THE STATE of ALASKA
GOVERNOR SEAN PARNELL

Department of Natural Resources
Joe Balash, Commissioner
Department of Revenue
Angela M. Rodell, Commissioner

February 11, 2014

The Honorable Eric Feige, Co-Chair
The Honorable Dan Saddler, Co-Chair
House Resources Committee
Capitol Rm. 124
Juneau, AK 99801

Dear Representatives Feige and Saddler:

Please find the following responses to questions, which were asked by committee members after the January 28th walk-through of the Memorandum of Understanding signed by the State of Alaska and TransCanada.

1. We have the MOU agreement before us; is there also a separate "termination contract" related to the AGIA license between the commissioners and TransCanada? Will that be made available?

   There is not a separate "termination contract" related to the AGIA license. As discussed in Recital 11 of the MOU, if the Legislature approves the enabling legislation that is before it this session, then the Commissioners have committed to initiate an uncontested abandonment of the AGIA License under AS 43.90.240(a), pursuant to the AGIA procedures for determining whether the AGIA project is uneconomic. Further, under Recital 12 of the MOU, TransCanada has committed to agree that the AGIA project is uneconomic upon the enactment of the enabling legislation and the execution of the Transition Agreements (*i.e.,* the Alaska LNG Project Equity Option Agreement and the Alaska LNG Midstream Services Agreement).

2. The MOU states TransCanada's capital structure and cost of capital; how can we know that the given is the best deal the state could get?

   TransCanada's capital structure and cost of capital as stated in the MOU are comparable to and in some cases more favorable than the competitively bid AGIA terms. For example, in TransCanada's AGIA license application, which the legislature approved after a competitive bid process, TransCanada initially offered a return on equity of approximately 14 percent, higher than the 12 percent provided in the MOU. In addition, the 75/25 debt/equity ratio in the MOU is highly competitive and more favorable from the State's perspective than the 70/30 capital structure required by AGIA to ensure low rates for the project.

3. TransCanada's average ROE as a corporation is 8-9%. The MOU seems to provide a 12% ROE. Please explain the negotiations that arrived at the 12% ROE.

   Return on Equity (ROE) is inextricably linked with capital structure, and thus both ROE and capital structure must be viewed together. As explained at the legislative hearings on the MOU by Commissioner Balash, in the negotiations, a lower ROE could have been obtained at the cost of a higher amount of equity and lower amount of debt in the capital structure. Economic analysis performed for the State by Black and Veatch during the negotiations demonstrated that having less equity and more debt in the capital structure is significantly more valuable to the State than having a somewhat lower ROE. Thus, the State bargained for the highly favorable capital structure with the 12 percent ROE reflected in the MOU, which as noted above is lower than the 14 percent ROE in TransCanada's competitively bid AGIA license that was approved by the legislature.

4. What other avenues were pursued to dissolve the AGIA contract? If no others, why not?

   See the response to Question No. 1 above. The AGIA contract is not yet dissolved, but the groundwork has been laid to do so upon the passage of the enabling legislation in HB277/SB138, as provided in the MOU.

5. Is the state discussing commercial and fiscal terms with AK LNG a potential violation of AGIA? Is AK LNG a competing project? Are we already at risk for damages under AGIA?

   The State's discussions with the AKLNG parties concerning fiscal terms are not a potential violation of AGIA because TransCanada has agreed to participate in the process with the AKLNG parties - the State, the Producers and AGDC. Thus, the State's discussions with the AKLNG parties do not put the State at risk for damages under AGIA.

6. Please outline, clearly, if the enabling legislation passes to TransCanada's satisfaction and the MOU 'takes effect':

   a. What is TransCanada committing to?

      After Enabling Legislation is passed that the State and TransCanada determine provides sufficient authority to move forward under the MOU, TransCanada is committing: to negotiate and execute the Alaska LNG Project Equity Option Agreement ("Equity Option Agreement") and the Alaska LNG Midstream Services Agreement ("Midstream Service Agreement") (together, the "Transition Agreements"); and to fund the portion of the development costs associated with the State Gas Share for the pipeline component under Pre-FEED and FEED agreements (costs to be negotiated by the parties). The Equity Option Agreement gives the State the option to acquire up to a 40 percent ownership interest in the TransCanada subsidiary that will own a portion of the pipeline and gas treatment plant ("GTP") components of the AKLNG project. The Midstream Services Agreement sets forth the rates, terms and conditions of the service that the TransCanada subsidiary will provide the State in exchange for processing and transporting the State Gas Share on the AKLNG project.

   b. What is the state committing to?

      After Enabling Legislation is passed that the State and TransCanada determine provides sufficient authority to move forward under the MOU, the State is committing to negotiate and execute the Transition Agreements described above. Under the Equity Option Agreement, the State will have the option to acquire up to a 40 percent ownership interest in the TransCanada subsidiary that will own a portion of the GTP and pipeline components of the AKLNG project. Under the Midstream Services Agreement, the State will pay the TransCanada subsidiary a rate for processing and transportation service on the GTP and pipeline components of the project.

   c. What are the relevant timelines?

      As set forth in Section 3.1 of the MOU, the Equity Option Agreement and Midstream Services Agreement are to be finalized and executed within 90 days after the Enabling Legislation is passed.

      Section 4.1 of the MOU provides that the MOU will terminate by July 31, 2014, unless extended by the parties, or upon the occurrence of several other conditions listed in Section 4.1.

d. Is there a state financial contribution?

If the MOU terminates for any reason other than the termination that would occur as a result of execution of the Transition Agreements (e.g., the Enabling Legislation is not adopted), then the State would reimburse TransCanada for its post-December 31, 2013 development costs and Pre-FEED costs for the AKLNG Project, plus interest, less AGIA reimbursements received by TransCanada under the AGIA Project Plan Amendment 1B. Section 8 of the Midstream Services Agreement also contains similar provisions concerning reimbursement of development costs. After the project goes into service, the State would be obligated to pay the rates for processing and transportation service set forth in the Midstream Service Agreement.

7. Please clarify whether the state itself, or an entity of the state (such as AGDC) would enter into commercial contracts with the Licensee, TADI and the ANS Producers, subject to legislative authorization. What other "entities of the state" could be involved?

The State itself, as owner of the gas, or an Affiliate designated by the State, would enter into the Midstream Services Agreement to ship the State's gas subject to legislative authorization. The State or an Affiliate designated by the State (such as the AGDC subsidiary proposed in the Enabling Legislation) would enter into the Equity Option Agreement to hold the State's investment in TransCanada's midstream entity, subject to legislative authorization. The State or an Affiliate designated by the State would also enter into contracts with the ANS Producers subject to legislative authorization. No other entities of the State are anticipated to be involved in these agreements. The role and function of the AGDC subsidiary would be to carry the State's interest in the project, consistent DNR and DOR decisions about disposition of the State Gas Share.

8. Does the administration have legal guidance that the standard of 'uneconomic' in 43.90.240(a), is met due to a determination that two projects cannot proceed? If so, please provide to the committee. (MOU page 3, item 11)

Because the provision in AS 43.90.240(a) for a mutual agreement by the parties that the project is uneconomic does not set out a specific standard, a standard of "reasonableness" would be implied. Also, there is some guidance by analogy in AS 43.90.240(b), which provides standards for a determination of uneconomic if the parties cannot agree whether the project is uneconomic.

In addition, Recital 11 of the MOU expressly recognizes that the AGIA procedures for uncontested abandonment, AS 43.90.240(a), will be followed after the passage of enabling legislation and execution of commercial agreements committing the ANS Producers to Pre-FEED. Thus, the MOU recognizes that the AGIA license has not yet been superseded at this time, but may be abandoned in the future.

9. Where in the MOU or related documents is TransCanada required to build/operate the pipeline? Could TransCanada instead only own part, and have someone else build/operate?

The MOU does not address what entity will be building or operating the AKLNG Project components, or require any entity to do so. The AKLNG parties will negotiate how the Project components will be owned and operated during the Pre-FEED or FEED phase. While the State's preference is that the AKLNG parties would select TransCanada to build and operate the pipeline component of the project, and the State believes the potential for this outcome is enhanced by the decision to have TransCanada hold the State's interest in the pipeline component, it is possible that TransCanada could only own capacity in the pipeline and some other entity could be selected by the AKLNG Parties to build and operate the pipeline.

10. On what grounds are the project plan amendments confidential?

The project plan amendments are not confidential. The commissioners' approval of project plan amendment 1B is attached to the MOU as Exhibit A. Some of the information TransCanada submitted for the PPA is confidential at TransCanada's request because it is competitively sensitive proprietary information under AS 43.90.220(d-e) of AGIA.

11. Related to the Dec. 12, 2013, PPA approval letter: Page 3, near the bottom: Please clarify who gets the body of work done to date under the AGIA license, and when. Also, who will be the owner of work forward on the pipeline and GTP?

    TransCanada currently owns the work product, as the AGIA Licensee and as provided under AGIA. TransCanada is currently permitting the AKLNG parties to use such work product. When the AGIA License is abandoned, the State has an option to purchase the work product as provided under AS 43.90.240(e).

12. MOU page 5: (l)(iii): What is the estimated dollar figure for this?

    This question is referring to Section 1.1(l)(iii) of the definition of "Enabling Legislation" in the MOU, which provides that such legislation will fund the State's contingent and direct payment obligations for development costs under the Precedent Agreement to be negotiated with TransCanada and Article 4.2 of the MOU. The requested appropriation for the State to proceed to the Pre-FEED phase of the Project is intended to satisfy the condition set forth at Section 1.1(l)(iii) of the MOU. Since the development costs under Section 4.2 of the MOU and the Precedent Agreement will vary depending on the date of a Termination Event, it is not possible to estimate precisely what such development costs might be, but the State has requested an amount that it believes will be sufficient to cover its "contingent and direct payment obligations for development costs" as referenced in the foregoing definition.

13. MOU page 10, 8.4, would appear to supersede the AGIA contract. Is this correct? Is there any lingering obligation on the part of the state, or rights of TransCanada, related to AGIA if this MOU takes effect?

    The MOU does not supersede the AGIA contract. The integration clause at Section 8.4 of the MOU effectively provides that any other discussions between TransCanada and the State regarding the Transition Agreements are superseded by the MOU and its attachments. The Transition Agreements include the Equity Option Agreement and the Midstream Services Agreement.

    In addition, Recital 11 of the MOU expressly recognizes that the AGIA procedures for uncontested abandonment, AS 43.90.240(a), will be followed after the passage of enabling legislation and execution of commercial agreements committing the ANS Producers to Pre-FEED. Thus, the MOU recognizes that the AGIA license has not yet been superseded at this time, but may be abandoned in the future.

14. Please explain the MOU provision about transferring the project to "any state fund." What does this mean? How does the administration envision this working?

    If the State, through the AGDC subsidiary (as set out in proposed AS 31.25.122), exercises its Equity Option and acquires an equity interest in the TransCanada Entity, the State has the right to transfer its equity interest to a State Affiliate or a government fund. This means that if the State determines that its investment would be better placed within the investment portfolio of an existing State fund rather than held by an Affiliate, the State retains that flexibility. That decision would be made at the time of the exercise of the Option based upon the financing structure determined most appropriate and cost effective at that time.

15. What is the justification for giving TransCanada a five-year option on any Alaska gas project?

    This question relates to a provision in Section 9 of the Midstream Services Term Sheet, which provides that if the State exercises its termination right, then for a period of five years the State would offer TransCanada the option to participate in a substantially similar project to commercialize North Slope natural gas. Although TransCanada agreed that the equity interest in the project would revert to the State in the event the State terminates the Midstream Services Agreement (which the State has the right to do under the Term Sheet), TransCanada wanted to deter the State from taking advantage of all of TransCanada's work to advance the AKLNG project by terminating the MOU, without any compensation other than costs.

16. How do we know that the terms we agree to with TCAI will offer us a better return on our equity?

    Please see the responses to Question Nos. 2 and 3 above.

17. Why doesn't the MOU include a provision that declares the AGIA project "uneconomic," before the state and TransCanada agree to the enabling legislation is passed?

    Please see the responses to Question Nos. 1, 4, and 5 above.

18. How does this MOU eliminate the state's risk of treble damages?

    As explained above in the response to Question No. 5, the MOU does not expose the State to the risk of damages under AGIA, and, as provided in the response to Question Nos. 4 and 13, lays the groundwork for abandonment of the AGIA License, which would eliminate any possibility of damages under AGIA.

19. How do the proposed commercial agreements between the state and TransCanada mitigate the state's liability for lending assistance to a competing project under AGIA?

    Please see the responses to Question Nos. 1, 5 and 19 above.

20. Why is there no mention in the MOU of the treble-damages clause under AGIA?

    The MOU does not mention the treble damages clause under AGIA (AS 43.90.440) because the MOU does not expose the State to the risk of such damages, as explained above in the response to Question No. 5.

21. How does the debt/equity ratio relate to tariff rates? How does it relate to wellhead value for royalty and tax purposes?

    Because debt generally costs less than equity, the more debt that is in the debt/equity ratio (*i.e.,* the capital structure), the lower the tariff rates will be. Tariff rates directly affect wellhead value for royalty and tax purposes under the current royalty and tax structure because tariff rates are a cost that is deducted from sales revenues to determine the State's royalty and tax revenues. Similarly, tariff rates are important under the HOA and MOU because the State's profits from the sale of its gas will be net of the cost of the tariffs paid by the State to TransCanada. It thus is important to the State to have tariff rates that are as low as possible, a major driver of which is the debt/equity ratio. That is why the extremely favorable 75/25 debt/equity ratio that the State secured under the MOU is so valuable to the State, as discussed above in the response to Question No. 2.

22. Would gross natural gas tax be applied to the value of the gas after the cost of transportation was deducted?

    For gas produced after January 1, 2022, the tax levied on gas is 10.5 percent of the gross value at the point of production. The gross value at the point of production is determined by deducting the actual or reasonable costs of transportation, such as tanker costs and pipeline tariffs. However, for gas produced from leases subject to an election by the producers to pay the gas tax in kind under AS 43.55.014(b), "Tax as Gas" in HB 277, is a percentage (10.5%) of the volume of gas produced from a lease. Accordingly, the cost of transportation is not deducted by the producers from the percentage of the gas produced from a lease subject to AS 43.55.014, but a tax deficiency for Tax as Gas is assessed based on gross value at point of production, as described above.

23. Could we see a diagram laying out the ownership shares of each point in the value chain (GTP, pipeline, liquefaction trains, and marine loading terminal?

The ownership shares of each component of the project have not yet been negotiated by the State and the AKLNG parties. That negotiation will occur during pre-FEED, subject to the legislative approval. Section 5.3 of the HOA states that the parties anticipate that the State's share in each component would be approximately 20-25 percent. It is anticipated that the remaining 75-80 percent of the project will be owned by the ANS Producers in proportion to their gas ownership interests. The following chart is an estimate based on the working interest ownerships across Prudhoe Bay and Point Thomson assuming state equity participation of 20% or 25%:

| | | |
|---|---|---|
| State of Alaska | 20% | 25% |
| ExxonMobil | 34.6% | 32.5% |
| BP | 22.5% | 21.1% |
| ConocoPhillips | 22.9% | 21.5% |

The MOU also provides that TransCanada will hold the State's share in the pipeline/GTP components. The State will continue to hold its share of the liquefaction plant component, but has the ability to find other partners to hold part of its interest in that component if that will help advance the project.

24. Could we see a flow chart showing the many steps in the process, e.g the Transition Agreements, enabling legislation, Trigger Events, HB 277, negotiation of contracts, contract signing, creation of JVs, 2015 legislation, etc.

The Departments intend to provide a flow chart to the committee tomorrow, February 12.

Sincerely,

Joe Balash
Commissioner, Department of Natural Resources

Angela M. Rodell
Commissioner, Department of Revenue