Wyoming
PIPELINE AUTHORITY

DATE: September 26, 2007

TO: Joint Minerals, Business and Economic Development Committee

FROM: Wyoming Pipeline Authority

RE: Incentives to spur timely construction of natural gas pipeline export capacity are in the best interest of the State

Summary

Wyoming is undergoing one of the increasingly frequent intervals when natural gas pipeline export capacity is insufficient to serve the production demands of the Rocky mountain region. The lack of sufficient export capacity results in lower prices in Wyoming and correspondingly reduced royalty, severance and ad valorem tax revenue. As an example, during the month of September 2007, prices for natural gas produced in Wyoming are approximately 40% of the national price. The price of gas in Wyoming in September 2007 will be approximately $2.50 per mcf below the price in the State revenue forecast. The State should consider incentives to encourage commitments by third parties to the construction of additional pipeline capacity so that the magnitude and frequency of low price intervals are reduced.

Discussion

There are two dramatic examples of price improvements that accompany export pipeline expansion. The first is the Kern River Transmission (Kern) system expansion that went into service in May 2003. In the twelve months prior to this expansion the price of gas in Wyoming as reflected in the monthly index was $1.87 per Mcf below the national price. In the twelve months following this expansion of Kern, the price of gas in Wyoming improved to $0.77 per Mcf below the national price. The improvement in the price of Wyoming gas owing to Kern's expansion was $1.10 per Mcf. The second example is the pending expansion of the Rockies Express Pipeline (REX) that will be completed to the mid-continent region of the country at the end of 2007. Based on nine months of actual prices and three months of forecast prices, Wyoming gas is priced $2.78 per Mcf below national markets for the twelve months ending December 2007. For the twelve months following the anticipated completion of the REX expansion, Wyoming gas is priced in the forward financial markets at $1.56 per Mcf below the national price. The improvement in the price of Wyoming gas owing to the REX expansion is therefore approximately $1.22 per Mcf.

Analysis

The Wyoming Economic Analysis Division has estimated that every $0.10 per Mcf improvement in the price of Wyoming natural gas yields an additional $23 million in combined severance tax, federal mineral royalty and school foundation portion of ad valorem taxes for the State. Applied to the Kern and REX expansions, if these expansions had taken place just one year earlier, the added first year gross benefit to the State would have been $253 Million and $281 Million respectively.

During the Joint Minerals, Business and Economic Development Committee meeting held in June 2007, the WPA outlined a number of risks that attach to early commitments to pipeline expansions. These risks are generally driven by the long lead time between capacity commitments and the actual completion and availability of the capacity. These risks include but are not limited to errors in the assessments of individual company needs, errors in the forecast of the entire Rockies production base, permitting and environmental delays impacting production and the availability of drilling rigs and crews. As described in the June presentation by the WPA, once a commitment to expansion capacity is made, the contracting party is responsible for 100% of the fees in the contract whether or not the contracting party has any gas to put to the capacity. These non-refundable contract obligations inspire a very cautious approach to capacity commitments. Unfortunately for the State of Wyoming, the attendant delays in expansions can seriously impact the price of natural gas in Wyoming and consequently the revenues of the State. Owing to constitutional prohibitions, the State can not directly intervene to sponsor pipeline capacity as a means to serve its own interests in timely expansions.

Recommendation

The State sould adopt an incentive program to encourage earlier support for pipeline expansions. In particular, severance tax abatement should be offered during the first three years of any ten year or longer transportation agreement. The severance tax abatement would begin the first full month of operation of the expanded capacity. The abatement would apply on a monthly basis to the quantity of expansion capacity commitment. For example, if a party enters into a ten year expansion agreement for 30,000 Mcf per day of expansion transportation capacity, then that party or its assignee would be entitled an exemption of severance tax for 900,000 Mcf of gas in a calendar month that had thirty days. The incentive program would only apply to agreements meeting a definition of expansion capacity that are entered into on a binding basis during a twenty four (24) month window beginning October 1, 2007.

Based upon the price improvement observed in the Kern and REX expansions and using the average thereof, the benefit of a one year acceleration in the construction of export pipeline capacity would create a first year gross benefit of approximately $267 Million. Assuming a gas price of $5.00 per Mcf, a 6% severance tax rate and a capacity expansion of 500,000 Mcf per day, the three year value of foregone severance tax revenue would be $165 Million. **If the State creates an export pipeline incentive program, the net gain based solely on the price improvement in the first year less the three year cost of foregone severance tax collections would be $102 Million. If the incentive program caused an expansion to occur two years sooner than otherwise, the gross benefit would rise to $534 Million and the net benefit to $369 Million.**