ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON OIL AND GAS
February 20, 2003
4:29 p.m.

MEMBERS PRESENT

Representative Vic Kohring, Chair
Representative Hugh Fate
Representative Lesil McGuire
Representative Norman Rokeberg

MEMBERS ABSENT

Representative Mike Chenault, Vice Chair
Representative Harry Crawford
Representative Beth Kerttula

COMMITTEE CALENDAR

OVERVIEW BY ALASKA OIL & GAS ASSOCIATION (AOGA), PART 2

- HEARD [See 3:25 p.m. minutes for this date]

SPONSOR SUBSTITUTE FOR HOUSE BILL NO. 28
"An Act relating to adjustments to royalty reserved to the state to encourage otherwise uneconomic production of oil and gas; and providing for an effective date."

- HEARD AND HELD

PREVIOUS ACTION

BILL: HB 28
SHORT TITLE:OIL & GAS ROYALTY MODIFICATION
SPONSOR(S): REPRESENTATIVE(S)KOHRING, ROKEBERG

Jrn-Date	Jrn-Page		Action
01/21/03	0039	(H)	PREFILE RELEASED (1/10/03)
01/21/03	0039	(H)	READ THE FIRST TIME - REFERRALS
01/21/03	0039	(H)	O&G, RES, FIN
02/19/03	0246	(H)	SPONSOR SUBSTITUTE INTRODUCED
02/19/03	0246	(H)	READ THE FIRST TIME - REFERRALS
02/19/03	0246	(H)	O&G, RES, FIN
02/19/03	0246	(H)	REFERRED TO OIL & GAS

WITNESS REGISTER

BONNIE ROBSON, Deputy Director
Division of Oil & Gas
Department of Natural Resources (DNR)
Anchorage, Alaska
POSITION STATEMENT: During hearing on SSHB 28, conveyed overall support with three possible amendments: delete the language extending this to portions of pools, use the original language with regard to obtaining data necessary to evaluate the application, and allow DNR to choose the independent contractor to evaluate the application.

ACTION NARRATIVE

TAPE 03-8, SIDE A
Number 0001

CHAIR VIC KOHRING called the House Special Committee on Oil and Gas meeting back to order at 4:29 p.m. Representatives Kohring, Rokeberg, Fate, and McGuire were present at the call back to order. [For the Overview by the Alaska Oil and Gas Association (AOGA), Part 2, see the 3:25 p.m. minutes for this date.]

HB 28-OIL & GAS ROYALTY MODIFICATION

Number 0020

CHAIR KOHRING announced that the committee would hear SPONSOR SUBSTITUTE FOR HOUSE BILL NO. 28, "An Act relating to adjustments to royalty reserved to the state to encourage otherwise uneconomic production of oil and gas; and providing for an effective date."

CHAIR KOHRING, joint sponsor along with Representative Rokeberg of SSHB 28, informed members of the intention to explain the bill but not move it from committee that day. Describing the bill as "royalty adjustment legislation," he said the intent is to modify a 1995 law that reduced royalties on marginal fields in order to spur development of uneconomical fields. There are several fairly sizable changes.

CHAIR KOHRING explained that SSHB 28 would give discretion to the commissioner of the Department of Natural Resources (DNR) to make decisions with regard to royalty reductions on marginal

fields, in order to expedite the process; now, by contrast, [a proposed modification] goes to the commissioner and then to the governor for final consideration. The bill also clarifies and simplifies procedures relating to royalty reduction; he offered to provide details later.

CHAIR KOHRING indicated that under consideration is removal of a sunset deadline of July 1, 2015, for companies that would be able to approach the department to be granted [a modification]. [Subsection (j)(1)(A), beginning on page 1, line 1, removes that deadline.]

CHAIR KOHRING also pointed out that whereas statute now refers to marginal oil fields, [the bill's sponsors] also are looking at having it apply to portions of oil fields [which is in SSHB 28]. Chair Kohring expressed the desire to be a little more specific with this legislation, and to have the industry work with the bill's sponsors to identify specific portions within the oil fields.

Number 0262

CHAIR KOHRING explained that the bill is intended to jumpstart activity by allowing companies to come to DNR and present findings that they have uneconomical fields, which won't be developed without some royalty reduction. It doesn't change the public hearing process, which had been a concern with previous legislation. He called attention to DNR's fiscal note [which says that adding the language "portion of field or pool" could result in a negative fiscal impact to the state.] He also likened this to the debate involving Agrium a couple of weeks ago [on HB 57], since the desire is to give a break to an industry with the intent of allowing it to grow and develop.

Number 0392

CHAIR KOHRING highlighted the big question for the committee: where to draw the line on how much [the state treasury] is giving up through royalty reduction in exchange for further development of the industry that will help generate jobs and get more dollars flowing in the economy. He concluded by saying this looks at accomplishing the same goal as HB 69, the "permitting streamlining bill" [sponsored by him]: to encourage more drilling activity in the industry, although with SSHB 28 it is for oil, not gas. He invited Bonnie Robson to comment.

Number 0462

BONNIE ROBSON, Deputy Director, Division of Oil & Gas, Department of Natural Resources, noted that Mark Myers, director of the division, wasn't available that day and thus she would speak instead. Addressing why the ability to reduce royalties is a valuable tool, she told members:

> Quite simply put, royalty reduction can make economic oil and gas production that would otherwise not be economic. It can extend field life for a field in its sunset years, and it can bring into production a field that would otherwise be on hold pending better economics or better technology.
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> I'd like to work with an example today of royalty reduction and how it can bring these benefits. First of all, I think we need to assume an oil price of $16.00. And we choose that because companies often run their economics and make their decisions on whether to continue production from a field - or to develop a new field - based on an assumed oil price, rather than the actual or current or average annual price of oil. And $16.00 ... is in the range they frequently use.
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> But royalties are not paid to the state based on $16.00, and so the royalty reduction is not on $16.00 per se, but it's on the netback value of the oil. And if you work with a $16.00 oil price, you would typically have for, say, Prudhoe Bay oil, on the order of $6.00 in reductions: about a dollar for either the cost of NGL [natural gas liquid] manufacturing or field costs, where allowable; another $1.50 for marine transportation; and about $3.50 for TAPS [Trans-Alaska Pipeline System] tariff or pipeline transportation.
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> These deductions total $6.00, and so royalties are paid not on the basis of $16.00, but $10.00. And while royalties can be at 12-1/2 percent, 16-2/3 percent, or 20 percent, they most frequently are at 12-1/2 percent of the netback value, so that on a $10.00 netback, royalties would be paid at $1.25 per barrel.

Number 0668

MS. ROBSON continued:

And under the existing law, royalties can be reduced from the 12-1/2 percent to 5 percent if an application for royalty reduction is approved, meaning that the royalty take or the state's take could be reduced from the $1.25 in our hypothetical situation to $.50 per barrel. This would improve a company's economics by $.75 per barrel. And that $.75 per barrel matters: it effectively raises the assumed price of the oil from $16.00 to $16.75, and helps make the project more economic when compared to the other alternatives available to oil and gas companies.

While this difference that the state can make - on the order of $.75 per barrel in our hypothetical - is dwarfed by price volatility, companies nonetheless make their investment decisions based on their assumed price of oil, and not on actual prices of oil. So if the goal of the state is to, in fact, change the behavior of companies and to cause investment that would not otherwise occur, and they're going to work off an assumed price of $16.00 per barrel, the $.75 royalty reduction may induce investment or prolong field life even where $30.00 oil prices do not.

Number 0804

MS. ROBSON, addressing SSHB 28 specifically, continued:

The changes proposed by the sponsors to HB 28 do a number of things that ... have already been well described by the chairman. It's made the statute plain English; it simplifies language in a number of instances, even where the substance is not changed. But it does change the substance in a number of regards. To a certain extent, it certainly reduces the paperwork that goes with an application for royalty reduction. It also reduces the paper flow, and it eliminates the requirement of ... personal, [nondelegable] involvement ... by the governor.

But we think that some may view the most important aspect of the proposed change to the legislation [as] what it does to the current subsection (j)(3)(C)(i) [of AS 38.05.180]. And while there's some argument about how that subsection would be interpreted, basically it requires that the state, when it receives

an application for royalty reduction, evaluate that application in light of projected future oil prices. And while it allows for a royalty reduction at lower oil prices, it requires an increase in the royalty rate at higher oil prices - that is, it makes it mandatory.

Number 0924

MS. ROBSON continued:

So if we go back to our assumed hypothetical that we were talking about, if at ... an assumed price of $16.00 a company makes a showing that a project is not quite economic - and that, in fact, ... royalty relief on the order of $.75 per barrel would make that project economic - the state can drop the royalty rate down to, say, 5 percent, and accord the $.75 of relief. ... [Mandated] in return is that when oil prices are higher - say, above $17.00 per barrel - that the royalty rate not only would be at ... the contract rate of ... 12-1/2 percent, but be higher than that rate, so that the state, if future prices are as projected at the time of analysis, actually recovers more than would otherwise be the case, absent the application for royalty modification.

To restate that, basically it says to somebody coming in the door and looking for royalty relief that ... if price projections are accurate, your royalty burden is actually going to increase. And one of ... the aspects of the proposed amendment is that while it still allows for a sliding-scale royalty - that is, lower royalty rates at low oil prices and higher royalty rates at high oil prices - it does not mandate that the state, in its assessment, conclude that it will be better off per barrel in terms of the royalty take.

And it also allows the commissioner to exercise ... discretion in terms of what the state receives in return for any reduction in royalty rates. It may still want to take some of the upside, but it may feel, ... instead or in addition, that some work commitment, some obligation to drill additional wells or add additional gas-handling capacity within a limited period of time, [is] reasonable in exchange

> for providing the low-price protection, the royalty relief at the lower prices.

MS. ROBSON noted that the bill also removes the sunset date and express language allowing the disclosure of confidential information to the legislature.

Number 1109

MS. ROBSON pointed out that one aspect may be troubling to some parties: extension of royalty relief - currently available on a field or pool - to portions of fields or pools. Fields and pools aren't the same. A pool is an individual reservoir like the main reservoir at Prudhoe Bay - Sadlerochit - or one of many other reservoirs there like the Lisburne, the Point McIntyre, the Niakuk, the West Beach, and so forth. Each is its own pool; typically, they aren't in "hydrocarbon communication" with each other, are at different depths, and may have different oil characteristics. In contrast, a field is a larger conglomeration. For example, all the pools or reservoirs at the Prudhoe Bay Unit may be considered a single field; the same concept is true at the Kuparuk River Unit. Ms. Robson told members:

> We think that the current statute allows royalty reduction for a field or pool. And if you consider a pool a portion of a field, then the current statute also allows royalty reduction for a portion of a field. What it does not go on to do is allow royalty reduction for a portion of ... a pool. And there are some troubling aspects to allowing royalty reduction for a portion of a pool.

MS. ROBSON suggested thinking of a pool as a sponge or mud puddle, and then allocating water - from the sponge when it is squeezed, or the mud puddle when it is drained - to portions of the pool, either the perimeter or the center. She also mentioned the cost of draining the puddle or sponge, and asked members to imagine allocating the cost to either the perimeter or the center. It creates many complications in processing an application for royalty reduction, she pointed out, which includes the allocation of costs and production.

Number 1306

MS. ROBSON continued, providing an example:

> Right now at Prudhoe Bay there are over one hundred leases in the unit, and every lease, save one, bears a royalty rate of 12-1/2 percent. And so when it comes to the administration of leases for royalty purposes, at present we don't need to know whether oil comes from the center of any individual reservoir ... or whether it comes from the perimeter; the royalty rate is, and remains, 12-1/2 percent, and any royalty relief accorded for an entire pool or reservoir would extend to that pool or reservoir.
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> If there is an extension of royalty relief to portions of pools, then the division has to get in the business of allocating hydrocarbon production to portions of pools. It also has to get into the business of allocating the cost of the production from those pools to the various parts of the pool.

Number 1377

MS. ROBSON explained another complication: every pool or reservoir in Alaska - currently, to her recollection, there are some 55 or 56 participating areas or pools - would become eligible for royalty relief at some stage; there always would be the last barrel, or last thousand or hundred thousand barrels, that one could claim as marginal. She suggested it would put the division in the business of having to entertain royalty-reduction applications for every single pool and reservoir in Alaska at some point in time. She told members:

> Since leases and royalties are governed by a competitive bidding process, if we are, in fact, going to extend benefits to every pool and every reservoir in the state at some point in time, we may not want to do it through the process of applications for royalty reduction that must be adjudicated one by one, but by some more wholesale change in the laws of Alaska. That addition of portions of pools, then, is a matter of some concern to the division.

Number 1452

MS. ROBSON addressed three other areas in the proposed legislation that may be problematic or may just "be a matter of excessive worrying." First, the current statute provides for an independent contractor to be retained by the state for purposes of evaluating any application for royalty reduction, and that

independent contractor is to be paid for by the application. She explained:

> We think the initial intent behind that particular provision was not only to assure that the state had the necessary expertise ... to evaluate an application, but also to see that the applicant paid the cost of processing the application. It's ... unclear from the proposed amendment whether or not the state or the applicant would be the one entitled to pick the independent contractor under the proposed changes to the legislation. There is some concern that if the applicant is allowed to pick the contractor, and anyone who is able to do the math can be on the list of eligible contractors, that we put the applicant in the position of being able to - through the process of selecting the contractor - essentially guarantee the results it is looking for on the application.
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> We don't think that's the sponsor's intent. But, certainly, the language allows that possible interpretation, and there is some argument for staying with ... the existing statutory language that does allow the state to choose an independent contractor, paid for by the applicant, for purposes of evaluating the application for royalty reduction. Again, that may be excessive worrying on the part of the division, but it is a matter that you may want to discuss further.

Number 1591

MS. ROBSON discussed a second area of possible concern, in terms of implementation. The existing language allows the department to collect information it deems necessary to make a determination on an application for royalty reduction. However, the proposed bill says only information "reasonably available to the applicant" is to be considered by the department in evaluating the application. She explained:

> Unfortunately, it's possible that on any given application there may be some information that the department considers necessary but an applicant says is not reasonably available to the applicant. So there is an invitation to a dispute over what is and is not reasonably available to the applicant.

> Also, the department can be in a difficult situation because if it does not have the information it feels is necessary to process an application, ... it's unclear whether the application should then be granted, despite the department's inability to conclude the application is in its best interest, or whether the application gets denied because the department cannot conclude whether the application is in the state's best interest. And, unfortunately, that could result in a denial of an otherwise meritorious application, and we don't think that's the intent of the sponsors. We think the existing language in the statute may work. But, again, we may be "worrying" this issue a little too much.

Number 1693

MS. ROBSON addressed the third possible concern. Offering the belief that the bill has done a very good job of simplifying and cleaning up the language, she noted that it has removed express language that talks about the department's ability to "condition royalty relief and to require that assignments of royalty relief be approved by the department." She explained:

> We think that, even with the language as it is, the department would retain those rights. The department has historically interpreted its right to either grant or deny an application as the right to grant that application with conditions, rather than deny it. And we would assume that the department would continue to have those rights even under the modified or amended language. If that is not the intent of the legislature, then ... you might want to ... clarify that for us. But that was a question that we had, at least with regard to the proposed language.

Number 1753

MS. ROBSON concluded by saying the division supports SSHB 28 with [three] possible amendments: 1) delete the reference to portions of pools; 2) if thought necessary, provide "some return to the original language on DNR's ability to obtain data necessary to evaluate the application"; and 3) have DNR retain its current ability to choose an independent contractor to evaluate the application. She added that, on the whole, the division believes this is a very good effort to clean up the

current statute and provide an incentive for the production of fields not yet in production, as well as to prolong the life of fields that otherwise would be at their natural end.

Number 1811

REPRESENTATIVE ROKEBERG thanked Ms. Robson and the Division of Oil & Gas for working with the sponsors and offering constructive comments and criticisms. Explaining the reasons for introducing the legislation, he began by offering some history. As chair of the House Special Committee on Oil and Gas when he and Representative Kohring first were elected to the 19th legislature, he recalled that Governor Knowles had introduced HB 207, considered "the keystone of his economic policy" with regard to the petroleum industry. The committee held more than 15 hours' worth of hearings to develop the bill. When the bill reached the Senate Finance Committee, however, it was changed in such a way that it became a stumbling block, because it "accepted the concept of a concessionary modification as an incentive on the one hand, but it statutorily required that the state ultimately get a payback."

REPRESENTATIVE ROKEBERG agreed with Ms. Robson that the "(j)(3)(C)" language on page 3 [of SSHB 28] took away the commissioner's ability to create a royalty reduction on a sliding-scale basis that takes into account the various elements of production costs, oil prices, and so forth.

Number 1981

REPRESENTATIVE ROKEBERG pointed out that when he'd had that bill in committee, he'd been careful to develop a bifurcated track: one for existing fields and one for new fields. He explained:

> The governor's bill at the time was really related to newer fields, and I had a great concern about the existing fields of the Cook Inlet area, in particular, and then some of the older fields in the state that may well deserve and have some incentive justified. And particularly in the older fields, this type of language doesn't work. ... One size doesn't fit all, because I think you need to look at each particular, different application [for] fields or pool as a separate entity, and take those matrix of different issues together to make ... that decision. So to require that a field pay back something that it

doesn't make downstream, and put that in statute, I thought was a mistake.

REPRESENTATIVE ROKEBERG noted that there had been only two applications, to his recollection, neither of which led to production. Therefore, the bill hasn't been used - to his belief because it wasn't really workable. Thus he has always wanted to fix it, he said, since it was the first major legislation he'd worked on. Suggesting SSHB 28 fits with the current administration's desire for increased income from natural resources, he said it is designed to extend the life of fields or potentially assist in the development of a field that would not otherwise be developed. "And that was the context in which we had discussed this bill earlier," he added.

Number 2103

REPRESENTATIVE ROKEBERG pointed out that this is loosely called "180(j) of our oil and gas statutes." He said there have been provisions for royalty incentives for many years; HB 207 of eight years ago changed the statute, and the intent of SSHB 28 is to tweak it again to make sure it's workable, because it hasn't worked or made the state one penny. He also noted that there had been a previous application - from Conoco Oil Company, relating to Milne Point - during the Hickel Administration that Representative Rokeberg said he'd studied in great detail. Saying he was "somewhat astonished by the ultimate findings," he told members:

> It gave credence to the idea that the commissioner of natural resources, given the proper tools and given the proper statutory authority, with proper safeguards, should have the discretion to make that decision, because, lo and behold, the Hickel Administration, with a commissioner that came directly out of the "oil patch," turned down Conoco, and that gentleman ... is sitting in our audience today, [former] Commissioner Harold Heinze. And I studied in depth ... his work.

REPRESENTATIVE ROKEBERG indicated part of the endeavor with the previous HB 207 was to give the commissioner additional authority, on one hand, but to have safeguards in terms of the commissioner's best interest findings. However, the number of safeguards was overkill and added complexity, he suggested, including the Senate's putting the governor into the loop, because the commissioner of natural resources works for the

administration in power at the time. He voiced frustration that there is a perfectly good concept that could be applicable to some development in the state, but that it hasn't been workable because of certain provisions.

REPRESENTATIVE ROKEBERG suggested that oil companies may be reluctant to testify on [SSHB 28] because of fear of looking as though they are seeking a handout. He therefore proposed that this is not a handout but a helping hand, and the invitation is for the companies to bring forward applications that are meritorious. Each application will be judged on its merits, he said.

Number 2317

REPRESENTATIVE ROKEBERG addressed the first point made by Ms. Robson. Recalling that it was debated heavily in the House last time, he explained that with regard to extending it to a portion of a pool, his concern was about "step-outs" or certain areas that look marginal and might be considered part of the pool because of geology, for example. Saying it is an arguable point, he asked committee members to look at it further. He added, "I'll give [the Division of Oil & Gas] the benefit of the doubt here if they can prove ... otherwise, and we can remove that."

Number 2377

REPRESENTATIVE ROKEBERG addressed a second point by Ms. Robson, regarding the independent contractor. He indicated this area of the [previous] bill was developed in the House Special Committee on Oil and Gas at the time, in order to have "some real expertise available both to the commissioner and to the company involved that mandated that an outside consultant be brought in, somebody who could crunch numbers and had a reputation within the industry to assist in the analysis and development of the best interest finding." He offered that at issue are the changes [in the previous legislation] in the Senate, which to his belief [probably occurred] because the Division of Oil & Gas had wanted them.

Number 2404

REPRESENTATIVE ROKEBERG explained that [SSHB 28] defaults to the older concept of who picks the consultant. It is from a list of qualified consultants provided by the commissioner, but ultimately selected by the applicant. He added:

> The very simple reason is, the applicant's paying for it. ... I always took offense at the idea that an applicant would have to pay for a consultant selected by the commissioner. ... Ms. Robson brings up the point that, well, it may appear or may swing the guarantee of outcome to a particular contractor. But I believe by having the commissioner develop the shortlist of reputable consultants - and the reputation of that consultant should speak for itself, and there's relatively limited amounts of those people that could undertake that ... in the whole nation, I think, or worldwide - ... that should be adequate comfort for the commissioner. And the fact is, a rather large sum of money I would expect to ... have to be paid by ... the petroleum company bringing forth the application. And they're paying for it; they ought to get the final say. ...
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> It's kind of a philosophical thing, where ... I kind of take offense that the government's going to tell you that ... you have to hire somebody and then pick them for you, and then you've got to pay for it. ... I think it's something that needs further debate, and I'm certainly open to that particular debate.

Number 2514

REPRESENTATIVE ROKEBERG addressed a third area discussed by Ms. Robson, relating to page 4, line 28 [of SSHB 28], "**reasonably available to the applicant**". He recalled that that phrase stemmed from testimony eight years ago. There were a number of transfers of properties, particularly in the Cook Inlet area, from one company to another; there also had been testimony by Union Oil Company of California (Unocal) and by some of the successors in interest to those transactions that geological data didn't necessarily come with the purchase of some of those platforms out in the inlet. The reason for the provision, therefore, was to [avoid] an extra requirement of providing data that someone didn't even have.

REPRESENTATIVE ROKEBERG said while he appreciates the division's concern that this may be some sort of an "out," he believes the commissioner would have sufficient latitude or authority, if lacking adequate data, to deny the application. He mentioned a desire for assurance if an applicant could make a good enough case that the data was reasonably available if that applicant

didn't even have it. He characterized it as a "successor-in-interest-type argument." He also indicated the addition of the words **may** and **only** [on line 26] might alleviate problems. He continued:

> It seems to me that the consultancy and the other information and data that would have to be part of the application obviously would have to be sufficient enough to convince the commissioner to grant the relief. And if they didn't make their case, ... they wouldn't get it. ... We shouldn't make it mandatory that they get this data, because the commissioner could overdemand and never make a determination. So that's kind of the rationale behind that one.

Number 2643

REPRESENTATIVE ROKEBERG referred to Ms. Robson's mention of possible concern about assignment [of royalty interest]; he suggested the need to look at that and iron it out. Suggesting that all the issues can be resolved, he again thanked the Division of Oil & Gas for stepping forward in fundamental support of the bill, and said he looked forward to working to resolve the concerns.

Number 2671

CHAIR KOHRING, crediting Representative Rokeberg with the work on the bill, said he was looking forward to fine-tuning it and advancing it to the next stage. He thanked Ms. Robson for her thorough analysis and constructive criticism, noting that the view of the administration is generally positive toward the legislation. [SSHB 28 was held over.]

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Oil and Gas meeting was adjourned at 5:11 p.m.