

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

April 9, 2010

1:42 p.m.

MEMBERS PRESENT

Representative Craig Johnson, Co-Chair
Representative Mark Neuman, Co-Chair
Representative Bryce Edgmon
Representative Kurt Olson
Representative Paul Seaton
Representative Peggy Wilson
Representative David Guttenberg
Representative Scott Kawasaki
Representative Chris Tuck

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 305(FIN)(TITLE AM)

"An Act providing that the tax rate applicable to the production of oil as the average on oil and gas production for appropriation to the community revenue sharing fund; production tax value of oil, gas produced in the Cook Inlet sedimentary basin, and gas relating to the allocation of lease expenditures and adjustments to lease expenditures; produced outside of the Cook Inlet sedimentary basin and used in the state increases and providing for an effective date."

- HEARD & HELD

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 243(FIN)

"An Act relating to geothermal resources; relating to the royalty obligation for geothermal resources; transferring from the Department of Natural Resources to the Alaska Oil and Gas Conservation Commission authority over permitting and inspection of geothermal wells; providing for a regulatory cost charge for geothermal wells; and providing for an effective date."

- MOVED HCS CSSB 243(RES) OUT OF COMMITTEE

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 144(FIN)

"An Act relating to hunting permits and tag fees for musk oxen."

- BILL HEARING RESCHEDULED TO 4/12/10

PREVIOUS COMMITTEE ACTION

BILL: SB 305

SHORT TITLE: SEPARATE OIL & GAS PROD. TAX/ DEDUCTIONS

SPONSOR(s): FINANCE

03/08/10	(S)	READ THE FIRST TIME - REFERRALS
03/08/10	(S)	FIN
03/09/10	(S)	FIN AT 9:00 AM SENATE FINANCE 532
03/09/10	(S)	Heard & Held
03/09/10	(S)	MINUTE(FIN)
03/10/10	(S)	FIN AT 9:00 AM SENATE FINANCE 532
03/10/10	(S)	<Bill Hearing Canceled>
03/11/10	(S)	FIN AT 9:00 AM SENATE FINANCE 532
03/11/10	(S)	-- MEETING CANCELED --
03/12/10	(S)	FIN AT 9:00 AM SENATE FINANCE 532
03/12/10	(S)	Heard & Held
03/12/10	(S)	MINUTE(FIN)
03/18/10	(S)	FIN AT 3:00 PM SENATE FINANCE 532
03/29/10	(S)	FIN AT 9:00 AM SENATE FINANCE 532
03/29/10	(S)	<Bill Hearing Postponed>
03/31/10	(S)	FIN RPT CS 6DP 1AM NEW TITLE
03/31/10	(S)	DP: HOFFMAN, STEDMAN, THOMAS, EGAN, OLSON, ELLIS
03/31/10	(S)	AM: HUGGINS
03/31/10	(S)	FIN AT 9:00 AM SENATE FINANCE 532
03/31/10	(S)	Moved CSSB 305(FIN) Out of Committee
03/31/10	(S)	MINUTE(FIN)
04/01/10	(S)	TRANSMITTED TO (H)
04/01/10	(S)	VERSION: CSSB 305(FIN)(TITLE AM)
04/05/10	(H)	READ THE FIRST TIME - REFERRALS
04/05/10	(H)	RES, FIN
04/07/10	(H)	RES AT 1:00 PM BARNES 124
04/07/10	(H)	Heard & Held
04/07/10	(H)	MINUTE(RES)
04/09/10	(H)	RES AT 1:00 PM BARNES 124

BILL: SB 243

SHORT TITLE: GEOTHERMAL RESOURCE:ROYALTY/PERMIT/FEE

SPONSOR(s): MCGUIRE

01/27/10	(S)	READ THE FIRST TIME - REFERRALS
01/27/10	(S)	RES, FIN

02/10/10 (S) RES AT 3:30 PM BUTROVICH 205
 02/10/10 (S) Heard & Held
 02/10/10 (S) MINUTE(RES)
 03/11/10 (S) RES AT 3:30 PM BUTROVICH 205
 03/11/10 (S) Heard & Held
 03/11/10 (S) MINUTE(RES)
 03/18/10 (S) RES AT 3:30 PM BUTROVICH 205
 03/18/10 (S) Moved CSSB 243(RES) Out of Committee
 03/18/10 (S) MINUTE(RES)
 03/22/10 (S) RES RPT CS 1DP 3NR NEW TITLE
 03/22/10 (S) DP: MCGUIRE
 03/22/10 (S) NR: WIELECHOWSKI, STEVENS, FRENCH
 03/29/10 (S) FIN AT 9:00 AM SENATE FINANCE 532
 03/29/10 (S) Heard & Held
 03/29/10 (S) MINUTE(FIN)
 04/02/10 (S) FIN RPT CS 6DP 1NR NEW TITLE
 04/02/10 (S) DP: HOFFMAN, STEDMAN, HUGGINS, THOMAS,
 EGAN, ELLIS
 04/02/10 (S) NR: OLSON
 04/02/10 (S) FIN AT 9:00 AM SENATE FINANCE 532
 04/02/10 (S) Moved CSSB 243(FIN) Out of Committee
 04/02/10 (S) MINUTE(FIN)
 04/05/10 (S) TRANSMITTED TO (H)
 04/05/10 (S) VERSION: CSSB 243(FIN)
 04/06/10 (H) READ THE FIRST TIME - REFERRALS
 04/06/10 (H) RES, L&C, FIN
 04/09/10 (H) RES AT 1:00 PM BARNES 124

WITNESS REGISTER

SENATOR BERT STEDMAN
 Alaska State Legislature
 Juneau, Alaska

POSITION STATEMENT: Testified during the hearing on SB 305, on behalf of the sponsor, the Senate Finance Standing Committee, on which he serves as co-chair.

MARILYN CROCKETT, Executive Director
 Alaska Oil and Gas Association (AOGA)
 Anchorage, Alaska

POSITION STATEMENT: Testified in opposition to CSSB 305(FIN).

ROGER MARKS
 Logsdon & Associates, Inc.
 Gotha, Florida

POSITION STATEMENT: Interpreted an April 7, 2010, presentation from the Department of Revenue and offered his own remarks during the hearing on SB 305.

PATRICK GALVIN, Commissioner
Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Answered questions during the hearing on SB 305.

SENATOR JOE PASKVAN
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Testified during the hearing on SB 305.

SENATOR LESIL McGUIRE
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: As sponsor, introduced SB 243.

MICHAEL PAWLOWSKI, Staff
Senator Lesil McGuire
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Answered questions during the hearing on SB 243, on behalf of Senator McGuire, sponsor.

CATHY P. FOERSTER, Commissioner
Alaska Oil & Gas Conservation Commission (AOGCC)
Department of Administration
Anchorage, Alaska

POSITION STATEMENT: Answered questions during the hearing on SB 243.

KEVIN BANKS, Director
Division of Oil and Gas
Department of Natural Resources
Anchorage, Alaska

POSITION STATEMENT: Answered questions during the hearing on SB 243.

PAUL THOMSEN
Director of Policy and Business Development
Ormat Technologies, Inc.
Reno, Nevada

POSITION STATEMENT: Testified in support of SB 243.

ACTION NARRATIVE

[1:42:53 PM](#)

CO-CHAIR MARK NEUMAN called the House Resources Standing Committee meeting to order at 1:42 p.m. Representatives Wilson, Olson, Seaton, Edgmon, Guttenberg, Tuck, Neuman, and Johnson were present at the call to order. Representative Kawasaki arrived as the meeting was in progress.

SB 305-SEPARATE OIL & GAS PROD. TAX/ DEDUCTIONS

[Contains brief mention of HB 337.]

[1:43:14 PM](#)

CO-CHAIR NEUMAN announced that the first order of business was CS FOR SENATE BILL NO. 305(FIN)(title am), "An Act providing that the tax rate applicable to the production of oil as the average production tax value of oil, gas produced in the Cook Inlet sedimentary basin, and gas produced outside of the Cook Inlet sedimentary basin and used in the state increases above \$30 shall be 0.4 percent multiplied by the number that represents the difference between that average monthly production tax value and \$30, or the sum of 25 percent and the product of 0.1 percent multiplied by the number that represents the difference between that average monthly production tax value and \$92.50, except that the total rate determined in the calculation may not exceed 50 percent; providing for an increase in the rate of tax on the production of gas as the average production tax value on a Btu equivalent barrel basis of gas produced outside of the Cook Inlet sedimentary basin and not used in the state increases above \$30; relating to payments of the oil and gas production tax; relating to availability of a portion of the money received from the tax on oil and gas production for appropriation to the community revenue sharing fund; relating to the allocation of lease expenditures and adjustments to lease expenditures; and providing for an effective date."

[1:43:42 PM](#)

SENATOR BERT STEDMAN, Alaska State Legislature, as sponsor of SB 305, mentioned a letter from Dr. David Wood (ph), which he said shows what would have happened in 2008 and 2009 with the cross-subsidy that is currently in place. In response to Co-Chair Neuman, he suggested either Roger Marks or Dr. Wood could offer

explanation of the letter. He said Mr. Marks is a consultant to the Legislative Budget and Audit Committee, and he recommended the committee invite him to answer questions.

[1:46:02 PM](#)

SENATOR STEDMAN, in response to Representative Guttenberg, said he had not yet had time to have a discussion with Commissioner Galvin regarding his presentation at the last hearing on SB 305.

[1:47:17 PM](#)

MARILYN CROCKETT, Executive Director, Alaska Oil and Gas Association (AOGA), testifying in opposition to SB 305, said she would highlight key points of her written testimony [included in the committee packet.] She said AOGA continues to believe that legislation that proposes a major tax, such as production tax, needs to be evaluated to ensure that it will not impact the investment climate in Alaska. Ms. Crockett listed three concerns AOGA has regarding SB 305: it is premature to establish decoupling at this time; the justification for decoupling is flawed; and determining an appropriate mechanism for cost allocations is complex and further analysis should be done to ensure a proper methodology is established.

[1:49:23 PM](#)

MS. CROCKETT, regarding premature decoupling, stated that the impetus to pass SB 305 appears to be driven by the Alaska Gasline Inducement Act (AGIA) provision that purports to provide gas tax fiscal certainty through a lock-in provision on May 1. She said AOGA is concerned that the apparent rush to address the issue will yield a fix that is not needed now and will result in further complexity to Alaska's already complex tax regime.

MS. CROCKETT, regarding flawed justification for decoupling, emphasized AOGA's concern about the idea of decoupling and the justification that is being offered. She stated that in determining the rate of return to the state, there are three factors that come into play: the netback value, the amount of lease expenditures or deductible cost, and the number of Btu-equivalent barrels that are being produced. She said the analysis of the \$2 billion figure was based on generic deductible cost data released by the Department of Revenue for the North Slope for 2008, and it also relied on oil production forecasts published by the State of Alaska. She stated, "The way these data were used in the analysis yield figures that we

believe are not likely to reflect actual circumstances in 2020 when a major gas [pipeline] is likely to begin operation. In particular, oil production in 2020 is likely to be significantly lower than the state estimate, which reflects an annual decline of only 2.7 percent during the current decade from 2010 to 2019."

[1:51:00 PM](#)

MS. CROCKETT pointed out that historically, annual oil production decline rates have been 5.1 percent during the last 20 years and 6.6 percent during the last five. She explained that the difference in decline rate means that whatever the \$2 billion analysis used as the figure for lease expenditures per barrel, the cost per barrel using these historic decline rates would be one-third to almost two-thirds higher, which means the analysis significantly overstated the taxable margin per barrel and overstated the tax rate to the extent it shows progressivity as applying. Ms. Crockett said these distortions are inherent simply from the design of the analysis that produced the \$2 billion figure and did not depend on the particular numbers that analysis used as the netback prices of gas or oil, or the deductible cost per barrel. She said BP, in a letter to the Senate Finance Committee, dated March 12, 2010, stated that it is possible in some situations that the state would actually receive more production tax without decoupling than with it. Ms. Crockett stated, "If, however, this committee believes that SB 305 needs to be passed this session, then the key effective date of its provisions, oil and gas decoupling, and cost allocations, should be deferred until commercial production of Alaska North Slope gas commences."

[1:52:08 PM](#)

MS. CROCKETT, regarding AOGA's concern that the state should establish a proper cost methodology, emphasized that AOGA is troubled over the potential cost allocations that SB 305 would require before major gas development. She indicated that under the proposed legislation, tax payers would be required immediately to begin allocating costs between oil and gas, whereas AOGA recommends that tax payers begin allocating costs between oil and gas when commercial Alaska North Slope (ANS) gas production begins. She said developing a cost methodology allocation is a very complex issue.

MS. CROCKETT pointed out that the enactment of Alaska's Clear & Equitable Share (ACES) was designed, in part, to incentivize

investment and exploration of Alaska's resources; however, requiring cost allocations prior to major gas development could undermine that objective. She continued:

For example, if cost allocations are required prior to major gas development, how would costs associated with any lease or property, which ... contains both oil and gas or ... currently produces only oil and possibly trace amounts of gas, be handled when the production of the oil provides information about the reservoir and its potential gas development? Would any of the costs be required to be allocated to gas, thereby raising the tax on current oil operations?

MS. CROCKETT said on the North Slope there are producers with current oil production from one field that are also incurring gas related expenses for another field without gas production. She questioned how those gas-related expenditures would be handled. She asked if the those expenditures would be allowed, for that producer, against its oil-related production income or against future gas revenues from future gas production - revenues that the producer may not have until many years into the future, if at all.

MS. CROCKETT said cost allocation prior to major gas development could also result in unintended consequences for explorers. She said currently an explorer who takes the risk and incurs the cost to explore in Alaska, does so with the knowledge its expenses are deductible regardless of whether oil or gas is discovered. She said SB 305 is not clear, and AGOA is concerned that decoupling might be interpreted to mean that exploration expenditures will be deducted only for oil if oil is discovered and only for gas if gas is discovered. She stated that for an explorer with no production, or for one that only has oil production, discovering gas would mean there is nothing from which its exploration costs can be deducted for that discovery. She said the present tax without decoupling does not penalize explorers in this way, which is another reason why decoupling should be deferred until commercial gas productions begins. She reminded the committee that AOGA has advocated for reexamination of the entire production tax structure to ensure that structure really is achieving the goals originally set in 2007.

[1:55:06 PM](#)

MS. CROCKETT summarized her testimony.

[1:55:44 PM](#)

CO-CHAIR NEUMAN said he agrees with much of Ms. Crockett's testimony; however, where his opinion differs is in regard to the statement that AOGA feels it is premature to do decoupling at this time. He said an incentive of AGIA is that those who participate in the first open season would potentially have a lock-in on tax rates for ten years. The current tax rates were basically established for oil under ACES. Because of that, he said, the aforementioned lock-in would be at those tax rates, which could have a substantial negative effect on the state's general fund revenue.

CO-CHAIR NEUMAN offered his understanding that the intent of some of the language in SB 305 is to allow the state to "come back again and look at how taxes should be regulated," because gas is a product different from oil and should be treated thus.

[1:58:52 PM](#)

CO-CHAIR JOHNSON requested Ms. Crockett specify particular points in the proposed legislation that are of concern.

[1:59:35 PM](#)

MS. CROCKETT said she cannot point to specific provisions in the bill right now, but she will get that to members. She said essentially, it all depends on the operation that is being conducted. She continued:

If you are producing oil with trace amounts of gas in an existing field, you have a single facility that's doing that. But as you spend time and gain experience in developing that field, you learn more and more about the reservoir, and eventually you learn enough about that reservoir - you determine where the gas component of it is, if you will. So, in some respects you are spending dollars, your primary goal is to produce oil, but at the same time you're also having the benefit of learning more about that reservoir, which, in worst case, somebody could point to and say, "Well, no, ... we believe that this portion of the expenses that you've incurred really are aimed at determining what the reservoir qualities are and will benefit gas." That's one example.

[2:00:34 PM](#)

CO-CHAIR JOHNSON said producers at Point Thomson are going to sink a well that brings up gas, then turn that into liquid and put the gas back. He asked if, under SB 305, that would be a gas expenditure because the producer is learning about what the fuel is going to be, or if it would be considered an oil expenditure.

[2:01:07 PM](#)

MS. CROCKETT said she is not sure she is qualified to answer that question, but can find out the answer for the committee.

[2:01:23 PM](#)

CO-CHAIR JOHNSON expressed his concern that Point Thomson could be declared through regulation to be a gas field, which would mean its expenditures would not be allowed as a deduction until it sells the gas, which could be ten years down the road, if at all. The result, he said, would be the shutting down of Point Thomson. Companies may decide that it is not worth the risk. He said he wants the committee to focus on this issue.

[2:03:00 PM](#)

REPRESENTATIVE GUTTENBERG, in regard to Co-Chair Johnson's question, said he believes it is even more complex than that because generally there are multiple partners in any operation. He questioned how costs and profits would be allocated to one partner versus another. He asked, "Somebody has an investment for one purpose or another, and they ... want to see what's allocated for gas or oil ... even though they're doing the same thing. ... [Does] that happen now?"

[2:04:21 PM](#)

MS. CROCKETT replied she does not believe so. One reason it is so complicated is the example that Representative Guttenberg just used. A further complication, she related, is the whole issue of the joint interest billings. When partners do not have "all that data," the best they can do to pay taxes is based on the joint interest billing received from the operator. She said, "They have no way of knowing - assuming that we're now separating out costs for gas and for oil - how that allocation was ... made."

[2:05:07 PM](#)

REPRESENTATIVE TUCK directed attention to language in Ms. Crockett's written testimony, on page 2, second to last paragraph, which relates that oil production in 2020 is likely to be lower than the state estimate, and which shows some historic decline rates. He asked Ms. Crockett if she has a forecast, and he questioned, "What's wrong with the 2.7 percent current decline rate?"

[2:06:02 PM](#)

MS. CROCKETT said she is quite certain that the Department of Revenue wishes it had a crystal ball to figure out what decline rates would be, and she said she wishes the same. She said she is confident that the department did the best job it could based on the information it has to come up with those estimates. She pointed out that these are estimates were made currently to predict the production levels in the future; however, historically, the decline rate has been much greater than that. The whole point of the discussion is that nobody's figures will be accurate because there is no way of knowing what production will be.

[2:07:13 PM](#)

REPRESENTATIVE TUCK asked if the 2.7 percent was forecasted before the committee passed out some tax credit bills as an incentive to bring in more production.

[2:07:34 PM](#)

MS. CROCKETT said she suspects that is true, but said she cannot speak for Commissioner Galvin.

[2:07:48 PM](#)

CO-CHAIR NEUMAN said Governor Sean Parnell is trying to address the decline rate with HB 337. He indicated that the legislature is reactive when considering industry ups and downs in decline rates, and continues to create jobs in the state.

[2:08:21 PM](#)

REPRESENTATIVE TUCK, in regard to the Point Thomson scenario presented by Co-Chair Johnson, asked if Point Thomson is able to take advantage of capital credits right now with "the coupled situation."

MS. CROCKETT replied that she does not know the answer, but could find out.

[2:08:57 PM](#)

CO-CHAIR NEUMAN asked Ms. Crockett to produce information for the committee regarding how a field is developed - the geological work, the development, the credits, and the ratio of gas and oil.

[2:09:46 PM](#)

CO-CHAIR JOHNSON offered his understanding that Commissioner Galvin had [nodded] his head in confirmation that Point Thomson is able to take advantage of the tax credits under current law.

[2:10:20 PM](#)

REPRESENTATIVE GUTTENBERG drew attention to the final sentence in the first paragraph under "Decoupling is Premature," in the written testimony of Ms. Crockett, which read: "And that failure to address the dilution issue prior to that May 1 deadline might prohibit a future correction." He suggested that it might not. He asked, "Isn't it possible to correct things that are mutually beneficial to both parties after the May 1 deadline?"

[2:10:58 PM](#)

MS. CROCKETT answered that she believes that is correct.

[2:11:04 PM](#)

REPRESENTATIVE GUTTENBERG asked if it is Ms. Crockett's contention that "we haven't gone anywhere far enough in exploring the dilution issue."

[2:11:17 PM](#)

MS. CROCKETT responded that AOGA's primary concern is that this is a very complicated and comprehensive situation, and everyone believes they are trying to do the right thing; however, in a complicated tax provision such as this, everyone runs the risk of "not getting it right."

[2:12:14 PM](#)

REPRESENTATIVE SEATON, in regard to decoupling being premature, directed attention to AS 43.90.320(a), which read:

Sec. 43.90.320. Gas production tax exemption.

(a) If a person qualified for a resource inducement under AS 43.90.300 agrees under (c) of this section, the person is entitled to an annual exemption from the state's gas production tax in an amount equal to the difference between the amount of the person's gas production tax obligation calculated under the gas production tax in effect during that tax year and the amount of the person's gas production tax obligation calculated under the gas production tax in effect at the start of the first binding open season held under this chapter. If the difference is less than zero, the gas production tax exemption is zero.

REPRESENTATIVE SEATON noted that exemption is only for 10 years of production. He asked if it is AOGA's view that the gas production tax in effect at the start of the first binding open season includes a coupling with oil or "will be the ACES amount of gas tax and progressivity and those elements alone." He said, "I guess what I'm trying to do is find out whether AOGA's position is that the gas tax is irrelevant whether it's coupled or decoupled, as far as the law goes for this inducement."

[2:14:09 PM](#)

MS. CROCKETT responded that AOGA's primary concern is the impact on producers and explorers today, and it is the cost allocation issue that is the most troubling.

[2:14:28 PM](#)

REPRESENTATIVE SEATON said the committee has an important decision to make, and the basis of that decision is to find out whether gas production tax is the whole system of oil and gas taxes or whether it's the tax rate and progressivity applied to gas at the start of the open season. He asked if AOGA has a position on whether it makes any difference to the tax rate on gas whether it is coupled or not.

[2:15:12 PM](#)

MS. CROCKETT replied that she is not sure AOGA has answered that question.

[2:15:30 PM](#)

REPRESENTATIVE P. WILSON offered her understanding that Ms. Crockett had testified that AOGA would be against any measure that would make producers have to pay more.

[2:15:54 PM](#)

MS. CROCKETT said if she had stated thus, it was not her intent. She clarified AOGA's concern is in regard to the impact on explorers and producers today and how costs are allocated between the expenses that they incur that they can then apply against the tax that they need to pay to get to the tax rate. She said, "We don't know what any of that means yet." For example, she questioned whether a company exploring for oil but instead finding gas would only be allowed to apply those expenses against gas. She stated that producers will be required to allocate their costs between what they spend for oil and what they spend for gas, separately. So, the incentive for a company that does not currently have gas production today to explore for gas is reduced.

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The committee took an at-ease from 2:17 p.m. to 2:23 p.m.

[2:23:37 PM](#)

ROGER MARKS, Logsdon & Associates, Inc., offered a reminder for the record that Logsdon & Associates, Inc. is under contract with the Legislative Budget and Audit Committee to assist on gas taxation issues. He offered a PowerPoint presentation interpreting the presentation from the Department of Revenue on April 7 [entitled, "Comments on CSSB 305(FIN)"]. He said his remarks would relate how the department's results were derived and what they mean. He directed attention to [slide 2 of his presentation, which shows] page 8 of the DOR presentation, to the graph in the upper left-hand quadrant. The graph shows that under \$120 oil and \$8 gas, there would be \$8.5 billion in total oil and gas taxes if taxes were calculated separately, and \$5.5 billion if calculated combined. He continued:

Again, we're going to focus on what was called the tax that's apportionable to gas, under these two scenarios: the separate gas calculated - if oil and gas are calculated separately - at \$2.3 billion,

versus the attributed gas if ... under the status quo with oil and gas taxes are calculated combined.

[2:25:57 PM](#)

MR. MARKS, [referring to the information on slide 4], said gross value is derived by subtracting transportation costs from the market price. That amount is then multiplied by the amount of oil or barrels of oil equivalent (BOE), and then upstream costs are subtracted, and the result is a tax base and progressivity rate based on the production tax value per BOE equivalent. Mr. Marks offered a scenario to illustrate this calculation as follows:

We start out with \$120 and the \$8, and as we march down, we subtract the transportation costs to get the gross value. These are volumes: we used 500,000 barrels a day of oil and 4.5 Bcf a day of gas, which on a BOE ... is 750,000 barrels of oil. And we multiply the gross value times the BOE ... to get the total gross value. We add them up, we take out the non-royalty portion - one eighth - since tax is only paid on the non-royalty portion, and we had \$4.4 billion in costs, so track that for a net value of \$18,754 billion, and divide that by the total amount of BOEs for the year - 456 million - we get a net value of \$46.98. And based on that, progressivity is calculated on the portion above \$30, so based on that we get a 25 percent tax rate and 6.7 percent progressivity for a tax rate of 31.79 percent. And we multiply that by the production tax value, and we subtract the credits, and we get a tax of \$5.5 billion, and that matches what the administration got.

[2:28:00 PM](#)

MR. MARKS said AGIA has stabilized the gas portion of that tax. In response to Representative Seaton, he explained that under AGIA, any shipper that subscribes to the open season receives a tax exemption equal the difference between current tax and the tax in place at the time of the open season.

[2:29:48 PM](#)

MR. MARKS said with \$5.5 billion in total taxes, then the question is: How much of that is attributable to gas? He said this is a question that the Department of Revenue had to answer

to implement the AGIA provision, and the department recently adopted regulations to do that: 15 AAC 55 220. Because the AGIA tax inducement applied only to gas and the current tax is combined with oil, it was necessary for the department to ascribe that portion which is gas; the proportion of the total gross value that was gas is the amount of the total tax that is attributable to gas. He explained that the department was not allocating costs; it was allocating tax. Using the gross value, the biggest determinant of the difference between oil taxes and gas taxes is the difference in gross value; therefore, allocating the tax by means of the gross value, seemed reasonable to [Logsdon & Associates].

[2:31:41 PM](#)

MR. MARKS turned to the information on slide 4 of his presentation, which shows that the gross value for oil is \$20 billion and the gross value for [gas] is \$5.7 billion, which proportionally is 78 percent oil and 22 percent gas. He said 22 percent multiplied by "the 5.5 billion" results in what DOR called the "attributed gas tax" of \$1.2 billion. Mr. Marks turned to slide 6, which shows what taxes would be if oil and gas were decoupled. In the example, the total gross values for oil and gas are the same, and the cost of \$4.4 billion was allocated based on the relative amount of BOEs, which resulted in \$1.76 billion in costs allocated to oil and \$2.64 billion in costs allocated to gas. If those amounts are subtracted and then divided by the number of BOEs, the result is the net value of gas per BOE of \$9.98. Since it is less than \$30 there is no progressivity. There is a 25 percent tax rate, and with the credits, there is a tax of \$0.3 billion, which Mr. Marks reiterated is what the department figured. He said, "So, what we're looking at is the attributed tax under the status quo of \$1.2 billion for gas versus if the gas was calculated alone: \$0.3 [billion]."

[2:34:03 PM](#)

MR. MARKS directed attention to slide 7, and said if the \$9.98 net value per BOE from slide 6 is put on a per million Btu equivalent and divided by 6, the value of the gas would be \$1.66/MMBtu. Under the combined methodology the tax rate for gas was based on the combined net value of \$46.98 per BOE. When that amount is divided by 6, the result is \$7.83 per Btu. Using the status quo and the methodology to ascribe tax to gas under the department's regulations, gas with a value of \$1.66 would be taxed as if it had a value of \$7.83, he said. He added, "And

this is what would be locked in under AGIA using the status quo tax system."

[2:35:53 PM](#)

REPRESENTATIVE SEATON asked Mr. Marks to clarify that under existing regulations, the gas system in place at the start of open season would be "basically the 1.199."

[2:36:12 PM](#)

MR. MARKS responded, "Given these assumptions of this much volume gas, this much volume oil, [and] these prices - under ... the status quo tax and the department's regulations - yes, that would be ... what would be stabilized for ... someone who subscribes to the AGIA open season."

[2:36:38 PM](#)

MR. MARKS, directing attention to slide 8, reviewed that combining oil and gas dilutes the oil tax down, but related that it also "dilutes the gas value up." The net result is that oil tax goes down more than the gas tax goes up, which is not only bad for the state's finances, but is also bad for the producers. He concluded that locking in a rate that may be too high would negate the value of the AGIA inducement and may not be healthy for the project. He said, "This underscores the problem of combining substances of vastly different values for taxation."

[2:38:47 PM](#)

PATRICK GALVIN, Commissioner, Department of Revenue, in response to Chair Neuman, said in general Mr. Marks' observations have been accurate. However, he said, "It's just a matter of how you decide to look at a combined tax system." In the aforementioned assumption, wherein oil is \$120 and gas is \$8, the taxable value of the oil is being moved faster than the value of the gas is being increased, because the oil is on progressivity while the gas is not. He continued as follows:

If you were in a different situation where the values were at different places on the progressivity, you could end up in the opposite direction where ..., by combining them, the gas is coming down and the oil's going up. It's just that when you accept a combined system, you're saying that we're going to tax the oil and the gas as one mix going forward.

COMMISSIONER GALVIN said Mr. Marks' observation regarding the implication for the open season is valid. He said that from the perspective of the state's policy makers, the question is what to have on the table going into the open season. Having the status quo will result in a higher gas tax, which means that the state would be providing "less of an attractive inducement going in." On the other hand, he said, the state could always "offer it lower after the open season and bring that down."

[2:42:02 PM](#)

COMMISSIONER GALVIN, regarding the overall economic picture, said a system that combines oil and gas makes the gas component part of the conversation going forward. He said that issue should be included as part of the consideration for decoupling. He said what he tried to show during the department's presentation last Wednesday, and what Mr. Marks is trying to show, is that the state can decouple now, but it can also decouple later without any financial impact "because you're not locking in anything lower."

[2:42:58 PM](#)

CO-CHAIR NEUMAN said he thinks that the May 1 lock-in was Representative Seaton's question and AOGA's concern. He asked Commissioner Galvin if that lock-in could result in a lawsuit.

[2:43:41 PM](#)

COMMISSIONER GALVIN answered that the Department of Law has looked at this issue very closely, and the issue with regard to what is being locked in is the gas production tax obligation that is in effect on April 30. There are questions pertaining to exactly how much is locked in, what is being locked in under the status quo, and what would be locked in if SB 305 is passed. He stated, "The fact that the status quo is higher means that you can implement SB 305 after the open season, it will reduce the gas production tax obligation, and therefore it doesn't implicate what's been locked in; it's lower than it, so it won't create an exemption - it won't impact the ability to actually put in place SB 305 as it's currently structured after the open season."

[2:45:35 PM](#)

CO-CHAIR NEUMAN said the committee has given much consideration to the equanimity of the inducements and the issue of changing rules after the license is done. He asked Commissioner Galvin to think about that.

[2:46:02 PM](#)

REPRESENTATIVE TUCK asked if there are North Slope producers that do only oil or only gas.

[2:46:35 PM](#)

COMMISSIONER GALVIN said he thinks the question is actually whether the fields are producing one or the other, and he said that depends on the field. For example, he said Prudhoe Bay is producing tremendous amounts of oil and gas simultaneously, and currently the gas is being re-injected. In other fields on the North Slope where there is production, it is almost entirely oil, with very little gas that has to be handled. In the Foothills the inverse may occur, where there is almost entirely gas and very little, if any, oil. He said currently there is no one who is producing only gas, because "there's nobody to sell it to."

[2:47:36 PM](#)

REPRESENTATIVE TUCK recalled that Mr. Marks had said that combining oil and gas dilutes the gas tax up. However, regarding slide 3, he said, "We still see with it being combined ... in status quo that overall everything is down, even though they dilute the gas tax up." He asked, "Wouldn't that still be good for the producers?"

[2:48:26 PM](#)

MR. MARKS confirmed that with combining, oil is diluted down, which many people think undermines the state's financial interest, and that is the purpose of the hearing today. He said, "That which is valued more gets diluted down; that which is valued less gets diluted up." He said he is not guaranteeing the future, but if gas was worth more than it is today, it would be possible that "the combining of them" would raise taxes. He indicated that the rationale behind SB 305 is that the volatility could be removed by separating the substances.

[2:49:35 PM](#)

REPRESENTATIVE TUCK asked Mr. Marks to explain how combining oil and gas would be bad for producers.

[2:49:56 PM](#)

MR. MARKS explained that the result of combining is that tax on gas then goes from \$0.3 billion to \$1.2 billion, which is bad for the producers. What undermines the state's financial interest is that the oil changes from \$8.2 billion to \$4.3 billion, and "the oil effect overwhelms the gas," so overall the tax revenues change from \$8.5 billion to \$5.5 billion. He added, "Whereas when you go from the status quo to the bill, state's ... revenues go up [and] the gas taxes go down."

[2:51:36 PM](#)

REPRESENTATIVE TUCK said he hears what is being said, but it is the first time he has heard anyone say that in one particular scenario, what is bad for the state is bad for producers.

[2:52:23 PM](#)

REPRESENTATIVE OLSON expressed concern that the committee has until April 18, 2010, to address this issue. He said the ratio of the aforementioned \$120/\$8 example is 15:1, but currently oil and gas prices are approximately 20:1. He asked, "Wouldn't that strengthen the argument of the sponsor of this bill on the concerns for doing something in the next 10 days? Because the numbers that are on the screen are off significantly based on recent prices."

[2:53:07 PM](#)

MR. MARKS responded that Logsdon & Associates, Inc., has never made any representation on what future prices will be; however, the bigger the gap between oil and gas, the more the status quo undermines the state's financial interest by having gas dilute oil taxes.

[2:53:29 PM](#)

REPRESENTATIVE OLSON recollected that a couple years ago, the legislature was emphatically told that the ratio would never be 20:1 or 15:1.

[2:53:42 PM](#)

COMMISSIONER GALVIN indicated that historically the ratio has been between 8:1 and 12:1. He said no matter the ratio, the relationship holds that when decoupling is done, the gas tax goes down and the overall tax generally goes up. He said, "If you're concerned about the fact that oil tax is significantly lower going into the open season, that can be changed after the open season - that's not at stake."

[2:55:28 PM](#)

REPRESENTATIVE GUTTENBERG opined that the key issue in considering the right course of action is figuring out if the best position for the state on May 1 would be to have a higher or a lower gas tax. He asked if it is an accurate assessment that the state would be better off with a higher gas tax without decoupling than with decoupling when the producers come back to negotiate fiscal terms.

[2:56:40 PM](#)

COMMISSIONER GALVIN responded that although that is one consideration, he would not say that is the soul consideration. He indicated that the state is balancing the desire to have the inducement be attractive with the ability to retain flexibility. He said the AGIA inducement was to ensure that the state retain sovereignty over oil tax - that gas taxes would be on the table at the open season. The legislature can only surmise what tax system will work today and in the future. Furthermore, the legislature will decide whether certain aspects of a system should be fixed now or later.

[2:58:47 PM](#)

CO-CHAIR JOHNSON expressed concern that the state does not put itself in "a weaker negotiating point," because there will be a "contract parade on the pipeline," and "they're going to agree to something."

[2:59:56 PM](#)

COMMISSIONER GALVIN responded that in establishing a starting point for negotiations, neither SB 305 nor the status quo offers a "clean choice." He explained that at certain price differentials, the state will have much less revenue under the status quo than if it separates. Going in with a higher number would limit the state's ability to change the gas portion, but would still allow the state to maintain complete control over

the oil. He said there is no clear path. He said from the governor's perspective, the interests align more on the side of leaving the status quo, because it leaves more flexibility and does not create "a big shift of things just going into the open season."

CO-CHAIR NEUMAN commended Commissioner Galvin for his cooperation on this issue.

[3:03:05 PM](#)

REPRESENTATIVE SEATON reminded everyone that the charts being looked at [on slide 2] do not reflect current numbers; they reflect a situation in which there is 4.5 Bcf/d of gas flowing at various rates. He asked for confirmation that if the state chose this scenario, it would be guaranteeing that the inducement would be whatever is negotiated and could not be "higher than this 0.3 as shown under the left-hand column."

COMMISSIONER GALVIN answered, "Not entirely." He explained that the primary issue is that the cost allocation method is not set in statute. He directed attention to slide 2, which assumes not only the 4.5 Bcf/d of gas mentioned by Representative Seaton, but also 500 Mbbbl/d in oil production. He said at the \$120/\$8 scenario, the \$300 million changes to \$800 or \$900 million if the point of production cost allocation method is used. If the system is changed so that 90 percent of the costs are put on oil, then "it goes up to \$1.1 [million]." He said, "It's lower than the status quo, but it's uncertain until the regulations that would allocate costs are in play."

[3:06:44 PM](#)

CO-CHAIR NEUMAN said he thinks the 500 Mbbbl/d of oil and the 4.5 Bcf/d of gas reflect fairly accurate numbers on which to base the differential.

[3:07:34 PM](#)

MR. MARKS advised:

The higher rate that's being locked in - would be locked in under the status quo - is ... a 30-32 percent tax rate on something worth \$1.66. So, just keep that in mind as you think about the attractiveness of locking that in, which predicates that higher number.

[3:08:34 PM](#)

MR. MARKS returned to his presentation and directed attention to slide 9, which addresses the power of the status quo. He opined that it would be a mistake to assume that future discussions will focus solely on gas, because the same producers who produce gas also produce oil. He said the argument will come up that if the state becomes unhappy with gas taxes, then it can extract value from producers through oil tax increases. Because of that, Mr. Marks said he thinks there is a considerable likelihood that the issue will move beyond gas, and oil taxation will be predictably part of the discussion. Therefore, whatever the status quo is at the time inevitably will become the frame of reference for evaluation, and the state may be inadvertently or inevitably locking in oil taxes on May 1, as well as gas taxes.

[3:10:13 PM](#)

MR. MARKS concluded by talking about the Point Thomson issue, which brought up what happens in developing a gas field under both the current tax and under SB 305. He stated that the way current law works and the way SB 305 would work is not different. He continued as follows:

Let's say Point Thomson had no condensate - it was a pure gas field. If you're a North Slope oil producer incurring expenses to develop Point Thomson, the way ... the statute works now ..., whatever costs you incur, you allocate them between oil or gas based on the amount of oil or gas you produce. And if you're producing no gas, all of those costs will be allocated in oil, and you'd be able to deduct every single penny of expenditure you would incur to develop gas here.

... So, we've looked at this issue and we believe the current statute and SB 305 are both clear that the way the statute works [is] ... if a producer had no gas, [then] any expenditure they would incur would be deductible against oil at the time they incur it.

[3:11:47 PM](#)

CO-CHAIR NEUMAN said Mr. Marks' comments throw into question how a field is developed, whether producers pull oil, gas, or liquids, depending on what is available on market prices.

[3:12:18 PM](#)

MR. MARKS responded that any costs incurred are allocated against what is produced during the calendar year in which the costs are incurred. If a producer stated its intention of looking on for gas, but found only oil, all the expenses put forth would be allocated against the oil and could be deducted; the producer could get the credit as those expenses were incurred. He said Logsdon & Associates does not see any risk that those deductions would have to be deferred until the producer found gas.

[3:13:10 PM](#)

CO-CHAIR JOHNSON asked whether Commissioner Galvin agrees.

[3:14:01 PM](#)

COMMISSIONER GALVIN said at this point he would not make such a blanket statement. He said the way current statute is written "leaves the department having to evaluate whether or not to consider the timing issue associated with how you would apply some things, such as a Btu-type basis if it's on current production or if it's based upon what the purpose of the cost is." For example, if a particular tax payer that currently has only oil production is drilling in an area that is known to be almost exclusively gas, then the question would be whether it is appropriate to allow that producer to consider all those costs to be oil costs when nobody expects those costs to be incurred for the production of oil. Commission Galvin said given the way statute is currently written, that is something the department would have to consider as part of the regulation process and put out as part of the public review process.

[3:15:08 PM](#)

CO-CHAIR JOHNSON said that underlines his concern. He clarified that he does not want to leave this issue up to regulations, but rather wants clearly delineated whether or not expenditures will be allowable against oil production until such time there is a market for the gas. He said this is not an issue of trust, but a desire for clarity, which will make the department's job easier.

[3:16:23 PM](#)

CO-CHAIR NEUMAN offered his understanding that both current statute and SB 305 allow flexibility in a case in which there is a decline in investments, so that the industry can thrive.

[3:17:34 PM](#)

COMMISSIONER GALVIN concurred that the state always has the ability to adjust its tax policy if it finds its actions have caused a detrimental effect.

[3:17:55 PM](#)

CO-CHAIR NEUMAN added, "Unless they're locked in on May 1."

COMMISSIONER GALVIN said that is the only caveat, but the tax payer is not going to be limiting the state's ability to "make something more fair."

[3:18:55 PM](#)

REPRESENTATIVE SEATON asked Mr. Marks to confirm that other than the gas production obligation calculated under the gas production tax in effect at the start of the binding open season, the state may enter into discussions and is "in no way obligated on oil taxes other than what we have in statute."

[3:19:55 PM](#)

MR. MARKS answered that is correct. He said he is just suggesting that as discussions ensue, they will revolve around the status quo, whether it is \$8.5 billion or \$5.5 billion.

[3:20:10 PM](#)

REPRESENTATIVE SEATON offered his understanding that Mr. Marks is saying that gas production tax calculated and in effect at the start of the open season is accurately reflected in status quo calculations, and that the figure of [\$1,199,688,523] shown on slide 4 of Mr. Marks' presentation is an example of "the current way the calculation for gas tax would be," and is "what we would be obligated to honor as a ... maximum guarantee that we are giving them that they could have that if it's less than a ... few (indisc. -- coughing)."

[3:20:58 PM](#)

MR. MARKS responded, "If future taxes were above that amount, they would get a tax exemption equal to ... the difference between that amount and the \$1.199."

CO-CHAIR NEUMAN indicated that reference was being made to [AS] 43.90.320(a)-(c).

[3:21:40 PM](#)

REPRESENTATIVE TUCK referred to the term, "reverse dilution effect," and asked if research has been done yet to determine "how recent that we could have been potentially in that situation."

[3:22:11 PM](#)

MR. MARKS related that a few days ago he had sent to the chair an analysis regarding crossover points - when there is a positive and a negative delusion effect. He offered his understanding that an analysis has been done to determine whether total oil and gas taxes would have been higher under the combined taxation, and the answer was rarely.

[3:23:10 PM](#)

REPRESENTATIVE SEATON requested that the chair distribute the aforementioned analysis to the other committee members.

[3:23:47 PM](#)

SENATOR BERT STEDMAN, Alaska State Legislature, testified on behalf of the sponsor of SB 305, the Senate Finance Standing Committee, on which he serves as co-chair. He reviewed that the state changed from economic limit factor (ELF) to production profits tax (PPT), there were discussions regarding changing from a tax and royalty to a production-based system, and there were 20 percent credits, at which point the legislature stepped in with progressivity to protect the state from high oil prices and a declining percent of government take. He said now the dream is to have a gasline.

[3:25:01 PM](#)

SENATOR STEDMAN expressed concern about the \$120/\$8 forecast presented from the federal government on slide 6, when first gas will be present "'20 to 2030," and there is an impending lockdown on gas in just a few weeks, "only leaving us the oil

lever to move." He stated, "When I look on slide 6, and I see \$8.9 billion, I feel that's what belongs in the state treasury under this scenario, all other things being equal." He directed attention to slide 4, which he said shows that the revenue to the treasury is \$5.5 billion. He continued:

The spread is \$3.4 billion. ... There's only \$300 million in gas revenue on the screen right there. And the argument ... [that] this is an incentive or an inducement to bring the industry to the table to build the line - under this scenario, we'd be losing \$3.4 billion a year on a \$30 billion dollar project. That's ... 10 percent of the project. [In] 10 years you'd pay for the project. It's absurd; it's a mathematical shell game being played on the State of Alaska. And the best way we can boil it down is count the cash.

SENATOR STEDMAN talked about the challenging issue of cost allocation, and said work is being done to refine it. He said when building financial models, "it all comes down to the net cash flow." He reiterated that the numbers shown are alarming.

[3:28:04 PM](#)

SENATOR STEDMAN said the highest probability price scenario that the state will face "is right in front of us." He said when incentivizing a gasline, it is imprudent to give away the \$333 million in revenue. He added, "And you certainly don't add another \$3 billion on the table." He indicated that those in the legislature in the future when the gasline is up and running will be embarrassed by the deal that was made. He said some people have made efforts to make the public aware of this issue, but it is difficult, because it is not possible to set the gas tax until the infrastructure cost is known. He said the state is in a perilous position with the impending May 1 deadline. He said there is a lot less risk to the state to decouple the issue and work on the cost allocation. He said he sees that nobody wants to raise taxes on the industry. He said the legislature can solve those problems.

[3:30:07 PM](#)

SENATOR STEDMAN continued as follows:

But once we're in a position like this, if we were to try to raise that oil tax \$3 billion - up on the

screen it's \$8.6 [billion] - that's a third increase. Politically, I don't see how you could do it in the building - get the support, and mathematically, if you did that, I think you'd have a high probability of messing up your oil basin. The whole just spirals out of control, and the state's in a position where we can't ... fix it. So, it becomes a very ... destabilizing problem.

[3:30:48 PM](#)

SENATOR STEDMAN recollected that during PPT talks, the legislature was arguing over miniscule amounts, but today there are billions of dollars on the table that could affect the state for 2-10 years. He said Dr. Wood's work is available. He warned that "if this was to happen two or three times in a decade, it would severely hurt the treasury." He expressed gratitude for the committee's efforts to revue this issue. He posited that the scope of the problem is so large, it has taken many legislators a long time to grasp the magnitude. He said he wants to see good business practices from the state, a fair deal for the industry, and the basin opened up.

[3:33:02 PM](#)

CO-CHAIR NEUMAN said Senator Stedman made a telling argument when he said the only leverage that will be left will be the oil leverage. He said the tax rates on oil are already some of the highest in the world - up to 80-90 percent globally.

[3:33:31 PM](#)

SENATOR JOE PASKVAN, Alaska State Legislature, stated that the 6:1 ratio is law, and said the question is whether the dilution effect previously discussed should cause the oil tax structures to be separated from the gas tax structures. He said it is known that market pricing has dramatically deviated from the Btu benchmark; it is at approximately 20:1. Every one of the slides shown illustrate that combining the tax will have consequences. The risk is real, not theoretical, he emphasized. He reminded the committee that the U.S. Department of Energy forecast shows that the risk will continue for Alaska and that the magnitude of that market deviation will impose substantial risk upon Alaska.

[3:35:11 PM](#)

SENATOR PASKVAN recommended that the committee rely on the forecasts done by the U.S. Department of Energy, because he said the department is not influenced by any argument being advanced by the legislature or the administration and is, therefore, unbiased. He said the department can be relied upon to indicate the market deviation that shows the risk to Alaska. He submitted to the committee that "the combination of all of that provides a basis for decoupling as the proper result to occur at this time to protect the State of Alaska." He said at a 12:1 ratio, production tax is lost; at a 15:1, royalty is also lost; and at a 20:1 ratio, production tax and royalty are lost, and oil savings are compromised.

SENATOR PASKVAN, regarding an issue raised by Representative Guttenberg, said when Alaska goes to the table for discussion, it needs a stand-alone tax structure for oil and another for gas; the state should start those discussions with its production tax on gas, royalty from gas, and savings from oil on its side of the table. He concurred with the comment of Senator Stedman that the committee, when looking at the charts provided, should be consider how much is on the state's side of the equation.

[SB 305 was held over.]

[3:37:38 PM](#)

The committee took an at-ease from 3:37 p.m. to 3:50 p.m.

SB 243-GEOTHERMAL RESOURCE:ROYALTY/PERMIT/FEE

[3:50:55 PM](#)

CO-CHAIR JOHNSON announced that the next order of business was CS FOR SENATE BILL NO. 243(FIN), "An Act relating to geothermal resources; relating to the royalty obligation for geothermal resources; transferring from the Department of Natural Resources to the Alaska Oil and Gas Conservation Commission authority over permitting and inspection of geothermal wells; providing for a regulatory cost charge for geothermal wells; and providing for an effective date."

[3:51:26 PM](#)

SENATOR LESIL MCGUIRE, Alaska State Legislature, as sponsor, introduced SB 243. She said the bill proposes two policy changes in the area of geothermal energy. She remarked that

some areas of Alaska are already working on geothermal energy projects, while other areas have the potential for exploration. She said the first part of the bill addresses royalty provisions under Alaska law. She reviewed that at one time, geothermal leases in Alaska had a set royalty rate of 10 percent. She related that she was part of a group that discussed making the royalty rate zero, because the rate at the time was thought to be a deterrent to geothermal activity in the state. The first iteration of the bill proposed that zero rate. She said the premise was that geothermal energy uses hot water, unlike energy that uses hydrocarbons extracted permanently from Alaska.

SENATOR McGUIRE said after working with the Department of Natural Resources and listening to feedback from members of the Senate Resources Standing Committee, the group decided that while there is not a hydrocarbon that is extracted permanently, geothermal energy production would lock up land, which would be unusable for a variety of other purposes; therefore, the group decided that the responsible solution would be to put a royalty in place. In deciding what rate to set, the group considered other rates, including that of the federal government, which is 1.75 percent for the first 10 years, then 3.5 percent for ensuing years. She indicated that the group did not want to set a rate higher than that of the federal government and end up with circumstances such as that in the Continental Shelf and in parts of Prudhoe Bay, where people are investing in federal lands because the rates are lower. The royalty provision set, as under SB 243, matches the aforementioned federal rate.

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SENATOR McGUIRE emphasized that the bill is not being introduced for the benefit of any one company. She said she went to Iceland a couple years ago where she became enthusiastic about geothermal energy, and since then has been working to incentivize the use of geothermal energy. During this process, she said, companies entered into discussions and she realized that some provisions of Alaska law needed to be clarified. The first clarification was to put a certain royalty rate in place so that companies can make investment decisions. The second clarification was to formulate a regulatory scheme - an essential part of the bill that she said must be passed this year. She explained that currently, under state law, geothermal leases are regulated solely by the Department of Natural Resources.

SENATOR McGUIRE mentioned a utility company drilling in Pike's Ridge and a commissioner at the Alaska Oil and Gas Conservation Commission (AOGCC) who looked into that drilling. It was discovered that the area being drilled presented hydrocarbon deposits. She indicated that the utility company and AOGCC worked well together. She further indicated that state law could be enacted to benefit this situation. She said under SB 243, AOGCC would assume responsibility for regulating the conservation of the state's geothermal resource to prevent waste. It would also assume responsibility for "the act of drilling for a geothermal resource itself." She said she thinks that is important for the protection of both the state's resource and its workers.

[3:57:09 PM](#)

SENATOR McGUIRE related that under SB 243, the Department of Natural Resources would oversee leasing, unitization, and general land management issues. She asked that when the committee considers SB 243, it keeps in mind the months that have gone into its existence and the integral nature of the parts of the bill.

[3:58:19 PM](#)

CO-CHAIR JOHNSON indicated that he had found out that the original 10 percent [royalty rate] had not been selected for any particular reason.

[3:58:49 PM](#)

REPRESENTATIVE SEATON noted that the phrase, "**that includes state land**", had been added after "geothermal" in Sections 6 and 7, on page 3. He then directed attention to Section 5(a), which read, "The commission has jurisdiction over all persons and property, public and private, necessary to carry out the purposes and intent of this chapter." He further highlighted language in Section 5(b), which read: "The authority of the commission applies to all land in the state lawfully subject to the police power of the state, including private land, municipal land, state land, land of the United States, and land subject to the jurisdiction of the United States". He asked if the bill is structured such that a geothermal resource on private land that is subject to the police powers of the state is included, or if Section 6 and 7 "specifically exclude that unless it ... includes some portion of state-owned land."

[3:59:45 PM](#)

MICHAEL PAWLOWSKI, Staff, Senator Lesil McGuire, Alaska State Legislature, on behalf of Senator McGuire, sponsor, indicated that the language in Section 7 means that [lessees] would need the authority [of the commissioner] to enter into a unit agreement related to a system that includes state land. Section 6, he said, refers to the commissioner of AOGCC. Regarding Section 5, he said DNR deals with state land, but geothermal resource development might happen outside of state land. The AOGCC commissioner has the authority over plans of development, exploration, and drilling regardless of whether it is on state or federal land.

[4:01:21 PM](#)

REPRESENTATIVE SEATON said he wants to know if the bill sponsor intended for royalties to apply when the entire resource is on private land.

[4:02:05 PM](#)

MR. PAWLOWSKI offered his understanding that the royalty provision would not apply to private land. For example, if a Native corporation owned the subsurface rights, the state would not collect the royalty on that land. The royalty provision applies when the state owns the subsurface rights, he said. He further offered his understanding that AOGCC's role in investigation and conservation would extend to private land.

[4:02:58 PM](#)

CATHY P. FOERSTER, Commissioner, Alaska Oil & Gas Conservation Commission (AOGCC), Department of Administration, in response to Representative Seaton, stated that AOGCC will have police powers throughout the state as it does for oil, except for Denali National Park and Preserve and a few pieces of federal land. She explained that it does not matter who owns the land - AOGCC must ensure appropriate drilling practices and the best use of the resource. She further emphasized that it doesn't matter whether the land is owned by the state, the federal government, a Native corporation, or a private individual - AOGCC has authority for all of those lands in terms of oil and gas, and it makes sense to have it for land on which geothermal activity takes place.

[4:04:19 PM](#)

REPRESENTATIVE SEATON noted that the bill specifies 120 degrees. He asked if there is a portion of the bill that would provide an exemption for ground source, seawater source, geothermal recovery, or hydrothermal recovery.

[4:05:10 PM](#)

MR. PAWLOWSKI deferred to Kevin Banks to clarify the definition section of the bill.

[4:05:30 PM](#)

CO-CHAIR NEUMAN relayed that sea water and ground water pumps would not qualify under the specification for 120 degrees; therefore, they would need the exemption.

[4:06:05 PM](#)

SENATOR McGUIRE directed attention to language on page 7, in Section 17, which defines geothermal resources as "natural heat of the earth at temperatures greater than 120 degrees Celsius". Seawater that is heated up and cooled down for energy purposes would not qualify.

[4:06:41 PM](#)

REPRESENTATIVE SEATON directed attention to language on page 8, lines 1-2, which read, "or other resource extraction device or any commercial use of the natural heat of the earth". He said the use of the word "or" seems to separate "any commercial use of the natural heat of the earth". He said he wants to ensure there is no conflict created through the wording.

[4:07:19 PM](#)

MR. PAWLOWSKI related that there is concern that under current statutory definition of geothermal, nothing in Alaska could be considered to be geothermal, "because the temperature might be too low." He stated that commercial use of geothermal energy means using the heat of the ground for commercial purposes, generating power, and selling that power. He said the definition needed to be tightened to address the commercial application of geothermal energy.

[4:08:31 PM](#)

REPRESENTATIVE SEATON noted that the Juneau International Airport is installing ground source heat pumps to heat the entire facility, and he questioned whether that is a commercial use of the natural heat of the earth. He said, "I just want to make sure that we don't inadvertently tap into that for any other way."

[4:08:59 PM](#)

MR. PAWLOWSKI requested that the Department of Natural Resources' opinion be put on the record.

[4:09:11 PM](#)

CO-CHAIR JOHNSON said he understands Representative Seaton's concern. He recognized that Representative Seaton had to leave for another meeting, and said unless he objects to the bill, he would like to pass the bill out of committee.

[4:09:29 PM](#)

REPRESENTATIVE SEATON said he does not have an objection to the bill, but wants clarification on the record regarding the intent of "this language" in the bill.

[4:11:57 PM](#)

KEVIN BANKS, Director, Division of Oil and Gas, Department of Natural Resources (DNR), clarified that all of the provisions that are moving over to AOGCC are existing statutes that govern geothermal unitization and conservation and are currently embedded in the Department of Natural Resources as a consequence of statutes written three decades ago. He said it is the view of both DNR and AOGCC that a more practical use of the state's resources for managing these resources with respect to conservation and correlative rights need to be in the purview of AOGCC, because it has the experience in unitization with respect to private and municipal land owners.

In response to a question from Representative Guttenberg, he said if there were mixed ownership of a geothermal resource, in which a municipality is involved, and the development of that resource should occur, then the municipality's participation in the resource and the benefits it acquires from that resource would also come under the purview of AOGCC. He added, "And they would ... share in the cost of its development, just as they would share in the revenues." This would avoid a situation in

which private developers pursue the development of a resource, and then somehow the municipalities would be off the hook for paying their share of it or lose their benefits should the development occur on their land.

[4:14:17 PM](#)

MR. BANKS, regarding Representative Seaton's previous question about the 120 degree Celsius cutoff, said the department wants to ensure that commercial uses of geothermal resources when they are less than 120 degrees and are on state land should be subject to royalty provisions. If that occurs on private land, there would be no state royalty, he said; however, there is still a need to define geothermal resources sufficiently so that AOGCC's responsibilities can be invoked to ensure that people are not drilling wells that are unsafe. The language in the bill was intended to exclude heat pumps for domestic use. Regarding the Juneau International Airport, he said he does not know who owns the subsurface resources underneath the airport where the geothermal heat is being extracted. He said to the extent that an entity such as an airport or other business that happens to be using geothermal fluids that are less than 120 degrees, he suspects they would have to be regulated as a geothermal resource "under this definition."

[4:15:59 PM](#)

CO-CHAIR NEUMAN noted that 120 degrees Celsius is super heated water, above boiling point. He mentioned a rod that can be put into the ground to transfer heat and indicated that that is "pretty well covered in the bill." He encouraged a variety of methods for capturing geothermal energy. He directed attention to page 1, and indicated that under SB 243, DNR would handle the permitting processes, while AOGCC would handle the technical aspect of geothermal resources. He said there would be a combined effort to have oversight practices that ensure things are safely done. He then directed attention to language on page 2, which establishes the royalty of 1.75 percent, which matches the federal rate. He said there is value to state land to those who hunt and fish on it, for example, and he opined that the time frame for the royalties reflects this and is "very reasonable."

[4:18:01 PM](#)

CO-CHAIR JOHNSON opened public testimony.

[4:18:43 PM](#)

PAUL THOMSEN, Director of Policy and Business Development, Ormat Technologies (OT), Inc., testifying in support of SB 243, said OT leased 36,000 acres at Mt. Spurr, and is looking to develop on state land. He said OT thinks the proposed legislation encapsulates what has been discussed earlier and would bring royalty rates "into the market," which allows his company to compete. He stated that what is unique about geothermal development is that the product developed will remain within the state of Alaska. He said he thinks the sponsor recognized that in the bill and tried to reduce the impact to the rate payers in Alaska.

[4:19:49 PM](#)

CO-CHAIR JOHNSON closed public testimony after ascertaining no one else wished to testify.

[4:20:42 PM](#)

CO-CHAIR JOHNSON moved to adopt Conceptual Amendment 1, as follows:

Page 8, lines 1-2, between "device" and ";":

Delete "or any commercial use of the natural heat of the earth"

REPRESENTATIVE EDGMON objected for discussion purposes.

[4:21:13 PM](#)

MR. PAWLOWSKI pointed out that commercial development might not reach the 120 degree Celsius temperature, which would mean large commercial development might not qualify under Conceptual Amendment 1.

[4:21:46 PM](#)

SENATOR MCGUIRE suggested instead that the committee consider defining commercial use itself to mean the sale of heat or power to a third party.

[4:22:28 PM](#)

MR. BANKS said DNR can accept the suggestion made by the bill sponsor.

CO-CHAIR JOHNSON withdrew Conceptual Amendment 1.

[4:22:46 PM](#)

CO-CHAIR JOHNSON moved to adopt Conceptual Amendment 2, as follows:

Page 8, lines 1-2, between "or" and ";;":

Delete "any commercial use of the natural heat of the earth"

Insert "sale of heat or energy to a third party"

[4:23:18 PM](#)

SENATOR McGUIRE suggested instead that the language on lines 1 and 2 could be left as is and a definition of "commercial use" could be added in the definition section of the bill.

[4:23:36 PM](#)

CO-CHAIR JOHNSON moved to amend Conceptual Amendment 2 such that on page 8, following paragraph (9), a new definition of "commercial use" would be added to read: "the sale of heat or power to a third party". There being no objection, Conceptual Amendment 2, as amended, was adopted.

[4:24:18 PM](#)

REPRESENTATIVE EDGMON expressed his hope that Conceptual Amendment 2, as amended, accomplishes what was intended.

[4:24:30 PM](#)

CO-CHAIR JOHNSON clarified that the purpose of the adopted amendment is to exclude heat pumps used for personal use or the aforementioned use at the Juneau International Airport, for example. He said he would work with the sponsor and bill drafters to ensure that purpose is clear.

[4:25:00 PM](#)

CO-CHAIR NEUMAN moved to report CSSB 243(FIN), as amended, out of committee with individual recommendations and the accompanying fiscal notes. There being no objection, HCS CSSB 243(RES) was reported out of the House Resources Standing Committee.

4:25:39 PM

The committee took a brief at-ease.

4:26:24 PM

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 4:26 p.m.