

HOUSE FINANCE COMMITTEE
July 27, 2006
10:05 a.m.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [10:05:43 AM](#).

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 Eric Croft; Ken Alpers, Staff, Representative Eric Croft; Robynn Wilson, Director, Division of Tax, Department of Revenue; Judy Brady, Executive Director, Alaska Oil and Gas Association (AOGA); Mike Hurley, ConocoPhillips Alaska, Chair, Alaska Oil and Gas Association (AOGA); Cathy Foerster, Alaska Oil and Gas Conservation Commission (AOGCC); William Corbus, Commissioner, Department of Revenue; Representative Paul Seaton; Representative Ethan Berkowitz; Representative Harry Crawford; Representative Gabrielle LeDoux; Representative Les Gara

PRESENT VIA TELECONFERENCE

John Norman, Chair, Alaska Oil and Gas Conservation Commission (AOGCC)

SUMMARY

HB 3001 "An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the production tax; amending the definition of 'gas' as that definition applies in the Alaska Stranded

Gas Development Act; making conforming amendments; and providing for an effective date."

HB 3001 was heard and HELD in Committee for further consideration.

HB 3003 "An Act relating to oil and gas properties production taxes; providing for a production tax adjustment to increase the amount of tax at high oil prices and a production tax adjustment to decrease the tax on the production of heavy oil; providing for an exclusion of a certain amount of oil and gas from the gross value at the point of production; relating to the determination of the gross value of oil and gas at the point of production; and providing for an effective date."

HB 3003 was heard and HELD in Committee for further consideration.

HB 3004 "An Act relating to oil and gas, and to the oil and gas properties production (severance) tax as it applies to oil; providing for an adjustment to increase the tax collected when oil prices exceed certain amounts and to reduce the tax collected when oil prices fall below \$16 per barrel; providing for relief from the tax when the price per barrel is low or when the taxpayer demonstrates that a reduction in the tax is necessary to establish or reestablish production from an oil field or pool that would not otherwise be economically feasible; delaying until July 1, 2016, the deadline for certain exploration expenditures that form the basis for a credit against the tax on oil and gas produced from a lease or property in the state; amending the powers and duties of the Alaska Oil and Gas Conservation Commission; and providing for an effective date."

HB 3004 was heard and HELD in Committee for further consideration.

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#hb3003

HOUSE BILL NO. 3003

"An Act relating to oil and gas properties production taxes; providing for a production tax adjustment to increase the amount of tax at high oil prices and a production tax adjustment to decrease the tax on the production of heavy oil; providing for an exclusion of a certain amount of oil and gas from the gross value at the point of production; relating to the determination

of the gross value of oil and gas at the point of production; and providing for an effective date."

REPRESENTATIVE ERIC CROFT, sponsor, HB 3003, emphasized that there are two weeks left of the special session and the legislature needs to take action. HB 3003 is a simple approach to solving the oil tax dilemma.

Representative Croft referred to a handout entitled "HB 3003 - The True Value/Shelf the ELF Bill" (copy on file) and maintained that a tax on the gross is the preferred method. He highlighted the reasons why on Slide 1.

Representative Croft said that oil is a resource that Alaskans own. He discussed Slide 2. The tax is a severance tax and is different than an ordinary business tax and more like a royalty. It is dangerous to sell the resource based on a net tax.

Representative Croft related that there is a double objective - to develop new resources and to get a fair share. On Slide 3 he highlighted four reasons why North Slope development is flat. He emphasized the need to encourage new development and how high pipeline tariffs on TAPS discourages new development.

Slide 4 depicts what HB 3003 does: raises the same amount as the 20/20 PPT at \$60 oil, eliminates the complex and obsolete ELF language in AS 43.55.012-013, base 15 percent tax on wellhead value, provides for progressivity of up to 25 percent at higher prices, protects smaller fields and Cook Inlet with volume exclusion, reduces rate for heavy oil, broadens the ability to challenge TAPS tariffs, is four pages long.

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Slide 5 examines the point that HB 3003 raises the same amount as the 20/20 PPT at \$60 oil. He compared the estimated revenues of various oil tax bills. The fiscal note start dates in the governor's bill and HB 3003 are different. Representative Croft asked the question on Slide 6: Is 20/20 too low? He maintained that it is too low. He explained that he introduced HB 3003 at that level in order to focus discussion on the structure of the profit vs. gross systems. The discussion of the amount of tax can follow that.

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Slide 7 discusses eliminating the complex and obsolete ELF language in AS 43.55.012-013. Representative Croft made the point that a gross tax reform that preserves the ELF formula will continue to have major distortion and unfairness. At

projected oil prices Alaska doesn't need the extreme tax breaks some fields receive with ELF.

Slide 8 deals with the base 15 percent tax on the wellhead value. The only auditable item is transportation. It eliminates the 12.24 percent rate for the first five years and the obsolete cents per barrel tax.

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Slide 9 explains the progressivity of up to 25 percent at higher prices found in HB 3003. It uses a similar mechanism as many of the PPT versions. It increases the tax rate by 0.2 percent per dollar above \$50/barrel at the wellhead. The tax rate is 17 percent at \$60, 19 percent at \$70, etc. It hits a maximum 25 percent rate at \$50 above the trigger point, \$100 at the wellhead. It is easy to adjust the bill to get the desired revenue by changing the trigger point.

Slide 10 shows that the bill protects smaller fields and Cook Inlet with volume exclusion (standard deduction) of the first 10,000 barrels per day per operation unit. The lower a unit's production, the greater the tax benefits. The value of the exclusion would be pro-rated among unit participants based on the percentage of volume produced. The operating unit is defined by DNR approval, and using the unit agreement aggregates any satellite field with the main field.

The graph on Slide 11 shows how the smaller fields and Cook Inlet are protected. Kuparuk, under the current ELF is at 0.0 percent and would be raised up to 14 percent under HB 3003. Slide 12 states that HB 3003 protects smaller fields and Cook Inlet with volume exclusion (standard deduction) of the first 10,000 barrels per day per operating unit.

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Slide 13 deals with the reduced rate for heavy oil. Oil with API gravity of 18 or more pays the full rate. For each point below 18, the tax rate is decreased by 5 percent. Thus, API 17 oil pays 95 percent of the taxes of API 18 oil.

Slide 14 tells how the gross tax broadens the ability to challenge the TAPS tariffs. The biggest impediment to investment, according to AOGA, is regulation and high TAPS tariffs. The existing law says that "reasonable" costs equals "actual" costs unless three conditions exist. HB 3003 states that only one of the three costs needs to exist for DOR to intervene in determining reasonable costs.

Slide 15 explains that the bill is four pages long; simple, readable, and understandable.

Slide 16 compares the similarities between HB 3003 and HB 3004, Representative Gara's bill. Both are based on gross wellhead value, both use a base 15 percent rate, with lower rates for certain oil fields, and they both have progressivity with maximum rates between 25 percent and 27.5 percent that are reached at about \$100 oil.

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Slide 17 discusses the differences between HB 3003 and HB 3004. HB 3003 goes to a flat 15 percent rate. HB 3004 keeps the ELF, but substitutes a 5 percent alternative minimum floor. HB 3003 has the 15 percent rate for all prices up to the progressivity trigger point, whereas HB 3004 has reverse progressivity below \$16 and the ability to apply for tax relief. HB 3003 addresses tariff issues and HB 3004 addresses facility access issues. Both bills can be adjusted to generate the desired revenue.

Slide 18 deals with a possible alternative approach: capital development credits. Amendments have been drafted to include tax credits for well development and construction and to broaden the existing 40 percent exploration tax credit.

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Representative Croft concluded with Slide 19. He talked about the law of unintended consequences and maintained that minimum action to fix the known problem should be taken. He suggested that "if you don't understand it, vote no," but if success is the goal, the bill needs to be understood. He said that politics gets in the way of good policy, but the legislature can do great things if they don't care who gets the credit. He opined that a future legislation could continue and fix problems.

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Co-Chair Meyer said he asked Pedro Van Meurs how most foreign countries are dealing with the tax. Dr. Van Meurs responded that they are going with a net tax. The lower 48 states use a gross tax. Co-Chair Meyer asked if a gross tax would provide enough incentives for investment in Alaska.

Representative Croft responded that while most countries use a percentage of the net, they own the majority of the corporations and the resources. He maintained that the state of Alaska does not want to participate in such a system because many safeguards are missing.

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Co-Chair Meyer referred to Representative Gara's presentation regarding the second quarter earnings of the major oil companies. He inquired why there is not more interest in Alaska by those companies. Representative Croft replied that those companies are looking at worldwide competitors that own their facilities and most of the leases. There would be no way to compete on a level playing field. One way to determine a level playing field is to look at profits and investment. The anti-competitive situation on the North Slope would not be solved by imposing a net tax. Tariff and access are big issues and the legislature must foster exploration.

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Co-Chair Meyer opined that the focus should be on the production facilities. He asked if this discussion would be the same at lower prices. Representative Croft thought there needed to be a durable tax structure across the price range. He recalled the day when oil was never expected to break \$30. He related that price change seems to be cyclical. He concluded that the same discussion would take place.

KEN ALPERS, STAFF, REPRESENTATIVE ERIC CROFT, added that the discussion would be different because it would not have included progressivity over \$50.

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Co-Chair Chenault noted that weak facility access is a large problem. He opined that it was not brought on by producers, but by the make up of the field. He thought that in the future wells may be shut in because they are producing too much gas and not enough oil. He suggested building more production facilities or putting in a relief valve - a gas line. He suggested that companies make agreements with smaller producers and look at all options rather than letting capacity set empty. He asked how smaller corporations might have access to facilities.

Representative Croft said his preferred fix is a gas line so that explorers can bring their gas on line. The consequence of not doing this is dramatic. He speculated that as a company he would do some hard bargaining and price the big companies into doing it themselves.

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Representative Holm asked if oil is going to be increased through investment, and if TAPS are set in stone, and if the pipeline is being downsized, how can TAPS agreements be modified so that capacity could be increased. He was looking to set a procedure for the future to control entry

and access. Representative Croft responded that there are limitations on oil, but the criteria for assessment on reported tariffs can be changed. Excessive tariffs are detrimental for new exploration. Hands are somewhat tied on the oil tariff. There is a need to preserve competition by making rates fair and guaranteeing expansion power. He spoke of the dangers of destroying competition.

Representative Holm added that it is dangerous if the companies that put up the capital don't get a return on their investment. He gave a hypothetical example. He said the solution needs to be worked on. Representative Croft agreed. He spoke of monopolies and the justification for it. He also spoke of investment protection.

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REPRESENTATIVE PAUL SEATON asked about access to facilities with lower-volume fields under ELF. Representative Croft said it was chosen for that reason. He maintained that there was nothing wrong with the ELF concept of relief for smaller fields. "10,000 barrels per day per operation unit" was chosen as the fair number.

Representative Seaton asked if the challenge to TAPS tariffs would allow for interstate tariffs. Representative Croft explained that this broadens the ability to challenge TAPS. It expands the ability to inquire into the actual costs.

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At-ease.

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ROBYNN WILSON, DIRECTOR, DIVISION OF TAX, DEPARTMENT OF REVENUE, explained that the fiscal note for HB 3003 provides for contractual expenditures for reprogramming some existing tax division systems, a one-time charge of \$50,000 and a one-time expenditure of \$60,000 for assistance in drafting regulations. The personal services amount is relative to one-half FTE for an auditor and one-half FTE for an engineer and is related to heavy oil.

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At-Ease

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Presentation by AOGA and AOGCC on HB 3001, HB 3003, HB 3004

JUDY BRADY, EXECUTIVE DIRECTOR, ALASKA OIL AND GAS ASSOCIATION (AOGA), stated that all three bills raise taxes on the oil and gas industry, but are very different.

Ms. Brady highlighted the changes and policy issues of each piece of legislation. She read as follows (copy on file):

NB 3003 and HB 3004 are tax bills introduced for the first time in this special session. Both proposed bills go back to the present production tax – and add some new twists, in order to increase taxes; HB 3004 adds complications to the present tax system, and raises policy issues that are arguably outside the call of this special session; both are strictly tax increases on the gross production at a level that fails to address the critical need for Alaska to attract new investment at the same time as the state's share in oil revenues increases.

You have heard us say many times that declining production is the eight hundred pound gorilla in Alaska's future. Tax legislation must be configured to attract the new investment necessary to increase production. Incentives for new investment and reasonable tax rates that keep Alaska competitive with like oil and gas regions must be part of the package. Any legislation that overreaches on tax rates or neglects real world incentives will simply be a black hole that leaves Alaska as a backwater in worldwide oil and gas regions.

There are now 14 days left in this special session – and four tax bills on the table. HB 3003 and HB 3004 you've just been hearing. HB 3005 was introduced two days ago. We understand two other bills are being drafted. Of the four tax bills presently on the table, only one has been the subject of long and intense review and scrutiny – and that is HB 3001, the Petroleum Production Tax legislation. The PPT legislation was the subject of hundreds of hours of hearings in the last legislative session and in the last special session. It has been reviewed and critiqued by consultants hired by the legislature, the administration and the oil and gas companies affected. The parameters of this legislation are well understood.

We ask you to consider focusing the remaining days in this special session on reviewing, finalizing and adopting HB 3001. The fact of the matter is that developing clear, fair tax legislation that both incentivizes investment and brings a larger share of revenue to the state is rocket

science. Those of you who have spent hundreds of hours trying to develop fair, equitable legislation, are well aware of this fact. Rocket science takes time and so does tax legislation. The legislature has spent that time on a new approach for oil production tax in Alaska - a tax that reflects real production economics. A tax that substitutes real cost figures for the proxy Economic Limit Factor. The promise is that this tax will increase revenues to Alaska by over one billion dollars a year. The promise is that in addition to increased revenues, this tax will provide incentives for new investments for the new production so desperately needed.

AOGA Supports HB 3001 - Governor's PPT

- Even though many of our members remain concerned that the increased level of state take reflected in this bill will result in reduced investment in Alaska. This bill would raise taxes on the industry over \$1 billion a year at \$60/bbl.
- There continues to be a sense of astonishment in oil and gas financial circles about this agreement to a tax increase of this size.
- And would raise total government take to around 60%.
- "Government take" - royalty; production tax, corporate income tax; property tax, federal taxes
- What do "costs" have to do with it - costs have to be counted either directly or as a proxy to conserve oil in the ground in maturing fields
- PPT more accurately reflects true production economics
- The balance in the PPT is the higher tax rate counterbalanced by the reinvestment incentive.
- The balance is essential - throughout the hearings on PPT there have been references to countries with a "higher" government take than Alaska - as Pedro Van Muers and other consultants have pointed out, many of those countries either have government-owned oil companies or are using production sharing contracts. In both cases the governments take a bigger share of risk for a bigger share of profits.
- Some policy makers seem to be frozen between the concepts of "risk" and "profits". They want a lot more of the share of the profits; they don't want any share of the risk.
- This one-sided "two for me - one for you" won't work in the worldwide competitive market. Under those terms, Alaska's won't even place for new investment in any serious way.

Gross Versus Net tax – Criticisms of a net system seem to be based on a misunderstanding of how the present system works and how the PPT would work.

- The ELF in the current system is a proxy for costs. So in that sense the current system is a form of “net” tax. The PPT simply substitutes real costs for the proxy.
- Some legislators have expressed the concern that the state does not have the capability to determine real costs. However, the state currently audits the costs in the netback in a lot of detail.
- Operating and capital costs are in our state income tax return and property tax renderings.

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MIKE HURLEY, CONOCOPHILLIPS ALASKA, CHAIR OF AOGA TAX COMMITTEE, spoke to auditing. Every return filed by the oil companies is audited. The audit assessments over the past several years have been within 2% for what is anticipated payment. He reiterated that it is a 100% audit.

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Ms. Brady said she knew that the Department of Revenue has the capability to audit. She addressed previous court cases surrounding the production tax and prevailing value. Currently, the state has been through all necessary steps for a net production tax.

Ms. Brady continued with her presentation:

AOGA Does Not Support either HB 3003 or HB 3004

- These bills are simply tax increases with no counterbalance
- No re-investment incentives, do nothing to stem decline or encourage investment, there’s no structural change in the risk sharing.
- With HB 3003 ELF disappears so there’s no recognition of costs at all.
- HB 3004 is a band-aid approach - a higher rate, with much more complexity. It seemed puzzling that the sponsor spent so much of his time providing figures about the industries profits, yet was proposing a tax that has nothing to do with the profits.

Oil and Gas Tax Legislation Is Not a Game of Texas Hold 'Em

- Whether it is political one-ups-man-ship during an election year – or real belief that Alaska does not have to be competitive to attract new investment – the bidding up of how much the state of Alaska can “make” or “take” from oil production is going to lose the game for all of us.

The end game for oil and gas tax legislation can be about a higher return for the state of Alaska but must recognize the need for incentives that foster additional investment – bottom line – It is about increasing production and keeping Alaska competitive.

The pipeline is only half full. This must be turned around.

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Mr. Hurley addressed access. He maintained that access has not been denied.

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REPRESENTATIVE LES GARA commented on the access issue. He asked if ConocoPhillips' facilities had been made available to small producers. Mr. Hurley replied that a company called Windstar made use of ConocoPhillips' facilities but came up with a dry hole. He stated that there has been no production loss.

Representative Gara clarified that no other independent company has been able to produce oil through ConocoPhillips' facilities.

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Representative Gara wondered why, in spite of an increase in profits, exploration and investment have not increased. Ms. Brady replied that in the years when the oil company profits increased, so did the state's. As far as further investment, ConocoPhillips is investing “big time” this year. There are more wells being drilled. She did not know the investment figures, but thought all investments had increased. Exploration doubled during that time period. There is money going to investors in dividends and the Alaska Permanent Fund benefits from that; there is money going to investment; and there will be more buy outs. Analysts look at the reserves, which need to be explored or bought.

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Co-Chair Meyer commented on the only common ground found in the net versus gross debate, which is to increase investment and production. He asked if the net would help meet that objective better. Ms. Brady replied it would; net is based on profit. Net only, without incentives, would not work and would be dangerous. Under the net tax, the state takes a bigger risk through the incentives, and the companies can afford to take less profit at the top. She concluded that she prefers the net.

Co-Chair Meyer asked how to attract more oil companies to Alaska. Ms. Brady replied that the fiscal system is the only thing that the government can control. Shell Oil is coming back into Alaska and other companies are showing an interest. The state needs a big find.

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Co-Chair Meyer asked if AOGA represented all oil companies in Alaska. Ms. Brady replied that it represents all 18 companies.

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Co-Chair Chenault addressed a question about Prudhoe Bay to Mr. Hurley. He wondered what paper work would be required to allow for "gaming" of the system. He did not envision a scenario that the auditors could not work through. The state can audit for any detail and the level of auditing would be a choice made by the state and the legislature.

Co-Chair Chenault speculated that it would take all three companies to successfully "game" the state. If that was done there could be jail time and fines. Mr. Hurley agreed. Co-Chair Chenault thought that there were protective mechanisms in place.

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Representative Kerttula stated it wouldn't be collusion; there could be disagreements with the state over the rightful costs, which could result in court cases. Mr. Hurley recalled that there was a past case settled regarding tax costs. Representative Kerttula added that she has been involved in tariff cases regarding disagreements. She spoke to her history in the Department of Law. She disagreed with the usage of "fraud".

Mr. Hurley noted that AOGA submitted comments on the Governor's PPT bill requesting clarity on excluded costs. There are concerns by the companies.

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Representative Kerttula foresaw problems with costs when giving substantial weight to the agreements. She encouraged that a standard be established. She emphasized it is not a collusion situation.

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Ms. Brady pointed out that there is competition on the North Slope. Each company thinks their way is the best. Over the past 40 years, the state has had access to the disputed information. Many issues have already been worked out. Mr. Hurley pointed out grouping of costs, with 3 to 4 different conceptual models:

- * Inter-company billing
- * IRS reference to ordinary and necessary
- * DNR regulations for net profit sharing exclusions

[11:45:42 AM](#)

CATHY FOERSTER, COMMISSIONER, ALASKA OIL AND GAS CONSERVATION COMMISSION (AOGCC), read from her prepared testimony (copy on file.)

Before proceeding, I want to disclose to you that, immediately prior to serving on the AOGCC, I worked as an engineering consultant and, as such, I participated in preparing the "North Slope of Alaska Facility Sharing Study" performed by Petrotechnical Resources of Alaska for the Division of Oil and Gas of the Department of Natural Resources. I discussed this participation with the other AOGCC commissioners and they agreed that this did not represent a conflict of interest. However, I did want to disclose the information to you.

The AOGCC recognizes the need to enable new operators to acquire reasonable access to existing facility infrastructure.

If the Legislature adopts HB 3004, the AOGCC will do our best to implement it. That said, there are a few challenges to implementing this bill as it is currently written and, if you'll bear with some technical description from me, I'll explain what those are with some suggested ways around them.

The bill requires working interest owners to provide access to production or other facilities "only if the commission finds that the facility has excess capacity and that directing the working interest owner to

provide access by or for the benefit of others would not materially interfere with the owner's paramount use of the facility." The AOGCC has two concerns with this wording.

First, there will never be excess capacity in the oil production facilities that this bill is targeting.

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Representative Gara related that he does not dispute the excess capacity issue. The question is if new facilities should be expanded and the costs charged to the company.

Ms. Foerster explained the capacity design by providing the history of oil, gas, and water in various fields. She used the example of expanded facilities and no excess capacity. The gas and water continue to increase, but not all oil produced can fit into the facility, which becomes a problem. She showed a hypothetical situation where Tarn comes in with 10,000 barrels and where that same amount must be taken out to provide room. Each well takes a priority ranking and the bottom wells get "backed out". There is no cost at this point to get into the facility.

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Ms. Foerster discussed how a new player with 10,000 barrels of oil would enter the market, backing out 9,000 barrels of water and 1,000 barrels of water. The cost to get in would be the sum of lost revenue and profit. The costs are very clearly spelled out in the DNR study. The lost area costs are debatable. The third issue concerns what a fair profit would be. Negotiation would have to take place.

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Co-Chair Meyer asked if the process would scare off new producers. Ms. Foerster said her opinion is that people assume that there is a monopoly going on. She suggested talking to Windstar who negotiated with ConocoPhillips.

Co-Chair Meyer commented that that was a dry hole. Ms. Foerster maintained that the negotiation process was held and was valuable.

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Ms. Foerster continued to read from her handout:

Even if we get past the "excess capacity" wording, there is a second complication. Since the owner's paramount use of the facility is to separate the associated gas and water from their oil, any back out

for another operator would interfere with their "paramount use of the facility."

Supposing that we work our way past these two concerns, let's next take a look at the fiscal impact.

First, a primary role here is a rate-setting role, and the AOGCC has no staffing or experience in rate setting. Therefore, to take on this rate-setting role we would have to hire accountants and/or other financial expertise. Second, we would need someone on staff who understands and can oversee facility optimization; we currently have no one on staff to perform that function.

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We have one final concern with placing this authority within the AOGCC. And that is the potential for conflict with the AOGCC's role implementing the Oil & Gas Conservation Act. The commission is charged with preventing waste, ensuring greater ultimate recovery, protecting correlative rights, and protecting ground waters. Decisions under this bill may be in conflict with the commission's responsibility to prevent waste of hydrocarbon resources and ensure greater ultimate recovery. For example, granting access to a production facility for one WIO's high-oil-rate well may result in the permanent loss of oil from the WIO whose marginal well is backed out of the facility.

Our recommendation would be to give this rate-setting responsibility to either a new or an existing agency that is intended as a rate-setting agency.

I want to conclude by reiterating what I said first: The AOGCC recognizes the need to enable new operators to acquire reasonable access to existing facility infrastructure, and if the Legislature adopts HB 3004, the AOGCC will do our best to implement it.

[12:07:05 PM](#)

Co-Chair Chenault suggested Representative Gara and AOGCC meet to discuss the issues and work out their differences.

ADJOURNMENT

The meeting was adjourned at 12:07 PM.