ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE
May 6, 2003
4:10 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

Senator Fred Dyson

OTHER MEMBERS PRESENT

Representative Chenault

COMMITTEE CALENDAR

SENATE BILL NO. 185
"An Act providing for a reduction of royalty on certain oil produced from Cook Inlet submerged land."
MOVED CSSB 185(RES) OUT OF COMMITTEE

PREVIOUS ACTION

SB 185 - See Resources minutes dated 5/5/03.

WITNESS REGISTER

Mr. Mark Myers, Director
Division of Oil and Gas
Department of Natural Resources
400 Willoughby Ave.
Juneau, AK 99801-1724
POSITION STATEMENT: Supported SB 185.

Mr. Tad Owens, Executive Director
Resource Development Council
121 W. Fireweed, No. 207
Anchorage, AK 99503
POSITION STATEMENT: Supported SB 185.

Mr. Larry Houlle, General Manager
Alaska Support Industry Alliance
4220 B Street
Anchorage, AK
POSITION STATEMENT: Supported SB 185.

Mr. Kevin Tabler, Manager
Land and Government Affairs
Union Oil
Anchorage AK
POSITION STATEMENT: Supported SB 185.

ACTION NARRATIVE

TAPE 03-41, SIDE A

SB 185-ROYALTY REDUCTION ON CERTAIN OIL/TAX CRED

CHAIR SCOTT OGAN called the Senate Resources Standing Committee meeting to order at 4:10 p.m. Present were Senators Wagoner, Elton, Lincoln and Chair Ogan. The Chair announced SB 185 to be up for consideration.

MR. MARK MYERS, Director, Division of Oil and Gas, Department of Natural Resources (DNR), said he believes the purpose of SB 185 is to keep the Cook Inlet infrastructure in production for a longer period of time, particularly the offshore platforms. All of the Cook Inlet platforms are late in field life: peak production occurred in the late ‘60s to early '70s. Production has steadily declined with the exception of the recent discoveries at Redoubt on the Osprey Platform. The state can use its statutory authority to offer royalty reduction to provide an incentive to keep the platforms in production. DNR will be required to make an individual finding for each platform.

The division has a great deal of data on the economics of the reservoir properties. It can determine, fairly accurately, when a field will cost more to operate than oil production warrants. At that point, companies have to decide whether to close the infrastructure. Lowering royalty at a strategic time can actually extend the useful economic life of the field. SB 185 would reduce the 12.5% royalty to 5% under certain trigger prices, thereby extending the field life up to 14 months. Mr. Myers explained:

> In doing so, the state foregoes royalty on the front side that it would otherwise get, but extends the life

> of the field and picks up some royalty on the far side.... There may be additional incremental opportunities off those platforms for exploration wells. We know some of them do have some exploration prospects that some of the current operators are considering, or a new operator now might buy the facility at a later point in time ... so, all in all, the goal of the bill is to extend the lives of these platforms.

MR. MYERS showed the committee maps illustrating Cook Inlet fields and facilities, oil and gas units, oil and gas pools and recent activity in the Inlet. He explained that multiple fields share the on-shore processing facilities used by the platforms. They want to keep the entire infrastructure in tact because if individual platforms are pulled off, the overall economics of the processing facility will go down and the cost will go up, accelerating the decline of the other platforms.

He found that platform economics cluster under two groups. For one group the economic break was approximately 1,200 barrels per day; the other clustered around 750. The division used these economic criteria to put the platforms into two separate categories to generalize. He noted, "If you looked at the individual platform-by-platform economics, you would do just a normal royalty process, which is available under current law."

MR. MYERS told members the fiscal note details the amount of current oil being produced on the platforms, the break-even point, and when they would be expected to cross over that point. A $20 netback oil price was assumed for that analysis.

MR. MYERS said the negative to the state on the royalty side is $200,000 to $600,000 per year and he doesn't think that's a lot considering the value of extending the life of the platforms in the Inlet. The value of an incremental discovery using the infrastructure could well exceed the value of the foregone royalty.

SENATOR ELTON said it seems to him, without this bill, companies would make a decision about exploration or about what to do with the existing infrastructure earlier. He wanted to know why an earlier decision may not be as beneficial as a later decision.

MR. MYERS replied that companies have to look at multiple factors when they get near the end of field life and one of them is the cost of abandonment, which is pretty high. Generally, when a platform is abandoned, the equipment is removed for multiple platforms, not for a single platform. The state does not want the companies to pull out three or four platforms because that would have a significant impact on the infrastructure and accelerate the decline of the other platforms. So, extending life earlier allows for planning and exploring of other possibilities that might keep production going.

MR. MYERS added that in reality, royalty reduction will help only during a limited window. The state gets a 12.5% royalty from a platform of 1,200 barrels per day. If the royalty drops to 5%, that eliminates about 85 barrels per day. As production declines further, you'll go through the 85-barrel decline pretty fast. That's why the window is only 14 months. He explained:

> The one concern you would have in a bill like this is if you're getting near that number, you might choke your wells back, you might try to get below the amount to trigger...If you look at (g)(2) I think it is in the bill, there's language in there specifically to disallow your royalty reduction if it's not for reservoir related...So, mechanical choke backs or lack of facilities is not an acceptable reason....
>
> We tried to prevent cases where there might be artificial gaming of it. So, we think generally that we'll have the ability to make sure it's a reservoir related decline. This allows them up front to know they're going to get the royalty reduction they would get under the statute anyway and there's more certainty. Now it would trigger a little bit earlier in the cases of some platforms. That's why it has a negative fiscal note here. So, you get a little bit advantage, but again, that certainty, if it helps in the economics of someone operating for a longer period of time, they can maybe plan some additional work-overs.
>
> It also might help in the sale of properties. You may have current operators that decide that it isn't worth the incremental investment to go out there and drill that exploration well, that deeper prospect. A new company may come in. XTO is an example [of] who bought the platforms and have done very well. So, we expect to see trades and ownership. This provides, again, a little more value to the platform and again, we think

it's healthy as long as the proper environmental protections and bonding are in place that there be sales and transfers and new ideas come in....

SENATOR ELTON asked if the state is creating a disincentive to invest in infrastructure or technology with the 1,200 barrel per day provision, because if they do that, recovery might go back up.

MR. MYERS replied that in reality, it's doubtful - the cost of a work-over for a well would be in the hundreds of thousands of dollars. Drilling new wells costs several millions of dollars. The difference in royalty wouldn’t be enough to cover the cost of that sort of activity.

CHAIR OGAN praised the quality of the division's fiscal notes. He said he learns a lot from them and they are very helpful.

SENATOR WAGONER said two of the platforms they are referring to used to be known as Shell A and Shell C. Cross Timbers bought those platforms. Cross Timbers was a smaller company, which changed its name to XTO. That's an example of a major oil company selling off some of its assets to a smaller more independent company. XTO has had a drilling program for about three or four years and produces a little over 4,000 to 4,600 barrels per day. The smaller companies are basically production companies, not exploration companies.

CHAIR OGAN asked if XTO water-flooded one of the [platforms], it might qualify for the 1,200-barrel rather than the 750-barrel per day provision.

MR. MYERS replied the division looked at the economics, including the water and gas handling. XTO would certainly fall in the higher end of the 750 group, but its water-flood is about one-seventh of the ones in the 1,200 barrel range. He surmised, "So, they have a much lower operating cost than the other group of platforms."

MR. MYERS explained when platforms are clustered, some are going to fall in the higher end and some in the lower end within that cluster. XTO uses about 3,000 barrels of water a day for water flooding; other platforms are using 20,000 to 30,000 barrels of water per day. He said the division is trying to get close to the actual economics of the operating expenses of the platform and get a little ahead of the game to give some incentive beyond that. However, the division does not want to get too far in front because that would result in a large fiscal note.

CHAIR OGAN asked if he had staff to verify whether or not companies are manipulating the flow mechanically.

MR. MYERS replied that work would be done by the Alaska Oil and Gas Conservation Commission (AOGCC), which looks at the mechanical issues. His division looks at the royalty reporting and reservoir management through unit plans. The division would assist the AOGCC in the process and change the royalty accounting system to look at platform factors.

SENATOR LINCOLN said Gary Carlson with Forest Oil told the committee that Forest Oil put off the decline with an extension from one to three years. She asked why Mr. Myers said this bill extends the life of the field for up to 14 months.

MR. MYERS replied that he looked at the projected decline curves for the reservoir. If the production goes to around 1,200 or 750 and flattens more, they would be in that window longer. He used a fairly straight rate of decline based on the division’s and producer’s data, which he thought was predictable.

CHAIR OGAN asked, "Why not give them a break to the point where it doesn't hurt the state fiscally but still provides some incentive?"

MR. MYERS replied for two reasons:

> One is you want to be out front a little bit of when they actually reach that negative cash flow situation so they have a clear incentive to keep producing. You have to use a price of somewhere - you don't know if the price is going to be $18 or $24 or if it's going to be $20. So, again, our sensitivity was done at a specific price. You could do it on multiple prices [indisc.] but then you are really prophesizing into the future....

He said the division tried using just 1,200 barrels, but that produced a very high fiscal note and it was not realistic.

He said the bottom line is to get to a zero fiscal note. The division will have to look platform-by-platform and either be precise or be negative on some and positive on some.

CHAIR OGAN asked him what other incentives might be offered for Cook Inlet.

MR. MYERS answered that a number of years ago a royalty reduction was given to six fields that were discovered but not yet known to be in production. Two were oil fields, Sturiski Point and Redoubt Shoals, and four were small gas fields. The state decided it was worth the gamble to lower the royalty to 5%; almost all of those fields are now in production or near to it. The reduction was limited to the first 25 million barrels of production or 35 billion cubic feet of gas.

SENATOR SEEKINS arrived at 4:37 p.m.

MR. MYERS said two other royalty incentives have been offered for Cook Inlet. The first was a discovery royalty, which means under certain conditions a company could get a 5% royalty for a 10-year period after initial discovery. The second applies to utilities and is the higher valuation contained in SB 50 and HB 57, where the state uses the contract price rather than either the prevailing value or the higher oil value.

SENATOR LINCOLN asked for a list of the fields that now have the 5% royalty.

MR. MYERS agreed to provide that list. He noted those incentives were offered for early-in-life fields.

SENATOR ELTON asked Mr. Myers if the division predicated the fiscal note on $20 per barrel oil, whether there would be any way to peg the royalty rate reduction so if the price of oil goes up the reduction would be reduced and vice versa to protect the state and the company.

MR. MYERS replied that could be constructed and wouldn't be unusual in a traditional royalty reduction application, but because these platforms are so late in the life of the field, the differential is not huge when one runs the numbers. One of the bill’s purposes is to provide certainty and using different numbers would run counter to that purpose.

SENATOR SEEKINS asked, in reference to page 3, line 25 if someone could shut down below 750 in the last two days of the quarter to get the royalty reduction.

MR. MYERS replied a company could, but a protection was built in to (g)(ii) on page 4 for that kind of gamesmanship.

SENATOR WAGONER moved to adopt CSSB 185(RES), version \H, as the working document before the committee.

SENATOR ELTON objected but then removed his objection and CSSB 185(RES), version H, was adopted.

SENATOR WAGONER moved a conceptual amendment to allow the legal drafter the latitude to change some wording in the bill to "the first day of the month following the month". There were no objections and it was so ordered.

MR. TAD OWENS, Executive Director, Resource Development Council, supported SB 185 for all the reasons stated by Mr. Myers. He said it is appropriate for the state to consider incentives designed to prolong the life of existing fields, protect critical infrastructure and encourage opportunities for future investment. SB 185 addresses each of those goals.

MR. LARRY HOULLE, general manager, Alaska Support Industry Alliance, supported SB 185 for the reasons previously stated.

TAPE 03-41, SIDE B

MR. KEVIN TABLER, manager, Land and Government Affairs, Union Oil, said Union Oil is the predominate operator in Cook Inlet and supported SB 185 for all the previously stated reasons. It would help extend the field life so that new reserves might be found. Offering a royalty reduction sooner would be better than later.

CHAIR OGAN asked how a platform is shut down.

MR. TABLER replied that lease provisions require the facility to be removed. The intent here is to put off that ultimate removal until the economies of scale support moving multiple platforms at one time.

SENATOR WAGONER moved to pass CSSB 185(RES) from committee with individual recommendations. There were no objections and it was so ordered.

CHAIR OGAN adjourned the meeting at 5:08 p.m.