

HOUSE FINANCE COMMITTEE
April 27, 2006
1:45 P.M.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [1:45:29 PM](#).

MEMBERS PRESENT

Representative Mike Chenault, Co-Chair
Representative Kevin Meyer, Co-Chair
Representative Bill Stoltze, Vice-Chair
Representative Richard Foster
Representative Mike Hawker
Representative Jim Holm
Representative Reggie Joule
Representative Mike Kelly
Representative Beth Kerttula
Representative Carl Moses
Representative Bruce Weyhrauch

MEMBERS ABSENT

None

ALSO PRESENT

Representative Ethan Berkowitz; Representative Kurt Olson; Representative Harry Crawford; Angus Walker, Commercial Vice President, British Petroleum (BP) Alaska; Tom Williams, Senior Tax Counsel, British Petroleum (BP) Alaska; Richard Owen, Alaska Production Manager, Exxon Mobil; Brian Wenzel, Vice President, Finance and Administration, ConocoPhillips, Alaska

SUMMARY

CS SB 305(FIN) am

An Act repealing the oil production tax and the gas production tax and providing for a production tax on oil and gas; relating to the calculation of the gross value at the point of production of oil and gas and to the determination of the value of oil and gas for purposes of the production tax on oil and gas; providing for tax credits against the production tax on oil and gas; relating to the relationship of the production tax on oil and gas to other taxes, to the dates those tax payments and surcharges are due, to interest on overpayments of the tax, and to the treatment of the tax in a producer's settlement with the

royalty owners; relating to flared gas, and to oil and gas used in the operation of a lease or property under the production tax; relating to the prevailing value of oil and gas under the production tax; relating to surcharges on oil; relating to statements or other information required to be filed with or furnished to the Department of Revenue, to the penalty for failure to file certain reports for the tax, to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue as applicable to the administration of the tax; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the tax, and to the deposit of tax money collected by the Department of Revenue; amending the definitions of 'gas,' 'oil,' and certain other terms for purposes of the production tax, and as the definition of the term 'gas' applies in the Alaska Stranded Gas Development Act, and adding further definitions; making conforming amendments; and providing for an effective date.

CS SB 305(FIN) am was HEARD & HELD in Committee for further consideration.

#SB305

CS FOR SENATE BILL NO. 305(FIN) am

An Act repealing the oil production tax and the gas production tax and providing for a production tax on oil and gas; relating to the calculation of the gross value at the point of production of oil and gas and to the determination of the value of oil and gas for purposes of the production tax on oil and gas; providing for tax credits against the production tax on oil and gas; relating to the relationship of the production tax on oil and gas to other taxes, to the dates those tax payments and surcharges are due, to interest on overpayments of the tax, and to the treatment of the tax in a producer's settlement with the royalty owners; relating to flared gas, and to oil and gas used in the operation of a lease or property under the production tax; relating to the prevailing value of oil and gas under the production tax; relating to surcharges on oil; relating to statements or other information required to be filed with or furnished to the Department of Revenue, to the penalty for failure to file certain reports for the tax, to the powers of the Department of Revenue, and to the disclosure of certain information required to be furnished to the Department of Revenue as applicable to the

administration of the tax; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the tax, and to the deposit of tax money collected by the Department of Revenue; amending the definitions of 'gas,' 'oil,' and certain other terms for purposes of the production tax, and as the definition of the term 'gas' applies in the Alaska Stranded Gas Development Act, and adding further definitions; making conforming amendments; and providing for an effective date.

BRITISH PETROLEUM (BP)-ALASKA

[1:47:17 PM](#)

ANGUS WALKER, COMMERCIAL VICE PRESIDENT, BRITISH PETROLEUM (BP)-ALASKA, referenced handouts. (Copy on File). He noted that the Alaska North Slope (ANS) production is declining rapidly, despite current level of investment.

- At the current rate of decline, production could reach about 450,000 barrels per day in 10 years.
- To achieve the Department of Revenue's latest production forecast, investment will need to be significantly higher than the current level.
- The revenue projections provided to the Legislature by the Department & consultants rely upon production forecasts that require more capital than currently is being invested and make no attempt to quantify adverse impacts that increased taxes have on investment.

Mr. Walker pointed out that decline poses a serious risk to Alaska's future making it essential to carefully consider all factors. He encouraged a lower tax rate, which would reduce risk by attracting investment and generating production, revenue, jobs, economic activity and contributions to the Alaska Permanent Fund and sustainable benefits for all Alaskans. Lower tax rates also mean a healthier oil business and stronger foundation to build a gas pipeline.

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Mr. Walker continued, since 1999 both the industry and the Department of Revenue have consistently overestimated production and revised down the production forecasts significantly each year. That is of great concern.

The Alaska North Slope (ANS) production is declining at 6% per year. The development of Alpine, Northstar and Prudhoe Bay Satellites between 2000 and 2002, successfully stemmed North Slope decline for a number of years. However, with Northstar & Alpine on plateau or declining, 2005 saw a return to the 6% decline, which has characterized that area in the past. Unfortunately, there are no more fields of Alpine or Northstar's magnitude waiting to be developed.

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Mr. Walker addressed investment leading to actual production. The decline abatement experienced in about 2000, required investment levels above historical averages. The graph demonstrates cause and effect relationship between investment and production. The graph extrapolates the 6% historical decline to demonstrate what can occur to production if investment remains at current levels. Within ten years, Alaska North Slope (ANS) production will be approximately 450 mbd. The projection assumes investment stays at historic levels and is not adversely affected by increased taxation.

Co-Chair Chenault asked if investment dollars were industry wide. Mr. Walker explained they are the industry total expenditures.

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Mr. Walker pointed out that the latest Department of Revenue 2006 spring forecast is represented by the line above the blue wedge. The wedge represents the difference between the spring forecast and the expected decline at current investment. The cause & effect (investment and production) demonstrated in the 1998 to 2004 timeframe, provides an illustration of why significant investment is required to meet the Department's spring forecast. That future can only be realized if Alaska has a significant investment increase. It would be unrealistic to assume that the tax increases recommended by the current version SB 305, would lead to a significant investment. Unless investments are made, decline will continue at the current rate and the Department will be revising production forecasts down again.

The blue wedge indicates 1.3 billion barrel production over twenty years. At today's prices that represent tens of billions in State revenue lost because oil was left in the ground. It comes before consideration of an economic multiplier effect of the investment, which will create economy for jobs and business.

He commented on maximizing benefits to the people, which can not happen by increasing taxes on the oil industry.

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Mr. Walker stated that it is important to recognize that there is a difference between production forecasts that have been used to demonstrate the mechanics of the Petroleum Production Tax (PPT) tax and Alaska's current reality. The key point is that the Department's low & high volume production scenarios necessitate significant more investment than Alaska is now attracting. The low volume forecast requires at least twice the current level of investment and the high volume scenario, much more. Given that, the industry believes, it is unreasonable to assume that those scenarios represent a future profile in Alaska after a tax increase like the one proposed.

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Mr. Walker stated:

- The decline of North Slope production is the most serious threat to Alaska's future.
- The tax regime approved would directly impact how attractive Alaska is for investment, translating into new investment and a declined profile.
- The highest State revenue is derived from the greatest production not the highest tax and the benefits are maximized when increased investment spurs economic activity, creates jobs, offsets decline and extends the life of Alaska's oil and gas businesses.

The 20 percent Petroleum Production Tax (PPT) would increase the marginal tax rate on Alaskan operations from 56% to about 61%. According to the Department of Revenue that translates to an additional \$1 billion dollars a year revenue at current oil prices. It could swell the State's budget surplus. British Petroleum (BP) has agreed not to oppose the significant oil tax increase as a means of advancing the gas project, which was not an easy concession to make.

Mr. Walker added that an increase in tax would make sense if the future includes a gas pipeline. Without gas production, the increase over time would speed the decline and shorten the economic life of existing North Slope fields. A lower

tax rate reduces risk by attracting more investment and generating more production, revenue, jobs, economic activity, contributions to the Permanent Fund and more sustainable benefits for Alaskans. A lower tax rate would also mean a healthier oil business and stronger foundation on which to build the gas pipeline.

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Mr. Walker referenced Page 6 of handout #2, the key petroleum production tax (PPT) issues & solutions. (Copy on File). Page 6 identifies the eleven key issues of the bill.

- PPT Rate = 20%
- Progressivity = none
- Credit = 25%
- Special Conditions on Credit = none
- Transition (TIE) Credits = last five years, 2 to 1 new investments to old
- Effective Date = July 1st, 2006
- Use of Royalty Netback = Allowed
- "Abandonment" Costs = Already Addressed
- Safe Harbor = 95% due cumulatively during year, delinquent after 3/31 of next year
- Deductable "lease expenditures"= Clarify definitions (AOGA proposal)
- Non-Arm's Length Costs = Addressed

Mr. Walker clarified the most important feature to the industry is the tax rate. Any progressivity would act as a deterrent to Alaskan investment. If progressivity is inevitable, he urged it be based on net revenue rather than gross, which is in the Senate draft.

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Representative Kerttula inquired about a new Senate section, which reduces the taxable amount on gas. With a decline in production, she worried about a reduction in tax money. Mr. Walker replied it is important to look at the entirety of revenue received by the State. Gas typically has a lower tax rate than oil because of the difficulty getting it to market; that is consistent with other markets around the world.

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Representative Kerttula thought with the resulted decline, the State would receive less royalty. Under that scenario, Alaska could end up with "nothing back". Mr. Walker

reiterated that a healthy oil and gas business would serve Alaska well.

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TOM WILLIAMS, SENIOR TAX COUNSEL, BRITISH PETROLEUM (BP)-ALASKA, pointed out in the Senate version, there are special credit conditions, which pass the benefit on to the companies using the facilities. Tax is not part of the fee charged for exploration. The PPT falls on the fact that producing the oil is costly.

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Representative Kerttula asked about costs of building a facility credit and how it would be included in the tariff. Mr. Williams explained that if nothing were being charged for that tax, then a reduction in tax would not make sense. It would hamstring credits for the utility. The credit amount is not known for many years. The Department of Revenue is responsible for auditing and pass-through of credits. It can be loosed.

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Representative Kerttula pointed out that the credits were for costs and that she understood they were charged for in the tariff. Mr. Williams stressed that the facility costs what it costs. The credit reduces the price paid on the oil moving through the facility. The cost of the royalty is not passed on. There might be a credit for investments but that has nothing to do with the cost to build that facility.

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Representative Kerttula stated that the tax was reduced by the credit of the cost of the facility and that benefit should flow through to the customers.

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Mr. Williams claimed that each facility would have some part of their costs disallowed, based on production. The "decision-maker" must have confidence that the credit will exist before the investment is made to be effective.

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Representative Hawker referenced Page 2, suggesting a remedy to deleting certain material. Mr. Williams apologized for that error.

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Mr. Walker identified the importance of transition credits and the 2 for 1 provision, aligned with more investment is a solution that might work.

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Mr. Walker thought an effective retroactive date would be unfair; he urged the earliest tax enforcement implementation date be July 1st, 2006.

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Mr. Williams discussed the use of the royalty netback proposed in each version. He hoped for some guidance & instruction for the Department's calculations.

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Mr. Williams stated that abandonment costs are not an accounting term but rather cash costs incurred. The expenditures must be ordinary and necessary to produce gas & oil. Since those are cash-costs, there would be no issue until abandoned. To make the PPT cost-side work, it must be determined what partners are willing to pay for operating those fields & costs of running the field, different from abandoning the field. The current language is adequate to protect the State against situations where a field has not produced for a long time.

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Representative Kerttula asked about no credit/no reduction - the true abandonment. Mr. Williams responded that the costs of true abandonment remain true costs. Overly broad language creates more problems than it is worth. Abandoning & closing a facility is part of the cost of running business; it would be a legislative policy call. PPT is a cash tax and therefore, should be an allowed deduction to costs incurred for running a business.

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Mr. Williams mentioned the "safe harbor".

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Representative Hawker brought up the issue of an effective date. Mr. Williams asked how complicated would the legislation be made. He thought that the objective was to create a clear and understandable tax. The industry turns in production reports everyday; it takes tremendous effort to compile that information for each time there is an abandonment. It would be difficult for the Department to

determine if the data was correct. Representative Hawker disagreed that was "needlessly complex".

Co-Chair Chenault asked if abandonment costs are paid more than once. Mr. Williams did not think so as it is a cash based tax on cash expenditures. It is an expense.

Co-Chair Chenault asked if the industry returned to an abandoned well in the future, could there then be a second abandonment. Mr. Williams thought there could be similar expenses incurred at different times could be good for the State. Each expenditure is associated with different costs & each time there are required expenditures, it must be recognized.

Co-Chair Chenault submitted it could be claimed in the same-single well. He worried about auditing costs for abandonment. Mr. Williams pointed out that the PPT is less than 100% and costs incurred would be "out of pocket".

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Mr. Williams pointed out the safe harbor comparison. In the current system, the safe harbor is paid tax monthly. If it is not paid, the company can be exposed to interest and penalties for falling short. The problem remains with a budget determination. Coming in under-budget is good business for the State having less deducted costs.

Mr. Williams spoke to the cumulative correctness of the retroactive impulses. It would be easiest to determine true costs at the end of each year, the point at which penalties could be implemented. It follows the federal meeting system month-by-month test.

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Representative Hawker requested a copy of the April 13th letter from the Alaska Oil and Gas Association (AOGA). Mr. Williams agreed.

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Mr. Williams referenced the deductible lease expenditures, indicating concern with ordinary and direct costs. He recommended it be explicit.

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Representative Hawker agreed with the analysis but warned against intermingling "and / or". He asked if the preference would be "direct, ordinary & necessary". Mr. Williams agreed that would work but would be cumbersome. An alternative would be "direct, ordinary, & necessary, which

means direct costs under Subsection D". He stressed that it is important to safeguard the term of "art" for the ordinary and necessary.

Mr. Williams said it could not be tied to any specific location. Additional ambiguity results from language regarding the point of production. There are upstream costs incurred in support of the production and are ultimately field operation costs as proposed by AOGA.

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Mr. Williams addressed No-Arm's Length Costs, encouraging it to be "squeaky clean". An overcharged item is not an ordinary cost and existing language allows that. The Senate version incorporates the Internal Revenue Code (IRC) 482, including overseas costs that are cumbersome. It can take years for the IRS to complete that work. He stated the addition of IRC 482 was "overkill", recommending alternative language for protections of ordinary costs.

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Representative Kerttula questioned if the companies or the Department would be able to establish the validity of such work. Mr. Williams commented that the Department could look at that when no partners are involved.

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Representative Hawker referred to (J) and (K), AS 43.55.160. Mr. Williams advised that the credit sections were derived from the definitions of lease expenditures and are a subset. He thought the citations could be wrong.

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Mr. Walker concluded his testimony regarding the clarity of the PPT structure mechanics. Mr. Williams noted a technical flaw contained in the House Resource Committee version progressivity clause as related to West Texas Intermediate (WTI); he thought that instead the New York Mercantile Exchange quotes should be referenced.

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Co-Chair Meyer pointed out that BP recommends the 20/25 proposal. He asked if that would be adequate to stimulate exploration of heavy oil. Mr. Walker stated they are requesting a lower tax rate and that heavy oil is getting harder to pursue. He noted discovered technology that could make development more economic.

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Representative Holm inquired the logic for the increased investment production indicated on Slide 3. Mr. Walker explained it had resulted from large investments in the Alpine and North Star. Representative Holm asked the incentive for capital investment in Prudhoe Bay over that time. Mr. Walker observed that two large undeveloped fields led to the investment and there are no fields of that capacity waiting to be developed.

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Representative Holm thought a good price should be paid for that commodity, especially if a large pool for oil development is available. He asked if the price affects the value of investment. Mr. Walker stated that industry will invest as much as they can on economic projects; in the current environment that amount is about \$1 billion dollars a year, with the exception of the two large fields at Alpine and North Star. He expected that level of investment if oil prices remain high. Representative Holm argued that there has not been \$1 billion dollars invested in Alaska during recent years.

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Mr. Walker referenced Slide 3, explaining the history of the capital axis.

In response to a query by Representative Kerttula regarding high prices, Mr. Walker pointed out that the industry does not forecast price, but instead takes price risk.

Representative Kerttula commented that Congress might be rewriting some of the federal tax provisions regarding the write-off of geology studies surrounding exploration. She questioned if such federal action could impact profit under the proposed plan. Mr. Walker was not aware of that proposal.

AT EASE: [2:56:08 PM](#)

RECONVENE: [3:03:26 PM](#)

CONOCO-PHILLIPS, ALASKA

BRIAN WENZEL, VICE PRESIDENT, FINANCE AND ADMINISTRATION, CONOCO-PHILLIPS, ALASKA, stated that Conoco-Phillips does not support the legislation as passed from the Senate as it does not adequately encourage increased investment or long-term production.

Mr. Wenzel provided a choice of three alternatives:

- Focusing on maximizing short term tax revenues
- Balancing significant increases in short term revenues with an eye toward long-term investment
- Focusing primarily on long-term to encourage investment by the industry

Mr. Wenzel addressed an increase to production tax and how that affects investment; Alaska, currently, is running a budget surplus. He recommended that a balance be struck including tax credits as proposed by the Governor. The industry recognizes the Legislature's authority & obligation to set fiscal policy, and the industry agreed with the Administration on that proposal. They agreed to support a 20/20 proposal. Alaska must take a long-range view for maximizing State revenue.

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Mr. Wenzel encouraged the Legislature to create a vibrant & healthy oil and gas industry leading to more production and jobs for Alaskans. ConocoPhillips does not support the Senate version of the bill, as it will result in lower investment throughout Alaska. The Department of Revenue forecast is based on a level of investment that outstrips recent investment. He emphasized that to achieve production levels, it is important to encourage investment.

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Mr. Wenzel addressed the process and project evaluations with broad range of prices considered. Models are run multiple times to determine the expected value of each project. The list determines capital investment ranking order each year. To increase taxes in Alaska could shift industry projects down in rank of priority, which could become investment loss to Alaska. The bottom-line changes asset order from project happening around the world.

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To encourage further investment in Alaska, Mr. Wenzel recommended:

- Bringing the tax rate back to the 20%
- Eliminating the windfall profits surcharge element or if added, it should be based on a net provision
- The trigger threshold should be inflated & must change in value over time

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- An effective date of January 1st, 2007. Once regulations are in place through drafting & public review, taxpayers can read the regulations to apply to the Department of Revenue for approval for tax filing.

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Mr. Wenzel advised that ConocoPhillips investors expect their stock to make profits. The best way for Alaska to maximize benefits and share in that success is to take risks and design a fiscal system so that profits increase. That is what the Governor's PPT accomplishes. Higher tax rates & additional progressivity would be counter to the goal of encouraging investment.

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Co-Chair Meyer asked about credit amounts. Mr. Wenzel thought that a tax credit amount of 20% could encourage investment. He indicated that the tax rate is the most important feature.

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Representative Kerttula commented on the 20% rate with no progressivity and a decline in production. Mr. Wenzel responded that the provision to exclude 2/3 of the gas revenue could be a good solution. That would be a policy call.

Representative Hawker asked if that solution could eliminate the need to allocate costs between oil and gas. Mr. Wenzel said yes.

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EXXONMOBIL ALASKA

RICHARD OWEN, ALASKA PRODUCTION MANAGER, EXXONMOBIL, presented a handout. (Copy on File). He stated that ExxonMobil appreciates careful examination of the legislation to ensure that a correct balance is struck between additional government take and maintaining an active and healthy oil and gas industry in Alaska. All of the different versions of the PPT legislation represent a significant tax increase on the oil and gas industry. Any change in Alaska's fiscal regime impacts how the industry views the stability and attractiveness of the Alaskan investment environment, which in turn, impacts how the ongoing investment decisions are evaluated. Tax systems need to be carefully designed to ensure that the desired objective of resource development is achieved. It is critical to take into account the quality of the remaining

resource of the resulted of unintended consequences, such as reduced investments or lower reserve recovery. To offset current production decline, industry will need to make a significant increase in investments. He stated that the focus of the tax bill should be encouraging investment and growing production.

Mr. Owen pointed out that the version before the Committee, increases the already high base tax rate contained in the original bill to 22.5%. He warned that higher tax rates discourage investment. Companies are willing to accept the risks of long-term, capital intensive investments when there is a corresponding opportunity for upside potential. The proposal to increase the already high tax rate as prices increase does reduce the upside potential and will result in the industry recalibrating investment decisions.

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Mr. Owen urged the Committee to reduce the tax rate from the 22.5% to the 20% contained within the original bill. The industry also encourages elimination of the additional progressive feature, which increases tax when prices are higher.

ExxonMobil is disappointed that the provision allowing the use of a producer's royalty settlement agreement to determine the value of oil and gas removed. The PPT bill as originally proposed allowed the State to value a producer's oil and gas using the producer's royalty settlement agreement (RSA), negotiated with and approved by the Department of Natural Resources. The use of a producer's royalty settlement agreement establishes a methodology to determine the value for oil and gas that reflects current market conditions and includes a re-opener process for adjusting the methodology keeping it market reflective. The result of the re-opener process creates a self-adjusting system to determine the value of oil and gas, representative of market conditions. That provision is important to the industry and the State as it provides certainty to a producer on the value on which to pay the royalty and production taxes, while reducing the administrative and audit costs to both the State and industry.

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Mr. Owen urged the Committee to reinstate the provision, which allows the State to use the RSA methodology for determining the value of the product. Most importantly for ExxonMobil, the oil fiscal contract terms consistent with the Administration's proposal, would provide predictability and durability necessary to advance the gas project to the next phase. While predictability and durability are

important, their attractiveness is lost if it comes at too high a cost.

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Mr. Own noted that any change to the PPT legislation as originally proposed, could potentially jeopardize the ability to progress the gas pipeline and could require a reexamination of the gas pipeline contract. ExxonMobil recommends that the Committee:

- Adjust the tax rate to 20%, with an investment tax credit rate of 20%
- Eliminate the additional progressive tax rate feature
- Provide language allowing the use of RSA
- Make the effective date for the new system July 1, 2006

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Representative Kerttula addressed the years of litigation involved with the RSA. Mr. Owens was not familiar with the history of the litigation. He acknowledged that there is a different process for production taxes used at this time.

Representative Kerttula pointed out that using the ExxonMobil royalty agreements would result in a large revenue loss to the State of Alaska. Mr. Owen responded the process would be self correcting. Representative Kerttula argued that it could be a huge loss of revenue to Alaska using the agreement. Mr. Owen had not seen those calculations; he was aware of current arbitration discussions.

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Mr. Owen noted that arbitration had been going on for approximately two years.

Representative Hawker referred to language indicating that any change to the PPT legislation [Governor's version], could jeopardize the gas pipeline. He stressed that it was "naïve" to assume any bill put forth by anyone, including the Governor, would not be revised by the Legislature.

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Mr. Owen responded that changes from Economic Limit Factor (ELF) to the PPT could be a good move with the correct balance between industry and the State.

In response to a query by Representative Kerttula, Mr. Owen said the industry has been working to release a gas contract, but that it is not complete yet.

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Representative Kerttula questioned how long it would take ExxonMobil to complete the due diligence necessary between the oil and gas pipeline contracts. Mr. Owen explained it would depend on the extent of the changes. He addressed terms, predictability and stability of that contract. He added, it could take a week or two to analyze potential impacts.

CS SB 305(FIN) am was HELD in Committee for further consideration.

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[3:37:58 PM](#)

ADJOURNMENT

The meeting was adjourned at 3:38 P.M.