(H) FINANCE STANDING COMMITTEE * April 15, Tuesday, 8:30 AM HOUSE FINANCE 519

Committee Members:

Rep. Guttenberg, Rep. Costello, Rep. Stoltze, Co-Chair Austerman, Rep. T. Wilson, Rep. Edgmon, Rep. Thompson, Rep. Munoz, Rep. Gara and Vice-Chair Neuman.

Notable Questions From Committee and Responses from Testifiers:

8:54am-Rep. Thompson was concerned with the impacts of the construction of the pipeline on services such as police forces and medical services in Fairbanks and North Pole. He was wondering if financing to increase these kinds of services has been talked about.

Comm. Rodell: That is a concern, it has been discussed, but not in any great detail. When the Governor was working on his administrative order and we were looking at what types of things we needed in that order, there was a recognition that we're going to have to have an opportunity for that type of input and a recognition of that type of input because there are concerns, as you mentioned, policing. I know that there are concerns about domestic violence, and some of the things that came out of that, so we want to make sure that we recognize not only the infrastructure impact, but also the social impact and construct a financial plan along with that to help address a lot of the concerns that you raised so that we will be able to ramp up, because I think one of the benefits Alaska has versus this project occurring in other areas is that we do have the lessons from the TAPS construction and our goal is to manage the boom economy that will occur with that and how do we manage through that and not let it have the bust economy that followed when TAPS was done. So those will be things that we will be working on the next year with the Administrative order that also got reflected in the bill in section 68.

8:58am- Rep. Neuman wanted to know if they could get a series or list of impacts to the infrastructure within the state, such as bridges or pull outs, or other infrastructure projects that may have to happen on the haul road.

Comm. Balash: What I will get for the committee here today is a description of all the reports that are required as part of the FERC process, there are 13 of them that will be required, and I can't recall which number specifically, but there is one in particular that hits the socioeconomic impacts of project construction itself. So that's one of the things that we'll be able to tease out from there. In fact, as I recall, there is a specific mention of transportation …(crumply paper sounds)… But I will put that together for the committee.

Rep. Neuman then said that Rep. Thompson was asking about the social impacts and he was asking about the infrastructure impacts.

Comm. Balash: We understand and I think there's a specific component that speaks to transportation and infrastructure.

9:00am-Rep. Neuman then mentioned how he assumes that the companies will be working on the pipeline as well as on infrastructure on the upstream side at the point of production where there could be deductions on taxes. He asked how they will differentiate whether those are going to be used for gas pipelines or be used against oil taxes.

Dep. Comm. Pawloski: The way SB 138 is designed is that those expenditures that are made as lease expenditures, the standard allowable deductions, are deducted against the production tax value of oil, and there's no need to differentiate. Does this piece of equipment go specifically to gas? Does this piece of equipment go to oil? Those are not divided out. Those deductions occur against the production tax value of oil. So, the upstream investments that you've seen modeled by our consultants and your consultants include, in those early years prior to the start-up of the project, a revenue impact from primarily the build out at Point Thompson and some of the initial work at Prudhoe to put in a little bit of extra work on the upstream there, but the majority of the work is really at the Point Thompson field to build out. Point Thompson in particular carries with it additional oil production when you're producing more gas. Those revenues are also included in some of the analysis that you've seen so there's additional oil production that comes with the gas production in the models but the way SB 138 is structure is that there this no separation in the deductions.

Rep. Neuman said that bothered him because he thinks the producers will incur as much upstream costs as possible to deduct them from the taxes they'd be paying on oil and that the state may lose hundred of millions of dollars in taxes. Wants to know how the state will protect itself.

Dep. Comm. Pawlowski: In our modeling there is a financial impact of those deductions, that's very very clear. Part of the discussion about this issue goes to section 61 of the legislation, which is found on page 56 of the H version. One of the things we did in looking at the issue was how the point of production is defined and was defined in existing statute. And there was a specific section for gas through a gas processing plant or treatment facility and you can see that language being deleted on page 57, line 25-30. The reason we were deleting that language is to provide the clarity that Rep. Neuman is describing. Where you put that point of production is very important. So, the point of production is moved up to the inlet of the pipelines leaving the fields and so to move it up away from that specific gas related processing and treatment facility, that in previous iterations of this effort was potentially covered. So what we've done is change the point of production. Now, again, there are impacts upstream particularly in the Point Thompson field, and that's been discussed in just about every committee we've been through and shown in all of the models. One of the points I'd make to that, as Commissioner Designee Balash knows, is that the Point Thompson settlement provides two real opportunities for the development of the Point Thompson unit. The first is a major gas sale, what I think most Alaskans are looking for, producing all of the hydrocarbons at Point Thompson. The other is a cycling project where the gas is brought up, just like as it's done at Prudhoe today, the liquids drop out and it's re-injected. That would be increasing that cycling project and producing more oil. If that project were to occur under existing law, and it only produced liquids and re-injected the gas, all of those expenditures would be deductible, and you would wait to develop the gas. That is one of the reasons we looked very carefully at allowing the deductions because of the natures of the fields at that level are so interconnected. At the same time we also pushed that point of production as far upstream as we could in the legislation.

9:07am- Rep. Neuman asked where the point of production changed other than in the Point Thompson field.

Dep. Comm. Pawlowski: Thank you for the detailed question because it is really important in Prudhoe Bay, as you recognized, the pipeline leaving the central gas facility to the gas treatment plant. The gas treatment plant itself will actually be within the Prudhoe Bay unit most likely. That is actually excluded from the point of production, so that is downstream, the pipeline leaving the central gas facility to the gas treatment plant, those are taken out of the point of production at Prudhoe Bay so they're not included as upstream costs for the purposes of lease expenditures.

Rep Neuman Where the point of production was at then?

Dep. Comm. Pawlowski: The point of production for a field west of NPRA would be the point where the gas is, after mechanical separation, leaving the field to go to the inlet of a pipeline to transport that gas to market. The point is to take those pipelines that are moving the gas from the fields to the treatment plant out of the point of production and make them a downstream expenditure as opposed to an upstream.

Rep. Neuman: Everything used for the separation would be pre-Upstream?

Dep. Comm. Pawlowski: Page 57 of the H version, it's the first stage of separation, just that initial mechanical separation where the gravity lets the three fluids separate. Then there's separately the processing, that processing and all that gas related specific work is downstream of the point of production. It's that initial mechanical separation.

9:09am- Rep. Neuman asked if the equipment that is prior to that is the same type of equipment used in oil production.

Comm. Balash: Yes. That kind of equipment is necessary to initially separate the gas from the oil, so its equipment that is associated with oil production and it's one of those things that we find every difficult to break apart between oil and gas in the production processes. So, the recognition here is that we need that facility, that set of equipment, on site at the production pad in order to get the oil and so it's appropriate for that expense to be deducted as a lease expenditure in the production tax system.

Rep. Neuman: When more of those facilities start coming on board, pre-construction, and they're allowed as a deduction on 21 but they're going to be primarily used for 138, or gas production, how does the state differentiate whether at that point?

Comm. Balash: First of all, we think if we're seeing lots more new oil production facilities installed, that's probably a good thing for the state of Alaska. Number two, I'll also point out that when it comes to gas we are going to be receiving 13% of the gross. That we think is an excellent position for the state to be in even if we're allowing those upstream costs to be deducted as lease expenditures. So rather than being left with 35% of the net on gas, we'll be getting 13% of the gross on gas.
9:12am- Rep. Neuman: Explain where the point of production would change (at Point Thompson) in the differentials there when we're moving gas and now when we're just moving oil.

Dep. Comm. Pawlowski: For Point Thompson the point of production will be very similar because there will be a new pipeline built to move the gas from Point Thompson to the treatment plant which will be over Prudhoe Bay and the liquids line that is being built at 70,000 b/d is the capacity of that. It is being built bigger than the 10,000 b/d initial estimate of throughput to allow for the additional oil production or condensate production that's going to come out of the expanded build out of the Point Thomson unit. So the point of production will be where the gas is leaving the field and going into the new pipeline to move it from Point Thomson to the gas treatment plant.

9:13am- Rep. Neuman: Where is the point of production? At the inlet well, at the outlet well?

Dep. Comm. Pawlowski: It would actually be farther downstream from that so you'll have the cycling wells, those will go through a process where either the gas is metered- they will be upstream. The product coming out of that cycling process will go through a separation where the liquids will be separated from the gas then it's either after that mechanical separation or if the gas is metered leaving Point Thompson. That would be the point of production, is where it separates and goes into a meter or the line to move the gas from Point Thomson to the treatment plant, because the gas as its coming out of Point Thomson can contain impurities that need to be cleaned up in the treatment plant to be put into the project. So it's that point where it's either metered or right after the mechanical separation depending on the specifics of how that transmission system is developed.

Rep. Neuman: Is there anything in the HOA or in writing that specifically states where that is and what pieces of equipment will be counted as upstream costs and which ones will not be?

Dep. Comm. Pawlowski: There are specific definitions of the Alaska LNG project which is where we have defined the point of production. I think there's a side-issue that Commissioner Designee Balash is more equipped to talk about than me, and that is in the agreement in Point Thomson settlement about the treatment of upstream costs and the implications it has for royalty or other parts of our fiscal system.

Rep. Neuman: The wells, the injections, and those processing facilities upstream, are those going to be allowable deductions?

Dep. Comm. Pawlowski: They will be allowable deductions because they will be producing both oil and gas at that stage and they are necessary for both.

9:16am- Rep. Guttenberg asked about certain definitions. He mentioned that the natural gas act is defined on page 11 as using flanges. He said flanges can move. He said it made him concerned that it leaves the flange up to "shenanigans."

Dep. Comm. Pawlowski: The difference is in where and why these sections exist within the legislation. First, the reference to flanges, as you point out, comes in section 16 of the bill which is found on page 11 beginning on line 25 and goes through page 12, line 27. That is a specific definition of the Alaska LNG Project only for the purposes of authorizing and specifying the Alaska Gasline Development Corporation's participating in the project. So that was taken from the memorandum of understanding in which a deeper definition than the Heads of Agreement had. That definition has no relationship to the state's tax laws or the state's royalty laws. It is in the authorizing statute for the Alaska Gasline Development Corporation to participate in a project. The reason we felt that was necessary, as you'll recall, that the Alaska Gasline Development Corporation's power to participate in liquefaction is limited to its participation in the AK LNG Project. So we wanted to use the specific and available definition of the AK LNG Project for those purposes. The other sections you reference on the point of production are consistent with the way the state uses language building on all of the regulatory body of support that's been developed since really PPT, ACES, SB 21. We made no real changes to consistency of that language and its separate because that carries the connotation of being our specific way Department of Revenue determines point of production, and it's just different than what's going on in section 16.

Rep. Guttenberg: But in point of production for oil you have on page 56 going on to page 7, we're talking about point of production and the definition. You talk about oil and you talk about how that is a methodology, means mechanical or device or using the quality that the Department defines for those purposes. But in section B on gas you don't use that in there. You just have the definition which leaves ambiguity from my perspective. In oil it says, on page 56, line 30, "Point of production means mechanism or device to measure the quality of the oil that is approved by the Department for those purposes." You get to gas, you're talking about inlet, but you're not saying, "A device that the department has is using for that purpose." So there's a little bit of ambiguity there as to who is the defining party in saying exactly what that is. And in oil, it says it's you, and then in the gas section, B, you say it's just the inlet of the pipe. Would you have a problem with adding that to help you in your negotiations?

Dep. Comm. Pawlowski: The Department of Revenue implements the regulations that provide the specificity here. Let me talk to our auditors because they're the ones that actually implement these and I'll work with your office to see if there is an upgrade that would support clarity on the point of production.

9:21am- Rep. Guttenberg said that he was concerned that the sticker shock for maintenance of roads is going to be "amazing." He was curious if the roads would be brought up to standards before and rebuilt later. He thinks the numbers should be on the table, but DOT did not present them to the Legislature in their presentation to House Finance a day prior.

Comm. Balash: I think the distinction that Commissioner Kemp was making between deferred maintenance and heavy maintenance was something that's a result of planning and they plan very carefully to distinguish between how they spend their money and where they spend their money. With regard to the condition of the Dalton Highway specifically and the need to add to the material in the road base, which is what I think you're referring to, that's something we'll be happy to work with, with DOT on and provide some additional feedback. I think one of the co-chairs here is particularly interested in understanding what it is we are and are not going to be one the hook for as the state solely versus the project specifically and through our participation in the project for a portion of those costs. What I have been briefed on is the list of projects that was identified back in the 2005 sort of time frame, things that needed to be done on the Dalton Highway. A lot of things have been done, not nearly everything that needs to be, but there have been substantial improvements made on that particular road. But, the specific question about road base, and especially road base height, material that every time they go through with a grater, especially in the spring and the fall when things get rutted out, pushes material off to the side and you get deeper and deeper to the point that you're getting off of the gravel and down into the base itself. I think we all want to make sure that the roads in Alaska are passable after construction, which is going to be a good thing to be worried about. But we'll see if we can't get from DOT a little bit more of a definition and specificity on deferred maintenance versus heavy maintenance versus what might be necessary to deal with the road height and clearance issues.

9:25am- Rep. Guttenberg In the capital budget, there is an appropriation for the Yukon River Bridge for settlement. I know they're having problems with settlement issues and erosion around the bridge. Are you aware of that at this point?

Comm. Balash: I'm familiar with a slide that occurred on the North Side to the up-river end of the bridge, so there are some issues there where either settlement or stability are in question and I think my division of geologic and geophysical survey is doing some work to understand the geo-hazards in the region, for the project itself and the region at large. Exactly what needs to be done in regards to that bridge is an interesting question. Do you improve the existing bridge, or do you just build a new one? I think that's something that we're all pretty interested in.

9:27am- Rep. Austerman mentioned that SB 138 talks about the Alaska Liquefied Natural Gas Project on the first page, but on the second page it talks about the North Slope Natural Gasline Project. He says that indicates that there are two different projects going on and he wants to clarify that.

Dep. Comm. Pawlowski: The legislation before you, while it is enabling legislation for the Alaska Liquefied Natural Gas Project described in the Heads of Agreement, is also general law and therefore applicable and important to advance really any natural gas project. Right now the state is looking at two natural gas projects and that reference to a North Slope Natural Gasline is necessitated by building off of the architecture of House Bill 4 as passed by this body last year, because the terms and powers, the need of the Department of Natural Resources to facilitate gas moving through a project, you either fix the leases to prevent switching or promote contractual agreements is going to be needed whether it's for the large AKLNG project that is the state's priority, or if another project happens to be developed to facilitate North Slope Natural Gas. So, while we focus on the AKLNG project, the law before you in Senate Bill 38 really supports all forms of gas development on the North Slope and the specific two terms are because of the specific architectures of House Bill 4 asp assed by this committee in this body last year.

9:29am- Rep. Wilson The way I read most of this, we're going to take everything in gas. So taxes that we're currently in when dealing with oil with money, we're going to do that in gas. Is that correct to start with?

Comm. Balash: There's going to be much that we take in gas, but there's still going to be some fairly significant streams that we do take in cash, specifically the corporate income tax and the property tax.

Rep. Wilson So if we do gas and we check the market in one day and that's how we establish it and three days later it drops down, how do you do that without the guarantee that whatever credit you gave for that is actually what we will see as revenue.

Dep. Comm. Pawlowski: There are key agreements that govern the custody and transfer of the molecules. So the state actually has title to and owns something. This is what we do with royalty in-kind on oil now, the state never actually takes the title but the state has the right to under in-kind. Those arrangements are going to be long-term contracts, and you're right, they will have a moving price mechanism. This is actually what your consultants talked about. One of the reasons why the state may want to be hesitant about only using the producers to sell the gas is because they're going to have a different risk tolerance than the state. Sometimes LNG contracts are designed with what they call an "S curve," which is where there is a floor and then a ceiling so that you guarantee that your price is not going below a certain number and to offset that you guarantee that the buyer will not pay a price higher than a certain number. Those are all terms that are negotiated in the contracts and each contract will be different, those contracts are going to be developed, will go through the royalty board process potentially, but ultimately brought back to the legislature for approval. The contract itself will specify how money changes hands for the gas and the buyer is going to make a commitment that whether they take the gas or not they're going to pay the state. That's part of the underlying agreements to this project is those take or pay purchase agreements by the buyers.

Rep. Wilson I'm really concerned about the portion now that we're going to allow, even the tax portion liability from other companies, to take that chance in that kind of market.

Dep. Comm. Pawlowski: I think it's important to remember that in-value or in-kind, on the in-value circumstance, the producer is taking the molecule and selling it for a price, that price changes all the time. The difference in in-kind is the state is taking the molecule and the state is selling and the price is changing all the time. The actually end price change happens in-value or in-kind. Both circumstances you're subject to it. One of the things the state is concerned about in the LNG project is unless the State is involved and unless the State is directly holding those molecules we risk losing control over, is the state getting the right deal or the right deductions in place in the LNG plant? Because those are really what are going to drive the money left over from the State whether it's a tax, whether it's an in-value situation. We're subject to the same risks, in many ways the state has much more control potentially in an in-kind situation in this project.

Rep. Wilson said that answer didn't help at all.

Comm. Balash: One thing I want to point out for the edification of the committee and the public is that with a project that has a price tag like this property tax is going to be a huge cash flow element especially early on. That is something that will definitely be paid in cash, it is something that the state will benefit from with some degree of certainty and help mitigate some of those risks that we might otherwise experience with regard to commodity prices.

9:36am- Rep. Wilson: I read in here that we're talking about the difference between- not direct access to natural gas, and there's going to be a fund in here for that. So thinking of Fairbanks, I don't want just natural gas, I need affordable natural gas or it doesn't do me any good. So when we talk about direct access what does that really mean.

Comm. Balash: There's a couple of things that we can't know today, but that we will be taking additional steps to know in the next phase or stage of decision making, which we hope is going to be sometime next year. If you would please turn to page 60 and then section 67, the last committee adopted an amendment that would require the Department of Natural Resources to identify the various scenarios and methods of getting gas from the North Slope and down to market, but, also, within the state in terms of managing capacity. So that's something that we will be coming back to the public and the legislature with and one of the key questions there is going to be, who is responsible for satisfying in-state demand? Part of that is going to be driven by market factors and part of that is going to be driven by which players are engaged. Now one of the reasons we really like this particular construct in the HOA where each party is responsible for its share of the gas, its share of the infrastructure, and ultimately its capacity, is that everything stays even along the way. If we were to run into a scenario where the state and the state alone was to be responsible for satisfying in-state demand, then our share of the project when we got to the liquefaction plant would change. That would create some dis-jointment between and among the parties. So, exactly how we are going to resolve that is a bit of an open question and something that is going to need a lot more clarity before we come back and ask to take the next step. What I would observe and point out, especially for members from the interior, is that in the Memorandum of Understanding with Trans-Canada we have provision built in for back-call service. And what back-call service is going to allow us to do is determine whether gas from the North Slope that has a value with a transportation cost added to that value, that total number is more expensive than gas in Cook Inlet, this back-call arrangement is going to allow for a swap to take place so that Cook-Inlet pricing, south-central pricing for natural gas, will available up in the interior and other parts along the pipeline corridor. That's something that we think is going to create a very helpful market mechanism throughout the value chain here and along the corridor for all parties.

9:41am-Rep. Munoz: Listed out the two different projects, with their different funds, directors, etc. Wants to know at what point the two projects come together.

Comm. Balash: One thing that I suspect most members are familiar with is that the AKLNG project, the Heads of Agreement, these are all wonderful, fantastic developments. We think we've got an excellent shot of moving this project forward after all these years. But we're a long way from knowing that that's going to happen. The work that's going to be done during the Pre-FEED phase will include an assessment and an effort to initiate marketing of the LNG by each of the parties. That's the really key question. Are any of the parties, or all of the parties, going to be able to sell the LNG from this project at a price that warrants the ultimate investment required. So, as we move through the pre-FEED phase here, all of the parties combined are going to be spending somewhere in the order of $450 million jointly. When we get to the end of this pre-FEED phase and the decision come times for whether or not to enter the FEED phase, that price tag, the cost of continuing forward into the next phase is going to rise to somewhere on the order of $2 billion. So, even with that cost spread among the parties, that's going to be a very large chunk of change for any of the parties to go forward and that's going to represent a very significant decision point. If the decision to go forward is a positive one, that very likely means, unless something catastrophic happens, this project will happen. Nobody is going to go out and spend the hundreds of millions of dollars individually to go through FEED unless they expect to be voting "yes" on the final investment decision and moving into construction. From where we sit, and I think you've heard the Governor represent this before, AGDC and the ASAP project, and the ASAP project specifically, represent a back-stop or an ace-in-the-hole for Alaskans, to make sure that if for whatever reason AKLNG doesn't go forward, we still have ASAP as an alternative. Now the question of how quickly ASAP moves forward relative to AKLNG and vice-versa, is something that is best left to the board of directors at AGDC. And with the totality of changes that have been made to the AGDC statutes here, they're going to have that flexibility as a board to decide how and when to advance the ASAP project. Do they continue on the pace that they set starting with the passage of HB 4 last year? Probably to a point, but there is going to need to be an effort to get both projects to a similar place in their development so you can have an apples-to-apples comparison and decide which one is the one for the State of Alaska to get behind and back to the hilt. We think that probably occurs sometime next year, and the big question will be how far AGDC goes in the development of their builder-owner-operator arrangements as well as the conduct of an open season where they would seek commitments from shippers on that particular project. Those are the kinds of things that will need to be weighed and balanced out and be informed by the pace of progress of AKLNG. If, for example, pre-FEED, which is supposed to ramp up here this summer, is more of a whimper than a bang, then I would suspect the AGDC board would take that into consideration. If, however, AKLNG is let loose with a thunder clap and they're doing a lot of very serious work very quickly, that too would be taken into consideration as to how much of AGDC resources get spent on ASAP. So, hopefully we'll see some efficiencies gained by sharing information during this phase, but AGDC is going to enjoy some tremendous discretion to advance ASAP as that particular board sees fit or necessary or in the state's strategic interest.

9:46am-Rep. Austerman: Wanted ASAP to be clarified for the public.

Comm. Balash: With the passage of HB 4 last year, the legislature gave the Alaska Gasline Development Corporation a mission to go accomplish and that was, and is, to develop the in-state natural gas pipeline project. That's' what the statute says- an in-state natural gas pipeline project. The ASAP term is the Alaska Stand-Alone Project and that is something that AGDC has been working to advance in the last couple of years. (Austerman makes a joke about it being a "little" pipeline) It is a megaproject of its own and one that remains available to pursue in the years ahead if AKLNG doesn't move forward for whatever reason.

9:48am- Rep. Holmes: In the early years at least, the State of Alaska is bearing a lot of the financial risk, even if Trans-Canada is fronting the money, if the project doesn't go forward the state reimburses Trans-Canada. So we're fronting a lot of the financial risk, but my understanding is that when it goes into the actual meetings, Trans-Canada is the one that has a seat at the table, not the State. I was wondering if you could talk me through what sideboards and protections there may be on that to protect the states interest.

Comm. Balash: The tension between various interests at the table is one that we as, as the State of Alaska, are seeking allies in those instances where we have an alignment with those particular allies. Much like in this building and even in this committee those alliances can shift from topic to topic. So we think that in many respects the balance of interests and the tension between the parties that we've landed on here is one that's going to work ultimately in our favor because we are aligned with the producers in terms of wanting to keep a lid on the overall project costs and in seeking the highest value for the resource itself. And in those two instances we and the producers are fairly well aligned. Where the alignment breaks down, however, is in the development of gas that does not belong to the producers. We have a financial interest either through royalty, production tax, or both, and hundreds of trillions of cubic feet that are believed to be below the ground in the North Slope region generally. And for that reason, we are very encouraged by the alignment of interests we have with Trans-Canada to see the pipeline and the facilities designed in a way that will maximize or optimize expansions in the future. In that regard, having a company that's looking out for their own financial interests is something that we see as being very valuable. And to the extent that Trans-Canada's financial interest is advanced by moving more gas later on, that's aligned with our interests. In the here and now in the project, because Trans-Canada's going to make their money by charging us transportation service, we need to keep a close eye on the overall budget and construction costs. Again, we go back to the alignment we have with the producers to keep those things in check. As well, we have provisions built into the MOU that require Trans-Canada to basically check with us on things related to the work plan and budget. If there is a matter that we are dissatisfied with and we are opposed to, we inform them of that, and they are required to vote "no" within the governance structure within the joint venture itself. So there is a check, so to speak, an involvement on the part of the state where we will be very much aware of what's going on but relying on their specific expertise day-to-day to carry out this development and ultimately the execution of the project. There is a provision in the agreement itself, in the Heads of Agreement that is intended to help support the conveyance of information by Trans-Canada specifically or AGDC as well during this development phase, that they will have the ability, under subsequent agreements, to share information with the state agencies so that we're kept apprised of what's going on in the project, we know what's going on, and we'll be in a position to speak for ourselves with all of the parties.

9:54am- Rep. Holmes: Asked if the requirement where Trans-Canada must vote know if the state doesn't approve of something is a law-binding requirement.

Dep. Comm. Pawlowski: The provisions found on page 6 of exhibit C, the term sheet to the MOU, it's in the principles and the audit protocol and you have to look back to- the tariff is based on prudently incurred CAPEX and this is part of the process of defining what "prudently incurred CAPEX" is. The MOU itself has a different threshold of whether it is legally binding. These are terms that will be incorporated into the agreements. It will be binding in the precedent agreement, that interim agreement, that the Commissioner of Natural Resources will execute under the provision in the legislation for two years. It will be workable for those two years to be binding in the longer term to have that real deep relationship will have to come back to the legislature.

9:55am- Rep. Holmes: Wanted to know the administration's opinion on a 20% versus a 25% stake and also when and how that number will be locked-in.

Dep. Comm. Pawlowski: The 25%, the approximately 25% that we talk about, is the combination of the State's royalty share and the production tax. The production tax is levied after royalty, so the 13% production tax, when combined with the royalty share, comes out to roughly 25%. The Administration's decision around what was the appropriate tax rate was part of the work that the Department of Revenue and the Department of Natural resources undertook this summer with the royalties study, which there were hearings on during the summer; I know many members attended those discussions. What we looked at was where the state was preserving that value to the state that we would get if the project was to advance without the state making any changes. In that work we also ran multiple scenarios looking at, well that's not really an option, what would you have to do in an in-value world to advance the project? One of the things the DNR looked at was reducing royalty rates, reducing tax rates. We ran all these different scenarios, but the target we were trying to get to was preserving the value that the state would achieve. We looked at that over a range of prices, a range of costs estimates. High price, low investment cost, high investment cost, low price, multiple scenarios. And the 22% came out right about the middle of what you could expect under the terms of an extended Senate Bill 21 for that to actually be where the number should be. So in negotiations around the Heads of Agreement it was recognition that it's not the administration that sets tax policy, the administration may propose policy, the legislature is the one that acts that. So it was a recognition that it's a range of where the parties are willing to move forward. One of the concerns about increasing the tax rate is that is actually increases the cost to the State because we are participating in a larger share. Now, other committees have weighed that investment balance back and forth, but anywhere between the 20% and 25%, the parties have all accepted that we are willing to move forward on that project together. As to when terms get locked in, that is an open question at this stage. The Heads of Agreement talks about durability and talks about the duration of contracts and it recognizes that that duration is for a reason. It needs to be supporting LNG sales agreements. So, we'll bring that context back together, work with the legislature on it, but any contract that would do anything related to previous ideas of durability all come back to the legislature for approval. It's not known when that date will be at this point.

9:59am- Rep. Holmes: Wants to know if the ownership stake is still open to discussion and where the Administration is right now in terms of their recommendations.

Comm. Balash: The decision to be a participant in the project is one that the Governor reached and in reviewing the information, weighing the various risks cost etc., our estimation was that being an equity participant in the project made sense as long as our share of the project was 20% or greater. If the number were to fall below 20, we would probably recommend a different course of action. Conversely, you get up higher than 25% and some of the other parties start to question the value their getting out of the overall arrangement. The really important agreements that are going to be developed here in the next 18 months have to do with the long-term equity shares in the infrastructure, the joint venture agreements, the governance agreements, and the off-take and balancing agreements. It's going to be those two that you'll want to keep a close eye on because they need to match up. We need to make sure that we're not short or long in one of those. They need to sync up. So we're going to be spending a lot of time identifying some of the very small, but important, details around net profit share leases, sliding scale royalties, so we fix those, that adds to our royalty total, combined with our production tax interest, we think is going to arrive at or very close to that 25% figure. There may need to be some clean-up in the next phase, but having the legislature state now through SB 138 that our production tax interest is X, allows us to go forward and develop the remainder of those agreements to come back to the legislature.

10:03am-Rep. Costello: Asked Commissioner Rodell if the State should be trying to pay down its debt as we move forward this next decade.

Comm. Rodell: I think that that's an excellent question because the State has commitments today and it has liabilities today and so the things that we need to be doing between now and when the state… we'll do it initially when the state decides whether or not to enter into the FEED stage of this in hopefully 2016, 2017. And then we'll really have to decide again when we want to go to the final investment decision. And I think what we want to be doing today is to set the state up in a position where we've minimized, or managed our current liabilities, so that they are clearly within control, within the legislatures control, and that we've done the things we need to do to maintain the state's rating so that were given a lot of credit. And I don't mean from the rating agencies, I mean that from investors and our partners in this, the recognition that the state is a business partner that they want to enter into agreements with and they don't want to penalize the state and say, ok, you haven't kept your house in order so we're going to require extra collateral, we're going to require extra belts and suspenders because now we don't have the confidence we once had in you to enter into these contracts. So I think that as we move forward, and you're going to see this in the plan, both in the interim report that this legislation provides for, as well as in the final report, the opportunities that the state has to leverage its financial strength rating, that it has to partner with not only external managers or external partners, whether they be potential buyers of LNG, but also the partnering with individual investors within the state or the municipalities within this state and how we leverage those financial resources available to the entire state that we're going to benefit from. So we're going to be putting that report together and it's going to contemplate the other commitments the state has both from a liability standpoint already on the books, but also from a liability standpoint in recognition that we are a state government and we will be required to provide ongoing services. We'll also take into account the infrastructure needs, the impacts of that and is it better for the state, for example, to be using some of its debt capacity to fund roads being used by the general public, that are being incurred because of this project, for example, and to use equity or other mechanisms for the project commitment itself. So this report will be looking at those types of questions and coming back to this body with ideas about how the state can be in a position to participate in this project both for the FEED stage and the FID stage.

10:07am-Rep. Costello: It is my understanding that once the gas starts flowing that, because of our involvement with Trans Canada, we will see $300 million less annually coming into the state. Did the administration do any kind of risk-reward analysis in terms of that?

Comm. Rodell: We did look into the risks, and I guess I looked at it more as, not so much the risk versus the cost versus benefit, and looked at it as a cost-benefit analysis rather than a risk-reward because to me the forgone revenue that you speak to is more a cost of participation that yields greater benefits to the state. So, for example, one of the analyses that our consultants did for us was looking at, when we looked at the 20% participation versus the 25% participation, the state going it alone both at 20% and at 25%, what was revealed through that analysis was that the cost of TC's participation actually allows the state to get to the 25% easier than it would under the 20%. In other words, we could go it alone at 20% and we would receive X, but we would get way more going to 25% with Trans-Canada and the cost, going to 25% alone, in my estimation was not even an option for the state because the burden and the risk it would place on the state, the cost it would place on the state, was something that we were not in a position to be able to take on. So there was analysis done and I think what we really came down to is that the cost of that (?) was outweighed by the benefits in the long-term.

Rep. Austerman said he felt that this is an issue they should spend more time on and he would like to set a specific time frame and have the Departments go more in depth in the decisions.

10:10am-Rep. Costello: Can you explain the rationale or the philosophy behind not going with rolled-in rates?

Comm. Balash: The issues surrounding rate design and methodology for expansion scenarios is one that is near and dear to DNR's heart. We have a tremendous interest in making sure that any infrastructure that gets installed is going to be accessible to third parties but also affordable. The things that we historically have cared an awful lot about are a) the opportunity to have access and b) to have access on terms that are commercially reasonable or attractive. Now those terms are driven by the tariff and the tariff design and what we have found is that the capital structure, the debt to equity ratio for that tariff is huge, that you actually get a lot further by having that larger debt component than squeezing down on the return on equity component. So the goal is low tariffs, the lowest tariffs we can find and when we evaluate our partners, specifically BP, Conoco, and Exxon, they don't have the same desire for low tariffs. Their decisions are driven for different reasons in different ways on how structure the financing for the infrastructure. They come at it from a completely different perspective because they're involved in the entirety of the value chain and so their interest in low tariffs is not the same as ours. That's not to say they are interested in high tariffs, but it is something that is definitely at odds between them and us. So one of the things that we weighed was, not only the access to the pipeline and the pipeline facilities, but also the liquefaction plant. We've come to know an awful lot about pipelines and how they are regulated, either by the FERC or the RCA, but when it comes to the liquefaction plant, there's no question that FERC has exclusive jurisdiction on the regulation of the liquefaction plant. And that regulation is centered almost entirely on health, safety, and the environment. They do not regulate for access, they do not regulate for rates. So not only from the state's perspective, an interest for our own gas, but also for that of third parties. There's really not anything we can rely on from a regulatory perspective to ensure those things happen. So the solution to all of these problems we've found, to step into this participation role, in essence, each party would be responsible for their share of the project and what we have is, in the pipeline, basically four pipes within the pipe. There is not one tariff, there is a proprietary arrangement we're in. Each party is responsible for the financing of its share of the project and therefore able to set its own commercial arrangements for use of the capacity built with that CAPEX. That extends not only to the pipeline but on down into the liquefaction plant. So the whole question about rates kind of falls away because there isn't a rate that all of the parties are paying and contributing to. We each are responsible for our own share of the project, we can finance it however we like, and it's been described previously as a live and let live approach. Now, when it comes time to expand the pipe, what we have secured in the Heads of Agreement in Appendix A is the ability for any of the parties to expand any component of the project so long as the other parties are held harmless. What will happen is, when an expansion is desired by any one of the parties, they let the others know, and the others can participate, but they don't have to. The costs associated with that expansion from a CAPEX perspective are born solely by the expanding parties. And so that there's no impact on the others. So we think that is ultimately going to result in a situation environment where third parties are going to be confident in their ability to access capacity on the share of the pipe that the state and Trans-Canada are responsible for. We've secured in the Memorandum of Understanding an agreement on the capital structure for those expansions, even though we don't know what the cost of debt and the cost of equity will be in the future, but we have at least secured the capital structure for those expansion scenarios. Ultimately, how much spare capacity will be present in the line will is going to depend on the specific size. The initial plan right now is for that pipeline to be 42 inches. The initial throughput of the project is expected to be in the 2.8 billion cubic feet per day or so range. We understand that there's going to be upwards of a billion cubic feet per day of capacity available through compression before you have to get to looping. And its looping where the costs get really big and rolled in rate approach would become very important. So what we're going to do going forward is, during this pre-FEED phase, confirm through engineering studies and the like, what that capacity of the project ultimately is, what the increments look like, because the pipe is going to have a lot of flexibility in how big it can go. The liquefaction plant is another beast. The liquefaction plant, in all likelihood, when it expands, will expand in trains. In other words, the modules, the components that actually liquefy the gas and those are going to be coming together in the 750 to 800 million cubic feet per day tronches. So an expansion necessary to support the addition of another liquefaction train is going to be quite large and that's also going to require a very large discovery of gas. We think the potential exists for that sort of thing and we're looking forward to those possibilities. But in all likelihood what we're going to see is the smaller variety of increment with smaller discoveries of gas going to serve in-state markets, in-state growth in utility demand, or mines, or other industrial uses, and so the most important things- having access to the pipeline, and having a capital structure that results in low tariffs, we think we've achieved. Rolled in rates is something that we don't believe is necessary, but that is a very qualified answer and depends ultimately on the size and capacity of the project from day one to what its expandable to without looping.