

March 1, 2006

Senator Tom Wagoner and other members of the Senate Resources Committee

Thank you for the opportunity to share Pioneer's views regarding SB 305 eliminating the current severance tax system and replacing it with a Profit Sharing Production Tax.

Pioneer began its investment in Alaska in early 2003 with the drilling of 3 exploration wells in the shallow waters of the Beaufort Sea. Pioneer significantly expanded its Alaskan inventory at the October 2003 Alaska State Lease Sale where it was the largest participant and successful bidder on approximately 150,000 acres. We opened an office in Anchorage in early 2004 and now employ 26 persons in Alaska. In 2004, Pioneer concluded exploration agreements with ConocoPhillips and Anadarko across a vast portion of NPR-A. In 2005, Pioneer acquired a 10 percent working interest and the option to acquire up to an additional 40 percent working interest and possibly succeed ConocoPhillips as the operator of the Cosmopolitan Unit located in the Cook Inlet. Pioneer has significantly invested in the state and has assembled a substantial portfolio with an interest in approximately 1.6 million acres of leasehold.

On February 6, 2006, Pioneer announced that it approved and is commencing the development of the Ooguruk field on the North Slope of Alaska. Pioneer is the operator of the field, which is in the shallow waters of the Beaufort Sea approximately eight miles northwest of the Kuparuk River Unit. Pioneer has commenced operations to install an offshore gravel drilling and production site and we expect to complete gravel hauling activities by the end of winter. Following construction of the gravel drilling and production, a subsea flowline and facilities will be installed during 2007 to carry produced three-phase liquids to existing onshore processing facilities at the Kuparuk River Unit. Pioneer plans to drill approximately 40 horizontal wells to develop 50 million to 90 million barrels of estimated gross oil resources. Total gross capital to be invested in drilling and facilities is expected to range from \$450 million to \$525 million. The wells are expected to be brought on production as drilling progresses, with peak

rates of approximately 15,000 to 20,000 barrels of oil per day expected by 2010.

For independent companies like Pioneer, the challenges to building a business in Alaska are formidable. The remaining North Slope resources are nothing like the billion barrel fields that opened the Slope. The new wave of developers are working to commercialize: a) smaller, lower quality oil reservoirs, b) viscous oil resources, c) remote resources in NPRA, the foothills and offshore and d) natural gas resources, which will not have a market until the next decade. All of these resources are challenging to commercialize, but it is a challenge that must be met to insure new sources of supply for the state.

The North Slope is one of the highest cost areas in the world. Remote geography translates to some of the highest capital, lease operating and product transportation costs in the world. Additionally, North Slope projects have comparatively long cycles times. From buying a lease to selling oil takes 5 to 10 years depending upon drilling success and distance to existing infrastructure.

The largest challenge independents face on the North Slope is arguably uncertainty. To be successful, we must properly assess and make provision for a number of uncertainties related to exploration risk, future oil and gas prices, fiscal policy, regulatory processes and access to infrastructure.

The long cycle times for Alaska projects require that we make our investment decisions based upon a long term price projection. Although current prices exceed \$50 per barrel, the 10 year average price for North Slope crude is approximately \$25 per barrel. For Pioneer's Alaska projects, the price of oil in 2006 is irrelevant. The prevailing price in the next two decades will determine future cash flow for new projects.

Accurate assessment of risk is critical to the success of an exploration portfolio. Will the value of the fields we ultimately discover offset the cost of dry holes, land, seismic data and development costs? For many of the remote exploration areas in Alaska, it is difficult to project acceptable full cycle returns. In 2003, the state initiated exploration incentive credits for certain qualifying exploration expenditures. These incentives encouraged Pioneer to invest significantly in infrastructure challenged areas such as NPR-A.

When Pioneer was considering its first investments in Alaska, state officials were promoting the resource merits of Alaska basins. Alaska certainly contains world class petroleum systems. Additionally, the officials promoted the fiscal policy including the ELF formula and exploration incentives. Under the ELF formula, only very large new fields would pay severance tax and qualifying exploration expenditures in remote areas would receive exploration incentive credits at either a 20 or a 40% rate. With this fiscal system in place, Pioneer invested heavily in the state over the last several years. When we learned that a new severance tax policy was under development, we were quite concerned that any new system would be detrimental to our future investments and a departure from the fiscal system promoted to the independents by the state.

We recognize that the existing severance tax policy, as it applies to the large fields on the North Slope, is likely not sustainable and we are pleased that the proposed PPT taxes profits rather than revenues. Given that the state collects royalties right off the top, it makes sense that any additional government take should be assessed after costs have been recovered. This concept is important to the smaller, lower productivity and remote resources which are critical to future production growth. Although the proposed production tax rate of 20% is quite large when layered upon the other burdens of royalty, ad valorem tax, state income tax and federal income tax, the impact of the large tax rate is tempered by the allowance of cost recovery, investment tax credits and the proposed taxable income threshold.

Pioneer is pleased to see the provision included in the proposed legislation regarding the deductibility of transitional capital. The provision serves to compensate those companies, including Pioneer, who have made significant capital investments over the past five years based upon the fiscal terms in place at that time.

We have reviewed the testimony of the administration and agree that the PPT, as proposed, will provide incentives for new investment by all companies. Economic metrics for new investments will improve under the PPT versus existing tax law. This should encourage the development of marginal fields and will reduce the minimum economic size for exploration prospects, thus prompting more exploration and increasing the chances of finding commercial-sized fields. In addition, it should encourage re-investment in existing fields. We believe the PPT as proposed will entice

more companies to Alaska and increase competition. More companies and more ideas will lead to smarter field development methods, smarter drilling and production equipment, which will further reduce the minimum economic size of exploration prospects and grow the resource pie.

The tradable tax credits are a particularly effective incentive for the exploration and development of new resources. Under the proposed PPT, the higher risk, higher cost and long project cycle times associated with new resource exploration and development are partially offset by the ability to monetize these credits shortly after investment. In an exploration portfolio, the large majority of projects are not successful resulting in a total loss from all lease acquisition, seismic and drilling costs. The tradable tax credits would lessen the negative financial consequences of the inevitable dry holes explorers will drill.

A significant concern to Pioneer is the potential for a lack of liquidity for the tradable tax credits. Pioneer's outlook is to continue with very large capital expenditures in the state over the next several years. With only a handful of very large producers as potential buyers for the credits, and the proposed limit that a company may utilize purchased credits to offset no more than 20% of its tax, we are concerned that the market for the credits may not be competitive. New investors could face selling credits at a discount to tax payers who would in turn cash them in to the state at full value. We appreciate that a buyer of tax credits should recover its transaction costs, but we are concerned that the required discount might be substantially greater. We respectfully ask the legislature to consider implementing refundable credits with appropriate limitations to protect the state's cash flow in the event of low oil prices. The program could provide that credits be refunded at a modest discount to face value. This would allow the State, and not a third party producer, to benefit from any discount that a seller would be willing to accept.

We believe that the PPT as proposed improves Alaska's competitive position with respect to other investment opportunities around the world. Mr. Van Meurs' testimony indicated that the proposed PPT would improve Alaska's competitiveness versus a number of mostly large, international investment opportunities around the world. To attract companies of Pioneer's size and smaller, we believe that Alaska must effectively compete with U.S. lower 48 opportunities as well. With higher prevailing natural gas prices in the lower 48, gas resource plays (tight sands, shales and coalbed

methane) are attracting huge amounts of capital due to the relatively low risk, low cost and short project cycle time relative to exploration. The size of some of these resources is quite large resulting in increased competition in the U.S. for independent's capital. If Alaska wants to improve its competitive position and attract new investors, we believe that the legislature should take great care in making changes to the administration's proposal that would make it less competitive.

For new investors to Alaska, particularly smaller companies, exempting the first \$73 million of cash flow from taxation is a valuable feature of the PPT. The obstacles to new investors are high. Most new investment opportunities in Alaska are either small, infrastructure challenged, risky (exploration) or some combination of these factors. New investors are also handicapped by not owning the existing infrastructure and they lack the economies of scale enjoyed by the large operators. To be an effective operator in the state requires a huge commitment in highly compensated personnel to effectively navigate the regulatory and operational challenges that are unique to Alaska. Under existing law, it is unlikely that an explorer would pay significant production tax unless a huge field was discovered. A number of new companies were recruited to Alaska by the state and made substantial investments based on the existing tax law. Under the proposed PPT, exempting the first \$73MM of cash flow from taxation will help deliver an investment climate more consistent with the system that initially encouraged Pioneer to explore in Alaska and will help offset the high "start-up" costs.

In general, we believe the proposed PPT is a balanced program with appropriate incentives to encourage new investment in the state. We encourage the legislature to carefully evaluate the proposal and take care to insure that it results in fiscal policy that makes Alaska more competitive. We also respectfully request your consideration to make the tax credits in this bill refundable to allow the new investors the full intended advantage of the tax credit program. Thank you for this opportunity to express Pioneer Natural Resource's views on SB 305.

Pioneer Natural Resources Alaska, Inc.