

**OVERVIEW:  
DEPT. OF  
NATURAL  
RESOURCES,  
2006**

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**Alaska Department of Natural Resources  
Joint House and Senate Resources Overview**



**STATE OF ALASKA**

Frank H. Murkowski, Governor

**DEPARTMENT OF NATURAL RESOURCES**

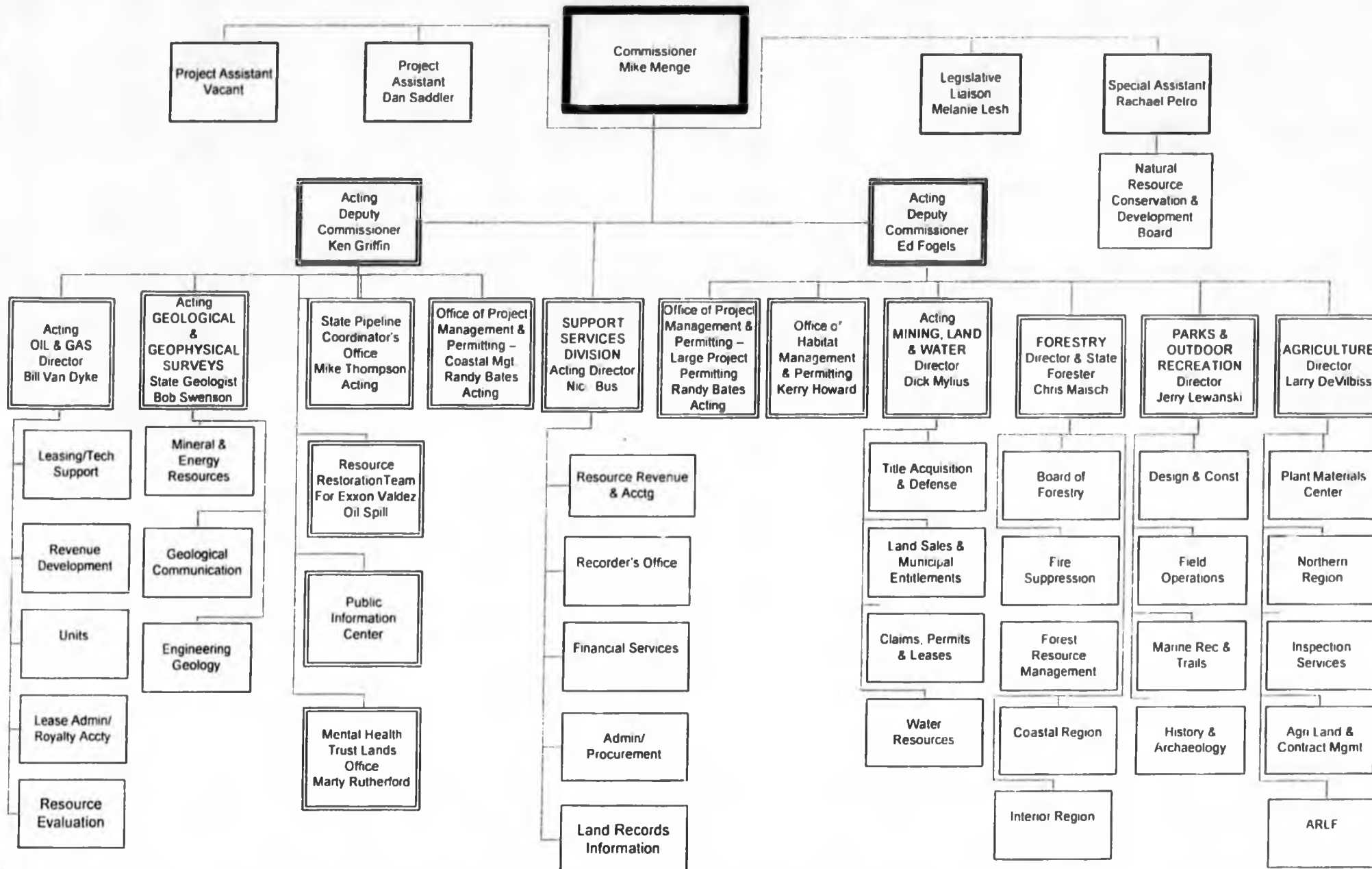
Michael L. Menge, Commissioner

January 18, 2006

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# Department of Natural Resources As of January 9, 2006



**OVERVIEW OF THE DEPARTMENT OF NATURAL RESOURCES  
PRESENTED TO THE  
JOINT RESOURCE-COMMITTEES  
WEDNESDAY, JANUARY 18, 2006**

**INTRODUCTION**

Chairman Wagoner and Co-Chairs Ramras and Samuels, and members of the House and Senate Resources Committees.

For the record, my name is Mike Menge. I am the Commissioner-Designee of the Department of Natural Resources. With me today are:

- Ed Fogels and Ken Griffin, my Deputy Commissioners
- Melanie Lesh, Special Assistant and Legislative Liaison
- Rachael Petro, Special Assistant
- William Van Dyke, Director Division of Oil & Gas
- Kerry Howard, Director of the Office of Habitat Management and Permitting
- Chris Maisch, Director of the Division of Forestry
- Jerry Lewanski, Director of the Division of Parks
- Dick Mylius, Director Division of Mining Land & Water
- Nico Bus, Director of Support Services
- Randy Bates, Director of the Office of Project Management & Permitting

Other staff are listening in from Anchorage & Fairbanks by teleconference.

Thank you for the opportunity to talk with you about the Department of Natural Resources. I am excited by the prospect of working with you this legislative

session. We have many opportunities as well as challenges before us. There is much we can accomplish. Our common goal of ensuring that the best interests of Alaskans are protected will serve us all well when dealing with the tough issues ahead of us.

The information presented in this Overview will give you an understanding of the breadth of resource issues and size of management responsibilities that the department deals with on a day-to-day basis. However, I will only be able to touch on the big issues with the short time we have today. If you need more information, our Division Directors are available for individual presentations. We would be happy to schedule those with you.

## **MISSION**

The department's mission is to *develop, conserve, and maximize the use of Alaska's natural resources consistent with the public interest.*

### **Missions and Measures**

We believe that DNR should be treated as a business – DNR is the business arm of the state. We understand that we are accountable to the legislature and citizens of Alaska and have established missions and measures that we follow. The only way that we can know whether we are succeeding is to see the results. Thus, we keep track of these missions and measures and update the information quarterly on the Governor's website (<http://www.gov.state.ak.us/omb/results/index.php>).

### **End Results**

Achieving results for Alaskans is what resource development is all about and we seek to achieve the following:

1. Encourage resource development that creates Alaskan jobs and ensures economic growth in all regions of the State.
2. Ensure resource development planning, management and new project approvals are based on sound science, prudent management, and responsive and meaningful public involvement.
3. Ensure resource sustainability and multiple use, including recreational enjoyment of the resource base.
4. Streamline natural resource leasing, sales, and permitting processes.

DNR recognizes that businesses come to Alaska based on business plans that meet their rate of return expectations, provide for the best cash flow, and offer the greatest security. Alaska competes in the world market for business – especially natural resource business. And, as you know, resource development is Alaska's economic engine!

The Administration understands that it has a major role in creating a positive business environment for the economic engine. Support can come in a variety of ways, such as providing certainty and reliability in processes and timing, or by eliminating duplication of procedures and unnecessary standards and regulations. Too often, such procedures increase a project's costs, but do not contribute to meaningful environmental protection. Support for business also means coming to the table to help solve issues so that good projects can move forward.

As the Governor mentioned in his State of the State address, the key to Alaska's future is the responsible development of our resource wealth. You'll recall he listed the State's Oil & Gas reserves; The Tongass National Forests, our state's largest; the tremendous mineral wealth of our vast deposits of gold, silver, copper, coal,

and molybdenum, and our large and spectacular land base. DNR plays a role in supporting the industries involved in all of these resources.

The State's most important new project is the Alaska gas pipeline. I have been personally and deeply involved with this project. I am confident we will deliver on the promise of a future secured by the gas pipeline. The negotiations have resumed and they will continue here in Juneau until completed. This project will be explained in great detail once we reach agreement so I won't spend much time on this now.

As part of these negotiations, the Governor has stood fast on what is called "Our Covenant for Alaska" linking the gas contract with long overdue reforms to the oil tax system. You can expect to see a gas pipeline contract that protects the public interest, returns maximum revenues to the state, and provides good job opportunities for Alaskans.

As the Governor stated the oil and gas pipelines will anchor our future. And along with the oil and gas that will be produced from existing fields, there are huge undiscovered resources of oil and gas to be developed on Alaska's rich North Slope, particularly on the coastal plain of the Arctic National Wildlife Refuge, NPRA, and in the Foothills of the Brooks Range.

## **INITIATIVES**

Significant progress is being achieved on promoting a positive business environment in Alaska. I will provide a quick update on some of the initiatives.

The **Alaska Coastal Management Program** was moved to DNR to streamline the process and make it more objective and accountable. The Alaska Coastal Zone Management Program changes were submitted on time and were approved by NOAA on December 29, 2005.

The functions of the **Habitat Division** were also moved to DNR's Office of Habitat Management and Permitting to facilitate permitting. Since that move, 99% of all Title 41 applications were approved, either as-is or with appropriate conditions to protect habitat, and the average permit issuance time is just 15 days, state-wide. OHMP also continues to work closely with ADF&G on large projects, and it is important to note that none of OHMP's decisions on these major projects have been elevated between our two agencies.

The State's **Large Mine Permitting team**, headed by DNK, has been a major success story. DNR not only manages and coordinates the activities of this inter-agency team, but participates as a technical reviewer of mine projects. The effectiveness of this team approach can be seen clearly in the fact that Alaska has been one of the few states that has successfully permitted new mines in recent years. DNR's large mine permitting roles have been enhanced and extended to all large project permitting, including Oil and Gas. Does it work? One new company progressed from lease issuance to permits in hand for a North Slope offshore well in three months and a well drilled in less than a year – a significant accomplishment, thanks to a unified effort by several divisions.

Through legislation you passed in 2003 DNR was designated as Lead Agency on Permitting for resource development. This has provided for enhanced interagency

cooperation, improved consolidation of responsibilities, and cleared an additional path for efficiently advancing resource development.

## **RESOURCE ISSUES AND PROJECTS**

Significant work is being done across the department. I'll take the remaining portion of my time to highlight some of the activities.

### **Oil and Gas**

We appreciate the legislative support for the added staff in our Oil & Gas Division. This allowed us to build up our staff and meet the workload demands in the expansion of oil & gas units, which is shifting from management of a few large fields, to management of many smaller fields. Each field requires a significant staffing commitment from the state to optimize its revenue potential and meet its lease requirements. Our oil & gas leasing and exploration licensing activities have grown and need to be adequately staffed. We need the staff to maximize the State's return on investment when developing our oil & gas resources.

DNR's Division of Oil and Gas, along with its Division of Geological and Geophysical Surveys conducted field work to further evaluate the potential for oil and gas on the Alaska Peninsula and to make the information available to the public. Results to date are very encouraging. We are starting to see significant industry interest. The Alaska Peninsula lease sale started from discussions with Alaska Peninsula residents and the Governor early in 2003. At the October 2005 oil and gas lease sale, the state sold 37 Tracts and collected \$1.2 million in bonus

bids. The area is remote and lacks modern subsurface seismic surveys. It will take a little time to build significant industry interest.

The participation by two majors, 14 independents, and eight individuals in our last five lease sales and the potential addition of Pioneer Natural Resources Alaska and Kerr-McGee -- both in partnership with Eni ("eh-nee") as new operators and producers on the North Slope -- are clear indications that the state's efforts to encourage oil and gas companies to enter the Alaska market are bringing results. Companies are voting with their pocket books and saying Alaska is a good place to invest.

### **Tundra Travel**

One of the serious problems facing oil and gas exploration on the North Slope is that the winter season for cross-tundra travel is becoming shorter. In fact, it had been effectively cut in half since the early 1970s. This change has increased exploration costs. To help solve this problem, DNR's Division of Mining, Land and Water with the appreciated support of several companies, worked with the US Department of Energy and scientists at Yale University to conduct scientifically valid research to extend the season without compromising the environment.

As a result of their work, in the last two seasons DNR was able to open the coastal plain to travel earlier than previous years.

### **Mining**

Alaska mining industry now has Red Dog, Greens Creek, Usibelli, Ft. Knox, and True North -- a tremendous foundation to build on. Pogo is nearing completion of construction and production of the first bar of gold is very close. A Grand

Opening is planned for June 5<sup>th</sup>! Kensington is still in the early stages of development. Other major mine development projects on the horizon, include Donlin Creek, Rock Creek, Chuitna Coal, Pebble Gold and Copper, and Nixon Fork.

The total value of mineral development added \$1.6 billion to the Alaskan economy. Staking and exploration activity is at an all-time high and metal prices for base and precious metals are at historic highs.

### **Timber Management**

The Administration has focused significant efforts towards saving the Southeast Alaska timber industry. The Division of Forestry has worked hard to provide state owned timber as a "bridge" to mills and processors until federal timber sales are again made available in significant volumes. Support of the value-added timber industry is essential to maximizing employment and providing economic stimulus in the region during this transition period. Work is continuing on revitalizing the Alaska Timber Industry. We are preparing a Memorandum of Understanding with the Forest Service calculated to have state and federal foresters working together to make more economically viable timber available.

In the Interior, the "New Growth Prospectus for the Forest Products Industry" is attracting potential investors. This public and private partnership is promoting the forest resources of the region, with emphasis on the hardwoods, paper birch and aspen. Plans for an updated forest inventory will enhance this effort and additional marketing efforts will continue.

In addition, OHMP has issued a General Permit that pre-approves most culvert installations in resident fish streams associated with timber operations. The use of this General Permit is voluntary, but it is another tool that the industry can use.

### **Land Sales**

Private land rights are important to resource development. Getting State lands into private Alaskan ownership is one of DNR's priorities. Each sale must comply with land use plans, public notice requirements, competitive bids, platting board requirements, surveys, title searches, and best-interest findings that take into account competing resource potential, access, wildlife, and other concerns. FY05 Revenues for Land Sales was over \$6.0 million. Through an increased subdivision program and the remote recreation cabin program, DNR offered more new land for sale to the public than at any time during the past 20 years.

### **Municipal Entitlements**

FY06 is shaping up to be a record year for DNR transfers of land to municipalities. DNR recently approved transfer of 215,000 acres to the Northwest Arctic Borough, the largest acreage ever transferred by DNR at one time. DNR transfers land to municipalities to provide an economic base and land for community needs. This is often the land that is most suitable and has the best access for private ownership. The total grant to date is over 1.3 million acres. DNR has transferred management authority to over 800,000 acres, leaving a little over one-half million acres to process and approve. In FY05 we completed the Aleutian East Borough Entitlement and in FY06 we hope to complete the entitlements for the Lake and Peninsula and the Matanuska-Susitna boroughs.

### **BLM 2009 and Other Land Transfers**

The federal Bureau of Land Management is accelerating land transfers to Alaska Native Allottees, the Alaska Native Corporations, and the State. As part of this process, in September DNR submitted revised priorities to BLM for 14 million acres still to be transferred to the state under Statehood Act land entitlements. DNR is also working to transfer title to the 250,000 acres that the Legislature granted to the University last session.

### **Recordable Disclaimers for Beds of Navigable Waters**

The State filed Recordable Disclaimers with BLM for 26 rivers and 15 lakes since FY04. As of October 2005, BLM issued disclaimers for 15 rivers and 11 lakes. These disclaimers do not transfer any land to the State of Alaska that we don't already own. This is simply an administrative process that allows BLM to formally disclaim any title interest in the beds of these state-owned navigable waters and clears the cloud on the state's title.

### **RS 2477s**

We tried the recordable disclaimer process with RS 2477s but were not successful. The Attorney General's office filed for two routes in Coldfoot and Chandalar Lake areas, with the intent to obtain quiet title action in court to protect Alaska land rights.

### **Parks**

About 4 million visitors come to our Parks every year. Alaskans love our parks – about 80 percent of our visitors are Alaskans. We know the value and benefit of our parks and our goal is to keep them open. The Governor hopes to expand the market for independent travelers and our State Parks play a key role in this. Hence

you will see an expanded emphasis on repairing long-overdue deferred maintenance in the Governor's budget for our Parks Units. In the Operating Budget we will discuss with you our experience of pushing the collection of more receipts in our parks and the dependency that created in our operating budget and what happens if we do not meet our targets.

The Department of Natural Resources and its Division of Parks and Outdoor Recreation have begun the process of developing a strategic plan, (the last one was written in 1971) that will, among other issues, address goals of financial stability and operations that reflect *common sense community* values.

### **Agriculture**

Promotion of Alaska Grown agricultural products were at an all-time high this year with introductions to new markets such as military commissaries throughout the state.

The Agriculture Revolving Loan Fund (ARLF) continues to serve the industry well and sale of repossessed assets continue to strengthen the fund for future agriculture business investments. The ARLF owns and manages several agricultural businesses and is working to return those businesses to the private sector. The ARLF board is currently working on selling Mt. McKinley Meat and Sausage. The board and the Division are working with industry and the Legislature to ensure the transition from state operations back to private enterprise goes smoothly.

The Division of Agriculture is helping expand Alaska's 100 million dollar timber industry by forging new export certification protocols which will make it easier and cheaper to export timber to markets like China.

## **Fire Management**

The calendar year 2005 was a much better year for Alaska than 2004, when we saw 6.4 million of the state burn. But 2005 was still the third-largest fire season on record with 4.6 million acres burning. Again, there were no lives lost or serious injuries and structure losses were kept to a minimum.

Land sales and development are facilitating an increase in urban interface, where more homes, cabins, subdivisions, and businesses are locating further into the remote areas of Alaska. Drier climates, earlier and later fire seasons, significant increases in lightning strikes, limited-modified-full protection issues, and costs require continual review of the approach to fires. Our response can range from the one extreme of putting all fires out, with resulting increases in fuel sources, to the other extreme of letting all fires burn themselves out. The Administration is reviewing all fire policies again this year. Also Alaskans should learn all they can about the Fire Wise program, which teaches landowners how to give their homes the best chance to survive during a wildland fire.

## **CONCLUSION**

In closing, I recognize that we have many opportunities and challenges ahead of us. We in DNR look forward to working with you in the Legislature so that – together-- we can meet the many challenges and opportunities ahead of us, and create the resource wealth necessary to provide for the State's needs in the years to come.

Thank you.

# PROFIT SHARING PRODUCTION TAX

Presentation to the Senate and  
House Resources Committee

January 18, 2006

# FISCAL SYSTEM OF ALASKA

The fiscal system applicable to oil and gas of Alaska consists primarily of four components:

- Royalties
- Production tax (severance tax, "ELF")
- Property tax
- State corporate income tax

Additionally, there is federal corporate income tax.

This presentation is about proposed changes in the production tax.

# CURRENT PRODUCTION TAX

The current production tax for oil is 12.25% net of royalty for the first five years of production and 15% thereafter. These percentages are multiplied by the Economic Limit Factor (between 0 and 1). The ELF lowers the production tax rate for smaller fields and fields with low productivity wells.

# CURRENT PRODUCTION TAX

$$ELF = \left[ 1 - \frac{(300 \times \text{wells})}{\text{volume}} \right]^{\left[ \left( \frac{150,000}{\text{volume}} \right)^{1.53333} \right]}$$

"wells" is the number of producing wells in the field; "volume" is the total daily production for the field

<b>Well Prod</b> <b>bopd</b>	<b>Wells</b>	<b>Volume</b> <b>bopd</b>	<b>ELF</b>
<b>300</b>	<b>2000</b>	<b>600000</b>	<b>0.00</b>
<b>300</b>	<b>500</b>	<b>150000</b>	<b>0.00</b>
<b>1500</b>	<b>100</b>	<b>150000</b>	<b>0.80</b>
<b>1500</b>	<b>20</b>	<b>30000</b>	<b>0.07</b>
<b>6000</b>	<b>5</b>	<b>30000</b>	<b>0.55</b>

An ELF of 0.00 means that the production tax is zero. However, royalties, property tax and corporate income tax remain payable.

# CURRENT PRODUCTION TAX

The current version of the production tax ("ELF") was introduced in 1989. The formula reflects economic conditions in 1989 when oil prices were in the \$ 14 - \$ 17 per barrel range and the values of 300 bopd for well productivity and 150,000 bopd for field productivity represented reasonable economic benchmarks.

Also the formula did not contemplate the subsequent development of a variety of satellite fields.

While the production tax stimulated the development of a variety of marginal fields, the benchmarks are now outdated.

Therefore, an overhaul of the production tax is in the interest of the State.

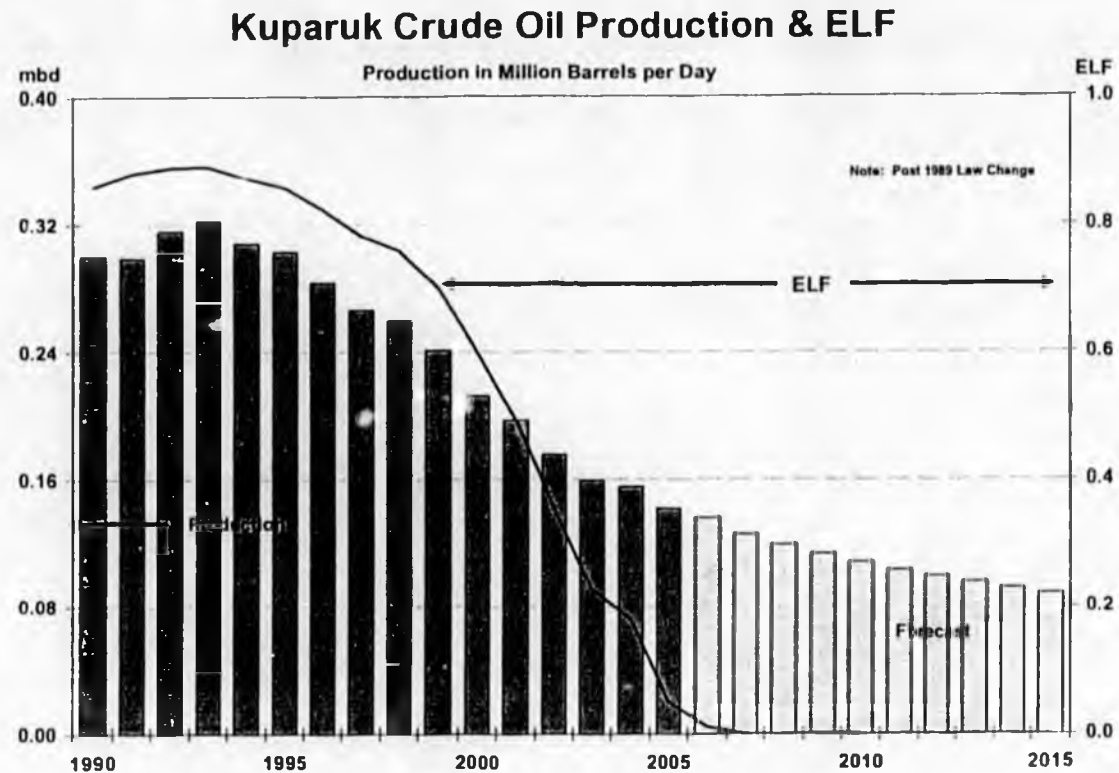
# CURRENT PRODUCTION TAX

The production tax has serious deficiencies:

- ELF is no longer rational in relation to well productivity and field production.
- ELF is not responding reasonably in case of field production decline
- ELF does not provide a reasonable balance under a range of oil prices
- ELF does not provide a sufficient incentive for re-investment

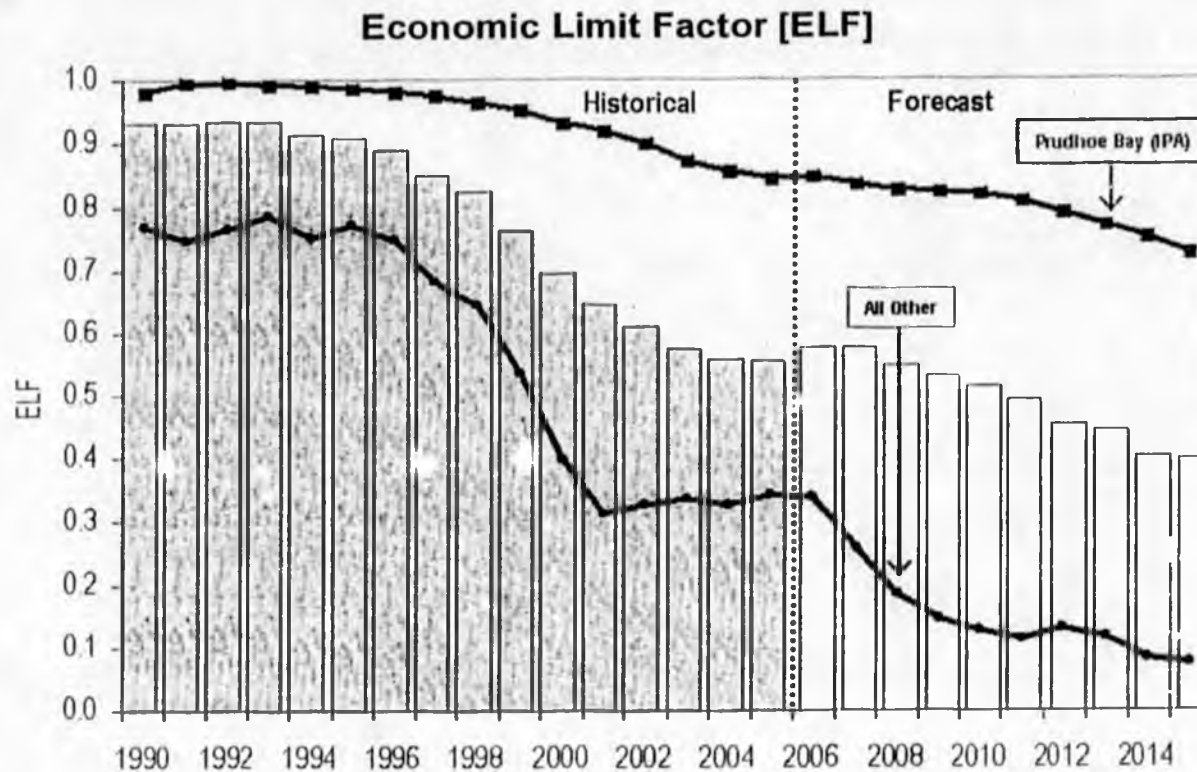
# CURRENT PRODUCTION TAX

ELF is declining faster than production in some fields.



# CURRENT PRODUCTION TAX

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# PROFIT SHARE CONCEPT

The Governor proposes a profit sharing production tax ("PPT") which is a complete replacement of the current ELF based version of the production tax on oil and gas.

The PPT will be a law of general application.

# PPT

The PPT is calculated as a tax rate multiplied by the corporate cash flow from production in Alaska from oil and gas, with tax credits to encourage investments.

It is a consolidated tax at the corporate level.

# PPT

The cash flow is calculated as:

Gross production revenues (net of royalties) based on wellhead prices, less the producer's lease expenditures:

- oil and gas capital expenditures (excluding the main pipeline)
- oil and gas operating expenditures
- property taxes

# PPT

There will be tax credits to encourage investment based on a percentage of the amount of the investment

Losses in any year can be converted to tax credits by multiplying the amount of the loss with the tax rate.

Tax credits can be transferred and traded

Explorers and independents will be able to monetize part of their investments immediately, thereby strongly encouraging exploration.

# PPT

Another important purpose of the tax credits is to create a progressive tax.

Progressive taxes can be created in different ways: tax credits, uplifts, IRR payout systems, sliding scales, etc.

Tax credits were selected as the mechanism for the PPT because this is most advantageous to explorers and new entrants.

# PPT

There will be features to provide a favorable tax structure for explorers and independents and encourage exploration and new entrants.

# PPT

The proposed PPT:

- Is based on actual economics and generates tax when there are reasonable profits
- Provides a reasonable balance between the State and producers over a wide range of oil prices
- Strongly encourages investment and re-investment in the State.
- Protects and encourages explorers and independents

# PPT Rate

The PPT tax rate and the tax credit rates will be proposed in the near future.

General principle is that the overall revenues to the State must be significantly higher at today's prices.

At low prices, the state revenues will be less than the current system, which provides a fair adjustment relative to market conditions.

For average prices, companies making low levels of investment will pay significantly more than the current system, while strong investors will pay an amount that could be less, depending on level of investment.

# International Experience

The PPT is a profit based system. There are two ways in which profit based systems are implemented around the world:

- Based on taxation systems paid in cash (similar to the PPT):

These are in use in more than 25 jurisdictions

- Based on production sharing systems

These are in use in more than 50 countries.

The large oil companies, including those operating in Alaska, work in many of these countries.

# International Experience

Examples of taxation based systems similar to the PPT proposal:

Algeria, Australia, Bolivia, Brazil, Canada (Alberta, Newfoundland, NWT), Denmark, Namibia, Norway, PNG, Saudi Arabia, Senegal, Thailand, Trinidad&Tobago, Tunisia, United Kingdom and Venezuela.

# International Experience

Examples of production sharing systems:

Angola, Azerbaijan, China, Egypt, India, Indonesia, Kazakhstan, Libya, Malaysia, Nigeria, Qatar, Russia, Vietnam and Yemen.

# PPT and Resource Development

The enhanced incentives to invest in exploration and development through the PPT as well as the gas line investment will create a new environment whereby Alaska will be considered by many petroleum companies a new core area for petroleum investment and increased oil and gas production.

# Conclusion

The current ELF based production tax is completely outdated, is a regressive tax and is no longer in the interest of Alaska.

Therefore the Governor proposes that Alaska adopts a profits based system that will provide on average for a higher government take for Alaska. It is a progressive tax with a strong incentives for investment and exploration. It will attract new entrants to Alaska.