

**ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON OIL AND GAS**

February 7, 2002

10:14 a.m.

MEMBERS PRESENT

Representative Scott Ogan, Chair
Representative Hugh Fate, Vice Chair
Representative Fred Dyson
Representative Mike Chenault
Representative Vic Kohring
Representative Gretchen Guess
Representative Reggie Joule

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

CONTINUATION OF ROYALTY-IN-KIND GAS SALE HEARING (continued from 2/5/02)

- HEARD; APPOINTED SUBCOMMITTEE

PREVIOUS ACTION

No previous action to record

WITNESS REGISTER

BONNIE ROBSON, Deputy Director
Division of Oil & Gas
Department of Natural Resources
550 West 7th Avenue, Suite 800
Anchorage, Alaska 99501-3560

POSITION STATEMENT: Discussed the royalty-in-kind (RIK) gas sale and answered questions.

MARK MYERS, Director
Division of Oil & Gas
Department of Natural Resources
550 West 7th Avenue, Suite 800
Anchorage, Alaska 99501-3560

POSITION STATEMENT: Offered information on the RIK sale process; highlighted the need for a two-pronged approach including both the RIK sale and federal legislation.

MICHAEL J. HURLEY, Senior Commercialization Specialist
ANS Gas Commercialization
Phillips Alaska, Inc.
P.O. Box 100360
Anchorage, Alaska 99501

POSITION STATEMENT: Testified regarding effects of the RIK sale on the producers.

ACTION NARRATIVE

TAPE 02-8, SIDE A
Number 0001

CHAIR SCOTT OGAN called the House Special Committee on Oil and Gas meeting to order at 10:14 a.m. Present at the call to order were Representatives Ogan, Fate, Kohring, Guess, and Joule. Representatives Dyson and Chenault arrived as the meeting was in progress.

CONTINUATION OF ROYALTY-IN-KIND GAS SALE HEARING

CHAIR OGAN announced that the committee would continue its hearing, begun Tuesday, February 5, 2002, regarding the royalty-in-kind (RIK) gas sale. He reminded members that much information had been covered at the previous meeting, but that testimony by the Division of Oil & Gas had been cut short by time constraints.

Number 0146

BONNIE ROBSON, Deputy Director, Division of Oil & Gas, Department of Natural Resources (DNR), testified via teleconference. She informed the committee that she would provide detail on matters she'd discussed previously, but also would address other important aspects to consider, in the context of the RIK sale, regarding issues raised by BP Exploration (Alaska) Inc. ("BP") and Phillips Alaska, Inc. ("Phillips").

MS. ROBSON referred to indication by Mr. Konrad of BP, at the previous hearing, that BP believes the RIK sale is premature. She told members:

If you will recall, initially the state started down the process of an RIK sale based on the statements by BP, Exxon [ExxonMobil Corporation], and Phillips that an open season for pipeline capacity could be as early as the first quarter of 2002. In light of that, we did begin the process, although we have been more recently informed by BP, Exxon, and Phillips that at this point in time, they do not currently envision that they will conduct an open season in 2002.

... That statement came within two weeks of one of those three parties' informing us that an open season could be in the second quarter of 2002. So, we do not feel that we have the guarantee that there will not be an open season this year. But as a practical matter, all we know is that an open season may be this year; it may be next year; it may be next decade. We do not know. So what do we do to prepare?

The important thing to remember is that when the open season closes, a decision between royalty-in-kind and royalty-in-value will have been made, and it will have been made for one of two reasons - either because this issue is treated today as if it were a "now or never" proposition, with recognition that the original capacity, 4 or 4.5 billion cubic feet a day, will not be again in play until 2025, 2030, or possibly 2035, [or], alternatively, a decision between royalty-in-value and royalty-in-kind can be made by inaction or by gambling that the open season will not be until at least the latter part of next year, when the legislature would have a chance to address the matter of an RIK contract in the session next year.

Number 0331

MS. ROBSON suggested it is more appropriate "to make a decision by treating the issue seriously today." She conveyed her belief that the committee sees the same need to address the issue in short order.

MS. ROBSON reminded members that there are only two seasons: the open season and the closed season. The open season lasts a matter of weeks, perhaps at most a matter of a couple months. Therefore, the closed season dominates; it will dominate for the period of construction plus 15 years and possibly longer. She cautioned:

When the season is closed, the pipeline is essentially a private pipeline. So if the state does not play now - if it does not participate in decisions made on what happens with the initial 4 billion cubic feet a day of pipeline capacity - it may not be able to play at all until, as I indicated, 2025 or later.

Number 0455

MS. ROBSON responded to an indication by the producers that the state should consider "the prospect of a future open season on expansion capacity as some solution to the state's needs." She told members:

I am going to suggest to you that that is not appropriate. First of all, an expansion is not a given. We do not know that there will be an expansion. And we have heard conflicting testimony on whether FERC [Federal Energy Regulatory Commission] can order expansion.

The "big three" [oil producers] would have us believe that FERC does have that ability. The FERC staff, the lawyers representing the State of Alaska, and those representing the explorers all indicate that they think that FERC does not or, at best, it is arguable whether FERC has that jurisdiction.

So I think it's safe to say that we have no guarantee that FERC can order expansion, and if FERC cannot order expansion, then ... the right to expansion rests in the sole control of the big three.

Number 0561

MS. ROBSON continued:

Even if FERC does have jurisdiction - as the big three suggest - they have suggested that it only exists where there is a showing made that there is some behavior on ... the part of those who own the pipeline, [that] there is something about the market structure that justifies FERC intervention. And that kind of proceeding is never easy, it's never cheap, it's never quick, and it's never certain. And I suggest to you that we should not rest all our hopes

for getting RIK gas into a pipeline on a future, possible expansion where there is such lack of certainty.

It is also possible that a future expansion may be controlled by preferential rights given to those who receive the initial pipeline capacity. And if the initial pipeline capacity is limited to BP, Exxon, and Phillips, and they have preferential rights to expansion capacity, again, we may not have the chance to play in expansion capacity at all. Nor may explorers or other sources of new gas.

But in any case, if we do have an opportunity to participate in a future expansion, our ability to ... work within that expansion will probably be limited to one-eighth of the expansion capacity, representing our royalty share. So if we start with a 4-billion-cubic-foot-a-day pipeline and expansion is on the order of 1 billion cubic feet a day - or, to make the math easy, let's say, .8 billion cubic feet a day - our role in the expansion may be limited to .1 billion cubic feet a day, that is, 100 million cubic feet of gas, at a time when our royalty share is on the order of a half billion or 600,000 million cubic feet [mcf] a day.

Number 0715

MS. ROBSON addressed the issue of fairness. She noted that BP and Phillips, in testimony at the previous hearing, had questioned the fairness of an RIK sale, at least if it is used as a "backstop" to new sources of gas. "Specifically, they implied that those who pay for the pipeline have the exclusive right to ship on the pipeline," she said. "They also say that a backstop - that is, any RIK sale that lets new sources of gas into original pipeline capacity, would cost them on the order of \$2 billion." To that, she responded:

I suggest to you that neither of these are true. First of all, as to their implication that those who pay for the pipeline have the exclusive right to ship, that is simply not the way it works. Ownership of the pipeline is devoid from the right to ship on the pipeline under current law. Those who own the pipeline do not have the ability or the right to ship even one mcf of gas on that pipeline unless they sign a ship-or-pay commitment for pipeline capacity. It is

those who sign a ship-or-pay commitment during the open season that acquire the right to ship gas on the pipeline.

Number 0802

MS. ROBSON, at the request of Chair Ogan, described ship-or-pay commitments. She noted that the expected duration is at least 15 years, but perhaps 20 or 25 years. She explained:

When the open season comes ... those who are willing to sign up for pipeline capacity of long duration - and I'll just use 15 years for simplicity - sign a firm contract. ... They say, "We will pay, for that capacity, ... a certain amount, say, \$1.25, \$1.50, for every mcf of gas within that capacity, regardless of whether we use that capacity or not."

So, if somebody comes to the open season and they say, "I am making a commitment now for a half bcf of gas per day," they, in fact, sign up to pay on the order of \$500,000 per day or more, regardless of whether they, in fact, ship gas. So, it is something that requires some risk, some nerve, some gumption on the part of a party, particularly a party who doesn't know whether they have gas or knows they have gas but doesn't know whether their gas can otherwise get into the pipeline, to show up in the open season and sign one of these contracts.

And I suggest to you, they are making a substantial commitment to this pipeline, even though they are not the ones that pay for construction of the pipeline at the time of construction. They pay for the pipeline by paying a tariff once gas flows, regardless of whether their gas is, in fact, flowing.

Number 0943

CHAIR OGAN noted that all members were present.

MS. ROBSON continued with ship-or-pay contracts, discussing the distinct roles of producers and those that build the pipe:

I think what you need to do is ... separate the role of BP, Exxon, and Phillips, as producers at Prudhoe Bay and potentially as producers at Point Thomson,

from their role as "pipeliners," if they are, in fact, the ones that build this pipeline. As producers, as owners of the gas, they will be signing a ship-or-pay contract with the pipeliners, whoever the pipeliners may be. They will not, as producers, be paying for the construction of this pipeline at the time of construction.

Now, if BP, Exxon, and Phillips are the ones to build this pipeline, you must regard them in the role of pipeliners, and so they undertake the obligation to pay for construction, at the time of construction, as pipeliners. And if, in fact, we have something like the pipeline consortium, a "foothills arrangement" building this pipeline, then it is not BP, Exxon, and Phillips who pay for construction of the pipeline at the time of construction; in fact, they simply sign a ship-or-pay contract at that time, as would anybody else who shows up for the initial open season. And they effectively pay for the pipeline on a per-mcf basis, through the tariff, once gas actually flows.

So you have to ask yourselves, when ... BP and Phillips suggested that it is unfair to use RIK as a backstop for new sources of gas, to look at what those new sources of gas must do to support this pipeline. They, like the producers, as producers of gas, must step up in the initial open season and sign a ship-or-pay contract to pay for pipeline capacity, regardless of ... whether they use it. ...

Number 1088

MS. ROBSON discussed the greater risk that she believes the explorers have:

I suggest to you, those who have not even discovered their gas yet, who are betting on a discovery of their gas, are, in fact, undertaking a greater risk in signing a ship-or-pay contract, than those that are sitting on a ... known source of gas that is produced day in and day out, and reinjected into the ground at this point in time.

I also have to ask whether it is fair [if] those who come forth in the initial open season and sign a ship-or-pay contract - regardless of whether it is the

producers or the explorers or any other potential source of gas - are precluded from playing in the initial 4 bcf of pipeline capacity.

Number 1135

MS. ROBSON addressed the producers' assertion that an RIK sale would cost them perhaps \$2 billion:

The second argument that the producers made with regard to an RIK contract, at least where it's used as a backstop for potentially new sources of gas, is that they say it would cost them on the order of \$2 billion. And this is their calculation. And I do have to thank the producers because after the hearing on Tuesday, I did have an opportunity to speak with some of the personnel ... from Phillips, and they gave me some additional information on how they calculated the \$2 billion that they referred to on Tuesday when testifying before you.

If you recall their scenario, they said, "Let's assume we start with a pipeline that has 4 billion cubic feet a day of capacity. And let's also assume that 4 billion cubic feet a day initially flows from Prudhoe Bay, but that after some period of time, .35 billion cubic feet, or 350 million cubic feet of gas, enters the pipeline from a non-Prudhoe Bay source." And they argued that this would, in fact, reduce their profitability to the tune of \$2 billion.

The information that I received after the meeting on how they got to \$2 billion is, they said, well, what will happen if you get .35 billion cubic feet of gas from a non-Prudhoe Bay source and put it into that initial 4 billion cubic feet of capacity is that, in fact, their equity shipments will drop by roughly 300 million, or .3 billion, cubic feet a day. The royalty share from Prudhoe Bay will drop by about 50 million cubic feet a day, and the big three, as owners of the 300 million cubic feet a day in equity gas from Prudhoe Bay that has been backed out or reduced, will lose a \$1 wellhead value on each and every mcf that they have been backed out of for a period of 20 years. So they took 300 million cubic feet a day, multiplied it by a \$1-per-mcf wellhead value, multiplied it by

360 days, for one year, and then by 20, for 20 years.
That comes out to \$2.2 billion.

Number 1311

MS. ROBSON discussed ways the producers might mitigate potential damage:

I suggest to you that BP, Exxon, and Phillips ... can mitigate that damage, possibly in its entirety so that they face no damage at all - certainly, substantially. ... One way in which they could mitigate that potential damage is for them to have participated in the RIK sale by offering a premium for gas that would have cost them less than \$2 billion. They decline to do so, despite some initial conversations in which they expressed interest.

But I think the second and real way for them to mitigate their damage: after gas is flowing, when they realize [a] new source of gas is going to come into the pipeline, when they realize they are going to be backed out to the tune of 300 million cubic feet a day, equity gas, they can at that time expand their own pipeline. They will have years' advance notice that new-source gas has been found, is ready for production, and is going into the pipeline. During those years, they can move to expand their own pipeline. They can take their gas to market. They can get that \$1 wellhead on each and every mcf for the 20 years, and they can totally mitigate the \$2.2 billion.

Alternatively, maybe they're not quite so quick in expanding their pipeline. Maybe it takes them 5 years to expand it. ... If they expand it in 5 years, as opposed to after 20 years, they limit their damages to \$500 million, not \$2.2 billion.

Number 1406

MS. ROBSON continued with mitigation for the producers, addressing tariffs and pipeline expansion:

The important thing to keep in mind is, if there is an expansion, and if it is their pipeline, they certainly have control over that expansion, as long as the

tariff for gas that comes in under expansion capacity is roughly equivalent to the tariff for gas that's flowing on the original pipeline capacity. Then they have totally mitigated their damages.

So it is only if the tariff on expansion capacity is higher than the tariff that goes with gas flowing on the original capacity that they stand to lose something. And if the tariff on the expansion capacity is a little bit higher than the tariff on the original capacity, but is less than \$1 higher per mcf - and I suggest to you that it would be - then they are not facing anything like \$2.2 billion in damages.

Now, what do we know about the tariff on expansion capacity? ... BP, Exxon [and] Phillips have come to us and they've painted a scenario where you have an initial pipeline on the order of 4.5 billion cubic feet per day. You can expand that pipeline, and you can expand it through compression to about 5.5 billion cubic feet a day. And the expansion capacity - that additional 1 billion cubic feet a day - comes in with a tariff that is roughly equivalent to the underlying tariff on the original pipeline capacity.

That is what they have represented to us. They have then indicated that capacity beyond 5.5 billion cubic feet a day becomes more expensive. So you have to do more than just adding intermittent compression stations, and that costs more.

But if what they say is true - if that expansion capacity costs no more than the original capacity, at least for the first billion dollars - then, again, they do not face damages as long as they expand their pipeline, which they control, to take in ... that .3 or .35 billion cubic feet of gas that is backed out under the backstop scenario.

Number 1547

MS. ROBSON continued discussing expansion:

And I indicate to you that ... perhaps it is a lot easier for those who own the pipeline - for the big three - to get the expansion of the pipeline, as opposed to leaving it to new sources of gas. If you

take the scenario where your new source of gas must come to BP, Exxon, and Phillips and ask for expansion of pipeline capacity, they have no legal right, under current law - or at least no more than an arguable right under current law - for that expansion.

BP, Exxon, and Phillips -- and this is nothing particular to these companies. It's to any three big companies that dominate a market structure. We could be talking about the auto industry, as opposed to the oil and gas industry in the state of Alaska. You have to ask, when a competitor ... comes to the big three and asks for something, are they certain to get it? And I suggest to you, no, they are not; that is, the producers will expand their own pipeline when it is in their own self-interest ... , as it would be under a backstop scenario. We cannot count on the producers' expanding their own pipelines when it is simply in their competitors' interest to expand that pipeline.

Number 1642

MS. ROBSON referred to indication by BP and Phillips at the previous hearing that they aren't troubled by every RIK contract, but by contracts that let a new source of gas into the original pipeline capacity. She noted that they'd referred to the backstop proposals made both by Chevron [ChevronTexaco Corp. as of October 2001], for Point Thomson gas, and by Anadarko/AEC [Anadarko Petroleum Corporation/Alberta Energy Company] for foothills gas. She remarked:

I'm going to suggest to you that every RIK contract offers the potential of letting new-source gas into the ... original pipeline capacity. The way it works is this: Anybody who is an RIK buyer will have to sign a ship-or-pay contract to take that gas off the North Slope. But once they've signed their ship-or-pay contract, they've committed to the pipeline for, say, 15 years to pay for that capacity. They are going to fill that [capacity]. They may fill it with the RIK gas; they may fill it with gas from another source.

Historically, every RIK contract has provided for the possibility that the contracts may not be of the duration initially contemplated. So, if you take an example where we sign a ... 15-year contract for RIK

sales, and the RIK buyer comes in and signs up for 15 years of pipeline capacity under [a] ship-or-pay contract, it is always possible that, for a multitude of reasons, that ... buyer will not, in fact, buy our gas for 15 years. They might not buy it because they find a cheaper source of gas; that could be new-source gas. They could terminate their RIK contract. Worst-case scenario, they could default on their contract and we could terminate it. But they would still own the pipeline capacity, and they may fill that with new-source gas.

So I suggest to you that if the producers object to a backstop RIK sale - the one that may let a new source of gas into the pipeline - they, in reality, are objecting to every RIK contract that we may enter now or in the future.

Number 1774

MS. ROBSON offered an example. The Trans-Alaska Pipeline System (TAPS), the oil pipeline, is a common carrier for which getting capacity hasn't been a problem; nominations for pipeline capacity are made monthly. By contrast, a gas pipeline would be a contract-carriage pipeline requiring long-term commitment of 15 years or more. If TAPS were contract-carriage and were full, it would have resulted in the same situation being faced now with gas, which would have been a problem for [the state]. She explained:

We signed a 1998 contract for the sale of royalty oil to Williams for their Fairbanks refinery. It was a contract with a five-year duration. And if they had had to sign a ship-or-pay contract, presumably they would have - to get that oil to their Fairbanks refinery, to refine it - through 2003.

In fact, what has happened under that contract - as is allowed under ... every RIK contract - is that they have reduced their volumes. And where are they getting their volumes from? They're getting it from new-source oil. They are buying Anadarko's Alpine production.

Number 1815

MS. ROBSON continued:

If this had been a contract-carriage pipeline, if this had been a full pipeline, we would have a problem. Anadarko would not have this opportunity to sell their oil, to put it on the Williams pipeline capacity, and to get it to Fairbanks. Yes, we may have had our RIK sale. Yes, it may have gone for the entire five years. But another interest of the state might not have been served, and that is in getting new-source oil into the pipeline.

So while we recognize the producers' concerns and we want to work further with them - we want to understand better their concerns and work to accommodate them - we also have to recognize that the interests of BP, Exxon, and Phillips are not the only interest of the state.

And while we are very happy to see them pursuing a natural gas pipeline at this point in time, we do have to look beyond the immediate interest in getting a pipeline. We do have to look to future exploration and new basins, and even getting Point Thomson gas online, as is suggested by Chevron's proposal to purchase RIK gas.

Number 1934

MS. ROBSON addressed access, referring to testimony at the previous hearing that while an RIK contract may provide access, it isn't the only potential answer. Theoretically, Ms. Robson told members, there are other ways to serve the access. For example, access could be improved through a change in federal law or through an agreement with BP, Exxon, and Phillips. However, the state and the legislature don't control federal law or the agreement of BP, Exxon, and Phillips.

MS. ROBSON pointed out that the RIK sale is a mechanism for access that is, by contrast, within the control of the state and the legislature. She concluded by emphasizing the need to keep that option available while pursuing other, theoretical options.

Number 2000

CHAIR OGAN referred to Ms. Robson's mention that a [producer] had said there could be a sale in the second quarter of 2002. He asked whether who said that is confidential information.

MS. ROBSON answered:

I don't know that it's confidential. I would prefer not to point fingers at one particular company. We also did have a similar representation come from the pipeline consortium, also in December and possibly also January of this year, that ... an open season could be as early as the second quarter.

So what happens is, when the producers say they do not ... currently envision that they will conduct an open season in 2002, that does not provide us with the comfort that we need, in case a ... pipeline consortium chooses to go to open season in 2002. It also does not recognize that while the producers on this date may not contemplate that they will conduct an open season in 2002, because so recently they were of the opinion that they might, we have to envision that they might - if they get the federal legislation they seek - go to [an] open season themselves in 2002.

Number 2083

CHAIR OGAN offered his understanding that a contract carrier - at least the oil pipeline - isn't regulated to the same extent by the Regulatory Commission of Alaska (RCA).

MS. ROBSON responded:

I think there's been universal recognition - by you, Mr. Chairman, as well as by some of the other legislators, by the Regulatory Commission of Alaska, by this division, by the Department of Law - that we have a problem on access, and we have a problem with the [federal] laws on access, that they ... are not tailored to the needs of the State of Alaska and its particular circumstances, but that changing that law is outside the control of the state, because it is a federal matter where the federal government preempts state law if any gas destined for markets in the Lower 48 or outside the state of Alaska is carried on this pipeline. And that will certainly be the case.

Number 2148

CHAIR OGAN noted that he is working on a resolution to send to the federal government; he mentioned the so-called energy bill before Congress. He asked Ms. Robson to provide a list of things she believes will facilitate gas development in Alaska; he cited access as a major concern. He added that a number of people have suggested RCA be at the table with FERC for some kind of joint management of the gas pipeline, should it happen.

MS. ROBSON replied, "We'd absolutely be happy to provide you with what we have."

Number 2231

REPRESENTATIVE DYSON asked: If this RIK sale is the best way to encourage or empower independent explorers to continue exploration, what happens to the independent explorers who don't prevail in the RIK bidding?

MS. ROBSON responded:

Certainly, those explorers and potential future explorers who are willing to come forth in the initial open season and participate at this time are going to have [the] advantage when the open season closes. It ... takes a certain amount of ability to withstand risk to come forth in this open season and nominate and pay for pipeline capacity, not knowing whether you are going to have gas. It does put those who do at some sort of advantage.

There is the possibility that future explorers can pursue pipeline capacity in one of a number of ways, but ... I cannot suggest to you that they are as certain or as sure or as desirable as what could theoretically be available to somebody participating now in the open season who does get an RIK contract, because, again, this really is a unique opportunity to play in the initial 4 billion cubic feet of pipeline capacity. And there isn't going to be a similar opportunity, we think, until 2025 or later.

The potential ways other explorers could obtain some of that initial pipeline capacity are, if it were to turn out that certain explorers did get an RIK contract and they did not find gas or did not find as much gas as they were hoping to find, there is at least the potential that they could assign their RIK

contract to other explorers who had proved more successful.

So once this contract is out there, if at all, it does become an asset for the state for getting certain volumes of new-source gas into the pipeline, but no greater volumes.

Again, future explorers will have a shot at expansion capacity, but I can't tell you that there will, in fact, be an expansion or that the tariff will be the same for expansion capacity or when that expansion will be. So explorers who do not play now will face a disadvantage. Hopefully, they will not consider it a hopeless state. But it is troublesome.

Number 2406

REPRESENTATIVE DYSON asked whether perhaps the RIK sale shouldn't have been winner-take-all, and should have allowed several explorers "to have had a piece of our royalty gas."

MS. ROBSON answered:

Basically, it is not necessarily a winner-take-all proposition. We indicated that we would be offering up to 70 percent of the state's royalty share, and on the 4-bcf pipeline that ... translates to 350 million cubic feet a day. If, instead, you have a 4.5-bcf-a-day pipeline, that's 400 million cubic feet a day.

We offered up to that amount. We did not indicate that simply because somebody offers to buy the entire amount, that we will, in fact, sell the entire amount to a single party. So we do have multiple bids from different parties seeking the lion's share of that 350-400 million cubic feet a day. If ... the Department of Natural Resources goes forward with a recommended contract, it's not necessarily going to be one contract; it could be multiple contracts, to serve the needs of multiple participants in the RIK sale process.

Number 2520

MARK MYERS, Director, Division of Oil & Gas, Department of Natural Resources, testified via teleconference in further response to Representative Dyson's question. He said:

We tried to create a process, through the RIK proposals, to allow for maximum flexibility to ... review those types [of] issues and ... not even to presume we knew, at the point of the sale, what the highest and best use for the state gas was.

So RIK backstopping is only one possible use of the state gas. And I think you've seen that with the bidding, again, where you have a company like Williams - which doesn't explore for gas in Alaska - involved with the process for a different reason. We've seen a local power utility worried about ... getting an in-state supply of gas. So the process was designed so that we could review all the potential and have a relatively open process in that review and discuss the various values that might be achieved by ... an RIK sale.

I think the other thing that's important to note is that that RIK sale was open to the producers to bid as well. If they were really concerned about mitigating the effects of an RIK sale, the obvious solution is to bid and offer the state more in value than they will receive in RIV [royalty-in-value]. Their response, at least Phillips' response, is the terms were commercially unreasonable. ... We see Chevron, ... Anadarko/AEC, Williams, and Alaska Power [& Telephone Company] showing that they ... believe to the contrary, by their bids.

So, once again, I think the RIK process was designed to be open enough to both meet some of the producers' concerns about ... the potential to mitigate the effects of ... RIK-RIV switching, but also to deal with the broader ... policy issue of what is the best and highest use for the state gas.

Number 2610

MR. MYERS referred to concern about later explorers and suggested a two-pronged approach. The first prong, the RIK sale, would allow for potential options and provide [assurance] to the state that it has a choice in how its gas is used. The

second prong, federal legislation, would enable expansion on a fair and equal basis, and would compel an economic expansion of the pipeline. He stated:

Your comments last time about common-carrier would solve the problem; that's absolutely correct. This whole problem of access wouldn't exist if the gas line is common carrier, but we've seen no indication that ... that is being contemplated or that that option is available. ...

The RIK sale is an imperfect solution. It only helps the first trench of explorers if, in fact, it is the choice of the legislature to use this gas for RIK backstopping. But further legislation is also needed to help that later round of explorers elsewhere.

Number 2655

CHAIR OGAN asked how the 70 percent figure was arrived at, and what the plans are for the other 30 percent.

MS. ROBSON answered:

The thought process behind that was that if we are operating with 4-billion-cubic-feet-a-day initial pipeline capacity, the state's royalty share, at one-eighth, is a half billion cubic feet a day, or 500 million cubic feet a day.

We thought it appropriate to reserve some future gas for a number of possible uses. And we thought 150 million cubic feet, or 30 percent of the royalty share, would be sufficient for anything that was likely to be contemplated in the ... near future, and in light of the fact that ... a future buyer, if they are to use the gas someplace other than the North Slope, won't have a way to get pipeline capacity, or not in significant volumes.

So if we reserve 150 million cubic feet a day, that's sufficient, certainly. For instance, if we wind up with Internet data centers on the North Slope, we still have gas available to sell to them.

If we want to sell some of that gas for in-state use, the producers have indicated ... that there may be 50

to 100 million cubic feet a day of pipeline capacity that is basically "flex" capacity that could be used to accommodate in-state demand. And we could fill ... that flex capacity with demand from future in-state buyers. But there's not going to be the flex, absent a formal expansion, for us to sell 250 or 350 ... million cubic feet a day, in a future gas sale, without there being another open season, because there simply won't be a buyer who can get the gas into the pipeline to take it to their destination.

The other thing is, we did need to retain some percentage of gas in value with the producers, because what they report as the value - what they sell that gas for - then becomes a baseline number used in calculating the price for royalty-in-kind purchasers.

Number 2784

CHAIR OGAN noted that in the audience were current and former employees of Phillips who were members of the Phillips Civic Action Program [Alaska]. He welcomed them to the committee.

Number 2810

REPRESENTATIVE FATE asked what the cost would be to add capacity if the pipeline increased from 4 bcf to 4.5 bcf in capacity. He inquired about a rule of thumb regarding this, suggesting it might be better asked of the producers.

MS. ROBSON answered:

I can tell you what we have been advised by BP, Phillips, and Exxon, but I cannot give you any independent information on this. We have been advised that, as currently contemplated, they're looking at an initial pipeline that really isn't on the order of 4 bcf a day, although the math is easy with 4 [bcf], and I think people keep falling back to that; it's more on the order of 4.5 bcf a day. And it will initially be designed with [an] eye towards some expansion at some point in time. ...

The "easy" expansion will come through adding compressor stations - not between every existing compressor station, but quite a few compressor

stations. And that will allow pipeline capacity to go up to around 5.5 billion cubic feet a day.

Beyond that - at least, we're being advised - you don't get your additional capacity simply by adding more compressor stations. Then you have to lay additional pipe. You have to do looping, and it may be full-line looping. Presumably, that's going to be more expensive.

So, our information is that you have about a billion cubic feet a day of expansion possible, that at least the representation on that has been, the tariff on that expansion will be basically the same price as for the underlying, original capacity, but then you get into what is currently envisioned as more expensive expansion.

Number 2923

REPRESENTATIVE FATE asked what the cost differential is in the design, at the front end, between a 4.5-bcf-a-day and a 5-bcf-a-day pipeline. He again noted that the producers may be better able to answer.

MS. ROBSON replied:

I think they're talking about the same diameter [of] pipe, regardless of what the initial capacity is. It's probably going to be a 52-inch thick-wall diameter pipe. It's just a matter of how many compressor stations you start out with.

Number 2970

REPRESENTATIVE DYSON said he'd been asking the same question that morning, and would have guessed on the order of 5 percent to build in capacity in the initial construction.

TAPE 02-8, SIDE B
Number 2970

REPRESENTATIVE DYSON reported that one of the "industry folks" he'd been talking to said it is certainly less than 10 percent. In response to a remark by Representative Fate, he surmised that if future expansion were to be facilitated by an increase in the diameter of the pipe from 48 to 52 [inches], it would be closer

to 10 percent. However, he encouraged Representative Fate to seek confirmation from someone more expert.

Number 2934

MS. ROBSON said:

The producers have told us, from the very beginning, that they are going to build a pipeline that will be expandable. So, to the best of my knowledge, they have never contemplated building a pipeline without the additional expense that comes in designing this pipeline with [an] eye towards future expansion.

Number 2918

CHAIR OGAN brought up the issue of the effect of the drawdown of gas on the production of oil, especially in the Prudhoe Bay Unit. That will be a factor in deciding the size of the gas pipeline, he said. He recalled that the drawdown effect is one of three major factors in the considerations of the producers. He said he'd really like to have an independent analysis of that, perhaps by a combination of [DNR] and the Alaska Oil and Gas Conservation Commission (AOGCC). He added, "I'll work on making sure funding for that is in the budget somewhere."

CHAIR OGAN thanked Ms. Robson and Mr. Myers for their willingness to communicate with the legislature.

Number 2858

MICHAEL J. HURLEY, Senior Commercialization Specialist, ANS Gas Commercialization, Phillips Alaska, Inc., came forward to testify, noting that he wouldn't dispute the benefits of an RIK sale to the state and to the exploration companies. He offered, however, that the cost of those benefits is being "basically placed on the producers." He added:

In our view, this isn't really a question of access. It's a question of who's going to carry the burden and who's going to take the risk for that additional access. We believe the RIK backstop provisions are basically shifting the risk of costs and risk onto the producers from those who want to go out and explore and find new gas.

Number 2759

CHAIR OGAN asked, "That's assuming the producers build the pipeline, correct?"

MR. HURLEY agreed, adding, "We haven't got there yet." He referred to discussion at the last two hearings about the burden and that it can be mitigated, is not too big, or is "just a burden on us." He said nobody, to his knowledge, has denied it is there. He stated, "From our perspective, ... it is a burden; it is additional risk." He then addressed expansion:

We did build this line with expandability in mind. We intend to expand this system if we can, and if it's economic. ...

If we just wanted to sell 4.5 bcf a day without making any potential for expansion, I think we probably could have gotten by with a 48-inch pipe. But we didn't. We're building a 52-inch pipe because we know we want to try and be able to expand this system. I can't tell you how much additional that costs; I haven't seen anybody put a pencil to it in terms of dollars. But there are additional costs already being incurred just to make that expansion capability available.

Number 2674

MR. HURLEY discussed the need for fiscal certainty. He said, "Let me suggest that the RIK scenarios we're painting here are a prime example of what kinds of things are understood by the industry to be fiscal certainty." Referring to the Alaska Stranded Gas Development Act passed in 1998 [as HB 393], he told members, "We had originally worked that deal out; the legislature approved it. That legislation was designed to be able to work through some of the fiscal certainty items." He said that was originally envisioned and designed to be for any commercial gas project, including a pipeline in the Lower 48, GTLs [gas to liquids], or LNG [liquefied natural gas]. Before passage, however, it was limited to LNG.

MR. HURLEY referred to AS 43.82.200, which he said recognizes the state's need to figure out some way to deal with this "RIV-RIK problem." He added that it's a problem in any kind of gas pipeline that uses contract carriage, which by its nature creates this kind of scenario. This kind of RIK backstop and the state's "flipping back and forth" is an issue, he said, and "increases the uncertainty for us or costs additional money to

build in upfront - and it's basically just a shifting of the burden."

MR. HURLEY told members, "We believe that access is going to happen." He referred to discussion regarding FERC and [lack of] guarantees and control. He said:

We believe that the FERC is a responsible regulatory body and does its job, just like they do everywhere else in the U.S. Not only do we have them watching over us, you folks yourselves have been doing a great job of looking over our shoulder at everything we try and do. So I don't believe that access is going to be a problem, in and of itself because, a) FERC regulates it, because b), Mr. Chairman, you're watching everything we do, along with lots of other members of the legislature and the Division [of Oil & Gas]. So if there are opportunities out there for expansion that make sense in our economics, we're going to do them - a) it's in our best interest to do them, and b) everybody's going to be watching us.

MR. HURLEY reiterated that he doesn't believe it is a matter of access, but of who will have the burden of risk and cost. "We believe this RIK backstop proposal shifts those burdens from new players to the existing players, to the existing players' detriment," he concluded.

Number 2462

REPRESENTATIVE GUESS referred to Mr. Hurley's testimony that if it's economic, expansion will occur. She pointed out that something economic from a pipeline standpoint might not be economic from a producer's standpoint; she asked which perspective he was speaking from. She also asked, once the [pipeline is built], what Mr. Hurley envisions the legislature's role to be in forcing expansion of the pipeline and providing access to new players.

MR. HURLEY responded that once the pipeline is built, there will be separation. He said there is a FERC requirement to keep those companies separate, and a fairly stringent set of rules about how affiliates can interact; in fact, the FERC recently published some new rules on affiliate interactions and a standard of conduct about how affiliates can interact. Mr. Hurley added, "I'm sure this Enron debacle probably hasn't helped, quite frankly."

MR. HURLEY said it will always be in the pipeline companies' interest to expand. Furthermore, it is also usually in the shipping companies' interest to expand because expansions are usually cheaper - or certainly no more expensive - if all that is required is additional compression, rather than additional sections of pipe. "So it's usually in everybody's interest to expand a pipeline," he concluded.

Number 2375

REPRESENTATIVE GUESS again asked how Mr. Hurley sees the role of the legislature is ensuring that happens once the pipeline is built. She said she sees nothing in statute, either at the federal level or state level, that will force "you all" to do something that may be in the state's best interest versus the "pipeline's" best interest.

MR. HURLEY responded that certainly there is nothing specific that will provide that power.

Number 2338

REPRESENTATIVE GUESS referred to Mr. Hurley's testimony about the producers' bearing the risk and cost of ensuring expansion if there is an RIK [sale]. She asked, "As a pipeline company, don't you just pass that on?"

MR. HURLEY answered:

The RIK backstop deal will not impact the pipeline company piece of this at all. The pipeline company is totally indifferent. ... The people that are impacted are the existing shippers. That's why, when I kind of went through that example, what happens is, the Prudhoe Bay shippers of equity gas are the ones that get cut back and get their revenue reduced. ... It has no impact at all on the pipeline.

Number 2308

REPRESENTATIVE GUESS said she has heard that there will be more than the three producers - Phillips, BP, and Exxon - bidding in the open season. She asked why none of the other potential shippers are coming forth and saying there is a problem with the RIK [sale].

MR. HURLEY answered that he wasn't aware of anyone who would "step up and bid big volumes of gas," with the exception of the three companies mentioned. He said there may be others, but none he was aware of.

Number 2263

REPRESENTATIVE GUESS referred to testimony that having common carriage would help solve this problem. She asked, "Is Phillips pushing to think outside the box and have this be a common carrier?"

MR. HURLEY replied:

No, I don't believe this could be a common carrier. Normally in the business, when you're selling gas, if you're in a common-carrier situation, you can get prorated out. So if I, for example, have a long-term contract, as Phillips, to sell gas to a utility in Chicago who's then providing power to light my grandmother's lamps and stove and heat, I can't be put in a situation where, at any given month, I can be prorated out of the line. I've got contracts to supply gas to ... people to heat their homes and do their business. So gas is virtually always sold on a contract-carriage basis.

REPRESENTATIVE GUESS noted that Mr. Hanley's testimony had indicated common carriage could be an option, whereas Mr. Hurley is saying he doesn't believe it could be.

Number 2180

CHAIR OGAN suggested it is important, at some point, to hear directly from FERC regarding pipeline access. He informed listeners that it had been discussed in the Joint Committee [on Natural Gas Pipelines] during the past summer; he said neither that committee nor DNR believes [FERC] has that authority. Furthermore, the independent explorers disagree with the assertion [that FERC has that authority]. Recalling FERC's testimony before the joint committee, he said there is some ambiguity.

REPRESENTATIVE DYSON, noting that he hadn't attended those meetings, suggested that members of the House Special Committee on Oil and Gas read the minutes and obtain background

information on FERC, including its mission and authority in implementing legislation.

REPRESENTATIVE FATE agreed that the FERC discussion was ambiguous regarding authority.

Number 2039

CHAIR OGAN recalled discussion that there was confusion over which federal law [FERC] needed to follow.

REPRESENTATIVE FATE said there also was an "unsettling" in that agency because of turnover in personnel. He added that the agency had been in the process of reorganizing.

Number 1996

REPRESENTATIVE DYSON remarked that if the legislature is going to pin its hopes for equitable and fair opportunities to get "all of our gas to market" on FERC's power and authority, he'd like to know whether FERC has done this kind of thing in the past and whether any court cases challenging FERC's authority have been decided one way or another. He agreed it is important to know FERC's authority.

Number 1946

CHAIR OGAN said at least one independent company has "FERC-type attorneys" on staff; he suggested that the company's bidding indicates a lack of belief that FERC can [compel access]. He restated the importance of discussing the issue further.

CHAIR OGAN asked whether anyone else wished to testify; there was no response.

Number 1869

CHAIR OGAN appointed a subcommittee consisting of Representative Fate, chair; Representative Guess; and himself. He explained that top priorities would include questions regarding FERC, access, and how the drawdown of gas will affect oil production. Noting that expertise would be required for the last issue, he asked that producers share information, if not with committee members directly, then with DNR and AOGCC. He reiterated that his own mission would be to get enough money to study the issues and make a decision on the RIK gas sale.

Number 1790

REPRESENTATIVE GUESS asked what connection exists between the RIK [gas sale] and the effect on oil production from the drawdown of gas.

CHAIR OGAN answered that for him, the effect from drawing down gas will directly affect the decision on the pipeline's capacity. It might not affect it, he acknowledged; there might be more than enough gas, with Point Thomson, for example, or mitigation measures may be put in place using carbon dioxide, water flooding, or other techniques.

CHAIR OGAN pointed out that production drops when there is warm weather at Prudhoe Bay because the turbines don't work as well to reinject the gas, to make the oil come out of the ground; he suggested that certainly a significant drawdown of gas also would affect production. He referred to testimony that this is one of three areas being investigated regarding pipeline capacity. He concluded that it is related to the RIK gas sale.

CHAIR OGAN thanked Mr. Hurley for his participation.

ADJOURNMENT

Number 1682

There being no further business before the committee, the House Special Committee on Oil and Gas meeting was adjourned at 11:27 a.m.