

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 7, 2007

1:01 p.m.

MEMBERS PRESENT

Representative Carl Gatto, Co-Chair
Representative Craig Johnson, Co-Chair
Representative Vic Kohring
Representative Bob Roses
Representative Paul Seaton
Representative Peggy Wilson
Representative Bryce Edgmon
Representative David Guttenberg
Representative Scott Kawasaki

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

OVERVIEW: DEPARTMENT OF NATURAL RESOURCES — DIVISION OF OIL &
GAS

- HEARD

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

KEVIN BANKS, Acting Director
Central Office
Division of Oil & Gas
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: Presented Division of Oil & Gas overview.

ACTION NARRATIVE

CO-CHAIR CARL GATTO called the House Resources Standing Committee meeting to order at 1:01:09 PM. Representatives Gatto, Johnson, Kawasaki, Kohring, Wilson, and Seaton were

present at the call to order. Representatives Roses, Guttenberg, and Edgmon arrived as the meeting was in progress.

OVERVIEW: DEPARTMENT OF NATURAL RESOURCES – DIVISION OF OIL & GAS

1:02:09 PM

CO-CHAIR GATTO announced that the day's only order of business would be an overview by the Department of Natural Resources, Division of Oil & Gas.

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KEVIN BANKS, Acting Director, Central Office, Division of Oil & Gas, Department of Natural Resources (DNR), referenced pages 2 and 3 of his written presentation and explained that by encouraging oil and gas exploration and development, the division maximizes revenue to the state. He stressed that his primary concern is making sure the state gets what it is entitled to under the provisions of its lease agreements.

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MR. BANKS then directed attention to page 4 of his written presentation regarding the gross oil volumes produced from state leases between January 2006 and November 2006. He noted that during this time period the State of Alaska received from its leases a gross oil volume of 32,823,355 barrels. This amount is four times the volume produced by the state's fourth largest producer, he pointed out. The state is in the enviable position of receiving approximately 100,000 to 120,000 barrels a day, he emphasized, a position most oil companies would be delighted to be in.

MR. BANKS reminded the committee that oil and gas revenue constitutes nearly 90 percent of the state's total General Fund (GF) revenue, as shown on page 5 of his written presentation. For fiscal year 2006 (FY 06), the division was responsible for about \$2.4 billion in royalty collections. He pointed out that the Division of Oil and Gas contributed more than half of all of the state's revenues for FY 06. Mr. Banks then referred to pages 6 and 7 of his written presentation and relayed that, over the past few years, royalty revenues on state lands increased while production decreased. He also pointed out that the state is selling over 60 percent of its royalty to Flint Hills Resources Alaska, LLC ("Flint Hills"), alone, and the resulting

revenue is more than the state receives from any other individual producer.

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REPRESENTATIVE SEATON asked what percentage of Alaska's royalty is taken in-kind versus in-value.

MR. BANKS reported that 60 percent of the state's royalty is taken in-kind and sold to Flint Hills Resources, the state's sole customer for royalty-in-kind (RIK). Responding to further questions, he noted that the State stopped selling to the Tesoro Alaska Company's ("Tesoro") refinery in Nikiski in 1998. Most of the oil used by this refinery comes from the Cook Inlet, with additional oil being shipped in from Valdez. Tesoro also ships oil by tanker to the Lower 48. In response to another question, he explained that state regulations require that the State receive more for sales of RIK. For example, the 2004 [Flint Hills] contract guarantees the state at least 30 cents more for its RIK. However, he continued, because of the formula used for calculating RIK, the state receives much more than that, as compared to what it receives for royalty-in-value (RIV).

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CO-CHAIR GATTO inquired whether Flint Hills had a lawsuit pending to recover some of that royalty money.

MR. BANKS replied that there are two disputes before the Federal Energy Regulatory Commission (FERC). One is a long-standing dispute regarding the calculation of components in the Trans-Alaska Pipeline System (TAPS) Quality Bank. He explained that when Flint Hills and other refineries take oil out of the pipeline, make products from it, and then dispose of oil back into the pipeline, they are changing the quality of the oil for all the other pipeline users. Therefore, he said, the refineries must pay into the Quality Bank to make whole those companies whose oil is being shipped all the way to Valdez. He stated that Flint Hills and Petro Star, Inc. will have to pay more into the Quality Bank if the State and other shippers prevail.

MR. BANKS said the second dispute involves the TAPS tariff for inter-state rates. Several years ago, he explained, the Regulatory Commission of Alaska (RCA) lowered the intra-state tariff. Today, the pipeline charges \$1.96 [per barrel] for shipping oil from Pump Station 1 on the North Slope to Valdez

for intra-state use, such as for the Nikiski refinery. However, the pipeline's inter-state rate has risen over the last few years and is currently \$5.20 [per barrel]. It is this difference that is at issue, he pointed out. The plaintiffs are asking the FERC to decrease the \$5.20 inter-state rate. Because of how the State calculates the price it charges Flint Hills for the State's RIK, he continued, the company deducts that \$5.20 from the price. If the FERC orders a new change to the tariffs that have been suspended during this litigation, a retroactive contract provision will allow the State to collect the \$3.24 difference from Flint Hills.

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MR. BANKS, responding to a further question, stated that it is the pipeline that charges the \$5.20 for the service of moving the oil from the North Slope to Valdez. After the oil leaves Valdez there are additional tanker charges. He explained that oil is valued at Pump Station 1 using a "net-back calculation." This calculation begins with the market price where the oil is sold on the West Coast, called the ANS Spot Price. Deducted from the market price is the cost of tankers or a location differential – one or the other – then there is a deduction for the tariff, as well as adjustments for quality.

MR. BANKS, referring to page 8 of his written presentation, then discussed the six sections comprising the Division of Oil & Gas: Resource Evaluation, Leasing/Permitting, Unit/Tech Support, Royalty Accounting, Audit Section, and Commercial Section. He outlined the duties of the various sections which include: developing concepts about prospects and exploration, monitoring development proposals received from the oil industry, monitoring and administering leases, conducting lease sales, maintaining the legal documentation of leases, calculating royalty and determining whether the state should take RIK or RIV, and ensuring that the environmental and other lease obligations are being met by the industry.

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REPRESENTATIVE EDGMON inquired whether the division's duties are easier since the Office of Habitat Management & Permitting (OHMP) was moved from the Alaska Department of Fish & Game (ADF&G) to the DNR.

MR. BANKS stated that there is now better access to the OHMP. He said one aspect that is different is that the roles between

his division and the OHMP seem more balanced and this has reduced the tension that existed before.

MR. BANKS then directed attention to the summaries of the division's 2006 achievements and activities as outlined on pages 9-14 of his written presentation and to pages 32-37, which summarize North Slope and Cook Inlet oil and gas development activities. These summaries, he explained, can be used to better interpret the features of the two maps included in committee packets.

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REPRESENTATIVE SEATON requested the definition of the term "PA" as used on page 11.

MR. BANKS began by explaining that a "unit" is an aggregation of leases over a prospect. Aggregating the leases provides efficient and economic production of the state's oil, and reduces the environmental impact because only one set of facilities is built over a field instead of many. The correlative rights of the lease owners within a unit must be protected when oil developments occur. At the initial formation of a unit, he continued, the size of the "tank," so-to-speak, is not quite known. As exploration occurs, an opinion can be formed about how big that tank is, and a participating area, PA, is then formed. Production from that PA is allocated to the various owners, including the state as a royalty owner. He explained that eventually the knowledge about a PA is refined and the unit will shrink to the size of that PA. The acreage remaining outside of the PA is then released for attracting new entrants.

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REPRESENTATIVE SEATON inquired what the distinction is when there are four PAs located within one unit.

MR. BANKS explained that a unit can contain more than one PA, depending on the zones that wells are producing from. A PA is defined by the pool of hydrocarbons. There could be a PA at one depth and another PA at a different depth. Defining a PA, he continued, determines what share of production each lease owner will receive from that PA. A PA manages the correlative rights of the various participants in the unit. For example, depending on the various lease ownerships on the surface, Company A might get 60 percent of the production from a particular PA and

Company B might only get 20 percent. In other words, a unit is a surface area designation and a PA is a reservoir designation.

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REPRESENTATIVE GUTTENBERG surmised that the definitions are for the horizontal surface as well as for the vertical depth of the different fields; therefore, facilities located right next to each other can represent very different entities. He then mentioned the previous administration's proposed Lease Monitoring and Engineering Integrity Coordinator's Office (LMEICO) to be established within the DNR, and asked what role the Division of Oil & Gas would be playing in the LMEICO and the addressing of regulatory gaps.

MR. BANKS stated that under the LMEICO, liaisons from the Department of Environmental Conservation (DEC), the Joint Pipeline Office, and other state and federal agencies would be physically located in one place. However, he said, the Division of Oil & Gas is suggesting that Governor Palin instead consider using a proposed Petroleum Systems Integrity Office (PSIO), described on page 20 of his written presentation, as an alternative. Rather than establishing a separate coordinator's office, liaison people would be identified within each of the departments and arrangements would be made for complete communication among those agencies. The liaisons first task would be identifying regulatory gaps and making sure those gaps are filled. The PSIO would reside within the Division of Oil & Gas because the pipeline facilities are within the units managed by the division and the unit agreements give the DNR the authority to manage and inspect facilities so that production occurs safely and continuously.

REPRESENTATIVE GUTTENBERG responded that it might take legislative oversight [of the PSIO] to make sure that that happens.

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MR. BANKS then directed attention to pages 32-33 of his presentation and to the two maps showing North Slope and Cook Inlet oil and gas activities for 2006-2007. He noted that the bold, black lines delineate the units and the callout boxes describe the activities underway within the units. He reported that exploration activities increased on the North Slope over the past year and that new players are involved. He also reported that the division just approved three new units shown

on the Cook Inlet map – the North Alexander Unit in the Matanuska-Susitna (Mat-Su) Borough area and the offshore Corsair and Kitchen units. Not illustrated on the maps, he continued, are companies working in the National Petroleum Reserve-Alaska (NPR-A) such as ConocoPhillips Alaska, Inc. and FEX, L.P., a company new to Alaska.

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CO-CHAIR JOHNSON asked whether permits have been issued for all of the leases awarded in the Cook Inlet over the past several years.

MR. BANKS said the answer is, "No," because the leases for 71 Cook Inlet tracts sold in May 2006 have not yet been issued. However, he stressed, that is not an abnormal length of time because a lot of survey work must be conducted after a lease is awarded. He said he believes that leases from a couple of years ago which experienced delays have all been issued. HE further explained that the timeline between purchasing a lease and taking possession for drilling is much less than two years. Title work is done by the Division of Mining, Land and Water, he continued, and an additional title person was hired to help with a backlog in the workload. Unlike earlier years, title work is now done after leases are purchased, rather than before, so that time is not wasted on surveying unsold leases. Furthermore, he said, the division offers leases throughout the whole area of the Cook Inlet each year. This provides industry with predictable and manageable access to the oil and gas lands in the Cook Inlet, he emphasized, and [offering leases throughout the whole area] also applies to the North Slope, the Beaufort Sea, and now the Bristol Bay region.

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REPRESENTATIVE GUTTENBERG asked if the attitude of the oil and gas industry has changed with the election of a new governor who is seeking changes to the previous proposed gas pipeline contract.

MR. BANKS said he is being told by exploration companies that they are targeting gas on the North Slope, not just oil. Also, he pointed out, there is an expectation on the part of new players that this pipeline is going to be built by the time they are ready to participate.

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REPRESENTATIVE GUTTENBERG requested an expansion on activities happening in the Nenana Basin.

MR. BANKS reported that there is an exploration license over the area and that some seismic work has been completed in conformance to the work commitments. However, plans for drilling a well are currently on hold, he said, because the Nenana Basin geology is very complicated and there is some uncertainty as to whether a drilling program there will yield an economic source of gas for local use in Fairbanks or for delivery to some kind of a pipeline. Mr. Banks further reported that the division's approval for putting the Nenana drilling on hold was not needed because a well was not part of the work commitment for the license. Evaluation of the seismic information is being completed, he continued, and questions remain as to whether an exploration well is the logical next step. He offered to send members a more complete summary of activities in the Nenana Basin.

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MR. BANKS, in response to a question, relayed that the public school trust fund receives one-half of 1 percent of the royalties and is not a large fund. He offered to research the topic and provide more information to members.

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CO-CHAIR GATTO requested clarification regarding the School Fund footnote on page 5 which states, "Includes Federally shared rentals + royalties".

MR. BANKS explained that Alaska receives "about 27 percent" of the royalties from federal lands located between three miles and six miles on the outer continental shelf (OCS). The federal government is obliged to share these particular revenues with coastal states under provisions of [Section 8(g)(2)] of the Outer Continental Shelf Lands Act. An example, he said, is the royalty collected by the federal government on its leases in the North Star Unit on the North Slope. Another example is the royalty received under provisions of the Mineral Leasing Act where the state receives 90 percent of the royalties from production on federal lands in the Cook Inlet. Beyond the six miles, all of the royalties belong to the federal government.

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REPRESENTATIVE GUTTENBERG inquired whether the percentage of royalty revenues paid under the Outer Continental Shelf Lands Act is the same for each state.

MR. BANKS said he thinks the [Section 8(g)(2)] revenues apply to all coastal states equally, a [27 percent] share of the royalties. Coastal states have tried through Congress to acquire a greater share of the OCS revenues, he commented, but to his knowledge those requests were denied because non-coastal states do not want their federal revenues clipped by a coastal state. He confirmed that the aforementioned revenues go into a pool that is then divided amongst the coastal states.

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REPRESENTATIVE SEATON pointed out that in the last Congress there was a bill in which the five southern states succeeded in getting 70 percent of those off-shore royalties and Alaska was cut out. He said he and others opposed the Bristol Bay leases because that same royalty distribution would have been applied to those leases.

MR. BANKS said he will get back to the committee on this issue, but offered his belief that there are no current leases in Bristol Bay on the OCS.

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REPRESENTATIVE EDGMON asked if the division plays any policy-making role in the OCS process in addition to any informational roles.

MR. BANKS replied that the division responds to the environmental and lease processes conducted by the U.S. Minerals Management Service on the OCS by providing comments for the governor's signature.

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REPRESENTATIVE GUTTENBERG inquired whether the magnetic mapping process done by the Division of Geological & Geophysical Surveys while looking for gold could also be useful in looking for oil.

MR. BANKS responded that magnetic surveys are indeed used for some of the initial exploration play for oil and gas.

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REPRESENTATIVE SEATON requested further information regarding the issues listed on page 15 of the written presentation.

MR. BANKS explained that on the issue of the Point Thomson Unit the lessees asked for a reconsideration of the DNR's November 2006 decision made by then-Commissioner Menge. In December 2006, the [acting] commissioner, Marty Rutherford, affirmed the first decision. Mr. Banks said the lessees sued the state on the issue of termination of the unit and there is currently a motion to consolidate the appeals into a single case.

MR. BANKS next referred to the issue of the North Slope Natural Gas Pipeline. He said the gasline team led by Acting Commissioner Rutherford is proceeding and there has been discussion with applicants and experts regarding how the [proposed] Alaska Gasline Inducement Act (AGIA) should be written. The legislature will help determine what the state wants out of the gas pipeline as it considers the AGIA, he said, unlike the process of writing the Alaska Stranded Gas Development Act which simply offered a contract to the legislature without its involvement.

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MR. BANKS then discussed the issue of New Unit Initiatives in Cook Inlet. Supply-and-demand is obviously going to be an extremely important issue for the Cook Inlet, he emphasized. This is highlighted by "ConocoPhillips" and "Marathon" announcing that they would like to extend their federal export license to continue shipping liquefied natural gas (LNG) to Japan through 2011.

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CO-CHAIR GATTO asked if exploration in Cook Inlet is for gas and oil and whether new wells have been productive.

MR. BANKS stated that recent exploration in the Cook Inlet has been for gas. More than 300 exploration wells have been drilled in the Cook Inlet over the past 50 years. During the last seven years, he said, 30 wells were drilled and many of those were targeting gas. The market appears to be opening up and changing, he explained, and new players are interested in participating. There are new reserves as a result of that exploration. Many of the wells were drilled into existing known

prospects and development on those is still pending. There have been a few dry holes too, he said.

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REPRESENTATIVE SEATON offered his understanding that some time ago the RCA had approved higher gas prices on the assumption that higher prices would stimulate development and exploration for more gas. He said he further understood that the RCA recently denied another proposed price increase because it determined that the gas companies had kept the profits and not expanded exploration. Are "we" left with a cheap price in the Cook Inlet that is not going to expand the exploration fields, he inquired.

MR. BANKS explained his belief was that the RCA's objection was to the price mechanism used in the contract being offered by ENSTAR Natural Gas Company ("ENSTAR") and "Marathon." The contract used the Louisiana Henry Hub price indices, which the RCA felt to be a market indicator unrelated to the real cost of providing gas in the Cook Inlet. However, he said, he did not think the RCA categorically stated that the [Henry Hub] price is too high, but rather that a better market price indicator might be one used closer to the wellhead in the Lower 48 and would still be higher than the prices seen in historical contracts in the Cook Inlet. He stated that, in his opinion, the "Unocal/ENSTAR" contract approved some years ago by the RCA did generate increased exploration activity in Alaska.

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MR. BANKS responded to further questions by pointing out that ENSTAR is reporting it will have a gap in its supply requirements beginning in 2009; ENSTAR will have to find sellers in the marketplace that can fill that gap, he said, and it will likely be at historical prices. He said a Division of Oil & Gas economist describes the market as a "tightened balance" - there is only so much gas that can be consumed in the Cook Inlet because it is isolated from any other destination. As a result, he continued, once that demand is satisfied it is hard to put any more gas in at any price. Mr. Banks stressed that there are significant resources [in Alaska] "where a market needs to be cracked open so that we can see an increase in reserves instead of what looks like a precipitous drop in reserves."

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CO-CHAIR GATTO discussed that many people feel the exportation of LNG from the Nikiski plant should be stopped and the gas instead saved for use in Southcentral Alaska. However, the demand for gas in Cook Inlet is three times higher in the winter than in the summer, he explained. Rather than storing gas to meet the winter demand, the LNG exports are simply reduced during the winter months so that enough gas is available for use in Southcentral Alaska. The end result, he continued, is that having LNG exports is good because it allows Southcentral Alaskans to have gas at a decent price. He asked whether it is possible to run out of gas if exportation of LNG continues, or is it that the gas is there and can be developed when the market demand is high enough.

MR. BANKS responded that there is a "chicken and egg" problem. The division's estimates show there is another eight years of known reserves in currently developed fields. There is another 1.6 trillion cubic feet (TCF) of gas that could be explored for, and this would add an additional eight years of supply. So yes, he said, there is more gas [in the Cook Inlet], but it is going to be harder to find and more expensive to develop. He went on to explain that if, for example, a producer discovered a field with 10 billion cubic feet (BCF) this amount would supply only a small fraction of the current [Alaskan] marketplace and, therefore, the producer would likely find a position in the marketplace. However, he said, if this same producer were to discover 100-200 BCF of gas, then that producer might be left standing in line waiting to develop that resource. Somehow, he stressed, the market needs to accommodate for large discoveries and this is an issue that is being discussed in respect to an export license extension.

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MR. BANKS further pointed out that the Nikiski LNG plant is the only LNG exporter in the U.S. He confirmed that Co-Chair Gatto's portrayal of the seasonal swings in the marketplace correctly describes what is at issue for ENSTAR and, to a lesser extent, other electrical utilities. What ENSTAR requires in a contract is that kind of deliverability and this can be provided for by developing the field with a lot of compression with a lot of wells, or by constructing and providing storage in spent fields where gas is injected during the summer and drawn out during the winter, or by "backing out" supplies that go to the Nikiski LNG plant.

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REPRESENTATIVE WILSON requested that Mr. Banks review page 31 of his presentation entitled, "Oil and Gas Incentives".

MR. BANKS explained that this page is an inventory of the kinds of incentives that can be offered either automatically or at the request and application of a lessee/producer. These incentives figure into the economics of an exploration prospect differently based on whether they can be counted on or whether permission must be requested. A royalty reduction incentive would need to be applied for. Exploration Incentive Credits (EICs), on the other hand, are offered with the lease and might be offered with a very specific work commitment. Additional incentives, he continued, are discovery royalties, Exploration Incentive Credits (EICs) through the Department of Revenue (DOR), and production profits tax (PPT) credits for North Slope producers. His understanding, he said, is that at very high price levels, when the PPT is at its maximum, the state may offer a tax credit of up to 60-70 percent of the cost of drilling an exploration well; however it remains to be seen whether this credit will affect exploration activity.

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REPRESENTATIVE GUTTENBERG referred to a recent article in The New York Times dealing with Gulf Coast oil and gas issues. The article said that in the long term, tax and other incentives for production did not result in producing any more oil and gas than would have been produced otherwise. According to the article, he said, incentives are generally reductions for things the oil companies were going to do anyway and, therefore, end up being enhancements for corporate bottom-lines. Referencing page 16 of the written presentation, he asked what the division is doing to expand the number of explorers and producers on the North Slope. He said he believes that facility access would open up more exploration and create more jobs in the state.

MR. BANKS agreed that facility access is extremely important, and that this applies to pipelines as well as machinery and buildings. Also, he said, low inter- and intra-state tariffs are important to a company that is looking to find and produce oil, because the tariffs affect the amount a company will get in "net-back" value. The state offers land [for lease] every year on the North Slope on a predictable and area-wide basis so companies know they will have predictable access to the resource.

MR. BANKS pointed out that the capacity and capability of facilities on the North Slope were examined as part of a division study done several years ago. He said the division is currently playing the role of ensuring that incumbents are playing fairly with newcomers. Virtually all facilities on the North Slope are running at or near capacity, he emphasized. They are constrained either by water or gas handling, or by oil in some of the newer oil fields. Putting a newcomer's oil into an incumbent's facility comes at the cost of having to back out some of the oil being produced by the incumbent. However, he continued, chances are that some of the fluids a [newcomer] is requesting to bring to an incumbent's facility have a much higher oil content than the fluids coming from the incumbent's oilfield. In this case, a [favorable] outcome might result because both parties will benefit from more efficient use of the equipment that is already there. Mr. Banks said he prefers to see the companies reach their own solution to the problem of facility access and, then, if this does not work the state could become more pro-active and get involved.

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REPRESENTATIVE GUTTENBERG noted that not everything on the North Slope is regulated by either the FERC or the RCA and some of those gaps become restrictions on trade. Wherever there are regulatory gaps the prices charged can be raised high enough to keep others out. He asked if either the division or the RCA is looking at closing such gaps.

MR. BANKS responded that the division will first be looking at the issues of systems and integrity to determine where there are regulatory gaps in implementing a monitoring program. However, he said, the question of facility access still needs to be explored. He pointed out that pipeline access is regulated by the RCA and the FERC, and the boundary is typically the boundary of the unit. The Division of Oil & Gas, through its unit agreements, has some authority that could perhaps be exercised for facility access upstream of the boundary of the unit. He said that the division is looking into what needs to be done and what the division can do in that regard.

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REPRESENTATIVE SEATON pointed out that the long-term issues for slowing the decline in oil production and for facility access apply also to gas. One of the biggest problems has been trying to provide capacity for the minor players, he said. He urged

the Division of Oil & Gas to participate in future discussions before the House Resources Standing Committee regarding the technology of converting gas to oil for injecting into the TAPS. He said his understanding is that this would extend the pipeline's life to the year 2035 without further oil discoveries, and that this would also give the state further options to consider when discussing a gas pipeline.

MR. BANKS stated that he planned to be in on those discussions.

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CO-CHAIR GATTO expressed his belief that converting gas to liquid is a last resort, or at least a backup plan, if the state is unable to get a gasline.

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REPRESENTATIVE GUTTENBERG offered his belief that money is supposedly being set aside for the dismantlement, removal, and restoration of the TAPS, should it ever come to that. He asked if Mr. Banks knew where those funds are being held.

MR. BANKS responded that those funds "are on the balance sheet of the owners of that pipeline." He offered to research the issue and provide the committee with further information regarding the current amount of those funds and where they are located.

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ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:34 PM.s