

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

April 5, 2010

3:34 p.m.

MEMBERS PRESENT

Senator Lesil McGuire, Co-Chair
Senator Bill Wielechowski, Co-Chair
Senator Charlie Huggins, Vice Chair
Senator Hollis French
Senator Bert Stedman
Senator Gary Stevens
Senator Thomas Wagoner

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

SENATE BILL NO. 245

"An Act relating to the salmon product development tax credit; and providing for an effective date by amending an effective date in sec. 7, ch. 57, SLA 2003, as amended by sec. 4, ch. 3, SLA 2006, and by sec. 4, ch. 8, SLA 2008."

- MOVED SB 245 OUT OF COMMITTEE

COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 280(FIN) AM

"An Act 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 a gas storage facility on state land; and providing for an effective date."

- HEARD AND HELD

INSTATE GAS TESTIMONY - DAVID GOTTSTEIN

SENATE BILL NO. 309

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

- SCHEDULED BUT NOT HEARD

SENATE BILL NO. 290

"An Act providing a credit against the tax on the production of oil and gas for drilling certain exploration wells in the Cook Inlet sedimentary basin."

- SCHEDULED BUT NOT HEARD

PREVIOUS COMMITTEE ACTION

BILL: SB 245

SHORT TITLE: SALMON PRODUCT DEVELOP. TAX CREDIT

SPONSOR(s): FINANCE

01/29/10	(S)	READ THE FIRST TIME - REFERRALS
01/29/10	(S)	RES, FIN
03/29/10	(S)	RES AT 3:30 PM BUTROVICH 205
03/29/10	(S)	Heard & Held
03/29/10	(S)	MINUTE(RES)

BILL: HB 280

SHORT TITLE: NATURAL GAS: STORAGE/ TAX CREDITS

SPONSOR(s): HAWKER, CHENAULT

01/15/10	(H)	PREFILE RELEASED 1/15/10
01/19/10	(H)	READ THE FIRST TIME - REFERRALS
01/19/10	(H)	L&C, RES, FIN
02/08/10	(H)	L&C AT 3:15 PM BARNES 124
02/08/10	(H)	Heard & Held
02/08/10	(H)	MINUTE(L&C)
02/15/10	(H)	L&C AT 3:15 PM BARNES 124
02/15/10	(H)	Moved CSHB 280(L&C) Out of Committee
02/15/10	(H)	MINUTE(L&C)
02/17/10	(H)	L&C RPT CS(L&C) NT 4DP 2NR 1AM
02/17/10	(H)	DP: LYNN, NEUMAN, CHENAULT, OLSON
02/17/10	(H)	NR: HOLMES, T.WILSON

02/17/10 (H) AM: BUCH
 02/19/10 (H) RES AT 1:00 PM BARNES 124
 02/19/10 (H) -- MEETING CANCELED --
 02/26/10 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 02/26/10 (H) <Bill Hearing Canceled>
 03/12/10 (H) RES AT 1:00 PM BARNES 124
 03/12/10 (H) Heard & Held
 03/12/10 (H) MINUTE(RES)
 03/15/10 (H) RES AT 1:00 PM BARNES 124
 03/15/10 (H) Moved CSHB 280(RES) Out of Committee
 03/15/10 (H) MINUTE(RES)
 03/17/10 (H) RES RPT CS(RES) NT 5DP
 03/17/10 (H) DP: EDGMON, OLSON, P.WILSON, SEATON,
 JOHNSON
 03/17/10 (H) FIN AT 9:00 AM HOUSE FINANCE 519
 03/17/10 (H) <Bill Hearing Postponed to 1:30 pm
 Today>
 03/17/10 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 03/17/10 (H) Heard & Held
 03/17/10 (H) MINUTE(FIN)
 03/18/10 (H) FIN AT 9:00 AM HOUSE FINANCE 519
 03/18/10 (H) Heard & Held
 03/18/10 (H) MINUTE(FIN)
 03/18/10 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 03/18/10 (H) Moved CSHB 280(FIN) Out of Committee
 03/18/10 (H) MINUTE(FIN)
 03/22/10 (H) FIN RPT CS(FIN) NT 9DP 1AM
 03/22/10 (H) DP: AUSTERMAN, FAIRCLOUGH, KELLY,
 N.FOSTER, DOOGAN, THOMAS, JOULE,
 STOLTZE
 03/22/10 (H) HAWKER
 03/22/10 (H) AM: GARA
 03/24/10 (H) TRANSMITTED TO (S)
 03/24/10 (H) VERSION: CSHB 280(FIN) AM
 03/25/10 (S) READ THE FIRST TIME - REFERRALS
 03/25/10 (S) RES, FIN
 03/31/10 (S) RES AT 3:30 PM BUTROVICH 205
 03/31/10 (S) Heard & Held
 03/31/10 (S) MINUTE(RES)
 04/05/10 (S) RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

REPRESENTATIVE MIKE HAWKER
 Alaska State Legislature
 Juneau, AK

POSITION STATEMENT: Sponsor of HB 280.

JAN LEVY, aide to Representative Hawker
Alaska State Legislature
Juneau, AK

POSITION STATEMENT: Commented on HB 280 for the sponsor.

MARCIA DAVIS, Deputy Commissioner
Department of Revenue (DOR)

POSITION STATEMENT: commented on HB 280.

KEVIN BANKS, Director
Division of Oil and Gas
Department of Natural Resources (DNR)

POSITION STATEMENT: Commented on HB 280.

JOHN SIMMS, Manager
Corporate Communications and Customer Services
Enstar Natural Gas Company, said he

POSITION STATEMENT: Supported HB 280.

DAVID GOTTSTEIN
No stated affiliation

POSITION STATEMENT: Commented on CSHB 369.

DON ETHRIDGE
Alaska AFL-CIO

POSITION STATEMENT: Supported CSHB 369 with project labor agreement language.

ACTION NARRATIVE

[3:34:04 PM](#)

CO-CHAIR BILL WIELECHOWSKI called the Senate Resources Standing Committee meeting to order at 3:09 p.m. Present at the call to order were Senators French, Wagoner, McGuire, and Wielechowski.

SB 245-SALMON PRODUCT DEVELOP. TAX CREDIT

[3:34:38 PM](#)

CO-CHAIR WIELECHOWSKI announced SB 245 to be up for consideration. He explained that it would extend the deadline for salmon processors in Alaska to claim a tax credit for purchasing equipment needed to develop value-added salmon products. The credit was initially enacted in 2003 and has helped to stimulate the creation of a variety of new products.

It has benefited fishermen, processors, coastal communities, and the state of Alaska, which has seen an increase in its collection of fisheries business taxes. Public testimony was unanimous in support of this program and its continuation.

[3:36:06 PM](#)

CO-CHAIR MCGUIRE moved to report SB 245 from committee with individual recommendations and attached fiscal note(s). There were no objections and it was so ordered.

HB 280-NATURAL GAS: STORAGE/ TAX CREDITS

[3:36:25 PM](#)

CO-CHAIR WIELECHOWSKI announced HB 280 to be up for consideration. [CSHB 280(FIN) AM was before the committee.]

[3:36:30 PM](#)

REPRESENTATIVE MIKE HAWKER, sponsor of HB 280, asked the co-chair if she had any questions.

CO-CHAIR MCGUIRE said she was comfortable with moving forward.

[3:37:44 PM](#)

REPRESENTATIVE HAWKER said he finished explaining Section 11 at the last meeting. It is making sure that the information about the disclosure provision for taxpayers receiving credits is communicated between the Department of Revenue (DOR) and the Regulatory Commission of Alaska (RCA). But, the meat of the bill is in Section 12 about the gas storage facilities development credit. It is a volumetric-based credit in the amount of \$1.50 per thousand cubic feet (tcf) of storage capacity. The credit, a financial support for reducing the cost of the supply chain of gas, is to be passed on specifically to consumers. The storage facility must be opened and commence operation during the years 2011-2015; so this bill, in fact, has a sunset. The credit is capped at \$15 million, which is the equivalent of a 10 bcf facility. It has been estimated that between 10 and 15 bcf is the realistic level of commercial storage to be brought forward, and the credit was designed to not provide great excesses.

SENATOR FRENCH said that responsible commercial efforts are already being made on a parallel track, and this has prompted him to question how much stimulation is needed from the state.

REPRESENTATIVE HAWKER said he very much shared his thought process, but HB 280, that develops a regulatory framework for the development of gas storage that does not currently exist in

Alaska statute, is critical so that a potential investor knows what they might be investing in. The reason for providing this credit is not to incent development of storage capacity, because that is already universally accepted as being critical to moving forward in providing energy security, but rather to ultimately to benefit the consumers at the end of the supply chain, because that development will involve an incremental cost in the supply chain.

REPRESENTATIVE HAWKER also said he recognized the potential controversy from other regions of the state who might feel they are not being supported equally. His answers to that are the PCE endowment and the hundreds of millions of dollars the state has put into alternative energy development balance it out.

[3:42:55 PM](#)

REPRESENTATIVE HAWKER said HB 280 also addresses deliverability requirements to make certain the state is not providing a subsidy for a facility that isn't fully used. Language on page 2 in Section 2 says to be considered for a credit a commercial facility has to be moving more than 100 mmcf/year. The Alaska Oil and Gas Conservation Commission (AOGCC) certifies the storage capacity; a minimum of 500 mmcf is required. The credit maxes out at 10 bcf.

CO-CHAIR WIELECHOWSKI asked if he sees the regulation component kicking in under language on page 10, lines 11-12.

REPRESENTATIVE HAWKER answered that the regulatory provision is a construct of a couple of elements and that is one of them. That language specifically excludes proprietary storage from being eligible for credits.

CO-CHAIR WIELECHOWSKI said he thought the term "available" on page 10, line 11, was vague, and asked what he thought about adding "at competitive rates to any producer or utility operating in Cook Inlet."

REPRESENTATIVE HAWKER answered that wouldn't cause him any concerns, but he needed to confer with counsel before making an absolute commitment.

[3:47:07 PM](#)

JAN LEVY, aide to Representative Hawker, stated that what he may have been asking on page 10, lines 11-12 that say "a utility regulated under AS 42.05" is not the provision that causes the storage facility to be regulated. This just means that they have

to be available to the utility gas. They wouldn't offer the storage space at a competitive rate; they have to offer it at a regulated rate, because they will be regulated by the RCA.

SENATOR FRENCH said Section 9 is the section that puts this facility under RCA regulation.

REPRESENTATIVE HAWKER agreed and added that it defines what a public utility is for the purpose of regulation; it specifically defines a facility that is furnishing natural gas not to the public for compensation, but to the utility-owned storage.

SENATOR FRENCH asked if that is the kind of facility this measure envisions giving a credit to.

REPRESENTATIVE HAWKER answered yes.

CO-CHAIR WIELECHOWSKI asked if he intended to limit the scope of this bill to below the 68th latitude, essentially Cook Inlet, and where that language would be located.

REPRESENTATIVE HAWKER answered that the intent of the bill is not to limit storage that is available for utility gas to the Cook Inlet. This sort of facility would be an essential part of adding the ability to provide gas delivery in the Fairbanks arena. He didn't want to constrict the ability to meet utility needs.

CO-CHAIR WIELECHOWSKI asked if the producers could possibly attempt to define what they currently have in Kuparuk and Prudhoe as a gas storage facility.

REPRESENTATIVE HAWKER answered that the proprietary storage exclusion on page 9, line 8, doesn't include "storage of natural gas owned or contractually obligated to the owner, operator, or manager of the natural gas facility". So, if gas is being put back into a well on the North Slope for pressurization or other purpose, it would not qualify. The credit is intended for a consumer delivery facility. Specific language excludes pipelines as well. The intent is to pass the credit on to the consumer.

MS. LEVY added that this storage facility has to be built within a certain timeframe and it would have to agree to being regulated.

[3:53:18 PM](#)

REPRESENTATIVE HAWKER said section 13 increases access to existing tax credits for developers, particularly in the Cook Inlet, by eliminating the Cook Inlet penalty (the point in statute where the differential tax is established between the Cook Inlet and North Slope regions). The credits generated in the Cook Inlet have to be discounted as if they were being used in a higher state tax regime before they can actually be used for credit. The idea is to keep Cook Inlet on an equal competitive footing with other regions of the state for attracting investment capital.

Section 14 is also in the production tax arena and is part of the accounting mechanism. It talks about how all gas that is injected into a storage facility is gas that is produced and pays tax and royalties. When that gas goes in it is presumed to be the first gas to come out. Native gas (at the bottom of the hole) is the last gas produced, and it doesn't get taxed until everything that was pumped into the reservoir is taken out. He explained that this section is providing a regulatory structure that makes it easier for the industry to build, manage, and account for facilities, knowing that when they put gas in they get it all out before producing any of the residual gas.

CO-CHAIR WIELECHOWSKI asked when Marathon Oil would get taxed under this section when it puts gas in a third-party facility and then pulls it out to sell.

REPRESENTATIVE HAWKER answered at the point they bring the gas to the surface and move it into the marketing arena. Putting it into another storage facility does not defer their payment of tax.

MS. LEVY added that the producer is taxed as they produce gas. Gas in a storage facility that is underground will have some native gas already and that is the "cushion gas." This is the gas that may eventually come out and people are wondering when it will get taxed.

REPRESENTATIVE HAWKER said whether a producer flares the gas or puts it in a cylinder above surface or pumps it below ground is irrelevant. The point is that the point of production (POP) is defined as the taxable point.

[3:59:14 PM](#)

SENATOR STEVENS joined the committee.

SENATOR FRENCH said native gas and cushion gas are not synonymous in his mind. Gas might have to be pumped in that you don't necessarily expect to get back out.

REPRESENTATIVE HAWKER explained that "cushion gas" is the amount of gas that is needed to make the facility operate, but native gas already exists in the bottom of the hole when the project is started. Cushion gas is pumped in to get the well pressurized; then "working gas" goes in and out. The bill says all the non native gas has to be taken out before one starts paying production taxes.

[4:00:20 PM](#)

He continued on to Section 15 and explained that ACES requires a two-year amortization of the credits. In the interest of incentivizing development, particularly doing their best to bring in better capitalized independent players, he has requested that the production taxes be available to the investor in one year, the first year, rather than them having to amortize it over two years. Section 16 is support for Section 15 and clears up all the language they need to accomplish that mission.

Section 17 is the issue of what is allowable for these development credits within the existing credits. This adds the well-related expenses.

[4:01:54 PM](#)

CO-CHAIR WIELECHOWSKI said as he reads it, Sections 16 and 17 relate to Section 18, which is sort of the heart of the incentivization.

REPRESENTATIVE HAWKER agreed, and said that Section 18 adds a new subsection on applying for a tax credit for well lease expenditures (page 16, line 2, (B)). This concept parallels a proposal that the executive has introduced on a more state-wide basis recognizing the difference between the existing tax credit structure, which is typically for areas outside of existing defined units, and this structure, which allows the state to come back inside the unit and provide credits for the well lease expenditures that are intended to increase, enhance, or mitigate the decline of well production and are directly related to the processes of operating a well and moving the fluids. Currently those in-field expenses do not qualify.

CO-CHAIR WIELECHOWSKI said he understood that subsection (m) in Section 18 is really increasing the ACES tax credit from 30 to 40 percent.

REPRESENTATIVE HAWKER agreed and explained that currently the ACES system has a tiered 30 and 40 percent credit available to exploration expenditures. That differential has to do largely with how far away a project is from an existing site. With the Cook Inlet's small footprint, it's advantageous and good public policy to eliminate the requirement to be stepped out so far and increasing the density of the wells in existing units needs to happen. HB 280 asks to treat them just as a straight 40 percent credit; the 30 percent tier is being eliminated.

CO-CHAIR WIELECHOWSKI asked if lines 16-17 still require that the state gets the discovery data from the producers.

REPRESENTATIVE HAWKER answered yes; the bill was crafted carefully to not change any of the technical aspects of the various credits and policy decision previously made. They are attempting to increase access the credits in the Cook Inlet.

[4:05:13 PM](#)

SENATOR HUGGINS joined the committee.

SENATOR FRENCH asked if the definition of "lease expenditure" relates to the flow of the oil and gas from the casing head but does not include the process of gathering, separating or processing well fluids downstream of that assembly (subsection (o) in Section 18 on page 16, lines 2-7). Did that mean up into the well tree and the wing valve and the place where you control the flow of the oil out of the ground but not the downstream separators and gas compressors?

REPRESENTATIVE HAWKER answered yes. He said this language was worked over very carefully with the Department of Revenue.

SENATOR FRENCH asked if that is the same approach ACES uses.

REPRESENTATIVE HAWKER answered that it follows along with ACES, but increasing the credits.

[4:07:32 PM](#)

CO-CHAIR WIELECHOWSKI said it looks like Section 18 has three essential changes; increasing the tax credit from 20 to 40 percent in subsection (m), changing the definition of "lease expenditure" in subsection (o); and he asked if that is the same as a lease expenditure under ACES.

REPRESENTATIVE HAWKER answered they are eliminating the existing 30-40 percent credit, not the 20 percent. A new subsection was created to define this issue for Cook Inlet, and that language was taken from current statute where the whole state was treated as one.

CO-CHAIR WIELECHOWSKI asked if language on page 16, lines 8-10, allows overhead expenditures to be included as a lease expenditure.

REPRESENTATIVE HAWKER answered yes; it allows an overhead component to expenditures that had been in previous versions of the statute in an amount that is consistent with the calculative methods already established in state regulation.

CO-CHAIR WIELECHOWSKI asked if a percentage is assigned to overhead.

REPRESENTATIVE HAWKER recalled that overhead percentage is at 4.5 percent.

[4:10:21 PM](#)

CO-CHAIR WIELECHOWSKI asked if language on page 15, line 25, makes the tax credit transferable and available for immediate use and provides that it does not expire. He asked as a matter of policy if the state wants tax credits that don't expire.

REPRESENTATIVE HAWKER answered in this case, they want to vest in a developer the value for their development efforts. They want this tax credit available immediately to all investors and later on in the bill it allows small producers to access the tax credit fund for immediate cash value for the same credit. He thought fully vesting in the value is an appropriate public policy in this arena.

[4:11:33 PM](#)

He went on to Section 19 and said this is where the state is allowed to use funds from the oil and gas tax credit fund making sure the cash flow moves to the front end of the discounting calculation.

CO-CHAIR WIELECHOWSKI said that really is aimed at encouraging small producers.

REPRESENTATIVE HAWKER said this one is specifically to reduce the cost of adding the gas storage facility to the supply chain to the consumer.

[4:13:14 PM](#)

He went on to explain that Section 20 eliminates the need for proof of spending money in Cook Inlet in order to receive the credits and promotes the independent small investors the state is hoping to attract. Current law says that before the credits can be sold back to the state further proof of spending an amount equal to the credit in Alaska is needed.

Section 21 gives the regulation authority that is ubiquitous to all bills.

[4:15:04 PM](#)

Section 22 is the new directive to the RCA to consider the consequences of saying "no" to a long term supply contract that is brought before them; something they have not had to consider before. They have to consider the impact on the consumer of more expensive gas or no gas. This section applies that same standard to the Public Advocacy division of the Department of Law when they intercede in a filing.

[4:16:15 PM](#)

Section 23 requests an immediate effective date.

SENATOR HUGGINS asked what the two largest hurdles have been in working this bill through the process.

REPRESENTATIVE HAWKER answered getting folks to understand what gas storage is and then reaching an accord about the equal importance of allowing proprietary storage for the purpose of inventory management by the producers - the overall policy call of whether credits are a good thing or a bad thing. He believes there is a place for both.

SENATOR HUGGINS asked the potential challenges of RCA's role in this.

REPRESENTATIVE HAWKER answered that the chief RCA executive helped craft HB 280. Earlier in the session the RCA asked him to provide the commission specific guidance on whether they would or would not regulate gas storage facilities. The bill makes the policy call that says if a gas storage facility is a third-party open-access facility or one that is owned by a public utility, that it is, in fact, regulated by the RCA. It is also crafted so that any proprietary storage that exists, inventory management only, is not regulated by the RCA, but it also does not receive

any of the potential subsidization benefits available under the bill to facilitate consumer deliverability.

[4:19:32 PM](#)

MARCIA DAVIS, Deputy Commissioner, Department of Revenue (DOR), commented that she liked the way the sponsor used the expertise of AOGCC, DNR, DOR and RCA and allocated to each agency what their role is. However, some gaps still exist that need to be solved so that it works well. One of the dominant concerns the department has, especially when writing a fiscal note, is the scope and where gas storage gets included. They heard testimony saying this was originally intended and designed to solve the deliverability problem for Cook Inlet and they assumed it was a Cook Inlet gas storage bill, but as they went through it they realized that the definition of "gas storage facility" was simply the depleted or nearly depleted reservoir pool in the state that is available for gas storage, and part of their job is to think about "what if" and "what could go wrong." She said their worst nightmares are obviously the large reservoirs on the North Slope and how they are different from Cook Inlet. One of the concerns, for instance, is on page 2, line 31, where it says "depleted reservoir or nearly depleted reservoir or pool". DOR needs an agency expert to say if something is going to qualify as a gas storage facility. The North Slope might have reservoirs that contain both oil and gas but they are located in different horizons of that reservoir. And what if it still has a lot of oil but all the gas is depleted or what if it has a lot of gas but all of the oil is nearly depleted?

Furthermore, she said the North Slope has a long history of straight-forward production, but now to optimize production producers are being more creative. She thought they would begin to see movement of resources into storage. For instance, if gas is a limiting factor, it might come out; but if it's not yet ready to be produced, because of sharing facilities, gas coming out of one field might be going into another.

SENATOR FRENCH asked if this is a Cook Inlet concern or a North Slope concern.

MS. DAVIS replied a North Slope concern. Generally in Cook Inlet as gas is being produced a market is readily available, although there are different times of the year when it will be stored until it's needed in a higher quantity than it can be delivered later on.

SENATOR FRENCH asked where North Slope gas would be sold to the public.

MS. DAVIS replied that the North Slope has utilities; the Dead Horse Utility is one and other owners actually utilize gas for running their facilities. Nothing limits who the public or the utility is.

CO-CHAIR WIELECHOWSKI asked if they could say this applies to below the 68th degree latitude.

MS. DAVIS said she is sensitive to Representative Hawker's comment that he doesn't want to harm the interests in Fairbanks, if someone ever wants to store gas on the North Slope and then move it to Fairbanks, and she was open to working that out with him.

SENATOR FRENCH asked if one of the administration's concerns could be alleviated by defining gas that goes into a storage facility as that gas which has been taxed.

4:25:50 PM

MS. DAVIS replied that language actually leads to the second large concern the administration has with the description of native and non-native gas being produced in Section 14 on page 12. Representative Hawker was absolutely correct in his description of the norm, which is that typically when a (Cook Inlet) producer produces gas and sells it, that is the sale point the DOR can readily look at to see the volume sold and the price. In this instance, the concern is if a utility owner wants to buy gas (from Marathon, for instance) and store it, and then wants to draw it out in January and doesn't want the DOR to say that is "producing gas" and therefore they must pay a tax. This is not the case, because the assumption is the tax got paid when they bought it from the producer. With current language, a producer could produce gas and because they don't have storage they pay to store it until they "produce it when they need to sell it." The department's dilemma is that a production took place, but now it's held in suspension. The department wants the freedom to work with that system and assess a gas when it "gets produced out and sold." If language gets "hard wired" to say the gas gets taxed when the producer produces it, a smart producer could game the system by having it taxed in the summer when it is cheap.

SENATOR FRENCH asked how the producers' proprietary storage wells work now.

MS. DAVIS replied that she has done some investigation into whether there is a long-standing rule or method of treating proprietary storage and that is unresolved. The question came up two or three years ago, and only one taxpayer is doing that.

SENATOR FRENCH asked if people within the department agree as to where the point of production (POP) is.

MS. DAVIS answered that they know where the POP is, but the question is on when the sale takes place and what value they use to assess against that gas. Is it the prevailing value before a sale has taken place or is it the value at the time the sale actually takes place? The department would take the position that it should be the value at the time the sale takes place.

[4:29:40 PM](#)

SENATOR FRENCH asked how much gas in Cook Inlet is sold like that where the department doesn't know the price isn't the majority of what is sold.

MS. DAVIS replied very little; but they are trying to get ahead of the curve, because they want to see a lot of gas produced and they want producers to have the freedom to store gas and not worry about it. It seems fair to give the department the freedom to tax it when it gets sold. A simple fix would be to say "non-native gas owned and stored by a person other than the producer of the non-native gas that is withdrawn...is not considered produced."

[4:30:42 PM](#)

CO-CHAIR WIELECHOWSKI asked if she wants to change Section 14.

MS. DAVIS replied yes, on the bottom of page 12, line 30. An insert would limit the application of that sentence to the situation where the non-native gas has a change of ownership.

On page 2, line 31, it would be helpful to have some agency advise the DOR when "depleted or nearly depleted" has happened.

In terms of administering the DOR credit on page 10, line 11 that says "must be available for the storage of gas that is owned by a utility regulated under AS 42.05," their credit hinges on the commencement of commercial operation and it relates to a gas storage facility. She didn't previously appreciate the nuance in this sentence until Representative Hawker pointed it out. The way this phrase is used here the

concern is that a utility providing gas to the public is clearly a utility that is regulated under AS 42.05. But in addition, a public utility can also be the company that is providing the storage service (page 8 - what a "public utility" is). So, two entities would be regulated under AS 42.05 - the storage company itself and the utility that is acquiring and using gas that the storage facility is providing. To them, this means that the gas storage facility must be usable and available for use by a utility. It doesn't say that the gas storage facility itself is a regulated utility, but she hoped that the section on page 8 applied.

[4:34:25 PM](#)

MS. DAVIS said she is having trouble connecting the dots, and she wanted to make sure the intent is for the credit to only go to a gas storage facility that is regulated and not to a private proprietary one.

She wanted to make sure the DOR would be providing needed confidential information to the legislature and interested parties in reference to Section 11, on page 9, lines 17-21. If you can imagine a company that owns more than one gas storage facility, she explained, this language allows them to give the name of the company and the total amount of the credit, but she wouldn't be able to break it down by facility, which is what they want to do since the credit is capped on a per facility basis. So, she suggested to insert "for each gas storage facility" on line 19 after "claimed by that person under AS 43.20.046".

[4:35:47 PM](#)

A provision on lines 25-28, page 11, says a person claiming the tax credit when they contract with a utility that is regulated under AS 42.05 must reduce the price it would otherwise charge that utility to reflect the tax credit. It is in the tax code, but the DOR would have no way of enforcing it. Ms. Davis thought this language duplicates section 7, which requires the RCA to insure that that happens. Assuming her understanding is correct she recommended dropping subsection (j).

[4:36:58 PM](#)

Moving away from gas storage, and looking at the Cook Inlet well lease expenditure credit, Ms. Davis said she would juxtapose the bucket of costs that will be subject to the 40 percent production tax credits against the governor's bill of a statewide 30 percent tax credit. She also wanted to point out how it relates to the underlying ACES (Alaska's Clear and

Equitable Share) as well. Essentially, both of them attempt to get at well-related expenses that don't qualify under the exploration credit because they are too far away. It's the "infield stuff" the extra work operators do to insure they are getting more production out of fields that are already going and that currently gets the 20 percent capital credit. Both of them are lease expenditures, but Representative Hawker has pulled it back to being just applicable to Cook Inlet and the Governor's bill applies to the entire state.

MS. DAVIS said they both have to be directly related to a well. The explanation for this under HB 280 is twofold. The first phase is essentially exploration and development that is clearly defined as a qualified capital expenditure under intangible drilling costs in the current capital credit section. It also includes another phase of credit that happens during production and is intended to cover just the well valve assembly down hole and expressly excludes the upstream gathering separation costs. It includes an overhead cost of 4.5 percent of expenditures. So, you multiply the total costs of expenditures in "buckets A and B" by 4.5 percent, and that gets added on as a credit. It also includes the seismic work within unit boundaries.

MS. DAVIS said language in HB 337 got simplified to essentially the same thing, qualified capital expenditures and intangible drilling costs. But a lot of members questioned what would actually be in production. The department had envisioned a field that was up and operating as being in production, but things like well deepening, well testing, well completion, recompletion, well work over, and sidetracking that are intended to access new parts of the reservoir are actually viewed as more development; it's not ongoing day-to-day work. So in the end they disregarded the production piece out of concern that the overhead allowance is not allowed under any other credit. And both of them provide for seismic within the unit boundaries.

CO-CHAIR WIELECHOWSKI asked what an intangible drilling and development cost is.

MS. DAVIS replied that it is defined under the IRS code as all costs associated with drilling wells, which includes the pad preparation, getting the ice road or access to it. It includes all costs whether they are capital or operating. The question is does it have salvage value at the end of the day. If it does, it doesn't count. But if it's going to get consumed and used and not really have any value and be depleted in the course of drilling the well, it's going to be considered an intangible

drilling cost. One of the nice things about referencing the IRS code is that it has a huge body of case law developed behind it that makes it very clear. Companies know what this means and won't have to wait around for the DOR to write regulations.

[4:43:08 PM](#)

KEVIN BANKS, Director, Division of Oil and Gas, Department of Natural Resources (DNR), said the POP and value of gas are concerns. He said the department considers the point of production to be when a royalty event occurs - that is when gas leaves the lease and goes into storage.

He elaborated that the department also has an issue with deciding what value is and if they should try to ascribe a value to royalty when gas is produced or when it comes out of storage. In their discussions with the storage lessees and producers that are using storage today, Mr. Banks said, they have actually offered up something of a trade: that storage costs are not a deduction for royalty, but royalty will be valued on the day that it is produced. In other words, they "let go of the rope" in terms of trying to figure out when the gas leaves storage to come up with some sort of value methodology. So, if the value of gas is sometimes low and that's when production is occurring, that is the value they will use in calculating the royalty in that case. It fits in nicely with HB 280 because now they don't have to figure out whose gas is who's when it comes out of storage.

[4:45:12 PM](#)

SENATOR STEDMAN joined the committee.

[4:45:46 PM](#)

MR. BANKS said when the bill came out of the House it had a measure that says the credit allowed for storage is based on \$1.50 of the storage working capacity and limited it to \$15 million; now it's limited to 25 percent of the cost of building the storage. This puts a nice box around the state's exposure in providing these kinds of credits - a good thing. At least they know, when the state is committing funds, that there is some kind of potential access that will be available to utilities with respect to storage.

Lastly, on the question of tax credits for exploration and development wells, he recalled discussions about potential supply in Cook Inlet and he said all of the new production the department examined involved the drilling of wells within existing units. They are not looking to rank exploration to find

new supplies of gas. Having said that, none of that production would have received tax credits under existing ACES law. This bill then actually provides that tax credit for new supplies of gas that will come from existing units in Cook Inlet - an important point as they are now targeting the right development activity.

[4:48:39 PM](#)

MR. BANKS went on to the question of whether storage should be proprietary or third-party. He explained that the reason DNR is involved at all is that the right to inject outside substances into an existing lease for this kind of purpose does not exist in the current oil and gas lease. So, the DNR has to have a *storage* lease so that the owner of the oil and gas lease can move ahead and operate a storage facility of any sort. That puts the DOR "in the hopper" when it comes to extending a new right that doesn't exist - that is to inject and withdraw gas from a reservoir that is already under oil and gas lease. That means there are no opportunities in the Cook Inlet for storage except for those that are currently under lease. Most of that is under state land with an exception of Swanson River where the federal government has a storage lease.

From the perspective of the department, he thought a public purpose should be served if it is going to extend a private right over public land. Their principle then is that storage should be offered to third parties and that there should be some opportunity for others to use the storage in some way. That position gets stated in the form of a lease that they gave to some of their applicants. For him that was the start of the discussion about what this would look like.

MR. BANKS said he would allow lessees to meet existing supply contracts from storage, but as that obligation declined, the access in the form of interruptible service, for instance, should be available to others. Similarly, if there was a concern on the part of the developer about getting back their investment in the storage he was willing to take into account some methodology where they become their own "anchor-shipper" in the storage facility, so they would be assured of the amount of storage they would need. But again, as that space became available it should be offered to others.

[4:52:59 PM](#)

MR. BANKS said this bill has a commitment on the part of the state to see storage developed and it provides a credit; in order to get the credit you have to be regulated. He could work

with language in Section 4 that says the director cannot reject an application *solely* because it's not third-party storage. There could be a situation where they would reject an application, for instance, if the surface facilities that are built in conjunction with storage are on some kind of refuge or there is some other land use conflict that arises because of that. The word "solely" helps out in this regard.

CO-CHAIR WIELECHOWSKI invited Ms. Davis back. He asked both of them if this bill gets them to the point mentioned in a presentation from outside consultants hired by the utilities that said 13 new wells a year are needed for the next decade as well as gas storage.

MR. BANKS replied that the consultant was PRA, and they used the department's study as a starting point and basically validated their supply numbers. These credits target that kind of supply and based on the last 10 years of experience in Cook Inlet. Largely now, Cook Inlet producers have certain commitments to supply gas to the utility with whom they have contracted with. He thought any of them would drill wells in order to meet their needs. These credits reduce the cost to the producer of making a commitment to supply a certain amount of gas, and perhaps those lowered costs will be reflected in slightly lower prices to the consumer. There are no guarantees, and the outcome of this measure won't be known until time passes.

MS. DAVIS responded that she believes the gas storage credit is in the right direction simply because it hasn't been tried yet; and they all know that deliverability is a crucial link in the ability for producers to economically be able to drill expensive wells. She also observed that less than three people have taken advantage of the corporate income tax exploration incentive credit that is currently on the books at 10 percent.

CO-CHAIR WIELECHOWSKI asked Enstar to comment on their pursuit of a Cook Inlet storage facility with the TransCanada subsidiary and if this bill is heading in the right direction.

[4:59:47 PM](#)

JOHN SIMMS, Manager, Corporate Communications and Customer Services, Enstar Natural Gas Company, said he supported HB 280. Enstar also supports anything that can be presented to the consumer as a potential savings. They are moving forward with storage and have notified TransCanada that they would like to exercise their option to purchase the SS and work product, but they weren't able to reach an agreement on commercial terms.

SENATOR STEDMAN asked if he had a timeframe.

MR. SIMMS answered that their goal is to have this project initiated and under way by 2012.

SENATOR STEDMAN asked if their project would go forward without this bill.

MR. SIMMS answered yes; both Enstar and South-central Alaska need storage, but anything else is appreciated.

SENATOR FRENCH said when they spoke to Singh's (TransCanada subsidiary) about the issue of regulation, they said they are comfortable with it, and he asked Mr. Simms if he is comfortable with RCA regulation.

MR. SIMMS answered yes.

CO-CHAIR WIELECHOWSKI asked him to talk about the size of their facility.

MR. SIMMS said he couldn't talk about it at this point. They are still in negotiations.

[5:03:27 PM](#)

CO-CHAIR WIELECHOWSKI asked if this facility solves all of South Central's storage problems.

MR. SIMMS answered that it will help in the near term, but he couldn't comment further.

[5:04:10 PM](#)

CO-CHAIR WIELECHOWSKI invited Representative Hawker back.

[5:04:19 PM](#)

REPRESENTATIVE HAWKER commented that DOR's issues have been resolved amicably and everything else could be dealt with, too. This bill is not a panacea for resolving all issues, but it is targeting an important area.

[5:07:01 PM](#)

CO-CHAIR WIELECHOWSKI asked Mr. SIMMS if Enstar intends to provide storage to others.

MR. SIMMS replied that he didn't know what the arrangements would be.

CO-CHAIR WIELECHOWSKI set HB 280 aside for further work.

Instate gas testimony - David Gottstein

[5:08:37 PM](#)

DAVID GOTTSTEIN thanked them for hearing his views on CSHB 369 and the gas pipeline in general. The following is his statement:

I come at the pipeline questions not only as an interested Alaskan, but as a 20-year company analyst and Registered Investment Advisor with degree from the Wharton School, having also been a logistics and supply chain manager in a major grocery operation for almost ten years. Perhaps the intersection of these two disciplines allows me to look at the question at hand differently than most because any pipeline project is largely a combination of economics, logistics and finance.

The most important thing I have to say regarding logistics is, since logistics is mostly about moving weight and cubic volumes at the lowest cost per unit of distance, that any effort to get Alaskan's gas to Alaskans that doesn't include material export capacity will be terribly short-sighted and will cost the State of Alaska at least tens of billions of dollars over time in lost opportunity, in addition to saddling most Alaskans with much higher energy costs for decades to come than they would have to pay otherwise by piggybacking on top of an export volume-based and efficient distribution network. That means at a very minimum, a large diameter pipeline from the North Slope to a logistical sweet spot in the Interior must be the anchor of any pipeline project. We should concurrently spur to Fairbanks and South Central and then let the markets determine the fate of the remaining logistical foot-print, or rather sizing and routing, of any further distribution. When economics justify it, albeit Canada, Valdez/LNG, and any value added processing.

A bullet or rather small diameter line is a very high cost alternative and makes everything else less economic. Only by finding competitively cost efficient ways to deliver gas and gas products on an export basis will we be able to generate the economies of

scale for a gas pipeline sufficient to begin to lower what will otherwise be high energy costs for Alaskans.

The oil and pipeline companies must wait until they fill a pipeline through the open season process before they can commit to build because they are looking for immediate economic rent and returns on capital. And they can't otherwise finance such a project. Therefore, regardless of how they may be posturing now, uncertainty about intermediate to long-term gas pricing and demand means it could be a decade or more before boards of directors will be in a position to vote to dedicate the large capital investments necessary for a massive project such as the Canadian route. Everything they do in the meantime is the cost of posturing to maintain an option to actually build only when they want to.

But we can't afford, though, to freeze in the dark waiting. Only the State of Alaska has the vested interest in making sure we get Alaskan's gas to Alaskans in the shortest amount of time and provide for an efficient distribution network. One not offered by a small diameter line. We also need not leave our destiny to the calendars of outside boards of directors with very different interests. CSHB 369 recognized that, and therefore could be the right instrument to move forward on with some critical adjustments, but the document must first conform to the economics, I believe, and not the other way around.

The most important thing I have to say regarding the economics, and I am not suggesting this position, but rather just offering the baseline economics, is that the State of Alaska,...is the only entity as the owner of the resource who could write a check for cash to pay for the pipeline, charge zero for the tariff and make between \$50-100 billion. That is because we make the vast majority of our money selling the resource not in the transportation of it. When you start up with the economic focus and calculate what you get by investing the \$3 billion extra it would take to increase the size of the pipe from the North Slope to the Interior suitable for export capacity, the economic and business decision becomes quite simple because the returns are enormous. Only the state can

afford to incubate or have a portion of the pipe idle for a period of time and wait for the rest of the market to come to it. It puts us in a very powerful negotiating position. How long can we wait until the pipe needs to be filled before we lost he bet? The answer is 50-100 years if you look at it from an economic and financial perspective. I would be happy to share with staff how to make those financial calculations.

[5:13:09 PM](#)

And I am not talking about having the State take any construction risk, or to design, build, maintain or manage the project. That would be done by private sector partners who gain rights to future tariffs as negotiated. Hopefully this would include the Big Three and TransCanada. And we can further separate economic rights from governance rights in our negotiations.

So here are 12 things that the State of Alaska gets if it underwrites and elevates to Investment Grade a gas pipeline with efficient export potential, made possible by \$3 billion extra dollars and a patient development capital, which could be financed a number of different ways:

- 1. We avoid saddling Alaskans with high energy costs for 30 years or however long it might take to pay off the bonds necessary for a small diameter high cost per unit line. Only when export volumes are achieved will economies of scale be available to pass on to consumers in the form of lower energy tariffs and costs.
- 2. We avoid putting an export project at materially greater risk in terms of time and money by moving from a highly inefficient logistical foot print to a highly efficient one. Since we won't then have to build two sets of pipe to move the same amount of gas that could move much more efficiently the same amount of gas.
- 3. We get gas to Alaskans in as little as six to eight years.
- 4. We put our future and destiny on our timeframe instead of that necessary for an alignment of unpredictable, disparate, and naturally competing factors and interests outside of our control.
- 5. By announcing to the energy community that we are prepared now to build, and we invite them to

participate, we force them to act for fear of being left behind.

- 6. We greatly invigorate the potential for adding volumes not only to the gas pipeline, but the oil pipeline as well. This is because not only will we also make it possible for new oil and gas explorers on a spot basis, not having participated in an open season necessary to secure capacity, the opportunity to explore and produce, knowing they can get their product to market. And when the look for gas, they will find more oil and vice versa. Yesterday's continental shelf rulings magnify this potential.
- 7. The Oil and Gas Conservation Commission (AOGCC), for the first time will be empowered to maximize their mandate by maximizing the trade-off of oil and gas values, unconstrained by capacity limitations.
- 8. We position many parts of rural Alaska to benefit with reliable access to lower cost energy over time because of economies of scale.
- 9. We create the opportunity to approach Hawaii most importantly about Alaska being a long-term significant solution to their energy needs with a project that could actually happen unfettered with any export limitations.
- 10. We will jump start the economy and generate decades of improved prosperity for all Alaskans. With a long-term fiscal plan based upon the rational management of our energy wealth resulting in being able to continue contributing to the Permanent Fund in material ways for many years to come.
- 11. We avoid to a considerable degree exposing the state to long-term fiscal decay and hopefully put off until long into the future pressures to use the Permanent Fund to help pay for state government.
- 12. If we have buyers and a pipeline, the producers will have no choice but to supply our gas. The view that the producers hold the key to everything doesn't have to be.

[5:17:18 PM](#)

So how do we do earn all this? By doing the following:

Appropriate enough money this session to fully vet this approach. This can be done separately or by amending HB 369 to focus on a large capacity line from the North Slope to an Interior hub. Including what

role the State of Alaska could play in order to insure the project moves forward as soon as possible, on an Investment Grade basis. No research being done at the state level currently contemplates this scenario.

If we get our gas to a hub, the ratepayers can afford to take it the rest of the way. Just doing this alone this year will put pressure on the majors to take this upcoming season more seriously.

We can wait for multiple open seasons before we get started, adding at least one to two years to a project or we can start now. The sooner we announce to the world we are doing this the sooner serious negotiations can begin with potential buyers.

In terms of the legislation, I support legislation that attempts to do something, but without focusing on the economics, we lose the economics. Putting a time limit on the process handicaps and limits the results. I would rather see us engage in an expedited process rather than mandate a timeframe that limits a result.

I have no prejudice in terms of what state entity manages the process as long as the members are qualified, could with any extra advantages that might be inherent in a particular entity. I will offer that one could it would seem, greatly expedite the process by avoiding another time consuming RFP process simply by renegotiating the AGIA license with TransCanada as authorized within AGIA to convert the state to a co-developer of the big pipe to the Interior owning whatever rights the private sector chooses not to adequately bid on. In the end, that could even be very little.

[5:19:12 PM](#)

The only way we lose this bet is if China and India don't grow sufficiently in the next 50-100 years to make North Slope gas economic. That should be an easy bet. The only tough decision there might be is if we generate perhaps 2 BCF/day of demand from in-state use and Hawaii, along with Japan and South Korea perhaps, with an 80-90 percent chance of success and we are also faced with a much larger Canadian opportunity, and there isn't enough gas for both projects. Only if the Canadian option rises significantly above the 50

percent likelihood in a predictable timeframe might there be a real choice to make. But we don't have to make that decision until we are faced with that option.

Thank you, members of the committee, for allowing me to present.

[5:19:54 PM](#)

SENATOR FRENCH asked the significance of the "investment grade" labeling.

MR. GOTTSTEIN replied that it means a few things; on one end it means that purchasers of gas can with reliable enough certainty expect that the project will be done and that everything will happen according to plan. For instance, a defined benefit pension plan needs to achieve certain actuarial rates of return with a high probability of doing so. If it buys a revenue bond for a bridge and its debt service coverage ratio is 1 in 3 meaning it needs 100,000 cars a week to pass the bridge, but it can pay for its debt service with only 75,000. There is a lot of debt service coverage; so rating agencies and insurance providers might say it's suitable for investment. Typically that would mean a triple A or a double A rating. There in some sense must be a tie to a revenue stream if it's a revenue bond. On the other hand, that could be eclipsed while bringing the state's considerable credit worthiness to bear and simply make a general obligation of the state and instantaneously it would have investment grade status because it wouldn't require the success of the project in order to have the bond holders get paid.

He said he doubts that the pipeline project would not be successful, but he is painting two ends of the spectrum about what the state would have to do to be investment grade. He explained:

Today we have a chicken and an egg situation keeping us from being investment grade; that is the producers won't commit to a pipeline until they fill it and buyers won't commit to buying until they know it's a real project and have some way of determining things like tariff. So the only entity because we have a vested interest in capacity that can, in effect, trump that whole process and say we'll take the development risk necessary to make this investment grade that will take us much further down the road into a position

where we actually have pipe and we actually have the opportunity to get buyers.

CO-CHAIR WIELECHOWSKI thanked him again for his testimony.

5:23:03 PM

DON ETHRIDGE, Alaska AFL-CIO, said the legislation is for building a line and it states to use Alaska hire to the utmost possible, and "There is only one way to do that; and it's with a project labor agreement." That is what they want to see during the planning process.

5:24:29 PM

CO-CHAIR WIELECHOWSKI thanked everyone for their input and adjourned the meeting at 5:24 p.m.