

**ALASKA STATE LEGISLATURE  
SENATE RESOURCES STANDING COMMITTEE**

May 7, 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 Georgianna Lincoln

**MEMBERS ABSENT**

Senator Kim Elton

**COMMITTEE CALENDAR**

APPOINTMENT OF MR. RUPERT ANDREWS TO THE ALASKA BOARD OF  
FISHERIES

CONFIRMATION ADVANCED

CS FOR HOUSE BILL NO. 61(FIN)

"An Act establishing an exploration and development incentive tax credit for operators and working interest owners directly engaged in the exploration for and development of gas for sale and delivery without reference to volume from a lease or property in the state; and providing for an effective date."

HEARD AND HELD

CS FOR HOUSE BILL NO. 118(RES) am

"An Act relating to the transportation and sale of certain commercially caught fish by an agent of a commercial fishing permit holder and to the sale of fish; and providing for an effective date."

SCHEDULED BUT NOT HEARD

**PREVIOUS ACTION**

HB 61 - No previous action to record.

HB 118 - See Labor and Commerce minutes dated 4/8/03 and 4/15/03.

**WITNESS REGISTER**

Mr. Rupert Andrews  
Juneau, Alaska

**POSITION STATEMENT:** Alaska Board of Fisheries nominee

Representative Mike Chenault  
Alaska State Capitol  
Juneau, AK 99801-1182

**POSITION STATEMENT:** Sponsor of HB 61

Mr. Mark Graber  
Tax Audit Division  
Department of Revenue  
PO Box 110400  
Juneau, AK 99811-0400

**POSITION STATEMENT:** Answered questions about CSHB 61(FIN)

Mr. Chuck Logsdon  
Department of Revenue  
PO Box 110400  
Juneau, AK 99811-0400

**POSITION STATEMENT:** Answered questions about CSHB 61(FIN) and said the Administration takes no position on CSHB 61(FIN)

Mr. Kevin Tabler  
Manager, Land and Govt. Affairs  
Union Oil Company of California (Unocal)  
909 W. 9th Ave  
Anchorage, Alaska 99501

**POSITION STATEMENT:** Supports CSHB 61(FIN)

Mr. John A. Barnes, P.E.  
Alaska Business Unit Manager  
Marathon Oil Company  
PO Box 196168  
Anchorage, AK 99519

**POSITION STATEMENT:** Supports CSHB 61(FIN)

#### **ACTION NARRATIVE**

#### **TAPE 03-42, SIDE A**

**CHAIR SCOTT OGAN** called the Senate Resources Standing Committee meeting to order at 3:37 p.m. All members were present except Senator Elton, who was excused.

## CONFIRMATION: BOARD OF FISHERIES

CHAIR OGAN invited Mr. Andrews to come before the committee and asked him why he wanted to serve on the Board of Fisheries.

MR. RUPERT ANDREWS, nominee to the Alaska Board of Fisheries, asked to first read the following statement.

First and foremost, being on the Board of Fisheries, I see that product quality should be improved and enhanced in all commercial fisheries, [that] high recreational resource experience values are preserved and fish stocks are maintained for both subsistence and personal use through what we call the sustained yield principle. Many Alaskans rely on fish and fish products for their nutritional, social, economic and cultural well being. Whether the use is subsistence, personal, commercial or recreational, the responsibility of [indisc.] harvest and allocation to meet all of these needs is the mission of the Board of Fisheries.

For over 40 years, the fish and game department and the Board of Fisheries have penalized the efficient fishermen in the use of efficient technology as tools of management. The world globalization has defined a new competitive economy that Alaskans must recognize to participate and compete with other nations for a share of the world market.

To be a member of the Board of Fisheries is a constant learning process and can be both serious and rewarding at the same time: serious in that allocation decisions impact many Alaskans. There is no other state in the Union that has an equal democratic system for fisheries resource use and allocation as Alaska. We have 82 advisory committees in the state. It is this system that requires large time segments for board members, user publics, and the professional staff to satisfy human needs along with the needs of other wildlife species that rely on fish stocks.

I've had a lifetime career in Alaska's fisheries, both as a biologist, an administrator, and I concur with the concept of orderly and wise management practices, most importantly, prudent application where these animals live and they reproduce. Public renewable

resources, by their very nature, evoke political rhetoric over allocation - who gets what and how much. There are no simple answers to difficult allocation questions but there are rules - in other words to be fair to all concerned, to gather and use the best information available, and be guided by sound judgment values.

My commitment to you, members of the Senate Resources Committee, the Administration, and all Alaskans, includes my promise to listen carefully and respectfully to all members of the public before making a decision. To the best of my ability, my decisions will always be based on sound science, a need for conservation and sustained yield management. Once these concerns have been addressed, I will certainly do my best to make fair allocation decisions that are in the best interest of the State of Alaska. That completes my statement, Mr. Chairman.

SENATOR LINCOLN asked Mr. Andrews what he views as the Board's role in carrying out the state's mandate for a subsistence priority.

MR. ANDREWS said that answer is easy: the Board must follow Alaska statutes and the Alaska Constitution.

SENATOR LINCOLN asked Mr. Andrews if he supports a constitutional amendment for rural subsistence and said the choice to answer the question is his.

MR. ANDREWS said he certainly supports the public's right to vote on a constitutional referendum, which it has done several times.

SENATOR LINCOLN noted that Mr. Andrews, when he spoke about allocation decisions, said he would use the best information available and sound science. She maintained that sometimes the best information is not available and that the Board must often "dig" for it. She asked him to describe what he means by "sound science."

MR. ANDREWS said the brief answer is that sound science consists of those principles of investigation: analysis [and] research. He said it is true that the Board does not have all of the information and must rely on the best information it has. He said the business of fisheries management is not an exact

science. He attended the very first Board of Fisheries meeting in November 1959 and has watched the Board and its responsibilities grow and change. When he started with the State of Alaska in 1959, there were no geoduck or sea urchin fisheries. The fisheries problems have grown and become international in scope so the Board is now guided in part by international treaties, such as the Pacific Salmon Treaty. The fisheries issue is a complex and time consuming one and a learning process. He said he feels honored to be appointed by Governor Murkowski and he sees serving on the Board as the best way to culminate his fisheries career. He noted, regarding improvement of Alaska's marketing position, Alaska has an advantage. Alaska fish are wild and come from a pristine environment. He said when the Copper River sockeye hit Seattle every summer, banners go up in all of the stores in the city. He said that is the kind of marketing effort he envisions doing more of.

CHAIR OGAN asked Mr. Andrews if he was the director of the Division of Sport Fish in the Alaska Department of Fish and Game (ADF&G).

MR. ANDREWS said yes, for the last 13 years of his service.

CHAIR OGAN noted that Mr. Andrews attended a symposium on rainbow trout in Yellowstone and asked his opinion of a subsistence fishery for rainbow trout. He pointed out the federal subsistence board recently created one.

MR. ANDREWS said, speaking as a biologist, he believes it is a bad idea, particularly westward, where rainbow trout are 8 to 12 years old. That is the reproduction and replacement time for that species and there are not that many of them. They are vulnerable to gillnets. He said they are too valuable to be caught only once. He said in his view, subsistence should be focused on stocks of large numbers because subsistence has been an opportunistic situation since long before statehood. The subsistence salmon fin fisheries have been for the high population fisheries.

CHAIR OGAN said he has heard from a number of people about that issue. He also has some concerns about the federal subsistence board's decision. He asked if rainbow trout can live up to 20 years.

MR. ANDREWS said he has never seen a scale that goes up to 20 years but he has seen scales up to 12 years.

SENATOR WAGONER indicated the federal [subsistence board] has just announced a subsistence halibut fishery that allows a catch of 20 fish per day. He said commercial fishermen don't often catch that many. That decision is starting to worry him quite a bit because if the state does not get a handle on subsistence and the federal management of our fisheries, we'll be looking at an allowable subsistence catch of 150 red salmon per day. He asked Mr. Andrews what actions the Board can take to address this problem and help bring it to closure.

MR. ANDREWS said Alaska law makes for legal uses of fisheries, subsistence being a priority. Personal use has no priority. The Board must follow the law in this case.

SENATOR WAGONER said in this case, the federal government made the decision, not the Alaska Board of Fisheries.

MR. ANDREWS said there are subsistence statutes governing state lands and state waters. He believes the Board of Fisheries needs to do a lot more with its federal counterparts to get a better management perspective and rationalization. He said, as an example, the federal subsistence board allows subsistence trout fishing in the standing waters and lakes in the Tongass National Forest by hook and line. For 40 years, that was the Alaska statutory definition of sport fishing. Therefore, for enforcement purposes, it will be hard to tell who is subsistence fishing and who is sport fishing, creating a serious enforcement problem. He said prior to the passage of ANILCA, subsistence fishing was always done with the most efficient gear - gillnets, traps, or spears.

CHAIR OGAN said he agrees the state and federal boards need to talk more and he hopes Mr. Andrews spearheads that effort.

SENATOR LINCOLN commented that the solution to the subsistence issue is in the legislature's court.

SENATOR SEEKINS asked Mr. Andrews what criteria the Board of Fisheries used in overturning the customary and traditional (C&T) designation for the Chitina dipnet fishery and whether Mr. Andrews agreed with that finding.

MR. ANDREWS said the vote to overturn the C&T designation was 4 to 3. He was one of the three who voted against the change. He said the rationale behind the vote was that the Attorney General advised the Board there had to have been an error in the legal

handling of the 1999 decision. The Attorney General felt there was no error. The Attorney General also said that in applying the eight criteria, the Board needed to raise the bar when changing a subsistence fishery to a personal use fishery. The Board would actually be downgrading that fishery because subsistence has priority. The other criterion used was whether new information was available. He said he listened to Dr. Hall's report and did not believe there was any additional information that warranted a change. He is aware the Chitina fishery is an important one to a large number of people, particularly in the Interior where residents do not have the same opportunities to get salmon as coastal residents. He said the public owns the resource and the people in Fairbanks and the Interior need the opportunity to obtain the resources. He subscribes to the notion that the best place for an Alaskan salmon is on an Alaskan dinner table.

SENATOR SEEKINS said people are now limited to one king salmon per family from the Copper River while the commercial fishery shipped out a record tonnage of commercially caught king salmon. He asked, in terms of allocation, whether that is an issue the Board of Fisheries needs to address.

MR. ANDREWS said it is. The Board is on a three-year cycle and the allocation issue should be coming up within the next two years.

SENATOR SEEKINS said he is pleased to see that Mr. Andrews would not abrogate the people's right to vote on any kind of a constitutional amendment. He said he believes Alaskans have the right to vote on any properly introduced constitutional amendment and he would find it hard to vote for anyone who does not support that constitutionally guaranteed provision.

SENATOR SEEKINS then noted that Mr. Andrews said Alaska law places subsistence use as the highest priority and says the state cannot discriminate against a subsistence user based on where he or she lives. He asked, "I'm wondering where you put, in terms of priority then, personal use versus commercial use in harmony with the Constitution."

MR. ANDREWS replied, "Mr. Chairman, I don't think you want to go there on that one - in other words priority one, priority two, priority three."

SENATOR SEEKINS said that many people tell him they want to feed their family and question whether there should be a higher priority for personal use than fish sold in the market.

MR. ANDREWS commented that he thinks allocation decisions are made between commercial and recreational fisheries based on the ability to harvest. 140 million salmon are harvested in the state each year; the recreational fisheries do not have that capacity. It is in the best interest of the state to give the commercial fisheries some priority.

SENATOR SEEKINS said he views a recreational fishery as a catch and release fishery. He is referring to the personal use fishery - providing for one's family. He said the line between that and subsistence is vague at times.

MR. ANDREWS told members that about 25 years ago, an Inupiat man sat on the Board of Fish and Game when a proposal on catch and release was put forward. He said Inupiats release fish that are too small to eat; that was his idea of catch and release.

CHAIR OGAN thanked Mr. Andrews for his time.

SENATOR WAGONER moved to forward Mr. Andrews' name to the full body for a confirmation vote.

CHAIR OGAN announced that without objection, the motion carried. He then called an at-ease and, upon reconvening, announced the committee would take up HB 61.

**CSHB 61(FIN)-OIL & GAS TAX CREDIT FOR EXPLORATION/DEV**

REPRESENTATIVE MIKE CHENAULT, sponsor of HB 61, told members this legislation creates a new income tax credit to encourage increased exploration and development for natural gas reserves south of the Brooks Range. He explained that to qualify for the credit, operators must successfully drill and develop new reserves and produce natural gas for sale and delivery. He described HB 61 as a "successful efforts" bill, meaning that no credits will be given for dry holes or for wells that are capped. He said the Cook Inlet and other areas in Alaska have great potential but face high development costs and exploration risk. By providing the credit for the successful efforts, more exploration will occur, leading to much needed new natural gas reserves. This will benefit the residents and businesses at no direct cost to the state. Increased drilling will also aid the general economic status of areas such as the Kenai Peninsula,

and Anchorage. In his opinion, the increased tax revenue from additional gas production will more than offset any fiscal impact from the proposed credit.

SENATOR SEEKINS referred to Version S and noted the definition of a binding payment agreement on line 5. He asked whether that is essentially an IOU.

MR. MARK GRABER, Department of Revenue (DOR), said he interprets a binding payment agreement to mean a contract for a future purchase.

SENATOR SEEKINS asked if DOR would consider a contract for a future purchase as an expenditure in the exploration of natural gas.

MR. CHUCK LOGSDON, DOR, said the binding agreement would be a contractual obligation to make a payment.

CHAIR OGAN asked if there would have to be a contracted expenditure for developing that particular field.

MR. LOGSDON said, "Yes, exactly."

SENATOR BEN STEVENS noted the bill refers to expenditures under (a)(1) [page 2, line 5], in the amount of 10 percent of the taxpayer's qualified capital investments; cash expenditures of binding payment agreements. He said he would interpret that to be a binding payment agreement, which would be, for example, the interest on a 10-year note for \$10 million that an investor borrowed, or the cost of borrowing capital.

SENATOR SEEKINS said he understands that but he could read this to say that before he went into production, during the time frame when he could use the capital expenditures to get a 10 percent tax credit, if he were to have a binding payment agreement down the line, he could ask for a 10 percent tax credit on expenditures he had not yet made. He questioned whether that was the intent.

SENATOR BEN STEVENS said he interprets that clause to say 10 percent of the total investments can be applied to the tax credit. Therefore, the total investment would be some cash plus borrowed money. The tax credit does not come into effect until that investment begins to produce revenue. In other words, the cost of borrowing capital is included in the investment cost because one can forecast what the total payments will be for the

investment. He said he understands Senator Seekins' point that the company will be taking a credit on something it has not yet paid, but that is the cost of the investment.

SENATOR SEEKINS said he would consider it to be the cost of the investment up until the point that a well began producing. However, if the money borrowed also included the cost of something for the development after the well began to produce, that is outside the original intent.

SENATOR WAGONER said another point is that a company will have financing for other aspects of the development, not just the well.

CHAIR OGAN asked Mr. Logsdon his interpretation of that language on page 2, line 1, regarding future contracts.

MR. LOGSDON responded, "I think the discussion that preceded - there's something different than a cash expenditure, the intent is to cover the cost of acquiring the assets that allow the development of the gas field."

MR. KEVIN TABLER, manager of Union Oil Company, thanked members for considering this legislation and informed them that the qualified capital investments are listed in (i)(1) on page 3, line 23. He then gave the following testimony.

Although [Union Oil] recognizes this bill may improve the economics of marginal oil reservoirs discovered or defined while exploring for gas, it is the identification and development of new gas reserves in Cook Inlet which are desperately needed if we're going to sustain our local economy in Southcentral Alaska. Without new gas reserves, value-added businesses and industrial exporters will suffer cutbacks in production, yielding to the ever-present Southcentral utility needs. These disruptions and supplies, left unchecked, will lead to a lower tax base, unemployment, underemployment and loss of the monetary cycling effect as dollars change hands throughout the community.

I place an emphasis on Cook Inlet as Cook Inlet is where Unocal's infrastructure base and manpower is best [indisc.] Although we do have working interests in fields on the North Slope, our ownership interest there is such that we have a minor role in the

exploration and development of the operation of those fields. While we recognize that incentives available to North Slope explorers and producers will have a beneficial impact on Unocal, the beneficial impact of incentive legislation in Cook Inlet is magnified when applied to the marginal nature of the mature fields and the declining gas reserve base in Cook Inlet. For this reason, incentive legislation such as HB 61 will help achieve that desired effect of identifying new gas reserves by providing a predictable and quantifiable credit to help lessen the inherent risk of costly exploration. The increased tax revenue from additional hydrocarbon production will more than offset the initial financial impact from the tax credit. The objective is not to shift the larger share of the existing pie to industry; rather the objective is to increase the size of the pie for everyone.

Unocal's considerable stake in its Cook Inlet infrastructure, manpower, and capital investments is continually threatened by internal global competition for investment dollars. Evidence of this vulnerability is confirmed by the recent drilling of three dry holes on the Kenai Peninsula by Unocal in an effort to meet the growing demand of the natural gas market. Although we were rewarded by a discovery in our Ninilchik unit with our partner, Marathon, an uncertainty of success has reduced our capital budget from \$75 million last year down to \$35 million in 2003. Providing us credits for successful efforts will definitely improve the attractiveness of our Alaskan exploration projects.

Not only will HB 61 create an incentive for companies currently active in gas exploration in Cook Inlet, the attractiveness of such credit will act as an industry incentive to those thinking of investing in exploration south of the Brooks Range. If you think of the credit as costing the state \$1 for every \$10 invested by someone else and paid out only in a success scenario, the risk to the State of Alaska is negligible when compared with the ancillary benefits of new reserve identification.

In conclusion, Unocal believes this bill will add certain attractive parameters to the companies during the investment decision-making process with very little exposure to the State of Alaska. Therefore, we

encourage your passage of this bill out of your committee. Thank you for the opportunity to speak and, if I can, I will answer any questions you may ask.

CHAIR OGAN noted that members had no questions. He then continued taking testimony.

MR. JOHN BARNES, production manager of Marathon Oil Company's Alaskan operations, thanked members for the time they spent earlier with him discussing the bill. He clarified that Marathon's view of the definition of binding payment agreements is that they could include two types of situations. The first would be for progress payments for a major facility installation, which often extend beyond the date of initial production. He pointed out that one of the changes to the bill made by a previous committee was on page 2, line 8. The provision "through the date the reserves produce gas for sale and delivery;" is a trigger point in the bill. If a company had a binding progress that came up after the initial gas, the intent was to include that cost. Also, if a small operator is unable to self-finance a project and seeks financing elsewhere, the bill recognizes the payment scheme. He then gave a Powerpoint presentation, the highlights of which follow.

- Marathon believes HB 61 will draw more exploration and production investments to the State of Alaska. The primary focus is on the Cook Inlet, but it would apply to other Alaska sedimentary basins that are south of the Brooks Range. The focus is on natural gas for which there is competition for funds on an international basis. The intent is to tilt the playing field toward Alaska's direction.
- HB 61 applies to 10 percent of qualified capital investment and 10 percent of qualified expenses. Looking at a timeline, a producer must explore and find gas, develop it, and put it in initial production - four significant hurdles. The producer cannot apply for the credit until all four hurdles have been overcome. This incentive can be factored into project economics. When a company is looking at investment opportunities, HB 61 lays out a tax credit, allowing a company to see in black and white the cost of doing business in Alaska.

**TAPE 03-42, SIDE B**

SENATOR LINCOLN interrupted to note that Marathon Oil describes HB 61 as only applying to successful efforts and asked how it defines "successful." She then asked what would happen if a

discovery ends up being very small and would not otherwise be economical to get to market.

MR. BARNES said the tax credit does not apply until the gas is brought to market so, while a company can accumulate the costs of the funds expended up to the point of first production, if the gas does not go to market, the state will not be impacted at all. He said "successful efforts" is defined as at the point at which gas is produced into the marketplace.

SENATOR LINCOLN asked if the quantity does not matter, the only thing that does matter is getting the gas to market.

MR. BARNES said the presumption would be that a company would not invest in a non-economic project. The risk on capital is much higher than the 10 percent credit. A company would make incremental decisions during each step of the exploration development process, based on the belief it will have a successful project. If, at some point, the project looks like an unsound return, the company will most likely decide not to proceed.

CHAIR OGAN asked if a company drilled four wells off of one platform and only found gas in one of the wells, whether the company could take the investment credit for the four wells.

MR. BARNES said the intent is to find new gas so if the platform was a new installation, the entire cost cycle would be subject to the tax credit for funds spent until first production. If the well was a new discovery from an existing facility, credit would only be given for the cost of that well.

CHAIR OGAN asked about workovers.

MR. BARNES said workovers are unlikely to be new reserves.

SENATOR DYSON asked if 10 wells are drilled from a jack-up rig and one well produces commercial quality gas, whether a company would get credit for the other nine.

MR. BARNES said that most often in offshore production, a company does a significant amount of forward spend prior to first production, the reason being that a company wants to come on production at the highest rate possible. At the same time, a company is making efforts to accelerate production. As written, HB 61 would include all expenditures up until the point of first production. Therefore, if a company drilled three wells before

it put in an offshore pipeline, then the credit would include all of those expenditures. He said although the state would spend 10 percent, the company would be spending 90 percent.

SENATOR DYSON asked if that would include the wells that don't produce.

MR. BARNES said he does not believe so.

SENATOR DYSON said Mr. Barnes could get back to him with a definitive answer later. He asked, if Mr. Barnes determines the state will not give credit for the non-producing wells, whether the cost of the jack-up rate would be prorated.

MR. BARNES said that is probably an unlikely event because a jack-up will come in and drill the exploration well and leave. The company would then put a facility on the property for full development. A jack-up typically drills one or two wells on a structure to explore and delineate so those would be included. He stated:

This is probably a policy decision that would basically say if you drill a top [indisc.] structure well and you find something and you drill down below and you don't, a company would see that as the cost of development. The State of Alaska might not. I think, after looking at it, I guess I struggle - I think it's an interpretive issue right now. I don't know that it's clearly defined in here.

SENATOR DYSON said the intent of HB 61 is to give credit for expenditures that lead to production.

MR. BARNES agreed.

SENATOR DYSON stated, "If I may, and this is back to Senator Lincoln, I think what she was getting at, the intention is here that you get credit for expenditures that lead to production."

MR. BARNES said that is correct.

SENATOR DYSON continued:

I want it on the record that it is my understanding of what you said that all expenditures that don't lead to production, you would not get a tax credit for and if we ended up with an interpretation here or a court

case in the future, that certainly would be the basis on which I'm going to vote for your bill.

MR. BARNES asked to clarify and stated:

Just trying to scan through my recollection of this bill and then answer the questions as they come up - in actuality, on page 3 of [CSHB 61(FIN)- Version S] that you should have in front of you, line 25 through about 27 probably aligns with Senator Dyson's comment that it says, 'for real property or tangible personal property used in this state in the exploration and development of gas reserves in a gas reservoir....' So, 'and development' would imply that it's probably only the successful wells so I would imagine that - and again perhaps the Department of Revenue might comment but if I were in their shoes those would be comments - would line up with your words, so maybe it's not so silent.

SENATOR LINCOLN said she reads that language to mean a company would receive the tax credit on the total tax liability in the state, regardless of how small the producing gas is. She asked for verification or clarification.

MR. GRABER, DOR, explained that the Alaska corporate net income tax is not calculated on a field or reservoir basis so the credit would apply to a corporation's overall Alaska tax liability. He said that DOR could not apply it [to a field] even if it wanted to because a corporation's net income liability in Alaska is based on a percentage of its profits from its worldwide operations.

CHAIR OGAN referred to the list of write-offs on page 4, and asked if those items must be new or whether it applies to existing items.

MR. GRABER said his understanding, according to the language on page 2, line 7, is that the credit applies to new assets first placed in service in Alaska.

MR. BARNES continued his presentation.

- HB 61 is needed because Alaska does not have much exploration and production activity compared to other areas in the world. Natural gas reserves in the Cook Inlet are continuing to decline. He referred to a chart of Cook Inlet

proven gas reserves for the last 13 years from the Department of Natural Resources (DNR) and said that proven reserves are defined as those reserves in the ground that have the highest confidence with enough supporting data to book those reserves through the Securities and Exchange Commission. In 1990, there was about 3500 bcf of gas in the Cook Inlet basin. From 1995 to 1997, the reserves increased but only due to a recalculation based on data on performance on existing reservoirs. After that recalculation was done, the reserves continued to decline to 2000 bcf last year.

- Deliverability is the rate at which gas can be produced. A chart on slide 7 compares supply and demand for the Cook Inlet gas production. In 1997, Cook Inlet could produce about 900 mcf per day - a world-class volume. By 2003, production declined to 663 mcf per day. The demand is just over 800 mcf per day so there is now a shortfall.
- Supply and demand rationalization is occurring due to the fact there is not enough gas to feed the low price consumer. The gas price is increasing, which has caused further issues with industrial consumers.

SENATOR DYSON asked for the definition of WACOG.

MR. BARNES explained WACOG is an acronym for the weighted average cost of gas. That is the average price that Enstar pays to purchase gas from producers. Right now, the WACOG is about \$2.55 per mcf. The Henry Hub price is a mark-up price for the Lower 48 gas markets. That price fluctuates; recently it was \$9.00 per mcf. He said that Enstar has contracted to purchase gas with a floor of \$2.75 with an upside price of a rolling average. He assumes other contracts will reflect that same price regime.

SENATOR DYSON asked if some customers were unable to get gas in 2003 because of the shortfall.

MR. BARNES said in 2003 there were industrial curtailments. The average consumer comes first and then there is a hierarchy based on price and contracts for utilities.

SENATOR DYSON asked who did not get gas.

MR. BARNES replied, "Agrium."

CHAIR OGAN asked if LNG is tied to the Henry Hub.

MR. BARNES replied:

LNG is tied to a landed price in Japan. There's a contract there. And then there's the State of Alaska royalty formula that calculates the netback for which royalties are paid. So the LNG does fluctuate based on a world market price scenario - not Henry Hub though.

CHAIR OGAN asked if the rough split of who gets what gas is about one-third LNG, one-third Agrium, and one-third consumer.

MR. BARNES said that is a rough approximation.

CHAIR OGAN asked if the consumer price is about \$2.55 and everyone else's price is lower.

MR. BARNES said that is correct and is a function of legacy contracts. He explained the Cook Inlet has a family of contracts in place. When there was an oversupply of gas 20 years ago, gas was signed for long-term commitments at very low prices. The industrials, Enstar and Chugach Electric signed some contracts. Supply and demand has shifted. There is a contract opening and Enstar has an unmet requirement that was not previously contracted. They are signing incremental contracts and, reflective of price conditions, new contracts are at higher prices.

SENATOR LINCOLN referred to the supply and demand chart and commented that she expected to see a fluctuation in demand during the time period from 1997 to 2003. She asked why demand remained consistent over six years.

MR. BARNES said that represents the peak requirement that occurs on the coldest day of the year. That is when Enstar, Chugach Electric and the industrials take their maximum daily requirements. He said there has been a small amount of growth in the Anchorage economy. Enstar typically forecasts about 1 to 2 percent growth per year. The average demand is going up but it peaks seasonally so the total requirement on the graph represents what happened on the coldest day of the year.

CHAIR OGAN noted other areas of the country warehouse gas to meet peak demands but no one is doing that in Alaska.

MR. BARNES said no one currently has gas storage available, although that possibility has been discussed.

He then continued with his presentation.

- The current proven reserves in Cook Inlet are 2000 bcf, with a 10-year production life that will decline over time. Market forces will affect rate declines but, on an absolute basis, the production life is typically represented as 10 years. Various government entities and private groups have estimated the probable reserves at 1050 bcf and the possible reserves at 2100 bcf. The chance of finding probable reserves is less than 50 percent; the chance of finding possible reserves is less than 10 or 20 percent. Therefore, a potential opportunity of 3150 bcf exists.

CHAIR OGAN asked who provided those figures.

MR. BARNES said the Potential Gas Committee, an industry group, provided the numbers. That committee looks at natural gas resources across various basins in the United States; it is funded by private and public dollars. The Minerals Management Service has done other studies. The numbers typically range from 1000 to 3000 bcf. He believes that number excludes non-conventional resources, such as coal bed methane or other alternatives that may be there. He said he does not recall seeing any numbers from DNR.

CHAIR OGAN asked if there are any bookable proven reserves at this point.

MR. BARNES said there are not. He then continued.

- Regarding the impacts of HB 61 on the State of Alaska, it should stimulate Cook Inlet and other basin exploration. It will aid in maintaining the Cook Inlet 200+ bcf/year production, the equivalent of a 13th month of North Slope production. He said the state is proud of North Slope production but should also be proud of Cook Inlet gas production. HB 61 should provide gas for the Cook Inlet utilities, industrials, jobs, royalties, and taxes.
- Marathon believes the fiscal impact to the State of Alaska will be positive. Both fiscal notes show a zero fiscal impact but discuss the difficulty of estimating the outcome of discoveries. Some of the factors that make the positive impact difficult to estimate are the number of developments that will be "incentivized," what new work will happen, how much gas will be discovered, the royalty value, and how much will be spent for exploration and development.

- The table entitled Fiscal Impact to State of Alaska is based on the following assumptions: a varied field size from zero to 500 bcf, development cost of 50 cents per mcf, royalty at 12.5 percent, severance tax at 7.5 percent, ad valorem tax at 2.7 percent, and a gas sales price at \$2.50 per mcf. For example, if an operator were to find a field size of 50 bcf, the operator would spend about \$25 million. The tax credit would amount to \$2.5 million. The gross revenue to the state would be \$125 million. Royalty on a state lease at 12.5 percent would equal \$15.6 million. The severance tax at 7.5 percent would equal \$9.3 million and the ad valorem tax would amount to about \$1 million. The total tax take would equal \$26 million. Therefore, an operator would spend \$25 million to find, develop and sell gas. That operator is eligible for a \$2.5 million credit. The state would ultimately receive \$26 million. Therefore, \$25 million was originally invested in the state and \$26 million is received later.

MR. BARNES said based on his conceptual model, the State of Alaska could receive from \$3 to \$10 of additional revenue for each \$1 of tax credit. The \$3 amount is the lowest amount for a discovery not on state leased property. The state would still receive severance tax and other funds. Marathon believes this credit is needed now. There is not enough exploration in the Cook Inlet right now to meet demand. If the Cook Inlet burns 200 bcf per year at 50 cents per mcf, at least \$100 million per year needs to be consistently spent on natural gas development. A lot of money is spent on offshore oil operations in the Inlet. Other areas of the state would also benefit from exploration and development, for example the Nenana Basin. Finally, new discoveries take about 3 to 5 years to bring gas to market.

MR. BARNES told members that to measure whether HB 61 has been a success, the state should look to see whether lease activity, drilling activity, construction activity and production increased. The credits apply to income tax so they will only apply to companies already in business and paying taxes in the state. He repeated that for every \$1 spent by the state, \$10 will be spent to find and develop new reserves.

CHAIR OGAN asked Mr. Barnes to suggest a timeframe for measuring success.

MR. BARNES said it will take time for industry to react. He said if a company already has a lease, the company will have to do seismic testing. Then it will have to progress the project

through the corporation to get it funded. He said most companies are now multinational; projects are judged against other worldwide investment opportunities. He hoped the state would begin to see early indicators in the next year or two. Some companies are already exploring but not on a high, sustained level. He said he hopes, after three to five years, the state could see increased activity.

CHAIR OGAN said he has considered adding a sunset provision to the bill to require the legislature to review whether the program has been successful.

MR. BARNES said 10 years equals about two to three investment cycles for a company. He said if no activity is occurring after five years, the state might review whether this is the correct incentive to use. Marathon believes a 10-year cycle is best because it takes three years from discovery to first gas, and the lease work, seismic, and permit approvals take a few years. He believes five years would not be long enough.

SENATOR BEN STEVENS said the committee was provided information about collective ownership of various fields in Cook Inlet. He noted that Marathon owns 100 percent of several fields and is a partner in a few multiple and joint ownership fields. He asked how the tax credit would be delineated when multiple owners invest in a field.

MR. BARNES explained that most field productions are not held in limited liability corporations. They operate under a joint operating agreement controlled by the State of Alaska in most cases. In that agreement, ownership is defined by percentage. Funds are invested along those percentages, earnings are made along those percentages and then royalty is paid. In this type of an ownership model, companies would pay taxes individually and invest individually. They know how much money they spent in a field that would qualify.

SENATOR BEN STEVENS asked if that would be part of the component mentioned in subsection (d) on page 2, line 24, which addresses a subscribed form designed by the department. He asked if that form exists now.

MR. LOGSDON said documentation of the joint operating agreement would substantiate the amount of the investment. Whether that would be concluded in the form is something DOR would examine.

SENATOR BEN STEVENS asked if Mr. Logsdon's office would be developing that form.

MR. LOGSDON said it would. DOR will develop this form associated with this tax credit for inclusion with the tax return.

SENATOR BEN STEVENS asked if DOR approves the operating agreements.

MR. LOGSDON said DNR would approve the operating agreements, which would also be subject to the Alaska Oil and Gas Conservation Commission's technical production compliance requirements.

CHAIR OGAN thanked Mr. Barnes. He then asked Mr. Logsdon to brief the committee on DOR's fiscal note.

MR. LOGSDON stated the Administration neither supports nor opposes the bill. DOR prepared a fiscal note because there are some uncertainties. He pointed out that HB 61 is not exactly the same as the federal investment tax credit but it provides a 10 percent credit on qualified capital investment. It also includes qualified services, which are defined in the bill. He said one question that was addressed in the fiscal note is that the corporate income tax liability in the State of Alaska is not specific to an apportioned amount of federal net income. He said the main uncertainty is the number of credits that will be taken and to what extent market forces alone will affect activity. In balancing the two, DOR elected to calculate a zero fiscal note.

CHAIR OGAN cited the last two sentences in the fiscal note, which reads, "A risk to the state is high if gas prices spur development on their own regardless of the tax credit. The state could be in the position of providing a tax credit that is no longer necessary to promote development." He asked if DOR has had an opportunity to review the models provided by Mr. Barnes in which the state would receive \$10 for every \$1 spent.

MR. LOGSDON said he has and that Mr. Barnes' calculations of the potential benefits are correct. His point was that the only real risk, which applies to any tax credit, is that the amount of activity attributed to the incentives might have happened anyway due to market forces.

SENATOR LINCOLN said, in her mind, a neutral position on legislation implies problems with the bill. She asked if the Chair plans to hold the bill in committee.

CHAIR OGAN said he plans to recess to the call of the Chair and let members consider the legislation over night. He asked members to consider placing a sunset provision in the bill based on the department's fiscal note. He said he would rather let the market drive development. He pointed out that artificially low prices on contracts are affecting the Cook Inlet market right now. He believes the Regulatory Commission's action to tie the price to the Henry Hub was helpful.

In response to Senator Lincoln's comment, SENATOR BEN STEVENS said his position is that CSHB 61(FIN) is a major policy call for the legislature to make, not the implementers. He thinks this policy call should be based on whether it will create incentives for investment. To do that, the legislature must weigh the positives and negatives of the incentive. It will provide a 10 percent credit against the investment cost only to an investment that will generate revenue. Therefore, the positive of the incentive is that it creates a royalty stream, a severance tax, and additional property tax. The incentive will only be provided if a company produces revenue.

**TAPE 03-43, SIDE A**

SENATOR BEN STEVENS said he strongly supports movement of the bill. He views the fiscal note as indeterminate on the up side.

CHAIR OGAN said he too supports investment tax credits. He decided to expand his own business based on a federal tax credit. He supports this legislation and would like to see it pass as soon as possible. He then recessed the meeting to the call of the Chair at 5:17 p.m.