

**ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE**

March 26, 2003

3:37 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

MEMBERS ABSENT

Senator Georgianna Lincoln

COMMITTEE CALENDAR

SENATE BILL NO. 50

"An Act amending the manner of determining the royalty received by the state on gas production as it relates to the manufacture of certain value-added products."

HEARD AND HELD

PREVIOUS ACTION

SB 50 - No previous action to record.

WITNESS REGISTER

Ms. Mary Jackson
Staff to Senator Wagoner
Alaska State Capitol
Juneau, AK 99801-1182

POSITION STATEMENT: Presented SB 50 for the sponsor

Mr. Gary Carlson
Forest Oil Corporation
1600 Broadway, Suite 2200
Denver, CO 80202

POSITION STATEMENT: Supports SB 50

Ms. Lisa Parker
Agrium
PO Box 575

Kenai, AK 99611

POSITION STATEMENT: Answered questions about CSSB 50(RES)

Mr. Bill Popp
Kenai Peninsula Borough
144 North Binkley St.
Soldotna, AK 99669

POSITION STATEMENT: Supports CSSB 50(RES)

Mr. Mike Nugent
Agrium
PO Box 575
Kenai, AK 99611

POSITION STATEMENT: Stated support for CSSB 50(RES)

Mr. Eric McDowell
The McDowell Group
Juneau, AK

POSITION STATEMENT: Answered questions related to CSSB 50(RES)

Mr. Mark Myers
Division of Oil and Gas
Department of Natural Resources
550 W 7th Ave.
Anchorage, AK 99501

POSITION STATEMENT: Supports CSSB 50(RES)

ACTION NARRATIVE

TAPE 03-17, SIDE A

Number 0001

CHAIR SCOTT OGAN called the Senate Resources Standing Committee meeting to order at 3:37 p.m. All members were present except Senator Lincoln, who was excused. The committee took up SB 50.

#SB 50

SB 50-ROYALTY GAS CONTRACTS

CHAIR OGAN noted the sponsor prepared a proposed committee substitute, labeled Version H.

SENATOR BEN STEVENS moved to adopt Version H as the working document before the committee.

CHAIR OGAN objected for the purpose of discussion.

MS. MARY JACKSON, staff to Senator Tom Wagoner, sponsor of SB 50, told members that Version H now conforms to HB 57, companion legislation that was heard yesterday in the House Finance Committee. She referred to a handout comparing SB 50 to Version H and provided the following explanation of Version H.

On page 1, lines 10-12, language was inserted that specifies that the contract will be used to accept a price for gas on or after the effective date of this particular act. In addition, it further defines a manufacturer as a manufacturer of agricultural chemicals. That is the predominant change in Version H.

On page 2, lines 10-11 and lines 30-31, and on page 3, line 7, language was again added to specify a manufacturer of agricultural chemicals.

On page 3, lines 8-12, the definition was expanded to reflect "manufacturer of agricultural chemicals."

On page 3, lines 13-18, new language was added so that applicability occurs on the date of passage of this act.

MS. JACKSON said the House's intent in making the above revisions was to clarify what a manufacturer is. House members had considerable discussion about the appropriate verbiage.

CHAIR OGAN removed his objection to the adoption of Version H; therefore Version H was the working document before the committee.

MS. JACKSON told members that the sponsor statement for SB 50 still applies. The intent of the bill is to provide certainty of the cost of the royalty gas to a manufacturing entity. That would be accomplished by allowing the commissioner to enter into an agreement with a manufacturing entity, similar to the agreements made with utility companies. She noted that representatives from the manufacturing company this bill applies to are present to answer questions about the fiscal implications.

CHAIR OGAN stated for the record that it is not his intention to move this bill out of committee today.

SENATOR SEEKINS referred to the language on page 1, line 8, that reads, "the commissioner shall enter into an agreement with the lessee to use or accept the price," and asked how the state can compel someone to agree on a lease price within 90 days.

MS. JACKSON said she doesn't know that the state could compel anyone, however the bill requires the commissioner to act within certain parameters set out on page 2, lines 28 and 29. It also requires the commissioner to enter an agreement when certain findings are in place.

SENATOR SEEKINS said the word "shall" indicates that the commissioner has no choice but to enter into an agreement within 90 days regardless of where the parties are in the stages of negotiation. He asked if that is common language.

MS. JACKSON said that is the existing statutory language so the commissioner is required to enter into an agreement with the utilities now. This bill inserts agricultural chemical manufacturers into the existing statutes.

CHAIR OGAN suggested discussing that point with the commissioner to see if that language has been problematic in the past.

SENATOR SEEKINS said whenever he enters into a lease agreement with a customer, both parties have to come to an agreement and no "shall" is involved.

SENATOR ELTON asked if the committee would be hearing from a department representative.

CHAIR OGAN said that Mr. Myers was available.

SENATOR SEEKINS suggested that the language on page 2, line 23, "unless the contract price is unreasonably low," might be the caveat. He said it appears that the commissioner must negotiate if a request is made and, as long as the price is not unreasonably low, the commissioner is compelled to enter into a lease agreement.

MS. JACKSON said that is exactly the point; the commissioner does not have the luxury of dragging his or her feet. The commissioner is required to go forward if DNR finds the agreement is in the best interest of the state.

CHAIR OGAN asked if the bill contains a provision that allows the negotiations to be reopened if the economics suddenly change.

MS. JACKSON said not that she is aware of, but that does not mean a provision could not be inserted into a contract.

CHAIR OGAN said he is sympathetic to Agrium's need to know what its cost of gas will be and there will be a cost to the state to provide that. He said part of the problem is the market for Agrium's product is soft, but if the market suddenly improves and the state is taking a loss, he would like to provide a way for the state to reconsider.

MS. JACKSON asked Chair Ogan if his intent is that the state should share the risk with the manufacturer, but it should also share any windfalls.

CHAIR OGAN said that is correct. He said that is a concept the committee can work on and talk to the manufacturer about. He then took public testimony.

MR. GARY CARLSON, Senior Vice President of Forest Oil Corporation, an upstream producer that concentrates mainly in Cook Inlet, said the focus of his testimony will be to provide the viewpoint of an upstream producer that may be entering into an arms length contract with Agrium for a future gas discovery. He made the following statement.

Gas exploration is only a recent focus in the Cook Inlet outside the companies that controlled the market. You now have companies like Aurora, Evergreen and Forest Oil beginning to invest in gas exploration and development with the anticipation of supply gaps in future markets. There is a small, but expanding demand by the utilities, and an anticipated large gap in the amount of gas committed to keep the Agrium plant at capacity. Forest Oil is actively investing in gas prospects in part due to this anticipated market.

Field size distribution analysis suggests that there are 100 BCF to 500 BCF accumulations yet to be discovered in the Inlet. The current annual production rate of 200 BCF can be broken down into service to various markets. A rough estimate would be 35 percent LNG, 25 percent fertilizer feedstock, 30 percent utilities and 10 percent fuel in oil and gas facilities.

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various markets. A rough estimate would be 35 percent LNG, 25 percent fertilizer feedstock, 30 percent utilities and 10 percent fuel in oil and gas facilities.

The commerciality of the projects is tied to capital required, rate that the asset can produce, and price. As an industry, we are working hard to drive down the costs using new technology and innovative utilization of current infrastructure. The gap in supply for the fertilizer plant is a key driver for the anticipated market. I will not try to address the price Agrium can afford to pay for its feedstock except to say that it ranges from \$1.50 to \$2.00 MCF depending upon fertilizer prices.

Under current law, these low product prices coupled with the potential of a 20 percent royalty burden would limit the number of small or moderate gas development projects that could be considered commercial. The other threat facing potential upstream investors in gas potential is the partial idling or shutting in of the fertilizer plant for Cook Inlet gas, thus eliminating the near term market.

The timeframe from exploration to first production can exceed 5 years; therefore, some degree of certainty is essential to encourage investment. Currently, the state has the ability and willingness to negotiate an equitable royalty settlement and that is a possible solution to this critical problem; however, there still remains a degree of uncertainty in the process.

As an upstream investor in the Cook Inlet, Forest Oil supports SB 50. I would be happy to answer any questions.

CHAIR OGAN asked Mr. Carlson how much gas Forest Oil supplies.

MR. CARLSON said all of Forest Oil's current gas is being consumed in lifting the oil production. He said Forest Oil has gas prospects and some excess gas production that it is trying to bring to the market. Right now, the only substantial demand is the Agrium plant.

CHAIR OGAN asked if it is fair to say the stability of that market drives Forest Oil's investment decisions in Cook Inlet.

MR. CARLSON said that is a good description. Forest Oil is counting on that market being available. It could make substantial investments today but if the market disappears it would be a difficult problem for the industry so certainty will help. In response to a statement by Chair Ogan, he offered to host committee members and show them the Osprey platform and its facilities. He said after investing \$200 million in the state, it has been good to see some return. Forest Oil began production in December.

CHAIR OGAN asked if Forest Oil has oil and gas reserves booked at this point.

MR. CARLSON said Forest Oil has reserves booked based on its ownership in the other fields and, when it purchased Marathon's oil fields, it had reserves booked in a small field that it bought from Stewart Petroleum. It has just booked reserves at Redoubt. Forest Oil's position is that it hopes the reserves wind up between 50 and 100 million barrels but it has only been in production a couple of months.

CHAIR OGAN asked what Forest Oil's output will be.

MR. CARLSON said it is producing around 3,000 barrels a day from two wells and it has another well ready to produce. The challenge is drilling wells two to three miles away from the platform; therefore Forest Oil can only drill three or four wells per year. Forest Oil hopes to build its production to 10,000 barrels per day but that will take time.

CHAIR OGAN again asked the amount of gas Forest Oil produces.

MR. CARLSON said the Redoubt Shoal development, which he was referring to, is primarily oil. The amount of gas is insufficient to lift the oil so Forest Oil is taking gas from the Westmoreland field to power the equipment needed to lift the oil. Forest Oil's anticipated sales in the future would be from new prospects that have yet to be drilled.

CHAIR OGAN thanked Mr. Carlson.

MS. LISA PARKER and MR. MIKE NUGENT of Agrium, AND MR. ERIC MCDOWELL of the McDowell Group, introduced themselves to members.

MR. NUGENT provided the following written testimony.

Mr. Chairman, members of the committee, thank you for the opportunity to testify before you this afternoon. My name is Mike Nugent and I am the General Manager of Agrium's Kenai Nitrogen Operations based in Kenai, Alaska. With me today is Lisa Parker, Government & Community Relations Advisor for Agrium U.S. and Eric McDowell from the McDowell Group. I am here today to speak in favor of the bill before you - SB 50.

As I view this legislation, it is just one piece of the pie, which could provide producers in Cook Inlet with stability, and Agrium with certainty of what the costs are to manufacture the products we sell. The major raw material we use to manufacture our products is natural gas.

Agrium's Kenai Nitrogen Operations is one of Alaska's few major value-added manufacturing operations. The Kenai plant is the second largest producer of nitrogen products in the United States, with the largest facility being in Louisiana. From Kenai, we manufacture 6% of the total nitrogen products in North America.

While we are located in Kenai, the majority of our product is exported to Pacific Rim countries, including Korea, Taiwan, Mexico, Thailand, and Australia, to name a few. In total, we exported product to fifteen different countries and in 2001 the gross sale value of our product was \$210 million (this is total sales). Kenai has been able to be competitive in world markets

- ✓ because of its location-close to Pacific Rim Markets,
- ✓ because there is a skilled workforce, and
- ✓ because there is a stable government.

Countries that compete with Kenai to sell fertilizer products - Russia, Indonesia, Saudi Arabia, and Venezuela - do not have these same attributes, particularly a stable government. However, what they do have are extremely low natural gas prices, which puts Kenai at a disadvantage in marketing our product. This disadvantage is in part due to current provisions in state contracts, which require the State of Alaska

to receive the highest prevailing price for the State's royalty gas.

The bill before you, SB 50, could help in that it would allow the commissioner to accept, as the price being paid to the state for its gas, the price that has been negotiated between Agrium and the producer.

Over the past few weeks there [have] been some questions with respect to the fiscal impact of this bill. With respect to the fiscal implications, I would like to offer the following comments:

1. The Department of Natural Resources has supplied you with a fiscal note. It does not consider the other economic impacts such as wages, purchases of goods and services, taxes, and new developments, to the State of Alaska; it only considers the impact of natural gas value.
2. This analysis is based on forecasts and these forecasts involve several variables such as volume, price, ownership, etc., all of which are very difficult to accurately predict. This analysis also assumes we are operating at full capacity or, in other words, consuming maximum volumes of natural gas.
3. As opposed to forecasting the future, the reality of today is Agrium's Kenai operation is currently curtailed due to the inability of suppliers to deliver adequate natural gas supplies. Our plant is operating on average at 75% capacity so there is currently a real revenue reduction to the state, Agrium, and the local economies, regardless of which price forecast is used.
4. Unless we are able to find a producer who can provide us with a large quantity of natural gas at a competitive price, and in the very near future, this curtailment will last for several years or could even result in our shutdown. We have had repeated discussions with the current and future producers in Cook Inlet and one of the primary areas of concern is the additional royalty the producer is currently subject to. To quote one of the producers in a letter sent recently to the City of Kenai:

As a producer looking to market our natural gas, there is great hesitation to enter into a gas sales agreement with a purchaser such as Agrium because it adds yet another layer of risk to the producer. A producer selling gas to Agrium runs the risk, in fact the probability, that several years after selling its gas to Agrium, the State will assert a claim that royalty needs to be paid on a value higher than the arms length negotiated contract price. This additional royalty, plus interest accrued at a higher-than-market rate, would have to be borne by the producer and/or by the purchaser. It is for this reason that Aurora Power and its natural gas marketing affiliate strongly endorse [SB 50] and the concept that royalty should be paid on the basis of arms length negotiated contract price.

1. As noted above, the development of new natural gas reserves is more difficult because of the risk of unknown state royalty gas values.
2. The risk is associated with the value or price being set by others in a process we have not participated in.
3. If we are not successful in developing additional competitive gas reserves, we will not survive as a business. As a result, the revenues to the State from royalty gas sales and the added value our business brings to the local economies will be zero.
4. Natural gas will have a different value to different consumers. One price does and will not fit all.
5. The overall economic benefits that different natural gas consumers bring to the local economies will be different. So, don't just focus on the value of the gas, look at the whole economic picture.

Eric McDowell from The McDowell Group is here to answer any questions you might have with respect to the economic benefits as well as the economic impacts this facility has in Alaska. In the study the McDowell Group undertook last year, they concluded "By Alaskan economic standards, the Agrium operation is exceptional for its combination of high pay levels, amount and concentration of expenditures in the local area, and the degree of value-added manufacturing that

occurs in Alaska prior to export. The result is a high multiplier impact.

Mr. Chairman and members of the committee, again, thank you for the opportunity to speak before you. We would be happy to answer any questions.

SENATOR DYSON asked if Agrium's international product tends to track natural gas prices.

MR. NUGENT said it does, to some degree, within the North American market, which Agrium does not participate in. He stated:

Fertilizer prices closely track the value of natural gas on an international market so the North American market does have some influence on the international market, but on the international market the prices tend to not track the value of natural gas. And the main reason for that is most of the other manufacturers or producers of fertilizers on the international market - the other countries I mentioned - Russia, Indonesia, Saudi Arabia - they tend to fix the value of their natural gas and they fix it at a very low level. They do not - gas in their countries [does] not compete in a free market.

SENATOR DYSON said he has seen a couple of reports that indicate that as early as five or six years from now, the price of gas may be \$6 per BTU on an international level. He asked if Alaska got its stranded gas to an advantageous market on the West Coast or the Great Lakes and it had that kind of value for heating and power generation, whether Forest Oil would have a competitive advantage.

MR. NUGENT said it could. If the value of natural gas in Cook Inlet was tied to a bigger market and driven higher by that market, then Agrium would have to make adjustments to either compete in that market or not continue as a business.

CHAIR OGAN commented that the value of Cook Inlet gas varies depending on whom it is sold to. He said if it is sold to the Enstar system, it is more or less tied to the Henry Hub by a formula. He asked if Agrium's long-term contract is quite a bit lower than the Enstar price.

MR. NUGENT said that is correct.

CHAIR OGAN asked if that puts Agrium at a disadvantage with the law of supply and demand so that if there is more demand for gas than is currently in production, the price of gas is likely to go up. However, Agrium needs the lowest price gas in the Inlet to be competitive with Indonesian gas.

MR. NUGENT said that is correct but within the marketplace, several other variables bring value to producers, one being that Agrium is a steady consumer of natural gas throughout the year, whereas the utilities demand a lot of gas in the winter and almost none in the summer. He said different consumers and producers within Cook Inlet will value gas differently and that is where the risk comes in if another producer and consumer strike a contract for a larger value that can have an effect on Agrium's business in that the state's portion of that gas can be hired at that higher value.

MS. PARKER said Agrium's current contract with its gas supplier through June of 2009 is not affected by this legislation. This legislation would apply to any future contracts that are entered into if this legislation is enacted.

CHAIR OGAN noted that is due to a change in the bill and he appreciates Agrium's consideration of it as that change made the fiscal note much more palatable. He then pointed out that Agrium is involved in litigation about reserves when Agrium bought the business. He asked if this bill would be in existence if Agrium believed the reserves it was buying were the reserves it got.

MR. NUGENT said he believes Agrium would be before the committee today but not with the same amount of urgency. Agrium's view of the reserves it was going to get from its supplier one year ago took Agrium further into the future than what the reserves are now predicted to be. This legislation has importance for the development of natural gas in Cook Inlet in the future by making it easier for the developers.

MS. PARKER explained that Agrium began discussions with the Division of Oil and Gas over 1 1/2 years ago to try to find a mechanism to provide stability for the state's royalty rate. Agrium was not in litigation with Unocal at the time; that litigation has nothing to do with SB 50. Agrium is trying to provide stability and reliability in gas pricing for value-added manufacturers in Alaska.

CHAIR OGAN asked for an explanation of how Agrium's current rates vary and current problems with those rates.

MR. NUGENT said in Agrium's contract with its main supplier, Unocal, the price is based upon the value of Agrium's products.

CHAIR OGAN asked if the amount of royalty paid to the state varies depending on certain factors so Agrium does not really know what it will pay at the end of the day.

MR. NUGENT said that is correct so, on a day-to-day basis, the state receives the same value for the gas that Agrium pays the producer. As time goes on, the state will monitor and compare that to the prevailing value for that Cook Inlet gas and can seek additional payment for the state's portion of that gas.

CHAIR OGAN commented the problem is that Agrium would not necessarily have that money budgeted.

SENATOR BEN STEVENS said Mr. Carlson gave a breakdown of total Inlet production at 35 percent LNG, 25 percent fertilizer feedstock, 30 percent utilities, and 10 percent for extraction at oil and gas facilities. He asked if the 25 percent fertilizer feedstock is at capacity.

MR. NUGENT said it is.

SENATOR BEN STEVENS asked if Agrium sees any growth in its consumption in the future.

MR. NUGENT said as a first step, Agrium would like to encourage and develop arrangements with other producers to produce enough gas in Cook Inlet to get Agrium back to capacity. Hopefully, if additional reserves are discovered, that additional gas could either be available to Agrium or other manufacturers.

SENATOR BEN STEVENS asked if Mr. Carlson's rough estimate is Agrium's consumption at capacity.

MR. NUGENT said yes, and in volume numbers, the consumption within Cook Inlet on an annual basis is about 200 BCF per year. Agrium consumes about 55 BCF, the Phillips LNG consumes about 80 BCF and the utility system and the oil companies consume the balance.

SENATOR BEN STEVENS asked if Agrium buys its consumption from Unocal who pays the royalty.

MR. NUGENT said that is correct.

SENATOR BEN STEVENS asked if it is based on the value of Agrium's product.

MR. NUGENT replied, "The price that we pay our supplier, Unocal, is based on the value of our product."

MS. PARKER told members the draft contracts that Agrium is discussing with the producers have an upside. They contain a set a base price so if the price of ammonia goes up and Agrium is making money, the price that Agrium pays the producer for gas would also increase.

SENATOR BEN STEVENS asked if Mr. Nugent said the commissioner is required to negotiate for the highest price available.

MR. NUGENT verified that he did.

SENATOR BEN STEVENS referred to Section 1(B) on page 2, line 9, and asked if that gives the commissioner the latitude to look into other justifications for price negotiations and to take the price generated from Agrium's product.

MR. NUGENT said there could be. In Agrium's existing contract, the value of the gas is based on the value of Agrium's product. He noted that as Agrium makes agreements with other producers in the future, that would be one way to price gas with a producer. There would be several ways to price that gas other than a set dollar amount per volume for a set period of time.

TAPE 03-17, SIDE B

SENATOR BEN STEVENS asked if Section B gives the commissioner the latitude to accept prices other than the highest price.

MS. PARKER said it does. Section B will allow the commissioner to accept the contract that's been negotiated between the producer and Agrium, as opposed to using the higher one.

SENATOR BEN STEVENS referred to language on page 2, line 29 that reads, "or other tangible benefits to the state;" and asked how the commissioner would quantify those tangible benefits.

MR. ERIC McDOWELL told members in the McDowell Group's study on the economic impacts of Agrium, the group looked at about 200 economic entities in Alaska over the years. He stated:

Of all of them, this seemed to come out - most beneficial in terms of other benefits to the state, first, in terms you're earning royalties off of this operation. Secondly, the stable year-round resident payroll has wages comparable to the North Slope, which is not all resident, but the average wage is \$84,000, it's year-round, it's stable. Taxes that might - otherwise the state would bear - are generated privately \$2.5 million per year to the Borough alone, just on that plant, \$50 million in payroll, housing taxes, so on and so forth.

So, we find that the multiplier effect to 300 jobs of this kind of that pay scale that are all resident through both - through all the multiple impacts, generate another 700. In this day and age, where we're measuring economic progress in Alaska in terms of MacDonald's jobs, to have this situation here that can be stabilized and enhanced by policies you can make is certainly an opportunity in favor of the kind of value-added manufacturing you would like to see a lot of in Alaska.

So, while the report is full of various numbers about the economic impacts of what we can say, it certainly is an operation that generates a lot of money from the private sector that goes to pay for public services and so forth.

A second comment I'd like to make - not directly part of our study but in looking at the fiscal note and in doing some analysis of our own, you have a peculiar market situation in there. You essentially have three buyers, and they're buyers for different purposes - utilities, LNG and fertilizer. What he's saying is there are different prices for each of those uses and they're consuming - they're kind of like a COSTCO - they're consuming 25 percent of the production of the Inlet. If that buyer drops out, what happens to the pricing structure of the state's royalties overall? It goes down to zero and the whole pricing structure, based on the way the state does it, sort of collapses.

And, so, what they're asking for, as I'm hearing it is, rather than a subsidy, is stability. By supporting this particular situation before you, where you're looking where you can continue an exceptional economic situation that has these other benefits that the commissioner is required to consider that we've quantified in this study, guarantees that you'll have continued royalty payments from a quarter of the gas produced in the Inlet plus encourage other production. So, there seems to be a lot of benefits to the state.

The risk, on the other side, is either decreased or no production by Agrium, in which case there are less royalties to the state and when, in the future, you might find another buyer for some other purpose you would have that gap of perhaps years of no revenue - royalties from that.... So, from an economic standpoint, I'll conclude my comments, and that is that there are some very substantial and positive economic benefits, especially in this time with the burden you have of considering the economy in Alaska. A major private operation is contributing substantially in lieu of money the state would otherwise have to contribute to support that region.

Secondly, recognizing that this is kind of a unique market - very limited consumers and that it probably is appropriate state policy to arrange it so that you can insure both revenue directly to the state and also the bigger issue of the economic benefits that are currently accruing and we hope would continue to accrue.

CHAIR OGAN noted that Senator Stevens zeroed in on the heart of the issue, that being that the state would give the same deal to a private company that it gives to the utilities: accepting the contract price as the royalty calculation. The justification for the utilities is that the break will trickle down to the customers who actually own the public utilities. Therefore, a little less money goes into the state treasury, but the money from a public resource is going back to the public. He noted the justification of SB 50 is that the legislature will adopt that same policy for a private company so the state will receive a smaller royalty in exchange for employment opportunities or other tangible benefits. He felt that the committee must decide whether this is a good public purpose for a public resource and justifies less money to the state treasury.

SENATOR BEN STEVENS noted the difference between Sections A and B, in terms of affiliation, and asked why an affiliated interest is defined as substantial influence of a family interest or common stock interest.

MS. JACKSON said the House was attempting to grasp a numerical value, which is the reason for the 10 percent factor. Beyond that, the parties become affiliated and could be gaining the interest.

SENATOR SEEKINS thought the intent appears to be that a manufacturer cannot buy gas at an advantageous price to wholesale it to itself. He commented [that addresses] the threshold of a relationship in which a company could get a good price from the state to wholesale it to itself to make a profit in another market.

SENATOR BEN STEVENS questioned why the two sections have different definitions but said he would research that question himself.

SENATOR ELTON said the relationship is defined on page 2, lines 9-21, which says it cannot be over 10 percent of the manufacturer's value-added product. He then referred to the existing language on lines 30-31, that says, "(C) the lessee and the utility are related in management, ownership, or other aspect; and." He asked if this legislation sets up two different standards, one that seems to allow the commissioner to find that any relationship is a reason to make a written finding denying the royalty provision, yet the earlier language defines it by 10 percent.

MS. JACKSON said she sees that as a double-edged sword because there would be two ways for the commissioner to deny a contract using either the 10 percent provision or because of a relationship to the management/ownership.

SENATOR ELTON responded, "Or, you could set up a situation in which it's 8 percent, which would be allowed under (B), but may not be allowed under (C)."

MS. JACKSON said that would be correct because the commissioner would have to make a written finding if it was under 10 percent but there was management ownership and "other."

SENATOR ELTON noted that Mr. Carlson outlined the percentage of gas that was going to the three different uses. He said the legislature has created this benefit for the utilities and this legislation extends that benefit to the fertilizer feed stock industry. He asked what effect that will have on the component of gas that is going into the LNG market and whether it will be disadvantaged because the legislature has created opportunities for two of the customers and not for the third.

MS. JACKSON said that is a good question.

CHAIR OGAN suggested asking a representative of the Division of Oil and Gas.

MS. JACKSON said regarding Senator Stevens' question about other tangible benefits, the one that has always come to her mind as a resident of the Kenai Peninsula is the 20-mil cap for oil and gas properties. The Kenai Peninsula is not at the 20-mil cap so the State of Alaska gets the difference right now. That can amount to 8 to 12 mils, which is a substantial amount of money.

MS. PARKER asked to clarify that the purpose of the language in Section 1(B) is to make sure the transaction is an arms-length one between the producer and the consumer, in this case the agricultural chemical manufacturer. She then said with respect to Senator Elton's question about disadvantaging the LNG component, the LNG plant is also in the exploration and production business. It supplies its own product as the Tyonek platform is dedicated strictly to the LNG plant. The negotiated settlement between the State of Alaska and Conoco-Phillips over the royalty share will provide benefit to Conoco-Phillips.

MR. BILL POPP, Oil and Gas Liaison for the Kenai Peninsula Borough, gave the following testimony.

The Kenai Peninsula Borough supports in principle the passage of SB 50 and views this legislation as an important step towards providing a stable business environment for the value-added manufacturing industry in the Cook Inlet basin.

Agrium is a key component of our economy of the Kenai Peninsula Borough. It's the third largest local employer. It generates nearly 300 direct high paying jobs and several hundred additional jobs within the local support industry and it does account for nearly \$25 million in direct payroll in our communities. The

Agrium facility generates nearly \$2.5 million in property taxes to the Kenai Peninsula Borough, which equates to approximately 9 percent of the total property taxes collected by the Borough in 2001. That number is holding true again this year.

SB 50 addresses the issues of price certainty and planning stability for Agrium by providing a consistent and reliable price structure for any royalty natural gas purchased by the plant for conversion into fertilizer or ammonia, products that compete for buyers in a highly competitive world market with razor thin margins at times. While SB 50 will not solve all the issues that face Agrium as it moves forward to compete for sales in the future, it does eliminate a significant uncertainty factor from its future business planning.

The Kenai Peninsula Borough supports the passage of SB 50 and has stated that support through the Kenai Peninsula Borough resolution 2003-024. So, on behalf of the Kenai Peninsula Borough, I do ask the Senate Resources Committee to support passage of this bill and I thank you for the opportunity to testify in support of SB 50.

SENATOR ELTON said it would be helpful to learn about the other incentives the state may offer for exploration and production in the Cook Inlet fields to put this legislation in context.

CHAIR OGAN suggested the committee get an overview of the oil and gas situation in Cook Inlet. He then asked Mr. Myers if he wished to comment on SB 50 today.

MR. MARK MYERS, Director of the Division of Oil and Gas, Department of Natural Resources, said he could clear up some questions about the criteria and how the negotiations would take place. He said the first misconception is that actual negotiations occur. Basically, in an AS 38.05.180(aa) treatment [hereafter referred to as (aa) treatment], the state accepts the contract price that the lessee has with the buyer. There is no negotiation involved, therefore the 90 days provides plenty of time. The state has no mechanism of negotiation; the state accepts whatever the parties negotiate external to the state. Regarding the criteria, the statute is rather unusual in the sense that (B)(2) lists the criteria the commissioner must consider as follows:

- (A) Is the contract price is unreasonably low?
- (B) Will increased employment opportunities or other tangible benefits result?
- (C) Is the relationship an arms length one? and
- (D) Is it in the best interests of the state?

He said it is important to note that line 29 contains the word "and." Therefore, all four of the criteria must exist for the commissioner to deny a contract, which makes it almost impossible for the commissioner to do so. He pointed out that language provides an automatic grant under almost anything but the most unusual circumstances.

MR. MYERS then clarified that the word "and" is on page 3, line 1 of the committee substitute.

CHAIR OGAN asked Mr. Myers if he would recommend using the word "or" instead.

MR. MYERS said he would if the committee's intent is to disqualify an applicant for any one of those conditions. He repeated that the standard is that the contract must be an arms-length contract. One reason the state uses the market value approach is that it is very difficult to demonstrate arms-length contracts. Almost all royalty contracts use market value rather than just the contract price. That is true of the state-federal leases in Cook Inlet. That provides additional value to the state, but it also provides confidence that the contract is not an arms-length one. He said the third thing to note is that the certainty goes to the lessee, not to the buyer of the gas under the contract. The state is not subject to the negotiations between a Cook Inlet producer and a buyer. Whether or not that benefit is passed on to the purchaser is purely due to that contract. Therefore, it is quite possible an Inlet producer might keep all of the value under the (aa) treatment and legitimately so. That is not for the state to judge. Mr. Myers said that the (aa) treatments are a bit unusual because the relief does not go to the intended party. However, it is passed on in utility cases but that would not necessarily be the case in a private manufacturing contract.

MR. MYERS said DNR feels comfortable with the fiscal note. It does not look at the upside potential of the plant remaining in existence, but that is not allowable in a fiscal note. The fiscal note contains some assumptions but outcomes were derived from various scenarios, which all have less royalty value to the state. That is simply because the state would have kept the

contract price if, in fact, it was higher. There are no cases in which this will provide more royalty value other than the plant either taking less gas from the state or the plant shutting down. He noted DNR's economist spent a lot of time working on this fiscal note with Agrium to do a solid analysis.

MR. MYERS said DNR is aware of the importance of the Agrium plant and a value added industry, however it does recognize that the value here, approximately \$2 million annually, has the equivalent effect of lowering their gas price by about 3.6 cents per MCF on Agrium's total gas take. He offered to answer questions.

CHAIR OGAN commented that he suggested the bill should contain a provision for a negotiation reopener if there is an upside to the market and Agrium's response was the price it pays is based on the price it gets for its goods. He asked Mr. Myers if he concurs that an upside is already built in.

MR. MYERS said it all depends on the contract Agrium has with the producer. Agrium can enter into a long-term, fixed price contract where compensation for adjustments in price value could be compensation other than gas price. Agrium could enter into a contract where it is directly proportional to the gas price and the gas price does go up. On the other hand, Agrium could enter into a contract price based on spot or market value in the Inlet or Henry Hub. Therefore, it would be fairly speculative to say how the state would benefit from that and, again, DNR is not a party to that contract.

MR. MYERS said his last point is on the question of how the state deals with the value of gas for the LNG facility. The state reached a settlement with the producer so it gets about half of the value of the gas delivered in Japan. In that case, the state recognized that it is dealing with a different market and different conditions. Other mechanisms could be used, as Mr. Carlson suggested, and some of those mechanisms could capture the upside. He repeated that the (aa) treatment was never meant to capture the upside. It was meant to provide a stable, lower price of gas, which passes on the benefit to the user of the gas.

CHAIR OGAN asked Mr. Myers if he sees any potential liabilities in the future due to this legislation setting a precedent for others.

MR. MYERS said that is a good question and certainly other value-added uses for natural gas exist. One of the issues is the higher value has brought in significantly more revenue. A rolling of that contract, under the lease form, will have a large-scale economic impact if applied to other users. He said this is a policy call, sort of an insurance policy that increases value to the gas producers selling to Agrium. That amount will vary depending on the contract price versus the market value. Similar treatment would provide additional economic value to any lessee.

CHAIR OGAN said the construction of a natural gas pipeline is a possibility so the legislature needs to be mindful that there will be other value added industries when it decides on this policy. There being no further questions, CHAIR OGAN adjourned the meeting at 5:00 p.m.

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