

HOUSE FINANCE COMMITTEE
April 16, 2024
1:37 p.m.

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CALL TO ORDER

Co-Chair Foster called the House Finance Committee meeting to order at 1:37 p.m.

MEMBERS PRESENT

Representative Bryce Edgmon, Co-Chair
Representative Neal Foster, Co-Chair
Representative DeLena Johnson, Co-Chair
Representative Julie Coulombe
Representative Mike Cronk*
Representative Alyse Galvin
Representative Sara Hannan
Representative Andy Josephson
Representative Dan Ortiz
Representative Will Stapp
Representative Frank Tomaszewski

MEMBERS ABSENT

None

ALSO PRESENT

Julie Sande, Commissioner, Department of Commerce, Community and Economic Development; Representative Tom McKay, Sponsor; Trevor Jepsen, Staff, Representative McKay.

PRESENT VIA TELECONFERENCE

Andrew Jensen, Policy Advisor for Energy Security, Office of the Governor; Robert Doyle, Chair, Regulatory Commission of Alaska; Dan Stickel, Chief Economist, Department of Revenue, Tax Division; Derek Nottingham, Director, Division of Oil and Gas, Department of Natural Resources.

SUMMARY

HB 307 INTEGRATED TRANSMISSION SYSTEMS

HB 307 was HEARD and HELD in committee for further consideration.

HB 393 COOK INLET/MIDDLE EARTH GAS ROYALTIES

HB 393 was HEARD and HELD in committee for further consideration.

Co-Chair Foster reviewed the meeting agenda.

#hb307

HOUSE BILL NO. 307

"An Act relating to the taxation of independent power producers; and increasing the efficiency of integrated transmission system charges and use for the benefit of ratepayers."

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JULIE SANDE, COMMISSIONER, DEPARTMENT OF COMMERCE, COMMUNITY AND ECONOMIC DEVELOPMENT, introduced the PowerPoint presentation "Integrated Transmission Systems" dated April 16, 2024 (copy on file). Ms. Sande moved quickly through slides 2 titled "The Railbelt Electrical Grid" and 3 titled "Railbelt Transmission Systems" that portrayed maps of Alaska's grid and transmission system. She elaborated that the Railbelt was the interconnected electrical grid extending from Homer to Fairbanks that was approximately 700 miles long and served roughly 75 to 80 percent of Alaska's population. Slide 3 depicted the transmission line and the colored areas represented who owned part of the transmission line. The lines were owned by either the Alaska Energy Authority (AEA) or the Railbelt utilities. She maintained that the current transmission system in Alaska was an inefficient system. The system was connected but not integrated and comprised of separate and independent utilities that were stand-alone. She noted that the committee would hear a lot of discussion regarding "wheeling" and "pancaking" rates. She explained that wheeling or pancaking rates was the charge per megawatt hour as the line crossed each section of the grid. Specifically pancaking meant the rates were "stacked." She likened the grid and wheeling rates to a toll road versus a highway. She indicated that the current model lacked integration and prevented the ability to lower rates for the rate payer. She furthered that if the bill became law

the Regulatory Commission of Alaska (RCA) would establish a process to transition from the current system to a new transmission cost recovery mechanism where transmission wheeling rates would be eliminated. Wheeling rates hindered wholesale power transactions and reduced the ability for Independent Power Producers (IPP) to enter power purchase agreements with utilities.

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Ms. Sande moved to slide 4 titled "Independent Power Producers." The bill would also amend AS 10.25.540, the statute related to the taxation of cooperative to extend its tax relief provisions to IPPs to sell their power to non-profit electric utilities. Taxes were a large portion of the overall cost structure for IPPs, which negatively impact competitiveness. The process of negotiating project related taxes often delays or kills projects. Extending tax relief to the IPP's ensured that all sources of power generators are treated equally.

Ms. Sande continued to slide 5 titled "What Does House Bill 307 Do?":

House Bill 307 aims to:

- Increase competition and efficiency within Alaska's transmission system.
- Reduce costs to the rate payer.
- Encourage the development of new power projects.

It aims to do this by:

- Requiring the Regulatory Commission of Alaska (RCA) to change the current mechanism of transmission cost recovery in the Railbelt.
- Eliminating transmission "wheeling" rates for inter-utility movement of electricity.
- Extending tax relief provisions enjoyed by Electric Co-ops to Independent Power Producers (IPPs).

Co-Chair Foster noted that Co-Chair Edgmon joined the meeting.

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ANDREW JENSEN, POLICY ADVISOR for ENERGY SECURITY, OFFICE OF THE GOVERNOR, ANCHORAGE (via teleconference), read through the sectional analysis of HB 307 (copy on file):

Section 1 - Updates the uncodified law of the State of Alaska by setting forth the purpose of the legislation: to eliminate pancaked rates and increase efficiency of integrated transmission systems of the state.

Section 2 - The bill amends AS 10.25.540(b)—related to the taxation of electric cooperatives—to include independent power producers. Under the bill, independent power producers would pay a “sales” tax on the kilowatt hours of electricity in lieu of any state or local ad valorem, income, or excise tax. The bill defines an independent power producer as a utility that only sells wholesale power to cooperative or municipal utilities.

Section 3 - The bill creates a new article in AS 42.05 relating to integrated transmission system cost recovery (AS 42.05.900 - 42.05.915).

Proposed AS 42.05.900 states the legislative findings for increasing the efficiency of providing electricity service to consumers.

Proposed AS 42.05.905 requires the Regulatory Commission of Alaska (“RCA”) to establish a transmission cost recovery mechanism and to provide a process where the electric utilities will transition from recovering transmission costs in utility rates to a transmission cost recovery mechanism. More specifically, this section requires the RCA to develop a cost recovery mechanism that achieves the legislative findings and allocates transmission costs in a way that recognizes a load-serving entity's local consumption compared with the total consumption on the system as a whole. The section further requires the RCA to establish a process whereby the transmission owning utilities will gradually transition from the

current cost recovery mechanism, in which transmission costs are recovered in base rates and wheeling charges, to the new transmission cost recovery mechanism.

Proposed AS 42.05.910 provides that the RCA will require all transmission-owning utilities to form an association whose only purpose is to have a tariff setting out how the transmission cost recovery mechanism is collected and disbursed, and to collect and disburse the transmission costs through the new recovery mechanism. The association will be regulated as a public utility.

Proposed AS 42.05.915 provides definitions for the new article. The section clarifies what sort of electric utility assets are deemed to be "transmission assets," subject to the cost-recovery mechanism of the new article. These include AEA's contractual charges for transmission to the Railbelt utilities but would exclude radial transmission lines that are built to connect independent power producers who sell their power to utilities under wholesale contracts. The cost of such radial lines will instead continue to be recovered in the cost of power provided, as is customary. This ensures that a load-serving entity that is not buying power from the independent power producer is not forced to shoulder the cost of connecting that power to the grid. The section also provides definitions for the terms "electric reliability organization" and "load-serving entity."

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Mr. Jensen elaborated that section one eliminated the current system of transmission rates for systems that were subject to integrative resource planning processes of an "Electric Reliability Organization" (ERO), which was the Railbelt Transmission System; the only one in that state.

Representative Josephson pointed to Section 2 and wondered what the impact of a sales tax on local governments was versus the current tax structure. Mr. Jensen responded that it would essentially "level the playing field" for all types of electrical generation. He explained that most of the system's electricity was provided by cooperatives and member owned utilities where under state statute were not

subject to local property tax. However, an IPP was subject to the tax and created an unfair advantage for power generation. As long as the provider was selling to a non-profit cooperative, it removed an unequal barrier towards increasing power generation in the Railbelt system.

Representative Galvin understood that the provision was seeking to remove barriers and wondered if it was similar to what was happening in the lower 48 states, which had more IPPs. She wondered whether IPPs in other states paid taxes. Mr. Jensen responded that he was not familiar with all of the tax structures in the lower 48 states. He was aware that Alaska cooperatives were different than in other states because they generated most of their own power versus merely being buyers and distributors of power.

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Representative Ortiz referred to slide 2 he asked if the administration would be opposed to amending the bill's title to include "to prevent inadvertent taxation of utilities that were not within the Railbelt." He understood that the bill was intended to focus solely on the Railbelt. Ms. Sande replied that she had not addressed the question with the governor but would follow up.

Representative Coulombe ascertained that the legislation created one rate for the entire Railbelt with the intention of reducing the cost to the rate payer, but she was not sure that was the case for Chugach Electric. She thought that Chugach was using wheeling rates to keep rate payers' costs down. She asked if the provision was positive for the whole Railbelt.

Mr. Jensen first replied to Representative Ortiz's question that the way Section 1 was structured regarding EROs there was only one such system in the state, however an ERO could be formed in any part of the state. Therefore, the bill was not specific to the Railbelt by intention.

Mr. Jensen proceeded to answer Representative Coulombe's question. He believed that initially there would be only minor adjustments in rates. The bill provided for a gradual unwinding of current revenue structures. He believed that in the long term it would lead to lower rates and benefit the entire system. He offered that currently, the cost of transmission was charged at the point of power generation

or at the point of transaction between utilities. However, by shifting the system to an end user cost, the cost of power would not include fixed costs that existed no matter what. He elaborated that approximately \$69 million out of an overall revenue requirement of about \$905 million were transmission costs or 7.5 percent of the average rate. Presently, independent power projects were regionally constrained due to wheeling traffic that crossed multiple system and could negatively impact the cost of power. He provided an example of a proposed 100 megawatt wind farm in the Interior. In order for a large project to share power that crossed multiple lines wheeling rates and tariffs would be involved. The legislation, over time, would benefit the entire system by allowing projects at a much larger scale that could serve the entire system instead of smaller regional projects.

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Representative Coulombe asked whether it was fair to say that some rate payers might see an initial increase in rates. Mr. Jensen responded that "it would remain to be seen." The legislation required the utilities to collaboratively develop a structure that was fair to the rate payers. He added that the utilities had already begun discussions and he felt that the result would be fair and beneficial. He could not guarantee how the rates would end up regionally. The answer would unfold once the utilities developed its cost recovery system. Representative Coulombe wondered whether the attempt to integrate the transmission line was focused on creating renewable energy. Mr. Jensen answered in the negative and stated that the bill was not restricted to renewables and was open to any form of power generation produced by IPPs. He emphasized that the governor favored developing the lowest cost power generation. Representative Coulombe asked Mr. Jensen to identify a few IPPs. Mr. Jensen identified Renewable IPP that developed solar farms in Willow and Houston and were currently developing a large project on the Kenai Peninsula. In addition, Alaska Renewables was vetting the development of wind farms in Susitna Valley and in the Interior. Another IPP, Fire Island Wind was owned by Cook Inlet Region, Inc. (CIRI). Representative Coulombe remarked that the examples were all renewable energy. She expressed concern that renewables were more costly and not consistent and once the tariffs and pancake rates were changed would not result in lower costs for the rate payer. Mr. Jensen

explained that currently, when a IPP made a deal with a utility the rate had to be lower than the current rates for power generation in order for Regulatory Commission of Alaska approval. He believed that the bill would diversify the energy mix for the Railbelt system and potentially for other parts of the state. He noted that more generation in the system would reduce demand for natural gas as an added benefit.

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Representative Stapp favored the bill and thought that it created equity in the Railbelt and unified the effort to reduce energy costs, which affected PCE rates as well. He referenced the governor's Transmittal Letter (copy on file) that mentioned the burden of wheeling rates that could derail new types of power generation that were "geographically dependent." He asked if his assessment was correct. Mr. Jensen responded in the affirmative. He added that recovering transmission rates via a surcharge on a utility bill would remove a large barrier to system wide larger power projects versus a regional project in order to avoid transmission charges. Representative Stapp recalled Mr. Jensen's testimony regarding the elimination of wheeling rates spurring extra generation making the system less reliant on natural gas generation prolonging the life of gas in Cook Inlet. He inquired if his recall was correct. Mr. Jensen replied in the affirmative and believed it was a "crucial" element to relieve demand for natural gas for power generation. He furthered that additional sources of power generation made it easier to project a fixed cost into the future versus a variable price for natural gas due to price volatility. Representative Stapp asked whether the bill was a crucial first step in tackling the gas situation in Cook Inlet, especially for Anchorage. Mr. Jensen responded in the affirmative. He elucidated that the transition to the new cost recovery would take a few years, but the bill's fixes would enable project development to accelerate by creating cost certainty.

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Representative Ortiz referenced section 2, page 2, line 1 of the bill: "each electric cooperative and independent power producer shall pay to the state,..." and page 2 lines 5 to 7: "...independent power producer" means a utility that only sells wholesale power to cooperative or municipal

utilities." He deduced that the provision included IPPS outside the Railbelt and asked if it was the intent of the bill was to tax IPPs outside the Railbelt. Mr. Jensen responded that the bill applied only to utilities within an ERO. The only way it could apply outside the Railbelt was if those utilities formed an ERO.

Representative Hannan shared that she had similar concerns as Representative Ortiz. She explained that the utility in Juneau was investor owned. She determined that it appeared the legislation excluded an IPP from getting a tax advantage for selling to an investor owned utility. She asked if she was correct. Mr. Jensen responded in the affirmative. He related that the cooperatives did not pay local property taxes, which was why the bill stipulated that if power was only sold to a tax exempt entity, then the seller would be treated the same from "a local taxation purpose." An investor owned company was already paying local property taxes for power generation therefore both the IPP and investor owned utility would pay property taxes and be on equal footing. Representative Hannan inquired whether the legislation required an IPP selling to a cooperative utility to share its tax advantage with the consumer. Mr. Jensen deferred part of the answer to the Regulatory Commission of Alaska. He reported that any power purchase agreement between an IPP and a cooperative utility was subject to a review and approval by the RCA. The commission had a process in place to assure a tax exemption was part of the rate.

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ROBERT DOYLE, CHAIR, REGULATORY COMMISSION OF ALASKA (via teleconference), affirmed that as part of the approval process, the commission would ensure the rate payers and utilities were part of a calculation called "avoided costs." He defined avoided costs as a negotiated rate that was both just and reasonable for both the rate payers and the utilities. The IPP bearing any part of a tax exemption would be a part of the review process. Representative Hannan ascertained that just and reasonable did not mean lower. She exemplified a situation where there was insufficient power generation and the IPP could produce more power but at a higher cost. She wondered whether that scenario of increased costs would be just and reasonable. Mr. Doyle responded in the affirmative and added that there was no guarantee that just and reasonable was always less;

there were multiple factors that had to be considered. He countered that if a truly open access system was in operation that lacked wheeling rates, a point of "economic dispatch" could exist within a "tight pool." He elaborated that the concept was that whoever could produce the power at the lease cost and cover its debt covenant should be the utility in operation. He would like to encourage a tight pool and economic dispatch stretching from Homer to Fairbanks in an open, non-wheeling transmission program without pancaking costs. It would allow the economic dispatch to take place and help lower costs. He maintained that there was no rate guarantees for utilities or IPPs with an RCA approved return on an investment and there was no guarantee that rates would increase. He indicated that for Power Purchase Agreements, long-term contracts included escalating costs that accounted for inflation, etc.

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Representative Hannan directed her comments and question to Mr. Jensen. She reiterated that the discussion was exclusively about the Railbelt transmission grid and the reason that narrowing the scope was unnecessary was because no other transmission system formed an ERO. She reiterated that Juneau's investor owned utility was excluded in the bill. She relayed that there was a long development of an IPP plan in Juneau that would likely result in an intertie between Lynn Canal communities and mine power generation. She deemed that the bill impacted both the generation rates, regulation, and created a tax disadvantage for the IPP to operate and collaborate with the existing utility. She was concerned with the unintended consequences of the bill. She wanted the bill narrowed to the Railbelt, and some language changed. She deduced that if the Juneau utility became part of an ERO in 5 years it would be tied to other EROs (like Bradley Lake) costs that were irrelevant. She wondered how HB 307 could be crafted to help the Railbelt but not have ripple effects for other utility groups.

Mr. Jensen answered that he appreciated her perspective and acknowledged that he heard similar concerns from others. He emphasized that he would be happy to work with her to address any potential unintended consequences. He elucidated that the Bradley Lake project was mentioned [in the bill] because it was state owned, managed differently than a regulated utility, and had a fairly unique cost

recovery structure. The administration wanted to ensure that the utility was accounted for in the definitions included in the bill. He was not suggesting Bradley Lake rates could stretch into Southeast Alaska and impact rates.

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Representative Galvin noted the discussion around creating the opportunity for IPPs and concerns around "pancaking." She inquired whether there was a way to include a provision that protected rate payers during the transition period against rate increases. Mr. Jensen replied that the bill was not overly prescriptive and provided for a gradual process due to the time it would take utilities to develop a cost recovery system. He offered that the unfolding transition process allowed for mitigation through the new tariffs, RCA rate approval, and a gradual implementation of the changes to ensure minimal if any impact on rate payers. He emphasized that it was a small percentage of costs of the overall system and believed that the bill had protective measures as he described. Representative Galvin appreciated the intention of the bill and wondered if there were any additional measures that could be built-in to keep the rates low or whether the RCA had the ability to maintain lower rates. Mr. Jensen commented that there was a robust public process for tariff setting. He noted that well-established protections were already in practice that applied to the provisions in the bill.

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Representative Coulombe believed that the legislation would not reduce costs to the rate payer. She was "pushing back" on the claim that integration would reduce costs but understood the need for the bill. However, she determined that the bill was not a cost saving measure. She asked for more information on the commission and wondered who was overseeing the initiative and thought there was a different governing body. Mr. Jensen responded that he wholeheartedly agreed that the measure alone was not a rate reduction tool. However, he believed that with greater energy generation over time, in the long run, it would result in lower rates, especially when compared to the specter of importing liquefied natural gas (LNG). He believed that ultimately it would reduce rates because the bill allowed for greater competition, greater diversity of energy supply, and less reliance on natural gas where a

great deal of price volatility was anticipated in the future. He explained that a coalition of utilities would be required to work cooperatively to bring a proposed transmission cost recovery tariff to the RCA for review, modification, and approval. Ultimately, it would be established by the RCA.

HB 307 was HEARD and HELD in committee for further consideration.

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#hb393

HOUSE BILL NO. 393

"An Act relating to oil and gas leases and royalty shares; and providing for an effective date."

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REPRESENTATIVE TOM MCKAY, SPONSOR, explained that the bill related to Cook Inlet and Middle Earth gas royalties. He mentioned recent discussions regarding gas storage. He related that he had introduced a package of energy bills that roughly formed an energy plan. He reminded the committee that Cook Inlet was an isolated and mature basin with a "hybrid closed market and a limited amount of consumption at 70 Billion Cubic Feet (BCF) per year." Any amount higher than 70 bcf needed to be stored. He added that importing LNG was not anticipated until 2030, and it would need storage as well. He believed that gas that was not developed did not benefit anyone and HB 393 was meant to incentivize more gas production. He read the sponsor statement (copy on file):

In the coming years, Southcentral Alaska faces a critical challenge: a projected shortage and ever-increasing decline in Cook Inlet gas production. This looming shortage poses a significant threat to the energy security of our state, with the potential to lead to drastic increases in energy prices for the residents and businesses of Southcentral Alaska. The prospect of diminishing in-state gas supplies and a reliance on liquefied natural gas (LNG) imports not only threatens our economic stability but also our way of life.

Due to the nature of this issue, bold and decisive action is required. HB 393 makes a significant change to the Cook Inlet royalty structure based on the idea that the Inlet is not attracting enough investment dollars and activity for development and exploration drilling. At this critical juncture, royalties on Cook Inlet gas which decrease drilling activity, increase the cost of gas, or lead to costly LNG imports represent a tax on southcentral ratepayers in addition to jeopardizing the energy security of our state.

This legislation seeks to address the anticipated gas production shortfall by decreasing royalty rates on new wells for gas used by Alaskans to 0%, with the goal of fostering an environment which will lead to increased drilling and exploration activities in the Cook Inlet region. This bill also reduces the base royalty on wells currently producing to 5%, which will extend the life of those wells leading to more gas production. HB 393 extends incentives to "middle earth" and allows drilling and development costs to be deducted against royalty burdens. The rationale behind HB 393 is straightforward: by enhancing project economics, we can attract more investment into natural gas exploration and production. This increased investment will not only mitigate the risk of a gas shortage but also has the potential to stabilize energy prices for Southcentral Alaskans.

HB 393 is an acknowledgment of the critical role that affordable and reliable energy plays in our lives and a recognition of the need for immediate action to secure our energy future. I urge my colleagues in the 33rd Alaska State Legislature to join me in supporting HB 393.

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TREVOR JEPSEN, STAFF, REPRESENTATIVE MCKAY, introduced the PowerPoint presentation "HB 393 Cook Inlet/Middle Earth Gas Royalties" dated April 16, 2024 (copy on file). He began on slide 1 titled "Cook Inlet Production Shortage:"

- State is facing a looming and increasing shortage of Cook Inlet natural gas production.

- Legislature has tools at its disposal via legislation to address Cook Inlet gas production.
- No "silver-bullet" solution.

The slide also contained a bar graph depicting proved developed and proved undeveloped Cook Inlet Gas through 2041. Mr. Jepsen elaborated that declining Cook Inlet gas production was expected to lead to a supply shortage from the 70 bcf standard necessary for Southcentral Alaska. He pointed out that the blue section of bar graph represented proven reserves and the orange portion was expected proved undeveloped reserves. The shortage was anticipated to begin in 2027. However, the shortage would develop over a period of 15 to 20 years. The impacts of importing LNG would significantly increase energy costs affecting the cost of living beyond Southcentral Alaska and possibly increase outmigration from the state. He believed that current decreasing worker retention rates would be exacerbated, and state and municipal government budgets would increase due to increased fuel costs. He voiced that royalty relief was the "most immediate and impactful tool at the legislature's disposal and passage of the bill was "crucial."

Mr. Jepsen continued on slide 2 titled "Poll Results: What Do Alaskans Want:"

- High level of support (59%) for state incentives to private companies and utilities to identify and pursue projects to ensure energy deliverability.
- Same support (59%) for creating financial incentives for oil and gas companies to find and produce more Cook Inlet gas.
- Significant opposition to importing natural gas (72%) with 44% having "strong" opposition.
 Most common reason for opposition: "there is plenty of gas, we're a resources state, we just need to get the gas." (46%)

 "Importing gas is more expensive" only cited by 18% of respondents.

- If residents were convinced imports are the cheapest option could be a sizeable shift in support, up to 60%.
- 87% of residents support the construction of a natural gas pipeline for in-state use and export ; evenly divided on the idea of reducing the PFD to help fund a gas line (40 percent support/49 percent oppose).

Mr. Jepsen expounded that HB 393 responded to the "high level of support for financial incentives regarding Cook Inlet gas production." He indicated that the bill was predicated on the idea that gas produced in Cook Inlet was used by Alaskans and high royalties acting as a disincentive or leaving gas undeveloped leading to importing LNG acted as a "tax on Alaskans." Mr. Jepsen continued on slide 3 titled "Market Dynamics" that contained a graphic depicting a hypothetical scenario that did not represent exact volumes and prices. He explained that proven developed reserves were the least expensive gas to produce and the least costly to the consumer. Moving right on the graphic to discovered but undeveloped gas was more costly and drove up gas prices. He moved further to the right that depicted undiscovered reserves where production was significantly more expensive due to exploration and development costs. He shared that according to the Department of Natural Resources (DNR) there were hundreds of bcf of discovered and undiscovered gas in Cook Inlet. He offered that changes to royalties lowered net costs to the producers and pass through costs to the consumers and increased project economics. However, the royalty relief must be sufficient to produce desired results.

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Representative Hannan inquired about the poll on slide 2. She asked for the date the poll was conducted, the poll size, and poll geography; statewide or Railbelt only.

Mr. Jepsen responded that the number of participants was 402 resulting in a 95 percent confidence interval of 5 percent plus or minus a margin of error. The population size was representative of the share of the population in Southcentral. He offered to provide the exact geographic distribution of poll respondents. The poll was taken the prior summer. Representative Hannan remarked that the poll

seemed "broader." She asked who paid for the poll. Mr. Jepsen affirmed that the poll was broad based. He added that it was conducted by Dittman Research and paid for by Enstar.

Representative Stapp cited Mr. Jepsen's statement that the royalty represented a tax on all Alaskans. He asked what the current royalty on North Slope gas was. Mr. Jepsen replied that it was 12.5 percent. Representative Stapp asked who paid for the royalty on North Slope gas. Mr. Jepsen was uncertain. Representative Stapp explained that the Interior Gas Utility (IGU), in Fairbanks had a contract with Hilcorp through a Hilcorp subsidiary called "Harvest" to truck Liquefied Natural Gas (LNG) to the Interior beginning in October [2024]. He noted that it was full royalty gas. He asked if Mr. Jepsen considered that "a tax on all Alaskans paying for royalty on gas for domestic use." Mr. Jepsen answered that he considered it a tax on Fairbanks residents and "probably should not be assessed either." He shared that Rep. McKay was of the opinion that royalty on gas used by Alaskans represented a tax. Representative Stapp asked for Mr. Jepsen to elaborate on the following bullet point from slide 2, "If residents were convinced imports are the cheapest option could be a sizeable shift in support, up to 60 percent." Mr. Jepsen responded that it was related to the question of support for importing natural gas that had 72 percent opposition unless it was the cheapest option.

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Representative Josephson understood that one way to incentive production was to reduce royalties. He cited the statement that royalties were "a tax on the consumer by implication." He deduced that it [royalties] was a contributor to costs but was "the ownership share." He asked if he was correct. Mr. Jepsen replied in the affirmative. Representative Josephson stated that it [royalties] was "linked to the Permanent Fund (PF) corpus." He recalled that during "the oil tax debates over the previous decade" the slogan "it's our oil" was displayed by some who wanted "a more progressive tax" structure with greater benefits to state treasury. He countered that the only part that remained the state's share was the 12.5 percent royalty and believed that it was "effectively our remaining mineral right." He asked whether his assessment was correct. Mr. Jepsen answered in the affirmative.

Representative McKay interjected that "only if the hydrocarbon gets produced." He added that it contributed nothing to the PF if it was never produced. Representative Josephson offered that in a range of options as a solution it [royalty relief] "would be on the list." However, it was not a guarantee. He asked if the governor's version [HB 276-Reduce Royalty on Cook Inlet Oil and Gas] was comparable. Representative McKay responded that nothing was guaranteed. He offered that the provision acted as an incentive for the private sector to produce. He had multiple discussions with the private sector partners and concluded that HB 393 would result in increased gas production in Cook Inlet. He believed that when oil taxes increased projects were cancelled, and industry jobs were cut. He intuited that the opposite effect would happen if taxes were lowered. Representative Josephson was troubled by contradictory statements regarding the importance of the state's "mineral interests and that it was the people money" who were entitled to it versus viewing royalties as an "imposition on the people and a penalty on them" and was viewed negatively. He could not reconcile the two arguments.

Mr. Jepsen interjected that he viewed the issue as significantly different than the oil on the North Slope, which he characterized as a "global commodity" that was not typically utilized in the state. Conversely, Cook Inlet gas was used solely by Alaskans. He was not advocating for a royalty reduction of North Slope oil. Representative Josephson asked how the bill differed from the governor's version. Mr. Jepsen responded that the governor's bill was rolled into HB 223-Oil/Gas Royalty Rates; Cook Inlet Develop, sponsored by Representatives Rauscher as a compromise between the two bills' royalty package. The legislation confined the royalty reduction to "new pools" that were either never produced or had stopped production. House Bill 393 made no distinction but offered a zero royalty rate for all new gas pools drilled.

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Representative Josephson deduced that the governor's proposal was less "generous" as to previous developments. He asked for affirmation. Representative McKay responded in the affirmative and added that his legislation was easier to administer. He believed that it would be difficult to measure old gas and new gas and apply different royalties.

His legislation applied a zero royalty to all gas produced. Representative Josephson understood that DNR assessed different royalty rates on different fields all the time on the North Slope. Representative McKay agreed but would need to defer to the Department of Revenue (DNR) for an exact answer.

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DAN STICKEL, CHIEF ECONOMIST, DEPARTMENT OF REVENUE, TAX DIVISION (via teleconference), confirmed that the question pertained to royalty and how DNR accounted for varying royalties on the North Slope. He acknowledged that there were different leases with different royalties within an existing field. He reported that DNR had a robust methodology on how it was calculated. He explained that DOR applied the tax to the oil and gas that was left over after accounting for the royalties. The department's role was simpler than DNR's process. He disclosed that some areas of the tax code distinguished between old and new oil and those provisions were on a field specific basis. Representative Josephson surmised that DNR had the capacity to make the differentiation.

Representative Galvin wondered why the bill would propose a royalty give away if gas was already being produced. Representative McKay answered that he did not like the word "give away" and believed that it implied a "sinister motive." He reiterated that the bill was an attempt to incentives all gas production in Cook Inlet from new and existing wells. He characterized HB 393 as aggressive and said that all gas production would be incentivized.

Mr. Jepsen added that the reason for the royalty reduction for producing wells was that the cost of operating the well exceeded the cost of production and was "shut in" at some point in time. He indicated that some Cook Inlet wells were shut in too early because the royalty rate was too high.

Representative Galvin understood the economic justification and thought it "made sense." She relayed from a prior committee hearing on the importance of incentivizing heavier on the early years of production as companies drilled new oil or gas fields. She asked how many years royalty would be dropped. Mr. Jepsen responded that there was no sunset provision. Representative Galvin asked why

there would not be a sunset clause if the goal was to incentivize new gas development.

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Representative McKay responded that he would be open to a sunset. He explained that gas wells often declined more rapidly than oil wells and most gas wells would need more economic help within 10 years. He determined that a future legislature could revisit a sunset date if it was added. He relayed that he had been asked why the problem reappeared after a solution was implemented 10 years prior. He discerned from his experience that it would not be unusual to reevaluate and adjust as necessary every ten years as the life of a gas field changed over time. Representative Galvin inquired as to who evaluated the wells. Representative McKay explained what "stripper wells" were (wells making 5 barrels a day for 20 years or more or wells with significantly reduced production but were still in operation) as an analogy to Cook Inlet. He believed that as long as the economics of Cook Inlet gas fields was monitored, Cook Inlet gas could keep producing for "a very long time." Representative Galvin understood that royalty was a contractual term in the lease and could not be changed by future legislators. She asked whether she was correct. Representative McKay responded in the negative and commented that a future legislature could take any action regarding royalties. He reiterated that his goal was to extend the life of Cook Inlet.

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Representative Josephson believed that it was prohibited to increase a royalty rate and that it could only be adjusted downward temporarily. He referred to Mr. Jepsen's comment that Cook Inlet wells were shut in because the royalty rate was too high. He countered that there were many reasons why shut ins occurred and the royalty rate being too high was only one reason. Representative McKay responded that the situation was referred to as a "lifting cost." He explained that lifting costs was the cost it took to pump the oil and gas out of the ground and get it to market. He hypothesized that if gas prices collapsed reducing the profit margin, it could eventually cause shut in wells due to economic conditions. In addition, any scenario where labor costs increased or shipping tariffs increased, etc. added to lifting costs. He acknowledged that there were many cost

factors that affected lifting costs and when lifting costs exceeded the price the wells could be shut in.

Representative Josephson inquired whether the producers could request royalty relief under existing law. Mr. Jepsen answered in the affirmative. Representative Josephson asked whether any Cook Inlet producers asked for a royalty reduction. He recalled that Cook Inlet provided the state \$40 million annually in royalties. He asked how the state would deal with the foregone revenue and provide agreed upon services with less revenue.

Representative McKay replied that there would be an impact on the General Fund (GF) and the PF. He noted that the [revenue] impact on the budget and PF from Cook Inlet was "minimal" compared to the North Slope. He relayed that he received an analysis about what would happen to consumer energy rates based on increases in natural gas prices, which had a "significant impact" on consumer energy costs. He asked Mr. Jepsen to relay the data.

Mr. Jepsen maintained that the impact on the rate payer was significantly higher than the \$40 million in lost revenue to the state.

Co-Chair Foster interjected that the discussion touched on many different policy areas, and he wanted to finish the presentation before further policy debate.

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Mr. Jepsen continued on slide 4 titled "Considerations for Energy Policy:"

- Short Term vs. Long Term.
- Risk vs. Cost -State needs to decide what level of risk is acceptable.
- Higher-Cost energy = Lower Risk Options.
- Lower-Cost Energy = Higher Risk Options.
- How policies interact.

Mr. Jepsen elaborated that risk to the state referred to revenues to the state via royalties. A higher cost of energy via importing LNG was a lower risk option because the state was not losing royalties. In addition, the state had the capability to store LNG in Cook Inlet. It was highly likely the state would be ready to import and store LNG before a gas shortfall. The higher risk option to the state in terms of foregoing royalties was focused on lower cost energy for residents and increasing the supply of Cook Inlet gas. Increased imports of LNG meant higher energy prices for residents for years to come. He suggested considering how policies interacted with one another and whether policies were complimentary. He concluded that HB 393 represented a high risk option which resulted in an immediate decrease in royalty revenues to the state but with the goal of increasing production and the supply of low cost energy to residents that works in conjunction with other legislation incentivizing Cook Inlet investment.

Mr. Jepsen continued to slide 5 (untitled):

The Case for Aggressive Royalty Reduction

- Cook Inlet represents a small share of the state's oil and gas revenues.
- Energy prices likely to double or triple in the next 15 years if mass LNG imports are the solution.
- An increase of this magnitude would result in rate payers paying 100's of millions to billions more in energy costs every year.

Mr. Jepsen reported that the slide also included a table of oil and gas revenue by type and geographic area, FY 2020 to FY 2023. Mr. Jepsen explained that the slide represented a rough fiscal impact on the state from royalty relief. He elucidated that the chart illustrated that the state made billions from the North Slope compared to tens of millions from Cook Inlet in a given fiscal year. The state would lose approximately \$45 to \$60 million per year. He noted that if the state did nothing Cook Inlet royalties would decrease over two decades as production dropped. Southcentral utilities made roughly over \$1 billion in the prior year with \$250 million of Enstar's profits derived from gas sales while 70 to 80 percent of other utilities

profits came from gas power electricity. He surmised that the risk from lost state revenue was worth the reward. The impact on the rate payer was not capped like royalties of \$45 million to \$60 million per year on Cook Inlet gas, which carried the specter of very large rate increases.

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Mr. Jepsen continued on slide 6 titled "Royalty Structure Modifications:"

Market has spoken: Cook Inlet under current royalty structure is not ideal for investment

Time Value of Money

What does the state want to incentivize?

Royalty and tax decreases on producing wells

- Extend the life of existing wells.

Royalty and tax decreases on new wells

- Increase the number of wells drilled.

Mr. Jepsen voiced that the rates of return on gas was "significantly" lower than oil." He summarized that by greatly reducing royalties, it boosted the rates of return for producers that made projects more viable. He disclosed that an additional policy included in the bill was not accessing royalties until payout, which was the recuperation of costs for oil and gas development, both in Cook Inlet and Middle Earth, defined as south of 68 degrees latitude (excludes the North Slope). He expounded that allowing investors or companies to recoup its costs more quickly was another way to quickly recover its initial investment costs.

Mr. Jepsen continued to slide 7 titled "HB 393 Overview:"

- Changes royalty structure for Cook Inlet:

0% for gas produced from new wells drilled starting in FY 25.

5% for oil produced from new wells drilled starting FY 25.

5% on oil and gas produced from wells drilled prior to FY 25.

- Capital expenditures associated with development of oil or gas can be deducted from royalty burden; Excludes North Slope.
- Requires commissioner to enter into lease negotiations to comply with these terms.

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Representative Stapp pointed to the second bullet point and asked whether it included Cook Inlet and Middle Earth. Mr. Jepsen responded in the affirmative. Representative Stapp asked if the royalty is zero and the production tax was near zero, what was being deducted from taxes. Mr. Jepsen responded that there would nothing to be deducted and it could not be deducted below zero. Representative Stapp asked what capital lease expenditures were being deducted against since essentially royalties and taxes were not being paid. Mr. Jepsen replied if there was zero royalty and no tax burden there would be nothing to deduct. Representative Stapp asked whether new wells would be drilled in Cook Inlet in FY 25 regardless of passage of the bill. Mr. Jepsen responded in the affirmative. Representative Stapp asked if it was a fair assessment that zeroing out the royalties on new wells that would be drilled regardless of the bill and applying that across the board would incentivize new production. Mr. Jepsen answered in the affirmative. He restated that it was not possible to target wells individually that were being drilled regardless of the bill's passage. He voiced that by decreasing royalties to zero for all wells the sponsor hoped to attract new players to the Inlet. He expounded that there were only 3 producers in Cook Inlet, with one producing the vast majority of gas.

Representative Stapp wondered whether there would be an influx of new producers if royalty rates were reduced to zero. Representative McKay would not make the promise, but anything over zero was good. Representative Stapp explained that few people had been able to convince him that the policy was needed to pursue new development. He reasoned that the bill implied that producers did not have the margin in the market space to recoup its profits. The natural inclination was to assume that Cook Inlet gas

producers sell its gas to consumers at increased rates to make up the lack of revenue. He wondered why it was not a market demand problem.

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Representative McKay deemed that Representative Stapp wanted the state to do nothing and allow the price of gas to increase, which spurred more production as would happen in a free market. He reported that he had consulted with an economist regarding that scenario. However, the problem was that economists did not have constituents and it was important that Cook Inlet and the Railbelt had affordable and reliable energy. He agreed that the legislature could do nothing and let costs increase, however, if they were wrong, the problem would get worse. He believed that by acting there would be some degree of confidence the problem would be solved.

Representative Stapp inquired what the current oil royalty was for Cook Inlet gas. Mr. Jepsen responded that it varied but was mostly 12.5 percent. Representative Stapp understood the gas concept but was unsure what happened with Cook Inlet oil. Mr. Jepsen responded that the majority went to the Marathon Oil refinery.

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DEREK NOTTINGHAM, DIRECTOR, DIVISION OF OIL AND GAS (via teleconference), responded that the majority of oil went to the Marathon refinery and believed the volume of Cook Inlet oil exported was very low.

Representative Stapp relayed a prior a dispute in Fairbanks where the refinery there was refining the state's royalty share of the oil. He referred to Representative Josephson's statement that royalty oil was the state's share of the oil. He wondered what would happen if the state was taking "our" oil royalty share and giving it to Marathon for domestic refining and consumption of gas. He asked "what does that actually do if we cut the royalty on our own state oil." Mr. Jepsen answered that gas wells produced an associated amount of oil. The bill was focused on gas, but if the royalty rate was decreased on the associated oil the project economics rate of return was further increased.

Representative McKay interjected that some oil wells only produced oil and some gas wells that only produced gas and some that produced both. Representative Stapp understood that gas producers had contracts with companies and when they sell the gas to power producers some of the existing contracts had state royalty provisions inside contracts in general. He asked how many contracts for Cook Inlet oil and gas there were and if they included royalty provisions. He inquired whether change in the royalty structure would change the existing contract terms of the contract. Mr. Jepsen deferred the answer to Mr. Nottingham.

Mr. Nottingham replied that he was not aware of any provision in the contracts regarding royalties. He expanded that there were statutes that allowed DNR to account for the royalty value to be at the contracted price. Therefore, the contracted price that the gas was sold at to the utilities was what the royalty value was based on opposed to market value indicators that was normally used for North Slope royalties.

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Representative Stapp asked how many wells or if exploration on state land was taking place in Middle Earth. Representative McKay responded that he was unsure of how many wells but knew of two developments. Representative Stapp reported that the fiscal note stated that currently there was no Middle earth exploration or developments on state lands or even expected soon.

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Representative Hannan referred to Section 2 of the bill and deduced that no royalties would be assessed in perpetuity on any oil or gas developments anywhere in the state other than on the North Slope. She asked if she was reading the provision correctly. Mr. Jepsen answered that the zero royalty on gas was for Cook Inlet and the capital expenditure portion of the bill was for Middle Earth. In addition, the royalty for oil was 5 percent and not zero.

Representative Hannan ascertained that the royalties were still charged but just the lease expenditures were deductible as an offset. Representative McKay affirmed and clarified that it applied to Middle Earth. Representative Hannan emphasized that the bill specified it applied

anywhere south of the North Slope and not only Cook Inlet or Middle Earth. She inquired that if oil was discovered in Juneau in 20 years no oil or gas royalty would be applicable. Representative McKay responded that he was trying to help Fairbanks develop its own natural gas field.

Mr. Jepsen interjected that the oil royalty would be 5 percent and the gas rate would be zero for Cook Inlet. Representative Hannan was confused because it was not clear in the bill, but she would accept Mr. Jepsen's interpretation.

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Representative Josephson referenced two prior major oil and gas bills. He noted that HB 247 (Tax; Credits; Interest; Refunds; O & G - Chapter 4 4SSLA 16 - 06/28/2016) ended Cook Inlet credits and HB 111 (Oil & Gas Production Tax; Payments; Credits Chapter - 3 SSSLA 17 - 07/27/2017), which ended credits and limited carry forward lease expenditures. He remarked that HB 393's royalty reduction went in perpetuity and asked if there was a failure to produce, could the producers draw down capital costs way out into the future. He asked what would incentivize production if capital cost credits could be earned at any time. Representative McKay answered that almost all bills he proposed in the current session would not require cash out of the treasury like the previous cash credit programs in the past. The legislation attempted to "front load proposals."

Mr. Jepsen replied that it did not make sense that a producer would make an investment and not try to recoup the investment. However, he saw a scenario of price decreases as a possible scenario where producers would not want to sell and wait to produce. He offered that Representative McKay was open to a sunset but noted that a ten year sunset would not be long enough.

Representative McKay exemplified that the Pika oil development took 13 years from discovery to first oil. He emphasized that the clock starts when the legislation was passed.

Representative Josephson asked if the legislature and the administration had done a thorough enough analysis on rates of return and project economics and whether or not current

leaseholders were merely refusing to produce even though their projects were economic. Representative McKay responded that he had many conversations with DNR and directly asked whether Hilcorp was meeting its lease obligations and drilling its required number of wells per year. He reported that the answer to the question was in the affirmative. He added that it was widely understood that the rate of return on projects in Cook Inlet was much less than on the North Slope.

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Co-Chair Foster asked for closing comments.

Representative McKay thanked the committee and offered to answer all the committee members questions in order to thoroughly vet the bill.

HB 393 was HEARD and HELD in committee for further consideration.

Co-Chair Foster reviewed the agenda for the following day's meeting.

#

ADJOURNMENT

[3:39:23 PM](#)

The meeting was adjourned at 3:39 p.m.