RESOURCE REVIEW Fall 2007

A PERIODIC PUBLICATION OF THE RESOURCE DEVELOPMENT COUNCIL FOR ALASKA, INC. www.akrdc.org

Special Supplement

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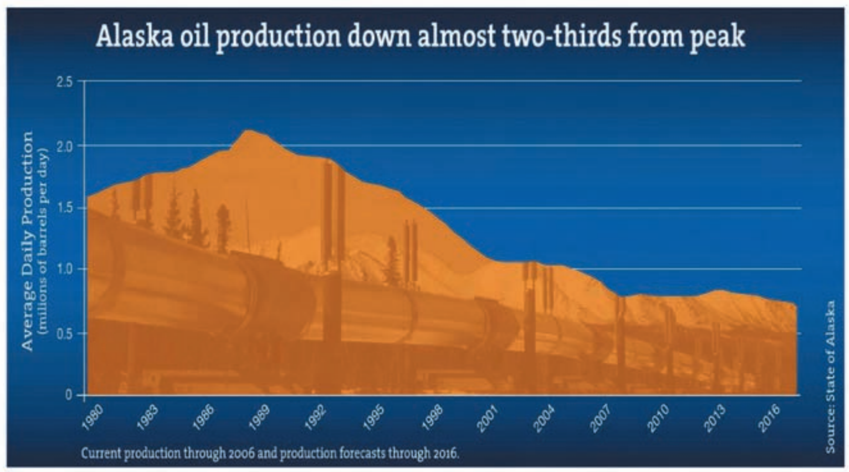
THE TIPPING POINT

SPECIAL SESSION: HIGHER OIL TAXES COULD HAVE LASTING NEGATIVE IMPACT ON ALASKA'S ECONOMY

By Chuck Logsdon

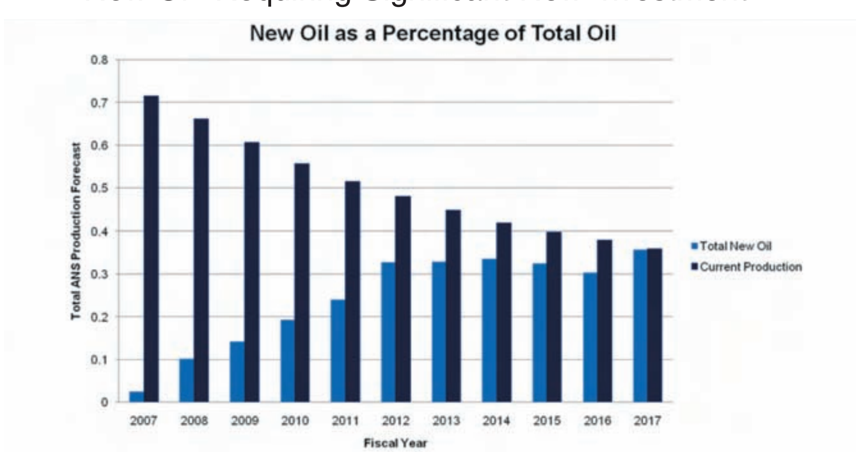
Alaska is at a crucial decision point with respect to its economic future. Total oil production flowing through the Trans-Alaska Pipeline System has plummeted by over 65%, falling from a peak output of 2.1 million barrels per day in 1989 to current levels of less than 700,000 barrels per day.



Every Alaskan should be worried about their economic lifeline being two-thirds empty. What do most people think when their own fuel gauge indicates there is only one-third left in their tank? Don't they consider investing in a full tank at the next station? That's what Alaska needs to focus its attention on now, putting more oil in the pipeline. But that will be easier said than done.

Over the last 11 years, the oil production decline rate has averaged 6% per year. Without the billions of dollars invested by industry over that same period of time, the decline would have been even more severe. This investment was to develop new stand alone fields like Alpine, satellite fields, and new investment in increasing the recovery from existing fields like Prudhoe and Kuparuk. The importance of further development in Alaska's so-called legacy fields was illustrated recently by BP's Doug Suttles in a recent presentation. In those remarks he pointed out that the new investment BP made in existing fields last year added more than 70,000 barrels per day of new production. A separate field producing oil at this level would be the fourth largest in Alaska.

In Ten Years, 50% of Alaska's Oil Production Will Come From "New Oil" Requiring Significant New Investment



- Department of Revenue, *Revenue Sources Book*, Spring 2007

Production forecasts by the Alaska Department of Revenue (DOR) suggest that the future decline in production will become even more pronounced without further investment in oil fields that are not yet developed or have not been fully developed. In fact, DOR is forecasting that "by FY 2010, one-quarter of our projected oil production will come from projects requiring significant new investment" and in 10 years, approximately 50% of the oil will need to come from "new oil."

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A MESSAGE FROM THE EXECUTIVE DIRECTOR

JASON BRUNE

IMAGINE A 68% TAX BITE TO YOUR PAYCHECK

68%. That's a big number. If Governor Palin has her way, 68% of the value of every barrel of oil produced in Alaska will go to government.

Really? Really.

As we head into this special session on oil taxes, it's extremely important we keep this number in mind.

Imagine, your paycheck comes in, and 68% is taken to be spent by government. According to MSN Money, individual Alaskans are taxed at a rate of 27.9% on average as a percentage of income, including all federal, state, and local taxes. An increase to 68% would cause a reaction similar to that of the colonists with their tea. Their motto of *taxation without representation* was one that resonated well with the people.

Today, resource development companies pay the bulk of Alaska's taxes. Absent a fiscal plan that includes a mechanism for individuals to pay their "fair share," Alaskans are left with a system of *representation without taxation.* Alaskans vote our elected officials into office with the hope that we won't be taxed and our Permanent Fund won't be touched. Sounds great to the average Alaskan, but for businesses contemplating investing in Alaska, it's a scary message.

> The special session begins October 18. Contact your legislator now and throughout the session and let them know you are concerned that increasing taxes will discourage new investment and harm Alaska's economy.

Alaska is currently the highest taxed oil and gas region in North America. We have three types of taxes that oil companies pay in addition to a royalty. I think it's important we differentiate between them.

What is a tax?

According to dictionary.com, a tax is: *(1.) a sum of money demanded by a government for its support or for specific facilities or services, levied upon incomes, property, sales, etc. (2.) a burdensome charge, obligation, duty, or demand.*

In Alaska, we have several types of taxes that are assessed on the oil industry. These include the severance tax (PPT), corporate income tax, and state and local property taxes. Last year, the PPT was set at a base rate of 22.5% which rises (up to 47.5%) as oil prices rise. Governor Palin has proposed to raise this base rate to 25% under her bill (up to 50% as oil prices rise). The corporate income tax and property taxes will not change under this bill, but their impacts to the state are no less important. Indeed, raising the PPT could result in less investment, leading to less infrastructure development, and ultimately lower property tax revenue for the North Slope Borough, Valdez, and other communities throughout the state. Guess what happens next—they will rely more on the state to provide services that are today offset by local property taxes.

What is a royalty?

Again, according to dictionary.com, a royalty is *a compensation or portion of the proceeds paid to the owner of a right, as a patent or oil or mineral right, for the use of it.*

In Alaska, royalties are determined by the terms of the individual lease contracts, which are signed *prior to* extensive exploration, development, and risky investment. Basically, a leaseholder commits to give the state a share of anything it finds and produces on the land. This amount in Alaska is usually 1/8th (12.5%) or 1/6th (16.67%) and cannot be changed unless both sides agree.

In sum, between taxes and royalty, today this amounts to nearly 63% of every barrel of oil. So, at $60/barrel, that would mean approximately $37.80 goes to one form of government or another through both the aforementioned taxes and royalties.

So what's left is profit, right? Wrong. That $22.20 is used to run day-to-day operations, employ Alaskans, buy supplies from contractors, etc. What's remains is profit.

Has profit become a dirty word?

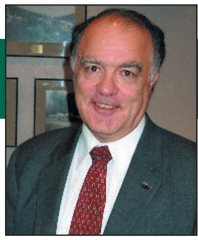
There's nothing wrong with profit. In fact, look at the top 50 holdings of our very own Permanent Fund Corporation (http://www.apfc.org/investments/top50.cfm). You'll see a pattern of companies that have done well with their investors' money. Indeed, as of June 30, 2007, the $40 billion fund has a few interesting facts I'd like to point out.

Do you know what company is the second largest stock holding of the Alaska Permanent Fund? Most of you will be surprised to discover it's ExxonMobil.

So, how is it doing? Not bad. In fact, of the top 50 stocks held by the fund, it's fifth in total return with a market value of 223% greater than what was invested. This return on investment for the state was bettered only by four companies: Total (269%), ConocoPhillips (264%), Apple (256%), and Altria (235%). Interestingly, three of the top five returns are from oil companies, (Chevron is 8th (199%) BP is 17th (161%) for those of you playing at home).

These oil companies are not only providing a return on investment to each of us through our permanent fund dividends, they're also providing good-paying jobs for Alaskans. I don't see Apple making iPods or Altria rolling cigarettes here. What investment are they making in Alaska? Among us, who do they employ?

During the AGIA discussions, Governor Palin stated in one of her weekly gasline briefings, "Remember, it is government's role to provide INCENTIVES for the private sector to build projects. . . We are doing our best to incent the private sector." Unfortunately, changing tax policy year after year does not incent. In fact, it likely does the opposite, steering critical investment dollars away from Alaska. If the tax rates rise yet again, these companies likely will, metaphorically speaking, throw their tea into the harbor by investing elsewhere.



A MESSAGE FROM THE PRESIDENT **JOHN SHIVELY**

OIL TAXES: RUSH TO JUDGMENT?

> "...With Alaska's upside down approach to tax policy, we have been steadily increasing taxes on the oil industry while the treasury has been collecting large surpluses. I guarantee you that if we were achieving such surpluses as a result of a personal income tax, the citizens would be demanding (and perhaps getting in a special session) a decrease in the tax rate."

As a friend of mine who is on the other side of the PPT debate from me said the other day, "Here we go again." For the third time in three years we are back debating how much we can tax the oil industry without doing long-term (and perhaps even short-term) damage to our economic future.

Because the issue is so important and so contentious, RDC is devoting this special edition of the *Resource Review* to the subject. Although I have many concerns with increasing production taxes again, I am going to address only two of them in this column.

The first concern is the idea that we need to set taxes as high as possible to gain our fair share because we are the owner of the resource. We hear this argument often from the "Tax to the Max" folks. Of course, tax policy is not based on ownership. If it were, the government would be able to tax our homes only if the government owned those homes.

In most places tax policy is set according to the needs of government, not according to how much the government can take. Many places, including a number of communities in Alaska, have limited the government's ability to collect taxes by establishing a tax cap. Such caps have become an acceptable means of helping political leaders control governments' seemingly unquenchable thirst for more money.

Taxes are usually increased when a government needs additional funds to run its operations. However, with Alaska's upside down approach to tax policy, we have been steadily increasing taxes on the oil industry while the treasury has been collecting large surpluses. I guarantee you that if we were achieving such surpluses as a result of a personal income tax, the citizens would be demanding (and perhaps getting in a special session) a decrease in the tax rate.

I should also mention that I believe we achieve our share of the ownership of the oil through royalties, not through taxes. Those royalties are based on a percentage of the value of the oil so that they increase as the price of oil increases.

The second issue I want to address is one you have heard many times before from RDC and others in the business community – the absence of a state fiscal plan. If this matter were not so serious, it would be amusing to see how the "Tax to the Max" politicians get around this subject, particularly since in the past many of them have feigned support for a fiscal plan for Alaska.

Some of them say we need to get the money from the oil companies now so that we can save it for the future. I would ask, "Save for what? Save for when?" If we had a fiscal plan, the citizens would be able to answer these questions.

Lacking a fiscal plan, our only option is to look at the recent past to see whether the government is capable of saving surplus tax dollars, and the answer seems to be a resounding "No." The large surpluses of the past few years have been blown through the way a full-speed tractor trailer might speed through a small patch of fog.

Some of the more intellectually honest "Tax 'em because we can" folks have a long list of items for which they would spend the new tax revenue. I would ask these enthusiastic big spenders, "Spend for how long? What happens when the money runs out?"

Absent a fiscal plan, there are no answers to these questions, and that is probably the most serious issue facing the state. I read recently that as Alaskans we enjoy the "lowest state and local tax burden as a percentage of personal income" in the nation (Alaska Economic Trends – September 2007). We achieve this lofty status without taking into account the Permanent Fund Dividend.

If our political leaders decide to base an ever-expanding state budget almost solely on significant increases in taxes on oil production, the combination of the continuing decline in North Slope production and a dramatic decline in the price of oil would be disastrous.

Such a high budget/low production/low price scenario would quickly remove us from the top of the least-taxed list I mentioned above and could easily send us into the kind of economic downward spiral Alaska experienced in the mid-1980s.

The special session of the legislature begins October 18th and could take one of two courses. The legislature can choose to take a short-term economic view and concentrate solely on how much money they can take from the oil industry.

However, it is my hope that the legislature will take the longer view and address the very difficult subject of how today's oil revenues fit into our fiscal future. It is unlikely that such a vital and complex subject can be dealt with in 30 days, and I see no reason to rush the judgment on this issue, given its importance to our future.

Another Tax Hike Looms For Alaska's Oil Industry

Third In Three Years: Alaska's Fiscal Stability For New Investment Ranks Low

(Continued from page 1)

The list of undeveloped projects includes areas that have significant economic, technological and logistical challenges, such as the offshore Liberty field and fields in the National Petroleum Reserve-Alaska (NPR-A). The DOR production forecasts also include fields that have not been fully developed, like the enormous heavy oil deposits overlying the legacy fields in the Prudhoe Bay and Kuparuk production units.

It is projected that there are 20 billion barrels of heavy, viscous oil on the North Slope. It will not be easy to get this oil out of the ground as it is in shallow deposits close to the permafrost zone. Making this oil flow out of the source rocks is like sucking up cold honey with a straw. The industry has made great strides in developing the technology and production techniques that will lower the cost of tapping this abundant resource, but it will still require a huge commitment of capital to fully develop the resource.

At the same time, large outlays of investment will also be needed just to keep the oil production decline at

Daily oil production in Alaska has plummeted 65 percent from more than 2 million barrels per day. Billions of dollars in new industry investment are required to keep the production decline from accelerating. Above is the Pioneer Natural Resources' Oooguruk field, expected to come online in the first half of 2008.

As taxes on Alaska's number one industry rise, the 49th state fell to number 47 out of 50 in a Forbes Magazine ranking of the best states to do business.

Alaska's largest oil fields at Prudhoe Bay and Kuparuk from accelerating.

Where will this capital come from? It will come from oil industry profits. This can take the form of either current cash or debt to be paid from future profits. The greater the likelihood of significant profit, the more likely these investments will be made.

The Palin Administration estimates the suggested modifications to PPT would significantly raise taxes by over $700 million. This is a significant increase and creates two disincentives to investment. First, higher taxes reduce profits and the pool of capital available to industry for investment in future production. Second, higher taxes make Alaska relatively less competitive with other petroleum areas in the world.

The proposed changes to the PPT raise tax rates at all levels of profit and even raise taxes when no profit is made at all in the case of the legacy fields. According to the DOR's own analysis, their recommended adjustments to PPT do not improve the economics of any sample project, a fact acknowledged during the state's October 2 press conference when DOR Commissioner Pat Galvin stated, "Frankly, we have not said that ACES improves the investment climate. Clearly, there is going to be a larger state share and that isn't going to make the economics of projects better."

This tax increase is designed solely to raise more revenue, and is coming at a time of budget surpluses, with no apparent plan for addressing the issue of the state's long-term reliance on oil production to support the economy. The state continues to rely almost exclusively on oil taxes and royalties to pay for discretionary, operating and capital expenditures, averaging 85-90%. The state spending of oil-derived revenues, along with oil industry operating and investment expenditures and federal spending are the linchpins of the Alaskan economy as we currently know it, and will continue to be until we obtain revenues from a gas pipeline, which is at least a decade away.

The proposed tax increase would be the third significant increase in oil taxes since 2005. By adopting additional, higher oil taxes, Alaska risks being labeled as a fiscally unstable region, thus reducing its ability to compete for industry capital. Alaska already has the highest government take in North

> "…Large outlays of investment will be needed just to keep the oil production decline…from accelerating. Where will this capital come from? It will come from oil industry profits. The greater the likelihood of significant profit, the more likely these investments will be made." – Chuck Logsdon

America and a higher than average government take compared to the world's other oil producing regions. In fact, according to the Wood Mackenzie Study of June 2007, Alaska ranks 99th out of 103 in fiscal stability. We have the dubious honor of being ranked just above Russia, Bolivia, Argentina, and Venezuela. This additional tax would not improve Alaska's ranking.

The most often mentioned reason for increasing the oil tax is that revenues have fallen short of "projections" originally made for PPT. Frankly, there is no "guru" who can divine the future and as a result, projections are educated guesses. The reality is that both oil prices and production costs used in the FY 2006 fiscal note accompanying the PPT legislation have changed substantially from original estimates. Although increased costs reduced industry potential profit, PPT still brought in $1 billion more in state revenue in FY 2007.

The PPT is a workable component of Alaska's oil fiscal system. It strikes a good balance between higher revenues to the state when industry profits are higher while at the same time providing needed incentives to encourage oil industry investment and reinvestment in Alaska's oil patch.

Remember, the goal is to get more oil in the pipeline. The current PPT is the better system to keep Alaska competitive and attract the essential investment necessary to achieve that goal.

Chuck Logsdon was the former chief petroleum economist for Alaska and has more than 25 years experience in petroleum economics, working for six different governors.

Facts About Alaska's Oil & Gas Industry

• The oil and gas industry creates more than 34,000 jobs a year in Alaska.

• Total petroleum revenues for FY 07 are projected to be over $5 billion, an amount that has doubled since FY 04 due to high prices and changes in Alaska's tax structure. This includes property taxes paid to local communities, and deposits into the Permanent Fund.

• Projected oil and gas revenues for FY 07 will provide 89% of the state's unrestricted general fund.

Where Is The Additional Oil Going To Come From To Fill Our Pipeline?

• Maturing North Slope fields are in natural decline.

• The oil pipeline is currently operating at one-third capacity.

• While the price of oil is important in assessing Alaska's revenue picture, production is also a vital component of the equation. Daily production has plummeted 65% since 1988 and continues to decline by more than 6% annually.

• Billions of barrels of oil remain on the North Slope, but the resources are challenging and expensive to develop. In 10 years, 50% of Alaska's oil will need to come from new sources, requiring huge new investments from industry.

A Healthy Industry Cannot Endure Tax Changes Year After Year

• The PPT tax system – adopted just one year ago – resulted in an additional $1 billion in taxes last year alone. Now the industry is facing an additional $700 million in new taxes.

• Two years ago, by administrative action, an additional $150 million in taxes were levied against the industry.

Why A Third Tax Hike In Three Years Is A Bad Move

• Alaska is now the highest taxed oil region in North America. When combined with other factors such as operating costs, labor, and environmental challenges, Alaska is among the highest cost regions in the world. Higher taxes will only exacerbate the challenges of rising costs and will dampen investment.

• Alaska ranks a dismal 99th out of 103 world regions in terms of tax stability. The oil industry needs a stable tax regime to move projects forward.

• Billions of dollars in new wells must be drilled to keep falling production from accelerating. Higher taxes may ultimately result in less revenue to the state as critical investment dollars needed to slow the decline in North Slope production are directed outside Alaska to other projects with better rates of return.

• Alaska can't tax its way into prosperity. To sustain its economy, Alaska needs to encourage new investment to get more oil in the pipeline.

• Where will this capital come from? It will come from industry profits. The greater the profit, the more likely these investments will be made.

• Other industries and businesses across Alaska's economic spectrum are worried higher taxes will further erode our fiscal stability. We run the risk of chilling our fragile investment climate across all resource industries.

• As investment and oil production wane under the weight of heavier taxes, all sectors in the state would experience a significant economic slowdown.

• Now is not the time to be changing the tax structure when all other factors, including the increased attention from environmental groups/global warming/litigation are working against Alaska.

Contact Your Legislator Today And Throughout The Session!

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Rep. Mike Doogan	25	465-4998	Rep_Mike_Doogan@legis.state.ak.us
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Rep. Mike Hawker	32	465-4949	Rep_Mike_Hawker@legis.state.ak.us
Rep. Lindsey Holmes	26	465-4919	Rep_Lindsey_Holmes@legis.state.ak.us
Rep. Craig Johnson	28	465-4993	Rep_Craig_Johnson@legis.state.ak.us
Rep. Bob Lynn	31	465-4931	Rep_Bob_Lynn@legis.state.ak.us
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PETROLEUM PRODUCTION TAX PRODUCES MORE

The state says one-quarter of our projected oil production will come from projects requiring significant new investment in just two more years.

The oil pipeline is two-thirds empty today and North Slope production is falling every day. As the governor said earlier this year: "The need for new energy in Alaska is real."

Delivering new energy was one of two goals of the Petroleum Profits Tax (PPT) passed last year. Increasing state revenues was the other. So far, PPT has delivered on both.

Through the PPT, an additional $1 billion in new revenues have been deposited into the state's general fund over the past 12 months and, according to projections from the Department of Revenue, this should increase to more than $4 billion by the fiscal year of 2011. (Remember — the PPT is just one of four state taxes on Alaska oil. Total petroleum revenues for the fiscal year of 2007 are projected at more than $5 billion.)

Northwest of the Kuparuk River unit, Pioneer Alaska Natural Resources expects to become the North Slope's first independent producer when its Oooguruk development project comes on line early next year. This $500 million project is a huge investment for Pioneer and its partner, Eni Petroleum.

"Pioneer believes the current PPT system achieves the state's desired outcomes — more revenue at higher oil prices and more investment through tax credits. Furthermore, the net tax structure levels the playing field for resources across the state. Resources that are more expensive to produce and therefore less able to bear a significant tax burden, are taxed at a lower effective rate. We believe the current system is a rational approach given the characteristics of a maturing basin like the North Slope, and it should be given a chance to work," said Ken Sheffield, Pioneer's president in Alaska.

Oooguruk is a small, offshore field that is expected to produce up to 90 million barrels of oil. It is part of the 13.7 billion barrels of oil that we know we can develop on the North Slope. But most of these barrels are very tough and very expensive to produce. Alaska needs more than $100 billion in new investments over the next half century to keep North Slope production healthy and the pipeline operating.

The governor has called for a special session of the Legislature on October 18 to consider a new oil tax to replace the PPT. The governor's proposal would increase the total government take to 68 percent, based on a $60-per barrel oil price, and would make Alaska's tax rate the highest in North America and among the highest in the world.

Maybe I'm being a bit naive, but I agree with the Anchorage Chamber of Commerce, which recently passed a resolution in support of tax stability. An effective state tax policy would accomplish six goals, the Chamber said, including "creating an environment that encourages exploration and development of all of Alaska's oil and gas resource base."

Amen to that — and to the Fairbanks Daily News-Miner, which wrote: "But impose too high a tax on those who will develop those resources and Alaska may see less in both revenue and resource development. Finding the right balance is difficult, but changing the tax structure year after year so that it maximizes revenue for the state even as global financial conditions change would put oil industry executives in the untenable position of trying to make sound investment decisions while on shifting sand. In such a situation, they are likely to be even more cautious about where to invest dollars."

The current PPT legislation requires a review of this tax within five years. Why is it necessary to address a revision to the PPT now?

The Legislature has the opportunity and option of addressing it during a regular session without incurring the enormous costs of time and money required by this call for a special session.

Gail Phillips is former Speaker of the Alaska House of Representatives. This editorial was originally published in the Fairbanks Daily News Miner.

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The Resource Review is the official periodic publication of the Resource Development Council (RDC), Alaska's largest privately funded nonprofit economic development organization working to develop Alaska's natural resources in a responsible manner and to create a broad-based, diversified economy while protecting and enhancing the environment.

Why Should Alaskans Worry About Declining North Slope Oil Production?

Oil production is our state's economic lifeline. Alaskans should be alarmed because daily oil production in Alaska has plummeted 65% from more than 2 million barrels per day in 1988 to 700,000 barrels today. The Trans-Alaska pipeline is only a third full, and oil production continues to fall. Production and revenue forecasts by the State of Alaska suggest the future decline in production will become even more pronounced without further investment in oil fields that are not yet developed or have not been fully developed. In fact, the state is forecasting that in 10 years, nearly 50% of our production will need to come from "new oil."

Billions of dollars in new industry investment can slow the production decline and help ensure a sustainable future for Alaska. However, a strong business climate with a stable tax environment is vital to steer this level of investment to Alaska, as opposed to opportunities elsewhere.

"We need to do a better job of aligning our tax policy with our goals. If our goal is to encourage exploration and reinvestment in Alaska to increase oil production, then increasing taxes again will have the opposite effect. This is Economics 101. We need to reward risk taking, not penalize it."

– Marc Langland
President, Northrim Bank

"Keeping oil companies guessing on what they will pay while they are considering building a $25 billion natural gas pipeline is poor policy."

– Lew Williams
Retired Publisher
Ketchikan Daily News

"The effects of this tax increase will ripple across our entire economy if it curtails new investment in oil and gas. Oil production is declining faster than the state and industry expected and that, combined with the increasing state budget, will create serious problems for our economy until new oil investment is made to flatten the production decline."

– Tim Bradner
Alaska Business writer

"For the third time in three years we are back debating how much we can tax the oil industry without doing long-term (and perhaps even short-term) damage to our economic future."

– John Shively
President, RDC
Former Commissioner,
Alaska Dept. of Natural Resources

"How well is PPT working? So well that it brought in about $1 billion more in state revenue in fiscal year 2007 than the old system would have brought in...We bring this up because Gov. Palin and her team should stop calling the petroleum profits tax, or PPT, a failure."

- Fairbanks Daily News-Miner, 9/6/07

RESOURCE DEVELOPMENT COUNCIL

Growing Alaska Through Responsible Resource Development

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