

Approved: March 8, 2005
Date

Carl Dean Holmes

MINUTES OF THE JOINT MEETING OF THE HOUSE AND SENATE COMMITTEES ON UTILITIES.

The joint meeting was called to order by Chairman Carl D. Holmes at 9:20 a.m. on January 18, 2005 in Room 526-S of the Capitol.

All members were present except: Representative Eric Carter - Excused
Representative Bonnie Huy - Excused
Representative Melody Miller - Excused

Committee staff present: Mary Galligan, Legislative Research
Jo Cook, Administrative Assistant

Conferees appearing before the committee:

Leo Haynos, Kansas Corporation Commission, Topeka, KS
Ed Cross, Kansas Independent Oil and Gas Association, Topeka, KS

Others attending: See Attached List

Chairman Holmes asked for bill introductions. Representative Sloan moved to introduce four committee bills. Representative Kuether seconded the motion. The motion carried. The four bills introduced are: 1) KCC authorized to participate in RTO decision making; 2) amend bifurcation statute to include 90 day regulatory schedule; 3) allow electric and gas utilities to earn on the investments in customer energy efficiency items (2004 HB 2518); and 4) a resolution urging the KCC to open a docket to require all electric utilities serving Kansas to belong to the same RTO.

Chairman Holmes welcomed Leo Haynos, supervisor of Natural Gas Pipeline Safety for the Kansas Corporation Commission, to the joint meeting. Mr. Haynos provided a power point presentation on the Kansas Underground Utility Damage Prevention Act (KUUDPA) (Attachment 1). He outlined the jurisdiction and requirements of the operators. Included in the testimony were photographs showing the results of accidents from improper excavating. Mr. Haynos told the committee that the real key to preventing accidents was communication between excavators and operators.

Edward Cross, Executive Vice President for the Kansas Independent Oil Gas Association (KIOGA), shared a power point presentation on The Kansas Energy Outlook - A Brave New World (Attachment 2). Mr. Cross shared the key energy issues for the state. He also explained the crude oil market structure and how the changing world economy and energy usage reflects on Kansans. Mr. Cross shared information on the industry's taxation structure in Kansas. Mr. Cross provided a copy of the Kansas Oil & Gas Industry strategic Analysis to the joint committee (Attachment 3). Mr. Cross responded to questions from the joint committee.

The meeting adjourned at 10:50 a.m.

The next meeting will be Wednesday, January 19, 2005 at 9:00 a.m.

**Kansas
Corporation
Commission**

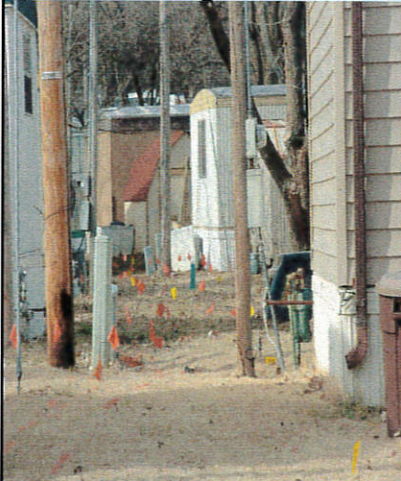


*Pipeline Safety
Section*

Kansas Underground Utility Damage Prevention Act (KUUDPA)

K.S.A. 66-1801 to 66-1814

**Kansas
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KUUDPA Jurisdiction

- **Excavators**
- **Utility operators**
 - Telephone
 - Cable TV
 - Electric
 - Gas
 - Hazardous Liquids

HOUSE UTILITIES

DATE: 1-18-05

ATTACHMENT 1

**Kansas
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KUUDPA Exempt Excavators

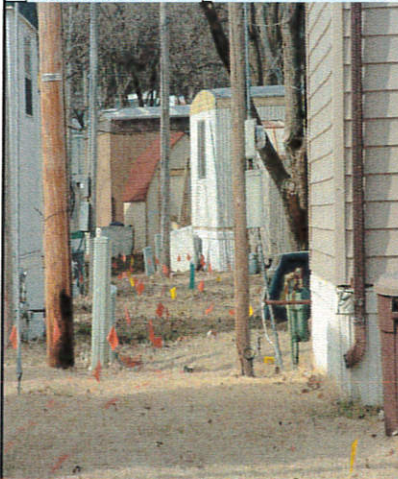


- Excavation related to oil & gas production.
- Excavation related to agriculture
- Excavation by Homeowners

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KUUDPA Exempt Operators



- Water Utilities
- Sewer Utilities
- Homeowners
- Oil&Gas production and gathering piping (outside city limits)

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KUUDPA Requirements



- **Excavators**
 - Call Before You Dig
 - Wait the Required Time
 - Dig with Care

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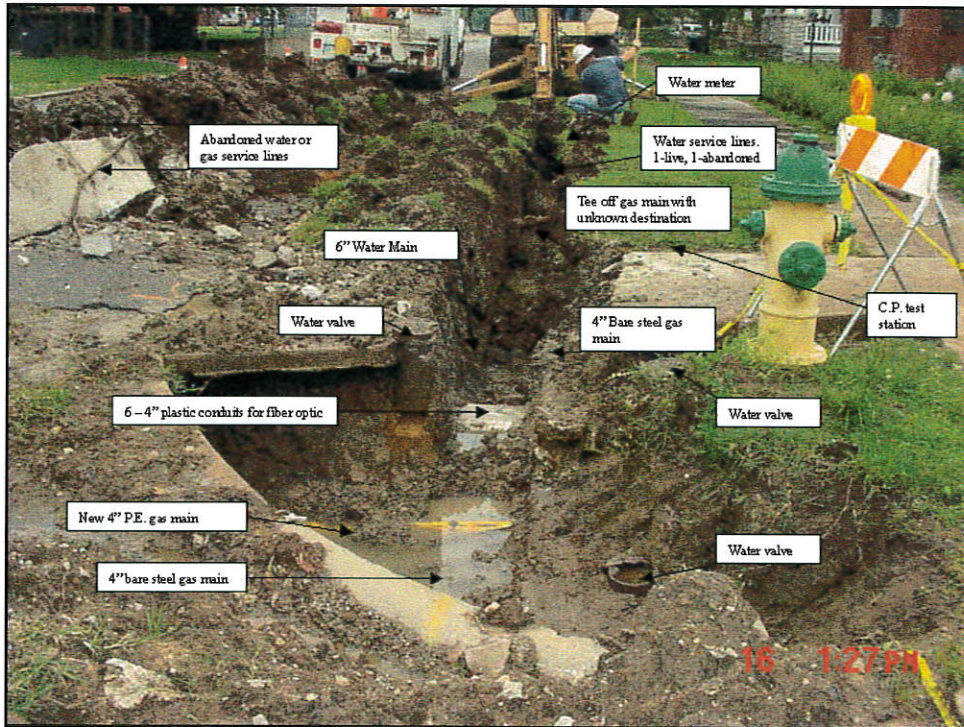
KUUDPA Requirements

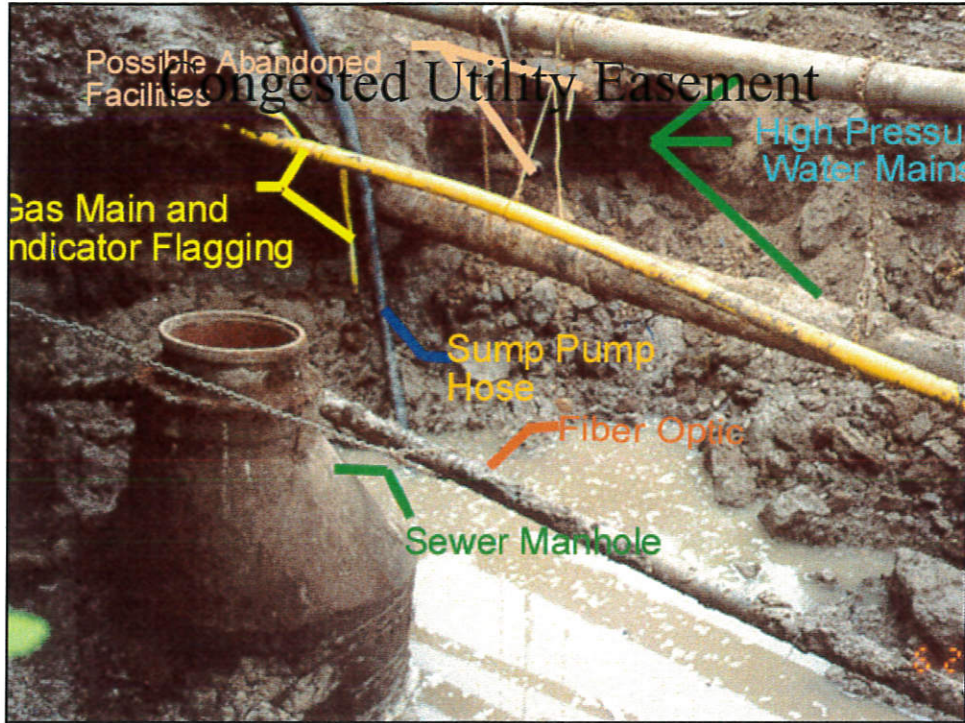


- **Utility Operators**
 - Participate in Call Center
 - Locate Facilities Within Allotted Time

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Kansas Corporation Commission

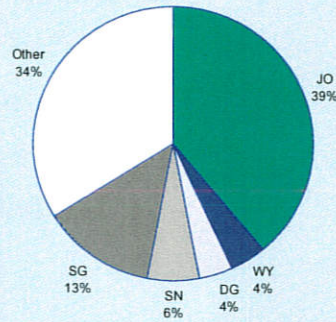
Pipeline Safety Section

Kansas 2003 Statistics

- 2.4 Million Locate Requests
 - (12 Million Utility Responses)
- \$4.3 Million Damages
- 6300 Damages Reported
 - 4200 telecom
 - 1800 natural gas

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Kansas Excavation Activity



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KCC Enforcement FY 2004



- **Complaint Driven**
 - 635 Complaints/Inquiries
 - 520 site inspections
 - 65 Noncompliances
- **Contractor Awareness**
- **KOC Operating Committee**

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KCC Enforcement

- **Johnson County Investigator**
 - 100% funding by OPS
 - Responds to damages
 - Writes non-compliances
 - Random inspections of locates

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Proposed KUUDPA Regulations

- **Under review by Dept of Admin.**
- **Projected Completion: July 2005**
- **Effective Date: January 2006**

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Proposed KUUDPA Regulations

- **Clarification of Statute Definitions**
- **Trenchless Excavator Operating Guidelines**
- **Operator Damage Reporting Requirements**

Trenchless Excavating

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HDD Driller's View

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Commission**






Kansas Corporation Commission

KUUDPA Summary

COMMUNICATION

Between excavators and operators

Pipeline Safety Section







DIG SMART

WE'RE COUNTING ON YOU!
Don't forget... Before you dig, get the scoop.

Your Logo Here

Dig Safely.
1-800-000-0000

The Kansas Energy Outlook . . .

A Brave New World . . .

Edward P. Cross, P.G., M.B.A.
Executive Vice President
Kansas Independent Oil & Gas Association
Joint Senate Utilities/House Utilities Committee Meeting
Topeka, Kansas
January 18, 2005

KIOGA

Key Energy Issues

- ▶ Fossil Fuels provide over 80% of U.S. Energy Supply
- ▶ Oil & Natural Gas will provide 65% of Domestic Energy Needs for next 20-25 years
- ▶ Alternative Energy Investments will not alter U.S. Energy Mix for Decades
- ▶ Oil & Natural Gas Core Component

KIOGA

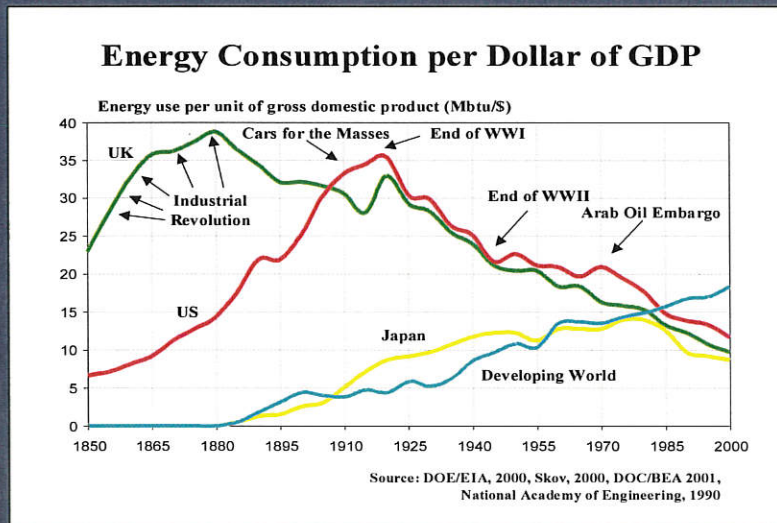
HOUSE UTILITIES
DATE: 1-18-05
ATTACHMENT 2

Key Energy Issues

- ▶ Independents drill 85% of wells in U.S.
- ▶ Independents provide 75% of America's natural gas supply
- ▶ Independents produce 60% of the crude oil in the lower 48 states
- ▶ 2003 NPC study said:
 - "Eighty percent of domestic natural gas production in ten years will come from wells yet to be drilled . . . Small, independent producers will drill most of these wells."

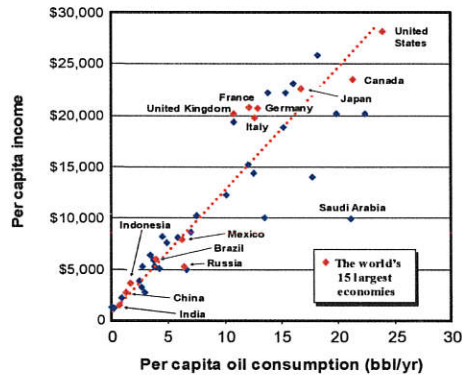
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Energy Intensity



Defining National Quality

Energy Consumption as an Indicator of the Wealth of Nations



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Kansas Oil & Gas Industry Statistics

- ▶ First Oil Well = 1860
 - Miami County
- ▶ First Natural Gas Well = 1873
 - Montgomery County
- ▶ Current # of Oil Wells = 40,850
- ▶ Current # of Gas Wells = 18,376
- ▶ Current # of Injection Wells = 15,428
- ▶ Current Total # of Wells = 74,654
- ▶ Current # of Operators = 2,113
- ▶ Current Oil Production
 - 33.961 Million Barrels Annually
 - 93,046 Barrels per Day
 - Ranked 8th Among 31 Oil Producing States
- ▶ Current Natural Gas Production
 - 423.03 Billion Cubic Feet Annually
 - 1.16 Billion Cubic Feet per Day
 - Ranked 7th Among the 31 Natural Gas Producing States
- ▶ Drilling Permits Issued in 2004 = 3,596
- ▶ Drilling Rate = 92%
- ▶ Number of Active Drilling Rigs = 65

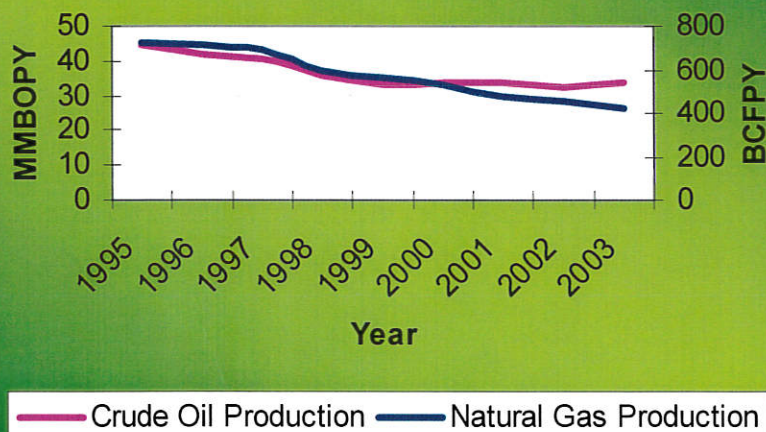
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Kansas Oil & Gas Industry Statistics

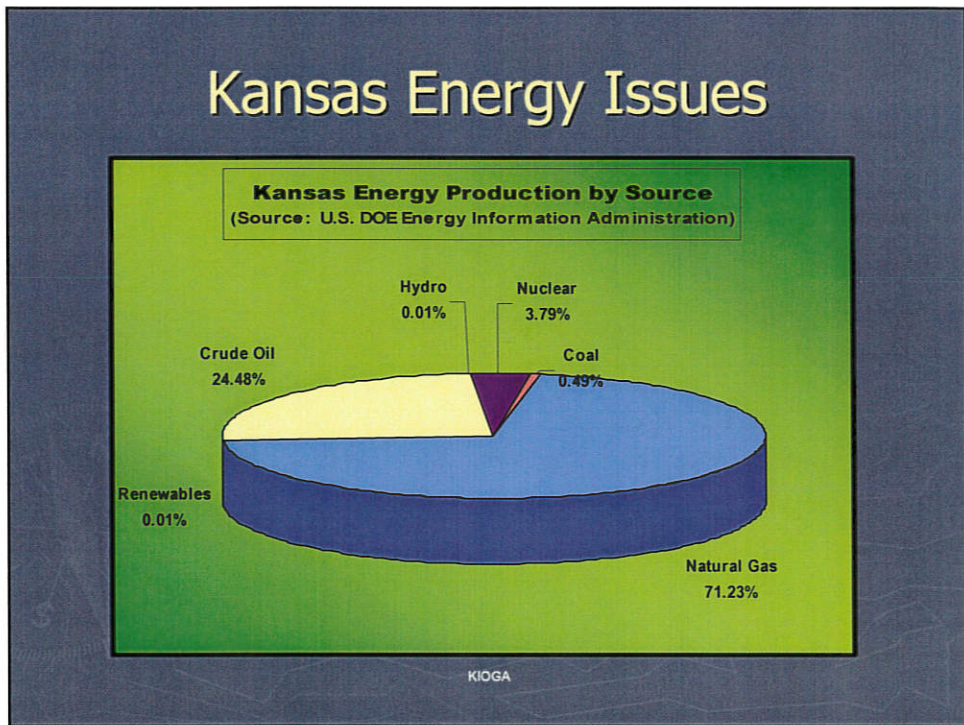
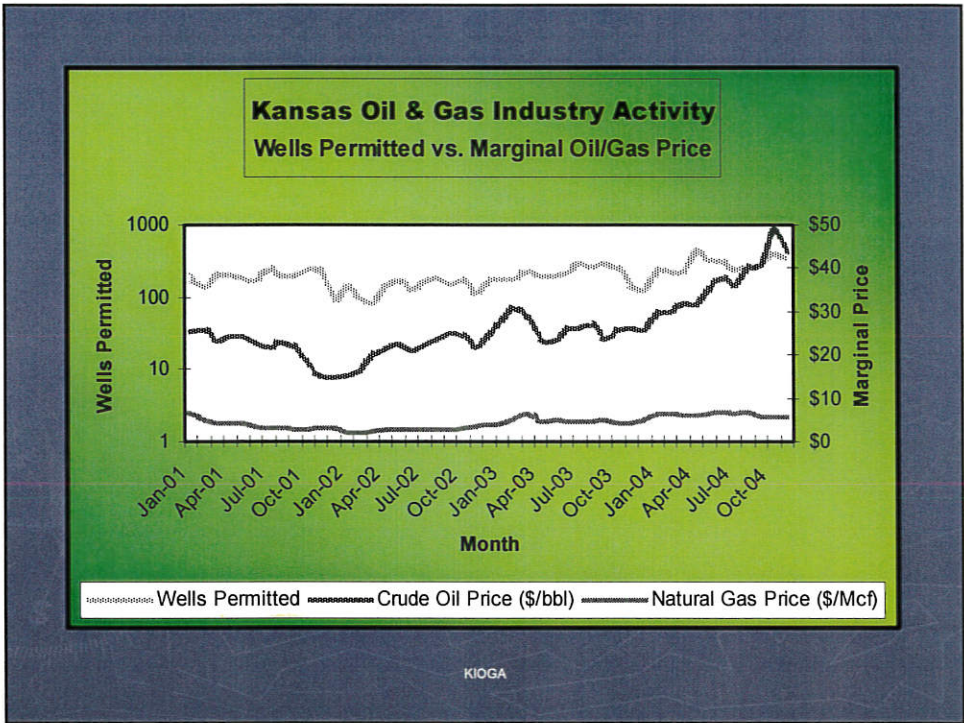
- ▶ Nearly \$3 Billion Industry
- ▶ 2nd Largest Kansas Industry
- ▶ Average Daily Oil Well Production = 2.27 BOPD
- ▶ Average Daily Stripper Oil Well Production = 2.09 BOPD
 - 74% of Total Kansas Oil Production from Stripper Wells
 - 80% of Total Oil Wells
- ▶ Average Daily Natural Gas Well Production = 63 Mcf/Day
- ▶ Average Daily Stripper Natural Gas Well Production = 32.8 Mcf/Day
 - < 1% of Total Kansas Natural Gas Production
 - 54% of Total Natural Gas Wells

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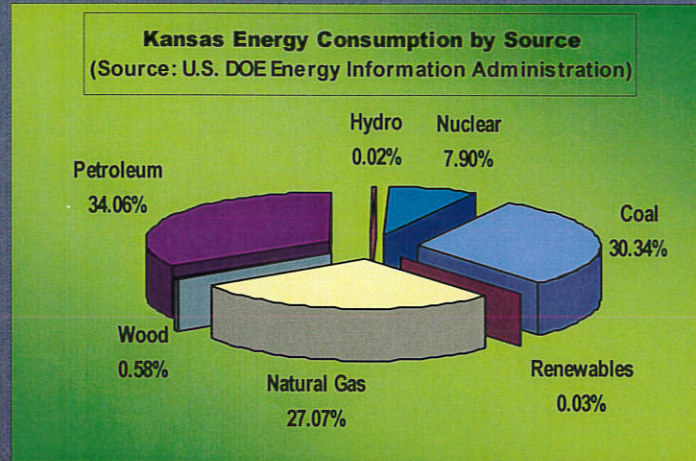
Kansas Oil & Gas Production



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Kansas Energy Issues



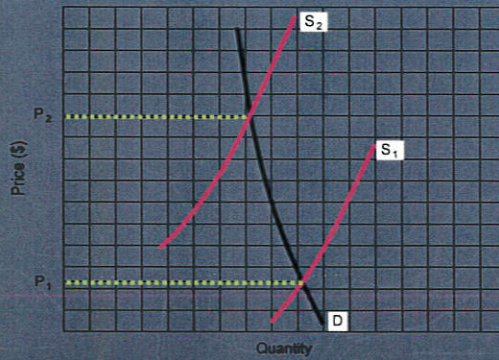
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Crude Oil Market Structure

- ▶ Oligopoly
 - OPEC Cartel Collude to Influence Market Prices
- ▶ Kansas Producers are Perfect Competitors
 - Price-takers not Price-makers
 - Cost Structure Optimization Determines Profit
- ▶ OPEC Supply Leverage Diminishing

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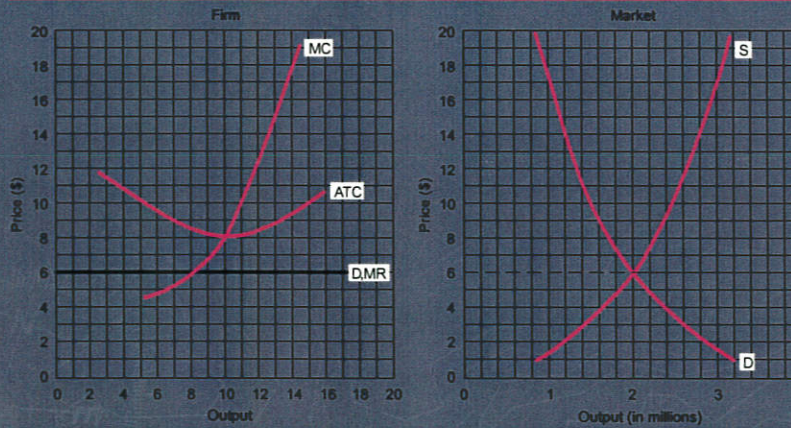
Withholding Supply to Raise Price



When supply is lowered from S_1 to S_2 , price rises from P_1 to P_2

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The Perfect Competitor

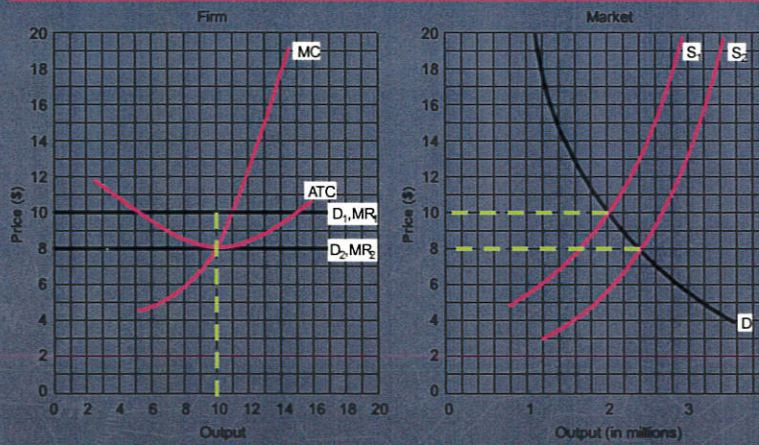


Kansas Oil & Gas Producers are Perfect Competitors

Price-takers not price-makers. Internal cost structure determines profitability.

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Effect of Supply Constraints on Perfect Competitor



Kansas Oil & Gas Producers Strive to Improve Operating Efficiencies in order to Realize Profit Maximization

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Kansas Oil & Gas Industry Statistics

Kansas oil was first discovered in the 1860's in Miami County. Today, more than 2,400 oil companies produce more than 58,000 wells in Kansas.

The Kansas oil and gas industry produces over 33 million barrels of oil annually.

-  **2 BOPD**
-  **NY Merc = \$45**
-  **Kansas = \$40.50**
-  **Royalties = \$6.08**
-  **Lifting Cost = \$16**
-  **Taxes = \$3.50**

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Typical Kansas Oil & Gas Property

	2005	2006
Gross Barrels	700	619.50
Net Barrels	595	526.60
Net Revenue	\$24,097.50	\$21,327.30
Operating Costs	\$11,200.00	\$9,912.00
Taxes	\$2,082.50	\$1,843.10
Net Profit	\$10,815.00	\$9,572.20
Net Present Value (NPV)	\$9,404.35	\$7,237.96

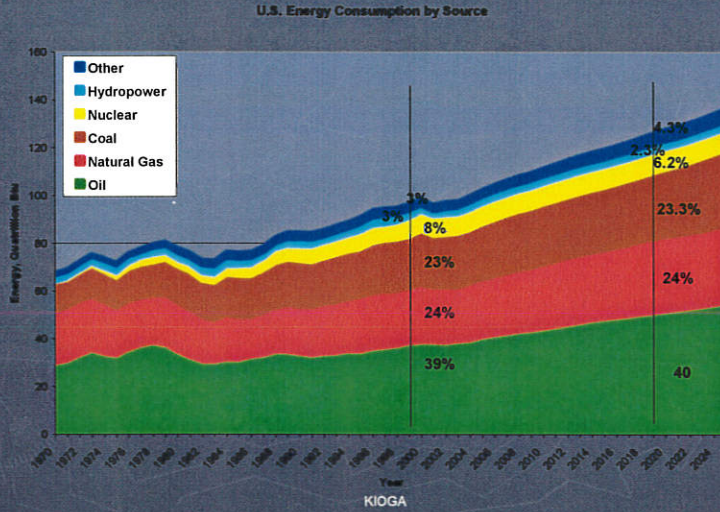
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New World Realities

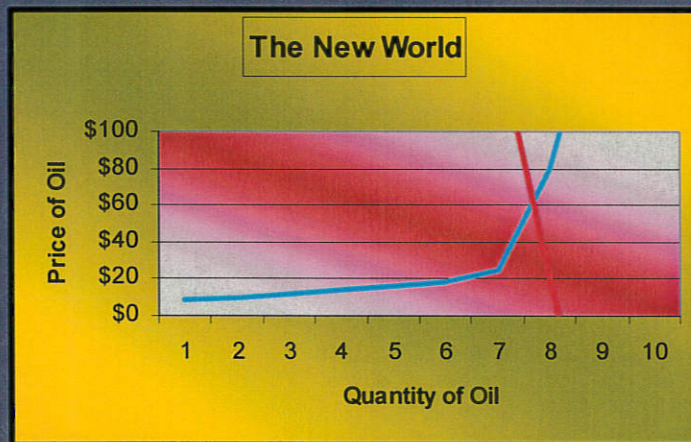
- ▶ OPEC and non-OPEC Reached Productive Capacities in the 1990's
- ▶ OPEC can Maintain Productive Capacity for 30-40 years
- ▶ Oil Prices will be Driven by Demand
 - EIA projects 1.6% Demand Growth through 2025
 - Chinese Oil Demand up 35% in 2004
- ▶ Future Oil Prices will be Demand Driven
- ▶ World Oil Demand Remains Inelastic
- ▶ World Oil Supply will become Increasingly Inelastic
- ▶ E&P Costs up more than 64% over last 4 years

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US ENERGY CONSUMPTION



OPEC Supply Leverage Diminishing



New World Realities

- ▶ Demand and Supply Inelasticities mean
 - When Demand Rises, Prices Rise Very High and Very Fast
 - When Demand Declines, Prices Fall Very Hard and Very Fast
- ▶ Kansas Oil Price Fluctuations could occur Very Quickly and Vary over a Wide Range
- ▶ Experts Project Oil Prices to range from \$38-\$40 per barrel in 2005 and \$42-\$43 per barrel in 2006.
- ▶ Experts Project Natural Gas Prices to be around \$5.50 per Mcf in 2005 and \$6 per Mcf in 2006.

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New World Realities

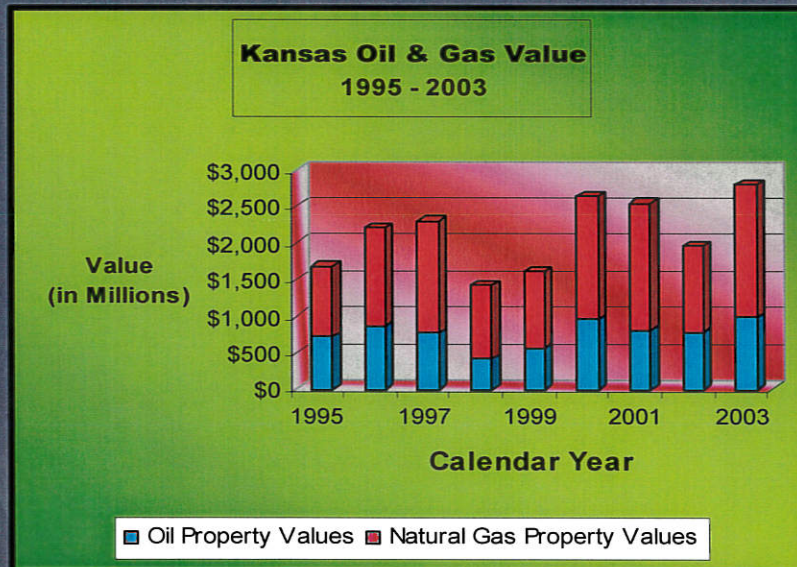
- ▶ Much Higher Prices will need to be seen before Demand Destruction becomes a Reality
- ▶ Consumer Conservation
 - 1970's = 5% of Total Household Income Spent on Gasoline
 - Today = 2% of Total Household Income Spent on Gasoline
- ▶ Alternative Fuels

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Kansas Oil & Gas Industry Taxation

- ▶ Contributes over \$192 million annually to State of Kansas in taxes
 - Support Families
 - Fund Schools
 - Build Roads
- ▶ Kansas Oil & Gas Producer taxed 5 times on each barrel of oil or Mcf of natural gas produced

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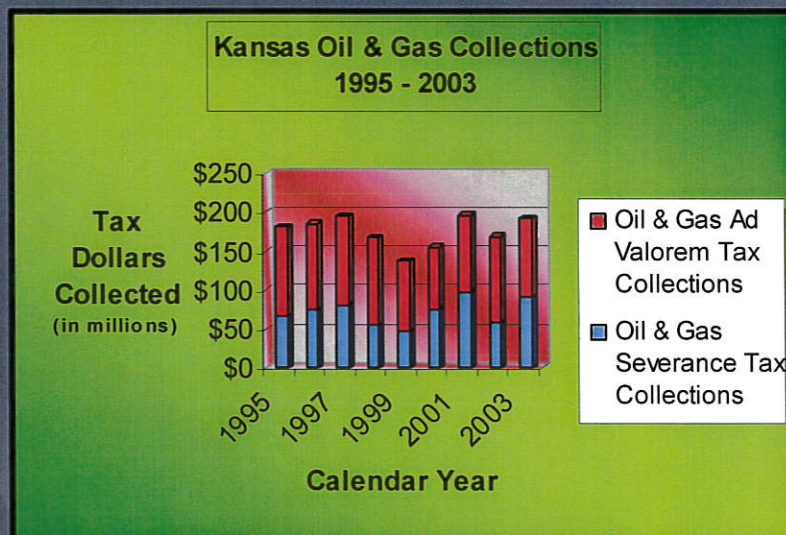


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Kansas Oil & Gas Industry Taxation

- ▶ Severance Tax
 - 4.33%
 - \$32.2 million more collected in 2003 than 2002
 - \$90.4 million collected last year
- ▶ Ad Valorem Tax
 - Equipment
 - Reserves
 - \$22.6 million more collected in 2003 than 2002
 - \$102.3 million collected last year

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Kansas Oil & Gas Industry Taxation

- ▶ Reduce ROI on E&P Investments by 26.5%
- ▶ Higher than 6 surrounding states
 - Marginal Tax Rate
 - Average Effective Tax Rate

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Kansas Oil & Gas Industry Taxation

- ▶ Need Policies to Enhance Access to Capital
 - Develop & Maintain Production
 - Raise Capital Through Production
- ▶ New Resources & Economic Development for Kansas
 - Carbon Dioxide (CO₂) Sequestration Potential in Kansas
 - ▶ Hugoton Field, Central Kansas Uplift, CBM Production Efficiency
 - More state, county, & local tax dollars
 - More state, county, local economic development

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Kansas Oil & Gas Industry Public Outreach Effort

- ▶ The National Petroleum Council Cited Public Image as the Number One Problem Facing Domestic Oil & Gas Industry
- ▶ KIOGA taking Proactive Approach
 - Public Relations Activities
 - Better Energy Education for Kansas Schools

KIOGA

Public Outreach Program Vision

Mission

Bring the vitality, contributions, and environmental responsibility of the Kansas oil and gas industry to light through positive action and education

Goal

Improve the image and credibility of the Kansas oil and gas industry

Objectives

- ❖ Public relations campaign designed to improve the image and credibility of the Kansas oil and gas industry
- ❖ Public education campaign to increase awareness about the significance and viability of the Kansas oil and gas industry

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Public Relations Activities

- ▶ Radio Advertising
- ▶ Outdoor Advertising
- ▶ News Media
- ▶ Civic Club & Professional Presentations
- ▶ On-Site Marketing
- ▶ Online Exposure
- ▶ Industry Workshops
- ▶ TV Advertising

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Energy Education Activities

- ▶ Better Energy Education for Kansas Schools
 - Curricula & Education Materials for Kansas Schools
 - Meet KSDE Learning Standards for Science & Social Science
 - ▶ KSDE Advocates for utility in Kansas Schools
 - Meet National Science Education Standards
 - Accredited in Part by the National Science Teachers Association & National Youth Leadership Council
- ▶ "Story of Petroleum" Education Series
 - Curricula, Lesson Plans, Educational Material, "Petro Pros", Posters, Coloring Books, CD's, etc.

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Energy Education Activities

- Teacher Workshops
 - "Fossils to Fuel" and "The Living Earth"
 - Assist educators in providing a model for collaborative learning using crude oil, natural gas, and energy issues

FOR MORE INFO...

Contact KIOGA at 785-232-7772 or visit website at www.kioga.org

KIOGA

Better Energy Education

- ▶ Focuses on Energy Value Growth
 - Optimize State Strengths
 - Minimize State Weaknesses
- ▶ Better Energy Education Produces
 - Better Energy Policy
 - Better Public Policy
 - Economic Growth

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KIOGA Education Programs



KIOGA

A Brave New World

Kansas oil and gas is good for Kansas, the economy, and the nation. Energy policy focusing on energy value growth will result in economic growth and demonstrate leadership in formulating sound energy policy.

Thank You

KIOGA

Kansas Oil & Gas Industry Strategic Analysis

PREPARED BY:

NOVEMBER 2004

Kansas Independent Oil & Gas Association
Edward P. Cross, Executive Vice President

Introduction

The Kansas oil and gas industry is a critical part of the Kansas economy. The Kansas oil and gas industry is nearly a \$3 billion industry that puts tens of thousands of people all across Kansas to work each day and pumps hundreds of millions of dollars into the state's economy each year; money that helps support families, fund schools, and build roads. The oil and gas industry ranks just below agriculture as the most significant Kansas industry in terms of gross state product.

The average oil and gas producer in Kansas employs 3 people and spends nearly \$2 per barrel of oil pro-

duced on environmental protection. Over 2,400 licensed oil and gas producers produce over 33 million barrels of oil annually and over 440 billion cubic feet of gas annually. Nationally, Kansas ranks 8th among the 31 oil producing states and 7th among the 31 gas producing states.

Oil and natural gas are an integral part of our society. Much of our high standard of living can be traced to the use of petroleum. Today, an estimated 6,000 products are produced from petroleum. Among these products are many types of transportation fuels, industrial fuels and chemicals, lubri-



**Kansas Oil & Gas
Energy for the Future**

cants, waxes, fertilizers, pesticides, photographic film, cosmetics, plastics, medicines, and more. The Kansas oil and gas industry does more than fuel Kansas and help the Kansas economy. The industry fuels America and makes significant positive contributions to our way of life!

Special points of interest:

- *Oil & Gas 2nd largest Kansas Industry in terms of gross state product*
- *Fundamental supply challenges face policymakers*
- *Oil & Gas Producers need Policies that enhance access to capital*
- *Oil & Gas constitutes 95.7% of Kansas' Energy production*

Inside this Report:

Natural Gas Challenge	1
Oil & Gas Industry Taxation Analysis	2
Taxation	3
Taxation	4
Kansas Energy Outlook	5
Key Energy Issues	6
Key Energy Issues	7

Challenges Facing Policymakers and the Natural Gas Industry

The high prices & concern over natural gas supply is an adjustment as natural gas moves from a commodity of relative abundance to one of relative scarcity. Low income individuals & families dependent upon gas for heat, as well as industrial end users dependent upon gas to create their products are hardest hit. Adjustments can already be seen as natural gas well drilling has increased & tremendous investment has begun in alternative energy sources.

New drilling, conservation measures, arctic pipeline projects, and alternative energy sources will not alleviate the supply shortfall in the immediate future or even within the next 3-5 years. Natural gas will remain the cheapest and most efficient energy source. Given the entrenched dependence upon natural gas for power generation needs, projections indicate investments being made now in alternative energy

sources will not alter the U.S. energy mix in significant ways for more than a decade. The fundamental supply challenge affects the oil & gas industry and policymakers. Competition between investments in alternative fuels, demand discouragement, and new natural gas supplies creates a significant challenge for policymakers in natural gas producing states, like Kansas. Policymakers in natural gas producing states should hope that new natural gas supplies win.

HOUSE UTILITIES

DATE: 1-18-05
ATTACHMENT 3

Kansas Oil & Gas Industry Taxation Analysis

The Kansas oil & gas industry contributes over \$192 million annually to the State of Kansas in taxes. These tax dollars come from oil & gas producers and royalty owners. We are happy to pay our fair share but also believe we are a highly taxed industry. Calendar year 2003 saw the oil and gas industry pay \$90.4 million in severance taxes and \$102.3 million dollars in ad valorem taxes. FY 2005 ad valorem taxes are sure to increase with assessed values for oil properties increasing by 25% and natural gas properties increasing by 39%.

According to production data provided by the Kansas Department of Revenue, total gas production in Kansas has declined by an annual average of 5.1% over the last 8 years and oil production has declined by an annual average of 2.4% over the same period. However, total oil production actually increased in 3 of the last 4 years including last year's 1.3 million barrel increase. Generally, as production declines, so too does tax receipts. However, marginal oil and gas prices have increased in the last 4 years and this increase in marginal prices have more than offset the decline in production in terms of taxes collected. Marginal gas prices have increased by

25.6% over the last 3 years and marginal oil prices have increased by 20.9% over the last 3 years. As a result, the Kansas Department of Revenue reports that Kansas collected \$32.2 million more in oil & gas sever-

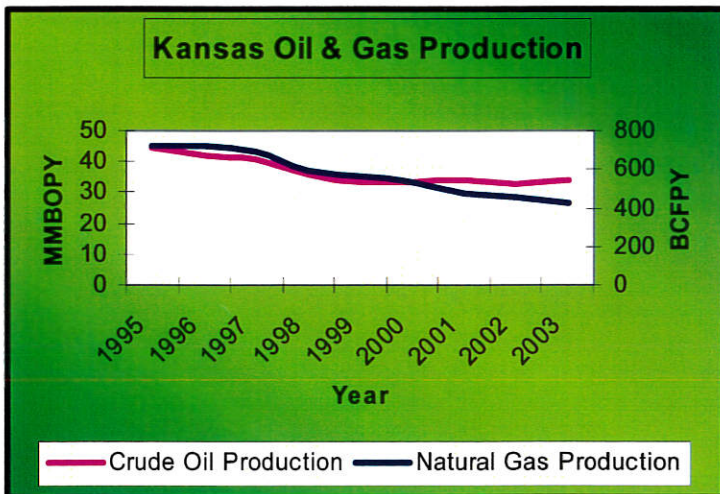
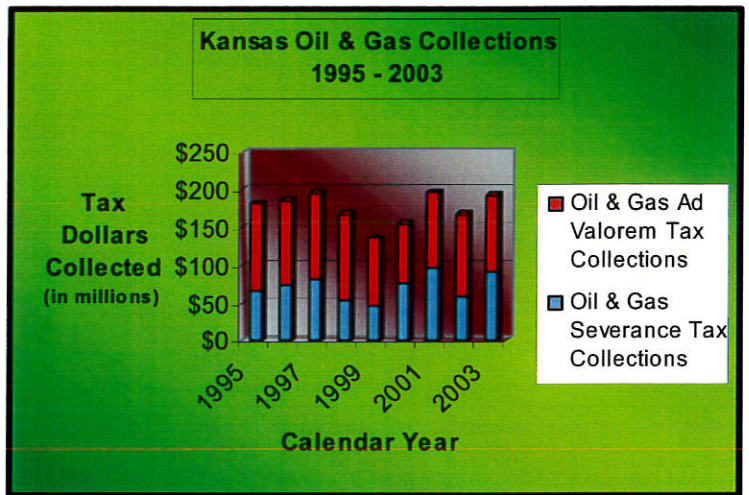
ance tax receipts in calendar year 2003 than in calendar year 2002 and \$14.6 million more in calendar year 2003 than in calendar year 2000. Kansas also collected approximately \$22.6 million more in oil & gas ad valorem tax receipts in calendar year 2003 than in calendar year 2000.

The relative tax burden on the Kansas oil and gas industry can be illustrated in three ways: marginal tax rate, discounted cash flow analysis, and finally the average effective tax rate.

Marginal Tax Rate

The marginal tax rate for the Kansas oil & gas industry is a measure of the taxes paid on an increase or decrease in the marginal price of oil and gas expressed as a percentage of revenues. A study conducted by Arthur D. Little, Inc. for *Kansas Inc* in 1990 on marginal tax rates remains relevant today. The *Little* report compared marginal tax rates in Kansas with 6 other oil & gas producing states (Colorado, Oklahoma, Texas, North Dakota, New Mexico, and Illinois). The marginal tax rate includes the combined effect of severance and ad valorem taxes on new primary production. Kansas' marginal tax rate on new primary production is 9.5% for oil and gas. Kansas marginal tax rates for both oil & gas production are higher than all the other 6 states. No state is as

high for either oil or gas. New Mexico and North Dakota are close to the Kansas level for oil production (9.0% and 8.9% respectively), but are considerably lower for natural gas (5.0% and 8.9% respectively). Illinois, the state most comparable to Kansas



new primary production. Kansas' marginal tax rate on new primary production is 9.5% for oil and gas. Kansas marginal tax rates for both oil & gas production are higher than all the other 6 states. No state is as

in terms of oil producing characteristics, has the lowest marginal tax rate at 1.3%.

Discounted Cash Flow Analysis

The discounted cash flow analysis evaluates the impact of taxes on the economics of specific investments over their entire life. For the oil and gas industry, the analysis is helpful in gauging the effect of taxes on new exploration and production investments. The *Little* study of 1990 remains relevant today. *Little* developed economic characteristics of several typical Kansas exploration projects and performed a discounted cash flow analysis of each under the various state tax systems of the six comparable states. An analysis using current economic characteristics corroborates the 1990 findings. The impact of state taxes (severance and ad valorem) is to generally reduce rates of returns by 25%-35% for all states. The differential impact of one state tax system versus another was minor. For Kansas, state taxes reduce the rates of return on new exploration and production investments by an average of 26.5%.

3-2

Taxation Analysis (continued)

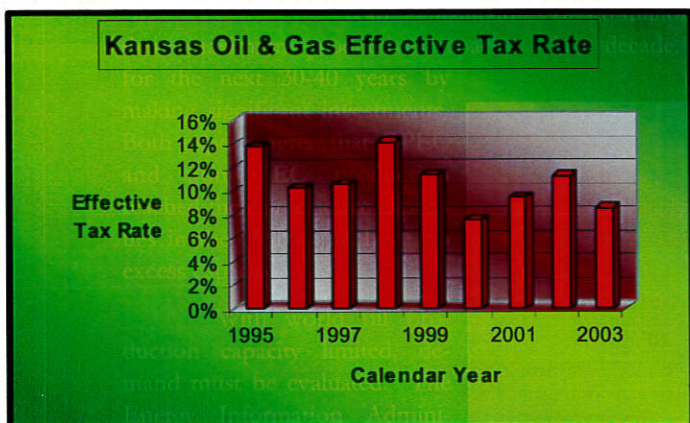
Average Effective Tax Rate

The average effective tax rate focuses on the total taxes paid in relation to total taxable value. The 1990 *Little* report defined the effective tax rate for Kansas at 9.7%, higher than Colorado, Illinois, New Mexico, Oklahoma, and Texas. The calendar year 2003 effective tax rate for Kansas was 8.63% and remains higher than most other oil & gas producing states. Different state tax systems greatly impact the average tax rate for the oil and gas industry. For example, the Oklahoma oil & gas industry pays a 7% severance tax and ad valorem taxes on equipment only, not reserves. On the other hand, the Kansas oil &

Henry Groppe, partner and founder of Groppe, Long, & Littell, a Houston-based consulting firm providing long-term forecasting, planning, and development for the energy industry said in August 2004 that tight supplies and high demand will keep oil and natural gas prices up for at least the next six years. Groppe said "It is no longer possible to find and produce enough oil in the world to supply the kind of growth rate you would have for oil at \$30 a barrel." Groppe pointed out that in constant dollars, oil reached \$80 per barrel before consumption was choked back in the early 1980's.

energy-to-GDP ratio, and more experience with energy price shocks. Dr. Brown projected oil prices to remain elevated, natural gas prices to remain high, and only a slight drag on the U.S. economy.

Energy market experts project oil prices to be around \$40 per barrel in 2005 and \$42-\$43 per barrel in 2006. Natural gas prices are projected to be around \$5.50 per Mcf in 2005 and \$6 per Mcf in 2006. Key to these projections are continued strong energy demand and demand growth. Events causing global or national demand destruction could reduce oil and natural gas prices considerably.



gas industry pays a 4.33% severance tax and ad valorem taxes on equipment **AND** reserves resulting in double-taxation of oil and gas reserves that leads to a 31% higher average tax rate than Oklahoma.

Oil & Natural Gas Prices

Crude oil & natural gas prices in Kansas continue to move upward. The Kansas oil & gas industry has worked through the tough markets of the past. Today, we enjoy the fundamental market growth and demand which has overcome the artificial market forces created by bad policy of the past. Many industry experts project oil & gas prices to continue to rise for years to come. In a presentation to the Kansas Independent Oil & Gas Association in August 2004, industry experts Henry Groppe and Dr. Michael Economides projected crude oil and natural gas prices to continue to rise.

Dr. Michael

Economides, a professor at Cullen College of Engineering at the University of Houston, corroborated Groppe's remarks. Economides based his projections on geopolitics. Economides calculated that the equilibrium price of oil was approaching \$30 per barrel, even after removing the ephemeral events

that effect the price of oil. He also said that demand destruction from alternative fuels, conservation, and other means will not touch emerging world demand.

In a separate presentation to the Independent Petroleum Association of America (IPAA) in October 2004, Dr. Stephen Brown, Director of Energy Economics at the Federal Reserve Bank of Dallas, spoke about oil and natural gas prices and the effect on the U.S. economy. Dr. Brown stated that OPEC has only about 1.5 million barrels of excess capacity and no longer have the ability to influence world crude oil prices through productive capacity. World demand now controls oil prices. Dr. Brown indicated higher oil and natural gas prices will result in only mild economic effects. Dr. Brown based his findings on the fact that real prices are not so high by historical standards, a reduced

Conclusions

Tax analyses indicate that Kansas taxes on oil and gas production are high relative to other states examined, and we are especially high considering the characteristics of the Kansas resource relative to most other states evaluated. Kansas oil and gas producers are taxed five times on each barrel of oil or Mcf of natural gas produced (severance tax, property tax on equipment, property tax on reserves, state income tax, and federal income tax). Kansas oil and gas producers pay considerably higher taxes as a percentage of revenue than most other oil and gas producing states.

The ad valorem tax structure has several features which are detrimental to the state's oil and gas industry and hinders economic growth in the oil and gas industry and the State of Kansas. Ad valorem taxes are levied based on ability to produce rather than actual production, resulting in very high taxes relative to revenues for some wells. In addition, ad valorem taxes vary county by county based on variations in local mill levies. Finally, ad valorem taxes encourage premature abandonment of oil and gas wells by applying a minimum tax to non-producing marginal wells, thus creating an incentive to plug and abandon such wells. Perhaps tax structure revisions are needed.

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Taxation Analysis (continued)

Policy Recommendations

Kansas oil and gas producers need policies that enhance access to capital to develop and maintain production. Tax reforms are particularly important for Kansas oil and gas producers. Independent oil and gas producers generate their capital through their production. We do not have the substantial additional resources possessed by many major integrated companies. Independents raise their capital through the wellhead, not by tapping equity markets or other corporate measures. Consequently, tax reforms that allow oil and gas producers to retain more of their revenues to reinvest directly translates into new resources and economic development for Kansas. Historically, independent oil and gas producers reinvest 100% of their cash flow into new projects. Kansas ad valorem tax collections have increased by more than 30% since FY 1999. Perhaps restructuring the severance and ad valorem tax structure would promote more economic growth for Kansas and more energy for our nation.

The Kansas oil and gas industry contributes over \$192 million annually to the State of Kansas in taxes. We are happy to contribute our fair share but, as pointed out, are a highly taxed industry. Perhaps restructuring the current severance tax structure could preserve the absolute tax dollars received by the State of Kansas while providing the incentives needed by oil and gas producers to

TAX REFORMS THAT ALLOW OIL AND GAS PRODUCERS TO RETAIN MORE OF THEIR REVENUES TO REINVEST DIRECTLY TRANSLATES INTO NEW RESOURCES AND ECONOMIC DEVELOPMENT FOR KANSAS

expand oil and gas development and create significant economic growth for Kansas. The current severance tax structure as defined in K.S.A. 79-4217 imposes an 8% tax rate on the gross value of all oil and gas severed from the earth or water. K.S.A. 79-4219 provides for a property tax credit in the amount of 3.67% for ad valorem taxes paid. Therefore, the effective severance tax on oil and gas severed from the earth or water in Kansas is 4.33%.

Independent energy industry experts and the U.S. Department of Energy predict oil and gas prices to continue to rise for many years to come. Oil and gas production in Kansas may decline over the next several years, but the decline in production will not effect tax receipts. Production decline will follow the law of diminishing returns, that is to say oil and gas production will decrease at a decreasing rate as oil and gas prices encourage more and more exploration and development. Perhaps the increase in marginal oil and gas prices will more than overcome the oil and gas production declines.

Now is the time to restructure the severance and ad valorem tax system to maintain absolute tax dollars received by the State while providing producers incentives to expand economic growth. Oil and gas ad valorem taxes have increased by more than 30% since FY 1999 and will continue to increase as marginal oil and gas prices continue to rise. Perhaps amending K.S.A. 79-4219 to increase the property tax credit from 3.67% to 4.5% will partially compensate the oil and gas industry for the 30% increase in ad valorem taxes paid. A property tax credit of 4.5% would make the effective severance tax rate 3.5% and allow producers to retain more of

their revenues to reinvest into more projects that generate economic growth for Kansas. Absolute tax revenues to the State of Kansas will not decline because of the increase in marginal oil and gas prices. Marginal gas prices have increased by 25.6% over the last three years and marginal oil prices have increased by 20.9% over the last three years. Credible analyses indicate marginal oil and gas prices will continue their rise for many years to come.

The ad valorem tax structure could be addressed directly. Only Kansas, California, and Texas assess ad valorem taxes on reserves. Other states assess ad valorem taxes on equipment only. Perhaps Kansas could restructure ad valorem taxes to eliminate the double-taxation of reserves. By assessing ad valorem taxes on equipment only, reserves would be taxed only once through the severance tax structure. An increase in the severance tax rate from the effective 4.33% to something around 6% could make up the difference between total taxes collected under the current ad valorem tax system of assessing equipment and reserves and the proposed ad valorem system of assessing only equipment. By eliminating ad valorem taxes on reserves, counties and companies will be able to greatly reduce administrative costs. The increase in severance tax receipts to the State's general revenue fund could then be allocated as seen fit back to the counties. Such a design would eliminate the need for counties to perform oil and gas property appraisals and greatly reduce complaints, all of which saves the State, counties, and companies time, money, and resources.

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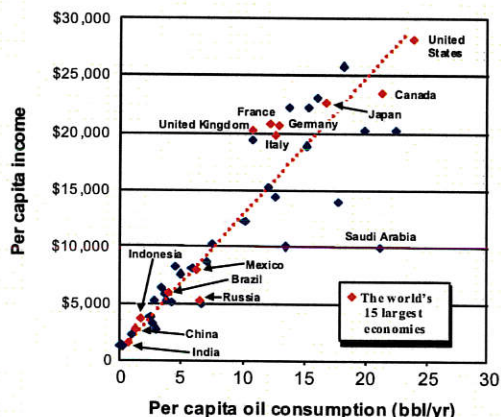
Kansas Energy Outlook & Key Energy Issues

Energy consumption in the U.S. is projected to increase 1.5% annually for the next twenty years according to the Energy Information Administration Annual Energy Outlook for 2004 (AEO2004). We must find new energy sources to maintain our standards of living. Energy intensity, as measured by energy use per dollar of GDP, is projected to decline in the U.S. at an annual average rate of 1.5% over the next 20 years according to AEO2004. The decline is projected from anticipated efficiency gains and structural shifts in the economy offsetting growth in demand for energy services.

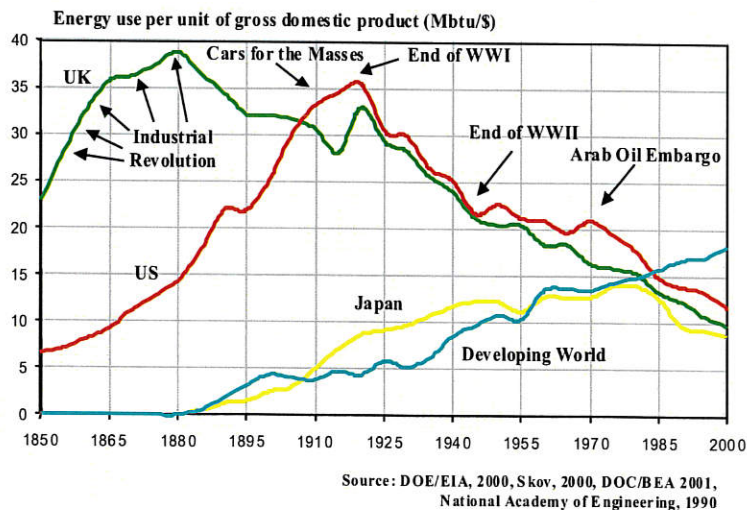
Energy experts Henry Groppe and Dr. Michael Economides recently made presentations to the Kansas Independent Oil & Gas Association addressing the key energy issues facing Kansas, the U.S., and the world over the next several years. Both experts are world-renowned for their knowledge on energy issues and have advised governments and companies worldwide on petroleum policy.

Dr. Economides said "The energy wealth and poverty of nations has replaced industrialization as the defining national quality." Economides uses linear regression to establish a clear link between per capita income of a nation and per capita oil consumption of a nation. The analysis verifies the relationship between the wealth of nations and oil consumption and suggests that measures to reduce a nation's oil consumption will also reduce a nation's standard of living. Credible analyses show that fossil fuels provide over 80% of the U.S. energy supply and that is projected to increase over the next decade. In addition, oil and natural gas will provide about 65% of domestic energy needs for 20-25 years into the

Energy Consumption as an Indicator of the Wealth of Nations



Energy Consumption per Dollar of GDP



future. Investments being made now in alternative energy sources will not alter the U.S. energy mix in significant ways for more than a decade. Oil and natural gas will remain a core component of the U.S. energy mix well into the future. Dr. Economides ruled out the potential for alternative energy forms to stem the demand for oil and gas. Economides related that oil was unquestionably the fuel of the 20th

century, but the world is now headed toward natural gas and eventually hydrogen. The transition to hydrogen will take some time. The energy content of other renewable fuels is less than the energy required to produce them. Hydrogen will eventually be produced from natural gas. Natural gas will be the energy of the future

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Energy Issues (continued)

Henry Groppe stated that Saudi Arabia reached the limit of its productive capacity in 1993 and that the outlook for oil production within the Organization of Petroleum Exporting Countries (OPEC) was not much better. OPEC production has been stable for over ten years. Saudi Arabia can maintain their maximum productive capacity for the next 30-40 years by making significant investments. Both experts agree that OPEC and non-OPEC production reached their productive capacities in the 1990's and have no excess capacity.

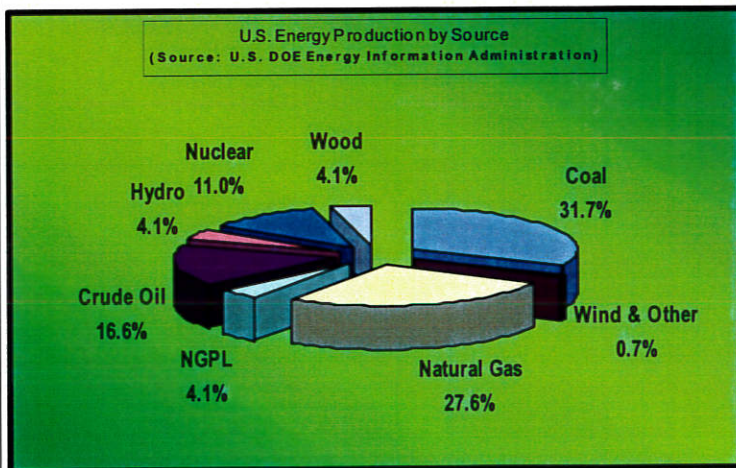
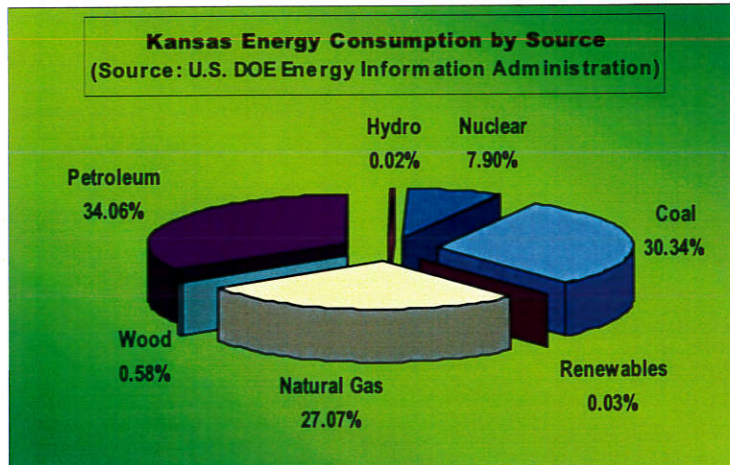
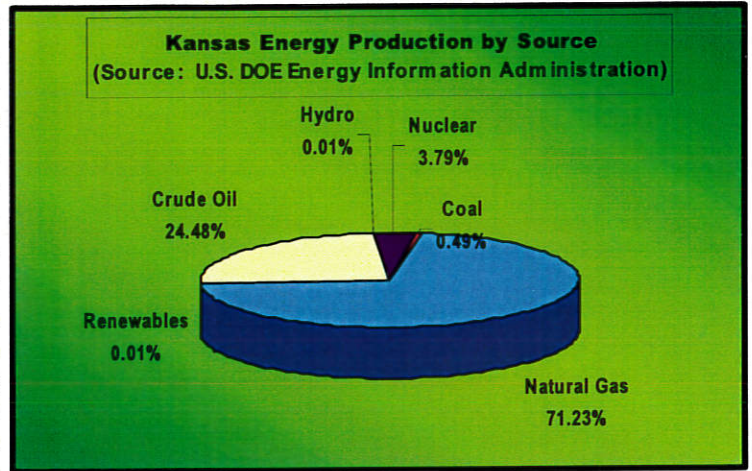
OPTIMIZING OUR STATE'S ENERGY STRENGTHS AND MINIMIZING OUR WEAKNESSES WILL BRING ECONOMIC GROWTH FOR THE ENTIRE STATE.

With world oil production capacity limited, demand must be evaluated. The Energy Information Administration projects world oil demand to increase by an annual average of 1.6% through 2025. However, both Groppe and Economides pointed toward China as a major player in demand growth. Chinese demand for oil has

grown by 2 million barrels per day over the past decade. The Chinese annual oil demand growth rate is by far the largest in the world, surpassing the U.S. oil consumption growth rate of 1.8 million barrels per day over the last decade. Economides said, "If

predicts China will be very assertive, if not belligerent in their posture as they seek the same energy supplies as the West. Energy will be the choke point for Chinese economic growth with their energy future passing through Russia. Groppe corroborates Economide's findings. A Groppe study

China were to consume the same per capita amount of oil that we use in this country, there would not be enough oil in this world to meet Chinese demand." China will increasingly compete with developed countries for energy supplies. Economides



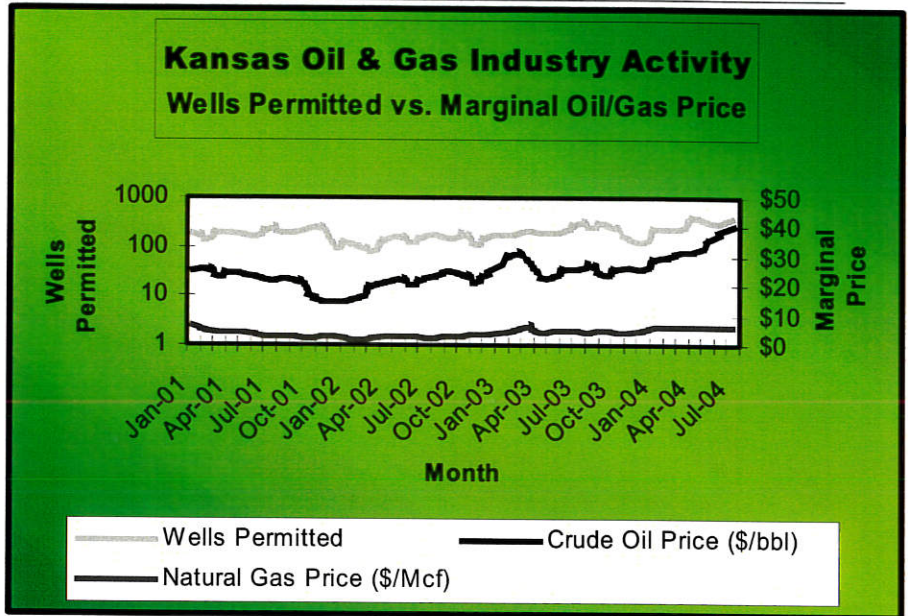
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Energy Issues (continued)

Long implicit as this may seem, my point is that Kansas is in a unique position. Demand for oil and gas will continue to increase for the foreseeable future and Kansas is sitting atop of vast resources. Since last year (FY 2004), the value of Kansas oil reserves have increased by 25% and natural gas value has increased by 39%. Oil and gas production rates may be declining, but independent producers and majors alike are not going to walk away from a \$3 billion asset anytime soon. Oil and gas production will continue to be a vital part of Kansas' economy for many decades to come. Demand destruction from renewable energies and conservation measures will not have a significant impact on oil and gas demand for decades.

The Kansas oil and gas industry is in a growth market with a large share of the State's gross product. A Boston Consulting Group strategic management matrix would classify the Kansas oil and gas industry as a "star".

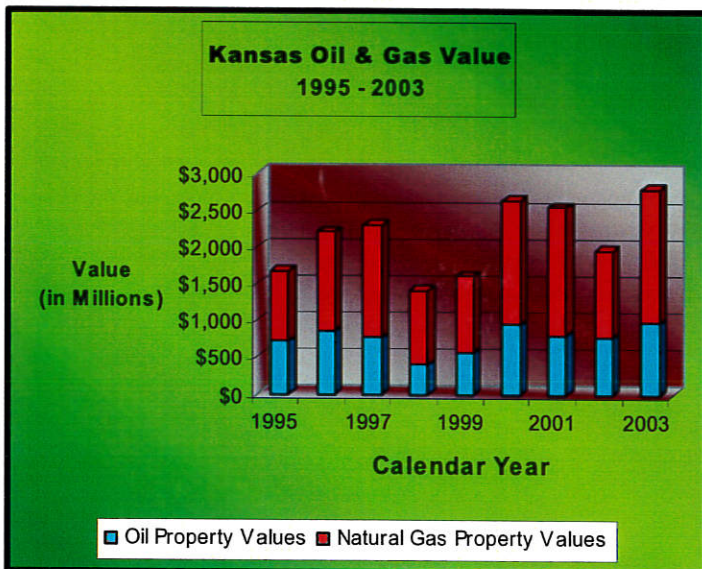
Kansas energy policy should focus on energy value growth. Realizing our strengths and leveraging our



energy efficiencies and intellectual capital to focus on what we do best will make a very effective energy policy. Our focus should be on optimizing energy efficiencies and putting our resources into the energies that optimizes our State's energy strengths and minimizes our weaknesses. Such a plan will bring economic growth for the entire State. Concentrating on energy export/import imbalances can prevent a prudent and effective energy policy from being developed. Kansas'

geothermal, and photovoltaics provide less than 0.01% of Kansas energy production. Fossil fuels account for over 91% of Kansas' energy consumption while renewables account for 0.03% of Kansas energy consumption.

Independent oil and natural gas producers drill 85% of the wells in the U.S. and are vital to the nation's energy supply. Independents collectively provide 75% of America's natural gas supply and produce 60% of the crude oil in the lower 48 states. According to the 2003 National Petroleum Council (NPC) Natural Gas Study, "Eighty percent of domestic natural gas production in ten years will be from wells yet to be drilled . . . Small, independent producers will drill most of these wells." The Kansas oil and gas industry is a vibrant and dynamic industry with over 2,600 wells drilled annually. Kansas oil and gas producers are environmentally responsible small business owners. Kansas oil and gas is good for Kansas, the economy, and the nation. Energy policy focusing on optimization of oil and natural gas production will result in economic growth, increased state revenues, and demonstrate leadership in formulating sound energy policy.



energy strength is oil and natural gas. Oil and natural gas production is the 2nd largest industry in the State. Oil and natural gas provide 95.7% of Kansas energy production while renewable energy like wind, solar,

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WE'RE ON THE WEB!

WWW.KIOGA.ORG

The oil and gas industry continues to face many challenges. Because of the efforts of KIOGA members, voters and policymakers in Kansas are learning that the oil and gas industry is working for them, the economy, and the environment. KIOGA is making a positive difference and creating value for the Kansas oil & gas industry. We have learned many things over the past. One of the most important things we have learned is that we can accomplish more than we realized was possible. We have only just begun to capture the value of the opportunities that our industry can create. We have elevated our expectations and truly believe our best performance is yet to come!

Kansas Independent Oil & Gas Association

Founded in 1937, the Kansas Independent Oil & Gas Association (KIOGA) is a nonprofit member organization representing oil and gas producers in Kansas, as well as allied service and supply companies. The purpose of KIOGA as stated in the original articles of incorporation, is “. . . to improve the market for oil and gas produced in Kansas and to promote the welfare of the oil and gas industry in the State of Kansas.” We are the lead state and national advocate for Kansas independent oil and gas producers. KIOGA represents the interests of the Kansas oil and gas industry at the local, state, and federal levels of government. We are committed to

ensuring that tomorrow's climate will be one in which our members grow and prosper. Our active presence before the Kansas Legislature, U.S. Congress, and state and federal regulatory agencies means the concerns of Kansas independent oil and gas producers are foremost in the minds of legislators and government officials. Our cooperative partnerships and networking with other state associations, the Independent Petroleum Association of America, (IPAA) and the Interstate Oil & Gas Compact Commission (IOGCC) means the concerns of Kansas independent oil and gas producers are heard in Topeka and Washington.

KIOGA's past successes have been due to the spirit and commitment of the Kansas oil and gas industry. That same spirit and commitment will carry us into the future. The Kansas oil and gas industry still faces many challenges. Today, KIOGA is well over 800 members strong. We believe we will achieve our goals because we have the human capital and corporate values essential for success.

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