

HOUSE FINANCE COMMITTEE
May 18, 2003
7:07 P.M.

TAPE HFC 03 - 102, Side A
TAPE HFC 03 - 102, Side B

CALL TO ORDER

Co-Chair Harris called the House Finance Committee meeting to order at 7:07 P.M.

MEMBERS PRESENT

Representative John Harris, Co-Chair
Representative Ethan Berkowitz
Representative Mike Chenault
Representative Richard Foster
Representative Mike Hawker
Representative Beth Kerttula
Representative Bill Stoltze
Representative Jim Whitaker

MEMBERS ABSENT

Representative Bill Williams, Co-Chair
Representative Kevin Meyer, Vice-Chair
Representative Eric Croft
Representative Reggie Joule
Representative Carl Moses

ALSO PRESENT

Senator Thomas Wagoner; Steve Porter, Deputy Commissioner, Department of Revenue

PRESENT VIA TELECONFERENCE

Dan Dickinson, Director, Division of Oil and Gas Audit, Department of Revenue; Mark Meyers, Director, Division of Oil and Gas, Department of Natural Resources, Anchorage

SUMMARY

CSSB 185(FIN)

An Act providing for a reduction of royalty on certain oil produced from Cook Inlet submerged land, and for a credit for certain exploration expenses against oil and gas properties production taxes on oil and gas produced from a lease or property in the state.

CS SB 185 (FIN) was HEARD and HELD in Committee for further consideration.

#SB185

CS FOR SENATE BILL NO. 185(FIN)

An Act providing for a reduction of royalty on certain oil produced from Cook Inlet submerged land, and for a credit for certain exploration expenses against oil and gas properties production taxes on oil and gas produced from a lease or property in the state.

SENATOR THOMAS WAGONER presented an overview of SB 185. He stated that the bill would amend statutes to provide for reduction of royalty on oil produced in certain Cook Inlet fields and platforms as they near the end of their production capability.

The intent of the legislation is to provide a monetary incentive in the form of royalty relief to help maximize production from old fields and extend the longevity of Cook Inlet oil platforms. In return, there would be continued employment in the area. Additionally, there could be production that otherwise would not be realized because the fields will become more economical due to reduced costs. He added that it would result in more oil production than originally realized, subsequently more unexpected royalty revenues even at the reduced rate.

Senator Wagoner added that encouraging production in the marginal fields could extend their life by 18 to 24 months. SB 185 also offers an exploration severance tax credit to explorers for work performed on or after July 1, 2003 and before July 1, 2007.

At present time, the maximum tax credits for exploration in Alaska results in costs of about 65 cents on the dollar; a number that compares poorly with the credits received from our Canadian competitors. Alaska is at the bottom of the list in terms of exploration credits. The bill provides a 40% tax credit for exploration applied against severance taxes, reducing costs in Alaska to 39 cents.

Senator Wagoner pointed out the Cost of Exploration chart in member's packets, concluding that the bill provides "bold step" in making Alaska a major player in the world market. (Copy on File).

Representative Berkowitz asked what a "bottom hole" was.

MARK MEYERS, (TESTIFIED VIA TELECONFERENCE), DIRECTOR, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES, ANCHORAGE, explained that a bottom hole is an area that is not on the path and based on the survey is the area in the bottom of the well. For the purposes of describing a three-mile area, the bottom hole location is where the bit finally ends in the bottom of the well. The bottom hole location

will typically be in a different location than the surface location.

Representative Berkowitz asked what "butted" meant. Mr. Meyers explained that "butting" is the actual date that drilling starts.

Representative Kerttula asked if the producer could directionally "drill out" of the three miles and continue to use those calculations. Mr. Meyers replied that the three miles of the bottom hole is used as a point of reference in the subsurface. If one well was drilled in one direction and another in a different direction, both wells would qualify if their horizontal distance was more than 3 miles. The search location could be the same location.

Representative Kerttula asked about existing wells. Mr. Meyers explained that an existing well was defined as a well that either was less than 15 years old or greater than 150 days old. The older exploration wells would not be considered a bottom hole.

Representative Kerttula asked what would happen if there were many wells going in around one another and if the 150 days would continue to be reasonable. Mr. Meyers advised that would allow for two companies to be drilling simultaneously during the season. More than one well would potentially be paid for in the same location under the program and they would all have to be exploration wells.

Representative Kerttula questioned if there was a need for incentive when a party already knows where the oil is and that it was worthwhile to drill. Mr. Meyers responded that there are other protections contained in the bill. One is that it cannot be an existing loan gas unit. There are examples where earlier discoveries were made and if the discovery was greater than 15 years old, then it would be considered under the bill.

DAN DICKINSON, (TESTIFIED VIA TELECONFERENCE), DIRECTOR, DIVISION OF OIL AND GAS AUDIT, DEPARTMENT OF REVENUE, ANCHORAGE, offered to answer questions of the Committee. He noted that Alaska was one of the only places in the world that does not have a program as proposed in the legislation.

Representative Berkowitz asked why Alaska had not implemented such a program before if it was "such a universal condition". Mr. Dickinson responded that the State did have prior rate credits in place in the royalties that were used actively in the 1980's. Conditions now are changing. It is anticipated that there would only be drilling where the good wells are located. At present time, many of the good areas have been taken. The State is

attempting to create incentives similar to other areas around the world.

Representative Berkowitz questioned how the proposed incentives would compare to other worldwide incentives. Mr. Dickinson noted that there was back up in member's packets that indicate such information. Most projects focus on exploration. Once oil is discovered, the company wants to get it to the pipeline. The place where the biggest difference is made is when oil is found in individual jurisdictions.

Representative Berkowitz commented that he did not understand the mechanism. Mr. Dickinson explained the production sharing agreement and that for every dollar produced, if it is reinvested, there will be a low or no tax rate on it. The federal government would be providing the 35 cents on each dollar for exploration in Alaska. If the bill passes, then Alaska would be "kicking in" another 40 cents per dollar per well.

Representative Kerttula agreed that the State needs to impact exploration now. She pointed out that the list indicates exploration only and does not indicate the other taxes or the stability of the other referenced governments. She inquired how Alaska currently ranks. Mr. Dickinson advised that legislators must look at total production costs and total State pay during these times of high prices. Alaska is one of the best places in the world for the companies to do business. Although, when prices are low, Alaska is one of the worst places to undertake business. He stressed that the Legislature must look at pricing, which is clearly part of the structure.

Representative Kerttula voiced concern with the 40% number and asked for an economic analysis on that determination. Mr. Dickinson responded that there are two important pieces of analysis. He commented on taking the 40% number and adding it to 35% of the federal government contribution, which would place Alaska approximately in the middle. Any change must be a bold move. He acknowledged that the legislation would be picking up a significant amount of the incurred costs. Mr. Dickinson stressed that drilling wells is expensive and that it needs to be a significant portion. There are additional documents that model three possible results.

Senator Wagoner pointed out that next year, there are three scheduled wells on the North Slope.

Representative Whitaker understood that the proposed legislation was part of a larger program for the continued oil exploration on the North Slope. Mr. Meyers acknowledged

that it is. Representative Whitaker added that the proposed legislation was a key component to that larger picture.

Representative Berkowitz voiced concern with the size of the package and the repercussions. He asked why it had taken so long to come before the Legislature if it was such a good idea. Senator Wagoner responded that Section 3 was the amendment to the original bill and that the drafters had been working on it for several weeks and took that long to develop this bill.

Representative Berkowitz pointed out that there is not a lot of back up on a bill that involved such a lot of work. He reiterated that there is not enough information provided warranting an informed decision.

Co-Chair Harris pointed out that the Governor has indicated that he is going to push for natural resource development. Senator Wagoner acknowledged that the Governor has indicated that he wants to grow the economy, which cannot happen without developing resources and this is the first step on the plan for development. He spoke about the twenty-five mile radius, encouraging exploration further out for exploring and drilling more remote areas and away from current production.

Representative Kerttula asked how the Department would be getting the seismic data and when would they be able to use it. Mr. Meyers responded that it will be available within six months. Under current permitting requirements, the State gets the data on all State lands. On private and federal lands, the State does not automatically receive that data. The legislation allows the State to get it, but allows the applicant six months to determine if they want to use the credit or not. Representative Kerttula clarified that the Department could use the data but could not release it to public for ten years. Mr. Meyers agreed that was correct.

Representative Kerttula reiterated that internally, the Department will be able to have the data but cannot use it for anything released to the public. Mr. Meyers replied that was correct.

Representative Kerttula asked what would happen if the data indicated that a rich area had been hit. How would exploration be started in that particular area and if that happened, how would the State receive the credit. She acknowledged that she supports exploration but is concerned about the State's finances.

Mr. Meyers responded that there are multiple issues contained within the question. The first issue is the seismic data from new areas, which is suggestive of oil or

gas. Only when it is calibrated with well data, can it be certain and that is not known until it is drilled. The seismic data provides basic structural information and in some cases an indication of hydrocarbons. The productability of the potential reservoirs does not just happen. The next step would be to encourage someone to go in and drill. In the early stages, seismic data was sought after acquiescing the lease of an area. In modern times, it is more typical to shoot before they acquire the leases and helps in the evaluation of the State land lease terms. On federal and private land, the ability to more effectively push is provided to open areas that have the highest potential. The seismic data on the private and federal lands is an important planning tool for the State. The data helps the State understand the common use of the facilities if those fields were produced. He reiterated that the data is very valuable and an important aspect of the bill, which gets the data distributed.

Representative Kerttula asked if the State adopts the legislation and if exploration is begun, would it be fair to say that the State has done their part by providing the break without any other royalty reductions. She indicated it would be a fair trade.

Mr. Dickinson explained that exploration is only a piece of the process. He thought that once that area is found, they would pay close to 12.25%. However, other incentives are needed. It is important to have a wide variety of tools. He pointed out that it is important that the dry holes also receive credits, as drilling a dry whole is risky exploration.

Representative Hawker questioned the mechanics of the credit. He asked if they were transferable with no expiration date. Mr. Meyer replied that was correct. The credits trade at about 95 cents to the dollar. He pointed out that there are three companies that have sent checks to the State in the range of \$20 million dollars. There are only four players that currently can take the credit. The legislation would open it up to a whole new set of players. He clarified that Section A indicates that the credit cannot be taken until July 1, 2004. It will have no effect in FY04, but the work can be done in FY03.

Representative Hawker emphasized that the utilization of any credits could not commence until July 1, 2004. Mr. Meyers agreed and pointed out that the work would have to be done before July 1, 2007. A four-year window has been created. There is no sunset on when the credit could be used.

Representative Hawker commented on the transferability and that the drillers do not have to be producers. Mr. Meyer advised that was correct. The intent is to bring other

producers in. They would still have to create their own funding. If the work was previously contracted for, they would not get the incentive. There is specific language addressing that concern.

Representative Hawker understood that was the May 13th, 2003 date. Mr. Meyer added that before July 1st, they could qualify. Once the plans are in effect, that would determine development.

Representative Hawker asked about the utilization of the credits. He understood that commencing July 1, 2004, qualifying production could offset their entire monthly liability using whatever credits are available. Mr. Meyer acknowledged that was correct. They could use their entire monthly liability for the severance tax; they would also have:

- Monthly royalty payments,
- Quarterly income tax payments, and
- Annual property tax payments.

Representative Hawker clarified that it would only be the severance tax. He asked if there had been consideration on how to "soften the blow to the treasury" by perhaps allowing the off set on ½ of the monthly liability of the producer. Mr. Meyer responded that HB 61 would create a credit for certain activities in Cook Inlet, indicating that not more than 50% could be taken in one year. The Department did consider that, however, in the context, the type of credits expected would be taken in three consecutive month packages. Because of the monthly tax, carrying it forward would still show in the same fiscal year.

Representative Hawker commented on the qualifying expenditures. He asked if there was a rule of thumb of how much the oil well costs and how much each drill site would generate a credit. Mr. Dickinson responded that a company could find a wide variety in Alaska. The types of well being referenced are 25-miles beyond the nearest infrastructure and typically run in the \$25 million dollar range. Mr. Meyers agreed that it was a wide range. Typical exploration costs on the low end are at about \$3 million dollars and the high costs would amount to approximately \$25 million dollars. Realistically, they could get multiple wells from a single path, so the individual well costs goes dramatically down. A good rule of thumb for a dry hole cost would be \$12 million dollars.

Representative Hawker asked if the State had any offshore projects that would qualify for this. Mr. Meyers replied there are. Examples would be using the offshore drilling

equipment. A well using that tool would cost in the upper end of the \$25 million dollar range.

Mr. Dickinson added that if the drilling were more than twenty miles offshore, at some point it would be on federal land.

Representative Hawker asked if a single well could be in excess of \$100 million dollars. Mr. Meyers stated that was correct and that offshore wells are ones that approach that price range. Another place where that could be applicable would be State waters around Cook Inlet. The individual well costs could run high but if they were open to a multi-cost program, the costs could decline.

Representative Berkowitz asked about work that is scheduled for this summer that has already been permitted. Mr. Meyer commented that the State has some ideas of the permitting. The companies that want to have additional commitments have not completed their budget outlines until typically late in the fall.

Representative Berkowitz asked why the State would give already scheduled work, incentives to do something that they are already going to do. He stated that is a "give away".

STEVE PORTER, DEPUTY COMMISSIONER, DEPARTMENT OF REVENUE, explained that they only do summer fieldwork. They cannot do seismic activity on the slope in the summertime. Most of the company's cycles for permitting happen in the late fall.

Representative Berkowitz reiterated that there are companies that are already committed to doing work during "x" periods of time. He questioned the incentive. Mr. Porter responded that there are only a few wells with multiple-year commitments, which is a unique circumstance. Exploration programs are generally year-to-year. He did not know of any approved wells at this time.

Mr. Meyers added that the committee process has not been completed on any of the wells. There are tentative plans that would be eligible for the credits and the credits could lead to additional drillings. He admitted that there was a risk for the first year plan but it is anticipated that there will be more investment in the State. That is the balance and the risk taken. Mr. Dickensen observed that it would be detrimental to delay one year's drilling season.

Representative Berkowitz requested further time to look at the bill in order to review the consequences.

Senator Wagoner reminded members that the companies that do the exploration, operate on time budgets also and that most

of the money for next year's operations is being negotiated at this time.

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Senator Wagoner reminded members that those companies are currently negotiating worldwide on exploration ideas.

Representative Kerttula referenced Page 7, Lines 8-10, pointing out the July 1st, 2003 date, the date that the boundaries would be set. She asked if that would still "roll" and what would happen with a unit after that date. Mr. Meyers replied that the length of a credit is four years. The only exception might be in certain areas of National Petroleum Reserve-Alaska (NPR-A), where many are within the 25-mile zone. Realistically, the unit must be formed and in those cases, the negotiated work permit would take into consideration the credits. He added that it is not likely that there will be any new units.

Representative Kerttula asked if there was a sunset pushing that concern. Mr. Meyers replied it was.

Co-Chair Harris stated that the bill would be HELD in Committee for further consideration.

Senator Wagoner acknowledged that there had been similar concerns voiced on the Senate side. He added that SB 185 was a "jobs" bill and would get people back to work. He encouraged passage of the bill.

SB 185 was HELD in Committee for further consideration.

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ADJOURNMENT

The meeting was adjourned at 8:00 P.M.