

HB

849

# STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

## DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

POUCH S - JUNEAU 99811

May 10, 1976

*File  
HB 849*

The Honorable Nels Anderson  
Chairman  
House Resources Committee  
Alaska State Legislature  
State Capitol Building  
Juneau, Alaska

Re: House Bill No. 849

Dear Mr. Anderson:

House Bill No. 849, an Act relating to the leases of state land for oil and gas and the taking of royalty gas from them, was introduced in the House on March 2, 1976 and was referred to the House Resources and Finance Committees.

For the consideration of the House Resources Committee, I am enclosing a copy of a memorandum prepared by Thomas K. Williams, Director, Petroleum Revenue Division, Department of Revenue, Anchorage, Alaska suggesting some amendatory language to the proposed legislation.

If you or any members of the House Resources Committee have any questions on the material submitted, please telephone the writer at 46J-2397 and I will contact Mr. Williams in Anchorage for further information.

Very truly yours,



R. D. Stevenson  
Special Assistant

cc: The Honorable Hugh Malone  
Chairman  
House Finance Committee

Thomas K. Williams  
Director, Petroleum Revenue Division  
Department of Revenue  
Anchorage, Alaska



"1776-A TRIBUTE FROM OUR STATE TO OUR NATION-1976"



AGO 546521 +

## MEMORANDUM

## State of Alaska

TO: R. D. Stevenson  
Special Assistant  
Department of Revenue

DATE: April 30, 1976

FILE NO:

TELEPHONE NO:

FROM: Thomas K. Williams *TKW*  
Director  
Petroleum Revenue Division

SUBJECT: SB 687; HB 849

In response to your request regarding SB 687 (introduced in the House as HB 849), the following is offered:

The Bill says it amends AS 38.05.181, but the statute it obviously is intended to amend is AS 38.05.180. AS 38.05.181 relates to geothermal resources.

The Bill would require future oil and gas leases to reserve an option to the State to defer receiving its royalty on production. It would not affect Treasury at this time since all expectations arise from leases already issued.

Administration of the Bill, and the decision to exercise the option in the future, would be the responsibility of the Department of Natural Resources.

TKW:dh

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

ROYALTY OIL AND GAS DEVELOPMENT ADVISORY BOARD

JAY S. HAMMOND, GOVERNOR

11TH FLOOR, STATE OFFICE BLDG.  
POUCH M - JUNEAU 99811

March 22, 1976

The Honorable Nels Anderson  
Chairman  
House Resources Committee  
Pouch V  
Juneau, Alaska 99811

Dear Mr. Anderson:

The following comments on H. B. 349 were prepared by the Division of Oil and Gas and given by me as testimony before the House Resources Committee on March 20, at Commissioner Martin's request.

1. We think inclusion of a provision such as outlined in this bill will be completely undesirable to the operators and will result in a highly reduced bid for leases which contain this provision. The instances where the State might want to use the banking privilege will be few, but each lease will have to stand the burden of having the provision in it.

The following example will show the effect on both the State and the operator by assuming a gross production from a well of 2,000 MCF per day and assuming that the State elects "to bank" its gas or apply the provisions of the proposed bill:

Total Gross Production  
2,000 MCF/Day

Royalty share of total sales rate  
250 MCF/Day

Working interest share of total sales rate  
1,750 MCF/Day

If the working interest has to market the full gross production, he would market 114% of his normal daily production for a period of three years at which time the State could start taking its royalty gas.

If the State took the gas on the minimum terms proposed in the bill, then the State would take 906 MCF per day for a one year period. This would represent a 45% reduction in the total sales rate that the operator had been taking for the three year period, or it would represent a 52% reduction in the normal operator's take of 7/8ths of the sales rate. Thus the operator could not fulfill the terms of most gas transmission purchase contracts because of erratic takes. Also, the erratic volumes available and the short time probably would not permit the State to obtain a favorable price or contract for its royalty gas. There are some other aspects of this bill regarding deferring the State's royalty production. During the three year period this royalty production was deferred, the State could allow the operator to take the full 8/8ths share of the total sales volume. If this were the case, the production tax the operator would pay during this period would be higher in the amount of the additional royalty share that he would be producing and selling. If, however, the State should decide to defer its sale of royalty production by reinjecting the royalty volume, the State would have to pay for the operating cost incurred for the gas reinjection and the production tax would be less than if the operator were taking the full produced volume. When the State decided to take its deferred gas at some future date, and during the period of time in which it was taking the deferred volumes, the production tax would be lowered by whatever amounts these volumes resulted in. In summary, any time the State should decide to defer its gas production, there are many variables that come into play. For example, the State could start incurring operating costs if it elected to have its deferred gas reinjected. Its royalty would go to zero. During the period the gas is being deferred, there would be no royalty income. And of course, there would be larger amounts of royalty income during the period that it elected to take its deferred gas back. Production tax, likewise, would be fluctuating in the reverse fashion. There could be periods of higher production taxes if the operator takes the full sales volume of 8/8ths of the production stream, but the production tax would be reduced dramatically during the time period the State elected to take its deferred royalty production in kind. All of these factors should be considered before an option that was available to the State, such as deferring its royalty production, was exercised.


In addition to having undesirable current production and income effects, the following discussion indicates some other problems with the bill:

1. Delay in the recovery of gas will necessitate production at a later time when operating costs are high. If it is too late in the reservoir life, the operator may want to give the lease back to the State, or abandon the property if it is uneconomic for him to recover the State's gas.
2. If the operator is producing royalty gas and the lease reaches the economic limit, we would lose the unrecoverable hydrocarbons. The operator probably couldn't be forced legally to operate at a loss even though we hadn't recovered our royalty gas.
3. Uncertainties of the reservoir recovery mechanisms could add a risk to the recovery of deferred royalty gas. For example, water fingering causes early or premature breakthroughs and watering out of wells, or scale deposition on the formation face causes cessation of production, or casing leaks flood out the well bore. These are some of the common causes that might result in premature abandonment of the well or reservoir. In these cases, if all of the State's banked royalty gas has not been recovered, it would be lost forever.
4. The State would have to follow reservoir performance very carefully to be sure that adequate reserves remain and could be recovered before the economic life of the equipment expires. If the operator has to make a major investment in equipment to finish a recovery process, he may chose to plug and abandon or give the lease back. It is questionable if we could force him to make capital expenditures late in the life of the field that would not pay out. Normally, it is this equipment failure that ultimately determines the precise abandonment date.
5. The bill is anti-conservation. It would encourage the operator to produce his reserves early in the life and attempt earlier abandonment of properties if the State waited too long to take its oil or gas royalty.
6. We have been considering possible use of sliding scale royalties in our bidding and inclusion of the banking provision would be an administrative nightmare to determine the amount of royalty gas that might be produced at some future date. This would also affect the volume that was subject to the tax laws.

March 22, 1976

7. It would defeat one of the purposes of sliding scale royalties since royalty recoveries would be delayed until lower production rates are achieved. The purpose of sliding scale royalties is to receive higher royalty income when production rates are high and this bill would completely defeat that purpose. It would permit the operator to recover 8/8ths of the production while the "banking" provision is in effect and then require that State royalties be recovered at a later date or while production rates are low.
8. The State will lose current income if there is any delay in its recovery of royalty on the chance that it can be produced later. If one considers a 10 per cent present worth factor, we would have to receive delayed additional benefits approaching a minimum of 35 per cent to even recover the same income and we question if the State can afford to wait on recoveries for that period of time.
9. The operator cannot permit a sizeable disruption in his oil or gas sales because they are made on long term basis if possible. If leases are on the decline, the operator cannot plan his sales unless long lead times are available and he knows precisely how the future production availability will affect his contracts.
10. Considering all of the above problems and uncertainties, at best, the operators will discount future lease bids highly to provide for this provision and we don't think it is necessary in the first place.

Yours truly,

  
William C. Fackler  
Executive Director