

HOUSE FINANCE COMMITTEE  
May 09, 2003  
8:45 A.M.

TAPE HFC 03 - 85, Side A  
TAPE HFC 03 - 85, Side B

CALL TO ORDER

Vice-Chair Meyer called the House Finance Committee meeting to order at 8:45 A.M.

MEMBERS PRESENT

Representative John Harris, Co-Chair  
Representative Kevin Meyer, Vice-Chair  
Representative Mike Chenault  
Representative Richard Foster  
Representative Mike Hawker  
Representative Carl Moses  
Representative Bill Stoltze  
Representative Jim Whitaker

MEMBERS ABSENT

Representative Bill Williams, Co-Chair  
Representative Eric Croft  
Representative Reggie Joule

ALSO PRESENT

Representative Ethan Berkowitz; Representative Paul Seaton;  
Representative Vic Kohring; Representative Les Gara

PRESENT VIA TELECONFERENCE

Mark Meyers, Director, Division of Oil and Gas, Department of Natural Resources, Anchorage; Gary Carlson, Senior Vice President, Forest Oil; Kevin Tabler, Land & Government Affairs Manager, Union Oil Company; William Nebesky, Commercial Analyst, Division of Oil and Gas, Department of Natural Resources, Anchorage

SUMMARY

#HCR5

HCR 5        Establishing a task force to make recommendations regarding a new design for the official seal of the State of Alaska.

HCR 5 was scheduled but not heard.

HB 198 An Act providing for a reduction of royalty on certain oil produced from Cook Inlet submerged land.

HB 198 was HEARD and HELD in Committee for further consideration.

HB 232 An Act relating to mercury classics; and providing for an effective date.

HB 232 was reported out of Committee with a "do pass" recommendation and with zero note #1 by the House Labor and Commerce Committee.

#HB232

HOUSE BILL NO. 232

An Act relating to mercury classics; and providing for an effective date.

REPRESENTATIVE PAUL SEATON commented that HB 232 would allow the Homer Chapter of the Kenai Peninsula Boys and Girls Club to operate and implement the "Homer Mercury Classic". The classics are not permitted under a gaming permit without legislation allowing a specific group or area to conduct it.

The Homer Mercury Classic will be held bi-annually, with winnings awarded in the spring to the person who most accurately guesses when the temperature reaches 55 degrees Fahrenheit. The other prizes will be given to the person who most closely guesses the time and date that the mercury drops to that temperature each fall. Each entry costs \$2 dollars. The proceeds from the classic will be divided between the Boys and Girls Club of Homer and the classic winner.

Members of the Boys and Girls Club, who already have the necessary equipment and expertise to manage the operation, will monitor the temperature hourly through a weather station at the Homer Clubhouse. The program that inspired the classic is called Global Learning and Observation to Benefit the Environment (GLOBE). GLOBE is an international program associated with the National Aeronautics and Space Administration, National Science Foundation, the U.S. Environmental Protection Agency and the U.S. State Department. The data collected from schools and other groups around the world are deposited into a database that is accessed by the aforementioned organizations to assist atmospheric scientists in their work. The program allows children to participate in scientific processes, while earning money for their program in non-competitive and educational way.

Three hundred, primarily seven to twelve year-olds, are

involved in the Homer Chapter of the Boys and Girls Club. The "Clubhouse" provides an excellent place for kids to "hang-out" in a safe and learning friendly environment. Representative Seaton urged support for the legislation.

Representative Stoltze noted his appreciation for the tightness of the title.

Representative Stoltze MOVED to report HB 232 out of Committee with individual recommendations and with the accompanying fiscal note. There being NO OBJECTION, it was so ordered.

HB 232 was reported out of Committee with a "do pass" recommendation and with zero note #1 by the House Labor and Commerce Committee.

#HB198

HOUSE BILL NO. 198

An Act providing for a reduction of royalty on certain oil produced from Cook Inlet submerged land.

REPRESENTATIVE VIC KOHRING commented that the goal of HB 198, which amends existing statutes in Title 38, would be to provide for a narrowly defined and specifically targeted reduction of royalty on oil produced from Cook Inlet fields and platforms as they approach the end of their economic lives. Plans to idle two of the 13 current oil producing platforms in the Inlet act as a reminder of the certainty of decline and ultimate end of production for those fields. Premature abandonment of those fields would not be in the State's best interest. The infrastructure created to serve those fields is extensive. Decreasing the State's royalty share from 12.5% to 5% near the end of field's life would improve the economics of the aging platforms and could result in a 14-month extension in production.

Representative Kohring suggested that prolonging production would help to achieve several important policy objectives:

- Use of critical infrastructure to support new exploration or development of adjacent lands,
- Delaying loss of industry jobs, and
- Increasing the total amount of oil and gas produced through the aging facilities.

To protect the State's economic interest, royalty reduction to 5% on oil produced from the targeted fields and platforms is designed to occur only when production declines below 1,200 barrels per day for the Dolly, Grayling, King Salmon, and Steelhead Platforms and continues at that level so long as production does not go above that threshold. For any

quarter, should production go above 750 barrels per day, the State's royalty share would increase 1% with each additional 100 barrels up to 1,200 barrels. The royalty share for production over 1,200 barrels would return to 12.5%. Those trigger production rates generally correspond to different economics of the two sets of platforms. By encouraging continued production of marginal fields, HB 198 would benefit the State and local economies through taxation and royalties, encourage future development of new oil discoveries by lowering the costs of industry infrastructure, as well as taking care of preserving jobs for Alaskans.

Co-Chair Harris pointed out that the legislation would extend rig life in the Cook Inlet area. Representative Kohring acknowledged that it would exclusively affect Cook Inlet.

Co-Chair Harris inquired if there was any indication that the rigs would be "shutting down" without the passage of the legislation. Representative Kohring explained that most of the rigs are getting to the point where they are no longer profitable, at which time, the industry will "moth ball" them.

Co-Chair Harris mentioned the possible loss of revenue in a year and asked the types of royalties that the State receives from these breaks. Representative Kohring noted that Mr. Meyers would be best to address that question. He added that if the facilities become "moth balled", there will be no royalties received by the State.

Representative Stoltze asked if these platforms were within the Kenai Borough taxation jurisdiction. Representative Chenault replied that they were.

GARY CARLSON, (TESTIFIED VIA TELECONFERENCE), SENIOR VICE PRESIDENT, FOREST OIL, focused on the maintenance of critical and scarce infrastructures associated with the mature oil fields in Cook Inlet. Platforms, the associated pipelines and related on-shore facilities represent irreplaceable infrastructure, which may facilitate the exploration, discovery and development of the undiscovered reserves. Any delay will provide opportunity to the industry to develop smaller scale oil and gas product prospects that would not stand the economics of a new infrastructure being developed. The operators need to get creative and they need the cooperation of their vendors to share the in those efforts.

Mr. Carlson believed that it was appropriate for the State to step in and act as a partner also. He commended the bill sponsor for the foresight used in support of the legislation.

MARK MEYERS, (TESTIFIED VIA TELECONFERENCE), DIRECTOR, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES, ANCHORAGE, stated that the agency had extensively worked with the bill's sponsor. The plan is modeled closely to when the operating costs exceeded the revenues. The fiscal note describes individual platforms and what their current production is and what their future production might be. He reiterated that the legislation had been carefully modeled to minimize the negative fiscal impact while continuing the life of the platform. It is estimated that reducing the royalty share by 7.5% could extend the economic life by approximately 14 months. There is a period of time when the operations could be profitable for a longer period. At the current rate of production, they are old infrastructures and the production is in a steady state of decline. Once the platforms are pulled out, the overall economic costs and viability of the projects increases on these platforms. The value of the entire industry rests on these dates and the hope is that future exploration will offset other quantities of oil to offset the date. The bill does not "fix" the issue of aging infrastructures but it does help and postpones it in order to buy more time. New discoveries need to be found.

Mr. Meyers continued that the incremental benefits would be in sustaining jobs and overall production refined in the Cook Inlet area.

WILLIAM NEBESKY, (TESTIFIED VIA TELECONFERENCE), COMMERCIAL ANALYST, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES, ANCHORAGE, advised that the bill would provide economic benefit to the State. It has been estimated that there could be as much as \$2.2 million dollars per month in royalty revenues, \$26 million dollars per year.

Representative Whitaker asked about the costs associated with the fiscal note. Mr. Meyers responded that the note was modeled from triggering the lower royalty at the trigger price, assuming the normal decline of the field with the incremental benefit of extended life, platform by platform. The royalty would be reduced and would be less but would also be adding an incremental wedge of royalty for the extra time the platform is in production.

Representative Whitaker interjected that there is a "possibility of an increase" to State revenues. Mr. Meyer acknowledged that was correct, commenting that it would extend the life of the platform. It could act like an "insurance policy" and that an incremental assessment would be made, keeping the entire infrastructure in tact as long as possible.

REPRESENTATIVE ETHAN BERKOWITZ asked if the premise for the legislation was that production costs were too high and the only way to keep wells going was if costs were reduced. He questioned if the only way to reduce costs would be to "give away" royalty oil. He requested some assurance that other factors relating to operating costs would still be managed in a prudent manner. Representative Berkowitz inquired if there had been consideration given to removing the royalty reduction if operating costs were somehow reduced in the future.

Mr. Meyer responded that these platforms are "late in their life" of production. The level of production does not provide a lot of space to do major operations on the wells. He surmised that the State was looking at "skinny" economics in the first place, which drives smaller operators to be more efficient. There are considerations in the bill under Section G(ii), which guarantees that protection be reservoir related and not a mechanical problem.

Representative Hawker pointed out the loss of revenue indicated in the fiscal note. He asked what the benefits would be to the State. Mr. Meyer acknowledged that the largest benefits are speculative. As the economics of the platform changes and gets smaller, the larger companies have more overhead. They may abandon the platforms earlier than another company. If the State provides incremental value, that might entice another operator to come in and invest more money in the facility, in looking at the exploration potential. It is hoped that notice will be taken of the advantage of such a prospect and drilling the exploration wells. Mr. Meyers commented that what the State "gives up" is relatively small in comparison to the exploration and operation of the wells. At some point in time, the platforms will be abandoned. The integrated economics on the Cook Inlet are operating efficiently and the State can extend their life by buying enough time for the next stage of exploration. That economy cannot be quantified.

Representative Hawker summarized previous discussion regarding reduction to the royalty rate. He inquired if one premise was that there would be some extension to the productive life of the wells. Mr. Meyer responded that had been modeled into the numbers and that there clearly would be an extension to the life of the platforms. The legislation will clearly lead to an extension of the ultimate production of the wells; however, what is not included in the note, is the current production decline and that royalty benefit is not known.

Representative Hawker commented that the model and the net change in revenue do factor into the Department's estimate of the extended production. Those numbers do not offset the revenues given up by reducing the royalty rates. Mr. Meyers

acknowledged that was correct, however, the Department has not captured the up-side. The negative effect has been minimized regarding the up-side potential. He reiterated that it is very important to buy time for the facilities. If there was a shut down, domino-effect data is not available but is definitely of concern. Experience indicates that a 30-40 million barrel field discovery is needed to offset another platform. Those numbers could be lower if an existing platform was used. He admitted that the tangible benefits cannot now be proven but that they do exist.

Representative Hawker reiterated that the Department believes that there are benefits but that they cannot be proven, hence, members need to make a judgment call.

Representative Berkowitz pointed out that the legislation asks that the State share in the downsize. He inquired if thought had been given to doing a "price trigger" for the royalty reduction. If the price of the product is high, the State should not have to forego the royalty share. Mr. Meyer replied that under AS 35.05.180, a mechanism had been written and would improve that process. If a typical economic platform was developed, then the State could customize it for that field. The problem remains that there is high administrative overhead with no certainty for results. One advantage of the current type mechanism is that it provides relative certainty for operating value in the royalty production.

Mr. Meyer continued, the State has attempted to look at a mechanism that was simpler and more predictable for the company with little downside for the State. When looking at individual platforms, it does not take into consideration structure questions. Mr. Meyers noted that the language would bring the royalty rate back to 12.5% under successful production increases.

Representative Berkowitz questioned if there were mechanisms in place that would allow the State to share in the up-side. He noted that if the price was at \$35 dollars per barrel, the State should not forgo its royalty percentage. That could be a lot of money and could serve many of the State funded programs.

Mr. Meyers explained that HB 198 would provide the average price used for planning purposes. The advantage to that mechanism is that it is appropriate for royalty reductions and projects out a certainty for operating value and profitability to the company, given the production forecast. The Division is attempting to stimulate more activity. If the company knows that there are set royalty costs, it can provide a clear quantifiable number of how much profit is

left in the platform. Mr. Meyers noted that it is indented to provide a thirty-year life to the platforms.

**TAPE HFC 03 - 85, Side B**

Mr. Meyers thought that there would be an overall yield price of \$23 dollars per barrel. The price was not customized platform by platform but rather as a reasonable assumption for the oil price.

Representative Whitaker asked if a fair characterization would be that the State would be "giving up some 'upside', insuring against the downside". Mr. Meyer responded that sharing in the upside has two advantages:

- The State will return to the 12.5% rate with increased production.
- If new oil is developed, the State receives the 12.5% royalty on a larger pool of oil that would not have been developed if the infrastructure had been removed.

Representative Moses injected that the bill acts like a "subsidization"; he voiced concern with a formula that presents a net loss to the State. Alaska cannot afford to subsidize any industry while at the same time cutting services. Mr. Meyers acknowledged that the State needs a diversified oil program with as many producers as possible. He pointed out how extending the life of the platforms would encourage newer, smaller companies to invest in oil exploration in Alaska. He suggested that the bill, while proposing an initial possible loss, also provides insurance for further developing of the industry. He concluded that the investment in the "up side" was worth the possible return. He emphasized that once a platform is closed, they cannot be replaced. In the current configuration, these platforms have been losing approximately fifty barrels per day. The bill presents a customized version to encourage investment.

Representative Moses responded that with the new methods of drilling, there is a possibility that platforms might be obsolete before long. Mr. Meyers responded that there are economic and environmental advantages to drilling off platforms. New technologies have improved in the Inlet, however, for bonding, operating platforms and the costs are on a thin margin, which is the reason that the State has compromised with the various groups.

KEVIN TABLER, (TESTIFIED VIA TELECONFERENCE), LAND & GOVERNMENT AFFAIRS MANAGER, UNION OIL, voiced appreciation for HB 198, which specifically targets those platforms that

are approaching their aging life. He provided his companies perspective and the benefits of the legislation. Unocal Oil is the predominate operator in Cook Inlet and operates 10-15 platforms in that area. It is the place where the company's infrastructure, manpower and capital investments are continually threatened by global competition investment dollars. For the last several years, Unocal has consolidated and restructured their Alaskan operations to focus on becoming the lowest cost producer in the Cook Inlet area. The Cook Inlet area, with their mature and declining fields and low margin properties, has extremely high operating costs and the regulatory uncertainty creates a challenging environment. The cost of cutting is a temporary fix. Mr. Tabler maintained that the only sustainable solution to longevity would be to increase the reserve base. HB 198 would not necessarily increase that base of a field or platform, but it will sustain the economic viability of the existing infrastructure. That could lead to the ultimate recovery of more reserves, having an offsetting effect.

Mr. Tabler added that equally important is the possibility for oil reduction to increase the attractiveness of making additional investments in the field. These properties have to compete internally with other opportunities that Unocal has. It is certain that if the economic viability is left unchecked, shut down would be accelerated, leading to a lower tax base, unemployment, and loss of monetary support throughout the community.

Mr. Tabler referenced that the cost analysis provided by Mr. Meyers, which had been based on an analysis supplied by the companies. He spoke to the "sub-economic" platforms and that the only thing that allowed those platforms to continue production comes from other platforms. Operating costs have to be spread across the rest of the platforms.

Mr. Tabler acknowledged that lay-offs have occurred and that it would only be a short period before additional platforms will be suspended. With the mature fields, when royalty relief is justifiable, the life extension of facilities is important to the overall infrastructure and is of primary benefit. In reviewing the language of the bill, different platforms have different thresholds for economic viability. Although each platform is different, the State should not lose sight of the overall economics of Cook Inlet. Those economics are sensitive to not only price but also the impact cost sharing. Additional costs place an initial burden on the remaining facilities and therefore shorten their life. The time to give relief is when they are still economic and there is still potential to extend the field to increase production. He maintained that the bill is a clear and concise vehicle to support future exploration projects. Mr. Tabler encouraged passage of the bill out of Committee.

HB 198 was HELD in Committee for further consideration.  
#

ADJOURNMENT

The meeting was adjourned at 9:52 A.M.