

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

April 21, 2006

2:09 p.m.

MEMBERS PRESENT

Representative Jay Ramras, Co-Chair
Representative Ralph Samuels, Co-Chair
Representative Carl Gatto
Representative Gabrielle LeDoux
Representative Kurt Olson
Representative Paul Seaton
Representative Harry Crawford

MEMBERS ABSENT

Representative Jim Elkins
Representative Mary Kapsner

COMMITTEE CALENDAR

CONFIRMATION HEARING(S)

Board of Game

Paul C. Johnson - Unalakleet

- CONFIRMATION(S) ADVANCED

HOUSE BILL NO. 498

"An Act authorizing tax credits against the production tax on oil and gas for qualified expenditures for challenged or nonconventional oil or gas and for qualified expenditures for nonconventional or renewable energy resources; giving the Act contingent effect; and providing for an effective date."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 498

SHORT TITLE: TAX CREDITS NONCONVENTIONAL OIL/GAS

SPONSOR(S): RULES

04/03/06	(H)	READ THE FIRST TIME - REFERRALS
04/03/06	(H)	O&G, RES, FIN

04/11/06 (H) O&G AT 8:00 AM CAPITOL 120
 04/11/06 (H) Moved Out of Committee
 04/11/06 (H) MINUTE(O&G)
 04/12/06 (H) O&G RPT 2DP 1NR 3AM
 04/12/06 (H) DP: ROKEBERG, KOHRING;
 04/12/06 (H) NR: SAMUELS
 04/12/06 (H) AM: GUTTENBERG, DAHLSTROM, MCGUIRE
 04/12/06 (H) LETTER OF INTENT WITH O&G REPORT
 (FORTHCOMING)
 04/19/06 (H) RES AT 1:00 PM CAPITOL 124
 04/19/06 (H) Heard & Held
 04/19/06 (H) MINUTE(RES)
 04/20/06 (H) RES AT 1:00 PM CAPITOL 124
 04/20/06 (H) Heard & Held
 04/20/06 (H) MINUTE(RES)
 04/21/06 (H) RES AT 1:00 PM CAPITOL 124

WITNESS REGISTER

PAUL C. JOHNSON, Appointee
 to the Board of Game
 Unalakleet, Alaska
 POSITION STATEMENT: Testified as appointee to the Board of
 Game.

VIRGIL UMPHENOUR
 North Pole, Alaska
 POSITION STATEMENT: Testified in support of the confirmation of
 Mr. Johnson.

REPRESENTATIVE NORMAN ROKEBERG
 Alaska State Legislature
 Juneau, Alaska
 POSITION STATEMENT: Spoke as the sponsor of HB 498.

ROBYNN WILSON, Director
 Tax Division
 Department of Revenue
 Anchorage, Alaska
 POSITION STATEMENT: Offered comments and answered questions on
 HB 498.

BILL VAN DYKE, Acting Director
 Division of Oil & Gas
 Division of Oil and Gas
 Department of Natural Resources
 Anchorage, Alaska

POSITION STATEMENT: Answered questions on HB 498.

MICHAEL HURLEY

ConocoPhillips Alaska, Inc.

Anchorage, Alaska

POSITION STATEMENT: Answered questions on HB 498.

JEFF SPENCER, Heavy Oil Specialist

ConocoPhillips Alaska, Inc.

Anchorage, Alaska

POSITION STATEMENT: Provided information with regard to HB 498 and answered questions.

ACTION NARRATIVE

CO-CHAIR JAY RAMRAS called the House Resources Standing Committee meeting to order at 2:09:31 PM. Representatives Samuels, Ramras, Seaton, LeDoux, Crawford, and Gatto.

CONFIRMATION HEARING(S)

Board of Game

CO-CHAIR SAMUELS announced that the first order of business would be the confirmation hearing for Paul C. Johnson to the Board of Game.

PAUL C. JOHNSON, Appointee to the Board of Game, informed the committee of his background, including that he has resided in Unalakleet for the majority of his life. He explained that his family moved to Unalakleet in 1964 because of the value they placed on higher education. Coming from a family with 12 siblings, Mr. Johnson said that he understands the importance of hunting and gathering wild game and fish, which his family relied upon for years. With regard to formal education, Mr. Johnson informed the committee that he attended four years of college, although he doesn't have a degree. He related that currently he is a small boat crab fisherman in Norton Sound. In fact, he said he has fished since he was 17 years old. He further related that he has served on several civic organizations and is currently a class A assistant guide. During the formation of the community development quota (CDQ) groups and the Norton Sound Economic Development Corporation, Mr. Johnson was the president of the [Norton Sound Economic Development Corporation] for a little over a year. Following that, Mr. Johnson noted that he worked as the chief executive

officer of the Unalakleet Native Corporation for 10-11 years. During those years, he said he was integral in working with the local tribe, the city, and the [Unalakleet Native Corporation] to solve and address community problems. He opined that his work experience and serving on the Southern Norton Sound Advisory Community Council have provided a fair understanding of the makeup of the state. In fact, he said having testified before the Board of Game has provided him a fair understanding of issues and how the board works. As illustrated by the aforementioned, Mr. Johnson stated that he isn't a stranger to public service locally and although he said he wasn't sure why, he said he looks forward to serving the state. He expressed the hope that he could bring his personal experiences and common sense to managing the state's resources.

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CO-CHAIR SAMUELS inquired as to Mr. Johnson's general thoughts with regard to predator control.

MR. JOHNSON opined that predator control is necessary when warranted by the situation and the facts of a particular region. He related that he is well aware of the impacts of predators on game, particularly with regard to moose and caribou in the Unalakleet region.

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CO-CHAIR SAMUELS inquired as to the other significant items that the Board of Game will face over the next several years.

MR. JOHNSON said that beyond predator control he was not sure. He related that he would take each issue individually and weigh the facts of the issue and the needs of the region impacted to make a good decision.

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VIRGIL UMPHENOUR related that he is a resident of North Pole, and has known Mr. Johnson when he was involved with the Board of Fisheries regarding the crab and herring fisheries in Norton Sound. Mr. Umphenour concluded by noting his support for Mr. Johnson's confirmation.

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CO-CHAIR RAMRAS moved to advance the name of Paul C. Johnson, as Appointee to the Board of Game, to the joint session for consideration. Hearing no objection, it was so ordered.

HB 498-TAX CREDITS NONCONVENTIONAL OIL/GAS

CO-CHAIR SAMUELS announced that the next order of business would be HOUSE BILL NO. 498, "An Act authorizing tax credits against the production tax on oil and gas for qualified expenditures for challenged or nonconventional oil or gas and for qualified expenditures for nonconventional or renewable energy resources; giving the Act contingent effect; and providing for an effective date." [Before the committee is the proposed committee substitute (CS) for HB 498, Version 24-LS1817\L, Chenoweth 4/20/06.]

CO-CHAIR SAMUELS reminded the committee that [at the last hearing] several of the large items were brought out. Without going into the specific language of Version L, he expressed the need to have a sense as to how the committee would like this legislation to [be changed] in order that he can work with the sponsor and the administration's staff to craft a committee substitute for the committee's consideration.

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REPRESENTATIVE GATTO referred to page 5, lines 20-31, of Version L and highlighted that it doesn't include nuclear energy.

CO-CHAIR SAMUELS related his understanding that there will be a motion to delete that entire [subsection] of Version L. He related his further understanding that there isn't a lot of willpower to offer these credits only to oil companies to do these types of projects.

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CO-CHAIR SAMUELS then began reviewing his list of concerns, beginning with credits for research and development. He related his concern with regard to how research and development will be audited, even if it's performed in the state. Furthermore, research and development credits may or may not lead to the development of heavy oil, which is the intent of this legislation.

REPRESENTATIVE GATTO, regarding the aforementioned concern, related his concern with use of the word "or" on page 2, lines

25-27. "If you put 'or' in, then research ... is wide open if it doesn't lead to development," he opined.

CO-CHAIR SAMUELS noted his agreement and indicated the desire to eliminate any credit on any research and development work that the industry may do.

REPRESENTATIVE SEATON noted his agreement, adding that this research and development is really research and development of techniques not development of a field.

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REPRESENTATIVE CRAWFORD also noted his agreement.

REPRESENTATIVE NORMAN ROKEBERG, Alaska State Legislature, sponsor, opined then that the committee's desire is to broaden the application of this legislation.

CO-CHAIR SAMUELS related his view that if a development credit is to be offered, it should be based on field geography. He opined that it will be difficult for the state to link research activity directly to [development in] Alaska.

REPRESENTATIVE ROKEBERG said he has no problem with that because it provides direction and a foundation for the remainder of the legislation. He assumed then that HB 498 could duplicate the provisions in HB 488 for implementing and auditing those credits.

CO-CHAIR SAMUELS said, "I would assume that that language would be identical, it would just be another credit for a specific area at a specific depth."

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CO-CHAIR SAMUELS then turned the committee's attention to the rate of the credit depending on the proposed production profits tax (PPT). He indicated that until final action on HB 488 or SB 305 occurs, it would be difficult to reach consensus on this issue.

REPRESENTATIVE ROKEBERG opined that clearly the rate of the credit has to be related to the baseline in the primary legislation [HB 488/SB 305]. For example, if HB 488 or SB 305 had a 25 percent credit, then it would be appropriate to lower the credit in HB 498.

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ROBYNN WILSON, Director, Tax Division, Department of Revenue, surmised that if the PPT rate is 20 percent and the credit rate proposed in HB 498 is 15 percent, then the total credit would be 35 percent. Therefore, she suggested that HB 498 could be drafted such that the credit rate is equal to 35 percent less the credit rate in the specified section [of statute as specified in HB 488 or SB 305].

CO-CHAIR SAMUELS then turned to the matter of how to determine what heavy oil is. He recalled that at yesterday's meeting, the committee came to consensus with regard to naming the specific areas that are currently heavy oil areas. The department indicated agreement with the aforementioned notion. However, he recalled that the debate was in regard to the future when there is the desire to add a new area and whether it would be the legislature or the commissioner that would approve such an addition. He acknowledged that there are pros and cons to both paths.

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REPRESENTATIVE ROKEBERG mentioned that Mr. Van Dyke had issued a memorandum, which may be appropriate for the committee to have.

CO-CHAIR SAMUELS said the committee could work with DNR to determine the current areas of heavy oil to be specified in the legislation.

REPRESENTATIVE SEATON said he didn't view this as a crucial decision that needs to be made by the commissioner at a certain point. Rather, he opined, that due to the long lead time required for these projects, the industry should have time to approach the legislature. He highlighted that one of the developments will be \$2 billion, which amounts to \$300 million in credits. The aforementioned determination is of a size that should come before the legislature, he suggested.

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MS. WILSON, in response to Co-Chair Samuels, opined that if the commissioner were given enough guidelines and criteria, the comfort level increases. She noted her concern with language such as "the commissioner shall determine" without the appropriate criteria upon which to make such a judgment. She

then related her belief that DNR would be the appropriate agency to determine what formations are heavy oil.

BILL VAN DYKE, Acting Director, Division of Oil and Gas, Department of Natural Resources, said that he is fairly comfortable leaving the decision [whether to add an area as a heavy oil area] with the administration. He mentioned that the decision could be reported to the Legislative Budget and Audit Committee, which is currently the case for royalty modifications.

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REPRESENTATIVE CRAWFORD, referring to the proposed definitions and guidelines for heavy oil, pointed out that it refers to an American Petroleum Institute (API) gravity of 22 while the legislation specifies an API gravity of 25. He inquired as to the pros and cons of either API gravity. He related his understanding that in other instances of challenged oil the [state] has the ability to apply for royalty relief. He asked if this legislation would be in addition to royalty relief.

MR. VAN DYKE said there is no single definition for challenged/viscous oil. However, he pointed out that the United States Geological Survey (USGS) uses an API gravity of 22 as a standard for heavy/viscous oil. He mentioned that the glossary of terms related to the PPT includes a definition for heavy oil with the standard of 20 API gravity. The staff at DNR feel more comfortable with the standard of an API gravity of 22. With regard to royalty modifications, royalty modifications could be granted on top of these proposed credits. "But certainly when we do the economic analysis, we will take into consideration that the project was earning tax credits in the economic evaluation," he said.

CO-CHAIR SAMUELS related his understanding that the only royalty relief the state has granted was the recent Pioneer royalty relief at Uguruk, although it wasn't for heavy oil by definition. The program, he commented, is relatively new.

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MR. VAN DYKE said that Co-Chair Samuels is correct under the traditional royalty modifications, although he noted that there are mechanical royalty modifications for Cook Inlet that are based on production rates per platform. Again, he agreed with

Co-Chair Samuels that the Pioneer request was granted on the basis of low-rate wells.

REPRESENTATIVE ROKEBERG recalled his time as chair of the House Special Committee on Oil and Gas in 1995 when he had the privilege of working on legislation that was a rewrite of statute that included the ability for the commissioner to grant royalty relief to marginal oil fields. He opined that the Senate made the statute unworkable and unintelligible, such that the only grant requested wasn't granted. Representative Rokeberg cautioned the committee with regard to providing the commissioner discretion in granting these credits because the credits aren't always granted. He then related his belief that the commissioner of DNR, due to his/her competency with regard to geology, should make the recommendation.

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CO-CHAIR SAMUELS posed a scenario in which the legislation provides the discretion to the commissioner, but specifies parameters such as a specific API gravity.

REPRESENTATIVE SEATON referred to the second paragraph of page 2 of Mr. Van Dyke's comments regarding proposed definitions and guidelines. That paragraph says: "The commissioner may grant credits for challenged oil produced from the areas excluded from eligibility in the definition (i.e., #1) above for challenged oil if that oil is produced using enhanced oil recovery techniques or other approved non-conventional recovery and production methods" Therefore, it would seem that the applicability could be for anything the commissioner approves with such a definition. He opined that [the legislature] hasn't had trouble getting credits through.

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REPRESENTATIVE ROKEBERG pointed out that Mr. Van Dyke made recommendations regarding the identification of areas and units similar to those identified by the oil producers, including the exclusion of drill sites 1C, 1D, 1E, and 1J of the West Sak formation as well as drill site S in Schrader Bluff. He inquired as to why the aforementioned drill sites should be excluded.

MR. VAN DYKE explained that his exclusion listed in item one under the first definition of challenged oil would exclude areas where projects are well underway and will occur with or without

these credits. He opined that it probably isn't necessary to grant credits in areas and formations where there is a core area within a viscous reservoir that is already producing today and promises more development in the future. However, he opined that it's necessary to consider credits outside of the core areas and in formations such as Ugnu where there is no regular production today and the oil is very viscous. Therefore, the first definition attempts to carve out the "sweet spots" under development today. He related his belief that it would make sense to grant credits for enhanced oil recovery in the sweet spots and credits for development outside of the sweet spots in the reservoirs.

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CO-CHAIR SAMUELS commented that the committee can work with DNR as the legislation is drafted.

REPRESENTATIVE SEATON recalled discussions with regard to the PPT when the DNR commissioner related his belief that the legislature wouldn't want to place big money decisions, with regard to the buybacks, on the commissioner. The commissioner has seemed to indicate that such considerations should be left to the legislature.

REPRESENTATIVE ROKEBERG opined that if by definition particular areas should be specified, then the only discretion comes about for new areas applying for consideration. Therefore, he opined that the commissioner should be able to do make such decisions if sufficient guidelines are in place.

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MS. WILSON highlighted the importance of specifying the process and approval if the commissioner is given the discretion to certify an area as heavy oil.

CO-CHAIR SAMUELS asked if the concern is that a developer won't know whether there's heavy oil until the first exploratory well is drilled in a new area. He recalled that testimony from the engineers related that there is some knowledge as to whether an area has heavy oil, although nothing is certain until the first well is drilled.

MS. WILSON, referring to page 2, explained that the credit is envisioned for exploration. Therefore, once an area is

identified as a potential target, the question of timing should be specified.

CO-CHAIR SAMUELS said he would talk to the commissioner of DOR, who recommended not leaving such determinations to the discretion of the commissioner. As far as identifying the current areas, he announced that he was available to work with anyone interested, including the industry, to develop the language. Co-Chair Samuels then recalled that the rate floating with the price is of a concern for Representative Crawford. He also recalled that there was a question as to whether the credits are transferable.

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REPRESENTATIVE ROKEBERG related his understanding that the consensus was to not make the credits transferable.

REPRESENTATIVE SEATON suggested that if [the notion is to allow credits] for exploration, then they need to be transferable. However, if the exploratory aspect is eliminated, then the transferability isn't of concern. "But if we are leaving exploratory stuff in, we don't want to cut out all the small guys that don't have big production going, and saying this is only for the big guys," he said.

REPRESENTATIVE ROKEBERG noted his disagreement. He opined that the assumption is that the majority of this will impact the larger producers. The issue is whether the smaller producers/explorers have the cash flow to offset [the development]. "If we just make it a standard on that issue that they have to have, before they can take any credit, I think that's okay," he said. He related his understanding that Representative Seaton is suggesting that it should be liberalized and transferable.

REPRESENTATIVE SEATON related his disagreement. He clarified that if the exploratory part is included, it would need to be transferable because explorers aren't necessarily large entities.

REPRESENTATIVE ROKEBERG said he doesn't understand Representative Seaton's logic.

CO-CHAIR SAMUELS interjected that two separate issues are being discussed. He related his understanding that the consensus at the prior hearing was to make the credit nontransferable. With

regard to the exploration, the question was whether to have another 15 percent exploration credit "because this doesn't say heavy oil on that line." Therefore, the aforementioned was going to be eliminated because it referred to the development of heavy oil whereas for exploration one wouldn't know whether the exploration is for heavy oil or not. He then inquired as to how it would be determined that an exploration expense is looking for heavy oil when, by definition, exploration is occurring. He reminded the committee that for a wildcatter, the .185 credits are up to about 60 percent in the PPT.

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REPRESENTATIVE ROKEBERG highlighted that it's known that Chevron has a heavy oil prospect south of the Kuparuk River Unit. The aforementioned site/area isn't included in the list because it's a prospect at this point. Therefore, he questioned why additional heavy oil exploration should be discouraged.

CO-CHAIR SAMUELS inquired as to how to differentiate between all exploration and exploration for heavy oil.

REPRESENTATIVE ROKEBERG replied, "We could make it a delayed effect. They'd have to prove-up and ... meet the standards and guidelines ... because that would be outside the area of named area." He related that the company could turn in a retrospective application, which is not uncommon.

MS. WILSON related her understanding that to give credit for heavy oil exploration seems to assume that the purpose is heavy oil, which doesn't make sense. She preferred there [to be a credit] for all exploration or no exploration rather than trying to prove. She expressed concern with the intention and the primary purpose.

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CO-CHAIR SAMUELS inquired as to the company's perspective and how it goes about exploring heavy oil.

MICHAEL HURLEY, ConocoPhillips Alaska, Inc., explained that oftentimes when a company sets out to explore it's looking for whatever oil it can find. He specified that often all that the company has is seismic data and other data that will indicate that hydrocarbons will be in a particular area. However, nothing is guaranteed until drilling takes place. Still, in areas that are relatively shallow and close to the perma frost,

one can expect it to be relatively viscous oil. Again, drilling offers the only knowledge as to what type of oil is actually present.

CO-CHAIR SAMUELS posed a scenario under which Conoco explored in a new area and found something that it thought would be heavy oil. After drilling and finding it to be heavy oil, Conoco would apply for the area to be included in the heavy oil tax credit. In such a scenario, he questioned how much of the total cost of exploration would Conoco have already expended to that point.

MR. HURLEY answered that it would be a relatively small amount. Developing a heavy oil resource includes a lot of expense for development wells. For the first exploration well, depending upon the nearest infrastructure, the cost amounts to about \$10-\$30 million. With regard to development of that well, the additional development wells and the construction of the facilities are where the cost lies.

MR. HURLEY, in response to Representative Rokeberg, noted his agreement that when a company drills shallower areas, it's likely to be viscous oil because of the nature of the crude and the proximity to the permafrost.

REPRESENTATIVE ROKEBERG interjected that if it's light oil per the guidelines, then the company wouldn't receive the credit.

CO-CHAIR SAMUELS surmised that a small amount of money was expended to find this heavy oil, while development of it requires a large amount of money. Therefore, once the heavy oil is found, the company can approach the appropriate entity to request the credits proposed in HB 498. Co-Chair Samuels suggested that the policy call is whether to do the aforementioned or only [allow the credit] for development.

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REPRESENTATIVE ROKEBERG commented that Representative Seaton has a good point if there is trouble identifying the heavy oil or the company runs into lenses of heavy oil during drilling, which he suggested is the more common occurrence. He then returned to the case in which a company would attempt to produce heavy oil from the beginning, which would result in the construction of the lacking infrastructure.

CO-CHAIR SAMUELS reiterated that development would still be the large expense.

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REPRESENTATIVE SEATON clarified that his problem is in a situation in which a company explores for gas and finds a little heavy oil and thus can receive the additional 15 percent tax credit.

REPRESENTATIVE ROKEBERG said he doesn't disagree with that line of thinking.

CO-CHAIR SAMUELS opined that if most of the money [expended] is in the development, he didn't mind having a credit for it. However, he expressed concern with regard to the possibility of a company going back and forth depending upon what is found in the well. He highlighted that there are already exploration tax credits on the books and incentivizing it separately would seem to be an entirely separate policy.

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REPRESENTATIVE ROKEBERG said, "If we identify let's say West Sak - we use the geographic definitions and the units ...; the boundaries are clear by AOGCC and DNR, then there's recognition. ... if you were exploring the shallower depths there, are you saying you don't get the credit for that? Like, ... you have to discover it first or can you discover it? That's kind of the question."

CO-CHAIR SAMUELS opined that once the area is determined to be heavy oil, then it will be considered development rather than exploration. He asked that if a heavy oil field is designated, would everything done in that field be considered as development or would some of it be considered exploration. He opined that once the area is determined to be heavy oil, then the credit would be received.

MR. VAN DYKE related his belief that if the definition of West Sak formation within the Kuparuk River Unit is used, then any West Sak activity would be creditable.

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CO-CHAIR SAMUELS turned to alternative energy and expressed concern with giving the credits to the big producers and not to others.

REPRESENTATIVE SEATON remarked that this legislation is complicated enough with only addressing heavy oil, and therefore he opined that [the alternative energy provisions should be] excised.

REPRESENTATIVE ROKEBERG related his belief that [the alternative energy provisions] were worth including, especially due to the source of funds being created. However, he noted his sensitivity to piling on [with legislation].

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REPRESENTATIVE CRAWFORD opined that there is a reason to do a heavy oil credit, but there is a price at which the heavy oil won't be developed no matter the credits available. There is also a point, perhaps \$50-\$55 per barrel, at which all oil becomes economic. [This legislation] influences the band in between the aforementioned and will lead to more oil development and oil in the pipeline. Representative Crawford said that he didn't see a reason to provide for more advantages after a certain price.

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REPRESENTATIVE SEATON commented that price prospectivity is difficult to gauge. He related his understanding that this is being viewed somewhat on history and thus if there was a three-year past average price such that the credit wouldn't apply if the average is over \$50 per barrel. Therefore, if for three years the range is \$50 per barrel, the companies are making decisions based on the credit on what the market is really doing. At that point, the state doesn't need to pay this proposed credit.

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REPRESENTATIVE ROKEBERG expressed concern with reviewing history to determine some predictors. The problem with that is that currently the price has hit an all time record high and the state isn't familiar with the situation and where it's heading. Representative Rokeberg then related that he doesn't believe there is any need for a floor because it's self-fulfilling.

REPRESENTATIVES CRAWFORD AND SEATON clarified that they weren't referring to a floor.

REPRESENTATIVE ROKEBERG then reminded the committee that the legislation includes a 10-year sunset. Having the aforementioned will result in incenting the development now and provide the legislature the right to come back and make an adjustment. Therefore, he recommended not having a cap.

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CO-CHAIR SAMUELS inquired as to whether there is a tax mechanism that would incent [development] without placing an investor in the position of being unsure about the economics.

MS. WILSON expressed concern about having the credit based on price because it is difficult to apply it since there is the potential for "bumping up and down over the trigger." From a tax administration point of view, a sunset in a reasonable amount of time makes some sense. She highlighted that had the committee had this discussion six years ago, no one would've imagined this price and the trigger would be different. It's difficult to look into the future and specify the appropriate cutoff. Therefore, she opined that she would support the notion of a sunset before a price cutoff.

JEFF SPENCER, Heavy Oil Specialist, ConocoPhillips Alaska, Inc., reminded the committee that these projects need to be competitive with other investment opportunities within each company's portfolio. At a given price, say \$50 per barrel, a light oil will be more likely to be pursued because of the lower operational costs, the higher recoveries and rates, and the better price for the product. Therefore, he agreed that there is no need to place a cap on the price as it would be very difficult to manage and would increase uncertainty. In fact, he said he couldn't even envision how to factor that into his economic analysis of a heavy development project.

REPRESENTATIVE GATTO questioned how it would work to implement an equivalency between light oil and heavy oil. He specified that heavy oil is worth less and is more difficult to get, and thus when heavy oil reaches the market the money collected is less than that collected by selling crude oil. If the difference [in value] between the two was known, as the price of oil drops, the state would simply get the royalty share. "I guess the question is: the equivalent value of a barrel of

heavy, when you take away this extra cost and the lower selling price," he said.

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MR. SPENCER opined that such would be complicated and difficult to administer. He highlighted that the price of oil changes widely within one day.

REPRESENTATIVE GATTO said the price of oil doesn't matter because the equivalent value is going to be a specific amount less and the state will make up the difference.

MS. WILSON noted her agreement that it would be more difficult to administer such. She then expressed concerns with settling on the prevailing value of all of it as well as the differential. Ms. Wilson opined that it's not workable and doesn't seem to justify the advantage specified.

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REPRESENTATIVE SEATON noted that Mr. Spencer said the difference in cost is the only incentive that makes it more difficult than light oil. The legislature could say it is a certain amount per barrel, and thus there doesn't have to be any worry about percentages.

REPRESENTATIVE GATTO agreed, adding the value of the product would also be included.

MS. WILSON said that if the committee wanted to go that way and [specify] the number that is the cost differential, it would be easy to administer. However, if the desire is to divvy up costs and assign them to either light or heavy oil on a field-by-field, month-by-month basis, it would be an auditing nightmare.

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MR. HURLEY opined that it's similar to incenting development of a differential type crude. The aforementioned can be accomplished in one of two ways. The incentive can be accomplished by providing some credit for development costs or by determining the differential per barrel on the product. However, he didn't believe there would be a single number [that would fit] the different fields. Mr. Hurley related his understanding that the sponsor originally went with providing an incentive on the development dollars because there would be more

incentive [to develop] the Ugnu field because more development dollars will have to be spent. Therefore, 15 percent of development dollars will be larger at Ugnu than it would be at West Sak, for example.

REPRESENTATIVE GATTO said:

But Ugnu has a number that's stuck on the name Ugnu of \$8 and West Sak has a number that's nailed right into the side of the barrel and it's called \$7. Then whoever produces it in whatever quantities, ... it's a pretty simple calculation that says this ... barrel has a bounty on it and it's a \$7 bounty - you get that just by turning it over. And now it's up to you to say, "You know what, I like that bounty, I'm going to produce what I can" You don't have to calculate much; it comes out of the ground and you put it in a wood stave barrel, we know what it's worth to us that we have to pay

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MR. HURLEY noted his agreement that the aforementioned is a way to do it. However, when using that method experts have to be utilized to determine the correct number on the correct barrel.

REPRESENTATIVE OLSEN opined that there is a certain appeal to this method because the credit wouldn't be given until the product comes out of the ground.

MR. SPENCER pointed out that it will be many, many years before Ugnu is commercially developed. With regard to the proposed 10-year sunset, Mr. Spencer opined that the incentive would no longer be available when Ugnu is finally developed. He related that it could 10 years before the first barrel is produced, and the company wouldn't recover anything until many years later under a per barrel scenario. However, if the investment can be made within the next 10 years, there would be an incentive to accelerate that development.

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REPRESENTATIVE ROKEBERG opined that the aforementioned sounds deceptively simple. However, the difficulty lies in determining the cost of the various formations and how the cost would be assigned. Such a methodology would cause an ongoing auditing situation, which would be labor intensive.

REPRESENTATIVE GATTO said there could be a number that doesn't sunset. Furthermore, it could be determined that after the first 10 million barrels, the remaining barrels could have a different [cost] assigned.

CO-CHAIR SAMUELS indicated that Representative Gatto's proposal would be appropriate in separate legislation.

REPRESENTATIVE SEATON returned to the notion of the rate floating with the price. He opined that it's problematic if companies aren't incentivized to enter into projects when oil is \$50 per barrel for three years, for example.

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CO-CHAIR SAMUELS said:

If they're looking at investing over a five-year timeframe and having no hope of getting oil ... until year six or seven, do you incorporate this into the math or do you not incorporate it into this math? And how would you know? Say you're at \$70 a barrel now, you're right ... we're throwing money away, no doubt about it. And then next year we're at \$50 and the year after that we're down to \$35 again and all of a sudden they didn't incorporate it into the math, the project doesn't go forward.

REPRESENTATIVE SEATON noted his disagreement and said that the project would go forward because the credit would be received if oil falls to \$35 or \$45.

CO-CHAIR SAMUELS inquired as to when the money is spent and how much would be spent. Practically speaking, how would one administer when the series of expenditures for exploration or development would occur.

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MS. WILSON reiterated her earlier testimony that this is a timing issue that could result in the amendment of claims. She opined that [the credit] via an oil price trigger would be problematic.

REPRESENTATIVE CRAWFORD opined that the committee is losing sight of what it's after. If the credit has a price ceiling,

then there's a guarantee that when the price of oil falls below the specified amount, the [companies] will receive the credits. However, the companies don't need the credits at the price per barrel of over \$55. Therefore, if the price goes above [the specified price], the companies don't need the credit because they've had plenty of incentive.

REPRESENTATIVE SEATON reminded the committee that the notion is to use a three-year calendar average, and thus won't fluctuate madly. He stressed that when the credits don't apply because the price of oil is higher than the specified price, the companies are making money hand over fist.

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CO-CHAIR SAMUELS asked:

You're idea would be they'd get the credits on all of the expenditures that they've had. At [\$]70, it's one thing to sit here and have the discussion, but let's say we put the pivot point at \$50. When ... three weeks ago when we all sat in this room on the PPT, we used ... \$60 a barrel it was going between [\$]59 and [\$]61. What are you going to do when your magic number is \$50 and you get a 15 percent credit. Well, it drops down to your tenth and all of a sudden a 15 percent credit would get \$40 million and all of sudden you don't get it

REPRESENTATIVE SEATON interjected that it would be based on three-year calendar averages.

REPRESENTATIVE ROKEBERG highlighted that if a cap is specified, that cap will be gamed. He explained that if the price went through the gap, he would, were he running the field, shut down any new investment, although production would continue. Therefore, the company would wait to continue production until the price decreases.

REPRESENTATIVE SEATON opined that a company wouldn't do that at \$50 per barrel.

REPRESENTATIVE ROKEBERG begged to differ, and highlighted that price fluctuates.

REPRESENTATIVE SEATON reminded the committee that it's a year-long average.

REPRESENTATIVE ROKEBERG opined then that the field would be shut down for a longer period of time.

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REPRESENTATIVE SEATON related his belief that with a three-year average price on a calendar year, everyone has the planning stages they need. He further related his belief that such a methodology would be self-correcting and not something that can be gamed.

REPRESENTATIVE ROKEBERG emphasized that the intention is to get investment in heavy oil. There are 20 billion barrels in Ugnu just sitting there. He then reiterated his belief that a three-year average can be gamed. Furthermore, there is no history to utilize in setting it.

REPRESENTATIVE SEATON pointed out that there are three-year average prices for West Texas Intermediate and Alaska North Slope West Coast, all of which are known numbers calculated in average prices.

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CO-CHAIR SAMUELS turned the committee's attention to his last major concern, which was the reference to gas in the title. He recalled that the engineers testified that generally speaking there isn't a lot of gas associated with heavy oil, which he said satisfied him.

REPRESENTATIVE SEATON commented, "As long as they put the 5,500-foot limit in there and identifying the fields, I don't have a problem."

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REPRESENTATIVE ROKEBERG requested that Ms. Wilson true up on subsection (f) on page 3 to HB 488 in terms of its application.

CO-CHAIR SAMUELS related his understanding that the outstanding issues are in regard to whether the determination of the credit should be left to the commissioner or the legislature, and the rate floating with the price. Co-Chair Samuels, in response to Ms. Wilson, confirmed that there was consensus that this won't be exploration tax credit legislation.

[HB 498 was held over.]

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at [3:38:58 PM](#).