SB 2001

(FILE 8)

INSTATE GAS

& COOK INLET

TAX STRUCTURE

TAX EQUITY FOR GAS PRODUCTION FROM BASINS OUTSIDE OF COOK INLET AND SOUTH OF NORTH SLOPE

Need: Several basins south of the Brooks Range could provide natural gas for which would (1) help alleviate large, looming gas production shortfalls in South Central, (2) result in delivery of local gas to Interior communities, and (3) provide gas for local uses in rural areas. In particular focus is gas exploration activity in the Nenana basin which is stalled in large measure due to gas tax changes made by PPT in 2006. Discovery of gas at Nenana could result in gas delivery to the entire Railbelt, including South Central.

Remedy: Changes to current PPT or pending ACES changes which would extend Cook Inlet gas production tax treatment for in state uses of gas that could be produced from basins south of the Brooks Range such as Nenana, Copper River, Healy, Yukon Flats, Wulik, Holitna and onshore Bristol Bay. There would be no change to the tax on any possible oil production from these areas.

Background: Prior to the enactment of PPT in 2006 several million dollars were spent by Andex Resources, Usibelli Energy, Doyon, Limited and Arctic Slope Regional Corporation gathering over 200 miles of seismic and performing other work related to conventional natural gas exploration, mostly on State lands in the Nenana basin under an exploration license. The Nenana basin is located along the Railbelt southwest of Fairbanks and to the immediate west of the community of Nenana. Earlier exploration programs and work under the current exploration license indicate the potential for gas in amounts that could provide pipeline gas and gas fired power to Railbelt communities from Fairbanks to Anchorage. There are no discoveries of oil or gas in this basin.

Pending is a decision to drill a 10,000 foot exploration well. However, Andex, the majority partner and operator in the venture, has declined to invest further due in major part to the 22.5 % PPT tax rate on any gas produced at Nenana. In contrast, Cook Inlet gas is taxed until 2022 at a much lower rate. The project has been suspended for soon to be three winter drilling seasons: first in anticipation of tax changes in 2006, the fallout from PPT enactment in 2007, and now the pending ACES proposal which because of timing precludes a drilling decision for 2008.

Nenana is the only pending gas exploration project designed to serve South Central and Interior Railbelt communities with pipeline gas and new gas-fired power which would be taxed at 22.5%. Moreover, Department of Revenue officials acknowledge that North Slope export gas will need to be taxed at a rate of perhaps 10% or lower before a large diameter pipeline could be sanctioned.

The potential of the Nenana basin is substantial. Experts note that as much as 6 trillion cubic feet of conventional natural gas could be recovered there. Cook Inlet has produced about 7 trillion cubic feet since the early 1960s. Yet, the Nenana gas project has a very high exploration risk profile because it is in a "wildcat" basin. There has been no discovery or production. There is no pipeline or other gas related infrastructure and services in the area. These elements, when combined with existing tax treatment, have resulted in the loss of the project's majority partner. Efforts to attract new participants to the venture have been unsuccessful.

<u>Questions heard from Legislators, staff and the Administration</u>

Why expand Cook Inlet tax coverage to all areas south of the Brooks Range, rather than to Nenana only?
Basins such as Copper River and Yukon Flats also could provide gas to the Railbelt. The Brooks Range and the southern boundary of the North Slope Borough are demarcation lines separating the North Slope from the rest of the state. Expansion of Cook Inlet treatment up to either of these lines addresses the accepted principle that North Slope gas will need specific tax treatment, leaving the rest of the state with a different approach focused primarily on in state uses. Other basins south of the Brooks Range could provide gas to local communities and rural development for heating and power, such as Red Dog Mine (Wulik basin) and the pending Donlin Creek Mine (Holitna basin).

Would extension of Cook Inlet tax coverage be good tax policy if a "big" gas find with export potential was made in one of these basins?
Current Cook Inlet tax treatment has a limited life; it will sunset at the end of 2021. First drilling at Nenana could not start in all likelihood until January 2009. Exploration and development, if successful, would take several years, probably until 2013-2015, to find enough gas to justify a pipeline to serve a portion of Railbelt needs. Even if larger quantities were found, that gas would likely go to South Central to make up for accelerating production declines in Cook Inlet. The North Slope gas line would not be in place until 2016 or later, and space in that line will likely be taken up by North Slope gas for many years before there would be expansion possibilities---all after the 2021 sunset of the special Cook Inlet tax provisions. And, the Legislature can always change laws.

Regardless, the Nenana gas project, for example, is intended to provide gas to Alaskans. We believe this would be the case for anyone trying to develop gas in these other basins south of the Brooks Range and outside of Cook Inlet. There are at least two solutions to lingering concerns about a "big find" which might be exported out of state. They are: incorporation of a production "ceiling" provision at which each new basin would lose Cook Inlet tax treatment, or a simpler provision which grants Cook Inlet tax treatment solely to in state uses.

Didn't "new area" basins outside of Cook Inlet and the North Slope get an additional PPT benefit last year?
Yes. An additional $6 million/year credit is available for oil and gas. However, in most financial models the PPT rules of general application, including the extra $6 million credit, are not competitive with identical projects in Cook Inlet. To assure that the areas south of the Brooks Range are treated identically to Cook Inlet, the $6 million credit as applied to gas should be eliminated if Cook Inlet gas provisions are granted.

It is important to note that the $6 million credit is still a very valuable tool to attract investors to explore for oil in remote, unexplored places such as the Yukon Flats north of Fairbanks. The $6 million credit as it applies to oil should not be repealed.

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October 30, 2007

Representative Mike Doogan
716 W. 4th Avenue, Suite 320
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Re: FNG's regulatory status
Our File No. : 2102

Dear Representative Doogan:

I represent Fairbanks Natural Gas (FNG) in regulatory matters, including matters before the Regulatory Commission of Alaska (RCA). My client wishes to thank you for your interest and questions during the recent House Oil and Gas hearing on HB2001, and has asked me to provide additional information regarding FNG's regulatory status. You asked Rep. Ramras whether or not FNG is a regulated utility. His response was not entirely correct.

FNG is subject to RCA regulation, and operates pursuant to RCA Certificate of Public Convenience #514 in designated areas of Fairbanks. In 2003 the RCA approved a conditional exemption from rate regulation based on AS 42.05.711(d), which states, "The commission may exempt a utility, a class of utilities, or a utility service from all or a portion of this chapter if the commission finds that the exemption is in the public interest."

RCA Order No. U-02-048 determined that "FNG operates in a competitive market, and it is in the public interest to grant its petition for exemption. Economic regulation is not necessary under these circumstances." The RCA further stated, "We do not see the need to impress a rate cap on FNG, given the ease with which its customers can change fuels. We grant FNG's petition in Docket U-02-48 for exemption from rate regulation *with conditions*."

The conditions imposed on FNG by the RCA include:

- FNG is required to file informational tariffs with RCA before making any changes in rates.

- FNG cannot discriminate against customers who cannot switch fuels. These customers must be included in the same rate class with others who can easily switch, and must be charged the same rate.

- FNG must maintain a current tariff with the RCA through its informational tariff filings.

- FNG must notify its customers, at least one billing cycle in advance, of any rate changes. FNG's customers have considerably better and earlier actual notice of rate changes than customers of most other utilities.

- RCA will review filings for unreasonable discrimination between rate classes. The RCA staff does not "rubber stamp" FNG's filings, and has rejected tariff changes sought by FNG.

- FNG must file annual reports with the RCA.

The RCA has recently determined not to reconsider FNG's conditional exemption, but has made it clear that it may reconsider the exemption in the future.

This regulation issue is relevant to FNG's effort to deliver an alternative fuel source to Fairbanks and its intent to pass along to Interior ratepayers the benefits of the tax ceiling currently enjoyed by residents of Southcentral Alaska.

Again, thank you for taking the time to raise these issues. Given your extremely busy schedule in deliberating the complex PPT, we appreciate your attention to this critical matter for FNG and Fairbanks natural gas users. Please do not hesitate to contact us with any further questions.

Sincerely,

ROSE & FIGURA

Mark L. Figura

MLF/blc
cc: House Oil & Gas Committee; Interior Delegation

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ROSE & FIGURA ID:907-278-5948 OCT 30 '07 16:05 No.009 P.02