HOUSE FINANCE COMMITTEE
March 18, 2010
9:25 a.m.

9:25:56 AM

CALL TO ORDER

Co-Chair Stoltze called the House Finance Committee meeting to order at 9:25 a.m.

MEMBERS PRESENT

Representative Mike Hawker, Co-Chair
Representative Bill Stoltze, Co-Chair
Representative Bill Thomas Jr., Vice-Chair
Representative Allan Austerman
Representative Mike Doogan
Representative Anna Fairclough
Representative Neal Foster
Representative Les Gara
Representative Reggie Joule
Representative Mike Kelly

MEMBERS ABSENT

Representative Woodie Salmon

ALSO PRESENT

Representative Peggy Wilson, Sponsor; Reid Harris, Staff, Representative Wilson; Casey Schroeder, Staff, Representative Bill Thomas; Roger Marks, Consultant, House Finance Committee.

PRESENT VIA TELECONFERENCE

Dick Mylius, Director, Division of Mining, Land and Water, Department of Natural Resources; Mark Earnest, Haines Borough Manager; Cody Rice, Petroleum Economist, Tax Division, Department of Revenue; Robynn Wilson, Income Audit Manager, Tax Division, Department of Revenue.

SUMMARY

HB 273 MUNICIPAL GENERAL GRANT LAND

CSHB 273 (FIN) was REPORTED out of Committee with a "do pass" recommendation and the previously published fiscal note: FN# 1(DNR)

HB 280 NATURAL GAS

HB 280 was HEARD and HELD in Committee for further consideration.

9:26:04 AM

#hb273
HOUSE BILL NO. 273

"An Act relating to general grant land entitlements for the City and Borough of Wrangell; and providing for an effective date."

9:27:16 AM

REPRESENTATIVE PEGGY WILSON, SPONSOR, spoke briefly to the legislation.

9:27:55 AM AT EASE
9:29:08 AM RECONVENED

REID HARRIS, STAFF, REPRESENTATIVE WILSON, explained that the bill related to land entitlements for the City and Borough of Wrangell. Wrangell had originally received a smaller land entitlement of 1,952 acres from the state when the borough was set up. The formula used by the Department of Natural Resources (DNR) for giving land to boroughs deeds 10 percent of vacant, unappropriated, and unreserved (VUU) state land; Wrangell is comprised of 97 percent federal land. Wrangell negotiated with DNR to get 6,506 acres total. Later, the borough realized that the 2,500 acre Sunny Bay parcel shown on the map (copy on file) was slated for the University of Alaska.

Mr. Harris referred to various parties who used the Sunny Bay parcel: Alaska Crossings, a statewide wilderness youth program; another individual with a guide business; and the inhabitants of Meyers Chuck. He explained that an amendment would allow the City and Borough of Wrangell to exercise control over the area to provide for the economic and recreational needs of its citizens. He pointed to a

conflict with HB 295, the university land grant bill, and noted that Representative Wilson had passed an amendment in the House Resources Committee giving Wrangell precedence over the university related to the requested land.

9:32:28 AM

Representative Fairclough asked whether Wrangell still has first choice over the university. Mr. Harris responded that the university bill was amended and would give Wrangell first choice over the university.

Representative Fairclough thought there was already a statute stating the fact and wanted to know why an amendment was also needed. Mr. Harris responded that HB 273 had been amended in the Community and Regional Affairs Committee (CRA) to provide 6,506 acres; the amendment before the House Finance Committee seeks to add an additional 2,500 acres (the exact size of the Sunny Bay parcel). He detailed that the sponsor wanted to amend both bills: HB 295 to give Wrangell priority choice over the university, and HB 273 to increase Wrangell's land grant to allow them to select the parcel.

Representative Wilson stated that the normal process allows a borough to select 10 percent; if the amendment passes the amount would only be one half of one percent. She added that the Sunny Bay parcel was not in the original bill because the boundaries of the borough were not known.

Representative Fairclough understood that the preference of the borough's selection over the university was already in current statute (AS 14.40.365). She asked whether something had changed to necessitate changing statute. Mr. Harris responded that the statute does not list the particular parcel.

Representative Fairclough wondered whether the intent was then further clarity. She asked if the statute allowing the borough first choice was still in place. Mr. Harris responded in the affirmative.

9:35:52 AM

Vice-Chair Thomas MOVED Amendment 1, 26-LS1292\R.4 (Cook, 3/16/10):

Page 2, line 6:
Delete "6,505"
Insert "9,006"

Co-Chair Stoltze OBJECTED for discussion.

Vice-Chair Thomas spoke in favor of encouraging the formation of boroughs, and opined that the state should give state land when a borough does not have enough. He hoped DNR would support the addition of the parcel.

9:37:27 AM

DICK MYLIUS, DIRECTOR, DIVISION OF MINING, LAND and WATER, DEPARTMENT OF NATURAL RESOURCES (via teleconference), addressed Representative Fairclough's question, explaining that the university statute needed to be amended because it was ruled unconstitutional, which is why the university land bill is before the legislature again. He underlined the fact that there is no current statute giving the borough preference over the university.

Mr. Mylius turned to the position of DNR on HB 273. He explained that the department agrees that the entitlement for the City and Borough of Wrangell was not sufficient. He detailed that the formula regarding how much land is allotted to municipalities is driven by AS 29.65 allowance of 10 percent of vacant, unappropriated, and unreserved state land. He noted that the City and Borough of Wrangell and Haines Borough entitlements are small because both are surrounded by national forest land. The department had agreed to work with both Wrangell and Haines to consider appropriate parcels of land in order to increase the entitlements. He reported that the number DNR proposed for the City and Borough of Wrangell was 6,506 acres.

Mr. Mylius stated that the department did not support the amendment to increase the entitlement because it felt transfer of the [Sunny Bay] parcel to the university was more appropriate. In addition, commitments had been made to the university. He noted that the House version of the bill had been amended in the House Resources Committee to remove the parcel, although the parcel is still slated for the university in the Senate version of the bill.

Mr. Mylius added that DNR supports the efforts of Wrangell and Haines to increase their entitlements.

9:40:15 AM

Representative Gara pointed out that the bill does not identify the parcels; he wanted to know whether the acreage discussed corresponded to the parcels. Mr. Mylius responded that the department had a “gentleman's agreement” with the City and Borough of Wrangell as to what lands would be selected. He noted there were limits to the land that could be selected, as the statutory definition of what lands municipalities can get is still “vacant, unappropriated, unreserved (VUU) state lands.” He stressed that all the lands that have been discussed with the City and Borough of Wrangell qualify as VUU lands; a subsequent decision-making process will have to take place to determine whether it is in the state’s best interests to transfer the specific parcels of land. He added that one of the big issues was impact on the state’s timber program in Southeast; the department wanted to minimize the valuable timber lands that would be transferred.

Representative Gara voiced concerns regarding the Crittenden Creek watershed and asked whether the watershed was part of the proposed land transfer. Mr. Mylius responded that the borough had indicated an interest in a portion of the parcel, not the entire parcel.

Representative Gara pointed to statute that requires the state to maintain a public access easement to water bodies (including streams) when it transfers land. He asked whether the “to and along easement” would be automatically reserved if the parcel was transferred to the borough. Mr. Mylius responded that providing for the easement is a requirement of any land transfer. Public and navigable waters are identified and then easements along and to the water bodies are reserved.

Representative Gara asked whether the easement language was required in the bill or if current statute was sufficient. Mr. Mylius replied that all land transfers routinely require the easement and that there is no need to reference it specifically.

9:43:37 AM

Vice-Chair Thomas asked whether the university parcel was part of the allowable timber cut in Southeast. Mr. Mylius

responded that the university parcels were not, but the parcels Wrangell is interested in were. Most of the parcels the borough wanted prior to the Sunny Cove parcel were not targeted by the university.

Representative Fairclough asked the estimated value of the 6,506 acres of land. Mr. Mylius replied that he did not know; municipal entitlements are strictly acreage driven and DNR does not calculate the value.

Representative Fairclough wondered whether the 9,006 acres requested by the sponsor should be incorporated. Mr. Mylius responded in the affirmative. He explained that although municipal entitlements are formula driven, there have been times when the legislature has chosen to change the purview. He gave the examples of Yakutat and the Lake and Peninsula Boroughs.

Representative Fairclough asked whether the constitutional challenge to the university land grant was the only reason the parcels were available. Mr. Mylius responded that the Sunny Bay parcel would have remained deeded to the university if the university land bill had not been challenged or if the state had prevailed. He added that the university would have to deed the parcel back to the state by May 1 if the university land bill did not pass.

9:47:00 AM

Representative Kelly queried the history of the changing acreage requested. Representative Wilson explained that Wrangell had originally asked for 19,000 acres; the amount has gone progressively down to 6,500. The amendment would add a parcel already used by residents and bring the total up to half of the original request.

Mr. Mylius added that the original entitlement for the City and Borough of Wrangell was about 1,900 acres, the formula-driven 10 percent of the VUU state land. The original HB 273 asked for 19,000 acres; DNR felt that amount was unacceptable as it would significantly affect university lands and allowable timber cut calculations for Southeast. Discussions with the city and borough resulted in agreement regarding the 6,500 acre figure. The Sunny Bay parcel was added still later; DNR still felt it was more appropriate for the parcel to go to the university.

Representative Kelly asked whether the parcel the amendment would add would violate the original university bill. Mr. Mylius responded in the affirmative.

9:51:43 AM

Representative Fairclough asked whether the university would be adversely affected by the 6,506 acre request. Mr. Mylius answered that the university would not be adversely affected. In 2005, Wrangell was not a borough and had no municipal entitlement. Wrangell formed a borough between the time the university land legislation originally passed and the present. The assumption was that the borough could trump the university on three of the parcels if Wrangell formed a borough. The Sunny Cove parcel was never discussed in 2005.

Representative Fairclough summarized that the university as well as Wrangell had expectations of receiving the parcel. She thought the measure before the committee represented additional growth inside Wrangell's new boundaries. She was looking for value in dollars. She thought the question was what the university would do with the property and wanted to balance that against benefit to Wrangell. She believed the university would probably sell the parcel for a profit. She wondered whether Wrangell was concerned that the community would be harmed if the land was clearcut or developed in a way that adversely affected employment. She noted that the state had other options available for the university that were outside Wrangell’s boundaries.

9:56:02 AM

Representative Austerman questioned DNR’s stance on the additional 2,500 acre request. Mr. Mylius responded that DNR did not agree with the additional increase.

Representative Austerman asked whether the department’s position was related to making sure the university got its land selections. Mr. Mylius replied that DNR supported the governor's bills in both bodies to give the land to the university. He noted that the pool of land in the current university bill was the same as that approved in 2005.

Representative Austerman asked whether any part of the 6,500 acres was included in the original university land. Mr. Mylius replied that the land was included but an

earlier provision (the 2005 legislation and the current version of the bill moving through the legislature) allows the borough to trump the university on certain parcels.

9:58:11 AM

Vice-Chair Thomas asked how many parcels in Southeast and how many in northern Alaska had been taken out of the university land grant. Mr. Mylius explained that of the original list submitted in 2005, amendments took out nine parcels, eight in Southeast and one in Kodiak. The current bill started with the nine parcels already out and he believed five Southeast parcels have been removed in the committee process on the House bill; the Senate bill has not moved yet. One additional parcel has restrictions and part of the Pelican parcel was taken out.

Vice-Chair Thomas emphasized that Southeast municipalities are trying to keep land. He did not believe giving the land to the university and the Mental Health Trust would provide incentive to struggling Southeast communities to grow and form boroughs. He thought the parcel being considered by Wrangell was necessary for the community to grow. He stated the communities should have preference over the university.

Representative Kelly thought the entitlement percentage would have resulted in 1,900 acres. He supported the fact that Wrangell's entitlement was met and now tripled. However, he pointed to the "tough fight" related to the university. Mr. Mylius agreed that the present legislation would triple Wrangell's entitlement.

10:03:50 AM

Representative Wilson noted that the 15 boroughs that had gone through the process had each received an average of 1.13 percent, the amount that Wrangell was asking for. She acknowledged that 97 percent of the borough is Tongass National Forest, along with some state land. The Department of Natural Resources did not want to give that state land to Wrangell, which left only the university land. She underlined that Wrangell would have received 19,000 acres if it had received the 1.13 percent average. She felt that the extra 2,500 acres requested in the amendment was fair since Wrangell had received only one third of 19,000 acres.

Representative Wilson asserted that the parcel is important to one of Wrangell's largest employers, Alaska Crossings, and that the community had already lost 50 jobs since last October due to mill closure. She did not want to lose another 85 jobs by giving the parcel to the university.

10:06:42 AM

Representative Gara needed more information about the university land bill. He asked whether Wrangell would have jurisdiction over the parcel if it were given to the university. Mr. Mylius responded that the land is already within the borough boundaries and would be subject to borough regulations; if the university received the land and developed it, the university would be subject to taxation. Mr. Harris noted that Alaska Crossings had already developed the parcel and intended to continue to use it as they have.

Representative Gara asked what would be different if the university had the land. Mr. Harris answered that the university land grant bill contains a privacy clause; the university does not have to tell the communities about its negotiations with sellers or land use plans. Wrangell is concerned that the land would be sold or developed. The borough intends to keep the parcel as it is for the use of Alaska Crossings and hunting guides.

10:09:53 AM

Representative Kelly asked whether there is other land available to the borough that is not university land. Mr. Mylius responded generally no; any non-university land is timber land that DNR wants retained by the state.

Representative Wilson highlighted the fact that state land is available, but DNR wants to use it as timber land.

Representative Fairclough queried the availability of other lands in the state that could be used by the university. Mr. Mylius responded that DNR had spent considerable time in 2005 putting the list together for the university. He stated that there is a limited amount of state land that can be used for revenue without major problems. For example, oil and gas land is specifically off limits to the university. There are other lands, but those could be

equally contentious. The university land bill does not have provision for substitute lands.

10:12:35 AM

Representative Fairclough queried the reasons for the original 10 percent calculation. Mr. Mylius replied that the number is from AS 29.65, the municipal land grant statute. The statute specifies 10 percent of VUU state land, determined by a combination of land classification and whether the legislature has set aside any land. For example, in Haines, the VUU calculation comes out low because a large percentage of the state land in Haines has been set aside by the legislature in the Haines State Forest and the Chilkat Bald Eagle Preserve. In Wrangell the 10 percent was low because there is so little state land. He did not think any of the state land in Wrangell was set aside by the legislature, and only a limited amount was VUU. The Department of Natural Resources determines VUU through land use plans; for example, settlement or public recreation lands by statute become part of the 10 percent and are available for the boroughs. Lands that are classified as forestry, oil and gas, or wildlife habitat are off limits by statute.

10:14:12 AM

Representative Fairclough listed the reasons she supported Amendment 1:

- There are other lands available to the university.
- The land was not available to Wrangell, but Wrangell needs land to start a borough.
- Not all lands are equal; DNR and state law does not put a value on the property, and does not distinguish between swamp land and beach front.
- There is limited access to land to the region, which is why the calculation for the borough of Wrangell is so low.
- The reason the parcels are available to the university is to turn them into revenue, which means the local community will not have control over the use of the land.

Representative Kelly asked whether the university was available to comment. Co-Chair Stoltze replied that they were not.

A roll call vote was taken on the motion.

IN FAVOR: Thomas, Austerman, Doogan, Fairclough, Foster, Gara, Joule, Hawker, Stoltze
OPPOSED: Kelly

The MOTION PASSED (9-1). Amendment 1 was adopted.

10:17:21 AM

Vice-Chair Thomas MOVED Amendment 2, 26-LS1292\R.5, Cook, 3/17/10:

Page 1, line 2, following "Wrangell":
Insert "and for the Haines Borough"

Page 2, line 6:
Delete "."
Insert ";
(15) Haines Borough – 3,167 acres."

Page 2, line 18, following "AS 29.65.010(a)(14)":
Insert "or (15)"

Page 2, line 31:
Delete "or (14)"
Insert ", (14), or (15)"

Co-Chair Stoltze OBJECTED for discussion.

Vice-Chair Thomas explained that the Haines Borough had only 2,800 acres left after the eagle preserve and the state forest were taken.

CASEY SCHROEDER, STAFF, REPRESENTATIVE BILL THOMAS, detailed that the amendment would make some technical changes and specifies the acreage amount as 3,167. The amendment would also put Haines on the same selection schedule as Wrangell.

Mr. Mylius commented that DNR worked with Haines on the issue and agreed that the original entitlement was low as so much of the land was in the forest and eagle preserve.

He thought Haines would propose a larger number of acres as a larger number had been agreed to.

Vice-Chair Thomas stated that the borough was asking for an additional 1,367 acres to the original entitlement. Mr. Mylius thought 1,809 acres had been agreed to. He referred to disagreement over one parcel.

Vice-Chair Thomas explained that the Lynn Canal/Lynn Sisters acreage was around 1,300 and the parcel had been removed from the university land bill. He noted that DNR did not want to give the parcel to the Haines Borough but wanted to use it for a marine park. He stated that he was not a fan of additional parks and had made a policy call: if the committee accepts the amendment, Haines will accept the amount; if not, he would go back to the original amount. He viewed Lynn Sisters as one of the best parcels and thought it could be used as an exchange.

Vice-Chair Thomas argued that the eagle preserve and the state forest lands have automatic expansion rights to any lands that the state selects, while the borough cannot expand its boundaries unless it takes land elsewhere and forces DNR to exchange land. He spoke to land that will not be available to the borough because it will automatically go to the eagle preserve and state forest when it has been relinquished by the federal government. His tactic was to get the requested parcel and exchange it later for land nearer Haines.

10:23:05 AM

Representative Kelly asked whether the 1,809 acres could be transferred without taking from the original university allocation. Mr. Mylius replied that the parcel would take from the university land; with the exception of a few hundred acres in Excursion Inlet, the parcel was in the 2005 agreement.

Representative Kelly queried DNR's position, which appeared to be positive [related to Haines' request]; he wondered why the department responded negatively to what seemed a similar situation in Wrangell. Mr. Mylius acknowledged DNR's positions were different regarding the two municipalities. He stated that there was no other land in Haines and the department felt Haines had made a good argument for the specific parcels. He explained that one of

the issues DNR had with the Sunny Bay parcel was that Wrangell did not want to develop it, while Haines had identified parcels for potential development. The issues were the intended use of the land and the impact to the university.

Representative Kelly summarized that the governor's bill and therefore the administration would not support the additional acreage request in Wrangell but would support the additional request in Haines. Mr. Mylius agreed.

Representative Kelly asked why DNR did not want to go to the original 3,167 amount. Mr. Mylius responded that the department originally wanted the parcel to go to the university. He stressed that when looking at municipal entitlements, DNR has to make a determination whether the entitlement is in the state's best interests. Part of the best interest determination is looking at land use plans. The northern Southeast area plan specifically calls for retaining the parcel in state ownership, possibly for future park use or because of its recreation value. The department cannot be sure the state's best interests would be protected if the parcel is transferred to the borough. The legislature is deciding to give more acreage, not giving specific parcels.

Mr. Mylius added that the reason the state could give the land to the university despite the land use plan is that the university legislation actually transfers specific parcels of land; in that case the legislature is the one making the best interest determination. With university transfers, DNR only needs to issue the deeds; there is no additional best interest finding or public process.

Representative Kelly commented that the development option proposed by Vice-Chair Thomas was more attractive to him than some "lock up" for a few people in Wrangell. He wished the university was present to speak, and maintained his concern.

10:28:43 AM

Representative Gara asked whether there was road access to the Lynn Sisters parcel. He also wondered how the community of Haines felt about the addition of the 1,300 acres.

MARK EARNEST, HAINES BOROUGH MANAGER (via teleconference), replied that much of land comprising the current Haines borough was placed into various reserve classifications by the state, primarily for resource development and other management designations. He added that when the third-class borough formed, it received 2,800 acres, the smallest entitlement; this resulted in Haines not receiving its entitlement under state law. Haines had worked with DNR to identify VUU lands that would be available. Originally, the Lynn Sisters parcel was identified. The borough and the community are very interested in acquiring the parcel. Subsequently, the property was dropped from the request.

Mr. Ernest emphasized that the community supported the amendment.

10:32:16 AM

Vice-Chair Thomas summarized that the parcels had been taken out of the university lands and he did not support giving them back to DNR to be put into park status. He wanted the land for the borough of Haines.

Co-Chair Stoltze clarified that the amendment was version R.5, 3/17/10.

Representative Kelly MAINTAINED his OBJECTION.

A roll call vote was taken on the motion.

IN FAVOR: Thomas, Austerman, Doogan, Fairclough, Foster, Gara, Joule, Hawker, Stoltze
OPPOSED: Kelly

The MOTION PASSED (9-1). Amendment 2 was ADOPTED.

Co-Chair Stoltze referred to the zero fiscal note by DNR.

10:34:31 AM

Vice-Chair Thomas MOVED to report CSHB 273 (FIN) out of Committee with individual recommendations and the accompanying fiscal note. There being NO OBJECTION, it was so ordered.

CSHB 273 (FIN) was REPORTED out of Committee with a "do pass" recommendation and the previously published fiscal note: FN 1 (DNR).

10:35:02 AM AT EASE
10:48:06 AM RECONVENED

#hb280
HOUSE BILL NO. 280

"An Act relating to natural gas; relating to a gas storage facility; relating to the Regulatory Commission of Alaska; relating to the participation by the attorney general in a matter involving the approval of a rate or a gas supply contract; relating to an income tax credit for a gas storage facility; relating to oil and gas production tax credits; relating to the powers and duties of the Alaska Oil and Gas Conservation Commission; relating to production tax credits for certain losses and expenditures, including exploration expenditures; relating to the powers and duties of the director of the division of lands and to lease fees for the storage of gas on state land; and providing for an effective date."

10:48:19 AM

Co-Chair Hawker introduced Conceptual Amendment 4, which clarifies that the benefit of the use of last-in, first-out (LIFO) inventory management would apply only to open-access storage facilities that qualify for the financial incentives in HB 280. He emphasized that the LIFO preferential accounting treatment would not apply to privately-owned or proprietary storage, defined as the warehouses in which a producer stores their own gas before delivery.

Co-Chair Hawker MOVED to ADOPT Conceptual Amendment 4:

Page 6, line 17, following “facility”
INSERT “regulated under AS 42.05.990(4)”

Page 12, line 12, following “facility”
INSERT “regulated under AS 42.05.990(4)”

Co-Chair Stoltze OBJECTED for discussion.

MARCIA DAVIS, DEPUTY COMMISSIONER, DEPARTMENT OF REVENUE testified that the department supported the amendment.

Co-Chair Stoltze WITHDREW his objection to the amendment. There being NO further OBJECTION, Conceptual Amendment 4 was ADOPTED.

10:52:07 AM

Representative Gara queried the administration's position on HB 280. Ms. Davis noted that the department supported improving and encouraging a broader scope of well expenditures, a concept applied statewide by the governor's bill as well as to Cook Inlet. She pointed out that the governor's bill differed in that it had a core concept of exploration credits, whereas HB 280 had capital credits at its core. She acknowledged that the issue could be approached from both sides; each has different structural changes that must be made.

Ms. Davis pointed out that the only other difference was that the governor's bill has a 30 percent credit, while HB 280 has a 40 percent credit. She thought the change might be justified as the 40 percent credit is targeted solely for Cook Inlet.

Ms. Davis reported that the administration's first question relates to HB 280's definition of the class of allowable costs as Cook Inlet well lease expenditures for the exploration and development phase. She thought the definition was simplified as essentially a lease expenditure that meets the Internal Revenue Code (IRC) 263 (intangible drilling cost rules). The department is concerned because of two pending U.S. Congress bills that would repeal the IRC provision, SB 1087 and SB 888. The intangible drilling cost definition is close to the department's qualified lease expenditure definition under AS 43.55.023 [Alaska's Clear and Equitable Share (ACES), Alaska oil and gas production tax credits, here called "023"]. Since the definition of capital lease expenditures is in place after a long regulatory process, she encouraged the committee to consider using the same definition, which includes the IRC 263 definition; this would enable Cook Inlet explorers and developers to understand the rule without waiting for further regulations.

Co-Chair Stoltze asked whether Congress would deal with the IRC issue within the next 30 days. Ms. Davis replied that regulations already in place that incorporate the same concept and scope of cost might make the process easier.

Ms. Davis turned to the administration's second question; on the production phase of the credit, HB 280 has done a good job of restricting the costs allowed to those that are wellhead and below. She cautioned that theoretically, the costs associated with abandoning, plugging, or suspending a well could directly relate to processes of operating a well. She questioned whether the committee wanted a credit for stopping production, when the intent is to add or increase production.

10:57:40 AM

Representative Gara questioned whether the credit as written in HB 280 would go to existing work that is not an enhancement. Ms. David replied that the credit is broader (although limited to Cook Inlet) and designed to cover costs that are related to the operation of a well. The credit is restricted to lease expenditure costs from the wellhead down, including day-to-day operations. She pointed out that lease expenditure is a broader concept than an intangible drilling cost and not designed to encourage the continued status quo operation of Cook Inlet wells as in addition to the life-cycle of the production phase.

Representative Gara asked whether the credit as currently written differentiates between capital costs that are expended for enhancements and capital costs that are expended for continuing operations. Ms. David replied that he was correct.

10:59:52 AM

Co-Chair Hawker disagreed. He clarified that the administration's concern related to Amendment 2 (previously adopted by the committee). He stressed that the amendment was intended to address intangible drilling costs related to exploration and development and not the demobilization period. He thought the department could clarify the intent through regulation or the issue could be dealt with in the legislative process. Ms. Davis agreed with Representative Hawker's remarks about the exploration and development phase. She was focusing on the on-going production phase.

She was referencing processes related to operating a well, one of the categories. Another category is moving fluids to assembly. She thought HB 280's definition of the cut-off at the wellhouse was good.

Co-Chair Hawker noted that the well maintenance processes facilitate and enhance recovery and lengthen the productivity of an individual well site. He agreed that the intent is to grant the benefit of the costs in calculating lease operating expenses.

Representative Gara asked whether Co-Chair Hawker would be open to language targeting the credit to enhanced production, whether for a new well or a substantial expansion of an existing production effort. Co-Chair Hawker believed such language would be overly restrictive as the bill is attempting to give the greatest possible latitude to encourage production. He pointed out that the biggest issue is wells at the end of production. He stressed that maintaining production is a challenge; he did not want to create anything that would require extensive regulation, but wanted to promote production in Cook Inlet.

11:03:36 AM

Representative Gara also wanted to expand and continue production and questioned how to make the distinction. Ms. Davis responded that the governor's goal has clearly been to provide tax relief or tax credits only where the state receives some benefit in return. The question would be whether the costs could be considered for wells at the end of production. She claimed that language in the governor's bill stipulated that well cost should increase or enhance production from a known pool. She thought the definition could establish that the well could be upgraded through the expenditures.

Co-Chair Stoltze noted that the governor was historically sensitive to Southcentral issues.

Co-Chair Hawker wanted to err on the side of promoting investment in the Cook Inlet rather than erring on the side of having the loss of credit compromise an investment decision by an investor.

11:06:36 AM

Representative Gara hoped to work on language that would not deprive someone of a credit if the credit would keep them from closing a well; he also did not want to grant the credit where it was not appropriate.

Ms. Davis turned to the administration's third question, which related to Amendment 2. The department is concerned about including an indirect cost element in a credit that is supposed to be about direct costs. She stated that subsection (o)(3) in the amendment represented a substantial departure from other credits; a credit is described in the subsection as being allowed based on a cost associated with overhead expenditure. Under current regulations describing lease expenditures (Section 165), credits are supposed to be direct costs. A direct cost used to include overhead, but 165(b) was amended to remove a reference to overhead. Overhead is considered an indirect cost. Current regulation tries to bypass the "nitpicking" approach of trying to detail how overhead is calculated under all the various agreements. Instead, calculation is made by taking a flat percentage of direct costs; 4.5 percent of the taxpayer's total direct cost is allowed as an indirect cost.

11:09:17 AM

CODY RICE, PETROLEUM ECONOMIST, TAX DIVISION, DEPARTMENT OF REVENUE (via teleconference), reported that preliminary information had been prepared and shared with the co-chairs.

Ms. Davis added that the data regarding Cook Inlet credits has been made available to the committee in written form.

11:11:01 AM

Co-Chair Hawker responded regarding subsection (o)(3), stating that the degree to which the legislature wants to allow credits for the lease operating expenses in Cook Inlet is a policy call. He added that the intent of HB 280 was to maximize the attractiveness of investments in the inlet for new drilling, expanded drilling, and maintenance activities.

Representative Gara questioned whether the overhead allowance would default to existing regulation if (o)(3) were not in Amendment 2. Ms. Davis replied that there would

be the basic underlying lease expenditure allowance for overhead, or 4.5 percent of the taxpayer's total direct cost. The taxpayer would then take the dollar amount identified and be able to deduct that overhead from the gross profits. In this manner, the amount would be used as a lease expenditure deduction against the sales price to arrive at a production tax value and would not be incorporated into any of the other credit provisions to obtain an additional benefit associated with the expenditure. She agreed that it was a policy call whether to apply the 4.5 percent charge against the expenditures identified as the Cook Inlet well lease expenditure application and then add it to the credit amount. The department would have to make a regulation describing the process.

Representative Gara asked whether the number would default to 4.5 percent without subsection (o)(3) in Amendment 2. Ms. Davis noted that the 4.5 percent operating expense deduction would be there regardless of what happens with HB 280.

Representative Gara asked whether HB 280 would add a credit on top of the 4.5 percent. Ms. Davis responded that the amount would be in addition; like other credits, the lease expenditures are the base amount of all the costs that get deducted from the proceeds to arrive at a production tax value. In addition, different subsets of costs are considered to calculate a credit; a specific expense might get used as a deduction to create the net tax and also be part of a credit.

11:15:51 AM

Representative Doogan queried the sponsor, related to Amendment 2, subsection (o)(1), about possible problems with "intangible drilling and development costs" under the Internal Revenue Code. Co-Chair Hawker responded that he did not know. He noted other concerns about Alaska codes that are changing.

ROGER MARKS, CONSULTANT, HOUSE FINANCE COMMITTEE, explained that there is precedent in statute for citing other tax codes as they exist on certain dates. He suggested that it would be very straightforward to say: "Cite the tax code as it existed on the effective date of the bill."

Representative Doogan asked for clarification. Ms. Davis responded that the challenge when a particular federal law is repealed is finding out what it used to say. The reference would be to the code not as an applicable law but as a law that embodies acceptably descriptive language. The department might have to embody the new language through regulation if the code was repealed and became difficult for taxpayers to find.

Representative Doogan wanted to make sure that the legislature was not making a law that would "blow up." Co-Chair Hawker discussed differences in the approaches.

Representative Doogan asked whether the language was flexible enough to take into account the possibility that the statute cited might go away.

11:19:56 AM

Ms. Davis offered to check with the Department of Law. She assured the committee that language would be checked with Legislative Legal Services to make sure the state statute is viable.

Representative Gara asked how the provision could be written to include the governor's proposal to apply the credit to enhanced production or operations. Ms. Davis explained that currently the bill has the underlying AS 43.55.023 (ACES) 20 percent capital credit, which would be unaffected. The underlying AS 43.55.023(a) could not be used to the extent that a taxpayer would prefer to utilize subsection (m) [Section 11] as a credit. Instead of the 20 percent credit, the taxpayer would be electing a 40 percent credit for a narrower subset of allowable expenses called Cooked Inlet well lease expenditures. The option for the taxpayer would be an AS 43.55.023 20 percent credit; to the extent that the credit is related to exploration and development, there is the AS 43.55.025 25 percent credit. Cook Inlet would be a 40 percent credit. One of the options has to be chosen.

Co-Chair Hawker noted that the enhanced investment credits were originally applied to the North Slope. The difference acknowledged higher risk with entitlement to higher credit. He added that the perimeters did not apply to Cook Inlet.

Mr. Marks informed the committee how Amendment 2 was intended to be structured and operate: in the universe of lease expenditures, there are capital costs and operating or non-capital costs. Under the statute, the capital costs get a 20 percent credit under AS 43.55.023(a). Amendment 2 describes non-capital costs, which currently do not get credits under the tax. The costs are a sub-set of operating costs and do not include all operating costs. For example, (o)(s) says "does not include the processes of gathering, separating, and processing well fluids downstream from that assembly." He pointed out that those would still be considered lease expenditures under the statute, but the costs being addressed in subsections (o)(1), (o)(2), and (o)(3) are subsets of the costs that are not capital costs; they do not include all operating costs but are a subset that are involved with operating a well as described in (2).

11:24:58 AM

Representative Gara summarized that HB 280 was written to take advantage of the "m" credit, which has been amended by Amendment 2. He asked whether the "m" credit is in place of the existing credits, whether 20 or 25 percent. Ms. Davis answered that the credit was an additional, alternative credit.

Representative Gara asked for more information about the "Cook Inlet penalty." Co-Chair Hawker replied that the issue was addressed in Section 11. He explained that when the Petroleum Production Tax (PPT)/ACES tax structure was adopted, the Cook Inlet basin was set aside as an exception; the Economic Limit Factor (ELF) tax mechanism was grandfathered for the basin. The rest of state had significant increases in production taxes that did not apply to Cook Inlet.

Co-Chair Hawker continued that the PPT/ACES system introduced the concept of credits that could be applied against tax liability for certain expenditures. He noted that it had been pointed out that spending a dollar in Cook Inlet would result in less tax liability to apply it to by special rule than if the dollar were invested elsewhere. He explained that a credit derived from an investment in Cook Inlet could be applied against a dollar of tax liability anywhere in the state.

Co-Chair Hawker asserted that the biggest problem in the state currently was production decline and that the only way to address the problem was increasing investment in exploration and development. He thought it was inappropriate to disadvantage Cook Inlet in the competition for the capital.

Representative Gara summarized his understanding of the situation and asked for more clarification. Ms. Davis explained that in Cook Inlet, a producer must first sell production then go through the ACES process of deducting Cook Inlet costs against that production to come up with the production tax value. The production tax value is then compared to a cap or ceiling on the tax (the ELF tax: zero for oil, and $0.17 per Mcf). If the ACES tax is higher, the producer only pays taxes to the cap. All of the lease expenditures applied to get to the cap comparison stay in Cook Inlet. Any other lease expenditures not needed to get to the cap are now free to be exported by the taxpayer to other regions (usually the North Slope).

Ms. Davis added that the reason for the de-coupling legislation moving through the Senate was the discovery that several Cook Inlet producers have Cook Inlet expenses that they are able to utilize under the current system and apply to reduce tax liability caused by North Slope oil. She emphasized that credits resulting from an expense can be used anywhere regardless of where the expense was. The credit gets applied at the bottom line of the final tax bill.

11:31:53 AM

Mr. Marks provided an example of how Section 11 was intended to operate: If under ACES, the Cook Inlet tax was $100 and under ELF the tax was $50, and a taxpayer had $200 in credits, the credits are reduced by the $50 difference. The resulting $150 credits could then be used to offset North Slope tax.

Representative Gara requested further clarification. His understanding was that a producer who pays a lower Cook Inlet tax does not have that much to write off from; he believed the amendment would help a producer who also has North Slope operations to write off the expenses.

11:33:17 AM

Co-Chair Hawker pointed out that the provision was not new, but the producer had to discount the amount of credit available to write off Cook Inlet tax liabilities.

Ms. Davis added that Section 11, subsection (m) related to lease expenditures. She asserted that lease expenditures are the larger expenses, and are the ones being emphasized: specifically, Cook Inlet lease expenditures up to the amount of the tax ceiling. The ones above the line can currently get applied elsewhere; the ones below the line cannot. She believed the provision would change the situation and allow the ones below the line to also be moved elsewhere.

Co-Chair Hawker interjected that the tax credit generated in Cook Inlet is allowed to be used at full face value anywhere in the state.

Representative Gara questioned whether the amendment would change the current ability of a producer to write off more lease expenditures than they are paying in taxes. Ms. Davis replied that under current law, a producer cannot utilize lease expenditures that were used to get to the cap. The new provision would change that and let the producer add the additional batch of lease expenditures to those that can be used elsewhere.

Representative Gara queried the administration's opinion on the provision. Ms. Davis replied that the administration has not proposed a change in the current "ring-fencing" laws as part the governor's bill. She noted that the governor wanted to know what the trade-off would be for the state for reducing the tax burden or providing a credit; when credits are given, there should be a return. She thought it was a policy question whether additional Cook Inlet incentives would provide return for the state.

11:37:06 AM

Co-Chair Hawker asserted that there would be "full value" and not doubling for investment. He stated that the provision was intended to level the playing field in order to encourage a developer/investor operating in both the North Slope region and in Cook Inlet to put money into the Cook Inlet. He emphasized the need for fuel in Southcentral.

Co-Chair Stoltze noted that representatives from Chugiak Electric Association were present and that they had about a quarter of a million people with concerns about the issue.

Ms. Davis stated that the administration agreed that trying to level the playing field is important; however, the starting point is a bill that does not have a level playing field with respect to tax rates because of substantial incentives for the inlet. She stressed that the policy call related to how much additional incentive the legislature feels Cook Inlet producers need.

Co-Chair Hawker acknowledged that there is an inequitable tax base. He argued that investor risk needed to be recognized; attracting investment is currently very difficult. The gas in Cook Inlet is expensive to access and has disadvantages that offset much of the tax value differentials. He agreed that a policy call is needed. He asked whether the state wanted to make an effort to make exploration and drilling in Cook Inlet more attractive to either new, independent, well-capitalized producers, or to existing explorer/producers. He argued that there was no cost to the state to attempt the enhanced access to existing tax credits offered in the bill.

11:41:32 AM

Representative Gara stated that he was more comfortable with the governor's method of spending money for new work. He thought that without enhancements, the bill could reduce the tax payments the state would receive and increase the credits it pays out. He opined that with the governor's credit, the money would come only if production was enhanced or extra action was taken to prevent the loss of production.

Representative Fairclough queried the current tax rate on gas outside the Cook Inlet. Ms. Davis replied that there is not much gas. She conjectured that for a taxpayer on the North Slope producing gas only, the tax would be 25 percent of the production tax value (profit at the point of production minus lease expenditures). She cautioned that every taxpayer is different because of varied mixtures of oil and gas. She calculated that given gas at $4.50 with cost of $2.50, the rough estimate would be $0.50 to $0.70 per Mcf.

Co-Chair Hawker added that the cost depends on the market. In addition, due to other legislation, gas produced and consumed in-state pays ELF rates just like the Cook Inlet. Ms. Davis agreed.

11:45:03 AM

Representative Gara was concerned that he had no way to assess the tax credit being granted in HB 280 for gas storage. He queried the administration's position on the issue. Ms. Davis replied that there have been many other bills relating to corporate income tax credits. She stated that the administration regarded the issue as a policy call with respect to what extent particular conduct should be incentivized. She noted that in HB 280, the state would be getting gas storage in exchange for granting a corporate income tax credit, which would be consistent with the administration's policy of providing credits in exchange for an agreed-upon action.

Representative Gara requested more information about the gas storage credit. He thought there would be a maximum credit of $15 million based on an allowable cost of $1.50 per thousand cubic feet of storage capacity. He did not know how to analyze whether the allowable cost was the fair amount.

ROBYNN WILSON, INCOME AUDIT MANAGER, TAX DIVISION, DEPARTMENT OF REVENUE (via teleconference), thought the issue was a policy call. She believed the issue had been addressed in the fiscal note.

11:48:35 AM

Mr. Rice pointed to page two of fiscal note 4 (attached to CSHB 280(RES), a prior version of the bill) and quoted:

> In 2004, the Federal Energy Regulatory Commission (FERC) estimated the median cost-of-service rate for [gas] storage at $0.64/Decatherm. One Decatherm is equal to one Mcf of natural gas if the natural gas contains 1,000 Btu/cubic foot. Escalating this cost for inflation produces a 2009 cost-of-service rate of approximately $0.72/Mcf of [gas] storage service.

Mr. Rice clarified that the calculation is not adjusted for potentially higher costs in Alaska. However, he thought the estimate was close.

Representative Gara asked whether the state would pay $1.50 when the cost of creating the storage would be $0.72. Mr. Rice replied that he could not definitively say what the cost of gas storage would be in Alaska. He could say that escalating the median cost of service for providing gas storage, according to FERC, results in a price of approximately $0.72 per Mcf; the credit is $1.50 per Mcf, or roughly double the median cost of service.

Representative Gara asked whether HB 280 would grant $1.50 per Mcf or up to $1.50 of the actual costs. Co-Chair Hawker responded that the credit is calculated at $1.50 per Mcf of new gas storage capacity opened within a certain timeframe (before 2015).

Representative Gara asked whether an entity could be paid more to create gas storage than it costs them. Co-Chair Hawker responded absolutely not; the credit was benchmarked based on available information (which is imprecise) to approximate at 10 percent on cost.

Representative Gara questioned how the state could know what the storage would cost. He pointed to differing numbers.

11:52:51 AM

Co-Chair Hawker reported that proprietary conversations were held with entities interested in investing and putting together a major open-access gas storage facility in the Cook Inlet.

Representative Gara stated that he had no way of analyzing how much of the cost the state should be paying. Co-Chair Hawker called attention to other information in fiscal note 4: an expectation that the amount of the credit would approximate the corporate income tax from operating such a facility for about 16 years. He stated that the goal was to allow the investor to recover their costs. The costs would ultimately be passed to the consumer, but the intent was to not have the additional costs be burdened by additional state taxes. He stressed that the bill was intended to be a

private sector bill and not a major government subsidy of gas storage.

Mr. Marks pointed out that looking at the credit as being a high percentage of the corporate income tax liability says more about the liability than about the credit. He maintained that in a gas storage facility, the only income the facility would have is its return on equity; in the big picture, that would be fairly small, depending on debt equity and the length of the life of the asset. He stated that for regulated facilities, the income piece would be small, and the credit could dwarf the income tax liability.

Representative Gara did not care how the credit related to how much someone would pay in taxes. He wanted to make sure that the state would not pay more in the credit than an entity paid to build the facility. Co-Chair Hawker stressed that the credit was calculated to approximate 10 percent of the cost of building the storage facility.

Representative Gara suggested adding that the credit could not exceed ten percent of the costs. Co-Chair Hawker stated that [exceeding ten percent of the costs] would be "highly unlikely." He maintained that the point of the volume metric approach to determining the credit was to specifically avoid having to go through a huge regulatory process in determining eligible and non-eligible costs. The question was the cost of the facility and what would be included. He emphasized that the intent was to determine and easily calculate the credit available using a credible third party as the benchmark, using the Alaska Oil and Gas Conservation Commission (AOGCC) to certify the working volume capacity of a facility.

HB 280 was HEARD and HELD in Committee for further consideration.

11:57:54 AM

Co-Chair Hawker referred to potential amendments.

#
ADJOURNMENT

The meeting was adjourned at 11:59 AM.