

BP Presentation on Proposed PPT

Alaska State Legislature
House & Senate Resource Committees
28th February 2006

Introduction – Ken Konrad

My name is Ken Konrad. I am Vice President, Gas for BP Alaska. We are here today to talk to you about the proposed PPT legislation – HB488 / SB305. I will make a few opening comments and then turn things over to Angus Walker and our PPT team.

Agenda



- How we got here
- Current realities of the Alaska North Slope
- Global perspective
- Impact of PPT on BP Alaska

Ken Konrad: Gas Vice President BP Alaska
Angus Walker: Commercial Vice President BP Alaska
Ray Hall: Senior Tax Economist BP Group
Tom Williams: Alaska Tax Counsel BP Alaska

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How we got here

Last week, after more than two years of negotiations, and a lot of hard work on all sides, we reached a very finely balanced agreement with the administration on a predictable and durable Fiscal Contract with Alaska. The Fiscal Contract will establish clear rules governing payments-in-lieu of taxes we would make to the State, including a PPT payment incorporated by reference from this legislation. Once ratified, the Fiscal Contract will enable a gas pipeline to advance in partnership with the State as an equity participant.

Much of what is contained in the PPT legislation was born in part out of the Fiscal Contract negotiations we've been in with the administration. I thought it would be useful to share an overview as to how and why we arrived at this point given that many of the discussions to date have been confidential as stipulated in the SGDA.

Mother Nature - oil and gas are unavoidably linked

Oil and gas form together when plants (and dinosaurs) are buried deep beneath the Earth's surface and, under great heat and pressure, are transformed into oil and gas.

The oil and gas co-exist in the same underground reservoirs, they are produced together through the same wells, flow together through the same flowlines and are processed together in the same facilities. Some fields have more oil than gas and some fields have more gas than oil or condensate. But it is exceedingly rare that one is produced without the other.

Because oil and gas co-exist physically, and are produced together through the same investments made in wells and facilities, they are also linked economically.

This inextricable physical and economic linkage is widely recognized by both governments and investors around the world.

North American royalty contracts cover both oil and gas. Internationally, production sharing contracts include terms for both oil and gas. General oil and gas tax laws across the U.S. and internationally always address both oil and gas.

Governments want to know how much money they will receive from oil and gas production. Similarly, investors need to know how much they will pay governments when oil and gas is produced and sold and make their investment decisions accordingly.

The economic linkage of oil and gas is particularly acute here in Alaska when considering a gas pipeline given the unique operating challenges on the North Slope and the criticality of economies of scale.

Oil Decline - additional oil investment needed to support ANS gas development

We, the producers and the State, currently have a problem. ANS oil production has been declining for over 15 years and *has been on an unsustainable trajectory*. Investment by all of industry has been insufficient to limit decline.

Unless we, and here I mean the entire industry in partnership with the State, are able to maintain economic levels of oil production to support and maintain vital North Slope infrastructure for many decades to come, a gas project can't be successful – it simply cannot be burdened with the cost of uneconomic oil production.

Investors need confidence that the fiscal regime will be sufficiently competitive to attract the enormous amounts of additional capital needed to maintain economic levels of ANS oil production for decades. Providing this confidence benefits both the State and investors against our common enemy – *production decline*.

Building a gas pipeline is effectively a commitment by the major producers to maintain vital North Slope infrastructure for another 40-50 years – This is a daunting challenge.

- Will there be enough investment to stem the long term decline in ANS production?
- Will there be sufficient oil production to keep the unit costs of operating TAPS at an economically viable level?
- Will there be sufficient oil production to cover the operating and maintenance investment costs of operating aging production facilities?

The answer can be yes. We know the oil is up there. Billions of barrels of oil that might otherwise be left behind in producing fields can be accessed. Viscous oil in and around existing infrastructure that was discovered decades ago holds promise. Exploration near existing fields and beyond in areas like NPRA may have potential.

But it is all very difficult. ANS production is declining for a reason – not for lack of oil, but for a lack of profitable ways to extract it. The totality of industry costs and taxes are high. But, we do believe with the right technology and the right fiscal regime, these historically unprofitable investments can be made viable so industry can convert resources into production to sustain ANS infrastructure.

This is why oil taxation policy should *appropriately balance risks and rewards* to enable this additional investment. Even prior to this proposed tax increase, investment has been insufficient to prevent ongoing production decline. The legislature needs to very carefully consider the impacts of a very large tax increase on future investment and long term production.

This is an important decision. And it should not and cannot be a shortsighted decision based on next year's budget or political calculus – this is our collective future.

Are we feeding or starving the golden goose? Will North Slope investment increase or decrease as a result of significantly higher taxes? Will the long term decline in oil production increase or decrease as a result?

What are the knock-on revenue effects on royalty, State Corporate Income Tax, and AVT taxes if investment is impacted? Is a high tax rate at modest prices appropriate?

The evolution of PPT and the Fiscal Contract negotiations

There has been a lot of speculation and innuendo about positions taken by both sides through the negotiation on the PPT. Unfortunately, this appears to be driving perceptions about what the tax rate should be rather than what is right for Alaska and what is right for industry.

I'd like to briefly give you an overview of how the PPT negotiation unfolded to hopefully clear the air and help us focus directly on the real issues at hand.

Since the onset of the fiscal contract negotiations, and indeed years before, BP has sought to make clear the importance of having a competitive and durable fiscal platform for both oil and

gas to underpin a massive gas investment. Including both in the Fiscal Contract is important for two fundamental reasons among others.

First, it provides confidence that the level of taxation will be competitive to enable the additional investments needed to mitigate the ongoing decline in ANS oil production so vital infrastructure can be maintained for another 40-50 years.

Second, it protects us from after the fact tax increases on our business after a gas pipeline has been built and we have no choice but to pay and produce regardless. This is what happened as TAPs entered service some 30 years ago.

In summary, both a competitive and durable oil tax regime are essential and should align well with State goals.

In the summer of 2005, the administration advised us that although they respected the importance to investors of having competitive and durable rules for both oil and gas in the Fiscal Contract, they did not see the ELF regime as properly suited as a long term solution. The concern being the tax base underpinning ELF was declining with time.

The concept of a PPT type structure was proposed by the administration to fix the so called ELF problem. We responded to the administration that if populated with balanced numbers, the PPT could be a viable long term structure with potentially positive attributes for both the State and industry.

In this regard we agreed to move off our preferred position which was to simply utilize the existing ELF based system for the duration of the fiscal contract and consider the PPT structure.

At that time, the mutually agreed goals of both sides for the PPT included:

1. all barrels should be subject to taxation
2. provide the State a balanced and proportionate share of the price / profit upside
3. stimulate additional investment critical to reduce long term production decline

Proposals were discussed intermittently through yearend and it was clear that there was a significant difference of opinion as to what numbers would create a balanced PPT that met these goals.

During that time, the State initially proposed and held to a 20% tax rate. The Sponsor Group had proposed a tax rate of 12.5% which we estimated would have increased State revenues by hundreds of millions of dollars per year at current prices and tens of billions of dollars over the long term relative to ELF. It would also have, we believe, stimulated more investment, more jobs and most critically more long term production.

On Saturday, February 18th, following a long and at times difficult negotiation, we were able to agree and conclude the gas portion of the Fiscal Contract with the State. The following day, we made another PPT proposal for the State to consider in advance of the planned executive meeting, including our Chief Executive, Dr. Tony Hayward.

This proposal made a very substantial move towards the administration's position while providing more support for investors at low to moderate prices where everyone agrees Alaskan investments are extremely challenged.

On Monday morning, February 20th, the Governor outlined to Dr. Hayward and the other executives his 20 / 20 PPT proposal. The proposal we had made to the administration the day before was rejected.

BP has agreed with the Governor that we will not oppose the rates and figures in the proposed PPT legislation before you today. Our Chief Executive and others have made the extremely difficult decision to accept the Governor's terms as a means to finalize a Fiscal Contract. We do believe that this PPT is at the far outer fringe of what should be seen as a reasonable or plausible range of outcomes.

We also need to be very frank with this legislature by saying upfront that we do not believe the 20% rate will maximize investment or in turn maximize long term production. Although the PPT structure has significant merit, and we support it, the overall size of the tax increase outweighs, we believe, the other benefits and goes well beyond optimum.

I hope this context has been helpful. We genuinely hope that this bill can be progressed in a thoughtful and objective manner. Alaska is at a crossroads.

I'll now turn things over to Angus Walker and our PPT team.

Introduction – Angus Walker

I am Angus Walker and I am the Commercial Vice President of BP Alaska.

I would like to start by thanking this Committee for this opportunity to provide testimony on the very important matter of House Bill 488 / Senate Bill 305

We recognise that between PPT and in due course the Gas Fiscal Contract you have decisions to make of great importance for the future of Alaska. We respect the responsibility that the Legislature has to do the right thing for Alaska and hope that we can inform those decisions through our testimony.

I would like to introduce my associates –

Ray Hall: Senior Tax Economist with BP Group in London

An economist by background, Ray has worked with BP since 1988, initially in commercial roles but latterly as a senior adviser on fiscal issues. Ray has held positions in organizations outside of BP including the United Kingdom Offshore Operators Association (UKOOA) and the International Association of Oil & Gas Producers (OGP). His most recent focus areas have been UK, Norway, Egypt and Trinidad.

Tom Williams: Tax Counsel for BP Alaska

It is particularly appropriate to have Tom here. He was Commissioner of Revenue for Governor Hammond and is widely recognised as the creator of ELF.

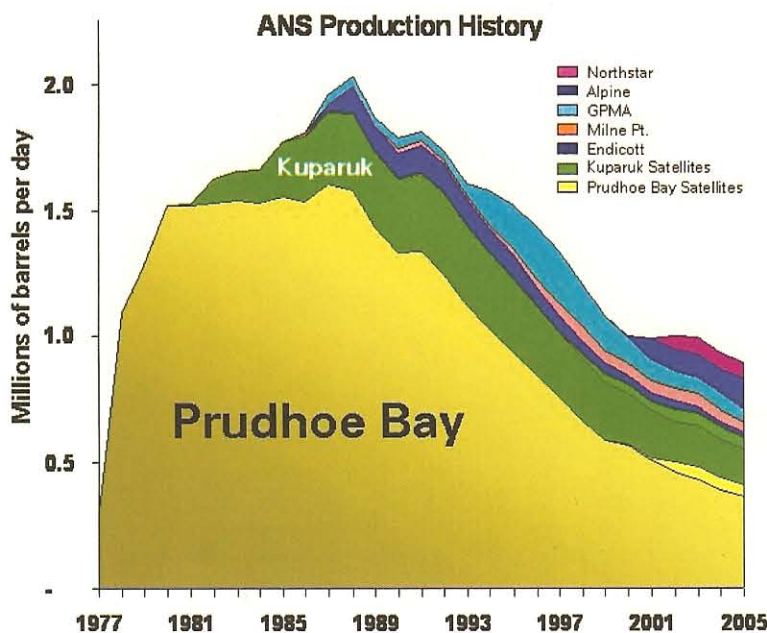
Our testimony will be in three parts, all of which are directly relevant to PPT and the issues before you:

- I will start by describing the current realities of our business and the remaining resources of the North Slope
- Ray will provide a global perspective by comparing fiscal regimes in a selection of the countries in which we do business
- I will conclude by describing the impact of this PPT legislation on BP's business in Alaska

It should be noted that since BP only has leases on the North Slope and in the Beaufort Sea, our remarks will be confined to that business and not other basins like the Cook Inlet in which we do not participate.

Current realities of the Alaska North Slope

Alaska North Slope: The Current Reality



- **Production declining at 6%**

- **ELF has stimulated additional investment through low tax rates**

We're looking at a profile of historical production from 1977 through 2005. The North Slope has produced over 15 billion barrels of oil to date, and while we look back with envy at the days of peak production it is clear that the business today is very different than it was 20 years ago.

To date BP has invested \$24 billion to create the Alaska business we have today. We have paid over \$32 billion of tax to the State of Alaska and \$24 billion of tax to the federal government.

In total we estimate that the North Slope participants have generated \$120 billion in taxes for Alaska & the Federal Government since first production in 1977. In addition, as an industry, we generate more than 34,000 jobs in Alaska every year.

But the harsh reality is that since production peaked in 1988, production has declined at an average 6%.

What this doesn't show is the underlying decline which would have occurred without the tens of billions of dollars industry has invested to stem decline. Natural decline of these fields is around 15%. As an industry we've managed to stem that decline to, on average, 6% over the last ten years by investing between 1 and 1.5 billion dollars a year in the North Slope business.

ELF has worked as intended

Each of the small wedges on this production profile represents the contribution from one of the North Slope's smaller fields. Many of these fields would not have been developed without ELF. And yes, whilst much but not all of this production pays Production Tax, it all pays property tax, royalty and state income tax and helps keep TAPS operational and economic.

ELF has and continues to encourage investment in these small or less productive fields, and has played a significant role in stemming overall North Slope decline.

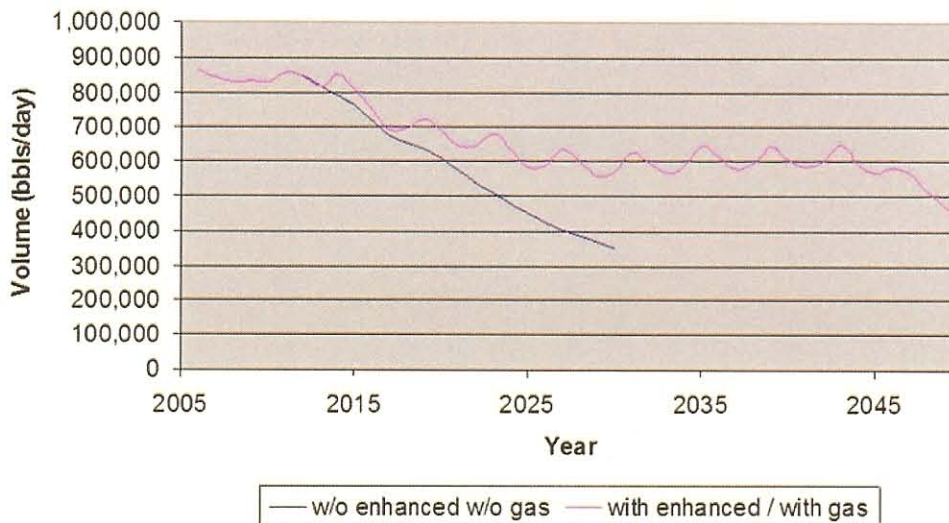
However, we recognise that ELF was designed as a surrogate for profitability and while it has been effective it is not perfect in today's price environment. And it is for that reason that we are supportive of adopting the PPT structure proposed by the Administration.

One of the most important issues for this committee to consider is the impact PPT will have on the decline of the Alaska North Slope.

DOR Scenarios



Figure 1
Volume Scenarios



Source: DOR Testimony: PPT Analysis020106 (DOR).ppt

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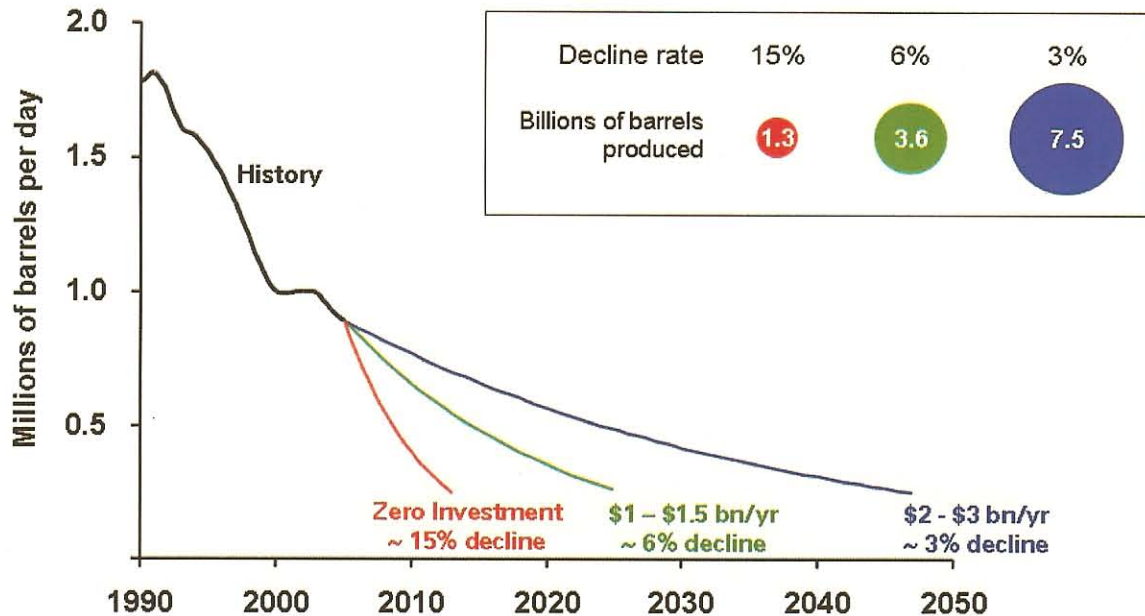
You will recognise the above slide from Roger Marks' presentation last week. It shows two forecasts of future production – the lower blue forecast represents a future without gas, the upper pink line represents a future where the oil business is revitalised by gas.

We agree that the futures with and without Gas look very different. A future without Gas is very much shorter and far less exciting than a future with gas!

But, for Gas to work, it must be built on the foundations of a healthy oil business, a business which must remain healthy for 45 years.

So what will it take to keep the oil business healthy?

Investment & Decline



We share the challenge of keeping Alaska competitive

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The simple answer is to stem decline.

The black line on this chart shows the history of North Slope production. The coloured lines look forward to the future.

With no investment the natural decline of the fields would be the lower red line and with in 10 years the business would be gone.

With the current levels of investment of \$1-1.5 billion / year) (which assumes the current tax regime), history tells us that decline will be around six percent per year. With that trajectory we can expect the business to last around 25 years, but nowhere near long enough to enable gas.

In order to enable gas we must reduce the rate of decline even more. 3% decline would require twice as much capital as is being spent today (\$2 - \$3 bn dollars per year). That is \$20 to \$30 billion dollars over the next decade alone. Alaska must compete to attract these dollars!

We share the challenge of keeping Alaska competitive: the State's part is to maintain stability and keep Alaska attractive to investors; our part is to provide the technology, innovation and investment.

The tax regime you approve will directly impact how attractive Alaska is and what the future decline will be. It is in the interest of all (industry and Alaska) that we focus on growing the pie rather than taking an increasing share of a declining pie.

So where will we find all this oil to stem decline?

The good news for Alaska is that we have a huge resource base!

Alaska has lots of oil and gas!



Billion barrels equivalent			
	Produced		15
	Known Remaining		17.5
	Developed	- Light	3.5
		- Viscous	0.3
	Undeveloped	- Light	4
		- Viscous	0.7
		- Heavy	3
		- Gas	6
	Yet to Find (Exploration)		5

Recoverable Resource



Source: DOR / USGS / BP

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To date we have produced 15 billion barrels, but there are 17.5 billion barrels remaining that we already know about, 3.8 billion barrels of which have been developed to date.

The remaining 14 billion barrels consists of:

- 3.5 billion bbls of light oil remaining in the existing reservoirs
- 1 billion bbls of viscous oil which we have started to produce
- 3 billion bbls of heavy oil lying in shallow formations below the permafrost
- 6 billion bbls of gas which we are working so hard to get to market

The scale of this known resource greatly exceeds that expected from future exploration. Future discoveries are expected to be of the order of 50-150 million barrels. It's not to say you should stop exploring, but you cannot rely on exploration to stem the decline of the North Slope.

While BP isn't exploring in the conventional sense, we are adding barrels. We're not only looking at develop our share of the 17.5 billion barrels, but we're looking to make it even bigger.

To put that in perspective, every time we increase the recovery efficiency by just 1% we access an additional 600 million barrels (400 mmbbls light oil and an additional 200 mmbbls heavy oil)..... Every 1% is equivalent to another Alpine!

It is for this reason we're investing in technology. We're exploring within our existing fields.

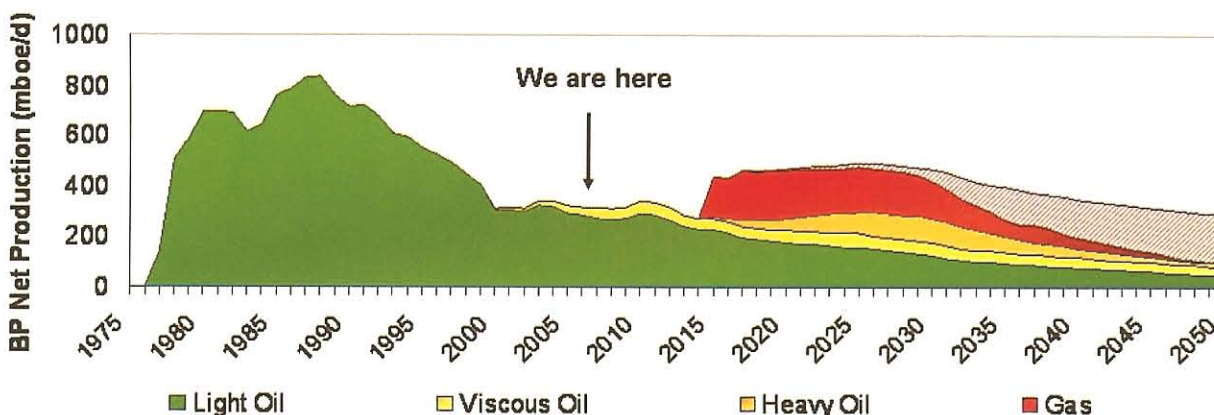
One example is that we're spending in excess of \$100 million implementing innovative technology to increase recovery at Endicott. If we're successful at Endicott it could add hundreds of millions of barrels of production across the North Slope. (Another Alpine?)

To develop the 14 billion barrels we know about would require well in excess of \$100 billion. And that kind of investment can only come from the Major oil companies of the world a fact supported by Pedro Van Meurs testimony. It thus mystifies us why so much of the testimony given to this Committee by Pedro Van Meurs focussed on the impact of PPT on new entrants when the future of the North Slope is dependant on making Alaska attractive to Major oil companies.

This is the reality of our business and the reality of the North Slope today.

It's the reality we encourage you to look at as you consider House Bill 488 / Senate Bill 305.

A 50 year vision



This is the graphic we use when we describe our vision for our business in Alaska.

It shows BP's production both historical and future. A few points we always make when we talk to this are:

- The future will be very different to the past.
- Three businesses built on top of each other all of which must be healthy.
- We face enormous challenges in creating this future
- Attractive and stable fiscal terms are key to making this happen, without it our vision will not come true.

I will now hand over to Ray Hall, who is going to provide a global perspective after which I will describe the impact of PPT on BP's business in Alaska.

Global Perspective

Refer to Raymond Hall's slides

[2006-02-28 BP Testimony - Global Perspective.pdf]

Impact of PPT on BP in Alaska

Much of the analysis presented to this committee has been based on specific cases – (50, 150, 500 mmbbl fields). These are of course academic examples and what I will do is to clarify the impact of implementing PPT on BP's business in Alaska.

I will do this through the lens of Government take.

Government Take



$$\text{Government Take} = \frac{\text{Total Taxes}}{(\text{Total Taxes} + \text{Industry Profit})}$$

Government Take in Alaska comprises 5 elements:-

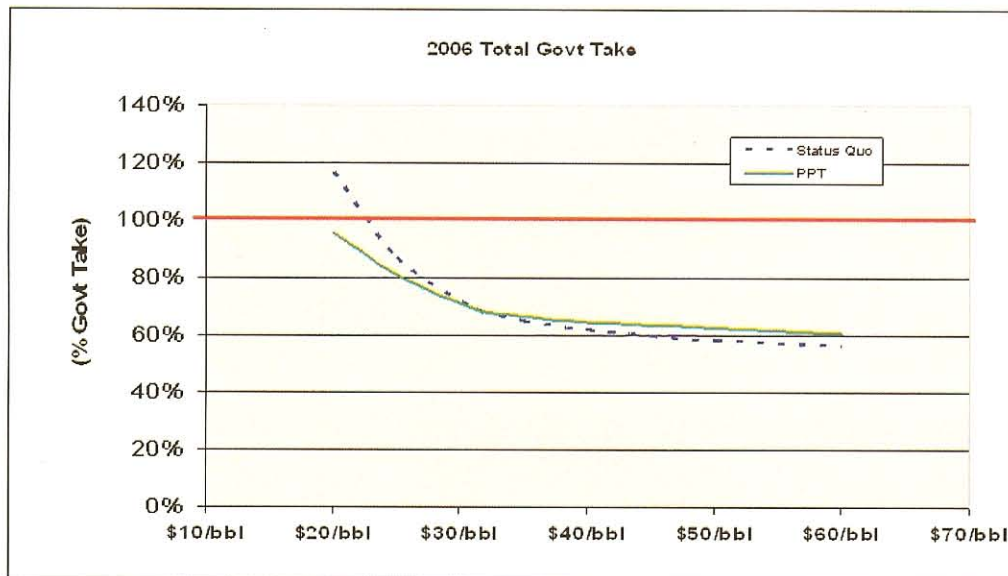
- | | | |
|--|---|---------------|
| <ul style="list-style-type: none">• Royalty• Production Tax• Property Tax• Income Tax | } | State Taxes |
| <ul style="list-style-type: none">• Federal Income Tax | | Federal Taxes |

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Government take is the percentage of total profit which is taken by government (in this case both State & Federal) with the remaining being the profit which goes to the investor.

Government Take is made up of a total of five elements: State income tax, property tax, royalties, production tax, and Federal income tax. The Investor's take is the investor's profit.

PPT Impacts on BP Alaska Government Take vs. Price



- **Government Take extremely high at low & medium prices**
- **Investors must make a reasonable return at medium to high prices for Alaska to be attractive**

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This chart shows the total Government take at different oil prices for the current Elf based system and PPT.

That's the real Government take on BP's business in Alaska.

The first point to note is that at low prices we do not make a profit. We make a loss. But regardless we continue to pay Royalty, Property Taxes and State income tax, which results in a government take of greater than 100%.

Under PPT, the Government take is around 70% at the moderately high price of \$30 / bbl. This is very high & especially considering the very high cost of doing business in Alaska.

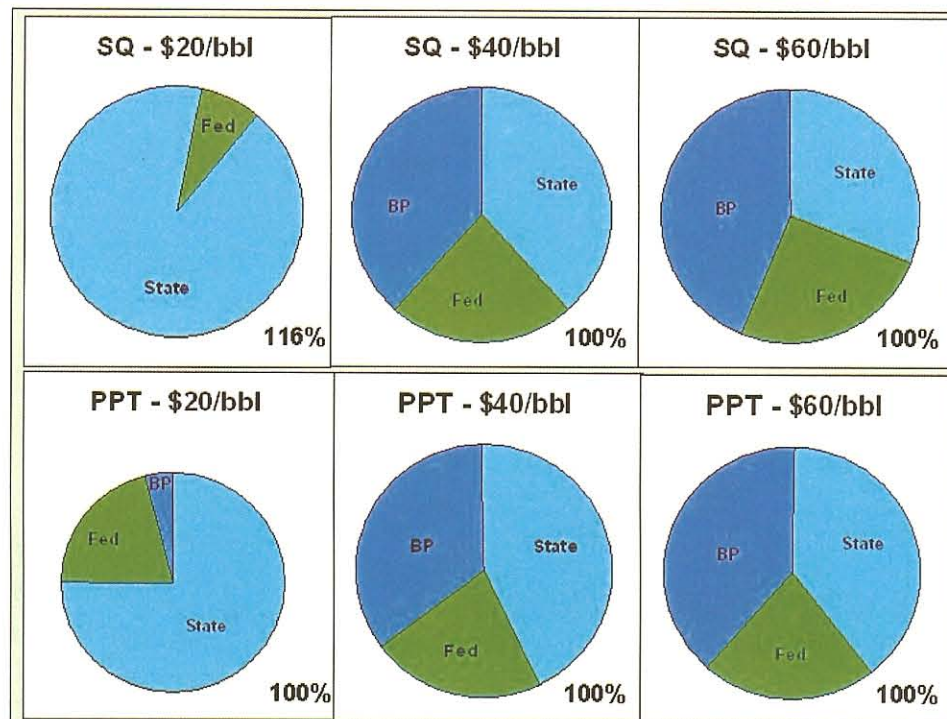
We absolutely must make a good profit in Alaska when prices are high. We make no profit when prices are low. Alaska is a price play and if you take away the upside price incentive then there is no reason for us to be here.

Alaska is a mature business with a challenged resource. In our opinion you should be concerned about overtaxing the industry rather than undertaxing it.

PPT Impacts Government Take (%)



Status Quo



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Here we can see the split between State, Federal and BP take under the current regime and PPT at low, medium and high prices.

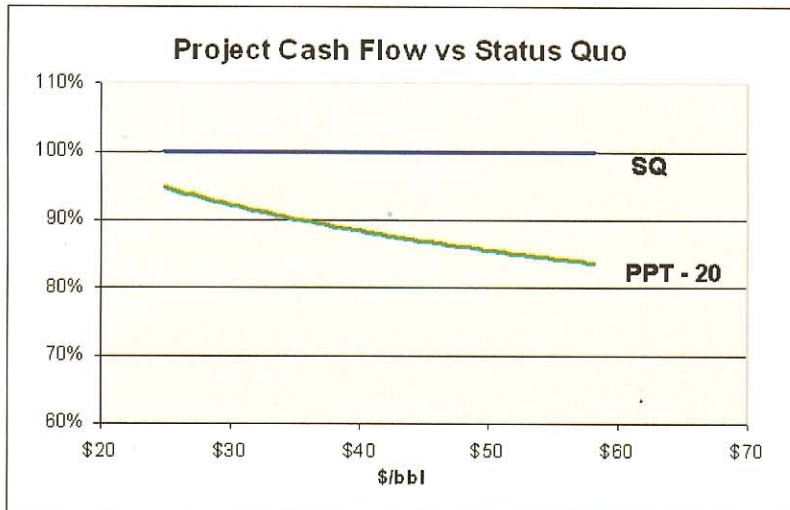
The left hand pies illustrate the problem for BP at low prices. Under the current system BP makes a loss at \$20 / bbl.

At \$60 / bbl the current system provides a higher % to the industry than to the State, but that is not new news. Alaska's fiscal system was designed to protect the state at low prices and compensate the industry at high prices. That is the nature of a regressive tax regime.

Under PPT, we would make an extremely modest profit at \$20. At \$40 the state gets a considerably higher share than BP. At \$60 the State's and BP's take is balanced.

Introduction of PPT squeezes our profit at higher prices, and let's not forget we make the investments, we take the risks and absolutely we have to make a good profit at high prices for Alaska to be attractive.

PPT Impacts Project Cash Flow



- **Rate of Return improves, but it's only one measure**

- **Project Cash is lower at all prices**

So what about future investments? We agree with Pedro Van Meurs, PPT will tend to increase the rate of return on many new projects, but we look at many metrics when making decisions about investing (Net Present Value (NPV), Net Income, and cash flow per barrel are but a few examples).

This graphic shows how PPT (20/20) impacts a new investment.

Rate of return is increased due to the positive impact of the capital credits on the upfront investment, but

Total return to the investor (after tax cash flow) is decreased due to the increased state take. This project takes the same effort / capacity to execute regardless of the tax regime. Increasing State take reduces total returns to investors making investments less attractive.

It is thus our sincere belief that the best result for Alaska is to implement a Petroleum Production Tax with a tax rate less than the 20% proposed by the Administration.

I would like to leave with you the key messages from this testimony.

PPT: Key Messages



- **Decline is a problem**
Alaska has been in decline because profitability has been insufficient to attract capital, not due to a lack of resources
- **Large increases in investment are required**
To stem ongoing decline and attract the required investment (\$50 - \$100bn), PPT must work for the major investors
- **Capital is mobile**
International investment flows to basins where it can earn a profit
- **Profit-based taxes are superior to revenue-based taxes**
The PPT structure has merit and could serve Alaska well for the long term
- **Higher taxes means less investment**
The 20% rate is very high and will not maximize investment and production
- **Oil needs Gas . . . and Gas needs Oil**
For Gas to work, the Oil business must be healthy

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On behalf of BP I would like to thank you for this opportunity to testify and wish you well with your deliberations.

We will of course be available to provide further testimony as appropriate.