

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON OIL AND GAS

January 26, 2006

5:08 p.m.

MEMBERS PRESENT

Representative Vic Kohring, Chair
Representative Lesil McGuire
Representative Ralph Samuels
Representative David Guttenberg

MEMBERS ABSENT

Representative Norman Rokeberg
Representative Nancy Dahlstrom
Representative Berta Gardner

OTHER MEMBERS PRESENT

Representative Kurt Olson

COMMITTEE CALENDAR

HOUSE BILL NO. 294

"An Act amending and extending the exploration and development incentive tax credit under the Alaska Net Income Tax Act for operators and working interest owners directly engaged in the exploration for and development of gas for delivery and sale from a lease or property in the state; providing for an effective date by amending the effective date for sec. 2, ch. 61, SLA 2003; and providing for an effective date."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 294

SHORT TITLE: GAS EXPLORATION\DEVELOPMENT TAX CREDIT

SPONSOR(S): REPRESENTATIVE(S) CHENAULT

04/30/05	(H)	READ THE FIRST TIME - REFERRALS
04/30/05	(H)	O&G, RES, FIN
01/26/06	(H)	O&G AT 5:00 PM CAPITOL 124

WITNESS REGISTER

SUE WRIGHT, Staff
to Representative Mike Chenault
House Finance Committee
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Provided the background on HB 294 on behalf of Representative Chenault, the sponsor.

JOHN A. BARNES, Manager
Alaska Production Region
Marathon Oil Company
Anchorage, Alaska

POSITION STATEMENT: Testified in support of HB 294.

JERRY McCUTCHEON

POSITION STATEMENT: Testified that HB 294 will not accomplish a lot, and suggested an alternative.

MARK GRABER, Income Audit Manager
Anchorage Office
Tax Division
Department of Revenue (DOR)
Anchorage, Alaska

POSITION STATEMENT: During discussion of HB 294, answered questions and discussed the accompanying fiscal note.

CHERYL L. NIENHUIS, Petroleum Economist
Tax Division
Juneau Office
Department of Revenue (DOR)
Juneau, Alaska

POSITION STATEMENT: Discussed the accompanying fiscal note for HB 294, and testified that from an economic standpoint, the price of gas is almost as much of an incentive as a tax credit.

ACTION NARRATIVE

CHAIR VIC KOHRING called the House Special Committee on Oil and Gas meeting to order at [5:08:47 PM](#). Representatives Kohring, McGuire, Samuels, and Guttenberg were present at the call to order. Also in attendance was Representative Olson.

HB 294-GAS EXPLORATION\DEVELOPMENT TAX CREDIT

CHAIR KOHRING announced that the only order of business would be HOUSE BILL NO. 294, "An Act amending and extending the exploration and development incentive tax credit under the

Alaska Net Income Tax Act for operators and working interest owners directly engaged in the exploration for and development of gas for delivery and sale from a lease or property in the state; providing for an effective date by amending the effective date for sec. 2, ch. 61, SLA 2003; and providing for an effective date."

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SUE WRIGHT, Staff to Representative Mike Chenault, House Finance Committee, Alaska State Legislature, sponsor, explained on behalf of Representative Chenault, that HB 294 is an act that amends and extends the exploration and development incentive tax credit that was originally enacted in 2003 as House Bill 61. This tax credit continues to apply under the Alaska Net Income Tax Act for operators and working interest owners directly engaged in the exploration for and development of natural gas, primarily in the Cook Inlet area. She informed the committee that any natural gas production and supply in the Cook Inlet area has been declining for a number of years. During that same time, demand has been increasing steadily. Therefore, a sharp increase in drilling to find new reserves is drastically needed. She stated that the original investment tax credit enacted in 2003, while modestly successful in stimulating new drilling and development, needs to be made a much more effective incentive in order for developers to increase capital spending in a large manner. These changes will go a long way toward achieving that goal, and it will also increase employment.

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JOHN A. BARNES, Manager, Alaska Production Region, Marathon Oil Company, stated that Marathon Oil Company is in support of HB 294. He informed the committee that Marathon Oil Company's Alaska operations are focused on the Cook Inlet natural gas industry. Last year [in 2005], Marathon Oil Company produced and sold about 68 billion cubic feet (bcf) of natural gas. He said that during [2005], Marathon Oil Company sold to "essentially" every natural gas market that was available. The markets include: ENSTAR Natural Gas Company, Chugach Electric Association, Inc., a liquefied natural gas (LNG) plant in Nikiski, Tesoro [Corporation], and Agrium Inc. He stated that the Marathon Oil Company is committed to the Cook Inlet natural gas market, including serving its long-term contractual commitments to the local utilities and seeking other available opportunities.

MR. BARNES reminded the committee that in 2003, the legislature passed and the governor signed, several bills that were directed at providing incentives for new exploration and development activities. Marathon Oil Company was particularly interested in House Bill 61, which was intended to incentivize exploration and development of natural gas reserves, specifically in Cook Inlet. He stated that HB 294 will strengthen the incentives.

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MR. BARNES said that one might ask about the need to incentivize natural gas development in Cook Inlet. The answer to the question is found by considering the long-term decline in natural gas reserves, which Cook Inlet has experienced. He stated that what must be addressed is whether there is currently sufficient exploration activity to arrest the decline in reserves, and not whether the Cook Inlet is running out of gas. At the current minimal level of Cook Inlet exploration, it's unlikely that Cook Inlet reserve additions will replace annual production on an ongoing basis. As such, natural gas reserves are at risk of continual decline in Cook Inlet. He informed the committee that the net result of not addressing the issue will be the loss of industries and associated jobs.

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MR. BARNES stated that the lack of Cook Inlet exploration is an artifact of the historic oversupply of natural gas, which kept prices well below Lower 48 prices, which created a lack of incentive for drilling. Furthermore, regulatory and permitting hurdles in Alaska have played roles in reducing project economies, due to uncertainties and predictably bringing projects online on time and within the budget. He announced that there is, however, good news. Recently, the U.S. Department of Energy completed a report, which identified significant potential in Cook Inlet for additional gas through infield reserve growth, new discoveries, and other gas sources.

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MR. BARNES informed the committee that the same report identifies the need for significant capital expenditures to bring the gas to market, including \$500 million associated with finding and developing infield reserve growth of 1.4 trillion cubic feet (tcf). An expenditure of \$5 billion to \$6 billion was associated with exploration and development of 6 tcf to 8.5 tcf of resource.

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MR. BARNES stated that the [aforementioned] targets represent a significant opportunity to reinvigorate the Cook Inlet natural gas industry. The net result of developing the reserves would be additional jobs, ongoing industrial use of natural gas, and revenue increases to the State of Alaska through tax and royalties.

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MR. BARNES posed the question: how will HB 294 help? He stated that Alaska projects are not considered solely on their absolute economic merit. Companies are scrutinized on a relative scale, in comparison to other opportunities around the world where people can invest. The intent of HB 294 is to level the playing field between Alaska opportunities and other opportunities around the world. He added that HB 294 is intended to provide an incentive to oil and gas development activities through an investment tax credit. Most importantly, under HB 294, the percentage of qualified expenditures that could be applied as a credit to offset future tax liabilities is increased from 10 to 25 percent.

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MR. BARNES added that timing is "very important" on Cook Inlet development. It currently takes an excess of three years to bring any potential Cook Inlet discovery to production. If a sufficiently high level of exploration activity can be stimulated, there's an increased probability that some discoveries may be brought to market sooner, which ultimately will benefit industries and consumers.

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MR. BARNES summarized that Marathon Oil Company believes that HB 294 can serve as a stimulus to enhance Cook Inlet exploration and development activities.

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CHAIR KOHRING opined that the legislation that the legislature passed in 2003 benefited the industry, including Marathon Oil Company, and inquired as to what the justification is for generously increasing the tax credits as well as taking out the

50 percent limitation. He also asked, "Why would that be needed in light of the fact that [House Bill 61] has been successful?"

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MR. BARNES responded that the key word is that [House Bill 61] has been "moderately" successful. If one looks at the overall level of activity in Cook Inlet, he opined that [House Bill 61] hasn't drawn the type of exploration that would ultimately benefit the State of Alaska. He added that another thing to consider is the multiplier effect. For example, if a company receives \$1 million in tax credit, that implies it has spent \$10 million in Alaska ultimately finding and developing natural gas. Then one would also have to think about the development cost and what the ultimate revenue to the State of Alaska would be, which is dependent on oil price. He stated that through severance tax, royalty, and ad valorem tax, the multiplier benefit to the State of Alaska is probably on the order of the investment that the company makes. The key point is that for every \$1 of credit, \$10 was spent in Alaska, making an important contribution to Alaska commerce.

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CHAIR KOHRING noted that money has also been generated which is in the state treasury. He said that his understanding is that there's about \$1.5 million, and that for every dollar that is in the state treasury, the industry is spending about ten times that. Therefore, he opined that there has been a benefit from [House Bill 61]. He expressed his concern that the legislature doesn't go "too far" in terms of extending "already generous" provisions, and added that the reasons for extensions are adequately justified.

MR. BARNES expressed his understanding of the need for the State of Alaska to determine the amount of stimulus it deems required to increase activity.

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REPRESENTATIVE MCGUIRE described another "incentive bill" heard by the House Rules Standing Committee. She opined that she's leery of eliminating the 50 percent requirement entirely. She also expressed her concern regarding extending [the sunset date] to 2024, and said that she doesn't see any justification for it. She opined that a periodic checkpoint is necessary. Therefore, she inquired about the reasoning behind the sunset date of 2024.

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MR. BARNES explained that if the "tool" works, one wants to try to get to the point where there is an "ongoing span profile" of Cook Inlet. He opined that having a sunset date of 2020 or 2024 offers a stable picture of a reward that could be there for ongoing investment. He informed the committee that currently, Cook Inlet burns between 150-200 bcf of gas per year. If one is able to find and replace reserves at \$1 per thousand cubic feet (mcf), it would imply that one has a \$200-million-per-year capital program occurring in Cook Inlet. In order to keep that level of activity going, one has to create an environment that draws the capital in. He said that he doesn't know whether Cook Inlet will ever achieve the degree of sustainability that's required.

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REPRESENTATIVE GUTTENBERG commented that a tax credit of up to 100 percent would allow operators to execute development exploration without risk.

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REPRESENTATIVE SAMUELS asked for examples of other tax and royalty systems around the world that the Marathon Oil Company deals with.

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MR. BARNES mentioned production-sharing agreements, which typically occur when there's a higher probability of the resource base. He also mentioned typical royalty and severance tax approaches. The U.S. government has implemented royalty reduction in an attempt to stimulate deepwater exploration. He said that Alaska is one of the few states [in the U.S.] that has implemented royalty reduction as an incentive in the oil and gas industry.

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JERRY McCUTCHEON opined that [HB 294] will not accomplish a lot. He suggested that a method to spur gas production would be to start taxing leases on which seismic information has not been collected and/or drilling has not occurred. He also suggested that if an operator is not drilling on a lease, he/she should

let another operator take over the lease to begin drilling. His motto is, "drill it or lose it."

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REPRESENTATIVE SAMUELS, referring to page two of [HB 294] and line five and line eleven, inquired about the 25 percent for qualified services in the state and asked whether it's an operating tax credit also.

MARK GRABER, Income Audit Manager, Anchorage Office, Tax Division, Department of Revenue (DOR), said no, and that it's for capital expenditures only; therefore, operating expenditures wouldn't qualify.

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REPRESENTATIVE SAMUELS quoted page 2, lines 4-6, of HB 294 which read, "10 percent of the annual cost incurred by the taxpayer for qualified services in the state during each tax year for which a credit is allowable for a qualified capital investment" and asked what a qualified service would be.

MR. GRABER said that he can't answer Representative Samuels question precisely. He added that the DOR has not performed any audits on the credits that have been claimed. He conveyed his understanding that a "qualified service" pertains to seismic work and to the types of things that will eventually get capitalized, as opposed to capital assets that are purchased.

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REPRESENTATIVE SAMUELS clarified that on page three, there is a definition of "qualified capital investment", but there isn't a definition of "qualified service."

REPRESENTATIVE GUTTENBERG inquired as to whether there's a definition of "qualified service" in [Alaska Statutes].

CHAIR KOHRING asked whether he would be correct in saying that Mr. Graber "wasn't aware" of what "qualified service" meant.

MR. GRABER confirmed "not precisely." He added that the first credit showed up in 2004, and the DOR "really" hasn't had time to audit it yet.

CHAIR KOHRING requested that the DOR identify "qualified service" in [Alaska Statute].

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CHAIR KOHRING inquired about the number of times since [House Bill 61] was enacted, that the credit has actually been taken advantage of, and by which companies other than the Marathon Oil Company.

MR. GRABER acknowledged that there are two companies that have "taken" the credit.

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CHAIR KOHRING asked whether it appears as though [House Bill 61] has been effective in terms of companies having interest in it and taking advantage of it.

MR. GRABER said that he wasn't able to answer Chair Kohring's question.

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CHAIR KOHRING indicated that [HB 294] might be held over in order to address some of the concerns of members. He expressed his support of the concept behind [HB 294], and of the committee doing something to accelerate additional development, particularly in the Kenai Peninsula. He opined that House Bill 61 facilitated additional development, and that the committee should be able to "tweak" [existing statute] in order to attract more companies and therefore, more investment.

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CHAIR KOHRING expressed an additional concern that might result in having to add a provision to [HB 294] if necessary, and [Legislative Legal and Research Services] would be able to make the decision. He said his concern is in regard to the potential gas line, "spurs," and any gas-related infrastructure, since he doesn't feel they should be included in HB 294. He opined that the State of Alaska doesn't want to be "too generous" to companies that build the gas line, with the credit increased to 25 percent. To "narrow down" [HB 294], he said his suggested wording would be, "The provisions of this act do not apply to cost and revenue associated with gas pipelines and

infrastructure." He added that the Marathon Oil Company seems amenable to his suggestion.

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MR. BARNES said that his initial thought is whether there are concerns regarding a North Slope gas line or spur line. The intent of [HB 294] is for exploration and development of new gas, south of the Brooks Range. He added that at a high level pass, there's a possibility that a gas line or spur line would be excluded, because gas from the North Slope is produced north of the Brooks Range. He said, "You're right, there may be a need to tweak and make certain there's not a gap there in the wording."

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REPRESENTATIVE SAMUELS asked whether [HB 294] specifies geographic location.

REPRESENTATIVE GUTTENBERG answered, "68th parallel."

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REPRESENTATIVE SAMUELS asked if the DOR has conducted any economic modeling to establish how much [money] would have to be spent and how much [gas] would have to be found, to make [the gas line] worthwhile. He added, "Not counting the impact on the economy, but the impact on the state treasury."

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MR. GRABER defined "qualified services" as, "Expenditures for labor, seismic, and other services that are directly applicable to a qualified capital investment." He added that "qualified services" does not include operating lease expenses.

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CHAIR KOHRING requested that Mr. Graber discuss the accompanying fiscal note.

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MR. GRABER explained that [HB 294] retains the following characteristics: only exploration and development outlays for gas wells qualify for the credit; the credit may be applied

against the taxpayers total income tax liability - the credit may offset tax arising from oil production and pipeline activity, as well as gas exploration and production; unused credits may be carried forward to the subsequent five years; and once gas production begins, additional outlays for the field cease to accrue credits. On the other hand, he explained that [HB 294] makes four significant changes to current law: increases the amount of the credit to 25 percent [from 10 percent] of the amount of qualified capital investment and qualified services spending; removes the 50 percent limitation on the amount of credits that can apply in a single year; removes the "successful efforts" requirement that developers must find and deliver new gas resources to market to qualify for the credit; and extends the sunset date of the investment tax credit from January 1, 2013, to January 1, 2020.

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MR. GRABER informed the committee that in the two years since the enactment [of House Bill 61], the DOR has seen claims of [\$]6.3 million. He added, "That relates to three fields."

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MR. GRABER stated that the rest of the fiscal note is essentially an economic analysis that he did not prepare.

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CHERYL L. NIENHUIS, Petroleum Economist, Tax Division, Juneau Office, Department of Revenue (DOR), informed the committee that some of the language in [HB 294 reflects language in existing statute]. She said that from an economic standpoint, the price of gas is almost as much of an incentive as a tax credit. Therefore, as long as the price of gas remains high, it should be a good incentive in addition to a tax credit.

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CHAIR KOHRING, upon determining that no one else wished to testify on HB 294, announced the closure of public testimony. He noted that the committee is holding [HB 294] in order to address the "50-50 split," the extension [of the sunset date], the definition of "qualified services," and the concern of gas-related infrastructure. He reiterated his support of the concept behind [HB 294].

5:47:10 PM

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Oil and Gas meeting was adjourned at 5:47 p.m.