

**ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON OIL AND GAS**

March 5, 2002

10:20 a.m.

MEMBERS PRESENT

Representative Scott Ogan, Chair
Representative Hugh Fate, Vice Chair
Representative Mike Chenault
Representative Vic Kohring
Representative Gretchen Guess
Representative Reggie Joule

MEMBERS ABSENT

Representative Fred Dyson

COMMITTEE CALENDAR

HOUSE JOINT RESOLUTION NO. 44

Urging the President of the United States, the United States Congress, and appropriate federal officials to support the construction and operation of the Alaska Highway Natural Gas Pipeline route.

- MOVED CSHJR 44(O&G) OUT OF COMMITTEE

HOUSE BILL NO. 220

"An Act establishing an exploration and development incentive tax credit for persons engaged in the exploration for and development of less than 150 barrels of oil or of gas for sale and delivery without reference to volume from a lease or property in the state; and providing for an effective date."

- HEARD AND HELD

PREVIOUS ACTION

BILL: HJR 44

SHORT TITLE:ALASKA NATURAL GAS PIPELINE ROUTE

SPONSOR(S): OIL & GAS BY REQUEST OF NATURAL GAS PIPELINES

Jrn-Date	Jrn-Page		Action
02/19/02	2307	(H)	READ THE FIRST TIME - REFERRALS
02/19/02	2307	(H)	O&G, RES

02/19/02 2307 (H) REFERRED TO OIL & GAS
03/05/02 (H) O&G AT 10:00 AM CAPITOL 124

BILL: HB 220

SHORT TITLE: OIL & GAS TAX CREDIT FOR EXPLORATION/DEV

SPONSOR(S): REPRESENTATIVE(S) KOTT

Jrn-Date	Jrn-Page		Action
03/29/01	0773	(H)	READ THE FIRST TIME - REFERRALS
03/29/01	0773	(H)	O&G, RES, FIN
03/29/01	0773	(H)	REFERRED TO O&G
04/20/01		(H)	O&G AT 8:00 AM CAPITOL 124
04/20/01		(H)	<Bill Postponed to 4/27>
04/27/01		(H)	O&G AT 8:00 AM CAPITOL 124
04/27/01		(H)	<Bill Canceled>
03/05/02		(H)	O&G AT 10:00 AM CAPITOL 124

WITNESS REGISTER

THE HONORABLE SCOTT KENT, Minister of Economic Development,
Minister of Government Services, and Minister Responsible for
the Yukon Development Corporation/Yukon Energy Corporation
Government of Yukon
Box 2703

Whitehorse, Yukon, Canada Y1A 2C6

POSITION STATEMENT: Testified in support of an Alaska Highway
pipeline project, the subject of HJR 44.

REPRESENTATIVE JOE GREEN
Alaska State Legislature
Capitol Building, Room 403
Juneau, Alaska 99801

POSITION STATEMENT: Offered a suggestion on HJR 44, Version C,
that became Amendment 2.

PAUL FUHS, Lobbyist
for Yukon Pacific Corporation
1635 Sitka, Number 301
Anchorage, Alaska 99501

POSITION STATEMENT: Testified in support of HJR 44; offered
language that became Amendment 3.

LINDA SYLVESTER, Staff
to Representative Pete Kott
Alaska State Legislature
Capitol Building, Room 204

Juneau, Alaska 99801

POSITION STATEMENT: Presented HB 220 on behalf of Representative Kott, sponsor.

JOHN A. BARNES, P.E., Alaska Business Unit Manager

Marathon Oil Company

P.O. Box 196168

Anchorage, Alaska 99519-6168

POSITION STATEMENT: Testified in support of HB 220 and answered technical questions.

MARK MYERS, Director

Division of Oil & Gas

Department of Natural Resources

550 West Seventh Avenue, Suite 800

Anchorage, Alaska 99501-3560

POSITION STATEMENT: Testified on HB 220 and answered questions.

CHUCK LOGSDON, Chief Petroleum Economist

Tax Division

Department of Revenue

550 West 7th Avenue, Suite 500

Anchorage, Alaska 99501-3566

POSITION STATEMENT: Voiced department's concerns about HB 220 and answered questions.

ACTION NARRATIVE

TAPE 02-13, SIDE A

Number 0001

CHAIR SCOTT OGAN called the House Special Committee on Oil and Gas meeting to order at 10:20 a.m. Present at the call to order were Representatives Ogan, Chenault, Guess, and Joule. Representatives Fate and Kohring arrived as the meeting was in progress.

HJR 44 - ALASKA NATURAL GAS PIPELINE ROUTE

Number 0060

CHAIR OGAN brought before the committee HOUSE JOINT RESOLUTION NO. 44, Urging the President of the United States, the United States Congress, and appropriate federal officials to support the construction and operation of the Alaska Highway Natural Gas Pipeline route.

CHAIR OGAN introduced a delegation from the Yukon Legislative Assembly: Mike McLarnon, the Honorable Scott Kent, Eric Fairclough, Gary D. McRobb, and Peter W. Jenkins. He invited Mr. Kent to testify.

Number 0191

THE HONORABLE SCOTT KENT, Minister of Economic Development, Minister of Government Services, and Minister Responsible for the Yukon Development Corporation/Yukon Energy Corporation, Government of Yukon, provided an update on what the Yukon Government has been doing to promote the Alaska Highway natural gas pipeline on the Canadian side of the border.

MR. KENT noted that he'd met Representative Green in Vancouver, British Columbia, approximately a month and a half ago, as part of the joint committee chaired by Senator Torgerson. He indicated the Yukon Government is working on opportunities including access to gas, training, and other opportunities for his constituents. He also indicated that Senator Torgerson had relayed the desire to have "real Alaskans and real Yukoners" working on this project when it becomes a reality.

Number 0267

MR. KENT reported that \$750,000 has been put in the upcoming budget to support the Pipeline Unit in the Yukon Territory's Department of Economic Development; he indicated the unit is doing an economic study that it can share with other governments in Alaska, British Columbia, and Alberta, as well as with the Canadian and United States federal governments. He explained that his government is lobbying [the federal government in] Ottawa to have the "NPA office" reestablished and set up in the Yukon, as well as making a streamlined regulatory environment, once this project becomes a reality, to ensure that it can be done as seamlessly as possible.

Number 0371

MR. KENT addressed First Nations and infrastructure issues:

On the First Nations front, the premier and the Federal Minister of Indian and Northern Affairs, as well as the First Nations with outstanding land claims, are working ... towards the March 31st deadline. ... It's hard work, and it's hard negotiating at the tables, but we're committed to it,

... as are the other two parties that ... sit at that table, which will provide even more certainty ... for the Alaska Highway pipeline once ... the producers come around and make their decision ... on the route.

As far as infrastructure in the Yukon Territory, ... we're improving the Alaska Highway significantly, not only at the Shakwak project that is funded by the U.S. federal government on the north Alaska Highway, north of Haines Junction, but our government is also doing some ... work between ... Champagne, Yukon, and north towards Haines Junction to ... improve that stretch of highway, too, so that ... the infrastructure is there and in place when ... the project proceeds.

Number 0484

MR. KENT emphasized the importance to Yukoners and Alaskans of having access to the gas once the pipeline is in place. He noted the benefits that will come from having that access, "to fuel future industries and to provide a keep-clean alternative energy source to our communities and to ... the industry," which will lead to strong, long-term economic development. Mr. Kent offered to answer questions regarding "our undying support for the Alaska Highway pipeline project."

Number 0553

CHAIR OGAN remarked that he has been impressed with the level of support for a gas pipeline project offered by the Yukon Government in particular. He noted that he, Representative Green, and other members of the joint committee went through Canada this past summer and met with Mr. Kent and others; he expressed appreciation for the premier's meeting with them at the airport as well.

CHAIR OGAN indicated he looks forward to a good working relationship in trying to facilitate the project; he noted that its fate is in the federal government's hands now, but offered his understanding that there is support in Washington, D.C. He referenced the upcoming Energy Council meeting there, which he, Representative Green, Representative Fate, Representative Joule, and a few other legislators would attend.

Number 0671

CHAIR OGAN briefly turned attention to efforts to open the Arctic National Wildlife Refuge (ANWR) [to exploration]. He said there are six times as many caribou at Prudhoe Bay as when oil drilling began, but noted that the premier [the Honorable Pat Duncan, Premier, Yukon Government] has said it is an emotional argument for her constituents.

MR. KENT reported that in the following week he would travel to Ottawa to "check in" and remind federal ministers and politicians about the importance of the Alaska Highway pipeline project to Yukoners and the benefits to all Canadians. He added:

We've always said [there are going to] be two projects in the north, one that will carry North Slope gas to market via ... the TAPS [Trans-Alaska Pipeline System] right-of-way and the Alaska Highway, and a second project that will take Beaufort delta gas up the Mackenzie valley and ... towards southern markets.

MR. KENT, with regard to ANWR, said:

There's certainly some things that we can agree on, such as the Alaska Highway pipeline, and there's some things that we ... agree to disagree on, such as ... the debate over ANWR. So I prefer to concentrate on the things that ... we both want to see happen, and the Alaska Highway pipeline is, of course, one of them.

Number 0925

CHAIR OGAN turned attention to HJR 44, sponsored by the House Special Committee on Oil and Gas. He offered a new proposed committee substitute (CS), Version C.

Number 0960

REPRESENTATIVE FATE moved to adopt the proposed CS [version 22-LS1577\C, Chenoweth, 2/28/02] as a work draft. There being no objection, Version C was before the committee.

CHAIR OGAN explained that HJR 44 urges Congress to support the construction and operation of the Alaska Highway natural gas pipeline route; this is being debated currently on Capitol Hill in Washington, D.C. He emphasized the importance of sending a unified message from the legislature.

Number 1065

REPRESENTATIVE JOULE requested that Chair Ogan highlight the differences between the original version and Version C.

CHAIR OGAN called an at-ease at 10:31 a.m. [A draft bill version used in preparing Version C was handed out by the committee aide. Like the original, it was labeled "22-LS1577\A" in the upper right-hand corner; however, it was labeled "HJR044A" in the lower left-hand corner, whereas the original version was "HJR044a." Furthermore, the draft was typed on numbered legal paper so that the first page and all subsequent pages had 25 lines numbered. Members noted that Version C's title used the words "Strongly urging" rather than "Urging".]

CHAIR OGAN called the meeting back to order at 10:37 a.m.

Number 1145

CHAIR OGAN explained that on page 3, the subsistence language has been dropped out of respect to those with concerns about subsistence on the North Slope; he said he believed it was best left silent. On page 4, the following language was dropped [after "terms," on line 22]: "do not have to pay for pipeline services that they do not use".

CHAIR OGAN further noted that on page 5, three "WHEREAS" clauses have been added [beginning at lines 6 of Version C]; in addition, the word "strongly" was added to lines [12 and 16, so it read "strongly urges" in both places]. He said the concern is that if momentum might be lost. He offered as an example that John Brown of BP, to paraphrase him, has said the project is not economically viable.

CHAIR OGAN referred to page 5, lines [20, 23, and 27, at the beginning of paragraphs (1) through (3), Version C]. He said he believes the word "provisions" is better here than "protections".

CHAIR OGAN referred to language regarding fair and reasonable access [remaining language in Version C, page 5, line 21, and new language that read "fair and reasonable tariffs" on page 5 [line 24]. He said it is to continue to encourage exploration by independent companies on the North Slope, in the foothills, and other places; without fair access and fair and reasonable tariffs, he explained, they may be discouraged from doing that.

Number 1336

CHAIR OGAN referred to page 6 of the draft [page 5, beginning at line 30, of Version C], noting that it contains new language [paragraph (4)]. He pointed out that the amount of any tax credit would be limited to periods when gas prices are extremely low, and it would be paid back when the gas prices are high. He commented, "I feel that if ... we're asking the taxpayers to share in the risk, that there's an upside, that the taxpayers should get a rebate." He pointed out that often taxpayers are asked to share high risks, but don't enjoy the benefits when the risks are low. He suggested it would make the resolution a little more "salable."

Number 1417

REPRESENTATIVE GUESS requested a copy of the enabling federal legislation, S. 1766.

CHAIR OGAN called an at-ease at 10:41 a.m. He called the meeting back to order at 10:43 a.m.

Number 1448

REPRESENTATIVE GUESS moved to adopt Amendment 1, on page 5, line 8, to change "will" to "may". [Thus lines 8-9 would read in part: "WHEREAS the large volume of gas delivered to the lower 48 states may initially stabilize gas prices at a lower level, bringing financial benefit to the lower 48 economy".] Representative Guess explained that perhaps the economist in her makes her worry about such a strong statement when she hasn't analyzed the gas market.

CHAIR OGAN asked whether there was any objection. There being no objection, Amendment 1 was adopted.

Number 1496

REPRESENTATIVE GUESS began discussion of the rationale for what would become Amendment 2. Given that federal S. 1766 has changed several times in the past week and that there are "a few hundred amendments floating around," she asked whether the committee is comfortable strongly urging passage of something whose final form is unknown.

CHAIR OGAN replied that the committee is strongly urging passage [by Congress] of something that incorporates these provisions [in Version C under the "FURTHER RESOLVED" clause in paragraphs (1)-(4)].

REPRESENTATIVE GUESS brought attention to page 5, lines 16-19, which read:

FURTHER RESOLVED that the legislature strongly urges passage during the first half of 2002 of the Alaska Gas Producers Pipeline Team's federal enabling legislation contained in S. 1766 so long as it contains a provision similar to that in H.R. 4 banning the over-the-top route and the following amendments:

Number 1558

REPRESENTATIVE GUESS said she didn't know how much a resolution means, but if S. 1766 turns out to contain provisions that "we're not comfortable with, as Alaskans," she was wondering how Chair Ogan was reconciling it.

CHAIR OGAN remarked that if a resolution contains an issue that he'll be voting on or is particularly interested in, he reads it, but otherwise he may not. He said the legislature obviously cannot control Congress, and this just says what the legislature would like Congress to do.

Number 1666

REPRESENTATIVE JOE GREEN, Alaska State Legislature, offered a suggestion that would become Amendment 2. Noting that he agreed with Representative Guess, he said there will be a significant number of amendments [to the federal legislation], including some by Alaska's own U.S. Senator [Ted Stevens]. He proposed saying "federal [enabling] legislation", then deleting "contained in S. 1766" and having the paragraph continue on. In that way, it would encourage something similar to H.R. 4 and banning the over-the-top route; it would then contain the provisions [in paragraphs (1)-(4), beginning on page 5, line 20, of Version C]. It wouldn't say anything different, but just wouldn't specify the particular [federal] bill.

CHAIR OGAN said it is a good suggestion.

Number 1729

REPRESENTATIVE GUESS moved to adopt Amendment 2, on page 5, line 18, to delete "contained in S. 1766". There being no objection, Amendment 2 was adopted.

CHAIR OGAN called an at-ease at 10:48 a.m. He called the meeting back to order at 10:53 a.m.

Number 1840

PAUL FUHS, Lobbyist for Yukon Pacific Corporation (YPC), came forward to testify. He stated:

I'm here to speak in favor of House Joint Resolution Number 44, and you might find that interesting since we're supporting a project which goes through Alaska to tidewater. But I want to explain to you why we're supporting this resolution. ...

First, there are two ways that Alaska gas could get to the U.S. market. And one could be the overland ... by-the-highway route, or the other could be as LNG [liquefied natural gas]. Now, people have said the LNG project is uneconomic, but none of the economic analyses that have been done included shipments of Alaskan gas to the U.S. as LNG. So we've done that, and on the 14th we'll be announcing an economic model to you, before this committee, of a project that we think works.

So why are we supporting this? Well, when you get down into the "BE IT RESOLVED" of this, there's a couple [of] really important provisions here, and one of these is the recognition of ANGTA [Alaska Natural Gas Transportation Act of 1976]. And we do recognize the validity of ANGTA, and I want to make it clear that also our presidential authorizations to export gas from Alaska are included under the ANGTA framework. So this is very important to our project, also, that ANGTA is identified.

Number 1932

MR. FUHS continued:

Also, the issues here on financial incentives, income tax credits, and when the prices are extremely low -- I did want to let you know that what I read in the

Peninsula Clarion, that ... when the prices went below [\$]3.75, that it would kick in, that it was [a] \$1.25-a-thousand-cubic-foot subsidy of the project, and prices are about [\$]2.20 today. So this would be fully in effect as long as the price is below \$2.50 a thousand cubic feet in the U.S. So I don't know how successful it's going to be to get the Rocky Mountain states and the Gulf states to agree to a subsidy that would essentially displace their gas anytime that it's below [\$]2.50, but if you can pull it off, that would be great, because it's probably what's necessary to make the highway project economic, according to what the producers have been saying about the economics of it.

Number 1968

Our fear is not that the Canadian route will be built. If it was, then a "Y-line" concept is the most economic configuration for both projects. You go to Canada; you take a spur line to Valdez - that's the most economic. Our fear is that the Canadian route will not be built, even after all the tax credits and everything else.

And we still haven't seen these studies that the producers said that they were going to bring to the legislature and talk to you about. ... But according to what John Brown [of BP] said, as you referred to, they believe it may still ... not be economic. Our point is that we do not require the Canadian line for our project to be economic, we don't believe. We're going to bring that before you and see if we can justify it.

Our biggest concern if this goes through - we heard talk, and [U.S.] Senator Murkowski said it, and other people have said it - if they are going to mandate a Canadian highway route for this project, what you could end up with down there is that the Canadian line never gets built, and then because of this mandate, we could not even sell Alaskan gas to our own country. Now, that would be a perverse outcome, if that's how it's stated, that we are mandating the highway route.

It should be treated fairly. And we don't have any problem with the subsidies; if this goes, it's great

for us, and it's great for Alaska, and it's great for Canada. But if it doesn't, we may be blocking our[selves] in the end. ... I think ... you don't want to do that.

Number 2053

MR. FUHS proposed a further amendment [later adopted as Amendment 3], to add the following:

these provisions are not intended to exclude the supply of Alaska North Slope gas to U.S. markets as LNG.

He explained, "Support the whole package. Do everything you can to try to get this line to go. But make sure that you don't exclude the potential of LNG sales of Alaskan gas to the U.S. That's all we're asking you."

MR. FUHS expressed pleasure at how the joint pipeline committee has treated both projects equally. He conveyed concern, however, that HJR 44's title says "the Alaska Highway Natural Gas Pipeline route", but noted that the "BE IT RESOLVED" clause [on page 5] says "a natural gas pipeline through Alaska along a southern route". Mr. Fuhs said that is more equal language, adding, "That could also even include our project. When you put 'Alaska Highway Natural Gas Pipeline route', you might be playing into something that mandates it and excludes Alaskan gas from going as LNG. That's our only concern with the resolution as it's written."

Number 2113

CHAIR OGAN asked whether anyone else wished to testify; he then closed public testimony. He called an at-ease at 10:58 a.m. and brought the meeting back to order at 11:03 a.m.

Number 2152

REPRESENTATIVE FATE moved to adopt Amendment 3 [Mr. Fuhs' proposed language, provided in handwritten form during the at-ease], to be placed under the "BE IT RESOLVED" section, as [paragraph (5), page 6, after line 3]. There being no objection, Amendment 3 was adopted.

Number 2203

REPRESENTATIVE GUESS moved to report CSHJR 44 [version 22-LS1577\C, Chenoweth, 2/28/02], as amended, out of committee with individual recommendations and the attached zero fiscal note. There being no objection, CSHJR 44(O&G) was moved out of the House Special Committee on Oil and Gas.

HB 220 - OIL & GAS TAX CREDIT FOR EXPLORATION/DEV

Number 2235

CHAIR OGAN announced the final order of business, HOUSE BILL NO. 220, "An Act establishing an exploration and development incentive tax credit for persons engaged in the exploration for and development of less than 150 barrels of oil or of gas for sale and delivery without reference to volume from a lease or property in the state; and providing for an effective date."

Number 2256

LINDA SYLVESTER, Staff to Representative Pete Kott, Alaska State Legislature, presented HB 220 on behalf of Representative Kott, sponsor, noting that the bill was introduced by request. She informed members that John Barnes of Marathon Oil Company would address technical issues and answer questions. Online was Chuck Logsdon from the Department of Revenue, who had written the indeterminate fiscal note [with regard to revenues]. Ms. Sylvester read from the written sponsor statement as follows:

HB 220 creates a new income tax credit designed to encourage increased exploration and development of natural gas reserves that are primarily located in the Cook Inlet region. To qualify for the credit, operators must successfully drill and develop hydrocarbon [reserves] that produce gas for sale and delivery. The credit can offset no more than 50 percent of an operator's annual income tax liability, and it would be effective for a period of ten years.

The tax credit would amount to 10 percent of qualified capital investments for each year. For example, an operator who spends \$20 million in a given year successfully developing natural gas reserves would receive an income tax credit for \$2 million, applicable up to one half of its income tax liability for that year. Credits in excess of 50 percent of the operator's income tax liability can be carried forward

for future years. No credits will be given for dry holes or for development of crude oil reserves.

The Cook Inlet region continues to have great potential for additional natural gas production. However, the combination of high development costs and relatively low natural gas prices [creates] a disincentive to drill for new gas reserves in this area, compared to other places. By providing a credit for successful exploration efforts, more drilling will occur in southern Alaska, leading to much-needed new natural gas reserves. And this will benefit all residents and businesses at little cost to the state.

In addition to the benefit of developing new gas reserves, increased Cook Inlet drilling will also aid the general economic status ... of the Kenai Peninsula and in Anchorage. Moreover, increased tax revenue from additional hydrocarbon production should largely mitigate the fiscal impact of the proposed credit.

Number 2420

JOHN A. BARNES, P.E., Alaska Business Unit Manager, Marathon Oil Company ("Marathon"), extended his appreciation and that of Marathon for the opportunity to testify in support of House Bill 220. He noted that Marathon is focused on the Cook Inlet natural gas business, having produced and sold about 68.25 bcf [billion cubic feet] of natural gas last year, an annual average of 187 million cubic feet a day. This production rate set a Marathon record for annual sales in Alaska. While the rate itself is significant, during cold spells in December last year Marathon produced, at instantaneous rates, in excess of 300 million cubic feet a day - an accomplishment he said every member of Marathon's Alaskan business is proud of; it required not only hard work, but also ongoing investments in wells and infrastructure. He said the regulatory and permitting environment plays a role in Marathon's ability to predictably bring projects to production within budget and on time.

MR. BARNES noted that project economics are critical to getting projects approved; that is the area in which HB 220 can have the largest impact. He said Alaskan project economics are considered not only on their absolute merit, but also relative to other worldwide opportunities in which Marathon and probably other companies can invest. "And the intent of House Bill 220 is to maybe level the playing field or even tip it in favor of

Alaskan opportunities," he said, noting that the bill is intended to provide an incentive to oil and gas development activities through an investment tax credit. Under HB 220, qualified expenditures could be applied as a credit to offset future tax liabilities; the credit couldn't be used to offset more than 50 percent of the taxpayer's liability, and there would be a term limit of five years.

Number 2528

MR. BARNES explained that to be effective for both the State of Alaska and the producer, the credit must act as an incentive to exploration and development. He said he would talk briefly about how HB 220 could impact Marathon and presumably other producers as they evaluate investment opportunities in Alaska and around the world.

MR. BARNES told members three issues impact investment decisions with regard to the Cook Inlet gas business: the resource base, the market opportunities, and the price at which the gas can be sold. The Cook Inlet gas business is critical to the Anchorage and Kenai Peninsula economies. Natural gas provides clean, cost-effective fuel to heat and light homes and businesses. It also serves as an important feedstock for two industries, the Agrium fertilizer and Phillips/Marathon LNG [liquefied natural gas] plants, which provide important jobs and local taxes. He mentioned that Marathon currently services over 60 percent of the local utility market and was the first producer that sold to all three of these users.

MR. BARNES reported that over the last few years, several technical evaluations have been completed "looking at Cook Inlet reserves and resources." The current Cook Inlet reserve base is approximately 2,000 bcf [billion cubic feet], based on the latest DNR [Department of Natural Resources] information. At an annual consumption rate of about 200 bcf a year, this is equivalent to nine or ten years' worth of production. He said:

These reserves are considered proven, both developed - which are currently capable of production - and undeveloped - for which some amount of additional work and expenditure is required to bring them on production. By local analogy, proven developed reserves are equivalent to "the fish is in the boat; you've weighed him, you can smell him, and you're going to eat him." ... Similarly, proven undeveloped reserves are typified by "the fish is on your hook by

the boat, you're ready to net him, you can tell how big he looks, but you've got to remember that they always look bigger in the water."

Number 2657

MR. BARNES turned attention to resources, noting that he would also mention probable reserves. He told members:

These represent unproven gas volumes for which engineering and geological data suggest that it's more likely than not that they'll be recovered. And for the Cook Inlet, various state, federal, and other organizations have provided some estimates. One group is the Potential Gas Committee; a couple of years ago, they provided an estimate of Cook Inlet probable reserves of 1,050 bcf, which is about five years of consumption at current rates. ...

The final category to consider is possible reserves, which represents gas volumes for which engineering and geological analysis suggest they are less likely than the probable reserves to be produced. And that same Potential Gas Committee estimated that there's about 2.1 tcf - that's 2,100 bcf - of possible reserves in the Cook Inlet.

MR. BARNES offered a key point: technical analysis strongly suggests there are additional gas reserves in the Cook Inlet to explore for and to develop. Unfortunately, these reserves are more difficult to find and more costly to develop "than our existing reserve base"; these risk and cost factors play against drawing investments to the Cook Inlet. However, he reiterated, technical data supports the high probability of finding additional Cook Inlet reserves.

Number 2728

MR. BARNES turned attention to the market. He said although Cook Inlet consumes a lot of gas, it is for all intents and purposes a closed market. At this time, no clear definition exists of available utility markets for sales sooner than about 2009 - a disincentive for investments. In fact, he said, a major, world-class producer recently stated in the press that it sees the Cook Inlet gas market as closed, and doesn't plan to invest in it. He added that some producers may be willing to make investments for other non-utility opportunities, or may do

so because they speculate that opportunities may open up sooner. He concluded, "But again, this lack of market opportunities does serve to drive investments elsewhere."

Number 2770

MR. BARNES addressed the final area to consider in evaluating Cook Inlet gas opportunities: the price at which the gas may be sold. It is in this area where HB 220 can probably serve as an incentive, he told members. Historically, most Cook Inlet local gas sales have been made at prices significantly below those received for gas in the Lower 48. The most recent ENSTAR [Natural Gas Company] gas sales contracts, however, are priced at or above Lower 48 benchmarks, which are above existing legacy contract prices in the inlet. Mr. Barnes reported that ENSTAR has said it has used this price structure in recognition of the need to "incentivize" investments in the Cook Inlet gas industry. He said these higher prices will help encourage new investments in Cook Inlet. Unfortunately, not all producers can avail themselves of these prices, and some gas purchasers may not be able to pay these higher prices. It is in this area where the impact of HB 220 must be carefully considered.

Number 2815

MR. BARNES offered a scenario that encompasses the three areas - resource, market, and price - and how they affect investment decisions. He told members:

If a producer looks at the Cook Inlet, he'll first ask himself, "What are my prospects for finding gas?" And once he believes that the risks are acceptable, then he'll look at the market. He'll see that some market opportunity may exist, but probably not at the gas sales price he could receive if he spent his monies ... in the Lower 48 or somewhere else.

That's where House Bill 220 may swing his decision to send investment dollars to Alaska. Furthermore, if sufficient funds from multiple companies are attracted to Alaska and the Cook Inlet, sufficient gas reserves might be found to potentially even attract a new industry or perhaps create competition, which ought to ultimately benefit the consumers.

MR. BARNES turned attention to the fiscal note, saying it raises an interesting comment that potentially all the tax liability

for oil and gas companies could be reduced by 50 percent. He told members:

If you use the number that they represent in the fiscal note for this year, it's about \$150 million income tax for oil and gas companies. If that number was reduced by half, that would imply that \$75 million in credits were available; that would imply, based on 10-percent capital lid, companies had spent \$750 million looking for natural gas or oil. Now, if you look at an average finding-and-development cost of about 50 cents to a dollar per mcf, that \$750-million expenditure would equilibrate to finding between 750 bcf and maybe 1.5 tcf. So in that case I would say that rather than the state believing that they have lost tax revenue, they should applaud themselves for actually having incentivized exploration and development, and bringing gas reserves to the table.

MR. BARNES concluded by saying Marathon Oil Company believes HB 220 can serve as a stimulus to maintain or even enhance Cook Inlet exploration and development activities.

Number 2930

REPRESENTATIVE FATE asked how far north [68 degrees North latitude, referenced on page 3, line 10] is.

MR. BARNES answered, "Brooks Range. It basically is trying to look for areas south of the Brooks Range."

REPRESENTATIVE FATE said the sponsor statement looks as though it is specific to Cook Inlet, and yet the bill contains a latitude farther north.

MR. BARNES indicated Cook Inlet is being used as an example, but that it could be taken as far north as the Brooks Range. He added, "For Marathon's business, you're accurate: our business is primarily the Cook Inlet, and that's our belief, as to the bill. But I would believe that it might serve as an incentive to other areas in the state."

REPRESENTATIVE FATE said there are several types of state tax liabilities in the oil and gas business, and yet both the sponsor statement and Mr. Barnes' statements refer to income tax. He asked, "What other credits against state tax liability do you foresee - tax against royalty?"

[Not on tape but recorded in the committee secretary's log notes was Mr. Barnes' reply: the intent is that it is against corporate income tax - State of Alaska income tax.]

TAPE 02-13, SIDE B
Number 2995

REPRESENTATIVE FATE inquired about the requirement [page 3, lines 15-16] that to qualify for this, [the reserves] must produce 150 barrels a day "or produce gas for sale and delivery". Suggesting it could mean almost any quantity of gas, as long as it could be for sale, he said, "My fear is that ... if we're going to have a tax rebate or a tax credit on the delivery system, [it] could amount to a lot, depending on what's involved in the delivery system, such as a pipeline."

MR. BARNES answered:

Again, those would get caught up in the overall project economics and, ... again, you're trying to aim it at successful efforts, where if you have wells that potentially have [a] ... lower gas rate - be they coal-bed methane or some other wells - in aggregate, though your well rate may be small, as you aggregate that together through your production facilities, compression, and then pipeline delivery systems; ... a company will analyze that as an entire capital investment. And that would be the ... qualified investment for which the credit would be applicable. And, again, a company will look ... at an entire project.

Now, the income tax that gets paid to the state ... is not based on a single well; it's based on the overall State of Alaska business. And ... in the case of a coal-bed methane or something, a new entry or a development in Kenai or someplace else, then that gets rolled into the overall company's income tax.

Number 2905

REPRESENTATIVE FATE brought attention to two bills [sponsored by him] that were heard in this committee: HB 307, which had already passed the House and which had to do with tax credits on exploration; and HB 308 [heard once and then held in committee], which had to do with tax credits on development. Suggesting

this current bill bundles those two together, he recalled testimony that HB 308 had cost the state millions of dollars because a tax on development is a tax on royalty. By contrast, there was more positive testimony on [HB 307] because [the tax credit on development] enabled the state to get stratigraphic data, geologic data, and proprietary data, for example. Representative Fate told Mr. Barnes, "You haven't said anything in the bill here, which includes exploration, whether or not you would be willing to give that data, or whether it would, in fact, be proprietary data."

MR. BARNES responded that [HB 220] is trying to get beyond ownership-of-land issues, where royalty incentives have been used in the past. He noted that there also are leases that are federal acreage, or where private landowners have the mineral rights and those are pooled into larger units. He said, "We have not tried to look at anything as to the sharing of data - you're accurate in that. The intent was to try to treat all production - be it from federal, state, or even private leasehold - in a manner that would encourage development across those."

MR. BARNES offered his experience that most wells ultimately going public anyway, so the data is usually available. He added, "There are some notable exceptions, but in my experience, at least where Marathon has operated, well data usually becomes available ultimately, and I believe the state usually benefits." Acknowledging that he hadn't answered the question, Mr. Barnes said that wasn't an issue that "we sought to address here."

Number 2777

REPRESENTATIVE GUESS inquired about Marathon's current activity in Cook Inlet.

MR. BARNES affirmed that Marathon does have current activity. That work was begun, including some of the leaseholds, in the 1997-99 timeframe. He said most exploration activities are a multi-year effort. He continued:

So in a multi-year program, we're just finishing off a land-acquisition program, some well work. And we will actually develop, if sufficient reserves are there, a discovery that was announced down south, and build a pipeline. I can tell you, when Marathon looks at future markets and future opportunities beyond those line-of-sight issues, there's a question mark. And so

I would just say that yes, we have been active. We are active. But current activity, as you've seen around the state in the oil and gas industry, is never an assurance of long-term activity.

Number 2709

CHAIR OGAN posed a scenario in which the bill is wildly successful, causes all kinds of development, and attracts more independent companies; he asked whether that could detrimentally affect the price. Referring to Mr. Barnes' indication that one major producer has already said the market is closed, Chair Ogan noted that a smaller, independent company might be interested in something a major producer wouldn't be.

MR. BARNES mentioned supply-demand curves. He agreed that if this were wildly successful and large supplies were found, then new market opportunities would be sought, whether LNG or Agrium expansion, for example. He said with a big discovery, marginal costs go down. The attempt would be a balance between the economics of a large discovery and the economics of "whatever projects ... you could potentially sell to." He added that other than for gas under contract at very high prices, it would tend to competitively push gas prices down, which he surmised would be positive for consumers and, hopefully, for the overall industry.

Number 2587

REPRESENTATIVE GUESS, noting that the discussion has centered on gas, asked why oil is included [in the bill].

MR. BARNES answered, "When we looked at putting this together a year ago, we were just basically trying to stimulate overall activity." He offered that although Marathon has focused on gas, Marathon has made others aware of the bill, although he doesn't know what their particular corporate outlook would be. He said oil had been added in recognition of stimulating overall Cook Inlet activity, which is nowhere near what it was 20 years ago.

CHAIR OGAN asked whether anyone is producing 150 barrels of oil [a day].

MR. BARNES answered that [Marathon] has one small field at Beaver Creek that produces about 180 barrels a day. He

mentioned platforms and added, "I do know that we have a very low-rate field."

CHAIR OGAN noted that this bill is about a tax credit for new [discoveries]. He conveyed his understanding that it is unlikely, unless perhaps there were an onshore discovery, that somebody would produce 150 barrels [a day] and build the infrastructure.

MR. BARNES suggested that other parties more active in oil might choose to discuss whether that should go higher or lower. He added:

We're not always very smart about what we'll find. Sometimes we find gas. Sometimes you find oil. Sometimes you find nothing. So that was the other reason to having some amount of flexibility, that you'd have some incentive, that if you found oil, to potentially try to get it on production, even if it was a smaller-type find. If it was a very large find, market forces ought to be a very good incentive. A smaller discovery, you probably need all the help you can get.

Number 2486

REPRESENTATIVE GUESS referred to [AS 38.05.180], subsection (j), whereby the state can reduce royalties if the economics [merit it]. Noting that it had been discussed with regard to HB 308 as well, Representative Guess said, "As a trustee of the state, that seems like a better approach because then we're actually reducing where people need the incentive." She asked, "Why not use that (j) provision?"

MR. BARNES replied:

My belief would be twofold. First, that's a negotiation, and you never know how a negotiation will turn out. And when you factor into your investment decision the fact that you have a risk - you ask whether you'll win - that will tend to be seen as a disincentive or an incomplete incentive to draw money into Alaskan-type expenditures. And the other point - and I know you guys are well aware of this; companies much bigger than Marathon have said it over and over - but the test of "is a project economic or not" is telling me that you're right on the edge ... of a

viable project. And ... though it seems significant on the royalty side, a reduction could be small in comparison to overall project risk, overall project "spend portfolio," and those projects will fall to the bottom of a prioritized list of where to spend your money.

And the intent of this bill was to basically recognize that an overall incentive that basically allows projects where you operate with a higher cost, which we have in Alaska, where you do have permit-timing and other issues, to try to get them higher up the project ranking ... on a worldwide basis. ... It's a difference between an absolute measure of economics versus a relative, when you have a portfolio. And companies are like you and I: you invest your money where you think you'll get the best return. And Alaska ... maybe doesn't draw ... as much investment as we'd all like.

Number 2349

REPRESENTATIVE GUESS offered her understanding that there is more activity in Cook Inlet now than has been seen in a while. Therefore, she questioned the need to take some potential state revenue to provide incentives for more activity.

MR. BARNES answered that with regard to activity in Cook Inlet, there are three or four onshore drilling rigs running. He added:

The inlet's not been able to respond as you see in the Lower 48 when prices are stronger. And when gas prices shot up, ... the rig count went up ... by a factor of about two. So while this activity level looks good, ... my belief is it's probably not enough that ultimately you'll bring the type of discoveries to the table that you'd like to see. ... If you have a one-in-three risk, three rigs running says you may find only ... one field. If you have ten rigs running, you might find three. So while it's undeniable that activity level's higher, the question I would ask is, is it as high as the state would like it to be?

REPRESENTATIVE GUESS added, "And at what cost."

MR. BARNES responded:

And, again, the analysis that I proposed was, I would feel real good to think that \$75 million of income tax was not being paid, because the implication is that people spent \$750 million, plowed into the economy, looking for oil and gas. And that ... could have a substantial impact across the board.

Number 2247

CHAIR OGAN noted that the Joint Committee on Natural Gas Pipelines had an extensive presentation the previous summer with regard to supply and demand; he suggested making that information available to the current committee. He mentioned peak loads and the possibility that by 2003 those might not be met. He suggested there might be some price incentives. He also mentioned ENSTAR and negotiations by the RCA [Regulatory Commission of Alaska] tying the price of gas to the Henry Hub, which he said increased the price quite a bit. He asked, "Did you have the opportunity to bid on that?"

MR. BARNES replied that it didn't go out for bid. He added, "We were having discussions, with alternate proposals."

CHAIR OGAN asked whether there is a possibility of getting in on "that ENSTAR deal."

MR. BARNES said the volume commitment is 450 bcf, "which is about 20 years if they have the gas." He added, "I do not know when Marathon can sell into that market - or any other producer."

Number 2153

CHAIR OGAN asked Mr. Barnes who is operating in [Cook Inlet] now, and whether anyone besides Marathon is "looking in Cook Inlet directly."

MR. BARNES answered that to his knowledge, Phillips [Alaska, Inc.] is drilling a big well at [Point] Starichkof, farther south on the peninsula; Unocal has drilled one well and is on a second well farther south around the Ninilchik and Deep Creek area, though he doesn't know the results there; Marathon has been active in exploration in the Ninilchik Unit, where it has announced a discovery; and Forest [Oil Corporation] is working

offshore on its Osprey Platform, a field he believes would benefit from the royalty reduction.

CHAIR OGAN recalled having made a decision, as a business owner, to spend capital money based on an investment credit on federal taxes. He thanked Mr. Barnes and called upon Mr. Myers.

Number 2037

MARK MYERS, Director, Division of Oil & Gas, Department of Natural Resources (DNR), testified via teleconference, noting that he would also provide a lead-in to the testimony of Mr. Logsdon of the Department of Revenue regarding the physical impacts of the bill in terms of the tax structure.

MR. MYERS agreed that a lot more activity is being seen. The division recently formed three new Cook Inlet gas units: the Ninilchik Unit, the South Ninilchik Unit, and the Deep Creek Unit. All have well commitments. Based on known planned wells plus the committed wells, he projected that perhaps nine exploration wells will be drilled in Cook Inlet, seven of those for gas - an historical high there. Although long-term activity isn't guaranteed, he predicted elevated activity for gas over the next several years. Mentioning the success of Forest Oil Corporation with Redoubt Shoal, Mr. Myers said that will be a very significant increase in oil production for the inlet. He noted that historically, gas production has been fairly flat since about 1981. Pointing out that oil production came down in the late 1980s and has held stable, he remarked, "We expect that to go up. But I think we're seeing some very encouraging movements."

MR. MYERS, returning attention to gas, said the ENSTAR contract clearly has gotten folks' attention. The "prevailing value" of gas has increased dramatically since 2000, from about \$1.36 to about \$2.50; despite the drop in the Lower 48 market, it has held at over \$2.00. Mr. Myers predicted it would remain high, saying that since 1995 it has been part of a gradual price increase for gas in Cook Inlet, "due to, again, the ... higher pricings for the commodity, especially to the utility market, but also higher LNG prices and also older contracts expiring for the utility market, and then newer gas being brought on at ... higher values." He added that it is expected the ENSTAR contract will expire in about 2007.

Number 1911

MR. MYERS highlighted positive developments: the gas pipeline being built, based on the success of the "go" (ph) well in the Ninilchik Unit, and future potential in other units for exploration. He listed active players in Cook Inlet: Unocal, Forest, Phillips, Marathon, Aurora Gas, Cross Timbers, Gas-Pro, and Evergreen [Resources], with some potentially significant exploration activity by Escapeta (ph). He also noted that Pelican Hills (ph) has bought mental health trust leases and is actively shooting seismic [data]. He added, "We're seeing, I think, a larger, more diversified industry of smaller players right now in Cook Inlet - very positive, from our perspective." Mr. Myers told members:

I guess in light of that - and in light of that we believe that, in large, the gas market is somewhat captive ... to the three major uses, the demand and supply curve being roughly equal now, higher prices leading to that ... additional exploration - we think we have a fairly stable situation in Cook Inlet. I guess, then, the question you have to weigh is: if we were to accelerate it, (a) would it in fact lead to additional gas being brought online, other than just additional reserves being discovered; and [(b)] what cost is there involved with that?

Number 1840

MR. MYERS, in response to Chair Ogan, offered his understanding that both Marathon and Unocal are participating in all three new gas units: Ninilchik, South Ninilchik, and Deep Creek. He added that "several of these units" are managed jointly by the state and CIRC [Cook Inlet Region, Incorporated], "so there's a combination of Native and state lands in them, as well as some fee acreage." In further response, he said in some cases there is federal acreage involved, as well as some university lands. "Fairly complication historical land-ownership pattern there and subsurface ownership pattern," he concluded.

Number 1752

CHUCK LOGSDON, Chief Petroleum Economist, Tax Division, Department of Revenue, testified via teleconference, noting that the Department of Revenue has several concerns with the bill. For one thing, the tax credit allowed against corporate income tax under the bill is allowed on oil and gas exploration and development south of the Brooks Range; however, most of the current revenue from the corporate income tax comes from

activities on the North Slope. As a result, a company with producing properties both on the North Slope and at Cook Inlet could use credits earned for exploration and development in the inlet to offset some or all of its North Slope-associated income tax.

MR. LOGSDON informed members that the big issue - as with all tax credits - is the difficult revenue question of how much additional incentive is necessary to make a project economically feasible. Currently, he noted, there are a number of significant incentives in the form of reduced royalty rates, exploration tax, and royalty incentive credits, all available south of the Brooks Range. This bill allows the credit without regard to the specific economics of a development prospect; this increases the risk that the credits will reduce state revenue without necessarily increasing industry activity beyond that which already would have been commercially attractive. That is [the department's] biggest concern about the bill.

Number 1669

CHAIR OGAN referred to the zero fiscal note from the department, pointing out that it is indeterminate [with regard to revenue]. He asked what would happen if the bill were successful in spurring further development. He inquired about an indication in [the analysis of the fiscal note] that the bill might result in "a wash" or actually making money for the state.

MR. LOGSDON replied:

That is correct. That's one of the reasons why it is difficult to put a revenue number, because unless you know the economics of the development activity, ... or have a good notion of what it could be, it's hard to put a number on whether or not the prospect would be ... a net gain or a net loss to the state treasury.

CHAIR OGAN asked Mr. Logsdon whether he believes it would be prudent, if the bill moved out, to add a sunset date, do some analysis, and see how it works.

MR. LOGSDON answered that at this point, considering the testimony from Mr. Myers, he didn't know that he was in a position to make any recommendation. He added that the department believes there is a very good risk that [the state] would give up revenue with a fairly high risk of getting little in the way of additional activity.

Number 1518

CHAIR OGAN asked whether there were further questions or if anyone else wished to testify; there was no response. He announced that HB 220 would be held over.

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Oil and Gas meeting was adjourned at 11:50 a.m.