

SB

92

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: SB 92
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Natural Resources
 Title Stranded Gas Development Act Amend. BRU Oil and Gas Development
 Component Oil and Gas Development
 Sponsor Senate Resources
 Requester Senate Resources Component No. 439

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Personal Services						
Travel	10.0	10.0				
Contractual	289.0	289.0				
Supplies	1.0	1.0				
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	300.0	300.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

FUND SOURCE	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
1002 Federal Receipts						
1003 GF Match						
1004 GF	300.0	300.0				
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	300.0	300.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2003) cost: 0.0
 Check this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

Full-time	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)
 This bill would authorize the executive branch to negotiate a contract with sponsors of proposed projects to develop stranded gas in Alaska. The payments required by the contract would replace some or all of the state royalties and taxes and municipal taxes that would otherwise pertain to major economic activity engendered by the project.

 Given the extended time frame to develop and market the large volumes of stranded gas, revenue impacts expected as a result of the bill are outside the time horizon of this fiscal note.

 Under AS 43.82.220, the state is responsible for evaluating and negotiating contract terms relating to royalties.

Prepared by: Mark D. Myers Phone 269-8800
 Division Oil and Gas Date/Time 3/3/2003
 Approved by: Tom Irwin Date 3/3/2003
 Agency Natural Resources

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

BILL NO. SB 92

ANALYSIS CONTINUATION

Pursuant to these responsibilities, DNR is requesting a total of \$600,000 over a two-year period.

The line item breakdown for the two years is as follows:

Contractual:

\$550,000 is to fund contractual services and advice from experts in technical, fiscal, regulatory, contract negotiation, legal, and financial areas. These technical, evaluative, and negotiation services would be required to assist the state in substantive and complex contract development and negotiation, potentially with multiple sponsors. The state does not have all of this expertise in-house. \$75,000 of these costs will be incurred in preparation for the application process regardless of whether there are applicants.

As per the proposed bill, contract applications may be submitted at any time up until June 30, 2006. Expenditures for contractual services, therefore, may be necessary over a number of years. Furthermore, one North Slope producer has estimated that contract development and negotiations will take two years. Since there is no way of knowing now specifically when expenditures would be required, it may be beneficial to treat this \$550,000 as a continuing appropriation.

The proposed legislation allows reimbursement of the state by the applicant for the expenses of independent contractors used to assist in the evaluation of an application. Consequently, some or all of these expenditures may be recouped.

\$28.0 is for miscellaneous contractual expenditures such as purchase of technical reports and conference participation.

Other:

\$20.0 to fund the travel for negotiations, and \$2.0 for miscellaneous supplies.

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: _____
Bill Version: SB 92
() Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
Title Stranded Gas BRU Administration and Support
Development Act Amendments Component Commissioner's Office
Sponsor Senate Resources Committee
Requester Senate Resources Committee Component No. 123

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Personal Services	89.5	89.5				
Travel	25.0	25.0				
Contractual	150.0	200.0				
Supplies	2.0	2.0				
Equipment	5.0	1.0				
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	271.5	317.5	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
-------------------------------	--	--	--	--	--	--

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF	121.5	117.5				
1005 GF/Program Receipts						
1037 GF/Mental Health						
1108 Statutorily Designated Receipts	150.0	200.0				
TOTAL	271.5	317.5	0.0	0.0	0.0	0.0

Estimate of any current year (FY2003) cost: 0.0
Check this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

Full-time	1	1				
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

See attached analysis.

Prepared by: Larry Persily, Deputy Commissioner Phone 465-5469
Division Department of Revenue Date/Time 3/4/03 10:47 AM
Approved by: Larry Persily, Deputy Commissioner Date 3/4/2003
Agency Department of Revenue

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

BILL NO. SB92

ANALYSIS CONTINUATION

BILL DISCUSSION

The intent of the Stranded Gas Development Act, AS 43.82, is to provide a mechanism for achieving the fiscal certainty that potential project sponsors say they need before proceeding with the large investment needed to bring Alaska North Slope natural gas to market. The Act allows the state to negotiate a contract for payments in lieu of taxes with a project sponsor. This contract could cover all state and municipal taxes on a project, including state corporate income taxes, production taxes, state and municipal property taxes, and any special municipal assessments. The Act also allows for negotiation of gas valuation methods for use in determining state royalties.

This bill would amend the 1998 Stranded Gas Development Act to:

- Expand the Act to include a natural gas pipeline to serve the Lower 48 states as an eligible project under the law. The existing statute limits the application of the Act to only liquefied natural gas projects. This amendment also would limit eligible applicants (non-LNG) under the Act to only a natural gas pipeline that would parallel the Trans-Alaska Pipeline System and the Alaska Highway, thereby eliminating from inclusion in the Act the so-called "over-the-top" route.
- Replace the June 30, 2001 deadline in existing statute for project applications with a new deadline of June 30, 2006.
- Add a requirement that only those projects producing gas from north 64 degrees north latitude (roughly Delta Junction) would qualify for the provisions of the Act.

OPERATING EXPENSES

The Act allows the Department of Revenue under AS 43.82.240 to recover from a project applicant the costs of contracting with an independent consultant to assist the state in evaluating applications submitted under the Act and in developing contract terms. Those statutorily designated program receipts are shown above.

The Act does not allow the state to seek reimbursement from a project applicant for any other costs. The department would hire a project manager for the estimated two years of contract development, negotiations and approval, and the personnel services, travel and equipment expenses for that position and other commissioner's office expenses are shown in the fiscal note as General Fund money.

The above costs are essentially the same as the Legislature approved for the Department of Revenue in passing the 1998 Stranded Gas Act.

The Stranded Gas Development Act

The Stranded Gas Development Act, AS 43.82, was passed into law by the Alaska Legislature in 1998. During the session it was House Bill 393. The application deadline for a project application under the Act was June 30, 2001. There were no applications by that date. Legislative action is required to reopen the option for a gas project developer. Such a reopener failed to win legislative approval last session, and has been introduced again this year as SB92, sponsored by the Senate Resources Committee.

The Act's genesis was in HB 250, which in 1997 established a North Slope Gas Commercialization Team in the administration to research and recommend changes to state law to encourage commercialization of North Slope gas. The team issued a report to the Governor in February 1998. The team's conclusions were that the project faced considerable risk, namely construction cost risk and gas price risk, and the state's fiscal system exacerbated those risks. Three of the risks of particular concern were fiscal uncertainty, the state's regressive tax system, and the front-end aspects of the fiscal system. We will discuss these in turn.

Given the high cost of the project, coupled with the volatility of gas prices, the project is financially risky. Given that the project is marginal under the current fiscal system, there is concern among potential project sponsors that if a project is started, the state could later modify the fiscal terms after the project had been built, changing its overall attractiveness to investors after they had invested. This is the fiscal uncertainty risk.

Second, there are two significant elements of the state's fiscal system that make it regressive. Regressivity means that the state's take in terms of share of the profits is high at low prices and low at high prices. Regressive systems exacerbate the risk of low prices to the project developers. First, the property tax is based on cost of the asset. The higher the cost, the higher the tax. Second, the basis of value for the severance tax and royalty is at the wellhead and does not consider capital and operating costs. Thus when capital and operating costs are high, and prices are low, the state's take is a high percentage of the low profits. (Regressive systems also reduce what the state's take could be at high prices, which means the state loses out on a greater slice of revenues during high prices and high profits.)

Third, the property tax makes for a front-end loaded system. The property tax is payable when construction begins, which could be several years before revenues start accruing. On a time value of money basis, this diminishes the rate of return on the project and exacerbates the risk of not recovering the investment.

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Senate Bill 92
Department of Revenue

After the team issued its report to the Governor, it worked with the major Prudhoe Bay producers to develop legislation to deal with these risks. The producers at the time had been studying commercializing gas through an LNG project to tidewater. The result was HB 393.

The law provided a mechanism for converting the state's fiscal system from a statutory basis to a contractual basis. This would provide for greater fiscal certainty. The fiscal system would be negotiated between the administration and the project sponsors and approved by the Legislature. And per the Act the contract terms could provide for a more progressive (less regressive) system.

The process for developing the contract was as follows: A sponsor would submit a project plan and application to the administration for contract negotiation. The project had to produce 500 billion cubic feet within 20 years and be an LNG export project. (The original bill called for any project. It was changed to only LNG during the legislative process.)

The sponsor group would negotiate fiscal terms with the state. Payments to the state would be made in-lieu of taxes. Fiscal terms would be customized to the specific project structure. The term of the contract could not exceed 35 years.

The commissioner of Revenue would be the primary agent for negotiating and implementing the contract. However, the commissioner of Natural Resources is also responsible for reviewing the project plan for acceptability, and for negotiating any changes in royalty issues. The only royalty provisions subject to negotiation under the Act are the gas valuation method and the timing of royalty in-kind and royalty in-value notices.

The law allowed the commissioner of Revenue to use independent contractors to assist in the evaluation of any project application, and to condition the contract on an agreement with the project applicant that it would fully reimburse the state for the cost of the contractors retained for the state's analysis. The fiscal note for the legislation authorized the Department of Revenue to collect and expend those application fees to cover its contractor costs. The Legislature also approved General Fund money for the Department of Revenue to hire a full-time project coordinator for two years to help manage the application review and negotiations. That position was never filled because there was no project application.

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Department of Revenue

In addition to replacing state oil and gas production taxes and corporate income taxes with a contract for payments, the Act also allowed the Revenue commissioner to include municipal sales taxes, municipal special assessments, state and municipal property taxes and any other state or municipal taxes in the negotiations. The intent was to wrap up as much as possible into the contract for payments in lieu of taxes.

Once a contract was developed, preliminary findings would be submitted to the governor. If the governor chose to proceed the preliminary findings would be given to the Legislature and the public. There would be a 30-day public review period.

After the review, the commissioner of Revenue would modify the contractual terms as appropriate and if acceptable to the sponsors. The final contract would be submitted to the governor. The governor would transmit the contract to the legislature with a request for authorization to execute the contract. Finally, the legislature would vote on it.

There was great concern by local municipalities that a contract could compromise the property tax revenues they might receive, especially given the concerns about the property tax discussed above. Accordingly, the Act requires that a portion of the payments due under the contract is paid to affected municipalities. Also, the law created a municipal advisory group to participate in developing contract terms.

The law also has provisions intended to help make gas available to communities, to promote local hire, and to deal with confidential information provided by the sponsors.

Testimony for SB 92
Dan Dickinson, Tax Division Director
Alaska Department of Revenue
March 4, 2003

My name is Dan Dickinson, Tax Division director at the Department of Revenue. With me is Roger Marks, a Petroleum Economist with the Tax Division, who will speak briefly about the history, intent and mechanics of the Stranded Gas Act. But first I think it is important to introduce ourselves, as the Department of Revenue has many responsibilities under the Stranded Gas Act, and the Tax Division has considerable expertise and experience in oil and gas matters.

Five years ago we were three divisions – the Oil and Gas Audit Division, the Income and Excise Audit Division and the Charitable Gaming Division. We are now merged into a single division.

What we do can be seen from the FY 2002 Comprehensive Annual Financial Report for the State of Alaska. You should have a copy of an excerpt from Table 1.13. Of total governmental fund revenues of \$3.5 billion:

- \$1.6 billion comes from the Feds
- Taxes are \$1 billion
- Royalties are \$0.9 billion
- Interest and investment income, plus all the other ways the government raises money (charges for services, fines and forfeitures and “other”), was more than offset by investment losses in FY 2002.

The Tax Division administers 19 of the 20 tax types that comprise \$1 billion tax figure. Of the billion dollars in taxes, all but a little more than \$100 million were oil and gas taxes. The state's oil and gas take is often characterized as four bites of the apple, and we are experienced at all four bites.

For the first bite: We are charged with auditing royalties and net profit share leases, and work with DNR on those matters.

The other three bites of the apple cover the three areas that we anticipate will be our focus in any Stranded Gas Act negotiation.

The second bite of the apple is the oil and gas property tax. Last Friday, the Tax Division's Oil and Gas Property Tax assessor and his staff mailed out the 2003 tax roll, showing oil and gas property valued at about \$13.5 billion. As petroleum economist Roger Marks will explain later, property taxes play a unique role in determining any natural gas project's profitability.

The third bite of the apple is the oil and gas corporate income tax. Income taxes are focused on taxing profits. As Roger will elaborate later on – the more we focus on taxing profits, the more progressive our system becomes. This is one of the stated goals of the Stranded Gas Act. We have a large experienced group in our division that works these issues and we expect them to be critical.

The last bite of the apple is the production tax. Like royalty, the production tax focuses on the commodity value of the resource at or near the wellhead. We have lots of experience in this area – market pricing, inter-company transfer pricing, how markets work, how energy contracts work, business practices and cost analysis.

Now, let me add a personal observation – but one that I think reflects what many of us in the division believe about what the state should be trying to achieve in any Stranded Gas Act negotiation.

Taxes – and the government take in general that is the subject of the Stranded Gas Act – should not distort commercial realities. The government's take should not be what is red-lighting this project.

As Roger will explain, our current fiscal system intensifies some of the risks faced by the producers. Ironically, not only the producers but the state could be better off changing those same aspects of its fiscal system. Stranded Gas Act negotiations should be about risk sharing, and who among the state and the commercial entities involved can best handle what risks. As soon as SB 92 becomes law we can start discussing how price risk will be shared or how return on the investment in the pipeline will be taxed, or really figure out what each party wants to get from this project – aside from “more.” There are lots of specifics that can be set aside until it is clearer how our gas will fit in with the market mechanisms that will be in place when we are ready to market. The state's role should not be to increase risks. Maybe we can make the project fly by reducing risk.

On the other hand, we have to make sure that the state is not naively underwriting a risky project. As the only ones who will still be around if things go sour, we don't want to be left holding a bag we didn't quite understand the dimensions of.

That's my quick overview of the Department of Revenue Tax Division. The administration strongly supports reauthorizing the Stranded Gas Development Act. We believe it creates a great mechanism to work these difficult issues we face. The Tax Division looks forward to being able to play our part in that work.

Thank you for the opportunity to testify and to introduce the people who will be doing a lot of the foot slogging in any stranded gas act negotiation.

STATE OF ALASKA
 Statement of Revenues, Expenditures, and Changes in Fund Balance
 Governmental Funds
 For the Year Ended June 30, 2002
 (Stated in Thousands)

STATEMENT 1.13

REVENUES	Total Governmental Funds
Taxes	\$ 1,019,878
Licenses and Permits	90,049
Charges for Services	157,458
Fines and Forfeitures	11,937
Rents and Royalties	867,100
Premiums and Contributions	19,612
Interest and Investment Income	1,203,336
Net Increase (Decrease) in the Fair Value of Investments	(1,583,223)
Federal Grants in Aid	1,552,694
Nonfederal Grants and Contracts	43
Other Revenues	154,713
Total Revenues	<u>3,493,597</u>

Source:
 State of Alaska
 Comprehensive Annual Financial Report
 For Fiscal Year July 1, 2001 - June 30, 2002
 (Page 22)

Prepared By:
 Department of Administration
 Division of Finance

Overview of SB 92
Presentation to the Senate Resources Committee
Roger Marks
Alaska Department of Revenue
March 5, 2003

Good afternoon, Mr. Chairman and members of the committee. My name is Roger Marks. I am a petroleum economist with the Tax Division of the Department of Revenue. I worked on the original Stranded Gas Act in 1998 and am familiar with its history, intent, and mechanics. I would like to provide a very brief overview of the Act at AS 43.82. A more detailed synopsis is with the fiscal note.

The Act originated in HB 250 in 1997 which established a North Slope Gas Commercialization team in the Administration to research and recommend changes to state law to encourage commercialization of North Slope gas. The team concluded that the project faced considerable risk, namely gas price risk and cost overrun risk, and that the state's fiscal system actually exacerbated those risks. Two of the risks of particular concern were fiscal uncertainty and the state's regressive tax system.

(A brief comment on the price risk: The cost of the project is very large: \$20 billion. That is a lot of money to any corporation, even ones the size of Exxon, BP or ConocoPhillips. If this project is built and something goes wrong, such as low prices, the sponsors face very large losses. And even if these are relatively low-probability events, the project may not be built if a company cannot tolerate a loss of that size. That is why the risk-reduction mechanism proposed in Congress, which is currently in place for non-conventional gas in the Lower 48, may be a very necessary linchpin in making this project a reality.)

By fiscal uncertainty we mean the threat of changes in fiscal provisions after a project is built, that may change the project's viability after it is too late to do anything about it. A project may be feasible under one tax system. If it is built under the assumption that the tax system in place will stay in place, but the tax system changes, the changes could cause heavy financial losses.

Second, there are two significant elements of the state's fiscal system that make it regressive. By regressive we mean that the state's take is a high percentage of income at low prices, and a low percentage at high prices. First, the property tax is based on cost. The higher the cost the higher the tax. This is a double whammy to an investor who incurs a cost overrun. Moreover, the property tax is payable when construction begins, years before revenues start accruing. On a time value of money basis this diminishes the rate of return, and increases the risk of not recovering the investment.

The second regressive elements are the severance tax and royalty. They are based on the value at the point where the gas comes out of the ground, and ignore upstream costs such as capital and operating costs. Thus when costs are high and prices are low, the state's take is a high percentage of low income. Again, this intensifies the danger of low prices.

I might add that a regressive system also limits the state's take at high prices. Fixing that could be very important to the state for securing more revenue when prices are high, without threatening the viability of the project.

The Stranded Gas Act was the result of trying to fix these shortcomings. The law provided a mechanism for converting the state's fiscal system from a statutory basis to a contractual basis. This would provide for greater fiscal certainty. The fiscal system would be negotiated between the state and the project sponsors, and approved by the legislature, after a public review period. Payments to the state would be made in-lieu of taxes. And per the Act the contract terms would provide for a more progressive (less regressive) system.

Most of the provisions subject to negotiation are the tax provisions. Given that the royalty represents the state's ownership share, there was not interest in making the royalty rate subject to change. The only royalty provisions subject to negotiation would be the gas valuation method, and the timing of royalty in-kind and in-value notices.

The Commissioner of Revenue would be the primary agent for negotiating and implementing the contract. However, the Commissioner of Natural Resources is also responsible for reviewing the project plan for acceptability, and for negotiating any changes in those royalty issues.

There was concern by municipalities that a contract could compromise their property tax revenues. Accordingly, the Act created a municipal advisory group to participate in developing contract terms, and the Act requires that a fair and reasonable share of the payments due under the contract be paid to affected municipalities with regard to the size of the tax base that may be exempted, and the economic and social burdens imposed by construction and operation.

The Act also has provisions for sponsors to help make gas available to communities, to promote local hire, to deal with confidential information provided by the sponsors, and to reimburse the state for contractors it may use to assist in the negotiation process.

Finally, there were some questions raised as to whether this would surrender or contract away the power to tax, which is forbidden by our constitution. It was the administration's judgment that this would not preclude future legislatures from imposing other taxes, but this contract would represent a solemn pledge, a moral commitment by the state, and a message to future legislatures that once it agrees to the terms it will not change them.

STATE OF ALASKA

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

FRANK H. MURKOWSKI, GOVERNOR

P.O. BOX 110400
JUNEAU, ALASKA 99811-0400
TELEPHONE: (907) 465-2300
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March 4, 2003

The Honorable Scott Ogan
Chair, Senate Resources Committee
Alaska State Legislature
State Capitol, Room 103
Juneau, AK 99801

Dear Senator Ogan:

Thank you for introducing Senate Bill 92 to extend and expand the Stranded Gas Development Act. We share your interest in this project and are optimistic that Alaskans are getting closer to seeing our natural gas move to market.

In reviewing SB92, we have three concerns we would like to share with you:

1. Our first concern is regarding Sec.1, AS 43.82.100, the definition of a qualified project. Although we recognize the intent of the Act — so that only North Slope gas is covered by this legislation and, if carried by pipeline to North America, travels on a route that follows the Trans-Alaska Pipeline System and the Alaska Highway — it is our opinion that other provisions of this bill and existing state law already implicitly achieve that goal.

Specifically, the existing AS 43.82.100(2) limits the provisions of the Act to “stranded gas.” Stranded gas is later defined in AS 43.82.900(13) as gas “that is not being marketed due to prevailing costs or price conditions.” It is our judgment that given the distribution of gas and the markets for gas within the state, this could *only* include North Slope gas. Therefore, we believe it is not necessary to have additional conditions inserted into the bill.

And, existing state statute (AS 38.35.017) prohibits the granting of any right-of-way leases in or adjacent to the Beaufort Sea. This is the legislation that banned any consideration of an “over-the-top” route for North Slope gas.

In addition, we believe the definition proposed in SB92 may be unnecessarily complex and perhaps even self-contradictory. The language references the definition of “North Slope natural gas pipeline” from the state Right-of-Way Leasing Act, AS 38.35.120. That definition then references another definition from the Pipeline Act, AS 42.06.630. The Pipeline Act defines “North Slope natural gas” as gas produced north of 68 degrees North latitude.

However, SB 92 references gas north of 64 degrees North latitude. We believe it would be better to avoid this discrepancy.

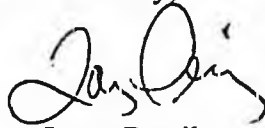
Moreover, the Pipeline Act only addresses the *intrastate* sale of gas. However, most of the gas in this project will be for *interstate* sale, which is not regulated by the Pipeline Act. Therefore, invoking the Pipeline Act to define the project (as in SB92) may have unclear consequences that are best avoided.

We believe the definition of a qualified project in the current committee substitute for CS HB16 (Resources) provides a clear and effective definition, with no material difference from what was crafted in SB 92. The Administration would prefer that definition.

2. Our second concern also regards the definition of a qualified project under the Stranded Gas Development Act. Although SB92 would expand the list of qualified projects under the Act to include a natural gas pipeline to the Lower 48, it does not include a gas-to-liquids (GTL) project. The administration supports any investment that would commercialize North Slope natural gas, and would prefer to include potential GTL technologies in the bill, as does CS HB16 (Resources).
3. Finally, the administration would like to impress upon potential sponsors the urgency of starting work. While the producers are looking for fiscal certainty, the State also wants certainty that a project will move forward in a timely manner. Accordingly, under Sec. 2 of this legislation the administration would prefer an earlier application deadline date of March 31, 2005, as is included in CS HB 16 (Resources).

The Department of Revenue is eager to work with you on this important legislation, and we look forward to a successful outcome of your efforts.

Sincerely,



Larry Persily
Deputy Commissioner

cc: Mike Tibbles, Office of the Governor
Mark Myers, Division of Oil and Gas, Department of Natural Resources
David Marquez, Department of Law

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

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Juneau, Alaska 99801-1182
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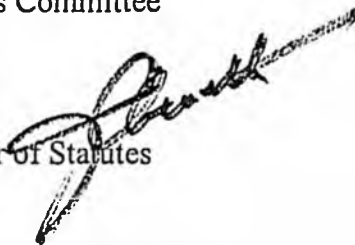
MEMORANDUM

March 4, 2003

SUBJECT: Ch. 104, SLA 1998, the Alaska Stranded Gas Development Act

TO: Senator Scott Ogan, Chair
Senate Resources Committee
Attn: Linda Hay

FROM: Jack Chenoweth
Assistant Revisor of Statutes



I am unable to provide a sectional analysis for House Bill 393 of the 1998 legislative session (Alaska Stranded Gas Development Act). Instead, of value to you may be the text of each of the two enclosures:

-- Governor Tony Knowles' transmittal letter, photocopied from the House Journal; and

-- the Attorney General's bill analysis for SCS CSHB 393 (Finance), the bill in its final version.

JBC:med
03-236.med

Enclosures

THE
FOLLOWING
DOCUMENT(S)
ARE
POOR
ORIGINAL
COPIES

Representatives Kelly, Dyson and
; and amending Rules 54 and 56,
ure."

ferred to the Judiciary and Finance

Representatives Kelly, Dyson and

relationship between a minor and a person
custody of the minor, and relating to
relationship when a minor has run away
aided by a person having the minor's

and to the Health, Education & Social
s.

Representatives Austerman and Hudson,

by the Department of Environmental
Department of Fish and Game to confidential
resources prepared or kept by the
AS 43.75; relating to certain salmon
ing for an effective date."

ferred to the Labor & Commerce

House Rules Committee by request of

HB 393

"An Act relating to contracts with the state establishing payments in lieu of other taxes by a qualified sponsor or qualified sponsor group for projects to develop stranded gas resources in the state; providing for the inclusion in such contracts of terms making certain adjustments regarding royalty value and the timing and notice of the state's right to take royalty in kind or in value from such projects; relating to the effect of such contracts on municipal taxation; and providing for an effective date."

was read the first time and referred to the House Special Committee on Oil & Gas and the Finance Committee.

The following fiscal notes apply:

Fiscal note, Dept. of Natural Resources, 2/11/98

Fiscal note, Dept. of Revenue, 2/11/98

The Governor's transmittal letter dated February 9, 1998, appears below:

"Dear Speaker Phillips:

Today I am transmitting the Alaska Stranded Gas Development Act to advance the development of Alaska's vast supply of North Slope natural gas. This legislation follows the recommendations of the North Slope Gas Commercialization Team which was established by legislation last year to build a framework to improve the economic feasibility and competitiveness of a North Slope gas project.

The bill authorizes the state to negotiate contracts with project sponsors to improve the economic feasibility of developing stranded gas on the North Slope. Contract payments would replace some or all of the state and municipal taxes applicable to the gas project including: 1) state and municipal ad valorem property taxes; 2) production or severance taxes; and 3) state corporate taxes. The state's royalty share of produced gas would not be subject to such a contract. Contract payments would be designed to improve project economics by "back-end loading" tax liabilities to allow project investors to begin to recoup some of their investment before facing a heavy tax burden.

HB 393

The contract payments would also be designed to provide the state with an increased share of the project's revenue if energy prices increase or if the sponsors are able to substantially decrease anticipated project construction costs.

Such contract payments were envisioned in both the House Concurrent Resolution relating to North Slope gas and the gas commercialization team bill passed last year. While the bill is unique in many respects, there are precedents for this type of incentive. For example, the LNG project on the Kenai Peninsula, which provides significant jobs and production and property tax revenue, benefited directly from the Alaska Industrial Incentive Act which provided tax advantages critical for development.

There are several major benefits to the approach authorized in the bill. Fiscal arrangements can be tailored to the specific economics of a gas project. Contractual payments are more likely to provide predictability for potential investors in a project. This method also addresses the critical element of local taxes by providing a mechanism for ensuring a steady payment stream to municipalities over the life of the contract.

Local hire and the use of local businesses in any project are also stressed in the legislation. Employers participating in the project are required to advertise locally for available positions, use Alaska job service organizations, and employ qualified Alaska residents and Alaska-owned businesses to the full extent permitted by law.

Any contract negotiated by the Administration would be subject to legislative review and public hearing. Additionally, I would encourage the legislature to require legislative approval of a contract because of the appropriate role of the legislature in such a unique and significant decision. Furthermore, if such a contract in lieu of taxes was considered a tax, the legislature may well be required to approve such action by law.

The bill recognizes that in the process of negotiating a contract it may be necessary to review confidential company data if the state's best interests are to be advanced. The bill strikes a balance between the public's right to review the basis for the contract and the company's right to protect proprietary information from their competitors.

HB 393

Confidentiality of proprietary info revealed, would both affect a cc significantly diminish the commer

The Stranded Gas Development Ac efforts to realize the benefits of t North Slope. While it is true a addressed before a North Slope ga project cost reductions, market c favorable federal tax laws, this bill our success. I urge your prompt at

Since
/s/
Tony
Govt

HB 394

HOUSE BILL NO. 394 by Repr:

"An Act relating to seafood p fishing operations and to tl collected by the Department o of Environmental Conservatic

was read the first time and referre

HB 395

HOUSE BILL NO. 395 by Repr

"An Act relating to civil lia defibrillator in providing eme

was read the first time and referre

HB 396

HOUSE BILL NO. 396 by Repr

"An Act relating to renting a

February 11, 1998

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February 11, 1998

2283

HB 393

Confidentiality of proprietary information is limited to items that, if revealed, would both affect a company's competitive position and significantly diminish the commercial value of the information.

The Stranded Gas Development Act is a critically important step in our efforts to realize the benefits of the enormous gas resources on the North Slope. While it is true a number of other factors must be addressed before a North Slope gas project becomes a reality, such as project cost reductions, market conditions, and the need for more favorable federal tax laws, this bill lays the necessary groundwork for our success. I urge your prompt and favorable action on this measure.

Sincerely,

/s/

Tony Knowles
Governor"

HB 394

HOUSE BILL NO. 394 by Representative Williams, entitled:

"An Act relating to seafood processing permits for direct-market fishing operations and to the release of certain information collected by the Department of Fish and Game to the Department of Environmental Conservation."

was read the first time and referred to the Resources Committee.

HB 395

HOUSE BILL NO. 395 by Representative Bunde, entitled:

"An Act relating to civil liability resulting from the use of a defibrillator in providing emergency aid."

was read the first time and referred to the Judiciary Committee.

HB 396

HOUSE BILL NO. 396 by Representative Bunde, entitled:

"An Act relating to renting a motor vehicle."

OFFICE OF THE ATTORNEY GENERAL OF THE STATE OF ALASKA

883-98-0083

1998 Alas. AG LEXIS 7

May 29, 1998

SYLLABUS:

[*1]

SCS CSHB 393(FIN)--Alaska Stranded Gas
Development Act

development of some or all of the approximately 35 trillion cubic feet of gas on the North Slope. Today that gas is stranded there because of the prohibitive cost of getting it to market.

REQUESTBY:

The Honorable Tony Knowles
Governor
State of Alaska
P.O. Box 110001
Juneau, Alaska 99801-0001

Sections 1 through 9 of the bill would authorize the commissioner of revenue to develop the terms of a fiscal contract with sponsors of projects to develop known gas reserves that currently cannot be marketed economically. Unlike the governor's proposal, the bill is limited to liquefied natural gas ("LNG") projects. In a letter of intent adopted by the Senate, Senator Kelly explains that while the state has studied the economics of a North Slope LNG project, no comparable study has been made of the next most likely alternative, a gas-to-liquids (GTL) project. The letter of intent suggests that the state should continue to explore any method of commercializing its stranded gas resources, and that an economic analysis of GTL may support amending the Stranded Gas Development Act to include it. The North Slope Gas Commercialization Team's Report to the Governor of December 15, 1997, in fact identifies an LNG project as the "most promising" alternative for commercializing North Slope gas [*3] and focuses its economic analysis exclusively upon it, although the fiscal principles in the Report which are incorporated in the bill, could be applied more broadly.

OPINIONBY:

Bruce M. Botelho, Attorney General

OPINION:

At the request of your legislative director, Pat Pourchot, we have reviewed SCS CSHB 393(FIN), the Alaska Stranded Gas Development Act, which would authorize the commissioner of revenue to develop new fiscal terms for projects that develop stranded natural gas resources in the state.

The bill is identical in most important respects to the bill introduced at the request of the governor. The bill is largely the product of the North Slope Gas Commercialization Team, which was established last year by House Bill 250. The team, which consisted of the attorney general, the commissioner of revenue, and the commissioner of natural resources, was charged with recommending terms for a contract that would improve the economic feasibility and competitiveness of a North Slope gas project. The team also was asked to recommend legislative provisions necessary or appropriate to implement such a contract. The purpose of the team's efforts and of the bill is to enable the state to create a fiscal regime appropriately [*2] tailored to the

The payments required by the contract would replace some or all of the state and local taxes that would otherwise apply to qualified sponsors as a consequence of their participation in a qualified project. Those taxes might include: (1) the state and local ad valorem property taxes that would be imposed on the project facilities; (2) the production or severance tax that would be imposed on the gas produced and marketed by the project; and (3) the state corporate income tax obligation arising as a consequence of the construction and operation of the project. In addition, the commissioner of natural resources may develop terms, which the commissioner of revenue may include in a contract, addressing timing and

notice of the state's right to take its royalty gas in kind, as well as a method for valuing the state's royalty share of gas. In effect, the bill would permit the commissioner of revenue to develop terms that would replace the state's current fiscal regime--which, if applied to a North Slope gas project today, would [*4] be relatively regressive and front-end loaded--with a regime that is more progressive and back-end loaded, in an effort to lower the risk of the project and boost the rate of return that investors could expect.

The principal difference between this bill and the version introduced at the governor's request is that the former, though empowering the commissioner of revenue to negotiate fiscal terms, does not authorize the commissioner to actually execute the contract. Instead, sec. 3 of the bill adds AS 43.82.435, which provides that the "governor may transmit a contract developed under this chapter to the legislature together with a request for authorization to execute the contract." The section further provides that the contract is not binding unless the governor is authorized to execute the contract by a subsequent enactment. In the view of legislative counsel, this aspect of the bill may reflect an encroachment by the legislature upon the powers properly reserved to the executive branch under the Alaska Constitution. However, legislative counsel also recognized that the executive is free as a matter of comity to acquiesce in what amounts to the legislature's request for more active [*5] oversight. In fact, the governor, in the transmittal letter accompanying his proposed legislation, encouraged the legislature to review the contract and approve it before it became effective. The governor made this request because of the importance of North Slope gas development to the state.

We agree with legislative counsel that the governor may acquiesce in the approach adopted by the legislature. We also note that it is far from clear that the legislature's approach would, in fact, violate the separation of powers doctrine. The legislature arguably has not usurped an executive function, but rather has divided its delegation of authority into two steps, rather than the traditional one. It should be noted, moreover, that both the negotiation of the contract and its submission to the legislature are discretionary. Finally, it is relevant that the contract that is to be provided to the legislature involves the state's fiscal regime, a subject substantially within the purview of the legislative branch under art. IX of the Alaska Constitution. Since the contractual payments in lieu of taxes authorized by this bill could be characterized as, in essence, a new tax, the legislature may [*6] well be required to levy the new tax by law. Viewed in this light, the legislature's approach might not only be permissible, but necessary, under the constitution.

There are a number of other important issues raised by this legislation. First, art. IX, sec. 1 of the Alaska Constitution provides that "the power of taxation shall never be surrendered." The bill raises the "surrender of the taxing power" question because it contemplates development of a long-term contract that reflects the fiscal terms applicable to the sponsors of a stranded gas project. The legislation itself, however, is not unconstitutional under art. IX, because it does not purport to bind future legislatures. Instead, it merely authorizes the commissioners of revenue and natural resources to develop appropriate contract terms. Authorization to execute the contract will not be delegated to the executive branch until the legislature has had an opportunity to review the contract and ascertain whether its terms are in the public interest. Even if that authorization is given, the legislature may expressly provide that the contract's fiscal terms are binding only so long as no future legislature decides to exercise the [*7] taxing power in a different way. In other words, the "surrender of the taxing power" issue may never arise. A concrete analysis of the issue must be left to the day the legislature decides whether, and if so under what terms, it will allow execution of a contract at all.

The second issue is the bill's provision in sec. 3, adding AS 43.82.500 - 43.82.520, for municipal participation and revenue sharing. Like the former Industrial Incentive Act (AS 43.25, repealed in 1986), the bill recognizes that changes in the state's tax regime will be ineffective to encourage development unless municipal tax changes are also included. Unlike the former Act, the bill includes provisions to ensure that affected municipalities receive a "fair and reasonable" share of the payments from a project that affects them. The bill also creates a municipal advisory group to assist the commissioner in developing the contract terms that may affect municipalities.

Third, the bill recognizes that the commissioners of revenue and natural resources may have to review confidential company data in order to develop fiscal terms that best advance the state's interests. The people of the state, however, have a right to [*8] know the basis for administrative decisions affecting their welfare. The bill strikes a balance between, on the one hand, the state's interest in encouraging competition and the right of companies to keep proprietary information from their competitors and, on the other hand, the public's right to review their elected and appointed officials' decisions. The bill does this by limiting confidential treatment to proprietary information that, if revealed, would both affect a company's competitive position and significantly diminish the value of the information. In addition, information loses its confidential status as soon as confidentiality is no longer necessary to protect the

company's competitive position or the information's value.

Finally, an important goal of this legislation is to facilitate the hiring of Alaskans in all phases of the construction and operation of a stranded gas project. The bill adds AS 43.82.230, which requires employers participating in a project to advertise locally for available positions and use Alaska job service organizations located throughout the state. Most significantly, the commissioner is directed, "within the constraints of law," to include a provision [*9] in a contract requiring sponsors to employ qualified Alaska residents and Alaskan-owned businesses. The commissioner of labor will prepare and present to the legislature an annual report compiled from state data bases, particularly quarterly unemployment insurance reports, regarding the residency of employees working in the state on the

project. We see no constitutional problem with these aspects of the bill, because the bill expressly provides that the Alaska hire provisions in the contract must be consistent with "the constraints of law."

Finally, we note that although the bill is unique in many respects, the legislature has passed comparable measures to encourage industrial development in the past. For example, the liquefied gas plant, gas pipeline, and related facilities on the Kenai Peninsula benefitted directly from the Alaska Industrial Incentive Act, former AS 43.25. Without the tax advantages provided by the Act at that time, the Kenai LNG facility might never have been built. Today, that facility is a significant source of jobs and property tax revenues in the Cook Inlet area.

We see no legal problems presented by this bill.