

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

March 5, 2003

3:30 p.m.

MEMBERS PRESENT

Senator Scott Ogan, Chair
Senator Thomas Wagoner, Vice Chair
Senator Fred Dyson
Senator Ralph Seekins
Senator Ben Stevens
Senator Kim Elton
Senator Georgianna Lincoln

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

SENATE BILL NO. 74

"An Act extending the renewal period for oil discharge prevention and contingency plans; and providing for an effective date."

MOVED CSSB 74(RES) OUT OF COMMITTEE

SENATE BILL NO. 79

"An Act extending the termination date of the Alaska Minerals Commission."

MOVED SB 79 OUT OF COMMITTEE

SENATE BILL NO. 92

"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 extending 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."

HEARD AND HELD

PREVIOUS ACTION

SB 74 - See Resources minutes dated 2/24/03.

SB 79 - No previous action to record.

SB 92 - No previous action to record.

WITNESS REGISTER

Marilyn Crockett
Alaska Oil and Gas Association (AOGA)
121 West Fireweed Lane
Anchorage, Alaska 99503

POSITION STATEMENT: Stated support for Amendment 2 to SB 74.

Dr. Lance Miller
Executive Director
Juneau Economic Development Council
612 W. Willoughby Ave.
Juneau, AK 99801

POSITION STATEMENT: Supports SB 79

Neil MacKinnon
Vice Chair
Alaska Minerals Commission
Hyak Mining Co.
1114 Glacier Avenue
Juneau, AK 99801

POSITION STATEMENT: Supports SB 79

Irene Anderson
Chair
Alaska Minerals Commission
Sitnasuak Native Corporation
PO Box 905
Nome, AK 99762

POSITION STATEMENT: Supports SB 79

Dan Dickinson, Director
Tax Division
Department of Revenue
PO Box 110400
Juneau, AK 99811-0400

POSITION STATEMENT: Supports SB 92

Roger Marks, Petroleum Economist
Department of Revenue
PO Box 110400
Juneau, AK 99811-0400

POSITION STATEMENT: Supports SB 92

Mark Myers, Director
Oil and Gas Division
Department of Natural Resources
400 Willoughby Ave.
Juneau, AK 99801-1724
POSITION STATEMENT: Supports SB 92

ACTION NARRATIVE

TAPE 03-9, SIDE A

CHAIR SCOTT OGAN called the Senate Resources Standing Committee meeting to order at 3:30 p.m. Senators Wagoner, Stevens, Dyson, Seekins, Elton and Chair Ogan were present.

#SB 74

SB 74-DISCHARGE PREVENTION & CONTINGENCY PLANS

CHAIR OGAN reminded members that SB 74 was heard at the last meeting and that an amendment is pending.

SENATOR SEEKINS moved to withdraw his motion to amend SB 74. There being no objection, the motion carried.

SENATOR SEEKINS moved to adopt Amendment 2, which reads as follows:

AMENDMENT 2

OFFERED IN THE SENATE RESOURCES COMMITTEE BY SENATOR SEEKINS

TO: SB 74

Page 1, following line 10:

Insert a new bill section to read:

** Sec. 2 The uncodified law of the State of Alaska is amended by adding a new section to read:

TRANSITION. Notwithstanding any contrary provision of AS 46.04, including the review procedures in AS 46.04.030, and the regulations adopted under AS 46.04, the expiration date of an oil discharge prevention and contingency plan approved by the Department of Environmental Conservation before the effective date of this Act shall be extended for two years, or for a shorter period if a shorter period is requested by the holder of the approved plan, if

(1) the plan is still in effect on the day before the effective date of this Act; and

(2) the Department of Environmental Conservation has not given a notice of violation of AS 46.04.030 to the holder of the plan that has not been corrected to the satisfaction of the Department of Environmental Conservation.

Renumber remaining sections accordingly.

SENATOR LINCOLN objected for the purpose of hearing an explanation of Amendment 2.

SENATOR SEEKINS explained that Amendment 2 allows a holder of an approved plan to request an extension for a period of less than two years.

CHAIR OGAN noted that several people were available to testify or answer questions on Amendment 2: Larry Dietrick, Marilyn Crockett, and Breck Tostevin.

SENATOR LINCOLN removed her objection. Therefore, Amendment 2 was adopted.

CHAIR OGAN took public testimony.

MS. MARILYN CROCKETT, Alaska Oil and Gas Association, stated support for Amendment 2.

SENATOR DYSON moved SB 74 as amended [CSSB 74(RES)] from committee with attached fiscal notes.

SENATOR LINCOLN objected to ask if this legislation will next go to the Senate floor.

CHAIR OGAN said that it has a zero fiscal note so it has no further referrals, but that the other body will review it.

SENATOR LINCOLN felt that since the Senate Resources Committee is the only committee of referral, it should do the best job possible on this legislation.

CHAIR OGAN replied, "For the record I think we have. We held it up a week and a half and we worked out a good compromise on the amendment. Some questions were addressed."

SENATOR LINCOLN said Amendment 2 was a good compromise but she still has concerns. She then withdrew her objection.

CHAIR OGAN stated that with no further objection, CSSB 74(RES) moved from committee.

#

#SB79

SB 79-EXTEND ALASKA MINERALS COMMISSION

SENATOR BEN STEVENS, sponsor of SB 79, told members this measure would extend the Alaska Minerals Commission to 2014. It is currently set to expire February 1, 2004. The Alaska Minerals Commission was established in 1986 to make recommendations to the governor and legislature on ways to mitigate constraints on development of mineral resources in Alaska. The commission is comprised of six appointees by the governor and three appointees each by the Senate President and House Speaker. He believes the commission has done an excellent job over the last 16 years. He highlighted some of the commission's recommendations that have been adopted:

- Passage of the Minerals Policy Act.
- Funding for the airborne geophysical surveys.
- Assisting in the creation of a task force for RS2477 trail inventory.
- Assertion of RS2477 rights-of-way.
- Legislative Resolution 31 passed in opposition of the creation of international parks, world heritage sites, and marine biosphere reserves in Western Alaska.
- Extending terms of permits when legal impediments prevent use.

SENATOR BEN STEVENS stated the Alaska Minerals Commission has been working well so he believes the Legislature should allow it to do its good work. He pointed out the recommendations in the executive summary of the Report of the 2003 Alaska Minerals Commission are valuable. He encouraged committee members to pass SB 79 on.

CHAIR OGAN took public testimony.

MR. LANCE MILLER, Executive Director of the Juneau Economic Development Council (JEDC), told members that prior to his current position, he was the projects manager with Placer Dome and he worked as chief geologist with Echo Bay [Mining] on the A-J project for nine years. He said SB 79 will extend the

commission for a longer period of time than has been done previously. He noted that the minerals industry is a billion dollar industry - the third largest in the state. Mining companies are committing their capital to Alaska over the course of 10 to 20 years, just to get a project going. Mines take at least ten years to build. He believes if the Commission is in existence for at least ten years running, that will send a good message to the industry. He summarized that if companies are willing to commit risk capital for that time frame in the hope of getting a mine going, a ten year extension of the commission will show good will toward a working partnership with industry.

CHAIR OGAN asked the length of the previous extension.

MR. MILLER said it was five years.

MR. NEIL MacKINNON, Vice Chair of the Alaska Minerals Commission and President of Hyak Mining Company, a small Juneau-based exploration company, told members he has been on the commission through several five-year extensions and five years passes very quickly. He said that when it comes time to write the Alaska Minerals Commission report, members do a vast amount of work that is not accounted for in the budget: they do the work to get it done.

MR. MacKINNON told members the Alaska Minerals Commission is made up of a diverse group of individuals, from placer miners to representatives of companies such as Cominco. Members bring a vast array of views therefore the Commission takes an overarching view of the problems facing the mining industry. The commission also tries to look ahead for potential problems. One example is essential fish habitat, which the commission picked up on its "radar screen" several years ago. It is a brewing problem that has not come to the forefront yet.

SENATOR DYSON asked Mr. MacKinnon to clarify what "essential fish habitat" means to the mining industry.

MR. MacKINNON said that the Stevens-Magnuson Act contains a few lines that give the National Marine Fisheries Service (NMFS) power over what it deems to be essential fish habitat. He said when the act was written, he thinks it was meant to address ground fish and bottom draggers. While the tendency of bureaucracies is to expand power as far as possible, he sees NMFS exercising that authority over creeks and any water body. He noted that numerous groups are working on the issue, including U.S. Senator Ted Stevens and the Resource Development

Council. He repeated that the NMFS policy has not yet been fully expanded so that keeping the issue on the radar screen may be enough to control the problem.

SENATOR DYSON asked:

So, when you say 'essential fish habitat' you're talking about the regulatory problems that come from those lines being in the National Marine Fisheries. And when you talk about wetlands problems, you're talking about the jurisdiction of the Corps of Engineers and others over wetlands and how that impact might - you're not just talking about the wetlands.

MR. MacKINNON stated the Alaska Minerals Commission sees this as a wetlands problem coming from another angle - the National Marine Fisheries Service, based on the 'essential fish habitat' definition, which is a rough definition.

SENATOR LINCOLN noted this will be the fourth extension of the Alaska Minerals Commission, which she supports. She pointed out SB 79 does not address the length of the terms of commission members and asked if members are appointed for a five-year term.

MR. MacKINNON said members serve at the pleasure of the appointee. He noted the statute is not clear about term limits.

SENATOR LINCOLN suggested that the term be clearly defined so that the people who are serving understand how long they will be in office. She noted that serving for five-years may seem like a lifetime to some people while that amount of time passes quickly for others. She then asked why, if the five-year extensions have posed no problem, the commission believes a ten-year extension will be more beneficial.

MR. MacKINNON replied:

Well, maybe it's just a perspective that five years comes real fast. That was part of the comment that it's been over and over so let's just put ten years and go for ten because it gives a little more permanence to it and, like I say, five years isn't that long.

CHAIR OGAN pointed out the statute says that members serve at the pleasure of the appointing authority and members must have at least five years experience in various aspects of mineral industries in the state.

SENATOR LINCOLN asked if the commission has ever recommended terms for members to the legislature.

MR. MacKINNON said that he was appointed by the Senate President, and if the Senate President chooses to appoint someone else, that is his choice. He said that one commission member brought up this discussion thinking that the commission should get some "fresh blood." However, in the history of the commission, there has been enough turnover from people leaving to take other positions or for other reasons. As an example, Tom Irwin will no longer serve on the commission as he has taken the position as the Commissioner of the Department of Natural Resources.

CHAIR OGAN asked how often the Alaska Minerals Commission meets.

MR. MacKINNON said it meets three times per year. Its report to the legislature is due in December.

CHAIR OGAN asked Mr. MacKinnon if he feels the report gets attention.

MR. MacKINNON said that depends on the make-up of the legislature, but it has during the last few years.

SENATOR LINCOLN said she is pleased to see that two women serve on the 11 member commission but she would like to see that number expanded.

MR. MacKINNON said that Irene Anderson is the Chair and that the women "probably do most of the heavy lifting."

SENATOR ELTON said he supports the Alaska Minerals Commission and feels it is a model that is being looked at for other economic sector proposals in Alaska.

MS. IRENE ANDERSON, Chair, Alaska Minerals Commission, maintained that a ten-year extension will save a lot of people time, such as legislators and staff. She agrees with Mr. MacKinnon that members come and go and that the group is very diverse. She indicated that ten years is not a long time period in the mining industry, especially when trying to build infrastructure in rural Alaska.

CHAIR OGAN asked Ms. Anderson to describe her background.

MS. ANDERSON said she comes from a family of placer miners in the Nome area. Her husband is originally from McGrath. She said her grandfather began mining in Nome in 1905.

Ms. Frankie Pillifant, staff to the Alaska Minerals Commission, was available to answer questions, however there were none.

SENATOR BEN STEVENS moved SB 79 from committee with individual recommendations and its attached fiscal note.

CHAIR OGAN announced that without objection, SB 79 would move from committee.

#

The committee took a brief at-ease.

#SB92

SB 92-STRANDED GAS DEVELOPMENT ACT AMENDMENTS

CHAIR OGAN told members that SB 92, sponsored by the Senate Resources Committee, reauthorizes the Stranded Gas Development Act. He indicated that he spent hundreds of hours working on the original legislation several years ago. He explained that he does not intend to take action on this legislation today, as similar legislation is working its way through the House. He said he would like the committee to get an overview of what the original Stranded Gas Act did. He said this Act has had a big impact on the State of Alaska, and especially on the communities affected by gas development. It gives the state a lot of latitude to negotiate settlements that highly effect local communities. He indicated that building a gas pipeline project through a community causes high impact to that community, for example by increasing the population. He noted SB 92 only reauthorizes the original Act. He asked Dan Dickinson to brief the committee.

MR. DAN DICKINSON gave the following testimony.

My name is Dan Dickinson, Tax Division director at the Department of Revenue. 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 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 separate divisions - the Oil and Gas Audit Division, the Income and Excise Audit Division and the Charitable Gaming Division. We are now merged into a single division. Some think that was a mistake. We named ourselves the Tax Division. It is what we do but no one wants to be seen talking to us anymore so, again, I appreciate the chance to come before this committee.

What we do can be seen from the FY 2002 Comprehensive Annual Financial Report for the State of Alaska. You should have a copy of an excerpt from Table 1.13. Of total governmental fund revenues of \$3.5 billion:

- \$1.6 billion comes from the feds
- Taxes are \$1 billion
- Royalties are \$900 million
- Interest and investment income, plus all the other ways the government raises money - charges for services, fines and forfeitures and 'other' were more than offset by investment losses.

The Tax Division administers 19 of the 20 tax types that comprise the \$1 billion tax figure. Of the billion dollars in taxes, all but a little more than \$100 million were oil and gas taxes. The state's oil and gas take is often characterized as four bites of the apple, and we are experienced at all four bites.

For the first bite we are charged with auditing royalties and net profit share leases, and we work with DNR closely 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 the apple is the oil and gas property tax. Last Friday, to meet our March 1 deadline, the Division's Oil and Gas Property Tax assessor and his staff mailed out the 2003 tax roll, showing oil and gas property valued at about \$13.5 billion. As Senator Ogan pointed out in his introductory remarks, 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. This 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 - market pricing, inter-company transfer pricing, how markets work, how energy contracts work, business practices and cost analysis.

Now, let me add a personal observation, but one that I think reflects what many of us in the division believe about what the state should be trying to achieve in any Stranded Gas Act negotiation - taxes - and the government's take in general is the subject of the Stranded Gas Act. It 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 the state could be better off changing those same aspects of its fiscal system. 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 SB 92 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 is clearer how our gas will fit in with the market mechanisms that will be in place when we

are ready to market it. The state's role should not be to increase risks. Maybe we can make the project fly by reducing risk.

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 reauthorizing the Stranded Gas Development Act. We believe 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.

Thank you for the opportunity to testify and to introduce the people who will be doing a lot of the foot slogging in any stranded gas act negotiation.

CHAIR OGAN asked Mr. Dickinson to give the committee an overview of what he envisions the state negotiations - pretty much on the part of the municipalities - to look like at the end of the day, including the sticking points.

MR. DICKINSON said Chair Ogan correctly identified what will be going on with the municipalities. Property taxes could form a very large piece of the fiscal take. Property taxes are set up so that they are due as soon as the project begins. It may be six years before any gas or profit flows to the project, but the project is taxable. Early property taxes can harm the rate of return on a project. On the other hand, those taxes are the sole source of revenue from those projects to the municipalities. In addition, the municipalities need those revenues to deal with population pressures and disruptions. Those are the tensions the state must balance. The municipalities must participate through a formal committee but ultimately the state is charged with making judgments on behalf of the municipalities and striking a delicate balance.

CHAIR OGAN commented that if all of the taxes are due when the materials and equipment hit the ground, it adds an

extra expense for the builders of the pipeline so the state allows them to negotiate a payment in lieu of taxes.

MR. DICKINSON agreed.

CHAIR OGAN said if he was the mayor of a municipality, he might not have a high comfort level with the state negotiating payments in lieu of taxes on his behalf. He asked Mr. Dickinson if he has heard any feedback from the municipalities.

MR. DICKINSON said he has, but he would first like to share some observations. First, the Stranded Gas Act will have to be passed by the legislature so if something is really askew, the legislature will have a role in making sure that municipalities have not been left out. The law specifically states there will be a fair and reasonable share of payments, so if there is a payment in lieu of taxes, the focus may have been on how that was arrived at. He thought the law establishes that the communities need to get a piece of that. As an example, Mr. Dickinson said:

Under our current oil regime, about 80 percent of the government's take is based on the value of the wellhead. About 10 percent is based on profits and about 10 percent is based on property taxes. If we were to look at a profit like this and say gee, let's switch it over and make it 80 percent based on profit and smaller pieces on wellhead value and property taxes, what we might do is make sure that the communities got those early dollars when they will need them, but the state would not be taking those early dollars and we would be hoping to be repaid or to make up [indisc.] by getting a piece of the profit later on. So, those are the kind of larger questions that we've got to deal with conceptually in the Stranded Gas Act negotiations.

CHAIR OGAN asked how it has been working out, as time goes on, that the state ends up with its share of these types of taxes and revenues due. He asked whether that keeps a project from being front-end loaded and how it has worked out at the end of the project after the pipe has been amortized and is profitable.

MR. DICKINSON said that is one of the things to be determined. The division could look at an income tax built on a rate of return built into the tariff or it could have a simple measure that defines the measure of possibilities so that if prices go above x, the payments will be a certain amount. He said all kinds of mechanisms can be used depending on the amount of price risk the state is willing to share.

CHAIR OGAN referred to Sec. 43.82.210, **Contract terms relating to payment in lieu of one or more taxes**, which lists nine taxes. He said that section essentially gives the commissioner broad sweeping authority on behalf of affected municipalities. He noted the "circuit breaker" protection is that the legislature has to approve the deal. He said he wanted to bring that to committee members' attention because the commissioner will have broad powers if a gas line is built in Alaska.

MR. DICKINSON pointed out that item (3), the oil and gas conservation tax, was repealed and replaced by other state or municipal taxes. He said the Chair correctly pointed out that the commissioner of the Department of Revenue has enormous powers under this act. He observed that the Department of Revenue assesses the values of the properties for which it levies taxes so it already plays a critical role in determining the revenues that flow to the department. The affected municipalities will be able to communicate with an advisory board that can relay concerns to the commissioner. He again agreed that this essentially identifies the sources from which the affected localities finance their local operations. The negotiations will be curious for the municipalities because they will have a lot to do with whether a project ends up being a net benefit for them.

4:10 p.m.

CHAIR OGAN asked Mr. Dickinson to consider the legislature's role in this. He noted the legislature will have a role in approving the deal but the idea of making sure that a legislator is appointed to the committee or in some oversight capacity over the negotiations has been suggested. He is opposed to putting that into the bill because he feels it is a separation of powers issue.

TAPE 03-9, SIDE B

CHAIR OGAN said the Administration has the authority to negotiate. However, he believes it would be in the Administration's best interest to have someone from the legislature be at the table, if not as an active negotiator as a participant in the discussions, so that the legislator can report back to the legislature and provide information. He asked Mr. Dickinson if the Administration has taken a position on that.

MR. DICKINSON said he cannot speak for the Administration, but stated:

No administration wants to bring a bill to the House and then sit down and - first impression - try to explain it. Clearly, the legislature will be involved. They'll get reports. There are a number of very big picture decisions about the shape of the state's revenue, whether - just how many risks it wants to bear that I think clearly we're going to be getting input - you know, the Administration's going to want input from across a spectrum, especially the legislature, because if suddenly the legislature's unhappy with the conceptual basis on which a negotiation is being made, we might as well not show up with a bill later. So, I think if the Administration wants to get this stranded gas tax negotiation going once it's [indisc.], if they do, clearly they're going to be involved with the legislature so that when that bill comes, you'll certainly get all of the oversight you need but there basically is something that they're fairly certain will result into the fiscal system that will then lead to the project. So, I think just as a matter of self interest, they are certainly going to keep the folks who get to vote on it involved.

SENATOR ELTON said he is assuming the broad powers as exercised by the commissioner under this act include his ability to negotiate different levels with different municipalities. For example, the commissioner could charge x mils in one jurisdiction and y mils in another jurisdiction under a municipal property tax.

MR. DICKINSON said he did not see why not. His personal opinion is the focus would be on issues such as impact

rather than on mils. For example, one community might have acres covered by piles of steel but no one near, while another community has a work camp of families with children in school and drawing on medical resources, therefore looking at the straight mil rate would not serve the problems of both communities.

SENATOR SEEKINS referred to Article 3 on page 10 of SCS CSHB 393(FIN) and read, "If the commissioner approves an application and proposed project plan under AS 43.82.140, the commissioner may develop a contract that may include" specific provisions. He asked if the commissioner is under any obligation to include any of the terms in that chapter.

MR. DICKINSON replied:

Absolutely. Looked at one way, the State of Alaska has a set of taxes in place that are - get to be applied as is. The question is can the commissioner use the power here to make a better project that is both better for the state and better for the folks who want to do the project. Obviously the negotiator, if he doesn't see anything worth negotiating, will [indisc.]. I think that's entirely correct.

SENATOR SEEKINS maintained that the commissioner could make a very simple contract or a very complex one.

MR. DICKINSON agreed. He said the department doesn't really know how many things it will want to bundle into the project yet.

With no further questions of Mr. Dickinson, CHAIR OGAN asked Roger Marks to testify.

MR. ROGER MARKS, Petroleum Economist with the Tax Division at the Department of Revenue, gave the following testimony.

Good afternoon, Mr. Chairman and members of the committee. My name is Roger Marks. I am a petroleum economist with the Tax Division of the Department of Revenue. I worked on the original Stranded Gas Act in 1998 and am familiar with its history, intent and mechanics. 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 actually 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, even ones the size of Exxon, BP or Conoco Phillips. If this project is built and something goes wrong, such as low prices, the sponsors face very large losses. And even if these are relatively low-probability events, the project may not be built if a company cannot tolerate a loss of that size. That is why the risk reduction mechanism proposed in Congress, which is currently in place for non-conventional gas in the Lower 48, 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 the tax system changes, the changes could cause heavy financial losses.

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 the 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 the gas valuation method, and the timing of royalty in-kind and in-value notices.

The Commissioner of Revenue would be the primary agent for negotiating and implementing the contract. However, the Commissioner 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 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 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.

CHAIR OGAN asked what provision of the Constitution Mr. Marks was referring to.

MR. MARKS said questions have been raised about switching the tax system from a statutory to a contractual basis. Article IX of Alaska's Constitution forbids that. He said it was the judgment of the Attorney General's Office that a contract would not prohibit future legislatures from imposing taxes. Insofar as it would not prohibit the legislature from imposing taxes, the contract would not be airtight.

There being no further questions of Mr. Marks, CHAIR OGAN asked Mr. Myers to testify.

MR. MARK MYERS, Director of the Division of Oil and Gas, Department of Natural Resources (DNR), told members it is hard to overestimate the importance of the gas line. With over 35 trillion cubic feet (TCF) of proven and over 100 TCF of additional potential gas, a gas pipeline will enable development of Alaska's incredible gas resources for the next 50 plus years. The stranded gas bill sets the stage for a broad based technical negotiation. It is strongly supported by the Administration as a vehicle to accelerate the construction of the North Slope gas line. In addition to dealing with issues of oil taxes, it also addresses major royalties and resource ownership issues managed by DNR, including royalty in-kind and royalty in-value, the evaluation methodology used for calculating the state's royalty share and appropriate transportation charges for royalty gas. On the oil side, the state's sale of royalty in-kind oil has stimulated Alaska's refining industry with a huge positive effect on the state's economy. The state's royalty in-kind sales for its gas could be used as a vehicle for opening a major petrochemical business in Alaska or for exploration on currently untapped basins. The Stranded Gas Act also opens the door for other negotiations in key areas involving DNR's resource management role with respect to oil and gas production on state land. As the state's manager of the state's oil and gas, the Division understands project risk and economic drivers from both the industry and government perspective.

SENATOR STEVENS asked if, during the enactment of HB 393, under the tariff settlement methodology (TSM) with the pipeline, the state would get its money at the front end and then the amount would shrink as the project aged.

MR. MARKS replied:

In the oil pipeline, actually the original tariffs were very high, in the order of upwards of \$6 as filed by the pipeline owners. What that did was actually lead - and since our wellhead values derived after subtraction of the tariff, what that did was create lower values for severance tax and royalty early on.

What happened in TSM in the settlement - the settlement method that you refer to, what that did was actually lower tariffs and it partially compensated for the high tariffs that were derived early on. So, it wasn't really - it didn't really start out to be that way intentionally but, as a matter of history, the pipeline tariffs were actually, as far as the state's concerned or as far as the sponsor - or who built the pipeline, that was back end loaded as well because they got to recover a big chunk of their money in the early years.

SENATOR STEVENS said that when the TAPS began operation, it was back-end loaded.

MR. MARKS said the tariff itself was front-end loaded but what that did was create a back-end loaded fiscal system because a high tariff on the front end resulted in low severance taxes and royalties for the producers.

CHAIR OGAN asked if the tariff is lower because the costs are lower, more revenue should be generated for the state in the front end of the project, regarding well price and netback.

MR. DICKINSON said an important observation is if the state chooses to get most of its revenue from the wellhead, the tariff will become very important. He said the higher the tariff, the lower the wellhead. He explained:

Let's propose that a portion of the pipeline is in Alaska and it costs \$10 billion. A very large piece of the tariff is going to be the interest on that \$10 billion, it's like the first couple years when you buy a house most of the mortgage payments are interest. That interest is going to be taxable. If you look at it from an income tax point of view, we say that's return on investment. So, for folks on that piece, then in fact what happens at the wellhead is less important. And those are the kind of mechanisms that we need to trade off as we look at how we are going to quantify our fiscal [indisc.].

MR. MARKS commented that if the [gas] pipeline goes to Chicago and the upper Midwest, the Federal Energy Regulatory Commission (FERC) will establish a tariff. He does not envision that a tariff would come out of this negotiation process. That is not

to say that another way of accounting for the pipeline costs could not come out of the negotiations, but the official tariff that shippers will have to pay to the pipeline will be established in a federal jurisdiction.

SENATOR STEVENS thanked Mr. Marks and said he was trying to clarify back-end loading in relation to the other large pipeline project in the state and how it compared.

CHAIR OGAN said that SB 92 extends actions taken by the legislature before for North Slope gas, contains a provision banning an over-the-top route and contains a deadline for the application. He explained, regarding the deadline:

We're saying we'd like to - if we don't have a project in the next few years, whether or not the legislature wants to take up the issue again. So, those are the policy calls I think we need to make on this bill. And, to be honest with you, I kind of picked a date out of the - kind of an arbitrary date so that's open for discussion and I expect we'll get some comments on that.

With no further questions or comments, CHAIR OGAN adjourned the meeting at 4:52 p.m.

#