

CS FOR HOUSE BILL NO. 71(FIN) am

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - FIRST SESSION

BY THE HOUSE FINANCE COMMITTEE

Amended: 4/28/05

Offered: 4/18/05

Sponsor(s): HOUSE RULES COMMITTEE BY REQUEST OF THE GOVERNOR

A BILL

FOR AN ACT ENTITLED

1 **"An Act providing standards for the interpretation of certain terms in state oil and gas**
2 **leases and unit agreements, requiring development, production, processing, and**
3 **marketing of gas that is determined to meet those standards, and setting a maximum**
4 **time limit on that activity; extending and amending the requirements applicable to the**
5 **credit that may be claimed for certain oil and gas exploration expenses incurred in Cook**
6 **Inlet against oil and gas properties production (severance) taxes, and amending the**
7 **credit against those taxes for certain exploration expenditures from leases or properties**
8 **in the state; and providing for an effective date."**

9 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

10 * **Section 1.** The uncodified law of the State of Alaska is amended by adding a new section
11 to read:

12 LEGISLATIVE FINDINGS REGARDING AMENDMENT OF AS 38.05.180. The

1 legislature finds that

2 (1) oil and gas leases issued by the state grant to the lessee certain
3 rights in state land and resources for the purposes of exploration, development,
4 production, processing, and marketing oil and gas from state land;

5 (2) those oil and gas leases require the reasonable development of state
6 land for oil and gas as the facts may justify;

7 (3) those oil and gas leases further mandate reasonable diligence in
8 producing oil and gas from state land;

9 (4) those leases also obligate the lessee to act with due regard for the
10 interests of not only the lessee but also the state as lessor;

11 (5) many of those leases have been extended beyond their primary
12 terms by commitment to an oil and gas unit agreement;

13 (6) unit agreements may vary from unit to unit and so do not contain
14 uniform language but generally reinforce the obligations of lessees to timely develop
15 oil and gas resources and to act to protect not only their own interests but also the
16 interests of the state as lessor;

17 (7) unit agreements also require that lessees periodically file their
18 proposed plans for future development of a unit and allow the state, as lessor, to
19 determine the rate of development of the unit and rate and quantity of production from
20 the unit in acting on proposed plans or otherwise;

21 (8) oil and gas leases are interpreted by courts sitting in oil-and-gas-
22 producing states to require that lessees develop and market oil and gas when those
23 lessees could do so for a reasonable profit;

24 (9) the executive branch of state government, under the authority of
25 AS 43.82 (Alaska Stranded Gas Development Act) and with the assistance of outside
26 experts, consultants, and counsel, has developed a sophisticated model that forecasts
27 future gas prices based on the best information currently available to the state;

28 (10) that model incorporates the costs estimated by the state's largest
29 oil and gas producers and others for the construction of an Alaska natural gas pipeline
30 and for upstream facilities required to produce and treat natural gas from the Prudhoe
31 Bay and Point Thomson Units for transportation through an Alaska natural gas

1 pipeline to markets inside and outside the state;

2 (11) the model calculates estimated rates of return on capital invested
3 for the total project, and for separate elements of the project, such as production from
4 the Prudhoe Bay Unit, production from the Point Thomson Unit, and the pipeline
5 itself;

6 (12) the model calculates estimated rates of return on capital invested
7 under a wide range of future gas prices, including a price considered a stress gas price,
8 the mean estimated gas price, and prices considered to have as low as a 10 percent
9 probability and as high as a 90 percent probability;

10 (13) rates of return from the model can be compared to various
11 measures of profitability, including, without limitation, rates of return historically
12 allowed by the Federal Energy Regulatory Commission on gas pipelines, the cost of
13 capital, rates of return on shareholder equity and capital employed for natural gas
14 pipeline companies, and rates of return on shareholder equity and capital employed for
15 oil and gas companies;

16 (14) the oil and gas resources of the state are to be developed for the
17 maximum benefit of the people of the state; and

18 (15) the state's best interests require the earliest reasonable date for
19 construction of an Alaska natural gas pipeline on terms that are both in the best
20 interests of the state and estimated to be reasonably profitable to the state's oil and gas
21 lessees.

22 * **Sec. 2.** AS 38.05.180 is amended by adding a new subsection to read:

23 (hh) The provisions of this subsection clarify and interpret the obligations of
24 an oil and gas lessee or unit operator where an explicit or implied term of a state oil
25 and gas lease or unit agreement requires the development, production, processing, or
26 marketing of gas meeting economic standards such as "reasonable profit,"
27 "economically recoverable," "reasonable development as the facts may justify,"
28 "reasonable diligence," "covenant to develop as a reasonably prudent operator in a
29 reasonably prudent manner," "good and diligent oil and gas production practices,"
30 "economically feasible," or "having due regard for the interests of lessor as well as the
31 interests of lessee." If the terms of the lease or unit agreement so provide,

1 (1) the standards shall be interpreted to require, at a minimum,
 2 development, production, processing, and marketing of gas from the lease or unit area
 3 as part of a project placing gas into one or more commercial markets if the
 4 commissioner determines, after review of relevant information then available to and in
 5 the possession of the department, that the estimated revenue from the project, based on
 6 the department's mean gas price forecast for that project, minus the currently estimated
 7 new costs of that project, appears sufficient to allow for a rate of return on new capital
 8 invested

9 (A) in the portions of the project regulated as to tariffs by either
 10 the Federal Energy Regulatory Commission or the Regulatory Commission of
 11 Alaska; the rate of return allowed under this subparagraph must be equal to or
 12 greater than the department's estimate of the rate of return that would be
 13 approved by the governing regulatory body; and

14 (B) in the portions of the project that are not subject to tariff
 15 regulation; the rate of return allowed under this subparagraph must be equal to
 16 or greater than the most recent 10-year simple average of overall company
 17 returns on capital employed for a sample group of oil and gas companies; in
 18 this subparagraph, the sample group of oil and gas companies may include,
 19 without limitation and subject to the availability of publicly reported
 20 information, the four largest international petroleum companies and the parent
 21 companies of the three largest petroleum companies operating in the state;

22 (2) whenever the commissioner determines that development,
 23 production, processing, or marketing of gas is required from a lease or unit area, the
 24 lessee or unit operator shall develop, produce, process, or market the gas, as
 25 determined by the commissioner, from the lease or unit area by a date determined by
 26 the commissioner, but in no event may that compliance date be later than seven years
 27 after the commissioner's initial determination; if a lessee or unit operator fails to
 28 comply with the commissioner's order, approval, decision, or determination, the
 29 remedies for the failure shall be as provided for in the controlling lease, unit
 30 agreement, other agreement, or operative document, or as provided by law.

31 * **Sec. 3.** AS 43.55.025(a) is amended to read:

1 (a) Subject to the terms and conditions of this section, on oil and gas produced
 2 **on or after July 1, 2004**, from an oil and gas lease, or on gas produced from a gas
 3 only lease, [ON OR AFTER JULY 1, 2004,] a credit against the **production** tax due
 4 under this chapter is allowed **for exploration expenditures that qualify under (b) of**
 5 **this section** in an amount equal to **one of the following**:

6 (1) 20 percent of the total exploration expenditures that qualify **only**
 7 under (b) and (c) of this section;

8 **(2)** [,] 20 percent of the total exploration expenditures that qualify **only**
 9 under (b) and (d) of this section [, OR BOTH, FOR A TOTAL CREDIT THAT DOES
 10 NOT EXCEED 40 PERCENT OF THE TOTAL EXPLORATION
 11 EXPENDITURES];

12 **(3) 40 percent of the total exploration expenditures that qualify**
 13 **under (b), (c), and (d) of this section**; or

14 **(4)** [(2)] 40 percent of the total exploration expenditures that qualify
 15 **only** under (b) and (e) of this section [, FOR A TOTAL PRODUCTION TAX
 16 CREDIT THAT DOES NOT EXCEED 40 PERCENT OF THE TOTAL QUALIFIED
 17 EXPLORATION EXPENDITURES].

18 * **Sec. 4.** AS 43.55.025(b) is amended to read:

19 (b) To qualify for the production tax credit under (a) of this section, an
 20 exploration expenditure must be incurred for work performed on or after July 1, 2003,
 21 and before July 1, 2007, **except that an exploration expenditure for a Cook Inlet**
 22 **prospect must be incurred for work performed on or after July 1, 2005, and**
 23 **before July 1, 2010, and except that an exploration expenditure, in whole or in**
 24 **part, south of 68 degrees, 15 minutes, North latitude, and not part of a Cook Inlet**
 25 **prospect must be incurred for work performed on or after July 1, 2003, and**
 26 **before July 1, 2010**, and

27 (1) may be for seismic or geophysical exploration costs not connected
 28 with a specific well;

29 (2) if for an exploration well,

30 (A) must be incurred by an explorer that holds an interest in the
 31 exploration well for which the production tax credit is claimed;

1 (B) may be for either an oil or gas discovery well or a dry hole;
2 and

3 (C) must be for goods, services, or rentals of personal property
4 reasonably required for the surface preparation, drilling, casing, cementing,
5 and logging of an exploration well, and, in the case of a dry hole, for the
6 expenses required for abandonment if the well is abandoned within 18 months
7 after the date the well was spudded;

8 (3) may not be for testing, stimulation, or completion costs;
9 administration, supervision, engineering, or lease operating costs; geological or
10 management costs; community relations or environmental costs; bonuses, taxes, or
11 other payments to governments related to the well; or other costs that are generally
12 recognized as indirect costs or financing costs; and

13 (4) may not be incurred for an exploration well or seismic exploration
14 that is included in a plan of exploration or a plan of development for any unit on
15 May 13, 2003.

16 * **Sec. 5.** AS 43.55.025(c) is amended to read:

17 (c) To be eligible for **the** [A] 20 percent production tax credit **authorized by**
18 **(a)(1) of this section or the 40 percent production tax credit authorized by (a)(3)**
19 **of this section**, exploration expenditures must

20 (1) qualify under (b) of this section; and

21 (2) be for an exploration well, **subject to the following:**

22 **(A) for an exploration well other than a well that is**
23 **described in (B) of this paragraph, the well must be** [THAT IS] located and
24 drilled in such a manner that the bottom hole is located not less than three
25 miles away from the bottom hole of a preexisting suspended, completed, or
26 abandoned oil or gas well; in this **subparagraph** [PARAGRAPH],
27 "preexisting" means a well that was spudded more than 150 days but less than
28 35 years before the exploration well was spudded;

29 **(B) for an exploration well that explores a Cook Inlet**
30 **prospect, the well must be located at least three miles from any other well**
31 **drilled for oil and gas with all distances measured as the horizontal**

1 distance between exploration targets, except that the exploration well that
 2 is located within three miles of a well drilled for oil and gas qualifies for
 3 the tax credit authorized by this subsection if the exploration well tests
 4 potential hydrocarbon traps that the commissioner of natural resources
 5 determines, after analyzing evidence submitted by the explorer and from
 6 other information that the commissioner of natural resources determines
 7 relevant, constitute a distinctly separate exploration target.

8 * **Sec. 6.** AS 43.55.025(d) is amended to read:

9 (d) To be eligible for the [AN ADDITIONAL] 20 percent production tax
 10 credit authorized by (a)(2) of this section or the 40 percent production tax credit
 11 authorized by (a)(3) of this section, an exploration expenditure must

12 (1) qualify under (b) of this section; and

13 (2) be for an exploration well that is located not less than 25 miles
 14 outside of the outer boundary, as delineated on July 1, 2003, of any unit that is under a
 15 plan of development, except that for an exploration well for a Cook Inlet prospect
 16 to qualify under this paragraph, the exploration well must be located not less
 17 than 10 miles outside the outer boundary, as delineated on July 1, 2003, of any
 18 unit that is under a plan of development.

19 * **Sec. 7.** AS 43.55.025(e) is amended to read:

20 (e) To be eligible for the 40 percent production tax credit authorized by
 21 (a)(4) [IN (a)] of this section, the exploration expenditure must

22 (1) qualify under (b) of this section;

23 (2) be for seismic exploration; and

24 (3) have been conducted outside the boundaries of a production unit or
 25 an exploration unit; however, the amount of the expenditure that is otherwise eligible
 26 under this subsection is reduced proportionately by the portion of the seismic
 27 exploration activity that crossed into a production unit or an exploration unit.

28 * **Sec. 8.** AS 43.55.025(f) is amended to read:

29 (f) For a production tax credit under this section,

30 (1) an explorer shall, in a form prescribed by the department and
 31 within six months of the completion of the exploration activity, claim the credit and

1 submit information sufficient to demonstrate to the department's satisfaction that the
2 claimed exploration expenditures qualify under this section;

3 (2) an explorer shall agree, in writing,

4 (A) to notify the Department of Natural Resources, within 30
5 days after completion of seismic or geophysical data processing, completion of
6 a well, or filing of a claim for credit, whichever is the latest, for which
7 exploration costs are claimed, of the date of completion and submit a report to
8 that department describing the processing sequence and providing a list of data
9 sets available; **if, under (c)(2)(B) of this section, an explorer submits a**
10 **claim for a credit for expenditures for an exploration well that is located**
11 **within three miles of a well already drilled for oil and gas, in addition to**
12 **the submissions required under (1) of this subsection, the explorer shall**
13 **submit the information necessary for the commissioner of natural**
14 **resources to evaluate the validity of the explorer's claim that the well is**
15 **directed at a distinctly separate exploration target, and the commissioner**
16 **of natural resources shall, upon receipt of all evidence sufficient for the**
17 **commissioner to evaluate the explorer's claim, make that determination**
18 **within 60 days;**

19 (B) to provide to the Department of Natural Resources, within
20 30 days after the date of a request, specific data sets, ancillary data, and reports
21 identified in (A) of this paragraph;

22 (C) that, notwithstanding any provision of AS 38, information
23 provided under this paragraph will be held confidential by the Department of
24 Natural Resources for 10 years following the completion date, at which time
25 that department will release the information after 30 days' public notice;

26 (3) if more than one explorer holds an interest in a well or seismic
27 exploration, each explorer may claim an amount of credit that is proportional to the
28 explorer's cost incurred;

29 (4) the department may exercise the full extent of its powers as though
30 the explorer were a taxpayer under this title, in order to verify that the claimed
31 expenditures are qualified exploration expenditures under this section; and

1 (5) if the department is satisfied that the explorer's claimed
 2 expenditures are qualified under this section, the department shall issue to the explorer
 3 a production tax credit certificate for the amount of credit to be allowed against
 4 production taxes due under this chapter; **however, notwithstanding any other**
 5 **provision of this section, the department may not issue to an explorer a**
 6 **production tax credit certificate if the total of production tax credits submitted**
 7 **for Cook Inlet production, based on exploration expenditures for work**
 8 **performed during the period described in (b) of this section for that production,**
 9 **that have been approved by the department exceeds \$20,000,000.**

10 * **Sec. 9.** AS 43.55.025(k) is amended to read:

11 (k) In this section,

12 **(1) "Cook Inlet production" means oil or gas production from the**
 13 **Cook Inlet sedimentary basin, as that term is defined by regulation adopted to**
 14 **implement AS 38.05.180(f)(4);**

15 **(2) "Cook Inlet prospect" means a location within the Cook Inlet**
 16 **sedimentary basin, as that term is defined by regulation adopted to implement**
 17 **AS 38.05.180(f)(4);**

18 **(3) "explorer" means a person who, in exploring for new oil or gas**
 19 **reserves, incurs expenditures.**

20 * **Sec. 10.** AS 43.55.025 is amended by adding a new subsection to read:

21 (l) The provisions of this section do not apply to the Arctic National Wildlife
 22 Refuge.

23 * **Sec. 11.** This Act takes effect immediately under AS 01.10.070(c).