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M E M O R A N D U M February 10, 2024

SUBJECT: Cook Inlet Tax and Royalty Exemptions
(CSHB 223(RES); Work Order No. 33-LS0886\S)

TO: Representative Tom McKay
Chair of the House Resources Committee
Attn: Ed King

FROM: Emily Nauman
Director

The committee substitute you requested, relating to royalty relief for certain Cook Inlet oil and gas production, is attached. Please consider the following comments.

1. Royalty Relief. Currently, AS 38.05.180(f) contains three existing royalty provisions related to Cook Inlet. First, AS 38.05.180(f)(4) sets the royalty rate at five percent on production of oil or gas from a new pool discovered on or after March 3, 1997, in Cook Inlet for a period of 10 years following the date of discovery of that pool, subject to conditions listed in that paragraph. Second, AS 38.05.180(f)(5), the paragraph amended in the governor's bill (HB 276), sets a five percent royalty rate for certain production from specific fields in the Cook Inlet. Third, AS 38.05.180(f)(6) allows the stairstep adjustment of royalty rates for production from specific Cook Inlet platforms and fields located offshore. How will subsections (mm) and (nn), added by the bill, and these existing paragraphs work together? Do you want to repeal either of the existing paragraphs? Do those paragraphs still apply?

Please also review the transition language, directing the commissioner of natural resources to enter into lease negotiations to amend existing leases[1]. Consider consulting with the Department of Natural Resources to be sure that section will be sufficient to achieve your intent.

2. Interstate Commerce. The bill provides for lower royalty rates for oil and gas used in the state. A court would most likely strike down such a rate structure that favors in-state use because the differential royalty rates discriminate against interstate commerce. Under this bill, oil and gas that is produced but not used in the state is subject to a higher royalty

[1] This language was added to prevent an unconstitutional impairment of contracts. Art. I, sec. 10, of the United States Constitution and art. I, sec. 15, of the Constitution of the State of Alaska prohibit a law from requiring changes to the terms of an existing contract.

rate. A Commerce Clause issue may be raised because oil and gas from the same lease or property is subject to different royalty rates depending on whether it is used inside or outside of the state. If a court finds the differential royalty structure violates the Commerce Clause, the remedy may be to strike down the provisions that limit the royalties on oil and gas used in the state.[2]

While the Commerce Clause relates to the power of Congress to regulate commerce, it also implies that only Congress has that power (referred to as the dormant or negative commerce clause) and therefore limits the power of the states to tax activities that affect interstate commerce.

In 1977, the U.S. Supreme Court established four criteria for judging the validity of a state tax on interstate commerce. In that decision, the court held that a tax does not run afoul of the Commerce Clause if: (i) the activity taxed has a substantial nexus with the taxing state, (ii) the tax does not discriminate against interstate commerce, (iii) the tax is fairly apportioned, and (iv) the tax is fairly related to the services provided by the taxing state.[3] The Alaska Supreme Court has developed a similar four-part test for determining the validity of a tax under the federal Commerce Clause.[4] While these cases relate to taxes, a similar argument can be applied to contractual royalty rates.

Imposing a higher royalty on oil and gas destined for use outside of Alaska compared with that used within the state violates the second part of the test, because the royalty rate discriminates against interstate commerce.

In *Camps Newfound/Owatonna, Inc. v. Town of Harrison*,[5] the U.S. Supreme Court considered a tax exemption offered by a town that was decreased for institutions that "operated principally for the benefit of persons who are not residents of Maine."[6] The Court characterized the issue before it as "the disparate real estate tax treatment of a non-profit service provider based on the residence of the consumers it serves."[7] The Court concluded that the differential treatment of the taxpayer based on its interstate clientele violated the dormant commerce clause. With regard to natural resources, the

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[2] The Commerce Clause appears in art. I, sec. 8, cl. 3, of the United States Constitution.

[3] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 51 L.Ed.2d 326, 331 (1977).

[4] *Sjong v. State, Department of Revenue*, 622 P.2d 967, 973 (Alaska 1981) (citing *Complete Auto Transit, Inc., v. Brady*, 430 U.S. 274, 279 (1977)).

[5] 520 U.S. 564 (1997).

[6] *Id.* at 568.

[7] *Id.* at 572.

Court noted, "We have 'consistently . . . held that the Commerce Clause . . . precludes a state from mandating that its residents be given a preferred right of access, over out-of-state consumers, to natural resources located within its borders or to the products derived therefrom.'"[8]

Based on case law such as *Camps Newfound*, it is likely that a court would find the differential royalty treatment in the attached bill, based solely on whether the oil or gas is used in the state, to be unconstitutional.

If I may be of further assistance, please advise.

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Attachment

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[8] *Id.* at 576.