

**April 6, 2006, Comments To Alaska Senate Finance Committee
CS For SB305 – Petroleum Production Tax
By Ken Thompson**

Introduction

For the record, my name is Ken Thompson. I reside in Anchorage. I am the Managing Director of Alaska Venture Capital Group, or AVCG, 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 my personally owned company, Pacific Star Energy, here in Alaska. AVCG has a technical and operational services' subsidiary company called Brooks Range Petroleum, with newly opened offices in Anchorage. Many of you know me as the former President of ARCO Alaska, Inc., and a past Executive Vice-President over ARCO's Asia Pacific region.

AVCG has been very active in the past six North Slope (NS) areawide lease sales and we have acquired over 160,000 acres of exploration leases in five exploration prospect areas, including new acreage we acquired in the recent March 1, 2006, NS lease sale. Our exploration strategy is to explore in the central part of the North Slope for fields in the 25-150+ 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 and these fields near infrastructure can be brought on more quickly. Our first exploration well in partnership with Pioneer Natural Resources – the Cronus #1 about 10 miles southwest of the large Kuparuk Field – completed drilling last week but results will remain confidential for some time.

AVCG plans two NS exploration wells next winter and two wells the following winter. Our 3-year exploration budget is \$46 million and with any future discovery success, we could have a gross development budget of \$500 million to \$1 billion in future years.

Let me now focus my comments on the CS for Senate Bill 305. As background, I reluctantly supported the Governor's proposed 20/20 PPT and even many details of the initial House version of the bill, HB488. But, somehow, things are beginning to derail. The CS SB305 and CS HB488 with their revisions from the original draft of a simple petroleum profits tax have evolved into very complex bills that are no longer a win-win for the State and industry, in my opinion. I don't fully understand how things began to derail into such complexity...perhaps it was due to anger at the Big 3 producers and the Governor for not revealing the natural gas contract details before demanding a new oil tax fiscal structure. Perhaps its anger at the Big 3 companies who are demanding tax certainty for 30 years when asking for three full decades of certainty truly is an unreasonable demand with Alaska's legislative type of democracy.

I don't understand all the dynamics of the past three weeks in the legislature, but this I do know. The CS for SB305 needs to be greatly simplified and it needs to move somewhere between what it is now and the Governor's proposal if a win-win solution is to be the end result that balances more revenue share for the State but in balance with attracting more new entrants and increased investment amounts.

I am an optimist. I personally think there is still time to avoid a train wreck in this complicated business of restructuring Alaska's petroleum taxation system...if the Senate Finance Committee acts quickly. I, for one, have not given up hope that there is a version – easier to understand and to implement - that can be a win-win for both the State and the industry. There is a simpler and better way, in my opinion, for the State to improve government take while not dampening exploration and development investment. Let me outline my suggestions for a win-win and my suggestions for simplification.

AVCG Owners' Perspectives

First, however, let me say that while I am Managing Director of AVCG, our other owners disagree strongly that any change should be made to the 20/20 PPT formula proposed by the Governor. The 20% PPT tax rate and the 20% credit originally presented in the Governor's bill should be the tax rate and credit enacted. Some of the AVCG owners, however, do not even support the PPT concept and believe the petroleum tax should be as simple as 10-14% of revenues and exclude any economic limit factor.

Quite honestly, the AVCG owners listened in disbelief when I told them the production profits tax rate being considered in the current CS to SB305 draft could add a "surcharge" at high prices that could significantly ramp up the additional taxes above the base PPT rate of 25%. And this surcharge will be in addition to the higher other revenues the State and Federal governments will already benefit from at higher oil prices: the State's 12.5-16.7% royalty, the ad valorem property tax, the 3-9% corporate income tax, lease bonus bid amounts, the ongoing annual lease rental amounts, and the Federal income tax rates averaging 20-35% of taxable income.

It all adds up, and AVCG Owners are saying, "enough is enough."

When I was communicating the latest CS to SB305 details to the AVCG owners by teleconference and email recently, I felt two overwhelming emotions. The first emotion was discouragement. My business judgment tells me the State crossed the line to excessive taxation that will dampen capital investment. Why invest in Alaska where you lose the upside gain at high oil prices to offset exploration risk when the government take will exceed 60%? There are politically secure opportunities in other U.S. states, Canada, the Gulf of Mexico offshore, the U.K., and other nations where government take is 55% or less. CS to SB305 takes away too much of the upside potential from the investor who is taking the risk.

But I also found interesting another strong emotion during that teleconference which surprised me a great deal. I was embarrassed. Here I was, telling a group of outside investors that recently put all of their focus and personal exploration budgets on the North Slope of Alaska, and now I was telling them that Alaska was creating the most complex, confusing production tax bill ever created since the disastrous Federal windfall profits tax. The windfall profits tax – structured similarly to the CS SB305 revenue surcharge - stalled investment in the U.S. oil and gas industry, resulting in an alarming increase in U.S. foreign oil imports which our nation lives with to this day. I was telling them that Alaska was levying the highest tax rate and government take in North America.

To back my points up, please let me cite some statistics. Currently, the total Alaska and Federal governments' take is just over 50%. The Governor's proposal moved this to 53% or so then the original SB305 moved the government take closer to 55%. Then the CS to SB305 with a 25% PPT boosted the government take to over 60% with its "surcharge." This compares to following total government take including Federal government shares:

Alaska currently	50%+ or less, dependent on oil price and field size
Alaska Governor's bill	53%
Alaska original HB488	55%
Alaska CS SB305	60%+
U.S. Gulf of Mexico	45%
Colorado	51%
Wyoming	52%
Kansas	53%
Texas	53%
New Mexico	53%
Oklahoma	53%
California	53%
Louisiana	57%

These tax rates apply to newer fields. Older, more mature fields at low production rates typically get exempted from these maximum tax percentages in various ways.

U.K.	50%
Canada	39-56%

The lower rates in Canada apply to the oil sands projects where billions of dollars for new investment are occurring with Canada's vision to lower government take on this resource base.

My overall key recommendation in my comments today is this: the State should not exceed a threshold of 55% total government take, 45% producer take. The State does own the resource and may be due more than a 50% take. On the other hand, it is the producer who is taking the capital risks and deserves at least 45% for making things happen...for moving an innovative exploration or development idea into production without which no revenues would flow.

Let me say that I'm excited about what's happening in Alaska's oil patch right now, and let's not dampen the spirit. The current versions of SB305 and HB488 have dampened my spirit. I am discouraged. Let's have a new tax bill that encourages, not discourages new entrants. But I do believe it is time the State share more in the take at high prices but there is a much simpler way.

My Personal Perspective

Now let me shift gears in my comments to you. Because I could not get buy-in for any alternatives from the AVCG owners except the 20/20 case, I have decided to speak out alone. As an Alaskan, I am concerned and feel I must try to share a personal perspective trying to balance what is best for my continued involvement in Alaska's oil and gas industry in balance with how the State must change its system to be competitive in the world and realize a higher government share.

So, let me turn my attention to what key changes I would make to the CS of SB305. Again, my views are not supported by AVCG owners or others in industry; rather they are my personal views.

1) Make Tax Rate Progressive But Greatly Simplify The Taxation Formula

When the Governor's office first announced a 25% tax rate then amended that to 20%, I could see the move by legislators to somehow bridge the gap from 20% to 25%. However, the approach used by the legislative committees based on the legislature's outside consultants' work is simply too complex and will be arduous to implement. I think – and perhaps all of you think – the Federal tax code is too complex. The changes to SB305 are also too complex and will lead to different interpretation, “gamesmanship” possibly by some companies because of the unwieldy progressive tax structure formula, and future costly lawsuits when the State disagrees with a company's calculations. And the number of accountants to keep track of these complexities on both sides will balloon! I urge you to simplify, simplify, simplify...yet still have some progression at higher prices.

For my company which drills the smaller oil traps that may add up, we do not have a lot of upside potential in seeing these smaller fields grow much larger in reserves over time in contrast to the giant Prudhoe Bay and Kuparuk fields. So our main upside is in oil price escalation to offset exploration risks and to offset the cycles of oil prices downward, a reality over time for any commodity. I urge you to consider a PPT rate of 20% at lower prices but gradually escalating to the 25% level only at higher prices.

I found it so interesting to see the Econ1 consultants and consultant Daniel Johnston saying the government should take more and more at high prices when not one member of the legislature asked them a very important question they should have been asked: “how much are you and your company investing in Alaska?” I was

shocked to see that these consultants, when calculating the future revenues to the State at various escalating rates, used the same oil production curves. In reality, less capital will be spent by industry at exorbitant production profits tax rates (tax rates above 25% when coupled with all other payments such as royalty, corporate income tax, ad valorem tax, lease costs and rentals, etc.). With less capital spending, the production curve will be lower...an increasingly higher tax rate may not in the end yield the forecasted revenues for the State.

On a related note, our company plans to go into the private or public equity markets to raise capital for future development. Such equity investors invest in the oil markets to be fully exposed to crude price upside. When they look at investments all over the world, and see that Alaska could tax with an escalating “surcharge” when others have a predictable flat tax, they will place their capital elsewhere to continue their exposure to higher crude prices. The consultants did not address this issue of the private and public equity markets and the desire for such investors to fully benefit from upside commodity price swings without hedging or escalated taxation at high prices. This was indeed a major oversight by Econ 1 and Daniel Johnston.

I also could not believe that the consultants failed to show capital spending elasticity graphs from different countries. They did the legislature a disservice by not doing so. By convincing legislative committees to adopt a complex progressive tax rate structure, or windfall profits tax, the consultants may feel they have been successful, but not one of these consultants will be around to defend their views in the future when capital spending declines at increasingly higher tax rates above the 25% level.

So, what is a simpler alternative? What is an alternative to yield more revenues to the State at higher oil prices with a balance to attract increased investment?

I suggest that the Finance Committee revise the bill to keep the production profits tax simply that...a tax on production profits, and not a complex way to further burden gross revenues with a surcharge. A simpler way in getting the progressive rate from 20% to 25% without the surcharge treatment complexity is to adopt a graduated PPT that does accomplish a higher State take at higher prices, yet leaves a reasonable producer take.

I recommend the following production profits tax schedule as a suggested one to “simulate” revenue results somewhere between the Governor’s proposal and the CS to SB305 proposal. It is one that everyone could easily understand and implement with the State realizing upside at higher oil prices yet not too much upside is taken away from explorers/producers for re-investment:

Up to monthly average wellhead price of \$50/barrel for a company: PPT rate of 20%

When monthly average wellhead price is between \$50-75/barrel: PPT rate of 22.5%

When monthly average wellhead price exceeds \$75/barrel: PPT rate of 25%

Let's be honest with ourselves: the surcharge is simply a windfall profits tax under a different name. I highly respect industry consultant Daniel Yergin who has an excellent reputation among industry personnel and government officials alike. In November, 2005, Mr. Yergin said this about a windfall profits tax: **“What a windfall profits tax does is introduce a lot of distortion. It reduces investment, it increases a sense of political risk and it doesn't achieve the goal that is intended...it will really lead to decreased supply.”**

I urge the Finance Committee to seriously consider this simpler approach. I personally ask that you have the Department of Revenue run the above case to compare the State revenues from the Governor's proposal to the current CS SB305 proposal, and to the existing ELF severance tax program. But when DOR models this approach, also ask them to run some sensitivity cases to reduced capital expenditures and reduced future oil production levels if CS SB305 stays in its current form. Please greatly simplify the bill. The complexity is simply not needed.

2) “Trigger Points” For Escalating PPT Should Not be WTI But Wellhead Value

Let me now address a second, very leveraging issue. The “trigger point” that increases the PPT tax rate from 20% should not be based on ANS West Coast (ANS) oil price. The “trigger point” should be when a company's average realized wellhead price in Alaska exceeds \$50 per barrel. Some say the trigger point should be at a lower price like in SB 305, but I do think there is strong merit that those who have invested and taken exploration risk and exposure to low prices should be able to benefit from the increased profits at higher prices...“share the pain, share the gain”...to this \$50/barrel wellhead level. However, I personally am fine with the State gradually increasing the PPT tax rate eventually to a cap of 25% when wellhead prices exceed \$50/ barrel.

Why should the State tie the PPT calculation to a company's realized wellhead price instead of to West Coast crude price? In reality on the North Slope, not one company ever sees West Coast crude prices. Every crude oil in Alaska is different in quality with viscous crude receiving less than the lighter crude oils, and oil produced from wells farther away from infrastructure receiving less wellhead value due to higher shipping costs. Conversely, oil in the Cook Inlet is close to actual refining or on the water to ship out of state and thus realizes on average a much higher wellhead value than most North Slope crude oils, a substantial plus to Cook Inlet operators who face higher operating costs with maturing fields.

So I ask, why should the tax rate increase with a price index such as West Coast price when there is such a variance in crude oil pricing factors on the Slope at the wellhead that directly affect each field's economics and economic limit differently? The production profits tax rate should not escalate at the same time for those who produce viscous crude or oil from a farther distance as compared to those who have

good quality oil right next to the TAPS line. If there is a “trigger point”, it should be one based on a company’s average monthly realized wellhead price for production.

I recommend that the “trigger point” for PPT tax rate escalation be \$50 per barrel realized wellhead price based on a company monthly average and not be based on \$40 West Coast price, thus allowing explorers and producers to share in the upside profits at prices to this level with no higher burden than the 20% PPT tax rate (plus burden of royalty, corporate income tax, ad valorem tax, Federal tax, etc.). Dr. Pedro van Meurs also recommended that the threshold level of \$40/bbl be re-considered. As also recommended by Dr. van Meurs, this threshold price should be linked with inflation.

3) The Transitional Deductible Allowance

Jumping immediately from the prior ELF severance tax to the PPT formula overnight wreaks havoc with a company’s budgeting and their forecast of available cash flow for near-term capital investment. A transition adjustment of some sort is appropriate and is fair.

I support the CS to SB305 that allows for a producer to take a credit with part of a producer’s transitional investment expenditures between April 1, 2001, and before April 1, 2006.

4) The Tax Credit “Standard Allowance”

The Governor proposed a \$73,000,000 annual allowance of production profits that would not be taxed by the PPT, essentially giving a \$14.6 million tax credit per company. The Senate Resources Committee revised this downward to a \$50,000,000 annual allowance as a reasonable compromise, or a \$10,000,000 tax credit; CS HB488 further changed this to a flat \$12,000,000 annual credit. The CS to SB305 further proposed that this be changed to an annual “standard tax credit allowance” for the first 5,000 barrels per day of production.

This “standard deduction” is very important to a startup company like AVCG/Brooks Range Petroleum trying to establish a foothold in Alaska and someday contribute substantial oil revenues to the State.

I favor the HB488 solution of a \$12,000,000 annual flat tax credit exemption due to its simplicity and it is a level playing field for producers of various crude oils with different wellhead values.

5) Institute A Tax Credit Repurchase Program

As protection for explorers and new entrants to Alaska, the version of the profits tax in the House, CS to HB488 devised a tax credit repurchasing program for those

credits a company earns on expenditures up to \$10,000,000 per year for investments in exploration and/or lease purchases in Alaska.

This is important to explorers like AVCG who does not yet have production revenues. Without such a repurchase program, our company might be able to sell our annual tax credits to one of the major producers but have to accept only 90-95% on the dollar or less. On the other hand, the State would not be giving up anything to repurchase the credits at 100% of value because the major producers would otherwise use the credits to reduce their tax bill and reduce revenue to the State. But using the State repurchase approach, the small explorer could turn around and re-invest the State-refunded credit into new leases, seismic or exploration drilling.

I recommend the Finance Committee support the tax credit repurchase program outlined in the CS to HB488 and amend CS to SB305 to incorporate a similar tax credit repurchase program.

Other Revenue Sources

As a concluding remark, I urge the State in this period of high oil prices to not simply try to gain into that upside by pulling only one lever excessively...the lever of petroleum production taxes. The State could be well advised to ensure they gain additional revenues from oil in Alaska by being an entrepreneur and considering revenues from other new related business, such as acquiring a 12.5% interest in the TAPS pipeline and stop paying \$3.70/barrel profitable tariffs to major producers when you could be sharing in those profits.

And work with the Federal government now to ensure that they share part of the Federal royalties with the State on future offshore oil and gas production from the Beaufort Sea which I consider to be of great potential as evidenced by major leasing recently by Shell and other companies. Other states are pursuing a share of Federal offshore royalties.

And the Alaska gas pipeline revenues will be significant. The State should own 20%.

Concluding Remarks

The above comments are my personal views offered with a hope that there can be an eventual win-win solution to this complex subject of the State realizing more revenues at higher prices while attracting exploration and development investors who can also realize upside at higher prices. I do believe the Senate Finance Committee can get things "back on track" and better balanced.

I sincerely thank the Committee for the opportunity to present my comments.

Respectfully submitted by: Ken Thompson