPhillips) would agree to offer to purchase any "qualified producer's" crude oil so that new entrants or small producers would not be disadvantaged in marketing their oil. In that section there was a clear definition of a protected "small producer"...actually, the Charter called such a company a "qualified producer." I quote from the Charter: a "qualified producer" means an entity with assets of less than \$1 billion (worldwide) which produces not more than 10,000 barrels of gross working interest ANS liquid hydrocarbons per day." Again, we hope the deduction provision remains in the bill. If there is opposition in the end, AVCG does hope the small companies are protected in some way; perhaps an innovation such as using the Charter guidelines may help.

That concludes my remarks. I tried to share the perspective of an independent exploration company that only invests in Alaska. I have shared the three things our company would not change in this bill and the three things we would change. All in all, I am optimistic that this bill with some tweaking could help AVCG/Brooks Range Petroleum attract new partners and new capital to Alaska, increase our exploration budget, and establish us as an important oil producer someday.

Thank you for this opportunity to make comments.

Ken Thompson