

**ALASKA STATE LEGISLATURE  
HOUSE RESOURCES STANDING COMMITTEE**

February 28, 2003

1:06 p.m.

**MEMBERS PRESENT**

Representative Hugh Fate, Co-Chair  
Representative Beverly Masek, Vice Chair  
Representative Cheryll Heinze  
Representative Kelly Wolf  
Representative David Guttenberg

**MEMBERS ABSENT**

Representative Mike Chenault, Co-Chair  
Representative Carl Gatto  
Representative Bob Lynn  
Representative Beth Kerttula

**COMMITTEE CALENDAR**

CONFIRMATION HEARING

Department of Natural Resources

Tom Irwin - Juneau

- CONFIRMATION(S) ADVANCED

HOUSE BILL NO. 16

"An Act amending the standards applicable to determining whether, for purposes of the Alaska Stranded Gas Development Act, a proposed new investment constitutes a qualified project, and repealing the deadline for applications relating to the development of contracts for payments in lieu of taxes and for royalty adjustments that may be submitted for consideration under that Act; and providing for an effective date."

- MOVED CSHB 16(RES) OUT OF COMMITTEE

**PREVIOUS ACTION**

BILL: HB 16

SHORT TITLE: STRANDED GAS DEVELOPMENT ACT AMENDMENTS

SPONSOR(S): REPRESENTATIVE(S) FATE

Jrn-Date	Jrn-Page		Action
01/21/03	0035	(H)	PREFILE RELEASED (1/10/03)
01/21/03	0035	(H)	READ THE FIRST TIME - REFERRALS
01/21/03	0035	(H)	O&G, RES, FIN
02/06/03		(H)	O&G AT 3:15 PM CAPITOL 124
02/06/03		(H)	Heard & Held
02/06/03		(H)	MINUTE(O&G)
02/07/03	0153	(H)	COSPONSOR(S): CHENAULT
02/07/03		(H)	RES AT 1:00 PM CAPITOL 124
02/07/03		(H)	<Pending Referral>
02/10/03	0172	(H)	COSPONSOR(S): HOLM
02/14/03		(H)	RES AT 1:00 PM CAPITOL 124
02/14/03		(H)	<Pending Referral> -- Meeting Canceled --
02/21/03		(H)	RES AT 1:00 PM CAPITOL 124
02/21/03		(H)	<Bill Hearing Canceled>
02/25/03		(H)	O&G AT 3:15 PM CAPITOL 124
02/25/03		(H)	Moved CSHB 16(O&G) Out of Committee
02/25/03		(H)	MINUTE(O&G)
02/28/03	0336	(H)	O&G RPT CS(O&G) NT 6DP
02/28/03	0336	(H)	DP: CHENAULT, FATE, ROKEBERG,
02/28/03	0336	(H)	CRAWFORD, MCGUIRE, KOHRING
02/28/03	0337	(H)	FN1: ZERO(CED)
02/28/03	0337	(H)	FN2: (DNR)
02/28/03	0337	(H)	FN3: (REV)
02/28/03	0344	(H)	COSPONSOR(S): KOHRING
02/28/03		(H)	RES AT 1:00 PM CAPITOL 124

#### WITNESS REGISTER

WENDY KING, Gas Strategies  
ConocoPhillips  
Alaska North Slope Development Team  
Anchorage, Alaska

POSITION STATEMENT: Related ConocoPhillips support of [CSHB 16(O&G) as amended].

DAN DICKINSON, Director  
Tax Division  
Department of Revenue  
Anchorage, Alaska

POSITION STATEMENT: Noted the administration's strong support of the committee substitute [CSHB 16(O&G)].

ROGER MARKS, Petroleum Economist

Tax Division  
Department of Revenue  
Anchorage, Alaska

POSITION STATEMENT: Provided an overview of the Stranded Gas Development Act during discussion of HB 16.

KEN KONRAD, Senior Vice President  
BP Exploration (Alaska) Inc.  
Anchorage, Alaska

POSITION STATEMENT: Testified in support of [CSHB 16(O&G) as amended].

MARK MYERS, Director  
Division of Oil & Gas  
Department of Natural Resources  
Anchorage, Alaska

POSITION STATEMENT: During discussion of HB 16, answered questions.

#### **ACTION NARRATIVE**

#### **TAPE 03-8, SIDE A**

Number 0001

**CO-CHAIR HUGH FATE** called the House Resources Standing Committee meeting to order at 1:06 p.m. Representatives Fate, Masek, Heinze, Wolf, and Guttenberg were present at the call to order.

#### CONFIRMATION HEARING

#### Department of Natural Resources

CO-CHAIR FATE announced that the first order of business would be the confirmation hearing on the appointment of Tom Irwin as commissioner of the Department of Natural Resources (DNR). Co-Chair Fate noted that everyone on the committee had heard Commissioner Irwin's presentation and thus he opened the hearing to questions.

Number 0246

REPRESENTATIVE MASEK mentioned the issue in which a strip of land between Anchorage and the Matanuska Valley owned by the Bureau of Land Management (BLM) was closed to access for hunting and target practice due to the amount of lead from the gun shell cartridges. Representative Masek related her understanding that there could be a land swap such that this parcel of land is

returned to the state under DNR. Therefore, she requested that Commissioner Irwin review that situation and provide thoughts on such a swap.

Number 0426

TOM IRWIN, Commissioner, Department of Natural Resources, related his limited understanding that the BLM is trying to cleanup this land for transfer. Commissioner Irwin said this would fall in line with the belief that the state wants to obtain all the land it's due transferred to it. He welcomed Representative Masek's input.

REPRESENTATIVE GUTTENBERG remarked that DNR is the face of Alaska and he wished the commissioner the best in management of DNR.

[Although there was no formal motion, the confirmation of Tom Irwin, Commissioner, Department of Natural Resources, was treated as advanced from the House Resources Standing Committee.]

#### HB 16-STRANDED GAS DEVELOPMENT ACT AMENDMENTS

CO-CHAIR FATE announced that the next order of business would be HOUSE BILL NO. 16, "An Act amending the standards applicable to determining whether, for purposes of the Alaska Stranded Gas Development Act, a proposed new investment constitutes a qualified project, and repealing the deadline for applications relating to the development of contracts for payments in lieu of taxes and for royalty adjustments that may be submitted for consideration under that Act; and providing for an effective date."

CO-CHAIR FATE noted that before the committee is CSHB 16(O&G). He then turned the gavel over to Vice Chair Masek.

Number 0696

CO-CHAIR FATE, Alaska State Legislature, speaking as the sponsor of HB 16, informed the committee that [CSHB 16(O&G)] encompasses six changes to the [Stranded Gas Development Act]. This legislation doesn't limit the technology to liquefied natural gas (LNG) as was the case with the [current] Act. Furthermore, this legislation allows a value-added perspective because [a qualified project is expanded to include] other markets as well as those markets within the state. This legislation changes the

net worth of a qualified sponsor from 33 percent net worth of the project to 15 percent, which allows and even encourages others to do exploration. This legislation also changes the date for submitting applications from June 30, 2001, to June 30, 2004. He informed the committee that there will be an amendment offered to change the aforementioned date to March 31, 2005, because the 2004 date was determined to be too soon. He noted that this was discussed with the administration, who is in agreement. This legislation changes the "contractor" language to the plural, "contractors", because there is usually more than one contractor with which negotiations are occurring. Finally, this legislation changed language relating to a \$1 million expense that's rebated to the state when expenses are incurred by the contractors. In the House Special Committee on Oil and Gas much time was spent working on this language. Today an amendment will be offered in which the comma between "reasonable, nonredundant" will be deleted. He explained that the language has been in the Act so that the expenses incurred by the contractors are reliable, reasonable, and not duplicative.

Number 1144

REPRESENTATIVE GUTTENBERG inquired as to the definition of stranded gas.

CO-CHAIR FATE explained that there is only one place in the state that has stranded gas, the North Slope. Therefore, when one refers to stranded gas they are referring to gas on the North Slope. In further response to Representative Guttenberg, Co-Chair Fate clarified that "stranded" means that the gas is going to market while "reinjection" does not go to market.

VICE CHAIR MASEK returned to the gavel to Co-Chair Fate and testimony was taken.

Number 1272

WENDY KING, Gas Strategies, ConocoPhillips, Alaska North Slope Development Team, related ConocoPhillips support of the passage of HB 16. She provided the following testimony:

ConocoPhillips has a three-prong strategy to make a gas pipeline through Alaska and Canada a reality. First, federal legislation to streamline the permitting process. Second, federal fiscal legislation which provides insurance against the risk

of extreme price volatility. And third, state legislation [reauthorizing] the Stranded Gas Development Act. The Stranded Gas Development Act is currently in statute and it provides a framework for negotiations and reaching an agreement between the state and other parties like ConocoPhillips over a number of issues. House Bill 16 is needed to modify the Stranded Gas Development Act; the existing statute, as currently written, applies only to an LNG project and not to a gas pipeline. In addition, the Stranded Gas Development Act has a date of June 30th 2001 by which companies had to file an application. If it were not for these two limitations, companies that want to build a gas pipeline could be negotiating with the state today under the Act and be further down the road toward creating jobs and revenues through building a gas pipeline. In conclusion, we support passage of HB 16 in as clean a form as possible. That means making the Stranded Gas Act applicable to a gas pipeline and extending or repealing the date of the Act. The committee substitute for HB 16 addresses these two requirements and we urge the committee to pass the bill.

Number 1441

DAN DICKINSON, Director, Tax Division, Department of Revenue, provided the following testimony:

With me is Roger Marks, a Petroleum Economist with the Tax Division, who will speak briefly about the history, intent, and mechanics of the Stranded Gas Act. But first I think it is very important to introduce ourselves, as the Department of Revenue has many responsibilities under the Stranded Gas Act, and the Tax Division has considerable expertise and experience in oil and gas matters. Five years ago we were three different divisions - the Oil and Gas Audit Division, the Income and Excise Audit Division and the Charitable Gaming Division. ... What we do can be seen from the fiscal year 2002 Comprehensive Annual Financial Report for the State of Alaska. [You should] have a copy of an excerpt from Table 1.13 .... Of total government fund revenues of \$3.5 billion:

- ... \$1.3 billion comes from the Feds

- Taxes are a another [\$1] billion
- Royalties are another \$900 million
- Interest [and] investment income, plus all the other ways the government raises money through charges for services, fines and forfeitures and "other", is more than offset by the investment losses in the state's account.

The Tax Division administers 19 of the 20 tax types that make up the \$1 billion tax figure. Of the billion dollars in taxes, all but a couple hundred million are oil and gas taxes. The state's oil and gas take is often characterized as four bites of the apple, and we are experienced in all four bites.

For the first bite: We are charged with auditing royalties and net profit share leases, and we work closely with DNR on those matters. The other three bites of the apple cover the three areas that we anticipate will be our focus in any Stranded Gas Act negotiation. The second bite of that apple is the oil and gas property tax. The 2003 tax roll showing oil and gas property valued at just about \$13.5 billion is being mailed out ... to meet the March 1st deadline. As petroleum economist Roger Marks will explain later, property taxes play a unique role in determining any natural gas project's profitability. The next bite of the apple is the oil and gas corporate income tax. Income taxes are focused on taxing profits. As Roger will elaborate later on - the more we focus on taxing profits, the more progressive our system becomes. That is one of the stated goals of the Stranded Gas Act. We have a large experienced group in our division that works these issues and we expect them to be critical. The last bite of the apple is the production tax. Like royalty, the production tax focuses on the commodity value of the resource at or near the wellhead. We have lots of experience in this area dealing with market pricing, inter-company transfer pricing, how markets work, how energy contracts work, business practices, and cost analysis. I would like to add a personal observation, but one that I think reflects what many of us in the division believe the state should be trying to achieve in an Stranded Gas Act negotiation.

Taxes and the government take in general ... should not distort commercial realities. The government's take should not be what is red-lighting this project. As Roger will explain, our current fiscal system intensifies some of the risks faced by the producers. Ironically, not only the producers but [also] the state could be better off changing these aspects of its fiscal system. The Stranded Gas Act negotiations should be about risk sharing, and who among the state and the commercial entities involved can best handle what risks. As soon as HB 16 becomes law we can start discussing how price risk will be shared or how return on the investment in the pipeline will be taxed, or really figure out what each party wants to get from this project - aside from "more." There are lots of specifics that can be set aside until it's clearer how our gas will fit in the market mechanisms that will be in place when we are finally ready to market. Fundamentally, the state's role should not be to increase the risks. And maybe we can make the project fly by reducing risk.

Number 1716

On the other hand, we have to make sure that the state is not naively underwriting a risky project. As the only ones who will still be around if things go sour, we don't want to be left holding a bag we didn't quite understand the dimensions of. That's my quick overview of the Department of Revenue Tax Division. The administration strongly supports the committee substitute for this bill. We think it creates a great mechanism to work these difficult issues we face. The Tax Division looks forward to being able to play our part in that work.

Number 1756

REPRESENTATIVE GUTTENBERG turned the issue of risk sharing and asked how the risks are balanced.

MR. DICKINSON answered that the state has to determine what it wants with regard to the stream of revenue it wants, the amount of built-in progressivism, and the risk the state is willing to

take. Therefore, this requires thoroughly airing and investigating the issues.

REPRESENTATIVE GUTTENBERG asked whether HB 16 places the state out of the way by opening the definition of stranded gas and extending the expiration date. He also asked if there is anything else that the state can do to avoid being an obstacle.

MR. DICKINSON related his belief that this legislation starts the conversation and allows the parties to know where the conversation can go. Mr. Dickinson said he believes that it's best to pass the bill with the amendments.

CO-CHAIR FATE asked if, after passage of HB 16 in both houses, negotiations would begin to explore the aforementioned areas.

MR. DICKINSON said that he hoped that would be the case. He identified the first piece to be negotiations for large contracts, which he said could start soon.

Number 1951

ROGER MARKS, Petroleum Economist, Tax Division, Department of Revenue, provided the following testimony:

I worked on the original Stranded Gas Act in 1998 and am familiar with its history, intent, and mechanics. And I would like to provide a very brief overview of the Act at AS 43.82. A more detailed synopsis is with the fiscal note.

The Act originated in HB 250 in 1997, which established a North Slope Gas Commercialization team in the administration to research and recommend changes to state law to encourage commercialization of North Slope gas. The team concluded that the project faced considerable risk, namely gas price risk and cost overrun risk, and that the state's fiscal system exacerbated those risks. Two of the risks of particular concern were fiscal uncertainty and the state's regressive tax system.

A brief comment on the price risk: the cost of the project is very large: \$20 billion. That is a lot of money to any corporation. If this project is built and prices go very low, the producers face very large losses which some of them may not be able to tolerate.

That is why the price mechanism proposed in Congress may be a very necessary linchpin in making this project a reality. By fiscal uncertainty we mean the threat of changes in fiscal provisions, after a project is built, that may change the project's viability after it is too late to do anything about it. A project may be feasible under one tax system if it is built under the assumption that the tax system in place will stay in place. But [if] the tax system changes, the changes could cause heavy financial losses.

Number 2046

Second, there are two significant elements of the state's fiscal system that make it regressive. By regressive we mean that the state's take is a high percentage of income at low prices, and a low percentage at high prices. First, the property tax is based on cost. The higher the cost the higher the tax. This is a double whammy to an investor who incurs a cost overrun. Moreover, the property tax is payable when construction begins, years before revenues start accruing. On a time value of money basis this diminishes the rate of return, and increases the risk of not recovering the investment.

The second regressive elements are the severance tax and royalty. They are based on the value at the point where the gas comes out of the ground, and ignore upstream costs such as capital and operating costs. Thus when costs are high and prices are low, the state's take is a high percentage of low income. Again, this intensifies the danger of low prices. I might add that a regressive system also limits the state's take at high prices. Fixing that could be very important to the state for securing more revenue when prices are high, without threatening the viability of the project.

The Stranded Gas Act was the result of trying to fix these shortcomings. The law provided a mechanism for converting the state's fiscal system from a statutory basis to a contractual basis. This would provide for greater fiscal certainty. The fiscal system would be negotiated between the state and the project sponsors, and approved by the legislature, after a public review

period. Payments to the state would be made in-lieu of taxes. And per the Act the contract terms would provide for a more progressive or less regressive system.

Most of the provisions subject to negotiation are the tax provisions. Given that the royalty represents the state's ownership share, there was not interest in making the royalty rate subject to change. The only royalty provisions subject to negotiation would be gas valuation method, and the timing of royalty in-kind and in-value notices. The commissioner of [the Department of] Revenue would be the primary agent for negotiating and implementing the contract. However, the commissioner of [the Department of] Natural Resources is also responsible for reviewing the project plan for acceptability, and for negotiating any changes in those royalty issues.

There was concern by local municipalities that a contract could compromise their property tax revenues. Accordingly, the Act created a municipal advisory group to participate in developing contract terms, and the Act requires that a fair and reasonable share of the payments due under the contract be paid to affected municipalities with due regard to the size of the tax base that may be exempted, and the economic and social burdens imposed by construction and operation. The Act also has provisions for sponsors to help make gas available to communities, to promote local hire, to deal with confidential information provided by the sponsors, and to reimburse the state for contractors it may use to assist in the negotiation process.

Finally, there were some questions raised as to whether this would surrender or contract away the power to tax, which is forbidden by our constitution. It was the administration's judgment that this would not preclude future legislatures from imposing other taxes, but this contract would represent a solemn pledge, a moral commitment by the state, and a message to future legislatures that once it agrees to the terms it will not change them.

Number 2252

REPRESENTATIVE GUTTENBERG related the notion that a gas project will occur when the market allows it and inquired as to Mr. Marks' opinion of that.

MR. MARKS highlighted that a significant linchpin is what occurs in Congress. The price risk here is very scary for companies, even those the size of ConocoPhillips.

REPRESENTATIVE GUTTENBERG asked if there will be a conflict with the commissioner of the Department of Revenue being the primary negotiator for negotiation and implementation since the commissioner of DNR is responsible for reviewing the project plan for acceptability.

MR. MARKS clarified that both commissioners would review a project application for suitability. He expressed confidence that both commissioners will "land on the same page in that judgment."

CO-CHAIR FATE interjected that at one point the commissioners were separated, but that language wasn't brought forth because it was determined that was an internal matter for which a memorandum of understanding would be written between the departments. This is an administrative issue that shouldn't receive legislative interference.

Number 2394

REPRESENTATIVE MASEK highlighted the importance of Mr. Dickinson's earlier statement: "As soon as HB 16 becomes law we can start discussing how price risk will be shared or how return on the investment in the pipeline will be taxed, or really figure out what each party wants to get from this project - aside from 'more.'" She expressed the need to expedite HB 16 in order to begin working on an LNG or natural gas project.

MR. DICKINSON said that clearly there are a gamut of issues that would be addressed and the earlier [discussions] start the more likely they will be productive.

CO-CHAIR FATE, in response to Representative Masek, clarified that the proposed date change that was mentioned earlier refers to the application deadline. He reiterated that the date change will be offered as an amendment.

Number 2529

KEN KONRAD, Senior Vice President, BP Exploration (Alaska) Inc., provided the following testimony:

Establishing a clear, simple, and predictable framework regarding royalty and taxes is essential if the gas pipeline project is going to advance to the next phase of activity. Without knowing what the rules are in advance, a project of this magnitude will not be able to attract investment. BP has been a supporter of the Stranded Gas Act since its development many years ago and we continue to be a supporter. And as such we support HB 16. However, ... we would be prepared to sit down at any time and begin these discussions and don't necessarily feel that we need to wait too long to begin these discussions because we are concerned that we can't finish the discussions until we begin them. So, we are ready at any time to move forward. And I would echo what Ms. King conveyed earlier that as the bill passes through the legislative process that we ensure that it remain a clean bill and that you don't ... add amendments that could inadvertently lead to being a disincentive for the project. But, as the bill stands now, we are firmly in support.

CO-CHAIR FATE, upon determining that no one else wished to testify, closed public testimony. He then turned the gavel over to Representative Masek.

The committee took an at-ease from 2:46 p.m. to 2:50 p.m.

Number 2666

REPRESENTATIVE HEINZE moved that the committee adopt Amendment 1, which reads:

Page 3 Line 6

Change date from June 30, 2004 to March 31, 2005

There being no objection, Amendment 1 was adopted.

Number 2689

REPRESENTATIVE HEINZE moved that the committee adopt Amendment 2, which reads:

Page 3 Line 12

Delete comma between reasonable and nonredundant

REPRESENTATIVE GUTTENBERG objected and inquired as to what Amendment 2 would accomplish.

CO-CHAIR FATE explained that the [deletion of the comma] ensures that there won't be duplicate billing. This is a protective mechanism, he said.

REPRESENTATIVE GUTTENBERG withdrew his objection.

There being no objection, Amendment 2 was adopted.

Number 2839

REPRESENTATIVE GUTTENBERG turned to AS 43.82.200 and referred to the following language: "terms regarding an equity or other participating interests in a project by one or more Alaskan based corporations or business." He interpreted that to mean that Alaskan-based corporation or business is guaranteed involvement. Representative Guttenberg inquired as to how that would impact the negotiation.

MR. MARKS related his belief that the process would be such that a sponsor group would come forward to the state with an application and whoever is going to have an equity interest in the project would be part of the sponsor group approaching the state for a stranded gas contract. He said he didn't believe it to be appropriate to bring in further equity participants in the contract development process. Whoever is going to be a sponsor should come in at the beginning to negotiate as one body. However, nothing precludes multiple sponsor groups from coming in to negotiate contracts if there is more than one possibility available.

REPRESENTATIVE GUTTENBERG expressed concern that an oil and gas field developer will come in after the fact and not have a gas line to take his/her product to market. In that case, what would happen; would that developer have access to the pipeline, he asked.

MR. MARKS explained that at the time the pipeline is constructed, there will be an open season. This is due to the Federal Energy Regulatory Commission (FERC) law. Anyone anticipating having gas to ship to the pipeline at that time [during the open season] can secure capacity. He related the

[department's] judgment that having the original sponsors build for capacity that might not be there is [inappropriate].

**TAPE 03-8, SIDE B**

MR. MARKS clarified that building for capacity that might not be there would add additional cost and risk to the project. Furthermore, pipelines could be constructed to have some expansion of capacity.

Number 2965

MARK MYERS, Director, Division of Oil & Gas, Department of Natural Resources, returned to Representative Guttenberg's question regarding contract development. He said, "The contract development part there in three and four under the Act, doesn't address the issue of access really." However, issues of access could be addressed under the more general provisions under the other conditions. Mr. Myers noted that access is of concern for all parties involved with the gas line. He related his interpretation that access could be included as part of the negotiations, although it isn't implicit in the Act that [access] would be negotiated.

Number 2895

CO-CHAIR FATE informed the committee that last year during the discussion of HB 519, two of the most critical issues were the frequency of open season and access to any proposed pipeline. The negotiators and the industry are aware of these issues. As has been expressed by the major producers, we need and want a second level mid-cap oil industry. Co-Chair Fate related his belief that the legislature could still weigh in with legislation should [there be the need]. However, Co-Chair Fate mentioned that he didn't want to interfere with these negotiations. Co-Chair Fate also mentioned that he didn't have a concern with regard to access and open season as he did a year ago and thus he hoped that this legislation could be forwarded to the House Finance Committee.

Number 2811

REPRESENTATIVE HEINZE moved to report CSHB 16(O&G) as amended out of committee with individual recommendations and the accompanying fiscal notes. There being no objection, CSHB 16(RES) was reported from the House Resources Standing Committee.

**ADJOURNMENT**

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:03 p.m.