

SCOMM

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FISCAL NOTE

STATE OF ALASKA
2002 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: HB 220
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
 Title Oil and Gas Tax Credit BRU Revenue Operations
for Exploration and Development Component Tax Division
 Sponsor Representative Kott
 Requester House Oil and Gas Committee Component No. 2476

Expenditures/Revenues (Thousands of Dollars)

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

OPERATING EXPENDITURES	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

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

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2002) cost: 0.0

Check this box (X) if funding for this bill is included in the Governor's FY 2003 budget proposal: ☐

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

See Page 2.

Prepared by: Chuck Logsdon, Chief Petroleum Economist
 Division Tax Division
 Approved by: Larry Persily, Deputy Commissioner
 Agency Department of Revenue

Phone 269-1019
 Date/Time 3/1/02 6:22 PM
 Date 03/01/2002

FISCAL NOTE

STATE OF ALASKA
2002 LEGISLATIVE SESSION

BILL NO. HB 220

ANALYSIS CONTINUATION

This bill allows a tax credit of 10 percent of qualified capital investment and 100 percent of annual labor, seismic and associated service costs related to a corporation's qualified oil and gas exploration south of the Brooks Range. The credit would be applied against corporate income taxes (AS 43.20), and would be limited to 50% of a corporation's tax liability in any one year. The credit would only be allowed for oil reserves that produce less than 150 barrels of oil per day or for any gas reserves that produce any volume - large or small - of gas for sale and delivery.

The state oil and gas corporate income tax in FY 2001 brought in \$338 million. FY 2002 collections are projected at \$150 million, due to lower oil prices. If corporations were able to accumulate enough exploration and development credits under the legislation, the state's corporate tax revenue could be cut in half in any given year.

It is difficult to evaluate the overall revenue effect of a tax credit. If exploration activity leads to the discovery of new reserves that go into production, then the state would receive new royalty and production taxes that may or may not offset the revenue loss due to the tax credit.

The bulk of the oil and gas industry's current state corporate tax liability is from production of high-value oil on the North Slope, while the credit is primarily focused on the development of much lower-value natural gas reserves. Although most of the taxable oil and gas corporate income is earned north of the Brooks Range, only qualifying exploration and development expenditures south of the Brooks Range could be taken against total oil and gas corporate tax liability. For example, an oil and gas corporation that already has operations in Cook Inlet and the North Slope could, with enough qualifying expenditures, reduce its total oil and gas corporate income tax liability by 50%. Additionally, an oil and gas corporation that does not currently have any activities in Cook Inlet could buy into an existing Cook Inlet operation and thus qualify for the credits.

The key issue to tax credits is the extent to which the additional incentive is needed to make a project economic. The current law, AS 38.180(f)(5), already allows a specific royalty reduction to 5% on the first 35 million mcf of gas and 25 million barrels of oil produced from a number of Cook Inlet fields: Falls Creek, Nicolai Creek, North Fork, Point Starichkof, Redoubt Shoal and West Foreland. The commissioner of Natural Resources also has the ability to reduce the royalty rates on any field in the state for which the producers can demonstrate that it is necessary to make the production economic. Cook Inlet fields also currently benefit from a discovery royalty provision in AS 38.05.180(f)(4) and the ability to apply for an exploration incentive credit in AS 38.05.180 and AS 41.09.010.

This bill allows the credit without regard to the specific economics of development.

ALASKA STATE LEGISLATURE

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House of Representatives
House District 24

Sponsor Statement

HB 220

HB 220 creates a new income tax credit to encourage increased exploration and development of natural gas reserves, primarily in the Cook Inlet region. To qualify for the credit, operators must successfully drill and develop hydrocarbon reserves that produce gas for sale and delivery. The credit can offset no more than 50% of an operator's annual income tax liability and would be effective for a period of ten years.

The tax credit would amount to 10% of qualified capital investment for each year. For example, an operator who spends \$20 million in a given year successfully developing natural gas reserves would receive an income tax credit of \$2 million applicable up to one half of its income tax liability for that year. Credits in excess of 50% of the operator's income tax liability can be carried forward to future years. No credits will be given for dry holes or for development of crude oil reserves.

The Cook Inlet region continues to have great potential for additional natural gas production. However, the combination of high development costs and relatively low natural gas prices create a disincentive to drill for new gas reserves in this area compared to other places. By providing a credit for successful exploration efforts, more drilling will occur in Southern Alaska leading to much needed new natural gas reserves. This will benefit all residents and businesses at little cost to the state.

In addition to the benefit of developing new gas reserves, increased Cook Inlet drilling will also aid the general economic status on the Kenai Peninsula and in Anchorage. Moreover, increased tax revenue from additional hydrocarbon production should largely mitigate the fiscal impact of the proposed credit.

LEGAL SERVICES

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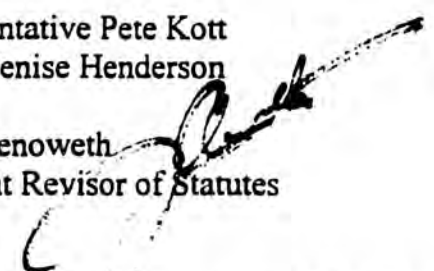
State Capitol
Juneau, Alaska 99801-1182
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MEMORANDUM

April 2, 2001

SUBJECT: House Bill 220, providing an oil and gas exploration and development incentive tax credit - sectional analysis (Work Order No. 22-LS0775\C)

TO: Representative Pete Kott
Attn: Denise Henderson

FROM: Jack Chenoweth 
Assistant Revisor of Statutes

The bill proposes to add, for a period of ten years before its repeal, provision for an oil and gas exploration and development incentive tax credit against the taxpayer's tax liability under the Alaska Net Income Tax Act (AS 43.20).

Bill section 1: This bill provision adds a new codified section, AS 43.20.043, that authorizes the credit and establishes its limitations:

-- subsection (a) authorizes the tax credit, applicable to any tax year beginning after 2001, against tax liability due under the Alaska Net Income Tax Act (AS 43.20); the amount of the allowable credit is based on 10 percent of the taxpayer's "qualified capital investment" (later defined) and 100 percent of the "qualified services" (also later defined) incurred by the taxpayer relating to a qualified capital investment;

-- subsection (b) sets parameters on what may qualify as a "qualified capital investment": those include cash expenditures or binding payment agreements made after December 31, 2001, for assets first placed in service during the tax year, as that phrase is defined in paragraph (2) of this subsection;

-- subsection (c) sets a maximum limit that may be claimed as a credit against the taxpayer's Net Income Tax liability: that limit is set at 50 percent of liability; expenditures that qualify for the credit in excess of the limit may be carried forward and applied in later tax years until exhausted or for not more than five years;

-- subsection (d) sets out the procedural requirements for claiming the credit and assigns the burden of proof for entitlement to the credit;

Representative Pete Kott
April 2, 2001
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-- subsection (e) sets out conditions on what may be done with a credit to which the taxpayer becomes entitled, under threat of forfeiture of any portion of an unused credit carry-forward;

-- subsection (f) imposes a geographic limitation on activity that may qualify for the credit: the credit is not available if an otherwise satisfactory "qualified capital investment" or "qualified services" associated with that investment occur north of 68 degree North latitude (generally, Alaska's Arctic Slope);

-- subsection (g) defines applicable key terms: it is within the definition that the substantive limitation of "property used . . . in the exploration and development of oil and gas reserves" is capped at production of oil of less than 150 barrels per day (though investment for recovery of gas for sale and delivery is set without limitation as to amount).

Bill section 2: This transitional provision is included so that a taxpayer, entitled by AS 43.20.043 to a full five-year period in which to claim as a carry-forward any unused portion of the tax credit, may make the claim on or after January 1, 2012, (the date set in **bill section 4** for repeal of the authority to claim the credit) until the earlier of the date on which any unused portion of the carry-over is exhausted or until December 31, 2016 (the day before the fifth anniversary of the credit's repeal). In other words, a taxpayer basing a claim of credit on qualifying improvements or services made as late as December 31, 2011, may have the full five years to exhaust its use.

Bill section 3 repeals the oil and gas exploration and development incentive tax credit.

Bill section 4 sets the effective date of the repeal of the credit at January 1, 2012.

Bill section 5, an effective date provision, gives the measure an immediate effective date.

JBC:glc
01-291.glc

Alaska State Legislature
House of Representatives

RULES COMMITTEE, CHAIR
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Memorandum

To: Rep. Scott Ogan
From: Rep. Pete Kott
Date: February 13, 2002

Regarding: HB 220
Oil & Gas Exploration Incentives

Attached to this memorandum is a copy of HB 220, relating tax incentives for oil and gas exploration. At this time, I would like to request a hearing in the Oil & Gas Committee, at the earliest opportunity.

If you need any more information, Linda Sylvester is the contact person for this item.



Representative Pete Kott

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**Testimony of John A Barnes, Marathon Oil Co, in
support of State of Alaska HB 220
House Oil and Gas Committee
March 5, 2002**

Good morning. My name is John ~~A~~ Barnes. I am the ^{Manager} ~~Business~~
~~Unit Leader~~ for Marathon Oil Company's Alaska Business ~~Unit~~.

Before I begin, I would like to extend the appreciation of Marathon Oil Company, as well as my own, for this opportunity to testify in support of House Bill 220.

- Bill structure -

Marathon Oil Company's Alaskan operations are focused on the Cook Inlet natural gas business. Last year we produced and sold 68.25 BCF, which is an annual average of 187 mmscfd. This production rate set a Marathon record for annual sales. While this is a significant production rate in and of itself, during cold spells in December of last year Marathon produced at instantaneous rates in excess of 300 mmscfd.

This is an accomplishment for which every member of our Alaskan business is extremely proud. I can tell you however, that this achievement requires not only the hard work of these Alaskans, but also ongoing investments in wells and infrastructure. Furthermore the regulatory and permitting environment also plays a key role in the ability to predictably bring projects ^{to production} ~~on~~ within budget, and on time.

Finally, and to no one's surprise, project economics are critical to getting projects approved. This is the area in which HB 220 can have the largest impact. Alaskan project economics are not only considered on their absolute merit, but they are also scrutinized on a relative scale in comparison to other worldwide opportunities in which Marathon ^{and other operators} may invest. The intent of HB 220 is to level the's playing field so to speak.

HB 220 is intended to provide an incentive to oil and gas development activities through an investment tax credit. Briefly,

under this bill qualified expenditures could be applied as a credit to offset future income tax liabilities. This credit could not be used to offset more than 50 percent of the taxpayer's tax liability.

Additionally, the term would be limited to five years.

To be effective for both the State of Alaska and the producer, the credit must act as an incentive to exploration and development activities. I'd like to talk briefly at this time about how HB 220 will impact Marathon, and presumably other producers, as we evaluate investment opportunities.

Speaking in regards to the Cook Inlet gas business, three issues impact investment decisions. These are resource base, market opportunities, and finally the price the gas can be sold for.

As most of you are aware, the Cook Inlet gas business is critical to the Anchorage and Kenai Peninsula economies. First, natural gas provides clean, cost-effective fuel to heat and light homes and

businesses. It also serves as an important feedstock for two industries, the Agrium fertilizer and Phillips/Marathon LNG plants. These businesses, provide important jobs as well as local taxes. I'd also like to mention that Marathon currently services over 60 percent of the local utility market and was the first producer which has sold to all three markets.

Over the last several years, several technical evaluations have been completed looking at Cook Inlet reserves and resources. The current Cook Inlet reserve base is ^{approximately 2,000} _____ BCF based on the latest DNR information. At an annual consumption rate of just over 200 ^{about 9-10} BCF per year, this is equivalent to _____ years of production. These reserves are considered proven, both developed, ^{which are capable of production} and undeveloped for which some additional work is required to bring them on production.

By local analogy, proven developed reserves are equivalent to :
"the fish is in the boat. You've weighed him, you can smell him, and you will eat him."

Similarly, proven undeveloped reserves may be typified by :

“the fish is on your hook by the boat and you are ready to net him.

You can tell how big he looks, but remember they look bigger in the water.”

I'd now like to discuss resources. *First I'll mention probable reserves.* These represent unproved gas volumes which engineering and geological data suggests are more likely than not to be recoverable. For the Cook Inlet, various State, Federal and other organizations have provided estimates. One such group is the Potential Gas Committee, which has estimated Cook Inlet probable reserves at 1050 BCF, or around five years of consumption at current rates.

A probable reserve definition could read:

“there are fish in the river. You may have caught some yesterday.

You may even be able to see them, but you have not caught any today.”

The final category to consider is possible reserves, which represents gas volumes which engineering and geological analysis suggest are less likely than probable reserves to be recovered. The same Potential Gas Committee has estimated Cook Inlet possible reserves at 2100 BCF.

A possible reserves definition could read:

“there is water in the river. Someone may have told you there are fish in the river. You have your boat on the trailer, but you may go play golf instead.”

In summary, technical analysis strongly suggests there are additional gas reserves in the Cook Inlet to explore for and to develop. Unfortunately, these reserves are more difficult to find, and more costly to develop. These risk and cost factors play against drawing investments to the Cook Inlet. But let me repeat myself, technical data supports the probability of finding additional Cook Inlet reserves.

The next area to consider in evaluating investments in the Cook Inlet is market. Although the Cook Inlet consumes a lot of gas every year, it is for all intents and purposes a closed market. At this time, no clear definition of available utility markets exists for

sales closer than 2009. This is a disincentive to investments.

In fact, a major world class producer has ^{recently} stated publicly they see the Cook Inlet gas market as closed, and do not plan to invest in it.

Some ~~However~~, producers may be willing to make investments for other non-utility market opportunities, or in speculation that utility opportunities may open up sooner. ^{But} Again, lack of market opportunities will serve to drive investment funds elsewhere.

The final area to consider in evaluating Cook Inlet gas opportunities is the price for which the gas may be sold. It is in this area where HB 220 may serve as an incentive. Historically, most Cook Inlet local gas sales are made at prices significantly below that which is received for gas in the lower-48. The most recent Enstar utility gas sales contracts however, are priced ~~at~~ ^{at or above} Lower-48 benchmarks, which are above Enstar's existing legacy contracts. These higher prices will help encourage new

ENSTAR has stated they used this price structure in recognition of the need to incentivize investments in the Cook Inlet gas industry.

investments to the Cook Inlet. Unfortunately not all producers can avail themselves of these prices. Additionally, some gas purchasers may not be able to pay these higher prices either. It is in this area where the impact of HB 220 must be carefully considered.

Let me walk through a scenario which encompasses the three areas I have touched on, those being resource, market and price.

If a producer looks at the Cook Inlet, he will evaluate his prospects of finding gas on a risk basis. Once he believes the risks are acceptable, he will look to the market. He will see that some market opportunities ^{may} exist, but probably not at the gas sales price he might receive if he spent his money in the lower-48 or elsewhere in the world. This is where HB 220 may swing his decision to send investment dollars to Alaska. Furthermore, if sufficient funds from multiple companies are attracted to Alaska, and the Cook Inlet specifically, sufficient gas reserves may be

found which may either attract new industries or create sufficient
competition to ^{ultimately} benefit consumers.

In summary, Marathon Oil Company believes HB 220 can serve as
a stimulus to maintain or even enhance Cook Inlet exploration and
development activities.

May I answer any questions.

-Fiscal Note