# Armstrong White Paper

## INTRODUCTION

For the first time since the discovery of Prudhoe Bay, many of the new opportunities in Alaska reside in new discoveries on the Slope recently made by independent oil companies. This new mix of independent companies, along with the major producers, could help Alaska realize an extremely lucrative future. However, Alaska must work to make these discoveries economical for the producers and its citizens with a tax policy that’s simple, fair and maximizes production.

## A SIMPLE PROPOSAL FOR A NEW ALASKA OIL AND GAS TAX LAW THAT ENCOURAGES EXPLORATION AND NEW FIELD DEVELOPMENTS AND STILL MAINTAINS ALASKA'S FAIR SHARE

Alaska’s general budget is almost completely dependent on oil production revenue from the North Slope. The vast majority of that production comes from the large "Legacy" fields that were discovered 20-50 years ago.

Recently, oil companies have discovered new fields on the North Slope that shows the region still has great promise and big potential for new production. Armstrong's recent success at "Pikka" and ConocoPhillips' recent successes at "Willow" and at "Greater Moose's Tooth (GMT)" attest to this.

Oil companies are working and investing under the Alaska tax laws created by SB 21 and HB 247. These bills were written to help insure the state’s revenues for years to come. However, the bills created the unintended consequence of the state being obligated to write checks to oil companies working and exploring in Alaska without regard to their success. This obligation is politically and fiscally untenable when the state is running a deficit. These tax laws are very complicated, difficult to understand, and slanted (despite efforts to the contrary) in favor of the existing "Legacy" producers versus new explorers. The state's current tax laws related to oil exploration and production are in desperate need of repair to insure the state's fiscal stability and to encourage continued and increased exploration activity. Note: This paper does not address or encourages any change to the tax structure or rates of the North Slope's legacy fields.

Alaska is an extremely difficult and expensive place to work, especially in comparison to the lower 48 states. There are +/- a dozen companies doing business on the North Slope; yet, there are hundreds of companies working in each of the U.S.'s other oil and gas basins (Permian, Williston, Appalachian, Eagle Ford, Anadarko, DJ, etc.). The number of companies working in Alaska is significantly less than any producing state in the nation. There is a reason for this fact that cannot be ignored and needs to be addressed.

Due to natural production declines, the legacy fields (Prudhoe Bay, Kuparuk River, Milne Point, Alpine, and other fields discovered and put on production prior to 2006) will provide a continuing revenue decline resulting in very little revenue to the state fifteen years from now. If Alaska hopes to have enough revenue for its state budget in the future, it must create a sustainable tax regime that encourages exploration and the development of new fields.

PROPOSAL FOR A TWO TIERED OIL TAX LAW

Alaska should consider creating a tax code that has two tiers, one tier for existing "Legacy" fields that were found between 1968-2005 and have been producing oil on the North Slope for the past 20-50 years and a second tier that encourages new exploration and new field developments. The key to Alaska's future and long term success is new oil production. A specific tax law that encourages exploration and development for new fields is needed.

The two tiered tax code will be fair to all players (new and existing producers on the North Slope), should not involve the state writing checks to the oil companies, gives Alaska it's "fair share" of revenue, and can create a competitive business environment with other oil producing regions in the U.S. and around the world.

The existing producing fields on the North Slope (the Legacy fields) should maintain a fair system that accommodates the challenges of doing business on the North Slope. The current tax rates for these fields are probably fair and are not the primary focus of this proposal.

A SUGGESTED "NEW" FIELD TAX STRUCTURE

The state should consider a simple, easily understood "percentage of the gross" production tax solution to apply to all new fields.

"New" fields should be defined by any and all areas that were discovered and put on production after 2006.

Suggested tax rates for "new" fields to insure a competitive atmosphere and giving the state their fair share might look like this:

- A base production tax rate of 5% [on the gross] for the first seven years of new production.

- After seven years, the production tax rate would increase to 10% [on the gross].

- 35% of all [qualified] capital expenditures "QCE" to be offset against production taxes until these capital expenditures are recouped.

- During this "recoupment period" the new production will offset the aforementioned 5% and 10% tax rates and companies would pay a minimum 2% production tax.

- New fields would pay full state royalties, unless specified differently under contract, and all appropriate corporate and property taxes.

Ironically, this "New" field tax structure is much tougher on explorers today than the original Alaska tax law system that was in place when the "Legacy" fields were brought online. These fields, have benefited the state and the legacy producers for the last 50 years, have created a $54B+ Permanent Fund and provided billions for the operation of state government and the creation of important and necessary infrastructure.

Additionally, the new fields being brought online today have a much higher state royalty burden (16.66% vs. 12.5%), have a significantly more difficult regulatory environment to deal with and more stringent environmental requirements than when the original Legacy fields were developed. [And a much higher cost structure to address.]

This proposed "New" field tax structure is simple, straight forward, easy to understand, allows the state of Alaska to maintain its fair share of revenues, and is competitive with other oil producing regions in the U.S. Most importantly, it does not pick "winners and losers" as it is open to any and all oil companies including Alaska's legacy producers.

This proposed tax structure is in the best interest of Alaska. It should not be viewed as a partisan proposal and should earn the support of both sides of the political aisle, the Governor and all oil companies. This proposal is a textbook example of a win/win for all.

Note:

I would seriously consider qualifying the accrued QCEs as credits and here is my reasoning:

1. We have experienced unprecedented changes to the tax structure over the past decade or so. Most of pressure comes from the fact that the state relies on oil revenues to fund its budget and many believe we don't get "our fair share." With each movement in oil price - or trend - a new cry commences. I don't expect this to change going forward;

2. This proposal bets on stability - invest today with the hope you can realize tax benefit in the future. Policymakers will be happy to cut their liability today, but tomorrow - well - is another story. Don't be surprised if they take the change

today knowing they will revisit policy down the road and limit or eliminate application of QECs against production tax liabilities;

3. By creating a credit the state creates a future liability and the investor secures a future benefit - real value is added to each project;

4. This credit, unlike the current NOL program, can only be used if future production comes on line. No more state $ for a simple investment - there is a clear line to production;

5. The credit program should be carefully crafted so that a credit accrues at the time of investment, and should the state change its tax policy down the road, an investor - should new production be brought on - can apply them, notwithstanding any subsequent tax change along the way. In short, a tax policy change should not be able to nullify accrued credits;

6. We are being responsible in offering up a new approach. We recognize the state's fiscal constraints and are putting forward an approach that eliminates the state's cash call. But in exchange, we should be asking for some future certainty that should we bring on new oil we have a program that insures we can partially recoup our investment.