



THE STATE
of **ALASKA**
GOVERNOR BILL WALKER

Department of Revenue

COMMISSIONER'S OFFICE

State Office Building
333 Willoughby Avenue, 11th Floor
PO Box 110400
Juneau, Alaska 99811-0400
Main: 907.465.2300
Fax: 907.465.2389

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Senator Cathy Giessel
1500 W Benson Blvd
Anchorage, Alaska, 99503

Dear Senator Giessel,

The purpose of this letter is to provide you with responses to questions asked of the Department of Revenue in a memo dated July 16, 2018 regarding the Alaska LNG Project. Please see the request in *italics* and our response immediately below the request.

1. *What is the role of DOR in this project? What is the detailed scope of work for the DOR.*

(a) Under SB 138 (2014), Revenue has the following roles:

- Finalize the report to the legislature on a proposed range of financing options (sec. 76(a)-(b)).

Sec 76 tasks the Department of Revenue to provide a report to the legislature on a range of financing options for state ownership and participation in a North Slope natural gas project. For each financing option, Revenue is to provide a risk analysis and impact to the state's bonding capacity and bond rating.

In January 2015, Revenue submitted to the legislature a draft interim report prepared by Lazard. That report is posted here:

<http://dor.alaska.gov/Portals/5/ALASKA LNG-PROJECT-LAZARD-INTERIM-REPORT-2015.pdf>

Under sec. 76(b) of SB 138, Revenue is required to finalize and submit the Lazard report to the legislature at the time that the Department of Natural Resources submits an agreement for legislative approval under AS 38.05.020(b)(11). If DNR determines that it will not have any agreements to submit for legislative approval, Revenue will finalize and submit the Lazard report shortly thereafter.

- Submit report to legislature on plan and recommended legislation to permit municipalities, regional corporations and residents to participate as a co-owner of North Slope natural gas project (sec. 76(c)).

Sec. 76(c) calls for Revenue to submit a report to the legislature on a plan and recommended legislation to permit municipalities, regional corporations and residents to invest as a co-owner of the State in the AK LNG project. Revenue is required to submit this report to the legislature at the time that the Department of Natural Resources submits an agreement for legislative approval under AS 38.05.020(b)(11). If DNR determines that it will not have any agreements to submit for legislative approval, Revenue will finalize and submit this report shortly thereafter.

- Re-engage Municipal Advisory Gas Project Review Board (MAGPRB) and annually report to Governor (sec. 74; AO 269).

Section 74 of SB 138 and AO 269 (<https://gov.alaska.gov/admin-orders/269.html>) provide for the establishment of a municipal advisory board (MAGPRB). The Board is staffed by the Department of Revenue and chaired by the Commissioner or Commissioner's designee. The Board is tasked with providing annual reports to the Governor on:

- Potential impact and benefits of new North Slope natural gas infrastructure on communities in the state, including consideration of tax structure under AS 29.45 and AS 43.56, as well as other payments before construction
- Recommendations for changes to oil and gas property tax under AS 43.56
- Recommendations for changes to oil and gas property tax under AS 29.45
- Recommendations for legislative or other options to minimize financial impact to communities affected by a North Slope natural gas project during construction
- Recommendations on impact and benefits to communities not in proximity to the North Slope natural gas project

The Board last met in February 2016. Its last report to the Governor is posted here: http://dor.alaska.gov/Portals/5/MAGPB/MAGP%20Board%20Annual%20Report%202015%20-%20FINAL%202_5_16.pdf:

The Department is in the process of gathering information regarding PILT practices on LNG projects around the world. The Department will also examine the work done to date on anticipated socio-economic impacts related to the Alaska LNG project. Once we have gathered additional information, the Department intends to re-engage the MAGPRB and submit a report to the Governor. The Department will also explore additional ways to engage with the municipal community on property tax/PILT issues. The Department anticipates that ultimately it will make a recommendation to state policymakers, including the Governor and Legislature, regarding PILT and property tax in connection with the Alaska LNG project. See p. 12:

http://www.akleg.gov/basis/get_documents.asp?session=30&docid=56857.

(b) Evaluation of opportunities outside of SB 138.

Outside of the tasks assigned by SB 138, the Department of Revenue will evaluate opportunities for State participation in AGDC capital fundraising. As we explained in our presentation, there are three capital pathways for funds for this project: appropriation of state funds, investment of state funds, and issuance of debt. Each pathway has a process and set of requirements that must be satisfied in order to access the funds. See p. 8:

http://www.akleg.gov/basis/get_documents.asp?session=30&docid=56857. In conjunction with any opportunity for State participation, the Department will provide analysis and advice to state policymakers, including the Governor and the Legislature, regarding use of these capital pathways to fund the Alaska LNG project.

With respect to investment of state funds, the Department of Revenue has statutory authority to manage and invest certain state funds under AS 37.10.070-.071 and AS 44.25.020. The largest funds under this authority are the Constitutional Budget Reserve (\$2.4B), the General Fund and other non-segregated investments (\$3.2B), the Power Cost Equalization Fund (\$1B). To the extent the Alaska LNG project presents opportunities to invest state funds, the Department will review the opportunity under its authorities and guidelines, including the prudent investor rule and the fiduciary standard of care. Note the majority of these funds are currently invested in fixed income securities because there's a relatively high need for liquidity and preservation of capital in order to meet near-term operating budget spending obligations.

In anticipation of an opportunity to review an equity look in FY 2019, the Department of Revenue may engage consultants with specific areas of expertise as needed. See p. 9:

http://www.akleg.gov/basis/get_documents.asp?session=30&docid=56857

2. Does the DOR plan on any legislative changes to relevant statutes for the next legislative session that is considered necessary for the progress of ALASKA LNG? If so, are those changes significant, either in the number of the changes or the magnitude of the changes?

At this time, Revenue has no legislative changes to propose. If appropriate, Revenue may instruct its consultant pool to analyze statutory issues within their area of expertise to make recommendations in this regard.

3. Does DOR have any analysis on the impact of ALASKA LNG on the State of Alaska's (SOA) net revenues? How much in net revenue is projected to the SOA if ALASKA LNG is built and operating?

There are two major categories of potential net revenues to SOA as follows: (1) net revenues to SOA not associated with any SOA investment in the Alaska LNG project, and (2) net revenues to the SOA resulting from SOA investment in the project, whether the investment is made via AGDC (a State-owned corporation) or from other sources of SOA capital. DOR is developing separate models to analyze each category of revenues and will be able to provide net revenue projections once the models are completed. An overview of each modeling effort is provided next.

- **DOR Upstream Model.** This model will utilize DOR's existing fiscal model to forecast net revenues to SOA from oil and gas royalties and production taxes as well as corporate income and property taxes. The model will compare long-term revenue projections for SOA for the case that the Alaska LNG project moves forward versus a base case of no project. The existing DOR fiscal model projections are based on oil production forecasts for each production unit, oil price forecasts, the structure of royalties for each lease, the structure of oil production taxes and tax payer expenditure forecasts. DOR is expanding this existing model to include gas production and pricing forecasts, and the structure of royalties and taxes applicable to gas. DOR is coordinating with DNR to identify data needs.
- **DOR Midstream Model.** DOR is developing a midstream model of the Alaska LNG project which will allow DOR to analyze the economics of the project and forecast net revenues to the State to the extent SOA is an equity investor in the project. DOR's consultant, Greengate LLC, is advising DOR on the development of the model and will provide an independent validation. The midstream model will allow DOR to evaluate the project from the perspective of the State as a potential equity investor. The model will allow DOR to analyze the basic economics of the project and the many factors that impact the project's economics. The model will forecast equity returns on invested capital as a function of project phase (pre-FID, post-FID/construction, post-construction/operation). The net

revenues to SOA will depend on several key factors including phase of project, amount invested and corresponding percentage of project's equity, tax-status of investment vehicle (pass-through vehicle or taxable corporation), exposure to construction cost overruns and manner of financing (debt vs. equity). DOR is making progress on the midstream model development and is coordinating with AGDC to ensure consistency of model input assumptions for the AGDC base case scenario.

4. What hurdles does the DOR see for ALASKA LNG to meet the necessary project milestones?

From DOR's perspective, the Alaska LNG project needs to be sufficiently developed before debt and equity financing can be secured. A key hurdle for the project is the lack of development capital needed by AGDC to complete the FERC regulatory approval process and complete the detailed engineering and design work (also called Front-End Engineering and Design or FEED). The FEED work is necessary to develop more accurate estimates of construction costs, operating costs and other critical aspects of the project's design which impact the economics of the project. Completing the FERC approval process and FEED work is necessary for the project to reach a positive final investment decision (FID). Attracting development capital, whether provided by SOA or third-party investors, will require AGDC to reach certain milestones such as binding terms and/or agreements governing gas purchases and LNG sales. DOR believes that overcoming these hurdles will require concerted and coordinated efforts across multiple State agencies, working closely with the legislature and other stakeholders.

5. What is DOR's role in the negotiations surrounding impact payments to local communities during construction of ALASKA LNG? What is DOR's role in the negotiations surrounding payment in lieu of taxes (PILT) arrangements and legislation?

See answer to question 1.

6. What are the types of internal systems controls that DOR is instituting in its modelling for the project and on the necessary inputs to the model?

DOR's development of the project model reflects the following financial modeling best practices and internal control procedures as follows:

- Input data tab generated using a standardized template that draws on original source data for capital costs and production profiles, and includes all input assumptions required by the model;

- User interface that allows user to enter alternative assumptions in specified data entry fields while locking/protecting other model elements from accidental changes by user;
- Calculations performed in a separate worksheet that imports all data and model inputs from input data tab and performs calculations in simple, step-by-step manner to allow easy validation;
- Internal audit checks using conditional formatting to allow model developer and validator to easily spot inconsistencies in calculation results;
- Model updates saved with new file name so that prior model versions are preserved;
- Independent review of model during development by two other reviewers;
- Cross-checking model results against AGDC's project model for base case scenarios and resolving sources of inconsistencies;
- Beta-testing of model by potential users and independent validation of model prior to releasing model for use and presenting results of model to decision makers.

In addition to ensuring the mechanics of the model are working properly, DOR will also be reviewing the reasonableness of input assumptions, drawing on expertise of outside consultants where appropriate.

7. What sort of risk assessment overview is the DOR using for its modeling? Are cost overruns from previous projects included in the risk assessment? What is the magnitude of risk from cost overruns to ALASKA LNG under the DOR's current analysis?

The purpose of the DOR modeling effort is to allow DOR to analyze the overall economics of the Alaska LNG project and the potential returns to SOA as an equity investor in the project. In general, since equity investors are last in line to receive cash flows from a project, any change that reduces cash flows below expectations will reduce equity returns and represents a source of risk. Cash flows can be reduced if revenues are lower and/or costs are higher. Thus, the starting point of DOR's risk assessment is to identify all factors that could decrease revenues or increase costs. For example, revenues could be reduced if LNG market prices are lower or gas production is less than expected. Costs could be higher if construction costs, financing costs and/or operating costs are higher than expected.

Once the relevant risk factors are identified, DOR will develop reasonable ranges for each input assumption to analyze the sensitivity of equity returns to changes in each factor. DOR's sensitivity analysis will include impacts to other key metrics such as the debt service coverage ratio. Single risk factor analysis (i.e., changing one input assumption at a time) will serve to inform DOR on the sensitivity of results to each factor. Multi-factor risk analysis will involve changing several input assumptions

simultaneously to test the effects of various combinations of changes. This work will allow DOR to rank the risk factors into high, medium and low risk groups.

DOF will also perform stress testing to analyze the impact of more extreme changes in input assumptions. Such extreme changes may be less likely to occur but the magnitude of the potential change may result in a large impact to the project and to equity returns. Stress testing will include risk assessment of potential construction cost overruns.

Depending on the availability and quality of data on previous projects, DOR will be able to analyze the impact of cost overruns of similar magnitude to such previous projects. Alternatively, DOR will be able to determine what level of cost overruns reduce equity returns to zero, result in negative equity returns, or threaten the project's ability to make debt service payments (i.e., default). DOR will also evaluate the likelihood of cost overruns of a particular magnitude and any mitigating measures available to the project and to the State. At this time, DOR does not yet have estimates of the magnitude of the risks associated with potential cost overruns.

8. For clarity, is the DOR responsible for the SOA's potential share of the tax revenues from the project? If so, and if there is a risk to those revenues, what sort of internal controls does the DOR have on ALASKA LNG to protect the state's revenues from taxes? (Clarification for Question 8 sent on 7/24/2018: AK LNG revenues to the State of Alaska, separate from the Alaska Gasline Development Corporation revenues, are the royalty proceeds from natural gas, and the revenues from the tax on natural gas. -Is the Department of Revenue responsible for the State of Alaska's share of the tax revenue? Would the decision to take Tax as Gas change the Department of Revenue's responsibility on that matter? -If the project has the potential to impact tax revenues, through deductions and other offsets, does the Department of Revenue have any recourse to preempt that from occurring?

DOF is responsible for the administration of state taxes. If DNR takes its royalty gas in kind, DNR and the lessees agree to amend leases under AS 38.05.180(hh), and a producer elects to pay tax as gas (TAG) under regulations adopted under AS 43.55.014, DOR would direct the disposition of the revenues from the gas delivered to the state as tax. This would be accomplished through an agreement with DOR and DNR to direct the disposition of revenue received from TAG per AS 43.05.010. DNR would manage the custody and disposition of the gas, including sale of that gas under AS 38.05.183. If the prerequisites for TAG are not met or no producers elect TAG, then DNR is not involved in disposition of gas tax revenue.

We are currently working with our partner agencies to develop estimates of expected tax impacts resulted from the project. DOR is conferring with DNR on the possible impacts of a tax as gas election by the producers in the event that DNR elected to take royalty in kind and modified leases under AS 38.05.180(hh) so that DNR may include that information in its best interest finding analysis. DOR administers state taxes established by law. The law provides that expenditures for the development and production of the leases associated with the project could be applied against the production tax value for North Slope oil production. The production tax statutes contain a number of provisions that may limit the impact of those expenditures on tax revenues.

Please let me know if you have any further questions.

Sincerely,



Sheldon Fisher
Commissioner, Department of Revenue