

ALASKA STATE LEGISLATURE
SENATE RESOURCES COMMITTEE

March 14, 2001
3:58 pm

MEMBERS PRESENT

Senator John Torgerson, Chair
Senator Drue Pearce, Vice Chair
Senator Rick Halford
Senator Pete Kelly
Senator Kim Elton

MEMBERS ABSENT

Senator Robin Taylor
Senator Georgianna Lincoln

COMMITTEE CALENDAR

Presentation on Alcan Highway Gas Pipeline route by Mr. Ken Thompson, President, Pacific Rim Leadership Development

ACTION NARRATIVE

TAPE 01-20, SIDE A
Number 001

CHAIRMAN JOHN TORGERSON called the Senate Resources Committee meeting to order at 3:58 pm. and announced a presentation on the Alcan Highway Gas Pipeline route.

MR. KEN THOMPSON, President, Pacific Rim Leadership Development, explained that Pacific Rim is a consulting firm he started when he moved back to Anchorage to provide Alaskan businesses, nonprofits, and churches with leadership advice on setting direction and strategy for the future and how to build good executive teams. He is working with 10 companies in Alaska. He does not do consulting with any of the major producers.

"I do have a passion for commercializing North Slope gas," Mr. Thompson said. He believes that gas prices will level at some point above \$3 and that would make it commercial to the Lower 48. In his last two years at ARCO he was executive vice president of their Asia Pacific region in charge of their companies in Alaska, China, Malaysia, Thailand and Indonesia. He was also head of global gas

marketing for ARCO. He was also appointed by, then, Secretary of Energy Richardson as one of two Americans to assist Asian nations in forging and formulating natural gas policies and power generation policies, as well as in South America. He wanted, as a citizen, to step forward and assist Alaska offering his consulting, experience and advice to the House and Senate. He would waive his fee over the next few years, because he thought it was, "important to get off on the right foot as Alaskans."

MR. THOMPSON introduced his concept of a "Gas Business Vision" for Alaska. He thought the state should have a broader vision than just the individual projects and do things right in the first few years to make sure they create broader opportunities and multiple markets in the future.

It's important to realize the producers are completing their studies to create a vision from their perspective. I think the state should also proactively complete its separate studies and create a vision that's best long-term for Alaskans. I advise the state would make mistakes while waiting for the producers to finish. While we may have a lot of details we do have to wait to do, based on what their final conclusion is, there are many things the state could do proactively regardless of their recommendations.

He said it's important to realize that the state and producers will differ in their perspectives. The producers must look at what's best from a discounted present value or rates of return. They ought to focus on that or their boards should run them off. On the other hand, the state needs to focus on 50 years of socio-economic benefit to the state. He thought with planning the state and industry could come together in the next few years with a win-win.

MR. THOMPSON recommended:

- Gas pipeline traversing Alaska - LNG might not be viable now, but it could be in the future. If you accept the gas business route, the northern route is a non-starter. That would not be best for Alaskans. He said we want multiple markets for our gas. The northern route would hold Alaskans hostage to one market. Access or the potential for access in the future to multiple markets, when you go to negotiate terms and price, you get better deals if that buyer thinks you can go elsewhere. If the state takes the northern route, the buyers will be in the Lower 48 only.
- "Natural gas hub" near Fairbanks or Delta Junction. The gas hub is physical, but more importantly, there is a contractual principle element of gas trading that is not currently existing in Alaska that needs to be finalized in the next few

years.

- o On the physical facilities, "Imagine a hub, a system of manifolds and valves near Fairbanks or Delta Junction and from that pipelines could converge." He could envision a small natural gas liquids plant near Fairbanks that could manufacture propane and butane off gas and ship those products to interior villages very much like what is done with diesel today. The propane butane would be much cleaner fuel for those villages. He also envisioned from that hub another trunk line into Anchorage that could be power generation for Anchorage and residential home use. This will be even more critical in 10 years if the industry is not successful in its exploration effort for more natural gas in Cook Inlet. He envisioned a fertilizer plant that could ship urea to China, which is closer to Alaska than Indonesia, which does that now. He envisioned a gas-to-liquids plant in Anchorage or Fairbanks sending clean diesel to the west coast. He noted that cleaner technology for gas-to-liquids fuels is progressing.
- o He strongly suggested before gas flows, the state should get the contractual system down, which is clear rules and regulation for the rights of gas access and netback pricing. Those rules are not clear in Alaska, yet. He thought Alaskans should be able to buy gas at a hub for \$1 if that's what it's selling for in Chicago, adjusted a little bit for volumes. Right now there are no regulations and rules in place to govern that. A supplier right now would be in a position to offer diesel to a community for only a few cents less than it would take to ship it up, but that would still be a lot more than a hub price. He reiterated that Alaskans should have access to gas at the netback pricing.
- o Another thing that's not clear is the rights of other people and other pipelines to tap into whether it be a hub or a spur line. He used an example in 1994 when ARCO discovered a satellite field near Prudhoe Bay. They wanted access into the Prudhoe Bay processing facilities, because the field was too small to construct its own facilities. It took them five years to gain access to those facilities, because some of the owners differed. Only during the merger were clear rules set for facility access on the North Slope.
- The state should retain its 12.5 percent royalty share of gas "in kind". Leases allow for the state to allow the producers to sell the gas and send the state a royalty check, but he favored keeping the gas and marketing it ourselves. Initially, that market would be the Lower 48, but the state can hire and contract with companies such as Enron Trading or Williams Energy Trading. "We need to iron out gas price valuation

methodology up front and when we market our gas, we will know what true market value is in the market. He explained:

If a producer is selling gas in Chicago at a certain price and the state is able to have our gas marketing company get a higher price, the producers must pay, under the leases at Prudhoe Bay, that higher market valuation. The leases stipulate "actual proceeds or market valuation" whichever is higher. In the past on oil, Alaska has never had a clear way to determine that market valuation. On gas, because of its liquidity and the large amount of gas trading, we do have a way on gas, but we need to clarify that up front and we can help do that by selling our share of gas. Also, when the state retains its share of gas, I think that will better facilitate instate gas use. For example, the state currently uses about 115 million cubic feet of gas per day (MCFD). The state's share at 12.5 percent at 2 BCFD would be roughly 250 MCFD and if the gas pipeline ramps up to 4 BCFD, it would be double that. The state's share would be much larger than current use and we can expand gas industry in our state.

- The State of Alaskan companies invest at least 12.5 percent share in the gas pipeline from the Slope to the hub and hub facilities. He feels the role of government is to provide a positive business climate and wouldn't normally recommend a state or government investing in a business venture such as this. But in this case, the state has had 20 years of discrepancies and lawsuits with TAPS owners over cost and tariffs. "I think Alaska on the gas pipeline needs a seat at the table." He recommended investment just from the hub to the North Slope and he has heard some estimates of \$2 - \$3 billion gross making the state's share about \$250 - \$400 million. He thought that was doable, if the state wanted to use that alternative. If the government decided not to invest, at least it could stipulate that Alaskan companies and corporations with boards in Alaska be able to purchase and invest in that 12.5 percent that would move the state's share of gas. "That way we have people at the table that are Alaskans and the decisions in boardrooms would be here and not just boardrooms in Bartlesville, Houston, or London.
- The final recommendation is that the state formulates policies and regulations for clear and transparent valuation and pricing to resolve up front and prevent lawsuits that have happened on oil.

Page four of his presentation illustrates what could happen in Alaska with the trading hub concept, particularly with principles

for trading. In the future, investors could choose to have spur lines instead of the physical hub, but we need to have the trading principles and regulations for trading to make sure there's clear access rules and clear valuation rules. It illustrates that there could be multiple markets over the next 50-years.

Number 1200

MR. THOMPSON said that the state does not need to do all of the suggestions on page five in one year, but they all happen daily in gas basins around the world. They are:

- 2001: Make a resolution supporting principles of a natural gas business in Alaska in conjunction with a Lower 48 gas line - in regards to access and trading to give Alaskans a broad view of where the state would like to go.
- 2002 - 03:
 - Regulations for clear, transparent netback pricing
 - Rules for clear, transparent access for in-state use
 - Rules for clear, transparent access for overseas markets
 - State finalize decision of investment in line, gas "in kind"
- 2004 - 06: State attract investors for hub and/or spur lines, in-state distribution, city infrastructure, value added processing

He concluded:

- Lower 48 market appears best currently, but cyclical
- Northern route holds Alaska gas hostage to one cyclical market long-term
- Southern route along TAPS route and Alaska highway provides access to future multiple markets
 - Alaska internal markets
 - Asia, West Coast U.S. - Recently, Phillips announced they would team up the El Paso Natural Gas to provide LNG to Mexico or California. Peru is also looking at LNG to Mexico and California. He said with a hub, a company like Yukon Pacific doesn't have to look at the economics of building the lines all the way from the Slope. They could perhaps build a smaller line from the hub down to Valdez, start off with the smaller less expensive project, fit in to some of the smaller markets that might be more commercial for them.
- State and Producers will see different calculations for northern vs. southern routes
 - Producers must focus on discounted present value, rates-of-return
 - State must focus on 50 years of socio-economic benefit to the state
- Find win-win solution for route traversing Alaska

MR. THOMPSON reiterated the need for establishing a trading hub in Alaska. He said that some of the same companies that are in Alaska work with the European Union (EU) to formulate the European Union Gas Directive that has clear rules and regulations for trading in transport of gas and power generation. Some of the same companies have trading hubs in the U.K. and he couldn't see why Alaska couldn't have that. "I think it's important."

MR. THOMPSON said that exhibit 10 reiterates some of the points made on the state retaining 12.5 percent share. Exhibit 11 highlights key points to consider on the state investing. He pointed out:

If the state did not see fit to invest, selecting Alaskan companies through a bidding process - quality native corporations, quality Alaskan corporations, for at least 12.5 percent could be very helpful to move the state's share of gas. It also means there are more profits kept in state. A plus of the state owning the pipeline, you get advance fees and tariffs that are fairly constant and not cyclical like the gas prices are.

MR. THOMPSON said exhibit 12 reiterates that the discussion of valuation and pricing policies has to take place with producers. He truly thought that would be a win-win situation for both the state and producers. The lawsuits generated angry feelings and a lot of dollars paid. This would resolve that upfront.

Exhibit 13 illustrates that before final rules and regulations were passed in the EU governing the natural gas business, they established a set of principles that are very easy to understand and straight forward. Those EU principles are:

- Gas transmission, distribution interconnected, no barriers
- State regulates gas business: nondiscriminatory, clear
- Fair and open access to the natural gas system
- Access to pipelines allowed under set of transparent rules. He noted that the are forms that protect buyers and sellers and the EU has that for trading of natural gas.
- Participants in the market will not abuse their dominant position nor engage in predatory behavior
- Participants have open, nondiscriminatory storage access
- Gas suppliers will compete freely for "eligible customers"

MR. THOMPSON summarized that the state doesn't have to do all the things at once, but he recommended some steps over the next few years:

- 2001: Resolution supporting principles of natural gas business in Alaska in conjunction with Lower 48 gas line

- 2002-03:
 - Regulations for clear, transparent netback pricing
 - Rules for clear, transparent access for in-state use
 - Rules for clear, transparent access for overseas markets
 - State finalize decision of investment in line, gas "in kind"
- 2004 - 06+: State attract investors for hub and/or spur lines, in-state distribution, city infrastructure, value added processing
- 2007: "GAS TO CASH" for Alaska, Alaskan companies, Alaskans!!

Number 1600

SENATOR ELTON commented that the producers' timeline is the end of this year for trying to decide on a project. "With these issues hanging out front, they could make an argument that it's difficult for them to make a decision when we don't know what the rules will be two years hence."

MR. THOMPSON responded that getting final regulations could require complex negotiations. He suggested having the principles of fair netback pricing in the resolution and principles for 2001. Knowing netback pricing at a hub or wellhead will be based on actual proceeds minus auditable transportation costs and would give producers a good feel for their economics as to what to use in their calculations. There are a lot more details behind that that could be in the regulations made in 2002 and 03.

SENATOR ELTON asked if the state has an equity investment in the line from the Slope to the hub, would we be less subject to less cyclical changes in gas prices because we would always be collecting a certain amount of revenue from the transportation of gas. He also asked why had Mr. Thompson strongly suggest "at least 12.5 percent" for a state stake.

MR. THOMPSON responded that 12.5 percent would give the state ownership that is capable of moving all of their share of gas. That could be important in the future. "If the market swings down in the Lower 48, the producers may (and this could be a valid case, if the prices cycle low) reduce their flow." But if Alaska has established with this royalty share of gas contracts in Alaska to move its full share, having that capacity to move the gas without having to purchase capacity from others would be wise. The state could incrementally move the volumes it sees fit and sometimes our perspective may differ from the producers.

He explained that they way TAPS ownership was originally split, each company could move about its equivalent. They wanted a straw big enough to move their share of oil and not have to pay others. He would use the same reasoning for the state.

SENATOR ELTON asked if our position at the table diminished if we only own a percent of a segment and how do the regulatory authorities handle that?

MR. THOMPSON answered, "I think the regulations should be on the whole system and it be in a department that's separate from one that may manage the ownership of the line, as well as managing the royalty shares."

SENATOR ELTON asked if we only own a percent of a section, would we still be treated as an owner in the system for the purposes of rate setting and the other regulatory functions.

MR. THOMPSON replied that was correct. It's hard to say where the producers' studies will lead, but they may size the line for what they see is the market in the Lower 48 and not be as interested in the Alaskan or Asian markets. If Alaskan's wanted to have capacity on the 50 year horizon, Alaskan companies and others have to recommend sizing that pipeline in a larger size from the Slope to the hub to allow for those future possibilities. If producers don't want to do that, they could fall back on other investors, maybe foreign investors who were interested in LNG. It is important for Alaska to own a part of that segment to size the future pipe.

CHAIRMAN TORGERSON said under that scenario, the state would be paying for the excess capacity.

MR. THOMPSON replied that was correct, but we might find pipeline companies that could also invest in that. It could be that the reason we're using that extra size, is for LNG in the future. "Yukon Pacific or even Japanese buyers might be interested in that incremental capacity."

CHAIRMAN TORGERSON asked if he foresaw problems with the realignment with smaller operators in getting access to the Prudhoe Bay facilities, the way the law is currently written.

MR. THOMPSON said the merger agreement on the existing production facilities had that as a key element that resolved much of the access issues.

While there is still some negotiation on value, there is a clear formula as to what rate of return producers are allowed. If you pay that fee that gets them that rate of return and there is capacity, then a small producer is allowed into the facility. It's very important. Take the reverse of that. What are the rules to allow a small entrepreneur in Fairbanks to build a spur line and create their small business near Fairbanks? The rules are not

clear. A producer could say no, I've got better markets south. Whereas, if there are rules that they did a competitive price and can be shown they have the financial capability and the capacity is there, they ought to have right to access the gas and do their project.

CHAIRMAN TORGERSON asked if hubs were the creature of legislation or negotiation between companies.

MR. THOMPSON explained that some elements are negotiations. Yet there are clear operating rules around in the UK, the EU and in the Lower 48. The mechanisms for trading in hubs in the UK is called the Natural Gas Trading Arrangement, a very clear set of principles. In the EU it's principles he enumerated on page 13, a European Natural Gas Directive. In the Lower 48 hubs, the rules and legal arrangements are known.

SENATOR PEARCE asked if the rules at Henry Hub, for instance, are state or federal.

MR. THOMPSON answered that at the Henry Hub they are federal (FERC) on some of the pipelines because of their crossing interstate lines, but most of the rules and regulations are state. It's clear rules when you know how to balance. So, if one producer can't make a contract and someone else is making up that volume, the gas is balanced later. This would be an issue at Prudhoe Bay for the state, if others cut back on production, because we still have our instate market. There are formulas for that; trading hubs do all those transactions for companies in the Lower 48.

SENATOR PEARCE asked once those rules are in effect, who regulates them.

MR. THOMPSON answered that to his knowledge in Texas, it's the Texas Railroad Commission. Some aspects of the netback valuation are regulated by the Texas Royalty Board. He was contacting them to see if there were lessons that would be valuable to Alaska.

SENATOR ELTON asked what he meant by clear access to gas. Was he talking about just the 12.5 percent royalty gas or any of the gas.

MR. THOMPSON replied that it could be any of the gas. If a producer for some reason makes a bid, it could be for the state gas or the producer gas, as well. He thought it would be more clear cut if the state could make decisions on gas in Alaska. "The state's not going to pay federal taxes on its proceeds. They may have an advantage for more sales in state that could be helpful."

CHAIRMAN TORGERSON said he didn't see how a hub would help unless the state built in additional capacity of line.

MR. THOMPSON responded that even if there's not any additional capacity and the line is sized for just 4 BCFD, the state's share is 500 MCFD. That could generate additional new businesses in Alaska making a hub. "Regardless of the physical hub being built, this issue of the contractual and the principles for trading are going to be important to be clarified before gas starts."

CHAIRMAN TORGERSON asked what he was using for a reserve number up North.

MR. THOMPSON answered that he had heard estimates that proven reserves were in the 35 TCF range. He knows that's there, but he has heard talk of 100 TCF. Some of the gas areas on the Slope are yet to be explored. "Just 35 TCF could be a 50-year kind of business."

SENATOR PEARCE asked how the state would manage to pay for 12.5 percent or part of a pipeline. Why would somebody want you to do that, just from the Slope to the hub.

MR. THOMPSON answered that that happens in the Lower 48. Different companies will have different ownership from a field line to a junction point. If the line splits, they can do different interests. It can be structured any way. He reiterated that the segment of at least 12.5 percent from the Prudhoe to the hub was important for the state to own for instate business. At this early stage, the state could work with producers to structure it if the state wants to invest.

SENATOR PEARCE asked historically how the hubs came to be.

MR. THOMPSON explained that most of his experience is in the Lower 48, but he has had nine years in Alaska.

Back in the 70s almost all gas was traded by medium to long-term contracts and we didn't have the natural gas trading that's happening now. There were just pipelines that were owned by pipeline companies and sometimes producers owned interest and sometimes they didn't. The pipeline companies would take gas from a field to the market in cities and power plants, etc. As businesses grew, more fields were discovered and more natural gas was used and more pipelines were built. Hubs came about because major lines found themselves crisscrossing and at one point, it was realized there would be a lot more flexibility if these lines could be interconnected in a way that people could supply into that hub. They could have access to not just the three markets off their one line, but maybe to nine or 10 if the lines were

interconnected. That was the physical reason for hubs. That is a factor here, but the other purpose of hubs was the contractual arrangements and setting rules of the trading price. Then you know the netback prices for taxation and royalties, as well. Also, at the hub you have control of gas balancing.

TAPE 01-20, SIDE B

CHAIRMAN TORGERSON thanked Mr. Thompson for his presentation and adjourned the meeting at 4:45 pm.