“Give Me A Break!”

How State, Federal and Oil Industry Parties Derive Income from North Slope Crude Oil:

An Independent Estimate of 2005 Revenues and Implications for Public Policy

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Richard A. Fineberg, Principal Investigator
Research Associates
P.O. Box 416
Ester, Alaska 99725

Even at production rates (approximately 45 percent of the peak North Slope annual production in 1988), Alaska's arctic petroleum province continues to generate high revenues for its principal parties, the State of Alaska, the Federal Government and the Oil Industry.[1]

- **At an average price of $52.01 / bbl. for the first nine months of 2005, the industry is on track to earn approximately $7.4 billion in net revenue from Alaska North Slope production and pipeline operations in 2005.**
- **The corresponding state and federal shares of the net revenue "take" (the difference between costs and production revenue) are approximately $3.8 billion (state) and $2.6 billion (federal).**

Put otherwise:

- **Conservatively reckoned, the industry is earning approximately $14,000 per minute, after all taxes and expenses are paid), or 53.5% of the net revenue "take."**

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[1] All data presented here are tendered as approximations based on analysis of the best data available for public review. For recommendations on improvements in public data, see: Richard A. Fineberg, *The Profitability and Economic Viability of Alaska North Slope and Associated Pipeline Operations* (Prince William Sound Regional Citizens' Advisory Council, April 27, 2005; available on-line at http://www.pwsrcac.org).

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In terms of net revenue, the stare is a junior partner in this enterprise.

- **Over the last decade, the state has received approximately 33% of the net revenue take, compared to 13% received by the federal government and 54% for industry.**

- **2005 will mark the eighth year of the last 10 in which the industry has received more than half of the net revenue “take.”**

- **Only once in the last decade (the low-price year of 1998) did the state “take” exceed that of the industry.**

- **As a general rule, the industry percentage of the “take” increases as oil prices rise.**

Slide 4

Why does the disposition of petroleum revenues matter anyway?

- **Alaska's Constitution states that the mineral resources of the state belong to the people and shall be developed "for the maximum benefit of its people."** [2]

- **Petroleum revenues constitute the major source of recurring public revenues for education and other social needs.**

- **Petroleum revenues, through mandated royalty and occasional direct legislative deposits to the Alaska Permanent Fund, contribute to the Alaska Permanent Fund Dividend.**

[2] Constitution of the State of Alaska, Article VIII, Sec. 2.

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Apart from the direct fiscal consequences of petroleum development on the public commonweal, it is generally recognized that petroleum development is a capital-intensive endeavor in which investors incur risks in the expectation of rewards. In a globally competitive environment, clear understanding of the economics of development is necessary so that an informed citizenry can evaluate the manner in which government officials are managing Alaska's resource wealth on behalf of the public.

Apart from the direct fiscal consequences of petroleum development on the commonweal, understanding the fiscal terms of development enables a concerned citizenry to determine whether the complex system administered by a gaggle of public agencies ensures that:

- **potential investors are able to compete on a level playing field; and**

- **public officials are managing the inevitable tension between profit-seeking and environmental mitigation measures appropriately.**

This set of direct fiscal consequences (preceding slide) and important public policy implications (this slide) constitute a framework or checklist against which the state's petroleum development policies may be evaluated.

What companies comprise this industry?

- **By virtue of their ownership of more than 90 percent of the production rights to the state's North Slope petroleum and a similar share of the Trans-Alaska Pipeline System (TAPS), three of the wrold's largest oil companies (BP, ConocoPhillips and ExxonMobil) earn more than 90 percent of the industry profits from North Slope production and associated pipeline operations.**

Note:* These figures do not include: (1) marine shipping profits; (2) downstream [refining and marketing] profits and the benefits to the vertically integrated major North Slope producers of a stable supply of oil for their West Coast refineries; (3) excess TAPS tariff revenues of approximately $1.72 per barrel in 2005, plus the value of retained DR&R (dismantling) funds previously collected under the terms of a disputed 1985 settlement agreement; and (4) cash flow from items such as depreciation.

Four principal revenue-generating mechanisms comprise the state share of the net revenue "take:"

- **Oil and gas property tax (assessed by the state at 2% of oil and gas property value)**
  (approx. 7% of state "take")

- **Royalty (typically 12.5% of gross production value)**
  (approx. 52% of state "take")

- **Severance tax (a tax on production tax of 15% of the remaining 87.5 percent of gross production value, significantly reduced by the economic limit factor [ELF])**
  (approx. 28% of state "take")

- **State income tax**
  (approx. 14% of state "take")

Over the last 15 years, the ELF – designed to stimulate production by reducing tax on smaller fields thought to be economically "marginal" at lower prices – has significantly reduced severance taxes.

Because transportation costs are subtracted from the basis price on which royalty and severance payments to the state are calculated, pipeline tariffs (shipping charges) reduce both royalty and severance payments.

Apart from distance to markets and the difficulties of operating in a northern environment, the two preceding slides make clear that from a public policy standpoint, Alaska's fiscal arrangements for petroleum development are unusual, if not unique, in at least two regards:

- **North Slope petroleum development is consolidated in the hands of three major companies; and**
- **Because virtually all of that development takes place on state lands, royalties and production taxes both are administered by – and accrue to – the state.**

The import of these consolidating effects is that any failure to assure effective management of petroleum development is liable to heighten potential negative impacts on both:

- **direct fiscal effects of that development (see Slide 4); and**
- **broader public policy consequences (see Slide 5).**

Slide 9

With this background in mind, let's look at the Alaska North Slope net revenue "take" data for the last decade:

Estimated Shares of Alaska North Slope Production and Associated Pipeline Net Revenue, 1996 - 2005

Nominal Dollars

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Totals
ANS West Coast Average Price ($/bbl.)	$20.44	$18.98	$12.55	$17.73	$28.28	$23.21	$24.72	$29.64	$38.84	$52.01	$26.64
Total Production and P/L Net Revenue ($ Millions)	7,590.7	6,098.6	2,441.1	4,088.1	7,513.0	5,308.4	5,782.4	7,447.5	10,168.2	13,771.8	70,209.9
Total State Share (Production + P/L)	2,216.4	1,949.7	1,406.6	1,697.9	2,137.1	1,912.5	1,933.4	2,264.8	2,804.8	3,843.0	22,166.3
State Percentage	*29.2%*	*32.0%*	*57.6%*	*41.5%*	*28.4%*	*36.0%*	*33.4%*	*30.4%*	*27.6%*	*27.9%*	*31.6%*
Federal Revenue	1,113.8	707.0	209.0	471.3	1,376.0	602.1	363.2	813.7	1,894.2	2,563.6	10,113.8
Federal Percentage	*14.7%*	*11.6%*	*8.6%*	*11.5%*	*18.3%*	*11.3%*	*6.3%*	*10.9%*	*18.6%*	*18.6%*	*14.4%*
Total Industry Profits (Production + P/L)	4,260.6	3,441.9	825.4	1,918.9	3,999.9	2,793.8	3,485.8	4,369.0	5,469.2	7,365.2	37,929.7
Industry Percentage	*56.1%*	*56.4%*	*33.8%*	*46.9%*	*53.2%*	*52.6%*	*60.3%*	*58.7%*	*53.8%*	*53.5%*	*54.0%*

Real (2005) Dollars

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Totals
ANS West Coast Average Price ($/bbl.)	$24.03	$21.93	$14.33	$19.98	$31.24	$25.04	$26.19	$30.84	$39.63	$52.01	$28.52
Total Production and P/L Net Revenue ($ Millions)	8,923.9	7,046.6	2,786.8	4,606.5	8,298.1	5,728.0	6,125.7	7,750.0	10,374.8	13,771.8	61,640.4
State Share (Production + P/L)	2,605.6	2,252.8	1,605.8	1,913.2	2,360.5	2,063.7	2,048.2	2,356.8	2,861.8	3,843.0	20,068.4
State Percentage	*29.2%*	*32.0%*	*57.6%*	*41.5%*	*28.4%*	*36.0%*	*33.4%*	*30.4%*	*27.6%*	*27.9%*	*32.6%*
Federal Revenue	1,309.4	816.9	238.6	531.1	1,519.7	649.7	384.7	846.8	1,932.7	2,563.6	8,229.6
Federal Percentage	*14.7%*	*11.6%*	*8.6%*	*11.5%*	*18.3%*	*11.3%*	*6.3%*	*10.9%*	*18.6%*	*18.6%*	*13.4%*
Industry Profits (Production + P/L)	5,008.8	3,976.9	942.3	2,162.3	4,417.9	3,014.6	3,692.8	4,546.4	5,580.3	7,365.2	33,342.4
Industry Percentage	*56.1%*	*56.4%*	*33.8%*	*46.9%*	*53.2%*	*52.6%*	*60.3%*	*58.7%*	*53.8%*	*53.5%*	*54.1%*

Notes:

Based on reported spot market price for Alaska North Slpe crude oil, actual state revenue as reported by the Alaska Department of Revenue and estimated effective tax rates from Citizens for Tax Justice / Institute on Taxation and Economic Policy reports. Annual results converted to 2005 dollars using the GDP deflator. (2004 and 2005 estimates based on Alaska Department of Revenue data through September and an assumed 25% effective federal income tax rate.)

For documentation and additional discussion see: Richard A. Fineberg, *The Profitability and Economic Viability of Alaska North Slope and Associated Pipeline Operations* (Prince William Sound Regional Citizens' Advisory Council, April 27, 2005), Ch. 3.

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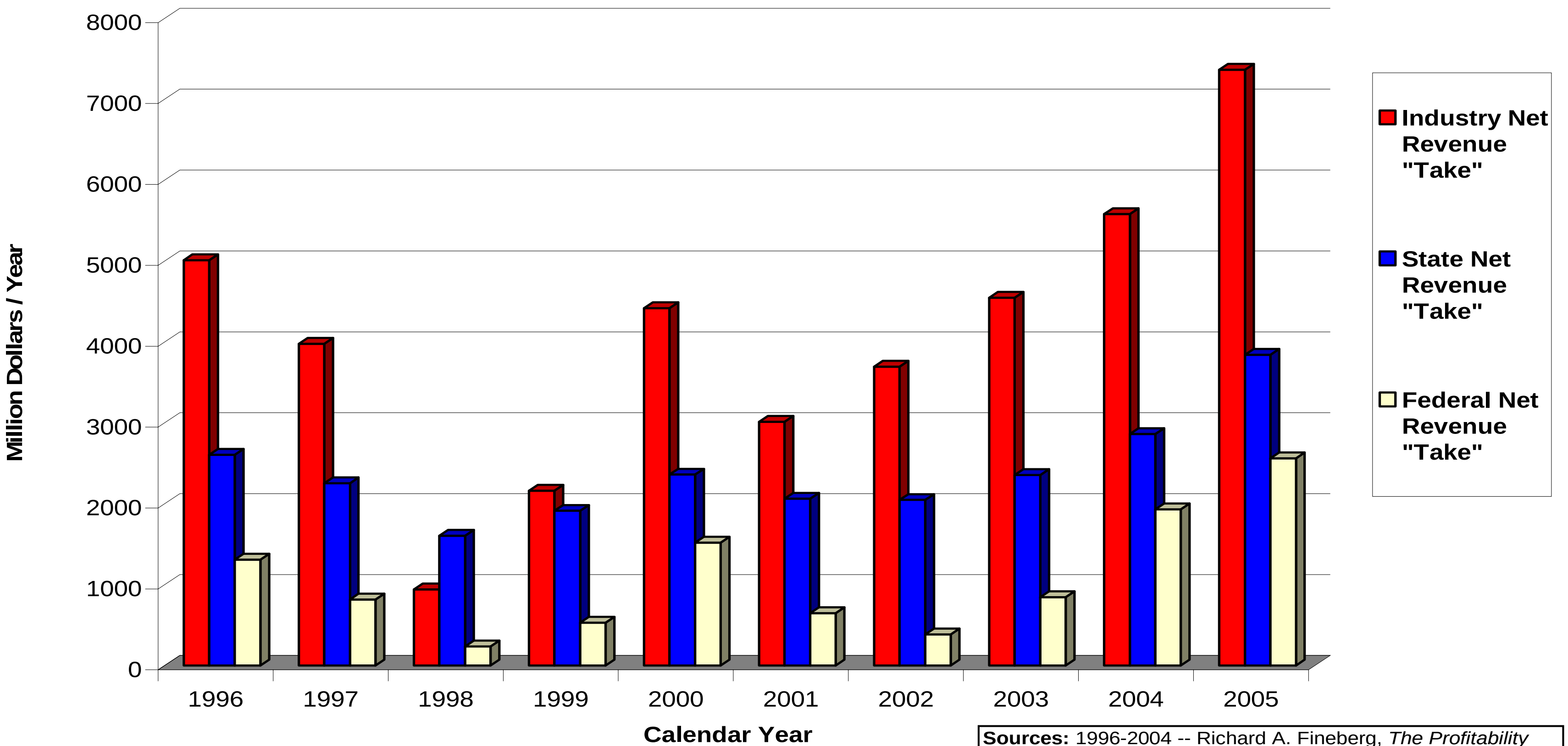
Industry, State and Federal Shares of Alaska North Slope Production and Pipeline Net Revenue "Take," 1996 - 2005

(Real [2005] $)



Sources: 1996-2004 -- Richard A. Fineberg, *The Profitability and Economic Viability of Alaska North Slope and Associated Pipeline Operations,* Figure III.-15; 2005 -- author's estimate (based on Alaska Dept. of Revenue data thru 9/05).

The ELF was adopted in 1981 and redesigned in 1989 to provide tax relief for smaller oil fields whose economics were deemed "marginal" at low oil prices. In the last decade, generally rising oil prices have rendered such incentives increasingly unnecessary.

In both nominal and real-dollar terms, during the six years of generally rising oil prices between 1998 and 2004, the increase in state's share of petroleum revenues lagged the industry by a significant margin. During this period, severance tax returns remained relatively flat.[3]

- ***While the ELF's application to smaller fields contributed to the decline in the state share of the North Slope net revenue "take" in recent years, the data in slides 9 and 10 suggest that during this period another factor – the decline in corporate federal income tax payments – played a more significant role in the relative increase in the industry's share of the net revenue "take."***

[3] In real-dollar terms, the severance contributed approximately $506 million to state coffers in 1998, compared to $731 million in 2004 (*The Profitability and Economic Viability of Alaska North Slope and Associated Pipeline Operations,* Figure III.-14). During the same period, the state percentage "take" dropped from 58 percent to 28 percent, while the industry take rose from approximately 34 percent to 54 percent.

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The complex relationships between the ELF and other government revenue-generating mechanisms must be examined carefully. As we have observed, there is a one-to-one relationship between industry federal tax dollars saved and the industry's increase in the net revenue "take."

- ***It is therefore important to calculate the actual federal tax rates (something that the Alaska Department of Revenue does not do).***

On the other hand, the consequences for industry of an increase in state revenue resulting from tightening (or closing) the ELF loophole may be a win-win proposition because its effects on industry are partially buffered by reduced federal income tax payment.

- ***In any event, if competition on the North Slope is deemed desirable goal, then care must be taken to ensure that changes to the ELF do not penalize independent developers.***

The following question emerges from this analysis:

- ***Can the ELF be modified to achieve its original purpose (enhancing competition), or can other improvements in the petroleum fiscal regime serve better to enhance competition while returning net revenue shares to a reasonable balance?***

To bring the net revenue "take" into balance, two alternative solutions that would not inhibit competition are readily available:

- **(1) A Windfall Equal Sharing Tax (WEST), similar to that proposed by the Alaska Public Interest Research Group, Oillwatch Alaska and the Alaska Forum for Environmental Responsibility,[4] would focus on the total revenue "take" and gradually increase industry's payments until parity is achieved.**

Under this proposal, unlike the ELF repeal, producers would always receive a share of any increase in oil prices.

- **(2) Aggressive pursuit of reduced TAPS tariffs (shipping charges) at the Federal Energy Regulatory Commission (FERC) could remove a major disincentive to North Slope development while increasing state revenue by more than $100 million for 2005 alone by reducing hidden profits to the TAPS owners (uncalculated in this model).[5]**

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[4] See: Richard A. Fineberg, "Windfall Equal Sharing Tax (WEST): A Proposal by Oilwatch Alaska," Oilwatch Alaska, February 1999, at http://home.gci.net/~oilwatch/west1.

[5] This estimate is based on a reduction of 2005 TAPS tariffs from the filed average of $3.72 at the Federal Energy Regulatory Commission (FERC, which regulates approximately 95 percent of the oil shipped through TAPS) to a tariff of approximately $2.00 ordered by the Regulatory Commission of Alaska (RCA, for the five percent of TAPS oil destined for in-state refining and therefore under state jurisdiction) in November 2002 and June 2004. (For background on TAPS tariff issues, see "TAPS Economics" at http://www.finebergresearch.com.)

Conclusions: Implications for Gas Line Negotiations

- ***We began this evening with one proposal to redress the imbalance in petroleum revenue; now we have three. We have also identified (by stumbling into them) major gaps in state petroleum information that turn consideration of even the broadest dimensions of the public debate into a futile excursion into esoterica. Witness, for example, the difficulty ascertaining basic facts that would not infringe on individual taxpayer rights, such as aggregate field costs and federal income taxes, reported on the calendar-year basis that most of the rest of the world uses to report developments and chart trends in the oil patch.***

- ***Further, we have observed that the Regulatory Commission of Alaska has twice found that a settlement between state negotiators and the industry that is now 20 years old is still costing the state over $100 million a year in reduced royalty and severance payments. This gain adds to the profits of the three major owners of TAPS, who are also the major owners of North Slope production rights.***

- ***None of this information augurs well for North Slope gas development – which the administration is promoting through secret negotiations that will not be available for public review and consideration unless or until the state's representatives forge an agreement with the above-mentioned major North Slope producers (who also hold production rights to the vast majority of the North Slope's discovered natural gas).***

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- ***The fiscal system for the development and production of natural gas is different from – and, some would say, more complicated than -- the oil regime. If and when experts reach agreement on production terms, they are bound to believe those terms are the best the state can obtain (or they wouldn't have agreed to them). Under the circumstances, the settling parties can hardly be expected to welcome careful scrutiny – let alone criticism – by individuals who have not been party to the negotiations and have not had time to review the merits of the many alternatives that will have been considered by the state negotiating team.***

- ***That's precisely the scenario that gave us the 1985 TAPS tariff settlement.***

- ***In 1999, former Governor Knowles (who also sent the gas line project marching down the Alaska-Canada Highway to the imperious slogan, "My Way Is the Highway!") negotiated a secret agreement with BP on proposed terms for the merger of BP with ARCO (then BP's major competitor on the North Slope). Despite public opposition and concern, the terms of the administration's secret negotiations failed the public interest so badly that they were overturned by the Federal Trade Commission and further modified – again to the benefit of the public interest – to settle a lawsuit brought by ExxonMobil.***

- ***More recently, we have seen how the confidential Wood-Mackenzie report on Alaska's status in the global arena was misinterpreted by legislative leadership and by the Alaska Oil and Gas Association, who thought they knew better than the public.***

<u>***Slide 16***</u>

The information we have discussed tonight testifies to the fact that the industry is better at negotiating than our public erstwhile leaders. What can we do about it?

The public can attempt to take control of its destiny by demanding:

- **Better information on the economics of petroleum development;**
- **more specific information on the goals and anticipated outcomes of gas line negotiations than the governor has provided;**
- **benchmarks by which informed citizens can judge an agreement, if and when one emerges;**
- **an explicit review mechanism that will enable concerned citizens to ensure that well-meaning bureaucracts, convinced they have done their best, are not allowed to lead us once more on a path that leads away from the public interest.**

Thank you for your interest, and your kind attention.