Alaska Oil Tax Analysis:
An Opinion on the Scott Goldsmith Analysis

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The State Legislature overturned the previous oil production (profits) tax, popularly known as ACES (Alaska’s Clear and Equitable Share) and put in place Senate Bill 21 (popularly known among oil industry insiders as MAPA, or the “More Alaska Production Act,” and also known as the Oil and Gas Production Tax). The voter referendum ballot measure #1, to be decided on August 19, 2014, is a vote on Senate Bill 21 (SB 21). A “yes” vote would rescind SB 21 and put ACES back in place. A “no” vote would maintain the SB 21 oil tax system. So “yes” for ACES; “no” to keep SB 21.

The idea behind SB21 is to lower taxes in order to make it profitable for new oil and gas investments on the Alaska North Slope (ANS). The ANS is a challenging environment where costs are high and environmental regulations are strict. SB 21 assumes that with lower taxes, more investment will occur. The hope is that in turn, SB 21 will increase discovery of more oil. Proponents argue future oil revenue streams will not decline as much with SB 21 in place, and, in the meantime, SB 21 may help the state’s oil and gas industry grow, bolster jobs and improve the state’s economy.

The real question raised is to what degree do SB 21 tax cuts make that happen? More to the point, how elastic is the supply of oil and the State’s revenue from this resource for a given change in taxes over the long run? Moreover, what is the macroeconomic multiplier for oil and gas investment in Alaska? If the supply of state oil is fairly inelastic over the long run, and if taxes are low, more profits go the Producers without a lot of new production; on the other hand, if the supply of oil is elastic, and if taxes are low, there is significantly more production and the state’s economy and future tax revenue will
increase. Therefore, if you believe oil supplies are fairly inelastic in the long run, which they have been, ACES will make the State more money. If you believe oil supplies are somewhat elastic, then SB 21 will make the State more money.

Typically, it takes a lot of work to find and develop a new petroleum resource. Often there are many failed attempts before one new oil field is discovered, offering little promise of reward. That’s why new oil and gas developments are considered one of the highest risk capital investment pools. While rewards can be high, it takes a huge pile of chips to survive more than a few passing moments at this roulette table, creating risk for new developments. ACES, however, did offer up-front tax credits for initial drilling and exploration. Those credits reduced some of the risks. ACES also reduced taxes during periods of low oil prices, making the state more vulnerable to revenue reductions, while simultaneously making the Producers less vulnerable to those same price and revenue reductions. ACES raised taxes, however, when oil prices increased so that the state could share in profits while they were available. The overall effect was to reduce the vulnerability the Producers faced in times of low oil prices so their tax costs fell if their revenues were falling. It also gave the state some upside benefits. The reason the oil companies prefer a new tax system is that they are facing those high taxes since oil prices are now high. This reduces their up-side profit potential, which they count on to cover any cost overruns or downside revenue reductions that make investment so risky.

The question before us on August 14th is, how should Alaska’s citizens vote: “YES” to revert to ACES or “NO” to keep SB 21 in place? One analysis of this issue was done by Scott Goldsmith of the Institute of Social and Economic Research (ISER). In a News-Miner commentary on Sunday, May 11, 2014, former governor Tony Knowles also commented on the Goldsmith study.
The Goldsmith study which I address in this opinion paints SB21 in a favorable light. Below, I offer eleven critical arguments which I urge Alaskans to consider when evaluating the Goldsmith conclusions and before casting their vote. The bottom line is, how much does Alaska gain from SB 21?

1.) On page 1 of the Goldsmith analysis, it states that the tax change combined with production increases, would produce higher revenues. However, if SB 21 had been in place during the time ACES was in place from 2008 to 2013, the state would have lost $8.5 billion in revenue according to a Department of Revenue report for the legislature in 2013. It would seem that you would need a lot of new oil fields to make up such a revenue loss. Roughly speaking, you would need about 10 to 20 new oil fields of the type Goldsmith shows on page 16 to make up for such a shortfall. There would be massive bottlenecks to get all those going within a small staging area near Deadhorse where men and machines would have to be launched from. The costs would be much higher than normal, and there would inevitably be delays. It would be better to start a few projects at a time over the course of many years in order to better coordinate them all, but then new projects would not be enough to overcome the loss in state revenues.

2.) The Goldsmith analysis directly compares SB 21 against the original promulgated form of ACES. This base of comparison may be unfair. Recall that on April 26, 2012, Governor Sean Parnell suddenly and abruptly withdrew an oil tax bill from the legislature's special session agenda. This was an unprecedented move, negating the possibility that the Legislature could have compromised and reached broad agreement on modifying ACEs instead of abandoning it altogether. Since, the governor’s unwillingness to continue the session meant that any compromise the Legislature could have achieved would most likely have been vetoed by the governor, then there was no point for the legislature to carry
on. Therefore, a direct comparison of SB 21 to ACES in its original form may be invalid because it simply overlooks any modifications that the senate could and might have approved in April 2012. While no one truly knows what modification the Senate might have adopted, what is clear is that political strategy trumped any sentient debate that might have improved ACES instead of adapting yet another Alaskan fiscal regime.

It should be remembered that the vote in favor of ballot measure #1 to rescind SB 21 and reinstate ACES is not an all or nothing vote. If the people reinstate ACES, there is still the possibility that the legislature can revisit the issue and come to a well-developed compromise. In April, 2012, the Senate was recommending several sensible changes to ACES to reduce oil tax rates if crude oil prices climbed to unexpected highs. Governor Parnell clearly derailed these proceedings on April, 26. Consider that points made in Goldsmith’s analysis and my rebuttal could and should have already been argued and openly discussed by the governor at the very beginning of his administration, complete with public and independent consultant input. He did not conduct a neutral analysis, the way Palin did at the beginning of her administration, nor did Parnell create a broad agreement and submit it to the legislature for further compromises. Instead he kept pushing only one solution. When he did not get it, he used a gerrymandered state senate boundary to get the senate votes he needed, which included two industry workers. Without the proper vetting process that should have begun in 2010, which could have resulted in a compromised solution, we are now forced to view commercials sponsored by oil companies where our friends and neighbors argue their case, pitting Alaskans against Alaskans.

3.) On page 15 of the Goldsmith analysis there is a graphic showing a consistently increasing cost and what looks to be a plateau for oil prices. The statement on page 15 is that, “historical movement of price and lease costs does provide some evidence that the production tax value per barrel
will be constant or lower in the future years.” Indeed, former governor Knowles also chimes in with the idea that “production costs (will be) increasing faster than oil prices (into the future),” and that “experts agree.” However, Knowles does not tell us who these experts are and what their status is. Goldsmith illustration shows that the difference between the price of oil and the cost of production increased from about $45 to $60 from 2007 to 2013, where Goldsmith assumes that price is the value of what the oil is sold for and cost is the extraction cost to get the oil out of the ground plus tariffs.

As we are all aware, the price of oil could increase much higher. For example, in March 2014, Chevron Corporation CEO, John Watson, said that the current $100 per barrel price of oil is the new $20 per barrel price. What he meant by that is that oil cost $20 per barrel ten years ago and at that time, not many experts, except myself and a few others, suspected that oil prices would go up. See Illustration 1 below. In the late 1990s and early 2000s, most experts, and the NYMEX futures price of oil, seemed to indicate that oil would stay at $20 per barrel for a long time. Now experts and markets indicate that $100 oil will remain the norm. The moral of the story is, never say never, and always keep energy in mind when budgeting household and business expenses.

The world reached an oil production plateau in about 2005, which was why prices rose so much. Then in 2009, there was an increase in world oil production due to the American shale oil revolution. However, notable shale oil regions around the world including Russia, China, Poland, France and North Africa have yet to see any significant shale oil activity because these resources are nationalized, which generally slows development. This suggests that the world might soon reach another plateau in oil production and that peak oil will again take center stage. At the same time, the economies of developing countries such as Brazil, Russia India and China, (the so called BRIC countries), are still growing, even if less robustly since the 2008 financial crisis. While BRIC growth seems sluggish lately, their growth rates have achieved 10% per year, and many economists believe that the potential growth for the
developing world is three times that of the developed world. When economic growth is that robust and when average citizens in these countries are on the verge of making $5000 per year, the number of cars bought and used can increase as fast as 20% per year. That signifies a huge potential increase in global oil demand. If oil supplies plateau or fall (as they can) and demand for oil skyrockets (as it has), the potential for higher global oil prices will naturally increase. If so, I opine that Alaska needs to get its fair share. Since Alaska’s resource constitutes the majority of its inherent wealth and its constitution remands this wealth to its peoples, Alaskan voters now face an opportunity to reinstate ACES, or if legislatures want a similar fiscal system, that makes not only its industry, but its people more competitive as the forces of globalization continue their march.

If we assume the governor’s prime objective is to prioritize the success of the oil and gas industry ahead of Alaskans success, his wisest strategy then would be to quickly put a lower oil tax in place, such as SB 21, before global oil prices increase. Many say that if oil prices do rise, the Legislature may still have an opportunity to modify SB 21 or reinstate ACES. However, Alaskans must consider that if Governor Parnell is re-elected, he would be able to veto any significant modifications to SB 21 or reinstatement of ACES. If Alaskan voters want to keep these decisions in their purview, rescinding SB 21 can start the process of reinstating a modified version of ACES. Given Governor Parnell’s past actions including his unwillingness to achieve a compromise of ACES, one might say that repeal of SB 21 may be their only choice.

Illustration 1. Nominal Oil Prices and The Trend
4.) Note in Illustration 1 that the trend of oil prices has been clearly upward, although there is some measure of uncertainty whether the flat trend will continue or not. One idea when looking closely at the trend is that we are in a new paradigm like the 1990s where the price will stay constant for the foreseeable future. Another is that this plateau in prices is only a small respite. However, the Watson statement from above (that the current $100 per barrel price of oil is the new $20 per barrel price) makes it clear how future energy prices may dramatically rise again. Alaskan voters must also consider that the illustration shows what is probably the chief reason for increased activity on the North Slope: prices are higher. In spite of lower natural gas prices, oil prices are relatively high providing current profit opportunity for the Producers, and while SB 21 diminishes monies retained in Alaska, the Producers’ profits continue to grow at near record levels. The questions this raises is what current increase in
investment on the North Slope is actively driven by profitable harvestation or what current increase is driven by a relaxation in taxes? The Goldsmith report implies that increased activities on the North Slope are due to Alaska’s tax relaxations is simply misleading because it conveniently ignores increased price fundamentals.

Plus, one would hate to not veto SB 21 only to see the price start moving upward again and miss out on the revenues we could have received. Yes, global oil production costs have risen, but Producer’s North Slope profits have risen in tandem. After a year under SB21 the Producers are clearly getting more while Alaskans get less. Nevertheless, the Goldsmith statement that suggests that current activity is all due to a tax change when clearly the price has risen substantially, is misleading. The diatribe of SB21 advocates, their expensive and surreal commercials’ all curtly resonate words such as “partnership” and “improving Alaska’s competitiveness.” It can be said that good partnerships share in both risk and rewards. Likewise, it can be asked, competitive for whom?

5.) Page 15 on the Goldsmith report addresses the cost side. Even if oil prices go up, costs near Prudhoe Bay will not go up nearly as much as oil prices because the Producers enjoy cheap natural gas to run their processes and to produce electric power. When considering remote field developments touted by SB21 advocates, Alaskans should realize that these fields face higher costs than North Slope legacy fields. While there are profits to be made on these marginal fields, it is highly unlikely that they will ever approach the huge rewards made on world class reservoirs such as Prudhoe. It’s been many decades since Prudhoe was discovered and it’s been many decades since a field like Prudhoe Bay has been discovered anywhere in the world. While offshore prospects have significant promise, it may be many decades before they can be safely commercialized.
A pivotal issue that Alaskan voters must consider when choosing to retain or repeal SB21 is whether citizens want to get more value from existing fields now or allow new far-flung marginal fields to be developed at less retained value latter? The answer to that question depends on marginal analysis not on a general, average analysis. The Goldsmith study does give an example of just such an analysis, but fails to explain how much of a reduction in tax revenue occurs to the existing oil fields due to SB 21. Also the timing on that analysis is imprecise as table 1 shows below where it would normally take ten years to obtain new production. A series of Monte Carlo simulations could better determine which regime offers the best outcome. Nevertheless, one strategy is to keep ACES even if new fields are not developed, but get as much value for the state as possible from existing fields. The State can always institute changes to its fiscal regime to incentivize the development of remote (and uncertain) fields after adjusting its risk and reward quotient on proven, economic world-class fields. In fact, it could do this by making changes to ACES that would more appropriately quantify the difference between profitable productions from legacy fields and those which may ensue from new or reworked fields.

One remote oil and gas field of interest is the Point Thompson Unit. It is roughly 60 miles away from Prudhoe Bay with no permanent road to it yet. Point Thompson has high costs and relatively low production values especially since it has a great deal of natural gas but not as much oil. Based on its lease terms (its partnership agreement with the State), ExxonMobil should have developed this field decades ago. If the partnership agreement had been enforced by Alaska’s Administration, ExxonMobil should have surrendered its lease due to its long policy of warehousing instead of commercializing this resource. If there were profits to be made from Pt. Thompson decades ago, one would think that Exxon would have risked capital to obtain them. While there may have been profits to be made, those profits obviously paled in comparison to those which Exxon reaped in other portions of the world. What does
this say about the Producers’ non-guaranteed promise (under SB21) to risk their dollars on Alaska’s remote, uncertain, and less profitable fields?

6.) Page 5 of the Goldsmith document discusses Alaska’s effective oil tax rates. Clearly, ACES retains lower taxes on downside prices and higher taxes when crude oil prices are higher. ACES also adjusts for production costs. SB21 does not adjust nearly as much and gives away most of the benefits of the oil at current prices, and its gross value reduction gives even more away in the case of marginal new fields. On page 19, the Goldsmith document explains that the new tax may create an early reduction in state revenue, during the time when there is new investment with a subsequent 3% rate of return such that the state receives a net benefit in present value terms. However, this assumes that oil prices will remain fixed at $100 per barrel. As illustration 1 and global demand increases imply, there is a very good probability that the price of oil may increase in the next ten years, in which case Alaska will retain a far lower present value than Goldsmith suggests.

7.) Goldsmith states that because there has been considerably new oil investment on the North Slope over the last year, this proves the new tax is working. However, when a new oil and gas investment is truly motivated by a change in taxes, it will occur well after a tax change is made. Once a tax change is made, the company’s headquarters will need time to analyze it, make a decision about new oil investment, and raise capital—usually allocated at the start of the company’s next fiscal year. Only then would permitting studies be initiated for new exploration. After that the permits have to be filed, and extensive seismic and exploratory wells would have to be drilled. Once proven, extensive engineering designs and more permits need to be secured as production facilities are constructed. This process can take as long as ten years, which is the time the Producers have consistently said it would
take to get new oil out of ANWR should it ever be opened up for oil and gas development. Find a
typical time sequence below:

Table 1  Proximate Timing of New Development

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When contemplating their vote, Alaskans should realize that there was actually a huge increase in permitting before SB 21 was in place, and there was another increase after SB 21 was in place. What is not clear is when the decision to initiate permit studies was made. Usually the time it would take to wait for a new tax regime and to initiate studies would be about one year such that permitting after SB 21 could have been a reaction to ACES or high oil prices rather than a reaction to SB 21. As former governor Knowles said, we need time to see if SB 21 is working or not. Since ACES was only in place about five years, it can equally be said that ACES in its original or modified form could have resulted in commensurate oil production investments.

The interesting example given on page 19 of the Goldsmith report suggests that it only takes four years to get a new oil field to production even though the timeline above suggests it’s more likely that it would take about ten years. Therefore, it would seem, that the Goldsmith analysis references a case where an oil field was already found but put on hold (warehoused) for better times. Likewise, it could also refer to a field that was adequately incentivized under ACES. More than likely the prospect might have been uneconomic until recent years because it demanded a higher oil price.

8.) The Goldsmith report states on page 1 that Alaska needs to attract outside investment. One of the claims put forward by the industry is that there are better prospects in other oil regions that have more attractive fiscal systems (lower net-tax systems). However, in other states the producers have to compete to buy leases from private mineral-rights holders and pay them royalties as well. In other countries, producers often need to enter into joint ventures with local national oil companies (NOCs), which take a direct share of profits. In Alaska, the Producers do not have to have joint ventures and they control the most rewarding leases, which provides a convenient barrier to entry for any new oil
companies. If any other oil company finds oil on state land, or even on federal land, that oil often has to
be processed by the current producers close to the TAPS gathering stations before the oil can be put into
the pipeline. The current Producers can and do charge exorbitantly for these “support services”.

9.) Investment in oil and gas is touted as a driving force of job creation in Alaska. The
Goldsmith report on page 27 lists a jobs multiplier of 2.4. That is, for every job created in the oil and
gas sector, you get 1.4 additional jobs indirectly when oil and gas workers spend money on the
economy. Normally, when government spending occurs in Alaska, the multiplier is only 1.5; therefore,
the Goldsmith figure has to be questioned, especially given that North Slope investments are relatively
isolated. We must not forget that many North Slope workers are from out of the state, and they tend to
only come in for work and leave, and in many cases, so-called in-state workers are workers that have
recently come to the state. This is not necessarily a problem for Alaska because out-of-state workers
still produce oil and their contributions provide Alaska certain value in oil revenue if not adding lesser
secondary value to local economies.

Capital equipment in the oil and gas sector also comes mostly from outside of the state, so new
investment tends to have a minimal impact on Alaska’s economy. Even when capital and labor are more
aggressively sourced from Alaska, the ultimate realization is that their higher costs increases
development costs, thinning taxable profits. In addition, the multiplier effect of new investment in
Alaska is small since any spending from jobs created in Alaska is quickly pushed to the Lower 48 where
we get most of our food, cars and other consumables. What occurs developmentally in more
economically integrated states does not apply in Alaska.
10.) Page 34 of the Goldsmith report addresses the marginal tax rate versus the average tax rate. The idea behind this is that if I work an extra hour of over-time, and earn $10 more, how much of those ten dollars will I keep and how much will the government take? Let’s assume that on average I am taxed at 30% for a day’s work, but once I work over-time my entire average tax rate increases to 31%, then not only the $10 of over-time is taxed at 31%, but all previous earnings are taxed at 31%. If the previous earnings were $100 for the day, then now instead of paying $30 of tax, I pay $31 plus the tax on the over-time. Essentially now I pay, not $3.10 of tax for that last hour, but $4.10 or 41%. This is not a lesson on marginal tax rates. Under this example, I worked for the extra money and paid taxes on it—plus more on what I earned prior to the overtime. Normally when one considers a marginal tax rate, you look at what you did to earn an extra dollar, the incentive to earn that extra dollar and how that extra dollar is taxed. However, in the case of oil company profits and oil prices, nothing is done to earn the extra dollar, it is just market forces that give you a gift of higher prices and greater profits. In the case of the ACES tax, the oil companies do not initiate extra work and investment to receive the extra money as they have a sunk cost investment that simply enjoys higher values. They are passively receiving the extra money, not working for it.

Goldsmith’s analysis is incorrect because new investment decisions will not be affected to the degree that their supposed marginal tax rate suggests. The increase in taxes for higher prices does not create that much less of an incentive for investing as implied, and therefore the investment has nothing to do with the marginal rate due to future one time changes in prices. The tax is higher pure and simple. When determining an investment, the analysis should be done using a Monte Carlo simulation run with several different future prices and the probabilities associated with all those prices. The concept of sunk cost is appropriate here because you are not actively increasing your investment to earn more money when the price rises.
11.) One matter often brought up by the oil and gas industry is that the Trans-Alaska Pipeline System (TAPS) is not full enough to continue working properly and that there could be a shut down long enough to cause the oil to freeze up and congeal, creating months of oil production reductions that could ruin the oil fields and Alaska’s finances. Governor Parnell and the industry touted the lower tax as away to create, “one million barrels of oil a day,” to fill TAPS and reduce the probability of a shutdown of the pipeline. However, a quick perusal at the Goldsmith graphic on page 17 shows that even with extra investment, whether that increase is due to ACES, SB 21 or increased oil prices, Alaska will still face a steady decline of about 6% through TAPS. So this idea that we can “reverse” production declines is clearly naïve.

Former Governor Knowles said that the continuing decline in oil production and therefore Alaska state revenues is an, “economic disaster for Alaska.” Therefore, we need to increase production so that we can “pay for education.” Also former University of Alaska President said in a Fairbanks Chamber of Commerce presentation that, “nothing is going to save you but more production,” and “jobs go away,” and that, “we’re broke.” You would never have believed that the solution to all of this is SB 21 after seeing the graphic on page 17 of Goldsmith’s report. Oil production is going down no matter what, so one might think the sensible route would be to make as much money off proven and producing oil reserves as possible, and maybe consider funneling more into the permanent fund as the Norwegians profitably decided to do several decades ago.

I would also like to mention several important matters not discussed by Goldsmith. One of the great things about the ACES tax was that it helped small new companies begin on the North Slope because credits were available to help new producers to overcome the risks of investments. One of the
problems on the North Slope is that the three big Producers own and control all of the oil and gas treatment facilities and they can charge high prices for the use of such facilities, making it difficult for new companies to break into North Slope development. At least ACES had incentives in place to help encourage new exploration.

One issue that is upmost on many Alaskan minds is the liquefied natural gas (LNG) project. Many commentators suggest that without SB 21 we will never get a gas-line or large LNG project. However, it should be noted, that the LNG project looks to cost $60 billion, of which Alaska is agreeing to foot much of the cost. Yet, the Alaska Oil and Gas Conservation Commission (AOGCC) has stated in testimony that developing an LNG project will cause a loss of oil production for the major fields of Prudhoe Bay and Point Thompson, which could affect Alaska’s oil revenue. The net gain to Alaska of a potential four billion cubic feet per day natural gas project will be limited after all the tariffs are deducted and Japan finds lower cost sources of LNG from the Lower 48 through the newly expanded Panama canal. So not only does such a project cost the state several billion dollars in initial investment as its stake in the project, we gain little in natural gas revenues and lose oil revenues to boot.

There was once a sage of businessman named Ross Perot, who, through his business acumen, became one of the board-of-directors of GM. When GM wanted to buy a new defense-aerospace company, it was stated that such a purchase would give GM new technology. Perot countered that if you need new technology, just buy the technology you want. “Why buy a cow, when all you need is a little milk,” he said. So why is Alaska buying a cow when all we need is a little milk. Instead of paying a portion of a $60 billion LNG project, Alaska can for about $2 billion build an 18 inch small bore pipeline from the North Slope to South Central Alaska and continue feeding the Kenai LNG export facility and continue assuring Anchorage and Fairbanks all the natural gas they will ever need. Such a project could be permitted in two-years as it would be near or under the haul road. Moreover, a massive
LNG project still needs more natural gas than is available from Prudhoe Bay or Point Thompson. Natural gas would be needed from ANWR, off-shore developments, MacKenzie Delta and shale oil and gas developments on the North Slope. Such projects and agreements are a decade or more away from reality.

My hope is that I can prepare and put forward a more comprehensive analysis of the issues surrounding the SB 21 tax rate at a future date. Just remember: “yes” for ACES; “no” to keep SB 21.

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